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BANKING AND CREDIT

Money and banking go together. They are complementary to each other. So after studying 'money' we must study banking. A 'Bank' is a very important institution in the modern society. Note that when society realised the benefits of using money as a medium of exchange, it also felt the need to store money in a safe place. This 'safe place' ultimately evolved over time into a bank, which deals with money in various ways. People make visit to a bank for various purposes; such as- to deposit their surplus money, to withdraw money from their account in order to make payments in cash, to take loan etc. In the economy banks play a very important role of facilitating the production, distribution and business activities.

OBJECTIVES

After completing this lesson, you will be able to:

- *understand the meaning of a Bank and Banking;*
- *explain functions of a Bank;*
- *understand the meaning of credit and the process of credit creation;*
- *distinguish between various types of banks in India.*

15.1 MEANING OF BANK AND BANKING

A bank is an institution which accepts money from public as deposits and gives loans to them. Banking refers to accepting for the purpose of lending or investment of deposits of money from the public, payable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.

15.2 FUNCTIONS OF A BANK

From the meaning as given above the functions of a bank are clearly understood. The primary functions of a bank are as follows :

1. Accepting deposits from public
2. Giving Loans.

PICTURES OF LOGOS OF SOME BANKS

15.2.1 Accepting Deposits from Public

A bank accepts monetary deposits from public which include individuals, groups, business firms etc.

It should be noted that when some body wants to deposit money in the bank, the bank accepts the money by opening an account in the name of the depositor. The bank gives an account number to the depositor. Whenever the depositor wants to deposit money again he or she has to mention the account number so that the bank will keep that money in that account. If the depositor withdraws money from his / her account then the bank deducts that money from the depositor's account. On the other hand, bank gives interest on certain types of deposits of the public.

Note that, the bank issues cheque books to its depositors. Cheques are used by the depositors to withdraw money from the bank and making payments to any party through the bank.

15.2.2 Giving Loans

The bank gives loans to public who want to borrow and who has the capability to repay that loan amount in future. What does this mean? For this we have to first know, as to why do people borrow? People borrow money because they want to buy some thing today or do some business for which there is not enough money with them at present. But they have the ability to repay that money in future. Goods, such as, television, refrigerator, washing machine, car etc are expensive items. Similarly, purchase or construction of house requires lots of money. For all these things, bank provides a loan. Bank also gives loan to start business.

15.2.3 Keeping Valuable Materials

There is another function performed by a bank. The bank also keeps valuable things of people such as jewellery, property documents etc. Normally, people want to keep valuables in safe custody which is provided by the bank in the form of '**locker facility**'.

INTEXT QUESTIONS 15.1

1. Name an institution in which someone can deposit surplus money?
2. Name any two purposes for which a loan can be sanctioned by a bank?

ACTIVITY 15.1

Visit a bank with your parents and enquire about the the ways in which that bank helps people and what all it does?

15.3 MEANING OF CREDIT

Credit is defined as the claim to receive payments. When a bank gives loans to people, then the bank becomes a lender and the person who takes loan from the bank is called a borrower. When bank gives loan today it also makes arrangements to recover the same from the person in future. This means that the bank can claim the money from the borrower in future. Accordingly, the bank is able to expand its deposits. This is called credit creation by the bank. So we can say that credit is created through the act of lending and borrowing.

15.4 THE PROCESS OF CREDIT CREATION

Now the following question arises – How does a bank create credit? Or to say in other words, where from does a bank arrange the money in order to give loan to others and how much of loan or credit it can create? We provide the answer below.

We know that a bank accepts money from public as deposits. Normally these deposits are supposed to be returned back to the public if they want to withdraw them. So if all the persons, who have deposited money in the bank, withdraw their total money, then bank will be left with no money at all. But such things normally do not happen.

From common experience it has been observed that once somebody deposits money in the bank, he/she doesn't withdraw it at once. Mostly, people withdraw a smaller amount from their deposit whenever they require and leave the rest of the amount with the bank. To make this possible, the bank always keeps some fraction of its total deposits in the form of cash from which it keeps giving money to people who come to withdraw it. This fraction is given in percentage term. What percentage of the total deposit has to be kept as cash? Well, this is decided by the banking authority of the country. The cash amount is kept as reserve for making cash payments to public who come to the bank to withdraw money. We call the fraction of the total deposit to be kept in the form of cash as **cash reserve ratio**. Once the bank calculates the amount to be kept as cash on the basis of cash reserve ratio, it deducts the amount from the total deposits and uses the rest of the amount to give loans to the borrowers. With this act of the bank, the process of credit creation starts from here. Let us describe the process of credit creation step by step through the following example.

