Management of Commercial Banking
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Importance and Forms of Commercial Banks
Lecture 01

Good morning. So, today we will start discussing about the first module of our course, which will be dealing with the functions, the importance, regulations and the financial statement, performance of commercial banks and before we discuss about the functions, regulations, financial statements and performance we should know that what exactly the bank is?

Or how we can define the bank? How we can define the commercial bank and as well as why the banks are so important? What is the economic significance of the commercial banks from the aggregate economic point of view? That is also very much required whenever we discuss about the management of commercial banking.

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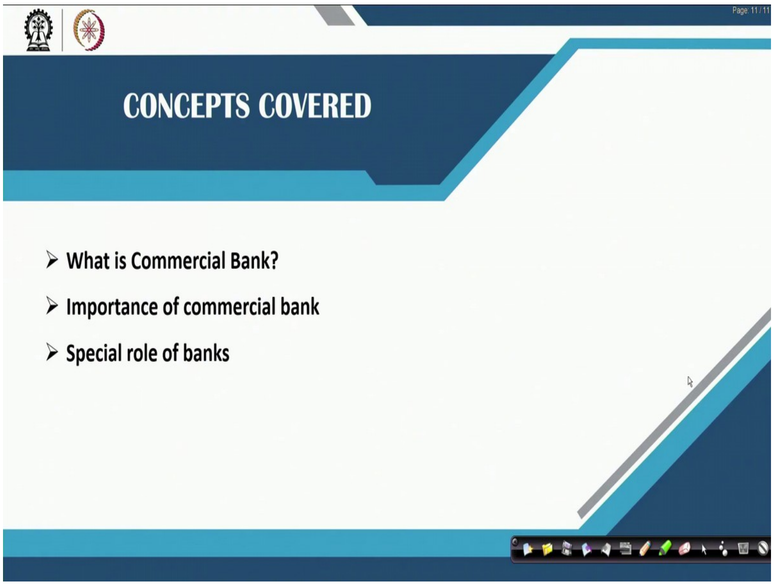

So, in this context if you see that these are the things what we are going to cover today in this particular session, one is how to define commercial bank and what are those different types of commercial banks are operating in India, and why the banks are important or the importance of the commercial bank.

Then why the banks are so special, because there are many intermediaries which work in the system, but still the bank always plays a very prominent role in comparison to the other financial institutions which operate in this financial system for any economy, not only the developing economy, both developed and developing economy we can see that the banks always play a very significant role or the banks are so special among all those intermediaries what we always operate, and what we see in the financial system.

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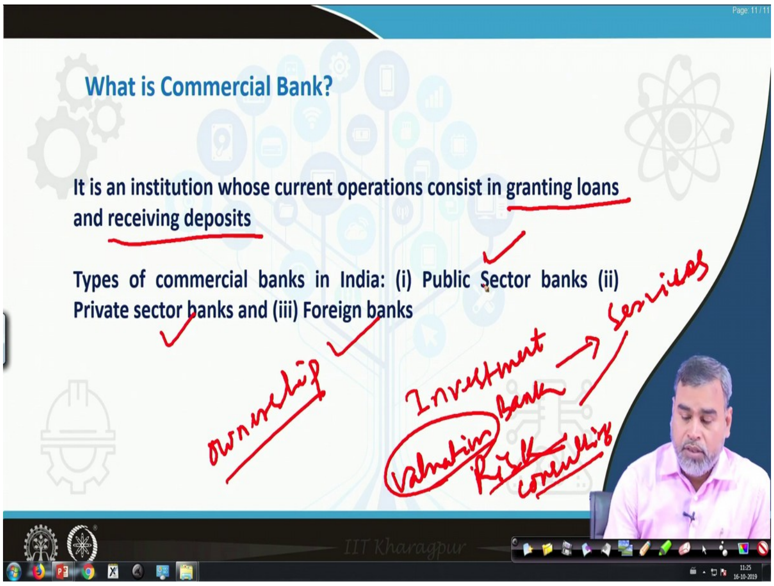

So, in this context let us define this commercial bank. All of you might have known that whenever we talk about banking there are many types of banks exist in the system. One is we can have the commercial bank obviously, then another bank is investment bank. Then we have some banks which are cooperative banks. Then you have the regional rural banks. Then all those banks if you talk about, but basically there is a clear cut distinction between the commercial bank and the investment bank. And what is the basic distinction?

