Financial Institutions and Markets
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Lecture – 22
Commercial Bank: Financial Statements

So, in the previous class we discussed about the basic functions of the Commercial Bank and what are the services the commercial bank give or provide. Here what we have seen that the commercial banks are so special and they provide different kind of services which are technology based. Mostly the importance was given to the online banking and the credit card operations and all this things.

So, today we can discuss or we will discuss certain issues related to the financial statements of the commercial bank and further we will see at how the performance of the commercial banks are measured.

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If you see in general accounting term whenever you talk about the financial statements there are three types of financial statements always we come across. The financial statements are mostly the balance sheet, then we have the second statement is basically your profit loss account or the income statement and another is basically the cash flow.

But, from the banking prospective the cash flow has some different meanings. So, mostly the performance is always consider, always observed, always analyzed from the two financial statements that is the balance sheet and the income statement. If you know that what do you mean by the exact balance sheet is, how the balance it can be defined? The balance sheet is basically what? It provides the organizations financial condition at a single point of time.

So, they if you see that any company's balance sheet including the bank's balance sheet it is always prepared on a particular date, usually the last day of quarter or the year. So, you might have seen that whenever we are talking about a balance sheet we are talking about like as on 31 March 2018. That means, as on 31 first March 2018 what is the financial condition or financial position of that particular company including the bank, that is basically reflected through the balance sheet.

Whether it is a bank or any other company that has no difference and only we have to see that the condition of that particular organization, particularly the financial condition of that organization is observed through the different parameters, there are different items and that is basically shows; that basically shows that the financial position of that company on that particular date.

But whenever we talk about the income statement, the income statement basically shows the all major revenues and expenditure, net profit loss dividends if at all the company paid and it also the measures the banks financial performance over a period. It does not show the performance at a particular point of time or at a particular date, but it shows the performance over a period of time, mostly the period of time is either quarterly or the period of time can be yearly.

So, the income statement is a flow concept or over the period of time what is the condition of financial condition of the organization that is reflected through the income statement. And whenever you talk about the balance sheet, the balance sheet shows the financial position of the company or a position of the bank at a particular date or a particular point of time; here the point of time is we are talking about a particular date. So, that is the basic differences between these two types of financial statements.

Although the cash flow has a different meaning for the banks, but if you talk about the cash flows, the cash flow is basically is always from the three activities; 1 is your

financing activities. Whenever, we measure the cash flow it is basically measured through the cash flow can be prepared from the financing activities of the company, 2nd one is your investment activities how that money is utilized, investment cash flow and 3rd one is basically your operating cash flow.

So, these are the different activities which always we try to observe whenever we are defining the cash flow statement of a particular company. But form a banking prospective we always measure the performance in terms of the balance sheet items and the items which are reflected in the income statements. So, this is the basically what the financial statement of the banks are.

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Liabilities of the Commercial Bank

- Share capital
- Reserves and surplus
- Deposits
- Borrowings
- Other liabilities and provisions

And here if you see how the balance sheet first of all we can discuss about the balance sheet. So, whenever we talk about the balance sheet; the balance sheet of a particular bank is defined, is divided all those items is basically in two side; one is your liabilities and another side is assets. There are certain assets and liabilities which are always considered in terms of the balance sheet of a particular organization including the bank.

So, when we are talking about the liabilities and the assets what are those different, let us was discussed about the liabilities then we can come to the assets. Then what are those liabilities? The liabilities is with first liability is always for any kind of organization is the share capital. Share capital means you are we are referring to the equity capital.

Why equity capital is a liability? The equity capital is a liability because the money which is invested by the different equity holders within that an organization the they are the owner of the company and the company of the bank has to pay the dividend and also the particular amount of the profit which is arise from that particular investment that is basically should be shared among the individual shareholders or the other type of shareholders, who are participating in that particular of operations. That is why equity capital is considered as a liability for the organization.

Then we have the reserves and surplus; reserves and surplus: why we say that reserves and surplus basically is a liability? Because, reserves and surplus does not provide any kind of return which is always there within the organization for some kind of contingency reasons. So, that is why this is also considered as a liability for the bank.

