Commercial Banking

- Meaning and definition
- Principle of sound banking
- Factor’s determining Liquidity of Banks
- Factor’s determining Profitability of Banks
- Credit creation of Commercial Bank

Meaning and Definition

Bank: **Institution dealing in money and credit.**

Safeguard savings of the public and

Gives loan and advances

Definition: "*Accepting for the purpose of lending or investment of deposit money from public, repayable on demand or otherwise and withdraw able by cheque drafts, order or otherwise*"- Banking Company Act of 1949

Commercial Bank: profit seeking business firm dealing in money or rather claims to money.

Principles of sound banking

A. Bank's Balance sheet

B. Portfolio Management: Tradeoff between Liquidity and Profitability

Balance Sheet of Commercial Bank

- Asset :credit items.
- Liabilities : debit items.
- Balance sheet shows the financial position of a commercial bank.
- Usually liabilities shown on left hand side and

  Assets on right hand side.

Balance Sheet of Commercial Bank

LIABILITIES	ASSETS
1. Share Capital	1. Cash In Hand.
2. Reserve Funds	2. Money At Call And Short Notice.
3. Deposits	3. Cash With Central Bank
4. Borrowings	4. Bills Discounted Including Treasury Bills
5. Other Items	5. Saving Deposits
	6. Investment
	7. Advances
	8. Other Items

Tradeoff: Liquidity and Profitability

Commercial banks should manage it assets and liabilities considering three objectives.

- **1. Liquidity**
- **2. Profitability**
- **3. Solvency**

Reconciling the twin objectives

A good bank should adopt a wise investment policy by distributing its assets in such a way that:

- ✧**Both the requirement of liquidity and profitability are satisfied.**
- ✧**The asset portfolio should strike a balance between liquidity and profitability.**
- ✧**The more liquid the asset, the less the profitable it becomes**

Factors determining Liquidity of Banks

1. Statutory Liquid ratio
2. Nature of Business
3. Banking Habits of customers
4. Business conditions
5. Number and size of deposits
6. Nature if deposits
7. Liquidity policy of other banks
8. Facility of clearing house

Factors determining Profitability

1. Amount of working funds deployed
2. Yield of funds
3. Cost of funds
4. Non interest income
5. Operating costs
6. Spread
7. Risk cost
8. Levels of NPAs

Credit creation by Commercial Banks

- **The demand deposit arises from**
- **Primary deposits**
- **Secondary or derivative deposits**
- **Cash reserve ratio**

Higher the CRR lower the credit creation and vice versa

Process of Credit Creation

Cash Deposit	**Rs. 100000**	**Rs. 80000**	**Rs. 64000**
Required Deposit	**Rs. 20000**	**Rs. 16000**	**Rs. 12000**
Excess Deposit	**Rs. 80000**	**Rs. 64000**	**Rs. 51200**
Deposit credited	**Rs. 80000**	**Rs. 64000**	**Rs. 51200**

Credit Creation

- **Deposit multiplier:**

$$D_m = \Delta D / \Delta R = 1/r$$

where, r is CRR

- **Credit Multiplier:**

$$C_m = \Delta C / \Delta R$$

where, $\Delta C = \Delta D - \Delta R$

$$C_m = \Delta D - \Delta R / \Delta R$$

$$= \Delta D / \Delta R - \Delta R / \Delta R$$

$$= 1/r - 1$$

$$= (1-r)/r$$

Limits To Credit Creation

- Amount of cash
- Cash reserve ratio
- External drain
- Supply of collateral securities
- Willingness to borrow
- Leakages
- Monetary Policies