The basic distinction is the investment banks do not accept the deposits. The basic jobs of the investment banks are to provide the consulting or the risk management services and as well as they provide also financing to the corporates for some specific reasons. Mostly the investment banks always provide the services like pricing of the IPO or they provide services in terms of the valuation of, in terms of mergers and acquisitions. So, if you see that basically this, if you talk about the investment bank, the investment bank is basically what?

It is mostly dealing with the services, services in terms of the risk management, and we can have the consulting, valuation services etcetera. So, that means whenever any company goes for IPO and all these things they always take the services of the investment banks or the merger banks what we call them, and they also provide the risk management services and the different type of consulting activities or any kind of mergers and takeover if it happens in the market, so then also those type of banks help in terms of the valuations.

So these are the basic job or basic functions of the investment banking. But whenever you talk about the commercial bank, the commercial banks basically take the deposits and they also provide the loans but the investment banks do not take the deposits. So, their operation is mostly confined to a particular segment which deals with, mostly the financial services but they do not have their own deposit base from where they can utilize that money for the loan and other things.

So, therefore the basic job of the commercial bank is granting the loans, providing the loans and they are receiving the deposits. So, these are the two major functions the commercial banks always do. So, here if you observe for the common people point of view, for common investor's point of view or the common stakeholders in the financial system point of view, if you see the commercial banks play a very significant role because these are the two basic things always we require in the financial system for many reasons.

We need money for investment, we need money for buying the houses and also we want to keep our money in the banks to get certain amount of returns. So, keeping those things in the mind that commercial banks basically, always have a very significant role in the financial system as a whole. Talking about the commercial banks in India, so there are many types of banks. Already, I told you we have the commercial banks in general like nationalized banks and all, and then we have also the banks like regional rural banks. Then we have also the banks like cooperative banks and all.

But our major focus is on the typical commercial banks which are prominent, which are operating in the system and which basically always we deal with in the day-to-day life. So, if you define those banks or if you see those banks which are operating in the system there are three types of banks which basically operate in the economy. One is the public sector banks, and second one is your private sector banks, and third one is foreign banks. And the other name RBI sometimes call them the foreign direct investment banks.

So here, what is the, how basically these classifications are made? These classifications are made on the basis of the ownership. That means whenever you talk about the public sector banks, mostly the public sector banks are owned by the government or the majority of the stake always the government has and whenever you talk about the private sector banks, the private sector banks ownership pattern is mostly different from the public sector bank because it is mostly dominated by the different private stakeholders or private shareholders.

And foreign banks, basically what, they are not the banks which are the parent banks which are existing in India. These are basically the different type of banks which parent bank is there somewhere in other countries but they do the operations in terms of their branch expansion and all these things in the Indian economy. So, therefore in terms of ownership, popularly the banks are defined in these three ways, the public sector, private sector and foreign banks which work in this particular system.

So this is what basically the banks are defined. This is the way the different types of banks which operate in the economic system or in the financial system in particular. Then moving to the other things that how basically this system works.

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Or how the commercial banks basically play a role for the aggregate economy or the development or the growth of the economy? All of you know that all type of transactions, whether it is a stock market transactions or whether it is a day-to-day transactions or it is any kind of activities where we need or we use the money, for everything the payment gateway is the commercial banks. The payment gateway means all the transactions are made through that particular bank.

So, bank is responsible to fulfill that transaction between buyers and sellers, between savers and investors, and all type of stakeholders which basically have the significance in the financial system. So, therefore, the commercial banks play a significant role in terms of the payment mechanism because this is the payment gateway for all type of transactions which are happening in the economy.

And second part, if you see second point, the commercial banks is the important part of monetary transmission mechanism. What do we mean by this monetary transmission mechanism? All of you know about Monetary Policy. So whenever you talk about monetary policy, so in the monetary policy sense, what basically the, what is the mechanism through which the money can be flown from one particular segment to another segment?