Then we have the another liabilities the deposits. So, the deposits are basically the major component one the most components in terms of the liabilities whenever we are discussing about the banks. And the deposits for the people or the household sector or the business sector who makes the deposits; deposits are the assets for them for deposits of the liability for the banks.

Why the deposit is a liability? Because the bank has to pay the interest against the deposits; so, any type of deposit what we are making, all though this is the major instrument or major resources for the bank for the operation, but still it is considered as a liability for the banks because we pay the interest against this deposits. So, the interest basically, interest payments are made against the deposit or the bank has to pay the interest rate against the deposit, that is why deposit is considered as a liability for the banks.

As usual you have the borrowings, any type of long term and short term borrowings whatever the bank take either the borrowings can come from RBI or the borrowings can come from other type of; other type of banks which are existing in the financial system.

So, any type of borrowings what the banks take against that borrowings they have to make the interest, they have to pay the interest against that. So, there is the fixed obligations they have because they have to pay the interest and as well as in the end they have to pay also the principal amount. So, because of that the borrowings are basically

considered as one of the major liabilities for the banks and as well as the other organization.

Then there some other liabilities, short term and long term liabilities then the provision over the bank keep against any kind of loss; the provisions against any kind of loss depending upon the credit risk. Whenever the bank provides the loans there is some kind of risk involved in that, there are different type of risk involved in that and the major risk what the bank can face that is basically the credit risk.

So, to overcome that kind of risk what are the banks do? The banks basically keep certain kind of provisions, loan loss provisions what they keep and the loan loss provisions are basically also considered as the liability because it does not provide any kind of return over the period of time.

So, this is also another type of liability always we observe or always you see. So, these are the major liability components of the commercial banks. So, here what we have seen that mostly the major type of liability what the commercial bank has that is basically your deposit. So, we have to understand more about the deposits what are the different type of deposits and how the, what are the factors which basically determine the deposit base of the commercial banks?

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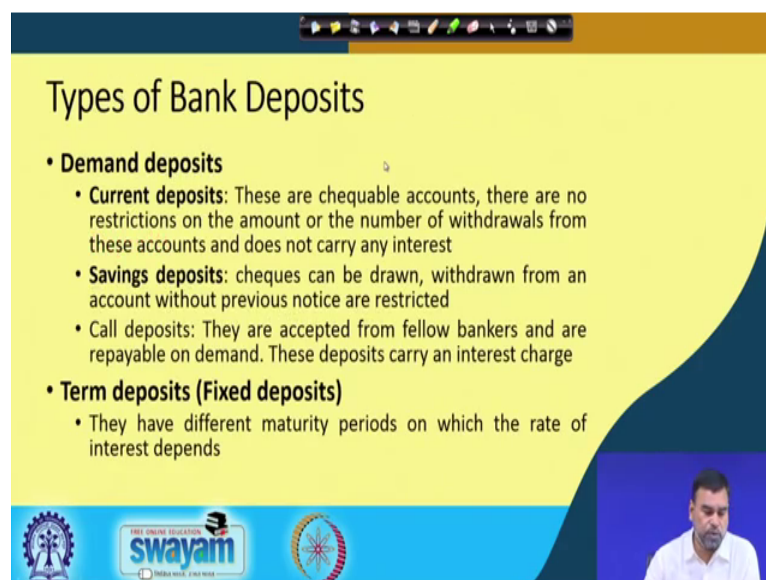

If you see this one then whenever you talk about the bank deposits because it is the one of the maximum component of the total liabilities comes from the deposit base. So, there are two types of deposits broadly; one is demand deposits another one is the term deposits or the time deposits. So, whenever talk about the demand deposits; the demand deposits again has been divided into two parts, other two types of demand deposits; one is current deposit second one is the savings deposit. That means, you might have already the idea that the people either have a current account in the bank or they can have a savings account in the bank.

