CHAPTER- SIX
FUNCTIONS OF COMMERCIAL BANKS IN INDIA

The commercial banks serve as the king pin of the financial system of the country. They render many valuable services. The important functions of commercial banks can explain as under: --

Primary functions

(a) Acceptance of deposits

I. Time deposits
   (i) Fixed deposits
   (ii) Recurring deposits
   (iii) Cash certificates

II. Demand deposits
   (i) Saving deposits
   (iii) Current account deposits

(b) Advancing on loans

i. Overdraft
ii. Cash credit
iii. Discounting of bills
iv. Loans and advances
v. Housing finance
vi. Educational loan scheme
vii. Loans against shares/ securities
viii. Loans against savings certificates
ix. Consumer loans and advances
x. Securitization of loans

(c) Investment functions
(d) Credit creation
(e) Dealing in foreign exchange

Secondary functions
(a) Agency services
   (ii) Collection of cheques, dividends, interests
   (iii) Payment of rent, insurance premium
   (iv) Dealing in foreign exchange
   (v) Purchase and sale of securities
   (vi) Act as trustee, executor, attorney, etc.
   (vii) Act as correspondent
   (viii) Preparations of income-tax return

(b) General utility services
   (i) Safety locker facilities
   (ii) Payment mechanism or money transfer
   (iii) Issue "Travellers Cheques"
   (iv) Letters of credit
   (v) Acting as referees
   (vi) Providing trade information
   (vii) ATM facilities
   (viii) Credit cards
   (ix) Gift cheques
   (x) Accepting bills
Primary Functions: -- The primary functions of the commercial banks include the following –

Acceptance Of Deposits: --

Time Deposits: -- These are deposits repayable after a certain fixed period. These deposits are not withdrawable by cheque, draft or by other means. It includes the following: --

Fixed Deposits: -- The deposits can be withdrawn only after expiry of certain period say 3 years, 5 years or 10 years. The banker allows a higher rate of interest depending upon the amount and period of time. Previously the rates of interest payable on fixed deposits were determined by Reserve Bank. Presently banks are permitted to offer interest as determined by each bank. However, banks are not permitted to offer different interest rates to different customers for deposits of same maturity period, except in the case of deposits of Rs.15lakhs and above. These days the banks accept deposits even for 15 days or one month etc. In times of urgent need for money, the bank allows premature closure of fixed deposits by paying interest at reduced rate. Depositors can also avail of loans against Fixed Deposits. The Fixed Deposit Receipt cannot be transferred to other persons.
Recurring Deposits: -- In recurring deposit, the customer opens an account and deposit a certain sum of money every month. After a certain period, say 1 year or 3 years or 5 years, the accumulated amount along with interest is paid to the customer. It is very helpful to the middle and poor sections of the people. The interest paid on such deposits is generally on cumulative basis. This deposit system is a useful mechanism for regular savers of money.

Cash Certificates: -- Cash Certificates are issued to the public for a longer period of time. It attracts the people because its maturity value is in multiples of the sum invested. It is an attractive and high yielding investment for those who can keep the funds for a long time. It is very useful account for meeting future financial requirements at the occasion of marriage, education of children etc. Cash Certificates are generally issued at discount to face value. It means a cash certificate of Rs.1,00,000 payable after 10 years can be purchased now, say for Rs.20,000.

Demand Deposits: -- These are the deposits, which may be withdrawn by the depositor at any time without previous notice. It is withdraw able by cheque / drafts. It includes the following:

Saving Deposits: -- The savings deposit promotes thrift among people. Individuals and non-profit institutions can only hold the savings deposits. The rate of interest paid on savings deposits is lower than that of time deposits. The savings account holder gets the
advantage of liquidity (as in current a/c) and small income in the form of interests. But there are some restrictions on withdrawals. Corporate bodies and business firms are not allowed to open SB Accounts. Presently RBI determines interest on SB Account. It is 4.5 percent per annum. Co-operative banks are allowed to pay an extra 0.5 percent on its saving bank deposits.

**Current Account Deposits:** -- the people who need to have a liquid balance maintain these accounts. Current account offers high liquidity. No interest is paid on current deposits and there are no restrictions on withdrawals from the current account. These accounts are generally in the case of business firms, institutions and co-operative bodies. Nowadays, banks are designing and offering various investment schemes for deposit of money. These schemes vary from bank to bank.

