Functions of Commercial Banks
(Note- This lecture is taken from internet for teaching purpose)

First we study how credit expansion takes place in bank by money multiplier process

The Money Multiplier refers to how an initial deposit can lead to a bigger final increase in the total money supply.

For example, if the commercial banks gain deposits of Rs 1 million and this leads to a final money supply of Rs 10 million. The money multiplier is 10.

The money multiplier is a key element of the fractional banking system.

1. There is an initial increase in bank deposits (monetary base)
2. The bank holds a fraction of this deposit in reserves and then lends out the rest.
3. This bank loan will, in turn, be re-deposited in banks allowing a further increase in bank lending and a further increase in the money supply.

Money Multiplier = \( \frac{\text{Change in total money supply}}{\text{Change in monetary base (reserves)}} \)

The Reserve Ratio

The reserve ratio is the % of deposits that banks keep in liquid reserves.

For example 10% or 20%

Formula for money multiplier

Money Multiplier = \( \frac{1}{\text{Reserve Ratio}} \)

In theory, we can predict the size of the money multiplier by knowing the reserve ratio.

- If you had a reserve ratio of 5%. You would expect a money multiplier of \( \frac{1}{0.05} = 20 \)
- This is because if you have deposits of £1 million and a reserve ratio of 5%. You can effectively lend out £20 million.

Example of money multiplier

- Suppose banks keep a reserve ratio of 10%. (0.1)
- Therefore, if someone deposits Rs100, the bank will keep Rs 10 as reserves and lend out Rs 90.
- However, because Rs 90 has been lent out – other banks will see future deposits of Rs 90.
- Therefore, the process of lending out deposits can start again.
Note: This example stops at stage 10. In theory, the process can continue for a long time until deposits are fractionally very small.

### Functions of Commercial Bank

In general, bank refers to a financial institution where we deposit our savings, withdraw our money in case of emergency and take loans.

The banker is under obligation to repay the money to the depositor as and when demanded by the depositor. The depositor can withdraw his money through cheques, drafts etc.

All the functions can be divided under the following heads:

1. Accepting deposits
2. Giving loans
3. Overdraft
4. Discounting of Bills of Exchange
5. Investment of Funds
6. Agency Functions
7. Miscellaneous Functions

#### 1. Accepting Deposits:

The most important function of commercial banks is to accept deposits from the public.

(i) **Current Deposits:**

The depositors of such deposits can withdraw and deposit money whenever they desire. Since banks have to keep the deposited amount of such accounts in cash always, they carry either no interest or very low rate of interest. These deposits are called as Demand Deposits because these can be demanded or withdrawn by the depositors at any time they want.

Such deposit accounts are highly useful for traders and big business firms because they have to make payments and accept payments many times in a day.

(ii) **Fixed Deposits:**
These are the deposits which are deposited for a definite period of time. This period is generally not less than one year and, therefore, these are called as long term deposits. These deposits generally carry a higher rate of interest because banks can use these deposits for a definite time without having the fear of being withdrawn.

(iii) Saving Deposits:
In such deposits, money up to a certain limit can be deposited and withdrawn as per use of customer.

2. Giving Loans:

The second important function of commercial banks is to advance loans to its customers. Banks charge interest from the borrowers and this is the main source of their income. Banks advance loans not only on the basis of the deposits of the public rather they also advance loans on the basis of depositing the money in the accounts of borrowers. In other words, they create loans out of deposits and deposits out of loans. This is called as credit creation by commercial banks.

3. Over-Draft:
Banks advance loans to its customer’s up to a certain amount through over-drafts, if there are no deposits in the current account. For this banks demand a security from the customers and charge very high rate of interest.

4. Discounting of Bills of Exchange:
This is the most prevalent and important method of advancing loans to the traders for short-term purposes. Under this system, banks advance loans to the traders and business firms by discounting their bills. In this way, businessmen get loans on the basis of their bills of exchange before the time of their maturity.

5. Investment of Funds:
The banks invest their surplus funds in three types of securities—Government securities, other approved securities and other securities. Government securities include both, central and state governments, such as treasury bills, national savings certificate etc. Other securities include securities of state associated bodies like electricity boards, housing boards, debentures of Land Development Banks units of UTI, shares of Regional Rural banks etc.

6. Agency Functions:
Banks function in the form of agents and representatives of their customers. Customers give their consent for performing such functions. The important functions of these types are as follows:
(i) Banks collect cheques, drafts, bills of exchange and dividends of the shares for their customers.
(ii) Banks make payment for their clients and at times accept the bills of exchange: of their customers for which payment is made at the fixed time.
(iii) Banks pay insurance premium of their customers. Besides this, they also deposit loan installments, income-tax, interest etc. as per directions.
(iv) Banks purchase and sell securities, shares and debentures on behalf of their customers.
(v) Banks arrange to send money from one place to another for the convenience of their customers.

7. Miscellaneous Functions:
Besides the functions mentioned above, banks perform many other functions of general utility which are as follows:
i. Banks make arrangement of lockers for the safe custody of valuable assets of their customers such as gold, silver, legal documents etc.
ii. Banks collect necessary and useful statistics relating to trade and industry.
3. For facilitating foreign trade, banks undertake to sell and purchase foreign exchange.
4. Banks advise their clients relating to investment decisions as specialist

5. Bank does the under-writing of shares and debentures also.
   (Underwriting services are provided by some large financial institutions, such as banks, insurance companies and investment houses, whereby they guarantee payment in case of damage or financial loss and accept the financial risk for liability arising from such guarantee)

vii. Banks issue letters of credit.
   (A letter of credit, or "credit letter" is a letter from a bank guaranteeing that a buyer’s payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make a payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase.)

viii. During natural calamities, banks are highly useful in mobilizing funds and donations.