So, whenever you talk about the current deposits or current account these are also the chequable accounts, the cheque can be issued against the current account, but there are no restrictions on amount or the number of withdrawals from these accounts and it does not carry any kind of interest. So, if you are going to open the current account in the bank then that account we will not face any kind of interest. So, will not be paid and interest against the current accounts, but there are no restrictions for withdrawal of the money in terms of amount and as well as the number of times.

So, n number of times, any number of times you can withdraw the money and also if it is required you can also withdraw any amount of the money whenever you need. So, that is basically a part of the current deposits and against that the banks basically open the current account.

Then we have this savings deposits; the savings deposits is cheque can be withdrawn; cheque can be drawn against that deposits and that carry generally the interest already 3.5 percent to 4 percent interest it carries and as well as also there are certain restrictions in terms of the amount of money withdrawn and as well as the number of times the money can be withdrawn in a particular period of time.

So, that is basically you called the saving deposits or the savings account what is the customer can open with the commercial bank. Then we have the call deposits their accepted from the fellow bankers and are repayable on demand this deposits also carry the interest the call deposits are not available the regular retail customers. They are basically available for the other banks which can have the account with that particular bank and they can also repayable on a whenever they need on or whenever they demand that amount and this deposits also carry certain amount of interest rate.

So, these are the part of the demand deposits whatever we have, then we have the term deposits on we are more popular popularly it is known as the fixed deposit or we are more accounted with the term fixed deposits. So, there are different type of maturity period the term deposits of the fixed deposits can be made for 2 months, it can be made for 6 months it can be made for 2 years 3 years or one year like that. So, depending upon the term to maturity the rate of interest varies.

So, the longer the term to maturity the rate of interest also will be more against that, but it has a certain limit after that the interested does not vary. So, these are the part of the term deposits or the fixed deposits and these are the two ways the deposits are basically defined in terms of the commercial banks.

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Factors Affecting Composition of Bank Deposits

- Increase in national income
- Expansion of banking facilities in new areas and for new classes of people
- Increase of banking habit
- Increase in the relative rates of return on deposits
- Increase in deficit financing.
- Increase in bank credit.
- Inflow of deposits from Non-Resident Indians (NRIs).
- Growth of substitutes

So, then we will see that what are those factors which basically affecting the composition of the bank deposits particularly in India and as well as the other countries. If one first and foremost factories and national income, if national income will increase then there is a possibility that the deposit base of the bank will increase. Because the level of income within the household and as well as the other kind of customers who are available in the particular market at that particular point of time that may increase.

Expansion of banking facilities in the new areas and new classes of the people because, you see if there are more number of banks and there is expansion of the banks and that creates the avenue for the people to make their savings or to create their savings account.

There is a possibility that your deposit base may increase, increase in banking habit because every day we all the transactions we are trying to make through online and all kind of digital payments are in demand for digital payments are increasing. So, that also make the people increasing their banking habit.

So, the banking habit is more or people are more interested to do the transactions through the banks because of kind of authentic record and as well as it has also has an free kind of spending or the transactions, then also that increase that also will increase the demand for the bank deposits in the system. And increase in the relative rates of return on the deposits, then you see that whenever the deposit rate is higher than the other type of investments or other type of instrument, financial instrument which are available in the financial system then also people demand for the bank deposits may increase.

Increase in deficit financing this is another reason through which also we are always we need more deposits should be there in the bank to cover off that financing whatever we have. And increase in bank credit; if you see that increase in bank credit is another reason that whenever you talk about the bank credit, the bank credit basically what? The loans.

If the loans will increase then it will increase the money supply already have explain that, a money supply will increase then the investment will increase, when investment will increase then output will increase, the if the output will increase, then the profit of the producer may increase. And if the profit will increase automatically that money will again come to the bank as a deposit.

So, that is also another channel through which the deposit base can be increased. So, there is a relationship between the bank credit or the bank loan against deposit base and inflows of deposit from NRIs. Already you know that NRIs is also one of the major sources of the money supply in the financial system, if the inflows are more from the NRIs then also the Non Resident Indians then the deposit of the commercial banks also, the total deposit base of the commercial banks also increase.

