Part I

Introduction to Banking in India

Cambridge University Press & Assessment
978-1-009-55645-3 — Regulating and Managing Banks in India
Amaresh Samantaraya
Excerpt
More Information

1

About Banks and Banking

Learning Objectives

- To introduce banks and the business of banking
- To understand banking business using the balance sheet of a bank
- To explain various items of assets and liabilities in a bank balance sheet
- To describe the key items in the income–expenditure statement of a bank and derive indicators of bank profitability and other major parameters
- To briefly highlight the various ancillary services provided by a bank
- To outline the role of bank branches which are the basic functional units for banking operations

1.1 Introduction

In any modern economy, dealing with banks has become an integral part of everyday life. Bank offices or branches are a familiar sight in marketplaces in cities and towns. The setting up of automated teller machines (ATMs) as a form of extension of bank branches has further expanded the presence of banks. Not only urban centres and small towns, but even the rural parts of India today are no longer unfamiliar with banks and banking. It is quite common for the general public to avail ordinary banking services like obtaining a bank loan for business or farming, operating a savings bank deposit account, taking a home or automobile loan, using a credit or debit card or making or receiving small denomination payments using the Unified Payments Interface (UPI). The reader may have some exposure to banks and banking activities in her day-to-day life. However, not everyone may be quite aware about the technical aspects of banking operations and the banking business. Many may not have adequate understanding about various types of assets and liabilities of banks and the technical details related to various banking products and functions. In this chapter, we provide the basic details about a bank and its activities to facilitate a comprehensive understanding of the banking business. The objective is to provide a formal introduction to banks and banking in the Indian context.

Section 1.2 describes ordinary banking services in the form of opening bank deposit accounts, facilitating financial transfers and extending loans. In the process, a typical bank acts as an interface between savers and borrowers. The bank is a legal entity incorporated under the law of the land. The legal provisions in India defining banks and banking functions are also briefly discussed.

Banks are basically commercial entities, with profit maximisation as their key objective. Like any other commercial organisation, two basic financial statements in the form of (*a*) the balance sheet and (*b*) the income and expenditure statement are quite helpful in developing a broad understanding of the functions and business operations of banks. Both summarise wider aspects of their activities. Section 1.3 explains the main functions and commercial activities in banking based on the balance sheet of a bank in India. Similar aspects are described using the income and expenditure statement of a bank in section 1.4. Section 1.5 highlights select ancillary functions or activities undertaken by a modern-day bank beyond the conventional lending and deposit-taking operations.

In India, banks operate under a branch banking system. Under this arrangement, a wide network of bank branches undertake usual banking operations. Important activities like mobilisation of deposits, disbursement of loans and other ordinary banking functions are carried out by such branches. Thus, bank branches form the operational units at the base level. A brief outline on operational aspects such as opening deposit accounts, extending bank loans and managing currency or cash in bank branches in India is provided in section 1.6.

1.2 Conventional Banking and Legal Provisions

Conventional banking involves two fundamental activities—namely, deposit collection and provision of loans. A bank acts as a financial intermediary between savers and borrowers. On the one hand, a bank provides an avenue for savers to deposit their surplus funds. On the other, it deploys the funds mobilised through such deposits in the form of loans to borrowers.

Savers are a set of people or institutions having spending requirements lower than their current earnings and wealth. They are conventionally known as *surplus spenders* (Pierce and Tysome, 1985). Savers are the ultimate lenders. The list of surplus spenders includes households, corporates and small business entities, government bodies, and so on. In India, a very large proportion of bank deposits are held by households, followed by private corporates and the government. For example, as on 31 March 2022, the share of households in the total deposits of scheduled commercial banks (SCBs)[1] was 62.63 per cent, while the shares of corporates and the government were 22.24 and 8.97 per cent, respectively (RBI , n.d.1).

The simple reason behind the need to borrow is spending requirements of firms, households and governments being in excess of their current earnings and accumulated wealth. Such borrowers are conventionally known as *deficit spenders*.

