

# 33

## Functions of Commercial Banks

### 33.1 Introduction

You have studied in the earlier lesson about different types of banks and their nature. It may be of interest to you now to know about the various services/functions performed by commercial banks. In this lesson, you will study about the various services provided by commercial banks to the business community in particular and the public in general.

### 33.2 Objectives

After studying this lesson, you will be able to -

- describe the various functions of commercial banks;
  - differentiate between primary and secondary functions of commercial banks;
  - classify and discuss the primary functions of modern commercial banks;
  - enumerate the various modes of acceptance of deposits;
  - identify various methods of granting loans;
  - describe agency and general utility services of modern commercial banks.
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### 33.3 Functions of Commercial Banks

The functions of a commercial banks are divided into two categories:

- i) Primary functions, and
- ii) Secondary functions including agency functions.

#### **i) Primary functions:**

The primary functions of a commercial bank include:

- a) accepting deposits; and
- b) granting loans and advances;

##### **a) Accepting deposits**

The most important activity of a commercial bank is to mobilise deposits from the public. People who have surplus income and savings find it convenient to deposit the amounts with banks. Depending upon the nature of deposits, funds deposited with bank also earn interest. Thus, deposits with the bank grow along with the interest earned. If the rate of interest is higher, public are motivated to deposit more funds with the bank. There is also safety of funds deposited with the bank.

##### **b) Grant of loans and advances**

The second important function of a commercial bank is to grant loans and advances. Such loans and advances are given to members of the public and to the business community at a higher rate of interest than allowed by banks on various deposit accounts. The rate of interest charged on loans and advances varies depending upon the purpose, period and the mode of repayment. The difference between the rate of interest allowed on deposits and the rate charged on the Loans is the main source of a bank's income.

##### **i) Loans**

A loan is granted for a specific time period. Generally, commercial banks grant short-term loans. But term loans,

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that is, loan for more than a year, may also be granted. The borrower may withdraw the entire amount in lumpsum or in instalments. However, interest is charged on the full amount of loan. Loans are generally granted against the security of certain assets. A loan may be repaid either in lumpsum or in instalments.

## **ii) Advances**

An advance is a credit facility provided by the bank to its customers. It differs from loan in the sense that loans may be granted for longer period, but advances are normally granted for a short period of time. Further the purpose of granting advances is to meet the day to day requirements of business. The rate of interest charged on advances varies from bank to bank. Interest is charged only on the amount withdrawn and not on the sanctioned amount.

### **Modes of short-term financial assistance**

Banks grant short-term financial assistance by way of cash credit, overdraft and bill discounting.

#### **a) Cash Credit**

Cash credit is an arrangement whereby the bank allows the borrower to draw amounts upto a specified limit. The amount is credited to the account of the customer. The customer can withdraw this amount as and when he requires. Interest is charged on the amount actually withdrawn. Cash Credit is granted as per agreed terms and conditions with the customers.

#### **b) Overdraft**

Overdraft is also a credit facility granted by bank. A customer who has a current account with the bank is allowed to withdraw more than the amount of credit balance in his account. It is a temporary arrangement. Overdraft facility with a specified limit is allowed either on the security of assets, or on personal security, or both.

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**c) Discounting of Bills**

Banks provide short-term finance by discounting bills, that is, making payment of the amount before the due date of the bills after deducting a certain rate of discount. The party gets the funds without waiting for the date of maturity of the bills. In case any bill is dishonoured on the due date, the bank can recover the amount from the customer.

**ii) Secondary functions**

Besides the primary functions of accepting deposits and lending money, banks perform a number of other functions which are called secondary functions. These are as follows -

- a) Issuing letters of credit, travellers cheques, circular notes etc.
- b) Undertaking safe custody of valuables, important documents, and securities by providing safe deposit vaults or lockers;
- c) Providing customers with facilities of foreign exchange.
- d) Transferring money from one place to another; and from one branch to another branch of the bank.
- e) Standing guarantee on behalf of its customers, for making payments for purchase of goods, machinery, vehicles etc.
- f) Collecting and supplying business information;
- g) Issuing demand drafts and pay orders; and,
- h) Providing reports on the credit worthiness of customers.