Then the growth substitutes, the other kind of alternatives which are available in this market and as well as other type of investment alternatives which are available in the market that also decides that how much bank deposits we should we should have. If there are more alternatives are available and that are lucrative industry, people may be

interested to invest their money in terms of those investments or those kind of assets. So, then automatically they deposit base will go down.

But if the alternative assets availability is relatively less, then what will happen? The demand for bank deposits also may increase because people will consider that this is the safest invest what they can make and the amount of return what they get out of this although this is very minimal or it is very less, but still it gives kind of safe return and also increases the saving habits of the people.

So, that is why growth of substitutes is very important factor whenever you talk about the composition of the bank deposits or demand and supply of the bank deposits in the particular system. So, these are the different factors which affect the composition of the bank deposits for the commercial bank.

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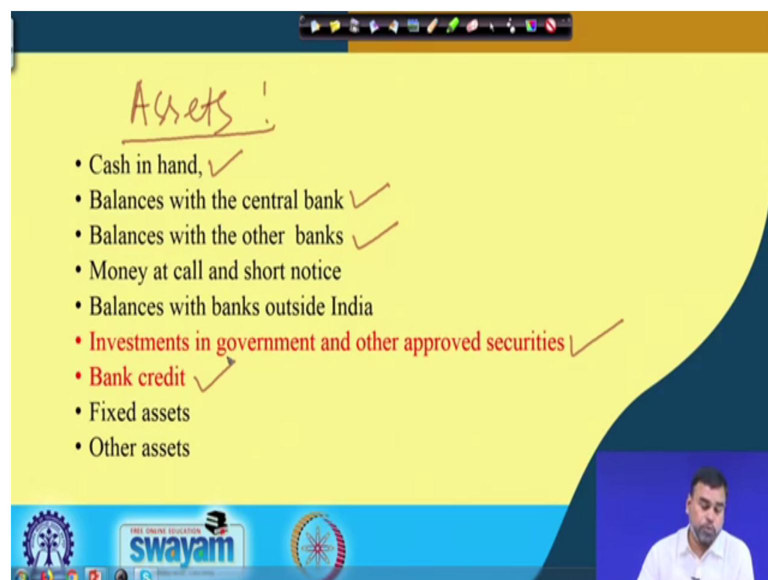

Then there are some, we are talking about there are other. So, these are the items which are basically the assets. So, these are the items these are basically the assets with the commercial bank; these are the different assets.

So, these assets are basically what? These are cash in hand, balances with the central bank, balances with other banks money at call and short notice, balances with the banks which are outside in India, investment in government and other approved securities, bank credit, fixed assets and the other assets.

So, whenever you talk about this we are basically what we are talking about there are different type of assets because just now we have talking about the liabilities and assets and out of them the major liability of the commercial bank in the deposits. So, there are different type of assets whatever cash the banks have to fulfill their liquidity requirements that is also asset for them.

Whatever balance they will keep with the RBI they get interest against that, because of that that is also one of the assets. Balances with other banks they get the interest out of this because of that this is considered as an asset, money at call and short notice whatever liquid instruments whatever they have they considered as an asset. Balances with the banks if they have any anything outside India there are fixed assets like land buildings machinery all this things whatever they have their considered the fixed assets.

But the major assets of the commercial banking system is investment in government and other approved securities and the bank credit. So, these are the basically major assets one is your investments and another one is the bank credit because the loan is one of the major components of the assets and investment is another component of the assets. So, these are the two things what basically we will discuss more, that what kind of policies the bank adopt whenever they discuss about investments or the deal with the investments and the bank credit.

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Investments, Loans and Advances

- **Investments**
  - Govt. of India Securities (SLR securities)
  - Other-approved securities (SLR securities)
  - Non-approved securities (non-SLR securities)
- **Loans and Advances**
  - Cash Credits And Overdrafts
  - Purchase And Discounting Of Commercial Bills
  - Demand And Term Loans

If you see that whenever you to talk about the investments the investments can be three type what the banks do; one is your government of India securities, government securities which are SLR investments or SLR securities.

