# Chapter 2
# COMMERCIAL BANKS

**OUTLINE**

- Role of Commercial Banks
- Structure of Indian Commercial Banks
- Functions
- Sources of Funds
- Investment Norms
- Motives of Investment Policy
- Assets Structure of Commercial Banks
- Profitability of Commercial Banks
  - Determinants of profitability
  - Profitability performance of commercial banks
  - Concepts used to measure the profitability

**Question Bank**
**Skill Development**

**LEARNING OBJECTIVES**

After reading the chapter you should be able to answer:

1. Role of commercial banks.
2. Structure of commercial banks in India.
3. Functions of commercial banks.
4. What are the sources of funds of commercial banks?
5. What are the investment norms in commercial banks?
6. Assets structure of commercial banks.
7. Motives of investment policy.
8. Factors determining liquidity.
9. Determinants of profitability.

situation is analysed the following two conclusions are clearly drawn.[2]

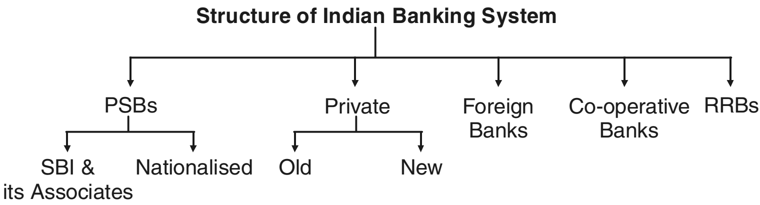
a) The Indian financial sector has considerably widened and deepened, thereby lending strong support to capital accumulation and overall economic growth.
b) The commercial banks in India constitute the single-most important component of the Indian financial system in bringing about the bulk of financial intermediation process in the country.

A significant part of this impressive record of financial development in India is attributable to the crucial role played by banks in the financial intermediation process. In India the financial sector comprises the banking system (i.e. commercial and co-operative banks), financial institutions (which include term lending institutions, i.e. IDBI, NABARD, ICICI, IRBI, IFCI, EXIM Bank and NHB at the all-India level and SFCs and SIDCs at the state level, besides investment institutions, i.e. UTI, LIC and GIC and other institutions including DICGC and ECGC), non-banking financial intermediaries and the capital market.

## STRUCTURE OF INDIAN COMMERCIAL BANKS

Having established the pivotal role performed by the banking system in the Indian financial sector and by implication, in the overall financial intermediation process, thus supporting the real sector of the economy. The strong points of the financial system are its ability to mobilize savings, its vast geographical and functional reach and institutional diversity. Between 1965 and 1990, the household sector's gross savings in the form of financial assets rose from 5.5 per cent to 12.2 per cent of net domestic product. Since 1969 when major banks were nationalized, the number of commercial bank branches increased from about 8,300 to well over 65,000 by 2005.

[2] Narendra Jadhav (ed.), "Indian Banking: In Retrospect and Prospects" Challenges to Indian Banking—Competition, Globalisation and Financial Markets, Union Bank of India, 1996, p. 374.




The commercial banking structure in India consists of: Scheduled Commercial Banks and Unscheduled Banks. Scheduled commercial banks constitute those banks, which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. RBI includes only those banks in this schedule, which satisfy the criteria laid down vide section 42 (6) (a) of the Act. Indian banks can be broadly classified into nationalized banks/ public sector banks, private banks and foreign banks. The Indian banks include 27 public sector banks excluding 196 Regional Rural Banks (RRBs).

## FUNCTIONS OF COMMERCIAL BANKS

Prof. Syers, defined banks as "institutions whose debt—usually referred to as 'bank deposits'—are commonly accepted in final settlement of other people's debts". According to Banking Regulation Act of 1949, "Banking means the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise". From the above definitions we can analyze that the primary functions of banks are accepting of deposits, lending of these deposits, allowing deposits to withdraw through cheque whenever they demand. The business of commercial banks is primarily to keep deposits and make loan and advances for short period up to one or two years made to industry and trade either by the system of overdrafts of an agreed amount or by discounting bills of exchange to make profit to the shareholders. From the above discussion, we can say that the following are the functions of commercial banks.