It may be started that the banks are currently working out with different innovative schemes for deposits. Such deposit accounts offer better interest rate and at the same time withdraw able facility also. Foreign banks mostly offer these schemes. In USA, Current Account is known as 'Checking Accounts' as a cheque is equivalent to check in America.

**Advancing Of Loans:** -- The commercial banks provide loans and advances in various forms. They are given below:
Overdraft: -- This facility is given to holder of current accounts only. This is an arrangement with the bankers whereby the customer is allowed to draw money over and above the balance in his/her account. This facility of overdrawing his account is generally pre-arranged with the bank up to a certain limit. It is a short-term temporary fund facility from bank and the bank will charge interest over the amount overdrawn. This facility is generally available to business firms and companies.

Cash Credit: -- Cash credit is a form of working capital credit given to the business firms. Under this arrangement, the customer opens an account and the sanctioned amount is credited with that account. The customer can operate that account within the sanctioned limit as and when required. It is made against security of goods, personal security etc. On the basis of operation, the period of credit facility may be extended further. One advantage under this method is that bank charges interest only on the amount utilized and not on total amount sanctioned or credited to the account. Reserve Bank discourages this type of facility to business firms as it imposes an uncertainty on money supply. Hence this method of lending is slowly phased out from banks and replaced by loan accounts. Cash credit system is not in use in developed countries.

Discounting Of Bills: -- Discounting Of Bills may be another form of bank credit. The bank may purchase inland and foreign bills before these are due for payment by the drawee debtors, at discounted values, i.e., values a little lower than the face values. The Banker's
discount is generally the interest on the full amount for the unexpired period of the bill. The banks reserve the right of debiting the accounts of the customers in case the bills are ultimately not paid, i.e., dishonored. The bill passes to the Banker after endorsement. Discounting of bills by banks provide immediate finance to sellers of goods. This helps them to carry on their business. Banks can discount only genuine commercial bills i.e., those drawn against sale of goods on credit. Banks will not discount Accommodation Bills.

Loans and Advances: -- It includes both demand and term loans, direct loans and advances given to all type of customers mainly to businessmen and investors against personal security or goods of movable or immovable in nature. The loan amount is paid in cash or by credit to customer account, which the customer can draw at any time. The interest is charged for the full amount whether he withdraws the money from his account or not. Short- term loans are granted to meet the working capital requirements whereas long- term loans are granted to meet capital expenditure. Previously RBI also regulated interest on loan. Currently, banks can determine the rate themselves. Each bank is, however required to fix a minimum rate known as Prime Leading Rate (PLR).

Housing Finance: -- Nowadays the commercial banks are competing among themselves in providing housing finance facilities to their customers. It is mainly to increase the housing facilities in the country. State Bank of India, Indian Bank, Canara Bank, Punjab National Bank, have formed housing subsidiaries to provide housing
finance. The other banks are also providing housing finances to the public. Government of India also encourages banks to provide adequate housing finance. Barrowers of housing finance get tax exemption benefits on interest paid. Further housing finance up to Rs.5lakh in treated as priority sector advances for banks. The limit has been raised to Rs.10lakhs per barrower in cities.

**Educational Loan Scheme:** The Reserve Bank of India, from August, 1999 introduced a new Educational Loan Scheme for students of full time graduate/post graduate professional courses in private professional collages. Under the scheme all public sector banks have been directed to provide educational loan up to Rs.15000 for free seat and Rs.50000 for payment seat student at interest not more than 12 percent per annum. This loan is on clean basis i.e., without calling for security. This loan is available only for students whose annual family income does not exceed Rs.100000. The loan has to be repaid together with interest within five years from the date of completion of the course. Studies in respect of the following subjects/areas are covered under the scheme.

- Medical and dental course.
- Engineering course.
- Chemical Technology.
- Management courses like MBA.
- Law Studies.
- Computer Science and Applications.
This apart, some of the banks have other educational loan schemes against security etc., one can check up the details with the banks.

Loans Against Shares/ Securities: -- Commercial banks provide loans against the security of share/ debentures of reputed companies. Loans are usually given only up to 50% value (Market Value) of the shares subject to a maximum amount permissible as per RBI directives. Presently one can obtain a loan up to Rs.10 lakhs against the physical shares and up to Rs.20 lakhs against dematerialized shares.

Loans Against Savings Certificates: -- Banks are also providing loans up to certain value of saving certificates like National Saving Certificate, Fixed Deposit Receipt, Indira Vikas Patra, etc. The loan may be obtained for personal or business purposes.