Firms and enterprises require vast amounts of funds for the setting up of factories, the construction of buildings, the purchase of machines or equipment, and so on. Such spending requirements often overwhelmingly exceed their current profits and retained earnings. So they heavily rely on borrowing or external financing. Big corporates can access funds directly by issuing corporate bonds and selling their equity shares in the capital market. Often they also avail project loans and working capital loans from banks. Small enterprises, however, do not enjoy the advantage of accessing funds in the capital market. They are thus primarily dependent on loans from banks to meet their borrowing requirements. Many households too avail bank loans to fund expensive purchases like a home or an automobile. The cost of an apartment or car very often exceeds the amount of accumulated savings and the current income of ordinary households. Similar to small business enterprises, households also do not have access to the equity and bond markets and turn to bank lending to fund such purchases. Households also use bank loans to meet their expenditure needs for consumer durables. The introduction of credit cards has further facilitated the use of bank loans for

[1] SCBs are commercial banks which appear under schedule 2 of the Reserve Bank of India (RBI) Act, 1934. These include all public sector banks (PSBs), Indian private banks (IPBs), foreign banks, regional rural banks, small finance banks and payment banks operating in India.

even routine purchases like groceries, fruits and vegetables, flight and train tickets, and so on. Governments borrow through issue of government bonds and treasury bills to fund their expenditure in excess of their own resources such as tax and non-tax receipts. Needless to mention, all governments across developed and developing countries borrow through issue of government securities. However, in the case of the latter, the reliance on borrowing is quite extensive as the scope for raising tax revenue is limited due to a variety of reasons. These include, inter alia, lower tax base due to weak economic conditions, poor tax governance, and so on.

In his popular book *Modern Banking* (1947), R. S. Sayers defines the conventional banking business as covering three main aspects. These are as follows:

- Changing cash for bank deposits and bank deposits for cash
- Transferring bank deposits from one person or corporation to another
- Giving bank deposits against bills of exchange, government bonds or the secured promises of businessmen to repay

In the following sections, we elaborate on the aforementioned functions of a bank.

1.2.1 Mobilisation of Savings in the Form of Bank Deposits

Readers must be familiar with bank deposits. There are several types of bank deposits. Many of us might have a *savings bank deposit account* in a commercial bank such as State Bank of India (SBI), Bank of Baroda (BOB), Indian Bank, Housing Development Finance Corporation (HDFC) Bank, Industrial Credit and Investment Corporation of India (ICICI) Bank, and so on. Opening a savings bank deposit account in a bank mainly serves two purposes: first, it is a safe and convenient means of keeping our savings; second, such accounts facilitate easy payment and settlement. Banks pay nominal interest on such deposit accounts. Deposits in savings bank accounts can be withdrawn through a withdrawal slip or cheque submitted by the authorised person. As per regulatory requirements, depositors need to submit a set of documents to establish their identity under the Know Your Customer (KYC) norms to avoid money laundering. The KYC documents for individuals generally include their passport, voter identity card, driving licence, Aadhaar card, permanent account number (PAN) card (issued by the income tax authority), and so on. For proprietary concerns, the acceptable KYC documents include their registration certificate, sales and income tax returns, goods and services tax (GST) or value added tax (VAT) certificate, certificate or licence issued by the municipal authorities, and so on. Banks also follow some simple eligibility criteria for different types of customers. Generally, savings bank accounts entail minimum deposit requirements. However, in August 2014, a special variety of savings bank deposits was introduced under the Pradhan Mantri Jan Dhan Yojana (PMJDY) in India which relaxed the requirement of maintaining a minimum balance in deposit accounts for the poor.

Many of us may also be familiar with fixed deposit accounts offered by banks. Such deposits have a fixed period of maturity. The maturity period may vary from a week to several years. Banks pay market-related interest rates on such deposits which are higher than the interest rate(s) paid on savings bank accounts. Details about various types of bank deposits offered by banks in India are provided in Chapter 10 in this book.

Deposits are received by banks in the form of cash or transfer of deposit claims. A customer can add to her balance in a deposit account by depositing cash in the bank branch or at its ATM. Otherwise, one can also transfer funds from another bank account through electronic transfer, cheques or drafts, and so on. Thus, bank deposits are 100 per cent covered by the assets offered by depositors to the concerned bank. Any bank is liable to pay its depositors the amount they have deposited either on demand or on the maturity date. Hence, bank deposits are treated as liabilities of the respective banks.

As indicated earlier, in addition to their utility as a safe mode of savings, bank deposits also facilitate payment and settlement. They constitute a form of money.[2] Amounts in a savings bank deposit account have the inherent characteristic of instantly being converted into cash. The same can also be used for undertaking payments through online transfers, debit cards, UPI, and so on. Banks in India also generally permit withdrawal of amounts deposited in a fixed deposit account before maturity without much difficulty. Necessary guidelines are provided in Chapter 10 in this book.