**33.4 Difference between Primary and Secondary Functions of Commercial Banks**

Primary Functions	Secondary Functions
1. These are the main activities of the bank.	1. These are the secondary activities of the bank.
2. These are the main sources of income of the bank.	These are not the main sources of income of the banks.

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|---|---|
| 3. These are obligatory on the part of bank to perform. | These are not obligatory on the part of bank to perform. But generally all commercial banks perform these activities. |
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### **Intext Questions 33.1**

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Write 'T' against the statements which are true, and 'F' against those which are false.

- a) A country cannot make commercial and industrial progress without a well organised banking system.
  - b) Loans may be granted only for long period by bank.
  - c) Primary activity of commercial banks includes accepting deposits and lending money.
  - d) Difference of interest allowed to public on deposits and charged on loan is the main source of income of banks.
  - e) In case of dishonour of a bill, which was discounted by a bank, the amount cannot be recovered from the customer.
  - f) A loan cannot be repaid in lumpsum by the borrower.
  - g) Primary functions of banks refer to basic activities of banks.
  - h) Overdraft is not a credit facility granted by bank.
  - i) Loans are generally granted against the security of certain assets.
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### **33.5 Different modes of Acceptance of Deposits**

Banks receive money from the public by way of deposits. The following types of deposits are usually received by banks:

- i) Current deposit
  - ii) Saving deposit
  - iii) Fixed deposit
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- iv) Recurring deposit
- v) Miscellaneous deposits

### **i) Current Deposit**

Also called 'demand deposit', current deposit can be withdrawn by the depositor at any time by cheques. Businessmen generally open current accounts with banks. Current accounts do not carry any interest as the amount deposited in these accounts is repayable on demand without any restriction.

The Reserve bank of India prohibits payment of interest on current accounts or on deposits upto 14 Days or less except where prior sanction has been obtained. Banks usually charge a small amount known as incidental charges on current deposit accounts depending on the number of transaction.

### **Savings deposit/Savings Bank Accounts**

Savings deposit account is meant for individuals who wish to deposit small amounts out of their current income. It helps in safe guarding their future and also earning interest on the savings. A saving account can be opened with or without cheque book facility. There are restrictions on the withdrawals from this account. Savings account holders are also allowed to deposit cheques, drafts, dividend warrants, etc. drawn in their favour for collection by the bank. To open a savings account, it is necessary for the depositor to be introduced by a person having a current or savings account with the same bank.

### **Fixed deposit**

The term 'Fixed deposit' means deposit repayable after the expiry of a specified period. Since it is repayable only after a fixed period of time, which is to be determined at the time of opening of the account, it is also known as time deposit. Fixed deposits are most useful for a commercial bank. Since they are repayable only after a fixed period, the bank may invest these funds more profitably by lending at higher rates of interest and for relatively longer periods. The rate of interest on fixed deposits depends upon the period of deposits. The longer the period, the higher is the rate of interest offered. The rate of interest to

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be allowed on fixed deposits is governed by rules laid down by the Reserve Bank of India.

### **Recurring Deposits**

Recurring Deposits are gaining wide popularity these days. Under this type of deposit, the depositor is required to deposit a fixed amount of money every month for a specific period of time. Each instalment may vary from Rs.5/- to Rs.500/- or more per month and the period of account may vary from 12 months to 10 years. After the completion of the specified period, the customer gets back all his deposits alongwith the cumulative interest accrued on the deposits.

### **Miscellaneous Deposits**

Banks have introduced several deposit schemes to attract deposits from different types of people, like Home Construction deposit scheme, Sickness Benefit deposit scheme, Children Gift plan, Old age pension scheme, Mini deposit scheme, etc.

## **33.6 Different methods of Granting Loans by Bank**

The basic function of a commercial bank is to make loans and advances out of the money which is received from the public by way of deposits. The loans are particularly granted to businessmen and members of the public against personal security, gold and silver and other movable and immovable assets. Commercial bank generally lend money in the following form:

- i) Cash credit
- ii) Loans
- iii) Bank overdraft, and
- iv) Discounting of Bills

### **i) Cash Credit :**

A cash credit is an arrangement whereby the bank agrees to lend money to the borrower upto a certain limit. The bank puts this amount of money to the credit of the borrower. The borrower draws the money

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as and when he needs. Interest is charged only on the amount actually drawn and not on the amount placed to the credit of borrower's account. Cash credit is generally granted on a bond of credit or certain other securities. This a very popular method of lending in our country.