15.4.1 Steps in Credit Creation

To make things simple, let us think that there is only one bank in the economy.

Let the banking authority has decided that the cash reserve ratio is 20 percent. So, the bank must keep 20 percent of its current deposit in the form of cash to make cash payments to persons who come to withdraw money.

Step1. A person called A, deposits Rs.100 in the bank. As a result the bank's deposits increases by Rs.100. As per rule the bank keeps 20% of 100 as cash. This comes out to be Rs.20. So the bank keeps Rs.20 to make cash payments. Now deduct 20 from 100. 100 – 20 = 80. So the bank can use Rs.80 to give loan.

Step 2. A person called B approaches the bank to take a loan of Rs.80. After the bank gives this loan, it can claim the amount from B in future. This means that by giving loan to person B, the bank can create another deposit Rs.80.

Now calculate the total deposit with the bank

First, person A deposited Rs.100. By giving loan to B, the bank is able to claim Rs.80. So after two steps the bank has total deposit of Rs.180. i.e 100 + 80 = 180

Step 3. Another person called C wants a loan from the bank. How much amount of money the bank can give as loan to C? In the previous step we saw that, the bank could increase its deposit by Rs.80 by claiming the amount from B. As per rule it has to keep 20% of 80 as cash before giving further loan to anybody. 20% of 80 = 16. So the bank will now keep Rs.16 as cash and give the rest of the amount as loan. 80 – 16 = 64. So the bank can give Rs.64 as loan to C. Again by claiming this amount from C, the bank can create another deposit of Rs.64 in step 3.

Continuing from the previous two steps, we can say that, after three steps the total deposits with the bank has increased upto 180 + 64 = 244. Or 100 + 80 + 64 = 244.

This chain will continue for some time. But when it will come to an end? You know that in each round the bank keeps 20% of the increase in the deposit as cash. You also know that the bank started with an increase in its deposit by Rs.100 in step 1. So the process of credit creation (or increase in deposits) will come to an end when 20% of the deposits of each and every round taken together become 100 itself. Then ask the question, 20% of what amount is 100? The answer is 20% of 500 is 100. This means that in our present example, with initial increase of the bank deposit by Rs.100 and cash reserve ratio of 20 percent, the total credit creation will be Rs.500. There is a link among these three. You know that 20% = 20/100 = 1/5. Here, 500 = 100 × 1/20% = 100 × 1/5 = 100 × 5. Accordingly we can give the following formula for credit creation

Total Credit = Initial Increase in Deposit × 1/Cash Reserve Ratio.

500 = 100 × 1/20%

Also remember another important point. Since the bank deposit is divided into 20% as cash and the rest as loan through various steps, the total deposit of Rs.500 can be divided in the following manner

Cash Reserve = 20% 0f 500 = Rs.100

Loan Amount = 500 – 100 = Rs.400

Now we can present the various steps (or rounds) of credit creation in the following manner

Steps	Increase in Deposit	Cash Reserve	Loan
1	100	20	80
2	80	16	64
3	64	12.8	51.2
4	51.2	10.24	40.96
5	40.96	8.19	32.77
……	……	……	……
……	……	……	……
Total	500	100	400

Finally, remember that, in the process of credit creation two types of deposits are recorded. The first one is called Primary Deposit. Primary deposit is the initial increase in the bank deposit resulted when the bank receives a new deposit from public. In our example given above, primary deposit is Rs.100 deposited by person A in the beginning. The second type of deposit is called Secondary Deposit. The deposits created due to the loans given by the bank in each round are called secondary deposits. Credit creation is possible due to the increases in the secondary deposits.

15.4.2 What is the Credit Creation Capacity of a Bank?

The credit creation capacity of a bank depends on the cash reserve ratio. If the cash reserve ratio is higher, then the bank has to keep more cash to make payments to public and accordingly, fewer amounts will be available for giving loans. So less credit will be created. Credit creation will be higher, if the cash reserve ratio is lower. In our above example, total credit was Rs.500, given that the cash reserve ratio was 20% and initial increase in deposit was Rs.100. Now decrease the cash reserve ratio to 10%. As a result total credit will be $100 \times 1/10\% = 100 \times 1/10/100 = 100 \times 10 =$ Rs. 1000.