Depositors will be inclined to place their savings in a bank deposit as long as they have confidence in the ability of the bank to readily meet their deposit withdrawal demands. This capacity of a bank to meet deposit withdrawal demands depends on whether adequate liquid assets or funds are available

[2] 'Money' is a form of financial asset which serves three major functions: (*a*) medium of exchange, (*b*) unit of account and (*c*) store of value.

with it. Cash balances are the most liquid form of assets. The liquidity of other assets depends on how quickly they can be converted into cash without any loss of market value. For example, a treasury bill or a government bond is highly liquid as it can be readily sold in the bonds market and can be converted into cash at the prevailing market rate. On the other hand, finding a ready buyer for a piece of land or plot is a time-consuming process. The owner of the land or plot may eventually sell at a price below the market rate if they cannot wait longer to find a suitable buyer. Hence, a piece of a land is not a liquid asset.

A bank has to maintain an adequate amount of liquid assets on a continuous basis. Any difficulty in meeting deposit withdrawal demands due to inadequate liquid assets may lead to impairment of public confidence in the bank. Extreme situations of such damage to depositors' confidence may lead to what are known as *bank runs*.[3] Such episodes have had devastating consequences on several occasions with bank failures and severe disruptions of economic activities. Details of such banking crises are provided in Chapter 6 in this book.

1.2.2 Transfer of Bank Deposits: Enabling Payment and Settlement

The second key aspect of banking entails transferring of funds from one depositor's account to that of another. Households, businesses and government entities undertake numerous transactions as part of their day-to-day activities. Businesses or traders make payments to their employees, raw material suppliers, agencies providing transport, providers of security and legal services, and so on, on a regular basis. They also pay rent, taxes, electricity bills and interest charges. Likewise, they receive numerous payments from the sale of their products and services. Government entities undertake similar transactions. Households make regular payments for their routine purchases using debit cards, online transfers, payments through cheques as also remit funds to other individuals or households.

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[3] A 'bank run' is a situation in which depositors rush to a bank to withdraw all their deposits for fear of the bank failing to meet future deposit withdrawal demands. Such events take place when depositors and the general public have concerns about the liquidity position and overall financial health of a bank. Often such concerns are based on actual financial difficulties of the concerned bank, but they may also sometimes be caused by misperceptions or rumours. Nevertheless, any general concern leading to 'bank runs' is a self-fulfilling prophecy, details of which are discussed in Chapter 6 in this book.

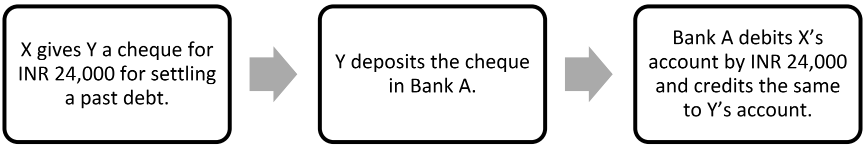

Figure 1.1(a) Transfer of funds when entities have deposit accounts in the same bank

Source: Prepared by the author.

Large transactions undertaken by any of the aforementioned stakeholders often involve the banking channel. Let us explain with simple examples how funds are transferred across different entities using the banking channel.

Suppose an entity X has to make a payment of, say, INR 24,000 to another entity Y. One simple way of making the payment is by using cash. Another popular way is using the banking channel. Assume both X and Y have deposit accounts in Bank A. It may be convenient for X to issue a cheque for INR 24,000 drawn on Bank A in favour of Y. On receipt of the cheque from X, the same can be deposited by Y in Bank A to get the proceeds from X. In this case, the transfer is relatively easy. The deposit account of X in Bank A needs to be debited (deducted) by INR 24,000 and that of Y needs to be credited (added) with INR 24,000. This is depicted in Figure 1.1(a).

The process of transfer becomes a little complicated if they have deposit accounts in different banks. Say, X has a deposit account in Bank A and Y in Bank B. In this case, Y receives the cheque for INR 24,000 from X for its claim. It will deposit the cheque in Bank B. In turn, Bank B will present the cheque to the 'clearing house'[4] to get the claim from Bank A on behalf of Y. The clearing house is operated by the central bank of the country or its agents. Our central bank is the RBI.

In the clearing house, for facilitating the settlement, the current account[5] of Bank A maintained with the RBI will be debited by INR 24,000 while that of Bank B will be credited with the same amount, effecting the transfer of

[4] A clearing house is an institutional mechanism provided by a central bank like the RBI or its agent commercial bank in different cities and towns to facilitate cheque transfers amongst the banks.

[5] Commercial banks maintain a deposit account with their central bank, like the RBI in our country, in the form of current account to facilitate financial transactions between themselves as also with the central bank.