1. ***Receiving deposits from the public***. The primary function of commercial banks is receiving of deposits in the form of savings bank account, current account and term deposits from the savers usually from the public. People usually prefer to deposit their savings with the commercial banks because of safety, security and liquidity. The aggregate deposits of scheduled commercial banks in India rose rapidly from Rs. 822 crores in 1951 to Rs. 3,763 crores in 1967. The total deposits of commercial banks was Rs. 4,661 crores in 1969 that increased to Rs. 34,237 crores by 735 per cent by 1979. The total deposits of commercial banks increased in the decade of 1981 to 1991 from Rs. 40,413 crores to Rs. 2,00,569 crores by 5 times. Out of which the proportion of current, saving and fixed deposits were Rs. 6,286, Rs.11,805 and Rs. 22,322 crores which is almost 1: 2: 3 ratio increased to Rs. 30,335, Rs. 56,152 and Rs. 114082 crores i.e., almost 5 times during one decade with almost same proportion. The total deposits with commercial banks by the end of 2005 increased to Rs. 21,00,000 crores.
2. ***Giving loans and advances***. The second major function of the commercial banks is giving loans and advances to the all types of persons, particularly to businessmen and investors, against personal security, gold and sliver and other movable and immovable assets. The bank advances loans in the form of cash credit, call loans, overdraft and discounting bills of exchange to businessmen. After reforms in banking sector and establishment of new private sector banks and foreign banks, the other commercial banks also started giving loans and advances not only to their traditional businesses but also for vehicles, housing, consumer durables, etc. by increasing the base of lending activities.
3. ***Use of cheque system and credit cards***. The commercial banks will allow the depositors of the bank to withdraw and make payment of their amount in their bank account through cheques. Now the banks are allowed to use debit and credit cards for making their payments.

4. ***Credit creation***. Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.
5. ***Financing foreign trade***. The commercial banks finance foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.
6. ***Transfer of funds***. Commercial banks will help the customers to transfer their money from one account to another account, from one place to another place through cheques. Now the transfer of funds from one place to another place, or from one party account to another party account or one bank to another bank is done through Electronic Fund Transfer (EFT). This facility helps in transfering funds from one bank to another bank or to another party account easy. The technology like MICR helps the banks to have innovative banking like anywhere banking, anytime banking, and virtual banking and so on.
7. ***Agency functions***. The commercial banks act as agents for customers to buy and sell shares, securities on their behalf. It pays subscriptions to insurance premiums, mutual funds, rent, water taxes, electricity bills etc on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers.
8. ***Miscellaneous functions***. The miscellaneous functions performed by the commercial banks are: it provides safety locker facility, making and receiving payments on behalf of its depositors, issuing letters of credit and traveller's cheques etc.

advances. A bank makes investments for the purpose of earning profits. First it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity. The Ghosh Committee recommended that "a bank's investment portfolio should be bifurcated into two parts, namely, 'permanent investment' and 'current investment'. The committee recommended that banks should make necessary provision for the depreciation in the value of current investment and there is no need to provide for permanent investment.

RBI has also advised the banks to classify the existing investment in approved securities into two categories. Initially from the accounting year 1992-93, banks should not keep more than 70% of their investment in permanent category, and 30% of the portfolio as current investments to facilitate valuing all the investments on fully 'marked to market' basis. Guidelines were laid down for transfer of approved securities from 'current' to 'permanent' and 'vice versa' in 1992. These guidelines ensure that latent losses are provided for at the time of such transfer. In 1993 the entire investment portfolio of banks other than investments classified as 'permanent' has to be classified into six categories for the purpose of valuation. The valuation will be done for each category of investments. While net depreciation has to be provided by debit to the profit and loss account, net gains have to be ignored. Permanent investments can be carried at book value. Premium will have to be amortized over the life of the investment but discount cannot be recognized as income. In between 1993 to 1998 the said minimum ratio of 30 per cent has been increased in a phased manner to 60 per cent as on March 31, 1998. It has further been decided to increase the ratio to 70 per cent for the year ending March 31, 1999. New private sector banks are required to market their entire investments in approved securities since March 31, 1997.

## MOTIVES OF INVESTMENT POLICY

The commercial banks have to follow the guidelines issued by RBI for investments. The following are the motives of investment policy of RBI.