## **ii) Loans :**

A specified amount sanctioned by a bank to the customer is called a 'loan'. It is granted for a fixed period, say six months, or a year. The specified amount is put on the credit of the borrower's account. He can withdraw this amount in lump sum or can draw cheques against this sum for any amount. Interest is charged on the full amount even if the borrower does not utilise it. The rate of interest is lower on loans in comparison to cash credit. A loan is generally granted against the security of property or personal security. The loan may be repaid in lump sum or in instalments. Every bank has its own procedure of granting loans. Hence a bank is at liberty to grant loan depending on its own resources.

The loan can be granted as:

- a) Demand loan, or
- b) Term loan

### **a) Demand loan**

Demand loan is repayable on demand. In other words it is repayable at short notice. The entire amount of demand loan is disbursed at one time and the borrower has to pay interest on it. The borrower can repay the loan either in lumpsum (one time) or as agreed with the bank. Loans are normally granted by the bank against tangible securities including securities like N.S.C., Kisan Vikas Patra, Life Insurance policies and U.T.I. certificates.

### **b) Term loans**

Medium and long term loans are called 'Term loans'. Term loans are granted for more than one year and repayment of such loans is spread over a longer period. The repayment is generally made in suitable instalments of fixed amount. These loans are repayable over a period of 5 years and maximum upto 15 years.

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Term loan is required for the purpose of setting up of new business activity, renovation, modernisation, expansion/extension of existing units, purchase of plant and machinery, vehicles, land for setting up a factory, construction of factory building or purchase of other immovable assets. These loans are generally secured against the mortgage of land, plant and machinery, building and other securities. The normal rate of interest charged for such loans is generally quite high.

### **iii) Bank Overdraft**

Overdraft facility is more or less similar to cash credit facility. Overdraft facility is the result of an agreement with the bank by which a current account holder is allowed to withdraw a specified amount over and above the credit balance in his/her account. It is a short term facility. This facility is made available to current account holders who operate their account through cheques. The customer is permitted to withdraw the amount as and when he/she needs it and to repay it through deposits in his account as and when it is convenient to him/her.

Overdraft facility is generally granted by bank on the basis of a written request by the customer. Some times, banks also insist on either a promissory note from the borrower or personal security to ensure safety of funds. Interest is charged on actual amount withdrawn by the customer. The interest rate on overdraft is higher than that of the rate on loan.

### **iv) Discounting of Bills**

Apart from granting cash credit, loans and overdraft, banks also grant financial assistance to customers by discounting bills of exchange. Banks purchase the bills at face value minus interest at current rate of interest for the period of the bill. This is known as 'discounting of bills'. Bills of exchange are negotiable instruments and enable the debtors to discharge their obligations towards their creditors. Such bills of exchange arise out of commercial transactions both in internal trade and external trade. By discounting these bills before they are due for a nominal amount, the banks help the business community. Of course, the banks recover the full amount of these bills from the persons liable to make payment.

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### Intext Questions 33.2

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Fill in the blanks with suitable words

- (a) There are four important ways of lending money by banks. They are :
- 1
  - 2
  - 3
  - 4
- (b) Bank loans can be divided into two categories viz \_\_\_\_\_ and \_\_\_\_\_.
- (c) When the loan is repayable on demand or at a very short notice, the loan is known as \_\_\_\_\_.
- (d) If the loan granted by a bank is on long-term or medium-term, the loan is called \_\_\_\_\_.
- (e) \_\_\_\_\_ is a flexible system of lending under which the borrower has the option to withdraw the funds as and when required.
- (f) \_\_\_\_\_ is an agreement with the bank by which a current account holder is allowed to withdraw over and above the amount in his account.
- (g) In discounting the bills the banks \_\_\_\_\_ bills of exchange before they become due for payment.
- (h) Due date of bill is also known as date of \_\_\_\_\_.
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### 33.7 Agency and General Utility Services provided by Modern Commercial Banks

You have already learnt that the primary activities of commercial banks include acceptance of deposits from the public and lending money to

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businessmen and other members of society. Besides these two main activities, commercial banks also render a number of ancillary services. These services supplement the main activities of the banks. They are essentially non-banking in nature and broadly fall under two categories:

- i) Agency services, and
- ii) General utility services.