So, the basic objective of the monetary policy is we can use some instruments, like the instruments are the interest rates, the interest rate is the instrument. Then it will have the impact upon the money supply and if the money supply gets affected then the investment gets affected. The investment gets affected then that will have the impact on the output or the growth. So this particular channel is called the monetary transmission mechanism.

So, let us take the example from India. So here in the Indian context the major instrument is rate, Repo rate. So, if we change the Repo rate, either you can increase or decrease the Repo rate then the Repo rate will have the impact on the market interest rate, the market interest rate in the sense, in Indian context our target rate is call money rate.

So, if the call money rate gets affected then obviously your lending rates of the banks get affected. So, if the lending rates get affected then obviously what will happen? The lending rate will have the impact on the bank credit. It will have the impact on the bank credit. If the bank credit gets affected then the money supply gets affected. If the money supply gets affected then obviously your investment gets affected. So, then finally your output gets affected.

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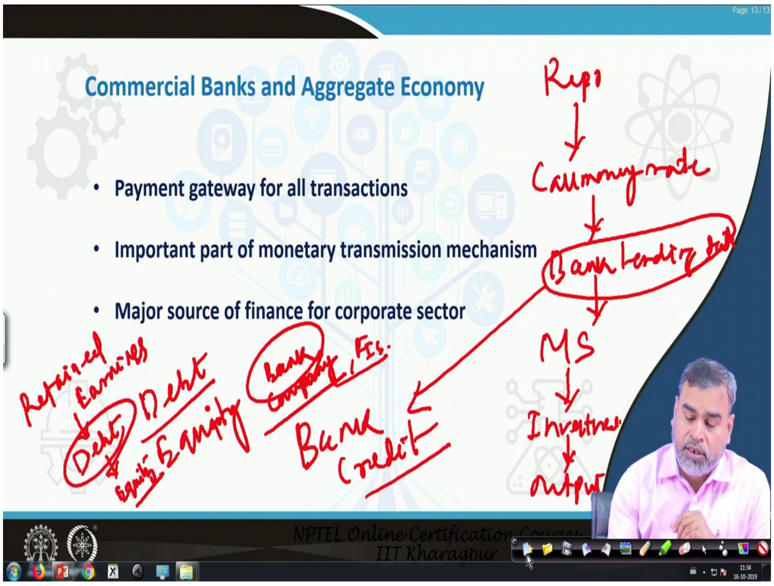

So, in summary very clearly I can tell you that you have the Repo, change in the Repo, Repo will have the impact on the call money rate. So if the call money rate gets affected then your bank lending rates gets affected. So if the bank lending rate gets affected then it will have the impact on the money supply. Money supply gets affected this will affect the investment then finally it will have the impact on the output.

So, you see here it is the bank lending. So, if the bank lending get affected then obviously lending rate will have the impact on the bank credit or the loan. So, in general what basically we have observed that in the transmission mechanism process particularly the monetary transmission mechanism process the commercial banks play very significant role because the money supply in the economy, this is one of the channels. In this process the money supply of the economy gets affected.

So if the money supply gets affected then obviously it will have the impact on both investment and as well as the output and also the price, inflation. The price change also happens through this. So in this context what we can say, so therefore what we can conclude that bank is integral part of the transmission mechanism of the monetary policy for any economy because bank credit channel is a very powerful channel through which the money supply in the economy can be controlled or can be changed. So, therefore, it has very strong impact on the economic growth process.

And the third one is another thing that it is also a major source for the corporate sector. What does it basically mean? It means that whenever any companies invest in the market, so they need certain kind of financing and what are those different type of financing? Mostly the prominent type of financing is the debt and equity. So, as per our theories what basically the companies do and what is the most suitable and reliable sources for them?

First basically what they will do, they will rely on their own profit. In our language we call it the retained earnings. First the retained earnings gets, will be utilized. So, if the retained earnings is not sufficient they will go for the loan or debt financing. Still it is not sufficient then they will go for the equity financing. But whenever you talk about the debt financing, the debt financing there are many sources through which the financing can be made.