1. ***Safety and security***. Safety and security of the funds which are deposited by the customers of the bank is very important in banks. The money which is deposited by the customers in banks should be safe and they should get back whenever they require. The banks should see that the money which is deposited in commercial banks should not be misused by the banks through its unscrupulous management or mismanagement and lead to loss and consequently lead to bankruptcy. Hence the RBI will guide the commercial banks through its monetary policies and issues guidelines to follow in their investment policies. To safeguard the interests of the depositors in commercial banks the deposits are insured up to Rs. 1,00,000.
2. ***Liquidity of funds in banks.*** Commercial banks have to maintain liquidity of funds deposited by the depositors of the banks. The banks should see that the money deposited is allowed by the banks to withdraw whenever the customers require during working hours of the bank. This will ensure more confidence among the customers of the bank. There are several cases where Indian commercial banks ensured liquidity to the depositors of the bank. Recently during 2001 the rumours spread among the customers of the ICICI Bank in Maharashtra that there is no cash in the bank. Hence many customers went for withdrawing of the funds deposited and the ATM counters were flooded with customers. The bank also made arrangements for cash and also assured the customers not to panic. Immediately the RBI assured that there is no liquidity problem in the bank. Hence liquidity in banks is a

very important motive of the investment policy. Therefore banks are directed to keep some percentage of the funds in the form of Cash Reserve Ratio in RBI and also insist to invest in Statutory Liquid Ratio to convert into easy liquidity.

3. ***Profitability of the bank.*** The soundness of any bank is measured by its profitability. The customers will come forward to deposit their funds with banks on the basis of the profitability of the banks. Hence the banks have to earn profits.

## Factors Determining Liquidity of Banks

The liquidity of a bank is determined by the top management of the bank on the basis of the nature of business conditions in a country. This is also guided by the central bank of that country to ensure liquidity in an economy. The extent of liquidity is ensured on the basis of the following factors.

1. ***The size of liquid reserves***. The size of the liquid reserves will depend upon the extent of liquid reserves considered essential by the banking community. If the liquid reserves in a bank will increase the liquidity position of the banks but the amount available for lending will decrease. During the year 1991 to 1995 the CRR of the commercial banks with the RBI was 15 to 14.5 percent on Net Demand and Time Liabilities (NDTL), hence the amount available with the banks for lending was less hence it hampered the growth of our economy. By realizing this problem RBI after accepting reform process in the economy reduced this ratio. Since then the amount available for lending with the banks has increased, consecutively the Credit Deposit (CD) ratio also increased. It was around 56 percent during 2004 it went up to 71 per cent during the month of February 2006 by showing good symptom of growth in the credit activities in an economy.
2. ***Banking habits of the people.*** Liquidity of a bank depends upon the banking habits of people. If the country is

6. ***Well organized money market.*** Well organized and developed money market is another factor which will have its influence on the liquidity position of the banks. If the money market is well organized, the commercial banks will borrow and lend their cash in the money market which reduces the idle money with the banking sector and also supports the liquidity position in the banking sector and also in an economy.

## ASSET STRUCTURE OF COMMERCIAL BANKS

Assets structure will reflect the deployment of sources of funds of commercial banks. The main source of funds of commercial banks is deposits. The other sources of funds are borrowings from other banks, capital, reserves and surplus. The deposits of commercial banks are from savings deposits, current account deposits and term deposits. These deposits constitute 80 per cent of the total sources of funds. Out of the total deposits, term deposits constitute 50 per cent. Borrowings are around 5 per cent of the total liabilities of the commercial banks. These sources are deployed by the commercial banks mainly on its financial assets i.e, loans and advances which constitute 48.6 per cent of the total assets of the banks. The investments is another important component of the assets of commercial banks which is around 40 per cent of the total assets of the banks during the year 2005. This is because of pre-emptions like SLR and CRR requirements in the banking sector. The investments in commercial banks have increased also because of surplus liquidity in Indian banks during this period due to reduction of SLR and CRR to 25 and 4.5 respectively during that period and less demand for loans and advances from credit-worthy customers. This scenario is changing in India due to increasing demand in credit from industrial, agriculture sector and also the growth of FMCG market.

The assets structure of the banks is governed by certain principles, like liquidity, profitability, shiftability and risklessness. The other factors which influence the assets structure of commercial banks are nature of money market, economic growth of the country, policies and vision of the governments. In the countries like India, China, Russia, North Korea and Brazil there is a boom in the growth of the economy hence naturally there will be heavy demand for the credit.