INTEXT QUESTION 15.2

1. A bank received a deposit of Rs. 200. It gave a loan of Rs.180 to a borrower. What is the cash reserve ratio?

2. In the above question find out the amount of (a) primary deposit, (b) secondary deposit and (c) total deposit?

3. Define credit?

15.5 VARIOUS TYPES OF BANKS IN INDIA

In India there are following types of banks.

1. Reserve bank of India (RBI), which is the central bank of our country.

2. Commercial banks.

3. Cooperative banks.

4. Development banks.

Let us discuss them briefly.

15.5.1 Reserve Bank of India (RBI)

RBI is the head of the banking system in the country. This means that all other banks such as, commercial or cooperative or development banks, follow the rules and regulations made by RBI. Its head quarter is in Mumbai. RBI's main function is to issue currency notes. The paper currency of various denominations such as-2, 5, 10, 50, 100,500 and 1000 are issued by the RBI. You can see the signature of the governor of RBI on these currency notes. The note, bearing the signature of the Governor of RBI is approved by the government so that it can be used for buying and selling goods and services. One rupee notes and coins as well as coins below one rupee are issued by Ministry of Finance, government of India.

Source: mysarkarinaukri.com

Another function of RBI is that it acts as banker to the government. In India both central and state governments take loan from RBI and deposit their money with RBI.

15.5.2 Commercial Banks

Just now we were discussing credit creation. The ‘bank’, which we were talking there, was actually a commercial bank. The functions of a bank which we have discussed earlier are also functions of a commercial bank.

There are some commercial banks which are under the public sector; for example- State Bank of India (SBI), Punjab National Bank (PNB), Bank of India (BOI), Indian Bank, Canara Bank, Bank of Baroda (BOB) etc.

There are other commercial banks which are under private sector such as- ICICI Bank, Yes Bank, HDFC Bank etc. These banks are privately run.

The aim of a commercial bank is to earn profit by charging rate of interest on loans and fees for various services such as issuing draft, transferring money etc.

15.5.3 Cooperative Bank

In India there are many banks which are run by cooperative societies and are governed by the laws of the state in which they are operating. Such banks are of two types - agricultural (or rural) and non - agricultural (or urban).

In rural areas cooperative banks provide credit for farming, cattle, fishery etc. In urban areas the cooperative banks provide credit for self employment activities, small scale industry, purchase of durable goods such as television, refrigerator etc. and personal finance.

Examples of cooperative banks are state cooperative banks, primary agricultural credit societies, urban cooperative banks, land development banks, and district central cooperative banks. These banks may bear different names in different states and areas.

15.5.4 Development Banks

To achieve economic development for the country, investment in industries and infrastructure is required. To make such thing possible there are development banks in India. These banks provide credit for a long period to private business companies and public sector units who want to establish industries and create infrastructure. Some example of development banks are Industrial development bank of India, Industrial Financial corporation of India and State Finance Corporations etc.

INTEXT QUESTIONS 15.3

1. Give one example each of a commercial bank, cooperative bank, and development bank?
2. For which activities, do the cooperative banks provide credit both in rural and urban areas? Give two examples of each.
3. Which is at the head of banking system in India?

WHAT YOU HAVE LEARNT

- Bank is an organization which accepts deposits from public and advances loans to people.
- Bank can increase its deposits by creating credit as lender. Credit means claims to receive payments from the borrowers.
- In India Reserve Bank of India is the head of the banking system.
- The different types of banks which are operating in the country are - commercial banks, cooperative banks and development banks, besides RBI.

TERMINAL EXERCISE

1. Explain two functions of a bank?
2. What is credit? How does a bank create credit?

3. What are the different types of banks in India?
4. Write short notes on the following.
   (i) RBI
   (ii) Cooperative Bank
   (iii) Commercial Bank

ANSWERS TO INTEXT QUESTIONS

Intext Questions 15.2

1. 10 percent
2. (a) Rs.200 (b) Rs.180 (c) Rs.380
3. A contractual agreement in which a borrower recieves something of value now or at present and agrees to repay the lender at some later date or future date.

Intext Questions 15.3

3. Reserve Bank of India