One of the sources is bank. It can be another company or any other financial institutions but what basically we have observed that the always the companies prefer the bank financing. So that is why first whenever they need any kind of debt financing the companies first prefer the bank financing. If still again it is not sufficient to cover up their deficit financing activities then they can rely upon the other financial institutions in the market.

So, therefore, the commercial bank financing is a very prominent source of financing for financing the corporate sector. So, there are other reasons also, commercial banks financing or commercial bank plays a very significant role in the financial inclusion process because the banks are available to everybody in the economic system and all. So, overall if you see what we can conclude, we can conclude that commercial banks really play a significant role in the economic growth process in the aggregate sense.

So, therefore, it has its own importance; it has its own significance. So, therefore, always it is desirable that banks should be sound. It should be efficient. It should be stable. So by that we can say that our economic system, particularly the financial system in the economy will be robust and we are less prone to any kind of instability in the economic system. So, this is what basically always gives you the idea that how the banks are really important in the financial system as a whole.

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Then next if you see that we have two types of systems operate in the economy in general in the world economic sense or in the all over the world if you observe there are two types of systems operate. One is your bank based economy and another one is the market based economy. There are certain advantage and there are some disadvantage also. Whenever we talk about the bank based economy, mostly our reliance on all type of the transactions in the financial system are done through banks only.

But whenever you talk about the market based system, in the market based system always we may not rely upon only the banks. We also give equal importance to the other financial institutions including the capital market and all. So, what has been observed, if you go back to 1980s and all, if you observe, the bank based economies are what? The bank based economies are mostly if you see, these are Japan, we have Germany, we have India.

So, these are the prominent bank based economy exist in the world. In 1980s if you see the growth rate of Japan, Germany and all, they enjoy very high growth rate in comparison to the other market based economy like USA. Why? Why we can say the bank based economies were performing better or they have certain advantage over the market based economy? The reason is that the bank based economy is basically is good in dealing with non-diversifiable risk. What do you mean by the non-diversifiable risk?

I hope all of you might have known there are two types of risk, one is systematic and another one is unsystematic. Systematic risk is basically what, which is nothing but the market risk which cannot be diversified. And another one is non-diversifiable risk which is unsystematic risk which is specific to the individual entity. It may be a company or it may be any kind of organization, this particular risk is specific or confined to that particular company itself.

So, therefore, what basically we can say that whenever we are dealing with non-diversifiable risk, so in that context see, there are many products which are available in the market. But banks provide many products also. So, whenever the banks product people are using for their portfolio construction, reasonably they are well-equipped to deal with any kinds of fluctuations in the aggregate economy like your inflation, interest rate etcetera.

In comparison to, if the portfolio is constructed by using mostly the risky products like equity, derivatives instrument and other things. So, therefore because they are good in dealing with, the banks are good in dealing with non-diversifiable risk then obviously the probability of loss in that particular segments are relatively less. So, that is the major reason that why the bank based economy are basically good in terms of enhancing that growth rate.

And it is also observed in the market oriented economy many people invest in equity. More than 50 percent investments are made in equity and as we know that equity investments are considered to be the risky investments. Why they invest in equity? Because the other products which are mostly the fixed income securities products or the less-risky products which are provided by the banks, they may not be adequately available to be considered in their portfolio.

But whenever you talk about the bank based economy, because bank is important and they play the most vital role in the economy growth process, the products are available in plenty. So, because the products are available in plenty then what happens? In those kind of economy the investments can be more diversified or people can choose their investment on the basis of their objective or on the basis of their requirements.

So, that is why the reliance on equity is relatively less in the market-oriented economy because the availability of the other products which are provided by the banks, these are also available in plenty. Then bank based economy is also better in inter-temporal risk sharing. What do you mean by this inter-temporal risk sharing? Because whenever we have the different segments which operate in the market, for example we can say that there is inter-temporal gap always happens.