So, minimum amount of investment that is a certain percentage of the total deposit has to be invested in that kind of securities and other thing is other approved securities. Other approved securities been there are some certificate of deposit or commercial papers whatever they have, they can be also part of the SLR investments, they can invest in those kind of securities is a relatively very liquid and softer. And another is non approved securities, they can invest in any kind of this risky bonds either it is a corporate bond or any other bond.

So, those kind of bonds are basically called a non SLR securities, they cannot be considered as a part of statutory liquidity ratio requirements, but they are considered as the investments and also they can also invest in the equity market or the stock market. So, these are basically the in non approved securities which are basically non SLR securities, but bank always invest in that because return from those kind of assets are relatively higher and they can maximize the return out of this.

And whenever we are about talking about loans and advances there are different kind of loans the commercial bank give, one is your overdrafts or cash credits. They can go for discounting or purchasing the commercial bills and demand and term loans.

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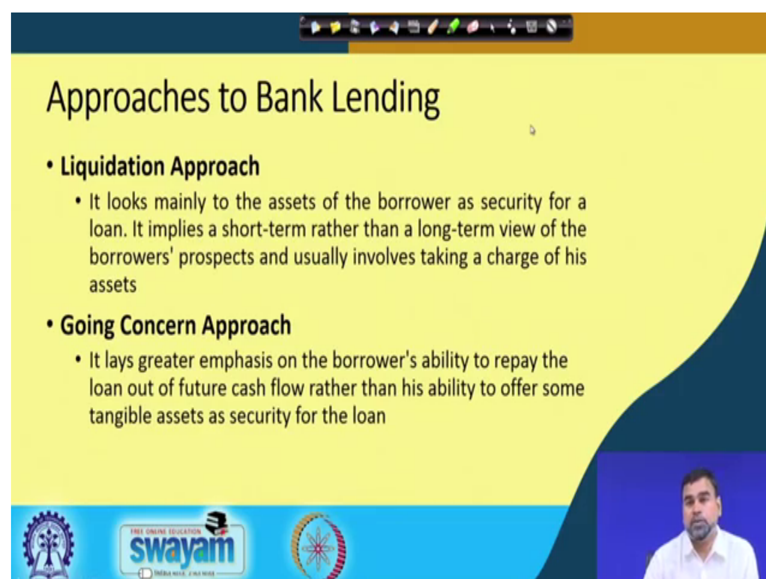

So, if you see this demand and term loans these are the two most important type of loan, what always we deal with. The whenever we talk about the loan the loan can be anything already we know that the loan can be industrial loan; Why we talk is demand and term loan? Because the demand loans are relatively short term in nature and term loans are relatively long term in nature.

So, industrial loan, you have a housing loan, you have the personal loan, you have also the loans related to like other objective like education loan so like that. For different purposes the loans can be given and some of the loans are very short term in nature that is why they called the demand loans. And there are some loans which are very long term for example, the housing loan that can go up to lets 20 years, industrial loan also can be given after 15-20 years. So, like that you have the vehicle loan also.

So, different kind of loans are available and depending upon the term to maturity of that particular loan we define them whether they are the demand loans or that term loans. And that is the major sources of revenue for the commercial banks can generate and they major source of the profit or income what the commercial bank can generate. So, these are this these are the major loans and advances for the commercial banks always use, but whenever you talk what the loans and advances what the commercial bank give there is certain policy they adopt, then how basically they provide this loans and what kind of theoretical basis against that.

If you see there are different approaches for the bank lending because this lending activities based on the different approaches; the one approach call the liquidation approach another approach is called the going concern approach. What do you mean by the liquidation approach and going concern approach? The liquidation approach is basically what? Whenever the bank provides the loan they basically look the value of the assets of the borrower as a security for the loan; that means, whenever we take the loan they see that whenever we are taking the loan they take certain kind of mortgage or collateral against that particular loan.

So, if there is a default then the bank and liquidity of the assets and can recover money. So, this particular approach is defined as the liquidation approach. So, it implies a short term rather than long term view of the borrower’s prospects and usually involves taking

charge of these assets. So, any point of time if you are asset value is not compatible with the loan what you are taking then maybe loan may not be granted for that.