Consumer Loans and Advances: -- One of the important areas for bank financing in recent years is towards purchase of consumer durables like TV sets, Washing Machines, Micro Oven, etc. Banks also provide liberal Car finance. These days' banks are competing with one another to lend money for these purposes, as default of payment is not high in these areas as the borrowers are usually salaried persons having regular income. Further, bank's interest rate is also higher. Hence, banks improve their profit through such profitable loans.
Securitization Of Loans: -- Banks are recently trying to securities a part of their part of loan portfolio and sell it to another investor. Under this method, banks will convert their business loans into a security or a document and sell it to some Investment or Fund Manager for cash to enhance their liquidity position. It is a process of transferring credit risk from the banker to the buyer of securitised loans. It involves a cost to the banker but it helps the bank to ensure proper recovery of loan. Accordingly, securitisation is the process of changing an illiquid asset into a liquid asset.

Others: -- Commercial banks provide other types of advances such as venture capital advances, jewel loans, etc.

Investment functions: -- Besides, loans and advances, a modern commercial bank also invest a part of its surplus funds in government securities and earns interest on them. In India, the commercial banks are required under statute to invest a part of their funds in government and other approved securities. Though the return from such securities is not very attractive, the funds invested in them are not only near liquid, but also secure from the risk of loss.

Credit creation: -- Granting of loans and advances is an important function of the commercial bank. But the process by which the bank grants loans and advances has special significance for the modern economy. As is well known, when the bank grants a loan to its customers, it generally does not lend out cash, equal to the amount of the loan, to the customer as an individual moneylender does, but, on
the contrary, opens an account in his (borrower’s) name and credits the amount of the loan to his account. Thus, whenever a bank grants a loan, it creates a deposit or a liability against itself. Since the deposits of the bank circulate as money, the creation of such deposits leads to a net increase in the money stock of the economy. This is known as creation of money or creation of credit by the bank. A modern bank, during its operations, creates quite a good deal of money, which has a far-reaching influence on the course of economic activity in the country.

**Dealing in foreign exchange:** -- The commercial banks also carry on the business of buying and selling foreign currencies. Ordinarily, the sale and purchase of foreign currency is done by the Foreign Exchange Banks. But in India, some commercial banks, in addition to their other functions, also do business in foreign exchange.

**Secondary Functions:** -- The secondary functions of the banks consist of agency functions and general utility functions.

**Agency Functions:** -- Agency functions include the following:

**Collection of cheques, dividends, interest:** -- As an agent the bank collects cheques, drafts, promissory notes, interest, dividends, etc., on behalf of its customers and credit the amounts to their accounts. Customers may furnish their bank details to corporates where investment is made in shares, debentures, etc. As and when
dividend, interest, is due, the companies directly send the warrants/cheques to the bank for credit to customer account.

**Payment of rent, insurance premiums:** -- The bank makes the payments such as rent, insurance premiums, subscriptions, on standing instructions until further notice. Till the order is revoked, the bank will continue to make such payments regularly by debiting the customer's account.

**Dealing in foreign exchange:** -- As an agent the commercial banks purchase and sell foreign exchange as well for customers as per RBI Exchange Control Regulations.

**Purchase and sale of securities:** -- Commercial banks undertake the purchase and sale of different securities such as shares, debentures, bonds etc. on behalf of their customers. They run a separate 'Portfolio Management Scheme' for their big customers.

**Act as trustee, executor, attorney, etc:** -- The banks act as executors of will, trustee and attorneys. It is safe to appoint a bank as a trustee than to appoint an individual. Acting as attorneys of their customers, they receive payments and sign transfer deeds of the properties of their customers.

**Act as correspondent:** -- The commercial banks act as a correspondent of their customers. Small banks even get travel tickets, book vehicles, receive letters etc. on behalf of their customers.
Preparations of Income- Tax returns: -- They prepare income-tax return and provide advices on tax matters for their customers. For this purpose, they employ tax experts and make their services available to their customers.

General Utility Services: -- The General Utility services include the following:

Safety Locker Facility: -- Safekeeping of important documents, valuables like jewels is one of the oldest service provided by commercial banks 'Lockers' are small receptacles, which are fitted in the steel racks and kept inside strong rooms known as vaults. These lockers are available on half-yearly or annual rental basis. The bank merely provides lockers and the key but the valuables are always under the control of its users. Any customer cannot have access to vault. Only customers of safety lockers after entering into a register his name account number and time can enter into the vault. Because the vault is holding important valuables of customers in lockers, it is also known as 'Strong Room'.