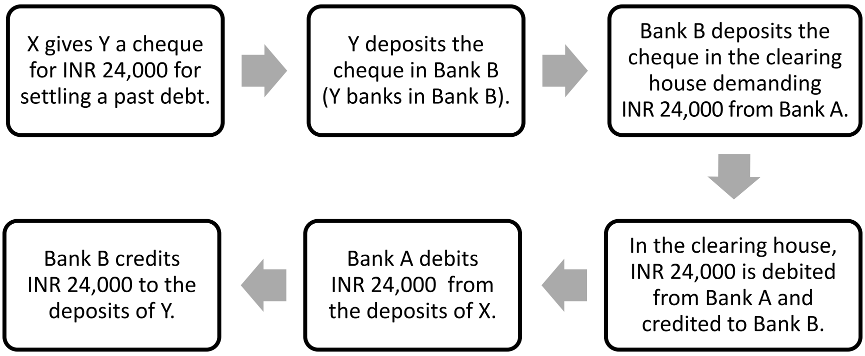

Figure 1.1(b) Transfer of funds when entities have deposit accounts in different banks

Source: Prepared by the author.

funds from Bank A to Bank B. Subsequently, the deposit account of X in Bank A will be debited by INR 24,000 and that of Y in Bank B will be credited with the same amount. Figure 1.1(b) illustrates this transfer of funds from X to Y through their respective banks.

It may be noted that on any given day, Bank A may be receiving several claims from Bank B on behalf of its depositors. Similarly, Bank B may also be receiving numerous claims from Bank A on account of dues from depositors of Bank B payable to depositors of Bank A. The net claims of Bank A from Bank B or vice versa may be calculated by consolidating all the claims and counterclaims amongst the depositors of Bank A and Bank B. Accordingly, the current accounts of Bank A and Bank B in the RBI can be debited or credited. For example, let us assume, taking into account all claims and counterclaims, INR 5 crore is the net claim of Bank A on Bank B; then the account of Bank A held with the RBI needs to be credited and that of Bank B needs to be debited by INR 5 crore. Consequently, at the bank level, the corresponding bank deposits of the entities involved in the claims and counterclaims need to be credited and debited appropriately.

Under the real-time gross settlement (RTGS) procedure used by banks for inter-bank settlements, banks settle dues amongst themselves on a real-time basis. Thus, if several payments are to be made from Bank A to Bank B and vice versa, such transfers are made on a gross basis, item by item in sequence. Assume Bank A needs to pay INR 5 crore to Bank B to settle a payment from one of its customers to a customer of Bank B. This transaction

Box 1.1 Distinction between gross and net settlements

Assume Sridevi and Sanjib are customers of Bank A and Ramakrishnan and Joseph are customers of Bank B. Let us consider a scenario where Sridevi is supposed to pay an amount of INR 10 lakh to Ramakrishnan and Joseph is supposed to pay INR 6 lakh to Sanjib.

Under net settlement, considering the obligations of the customers of Bank A and Bank B, a net amount of INR 4 lakh needs to be transferred from Bank A to Bank B. This is netting the INR 6 lakh payable from Joseph to Sanjib (from Bank B to Bank A) against the INR 10 lakh that is payable by Sridevi to Ramakrishnan (from Bank A to Bank B).

Under gross settlement on a real-time basis, first INR 10 lakh will be transferred from Bank A to Bank B to settle the payment of Sridevi to Ramakrishnan. A separate transfer of INR 6 lakh from Bank B to Bank A will be undertaken to settle the payment from Joseph to Sanjib. Gross settlement ensures that payer bank maintains the required amount of funds to be transferred to the payee bank for each transaction. If there is a default in one transaction in the sequence, remaining transfers cannot be undertaken. Therefore, the gross settlement procedure requires each bank to maintain adequate funds with the central bank to avoid any default.

or payment is carried out independently, irrespective of any other transaction on behalf of other customers. If there is a second payment of, say, INR 3.6 crore to be made on behalf of other customers of both banks, the same is undertaken separately rather than netting the two individual transactions. This is explained in Box 1.1.

As described here, the use of bank deposits facilitates safer and faster transfer of funds across individuals, businesses and government entities. Thus, banks function as the vital institutional infrastructure for the payment and settlement system in any modern economy.

1.2.3 Bank Lending and Investments

The fundamental function of banks is to convert bank deposits into loans and investments. There are many varieties of bank loans. Through bank loans in the form of project loans, a bank provides funding to a business entity to set up a production facility. Households avail home loans to buy an apartment or