## COMMERCIAL BANKS AND ITS FUNCTIONS

### **DEFINITION OF A BANK**

• The Banking Companies Act of India defines a bank as "A Bank is a financial institution which accepts money from the public for the purpose of lending or investment repayable on demand or otherwise withdrawable by cheques, drafts or order or otherwise."

## COMMERCIAL BANKS



According to CULBERSTON

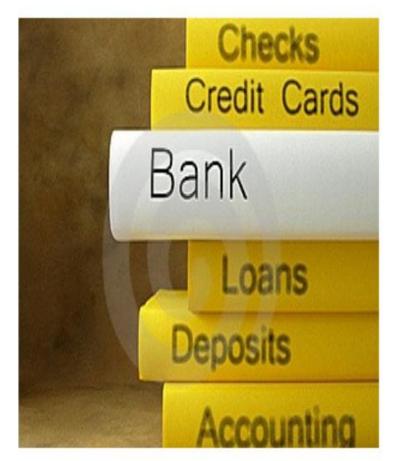
"Commercial banks are the institutions that make short term loans to business and in the process create money."

### FUNCTIONS OF COMMERCIAL BANKS

- Commercial banks have to perform a variety of functions which are common to both developed and developing countries. These are known as 'General Banking' functions of the commercial banks. The modern banks perform a variety of functions. These can be broadly divided into two categories:
- (a) Primary functions.
- (b) Secondary functions.

## **PRIMARY FUNCTIONS**

- 1. Acceptance of deposits.
- 2. Advancing loans.
- 3. Creation of credit.
- 4. Clearing of cheques.
- 5. Financing foreign trade.
- 6. Remittance of funds.



#### 1. Acceptance of deposits

It is the most important function of commercial banks.

They accept deposits in several forms according to requirements of different sections of the society.

The main kinds of deposits are:

### (i) Current Account Deposits or Demand Deposits:

# These deposits refer to those deposits which are repayable by the banks on demand:

 Such deposits are generally maintained by businessmen with the intention of making transactions with such deposits.

2. They can be drawn upon by a cheque without any restriction.

3. Banks do not pay any interest on these accounts. Rather, banks impose service charges for running these accounts.

### (ii) Fixed Deposits or Time Deposits:

Fixed deposits refer to those deposits, in which the amount is deposited with the bank for a fixed period of time.

Such deposits do not enjoy cheque-able facility.
These deposits carry a high rate of interest.

Basis	Demand Deposits	Fixed Deposits
Cheque facility	They are chequeable deposits.	They are non-chequeable deposits.
Interest payments	They do not carry any interest.	They carry interest which varies directly with the period of time.
Number of transactions	The depositor can make any number of transactions for deposit or with drawl of money.	Depositor generally makes only two transactions: (i) Deposit of Money in the beginning; (ii) Withdrawal of money on maturity.

### (iii) Saving Deposits:

These deposits combine features of both current account deposits and fixed deposits:

1. The depositors are given cheque facility to withdraw money from their account. But, some restrictions are imposed on number and amount of withdrawals, in order to discourage frequent use of saving deposits. 2. They carry a rate of interest which is less than interest rate on fixed deposits. It must be noted that Current Account deposits and saving deposits are chequable deposits, whereas, fixed deposit is a non-chequable deposit.

### 2. Advancing of Loans:

The deposits received by banks are not allowed to remain idle. So, after keeping certain cash reserves, the balance is given to needy borrowers and interest is charged from them, which is the main source of income for these banks.

## DIFFERENT TYPES OF LOANS AND ADVANCES BY COMMERCIAL BANKS

#### (i) Cash Credit:

Cash credit refers to a loan given to the borrower against his current assets like shares, stocks, bonds, etc. A credit limit is sanctioned and the amount is credited in his account. The borrower may withdraw any amount within his credit limit and interest is charged on the amount actually withdrawn

### (ii) Demand Loans:

Demand loans refer to those loans which can be recalled on demand by the bank at any time. The entire sum of demand loan is credited to the account and interest is payable on the entire sum.

### (iii) Short-term Loans:

They are given as personal loans against some collateral security. The money is credited to the account of borrower and the borrower can withdraw money from his account and interest is payable on the entire sum of loan granted.

#### 3. Creation of credit

Credit creation is most significant function of commercial banks. While sanctioning a loan to a customer, they do not provide cash to the borrower. Instead, they open a deposit account from which the borrower can withdraw. In other words, while sanctioning a loan, they automatically create deposits, known as a credit creation from commercial banks.

#### 4. Clearing of cheques.

It is the process of moving a **cheque** from the **bank** in which it was deposited to the bank on which it was drawn, and the movement of the money in the opposite direction. This process is called the **clearing cycle** and normally results in a credit to the account at the bank of deposit, and an equivalent debit to the account at the bank on which it was drawn

### 1. Agency Services:

Banks act as agents to their customers in different ways:

#### (i)Collection and Payment of Various Items: Banks collect cheques, rent, interest etc. on behalf of their customers and also make payment of taxes, insurance premia etc. on their behalf.

### (ii) Purchase and Sale of Securities:

Banks normally are more knowledgeable with regard to stock and share business. As such they buy, sell and keep in safe custody the securities on behalf of their customers.

### (iii) Trustee and Executor:

Banks also act as trustees and executors of the property of their customers on their advice.

#### (iv) Remitting of Money:

Banks also remit money from one place to the other through bank drafts.

## (v) Purchase and Sale of Foreign Exchange:

Banks buy and sell foreign exchange and thus promote international trade. This function is mainly discharged by Foreign Exchange Banks.

#### (vi) Letter of References:

Banks also give information about economic position of their customers to domestic and foreign traders and likewise provide information about economic position of domestic and foreign traders to their customers.

### 2. General Utility Services:

Commercial banks also provide certain services of general utility to the society:

#### (i)Locker Facilities:

Banks provide locker facilities to their customers. People can keep their gold or silver jewellery or other important documents in these lockers. Their annual rent is very nominal.

## (ii) Traveller's Cheque and Letters of Credit:

Banks issue traveller's cheque and letters of credit to their customers so that they may be spared from the risk of carrying cash during their journey.

#### (iii) Business Information and Statistics:

Being familiar with the economic situation of the country, the banks give advice to their customers on financial matters on the basis of business information and statistical data collected by them.