Why there is inter-temporal gap? Because on the basis of your objective your instruments may not be available in existing system. So whenever any retired people want to invest some money, so he or she may not be interested to invest the money in the equity market. He may be or she may be interested more to get some fixed amount of return at a reasonable period of time. So, because of that he can or she can make the future better.

So, that is why if he is in little bit higher income category he can put some money in the risky segments but still the risk can be shared because the banks basically are available which provide them some assured kind of return. And even if it takes some more risks in the financial system that basically does not affect much because the risk can be shared by the other types of positions what he has taken in the market.

But there is one disadvantage, the disadvantage is that the bank based economies are mostly conservative economies. Because of their conservative nature, because of their approach is little bit conservative, sometimes those banks do not finance to those companies which are relatively in the risky business or the business is not established, or the technology what the company is going to use that is not known to the banks, may be they reliance upon more new technology.

So, that is why the bank based economy is good at financing the new technologies. Sometimes that is a questionable or debatable thing, that whether really they are good or not. So, in that sense what basically we are talking about, this, sometimes some people argue that the banks basically provide the finance for the business where there is chance of growing but it is also observed, sometimes the bank based economies are not providing the finance whenever the technology what the company is going to use, that is relatively risky.

So therefore, the last point if you see, that is basically a debatable question, a debatable point that whether the bank based economy is good or not, that to finance these new technologies, still the debate is going on but in general acceptable if you see, they are relatively conservative in nature and sometimes they do not provide. That means you can say sometimes you can add that bank based economy is not good.

That is why I say that this is a disadvantage. You can say that although some people argue that bank financing is available for them but the bank based economy is not good at financing the new technology that is also one acceptable argument always you can consider. So this is what about the difference between the bank based economy and the market based economy.

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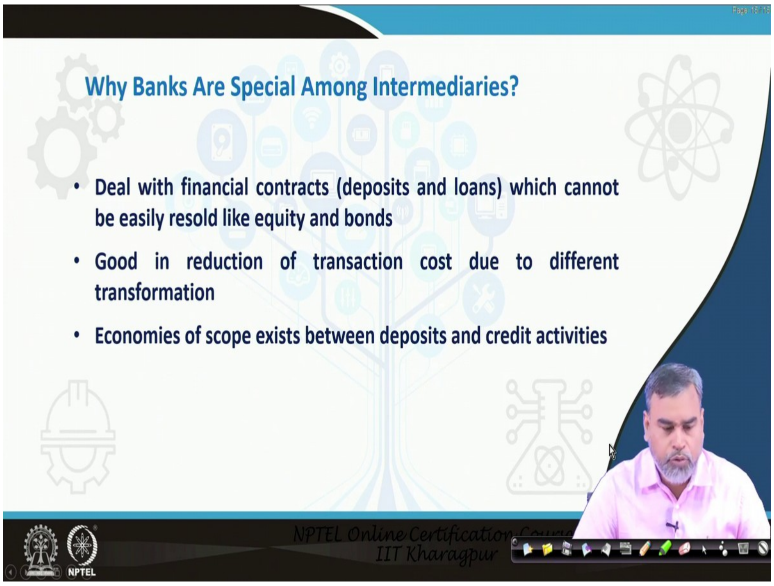

So, then we can move to that why the banks are special? The banks are special because they are good in, they deal with the financial contracts which cannot be easily resold by equity and bonds because you see, deposits and loans, these are not the marketable products. These are the non-marketable products. Because they are non-marketable products they are not easily resold in the market or they do not have a secondary market for that. But banks always deal with that kind of transactions, those kind of contracts, number 1.

They are also good in reduction of transaction costs due to different type of transformation. What kind of transformation? If you see there are many transformation they do, like quality transformation, maturity transformation and all these things. And there is economies of scope exist between deposits and credit activities because there are many products which are available by the commercial banks or provided by the commercial banks for investment in the market.

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So, already I told you that what are those sources of economies of scope and scale because there are large number of products provided by the commercial banks, number 1. And they have the expertise in managing the liquidity risk in the system. And they are able to diversify the investment in the market because of the existence of the more products which fulfill the requirement of the customers from the different perspectives.