So, that approach is called the liquidation approach, but whenever we go for the going concern approach, in the going concern approach the bank basically sees the borrower's ability to repay the loan out of the future cash flows rather than this ability to offer some tangible assets as security for the loan.

They see that whether they in the future how much revenue or how much cash flow this particular customer can generate. So, whether is it possible to recover that loan in terms of the cash flow what that particular customer is able to generate in the future. So, in that particular context we see what is the prospect of the outflow or the future cash flow of that particular customer. So, here the banks basically analyze your ability to pay banks does not analyze whatever assets you have and this whether the assets value is compatible with your loan amount what you are demanding.

So, this is what the going concern approach, for your information the India follows the liquidation approach mostly and US and other countries follows the going concern approach. Some people argue that liquidation approach is a backward looking approach and going concern approach is basically forward looking approach for the commercial banks. So, these are the different approaches for the bank lending and either of these approaches can be followed by the commercial bank.

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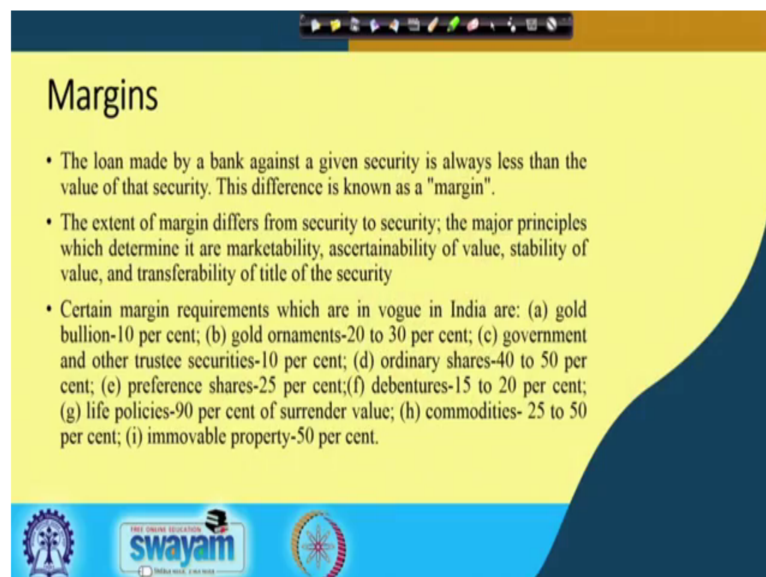

Then whenever they provide the loan they basically take certain kind of margin in the liquidation approach. So, whenever the loan made by the bank; the loan made by the bank against any kind of security is always less than the value of that security so this difference is called the margin. Just now we said whenever in the liquidation approach whenever you provide the loan always we consider certain assets as the security or as the collateral. So, whenever we give the collateral the collaterals value and your loan value there is a difference and always the value of the collateral should be more than the loan value. So, that amount is called the margin.

So, the margin basically differs from security to security and the major principles which determine its it or marketability, there accertainability of the value, stability of the value and transferability of the title of that particular security. For example, if you see if you are using gold as instrument than 10 percent is the margin, if you are using gold ornaments then it is 20 to 30 percent of the margin.

If you are using government and other securities then it is 10 percent, if you are using your equity ordinary shares it is 40 to 50 percent, if you are using preference share is 25 percent, if it is debenture it is 15 to 20 percent. Life insurance policies 90 percent of the surrender value, commodities 25 to 50 percent and any kind of immovable property that is 50 percent, land and all this things if you are using that mortgage.

Than the value of the total land always should be 50 percent always we considered the 50 percent of total that will be sanctioned amount for your loan. So, these are the margins which has been used and why this kind of margin concept is used because to avoid any kind of loss valuation of that particular asset. So, if there is a possibility that valuation of that particular asset may go down.

So, depending upon that from the beginning bank take the precautionary approach to keep that particular margin by that any point of time if loss any if you are the defaulter and the particular asset can be sold in the market then that should not offered the total amount recovered from that particular loan. So, this is what basically the margin and further will be discussing about the performance of the commercial bank and how it is measured. Please go through this particular references for this particular session.

Thank you.