### **i) Agency Services**

Agency services are those services which are rendered by commercial banks as agents of their customers. They include :

- a) Collection and payment of cheques and bills on behalf of the customers;
- b) Collection of dividends, interest and rent, etc. on behalf of customers, if so instructed by them;
- c) Purchase and sale of shares and securities on behalf of customers;
- d) Payment of rent, interest, insurance premium, subscriptions etc. on behalf of customers, if so instructed;
- e) Acting as a trustee or executor;
- f) Acting as agents or correspondents on behalf of customers for other banks and financial institutions at home and abroad.

### **ii) General utility services**

General utility services are those services which are rendered by commercial banks not only to the customers but also to the general public. These are available to the public on payment of a fee or charge. They include :

- a) Issuing letters of credit and travellers' cheques;
  - b) Underwriting of shares, debentures, etc.;
  - c) Safe-keeping of valuables in safe deposit locker;
  - d) Underwriting loans floated by government and public bodies.
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- e) Supplying trade information and statistical data useful to customers;
- f) Acting as a referee regarding the financial status of customers;
- g) Undertaking foreign exchange business.

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### **Intext Questions 33.3**

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Write “T” against the statements which are true and “F” against those which are false.

- (i) Accepting deposits is an essential function of a modern commercial bank.
- (ii) Granting loan to the borrowers is not the main function of a bank.
- (iii) Ancillary services are also known as supplementary functions of a commercial bank.
- (iv) General utility services are called non-banking services.
- (v) Services rendered by banks to the general public constitute the main function of banks.
- (vi) Bank charges some amount for the services rendered.
- (vii) Bank cannot buy and sell shares and debentures on behalf of customers.
- (viii) Bank stands guarantee against loan raised by its customers from other financial institutions.
- ix) Safe deposit vaults are made available by bank only to fixed deposit account holders.
- (x) Banks generally grant long-term loans to industries.

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### **33.8 What You Have Learnt**

In this lesson you have studied various services/functions performed by commercial banks. Commercial banks render services to the business community, as well as to the general public.

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The functions of banks are divided into two categories : (i) Primary functions, (ii) Secondary functions. Primary functions include accepting deposits and lending money. Loans given by banks are : Short-term loan and long-term loans. Banks grant short-term loan to its customers by way of cash credit, overdraft, discounting of bills.

Banks accepts deposits from the public and their customers in the form of Current deposit, Saving, deposit, fixed deposit, and under other deposit schemes. Banks grant loans to customers as demand loan and term loan.

The ancilliary services of banks are agency services and general utility services. Agency services are rendered as agent of customers, whereas general utility services are rendered to the general public.

### **33.9 Terminal Exercise**

1. Explain the Primary functions of banks.
  2. Explain the Secondary functions of banks.
  3. Describe the functions of modern commercial banks.
  4. Explain the methods of granting loan by bank.
  5. What do you mean by bank overdraft? Explain the procedure for granting overdraft by bank.
  6. Differentiate between loans and advances.
  7. Explain cash credit facility allowed by banks to customers.
  8. What do you mean by discounting of bills by bank?
  9. Explain in brief the agency functions of a commercial bank.
  10. Differentiate between Primary and Secondary functions rendered by bank.
  11. Describe briefly the various modes of acceptance of deposits by banks.
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### 33.10 Answers to Intext Questions

**33.1** True a) c) d) g) i)

False b) e) f) h)

**33.2** a) i) loans

ii) Cash credit

iii) Overdraft

iv) Discounting of bills

b) Short-term, Long-term

c) Short-term

d) Term loan

e) Cash credit

f) Overdraft

g) Discount

h) Maturity

**33.3** True i) iii) iv) vi) viii)

False ii) v) vii) ix) x)

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