Now let us examine each of the important assets of the commercial bank.

1. **Cash in hand and balances with RBI**. From the point of the liquidity in the commercial banks cash in hand is a very important asset but it is idle and it will not fetch any earnings to the banks. Cash in commercial banks depends upon various factors like uncertainty in the economy due to wars, famine, internal disturbance, the growth of banking system, network of branches, networking of banks, automation in banks and so on. The cash reserve requirements in the commercial banks was more during pre-reform period it was 15 per cent during the year 1994-95. Gradually RBI reduced it to 4 per cent based on the requirements of credit and it is now 5 per cent on Net Demand and Time Liabilities.
2. **Money at Call and Short Notice.** It is second line of defense of the commercial banks in cases of emergencies. If the call money market is well developed the commercial banks can lend their surplus funds in the call market for a day or up to 14 days it is called call market or over night market without keeping their surplus money idle. It can also lend for short period, where the borrower has to return the money borrowed from the banks when short notice is given by the banks. This is becoming a good business in the money market and constitutes around 4 per cent of the total assets of the commercial banks. The banks instead of keeping the money idle lend their surplus funds for short periods in the call market.
3. **Investments.** Investments constitute one of the important assets of the bank next to loans and advances. A bank makes investments for the purpose of earning profits. First,

it keeps primary and secondary reserves to meet its liquidity requirements. Banks invest in securities either for fulfilment of SLR/CRR requirements or for earning profit on the idle funds. Banks invest in "approved securities" (predominantly Government securities) and "others" (shares, debentures and bonds). The values/rates of these securities are subject to change depending on the market conditions. Some securities are transacted frequently and some are held till maturity. Total investments during the year 2005 by the commercial banks in India were Rs. 8,43,081 crores which is 37 per cent of the total assets. During the month of February and March 2006 the investments in Indian commercial banks have reduced because of heavy demand for credit. Some banks even sold their surplus investments in government securities which was more than SLR requirements and converted them into cash for lending.

4. **Loans and Advances.** The commercial banking industry in India has been playing a very important role in intermediating between the economic units, which have surpluses and deficits in their current budgets. By mobilizing financial surpluses in the economy and by channeling these resources into various sectors and segments of the economy, they are guiding the pattern of utilisation of a large proportion of the economy. The Government of India which owns a large segment of the industry, and the RBI, which is the central banking authority of the country, have been persuading the commercial banks to deploy larger and larger volumes of financial resources into certain identified priority sectors, for the purpose of accelerating the growth of these sectors. The total advances of commercial banks include bills purchased and discounted, cash credits, overdrafts, loans, unsecured loans, and priority sector advances. The component of loans and advances in the total assets of commercial banks is 48 to 50 per cent—in fact still growing in India. The management of this asset is a very important aspect in the banking sector. The non-performing assets in

banks is increasing. In addition to this banks are exposed to various risks such as credit risk, liquidity risk, market risk and operational risk.

5. **Fixed Assets and other assets.** The component of fixed assets and other assets do not form an important aspect in the funds of commercial banks since deals are more in financial assets than real assets.

## PROFITABILITY OF COMMERCIAL BANKS

Profitability is a key parameter in assessing the performance of any business firm. Even in the banking sector after the banking sector reforms the priorities in banking operations underwent far reaching changes. There had been a shift in the emphasis from development or social banking to commercially viable banking. Profitability became the prime mover of the financial strength and performance of banks; hence the performance of the bank is measured on the basis of its profitability. Now the main agenda is to enhance the profitability and reduce the hurdles which are faced by the banks in their profit maximization and to develop strategies to achieve this objective. In this changed scenario, profitability and productivity are the twin indicators of the competitive edge of the banking industry.

The main reason for the fundamental paradigm shift in the banking from social banking to "profit banking" was the introduction of capital adequacy requirements. There are four ways to achieve and sustain the required capital adequacy: fresh equity issue, ploughing back of profit, debt offering and revaluation of assets. Raising capital through equity route is very difficult because servicing the equity base, offering reasonable returns, raising fresh capital when the capital market is not favourable and when the performance of banks is not good. Similarly debt raising also will have the limitations too, as tier II capital cannot exceed tier I capital and subordinated debt cannot exceed 50% of the tier II capital. The scope of revaluation of assets for improving capital adequacy is limited and hence banks are left fee-based activities like letters of credit, guarantees, and acceptance commission is also responsible for growth in profitability of the banks now-a-days because of thin interest margin.