Payment Mechanism or Money Transfer: -- Transfer of funds is one of the important functions performed by commercial banks. Cheques and credit cards are two important payment mechanisms through banks. Despite an increase in financial transactions, banks are managing the transfer of funds process very efficiently. Cheques
are also cleared through the banking system. Correspondent banking is another method of transferring funds over long distance, usually from one country to another. Banks, these days employ computers to speed up money transfer and to reduce cost of transferring funds. Electronic Transfer of funds is also known as 'chequeless banking' where funds are transferred through computers and sophisticated electronic system by using code words. They offer Mail Transfer, Telegraphic Transfer (TT) facility also.

**Issue “Travellers Cheques”:** -- Banks issue travellers cheques to help carry money safety while travelling within India or abroad. Thus, the customers can travel without fear, theft or loss of money.

**Letters of Credit:** -- Letters of Credit is a payment document provided by the buyer's banker in favour of seller. This document guarantees payment to the seller upon production of document mentioned in the Letter of Credit evidencing dispatch of goods to the buyer. The Letter of Credit is an assurance of payment upon fulfilling conditions mentioned in the Letter of Credit. The letter of credit is an important method of payment in international trade. There are primarily 4 parties to a letter of credit. The buyer or importer, the bank which issues the letter of credit, known as opening bank, the person in whose favour the letter of credit is issued or opened (The seller or exporter, known as 'Beneficiary of Letter of Credit'), and the credit receiving / advising bank. The Letter of Credit is generally advised / sent through the seller's bank, known as Negotiating or Advising bank. This is done because the conditions mentioned in the Letter of
Credit are, in the first instance; have to be verified by the Negotiating Bank. It is mostly used in international trade.

**Acting as Referees:** -- The banks act as referees and supply information about the business transactions and financial standing of their customers on enquiries made by third parties. This is done on the acceptance of the customers and help to increase the business activity in general.

**Provides Trade Information:** -- The commercial banks collect information on business and financial conditions etc., and make it available to their customers to help plan their strategy. Trade information service is very useful for those customers going for cross-border business. It will help traders to know the exact business conditions, payment rules and buyers’ financial status in other countries.

**ATM Facilities:** -- The banks, today have ATM facilities. Under this system the customers can withdraw their money easily and quickly and 24 hours a day. This is also known as 'Any Time Money'. Customers under this system can withdraw funds i.e. currency notes with the help of certain magnetic card issued by the bank and similarly deposit cash / cheque for credit to account.

**Credit Cards:** -- Banks have introduced credit card system. Credit cards enable a customer to purchase goods and services from certain specified retail and service establishments up to a limit without
making immediate payment. In other words, purchases can be made on credit basis on the strength of the credit card. The establishments like, Hotels, Shops, Airline Companies, Railways etc, which sell the goods or services on credit forward a monthly or fortnightly statements to the bank. The amount is paid to these establishments by the bank. The bank subsequently collects the dues from the customers by debit to their accounts. Usually, the bank receives certain service charges for every credit card issued. Visa Card, BOB Card is some example of credit cards.

Gift Cheques: -- The Commercial banks offer Gift cheques facilities to the general public. These cheques received a wider acceptance in India. Under this system by paying equivalent amount one can buy gift cheque for presentation on occasions like Wedding, Birthday.

Accepting Bills: -- On behalf of their customers, the banks accept bills drawn by third parties on its customers. This resembles the letter of credit. While banks accept bills, they provide a better security for payment to seller of goods or drawer of bills.

Merchant Banking: -- The commercial banks provide valuable services through their merchant banking divisions or through their subsidiaries to the traders. This is the function of underwriting of securities. They underwrite a portion of the public issue of Shares, Debentures and Bonds of Joint Stock Companies. Such underwriting ensures the expected minimum subscription and also convey to the investing public about the quality of the company issuing the
securities. Currently, this type of services can be provided only by separate subsidiaries, known as Merchant Bankers as per SEBI regulations.

**Advice on Financial Matters:** — The commercial banks also give advice to their customers on financial matters particularly on investment decisions such as expansion, diversification, new ventures, raising of funds etc.

**Factoring Services:** — Today the commercial banks provide factoring service to their customers. It is very much helpful in the development of trade and industry as immediate cash flow and administration of debtors' account are taken care of by factors. This service is again provided only by a separate subsidiary as per RBI regulations.