4. **Provisioning for loan losses, loan quality improvements or non-Performing Assets**. Provisioning for loan losses and non-performing assets reduce the profitability of the banking system. NPAs, reduces the net profits of banks on account of loss in income and the provisioning for NPAs will reduce the profit of the banks.
5. **Interest rate movements**. Interest rate movements affect the net interest margins of the banks. A net interest margin refers to difference between interest on deposits and interest on advances. When interest rates increase, the impact is immediate on the advances, which reduces the demand for advances and reduces the profits of the banks. The change in interest rates are exposed to interest rate risks and asset-liability mismatches, which calls for Asset Liability Management (ALM).
6. **Rigidity of the operating cost structure**. About 60 to 70 per cent of the operating costs of Indian commercial banks is on account of employee costs. The other significant cost components are real estate and technology costs. These costs are non-controllable to a significant extent and are rising constantly hence, reducing the profitability of banks.

***Unit Specific factors***

1. **Banking structure**. Structure of the banking system will have its impact on the profitability of banks. The diversified banking structure with operations spread across regions having different economic/business profiles, like Indian public sector banks will have higher operating costs in view of a larger network, lower margins due to greater competition.
2. **Size of Bank**. Indian situation suggests that when banks are considered groups in terms of big, medium and small, the bigger banks have greater scope for economies of scale.

The per centages of total expenses to working funds are lower for bigger size banks than for small size banks. Whereas in other countries like European Investment Banks, a study of American and Japanese banks have observed that there is no convincing correlation between the size of banks and earning power.

3. **Branch network or Franchise strength**. A large network of branches located at potential centres provides access to low cost deposits as well as increased scope for earning more fee-based income in the form of commission on remittance services and bills for collection.

## Profitability Performance of Commercial Banks

Profitability is one major criterion for evaluating the performance of banks. If profitability has to be planned and improved, detailed, systematic and objective analysis is necessary. It calls for studying the factors determining profitability, how they behave, how they are related to each other and how valid inter-bank comparisons are.

To evaluate the profitability performance of the banks largely ratios are used as a tool for comparison. There is no unanimity in the selection of ratios. The ratios usually used are:

1. Net Profit / Net Worth
2. Spread / Working Funds
3. Burden / Working Funds
4. Interest Income / Total Earning Assets
5. Non-Interest Income / Total Earning Assets
6. Interest Expenses / Total Earning Assets
7. Non-Interest Expenditure (Operating Expenditure) / Total Earning Assets
8. Net Profit / Working funds
9. Net Non-Performing Assets / Net advances
10. Capital Adequacy Ratio
11. Savings Deposit / Total Deposits
12. Current Deposits / Total Deposits
13. Term Deposits / Total Deposits

shifted their attention to increasing non-interest income from fees. This fee based total revenue helps to raise net income flowing to bank stockholders.

5. **Interest expense** constitutes interest paid on deposits, RBI/inter-bank borrowings and others.
6. **Non-interest expenses** are also called operating expenses or overhead, which constitutes expenses incurred for establishment, rent, taxes and lighting, printing and stationery, advertisement, depreciation etc.

In order to evaluate the performance of the commercial banks the Reserve Bank of India uses CAMEL method. The prime task of regulatory agencies is to frame regulations and examine their adherence by banks through the examination process. This will help the RBI to evaluate how far a particular commercial bank has compliance with the guidelines. This is a major strategy in enhancing the control mechanism, supervision by the regulatory authorities. Central banks address to the issue by on-sight and off-sight inspections/examinations.

CAMEL refers to:

C = Capital Adequacy Ratio
A = Assets Ratios
M = Management Ratios
E = Earning Ratios.
L = Liquidity Ratios

## EXERCISE

### Two marks questions

1. Show the structure of commercial banks in India.
2. What do we mean by commercial banks?
3. What do we mean by intermediation role of banks?
4. What is payments role of banks?
5. Mention the agency role of banks.
6. Mention the sources of funds of commercial banks.
7. Mention the types of deposits of banks.