So that is why proper diversification, expertise in managing liquidity risk and availability of the large number of products, these are the major sources of economies of scope and scale in the banking sector.

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What are those major factors which affect the banking activities in general? You see these are the general factors. There may be some factors which are unique in nature. Obviously we have inflation. If there is inflation then banking activities gets affected because if the price level is high then obviously there is an impact on interest rate. If the interest rate gets affected then the bank loans and as well as deposits gets affected and because of that the banking activities gets affected.

Then we have the technology, if there is technology then obviously there is a huge change in the recent era because of online transactions and all kind of digitalization in the banking sector. The importance of the banks have gone up. Many people who are not doing, dealing with the banking business, now they are all comfortable with this kind of thing or the bank transactions or use of the banks day by day has increased.

Consumer's preference in the sense what we talk about, the consumers may be more inclined towards the banking because they have more reliance, they feel that banks are safe for the investment and all, for dealing with the transactions and all. Then you have globalization. In the globalized era because the markets are integrated and we are dealing with the world economy at a particular point of time then the banks are the major institutions which provide the incentive or provide the platform for those kind of transactions easily. So because of that globalization is a major factor which is affecting the banking activities in the system.

Then we have another factor is competition. Competition means I am talking about the market structures. The market structures are important also. For monopoly market, perfectly competitive market and all these things, these are also affecting the banking activities.

Whether the banking sector is a monopolistic market or is a monopoly market or is a perfect market that also affects the performance or the activities of the commercial banks.

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So, there are many other financial institutions, the list is a long list. All of you know that. We have mutual funds, we have hedge funds, we have investment banks already I told you. Then we have the finance companies. These are the different entities who are basically the leading competitors of commercial bank. But still commercial banks deal with those kind of thing and make their positions an unique position in the economic system because the availability, accessibility all kinds of things are more in the context of commercial banks than the other type of entities which exist in the financial system as a whole.

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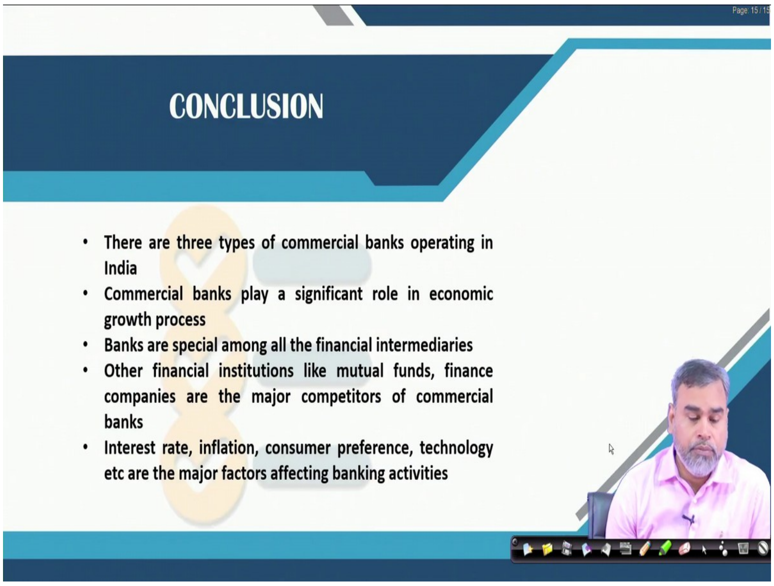

So then if you conclude then what are those things what we can get from this particular discussion? There are three types of commercial banks which are operating in India on the basis of their ownership. Mostly they are more popular in that sense, public, private and foreign and commercial banks play significant role in economic growth process because they are the integral part of monetary policy. They also provide the financing to the corporates. And they are also payment gateway for all type of transactions and all.

Banks are special among all financial intermediaries; the reason is basically because of economies of scale, economies of scope and because of their expertise for the risk management and all. Then the other financial institutions like mutual fund, finance companies, hedge funds these are the major competitors of the commercial banks because they provide the same type of financial services, where you can put your money for maximizing your return and all.

And interest rate, inflation, consumer preference, technology these are the major factors which affect the commercial banking activities in a financial system as a whole. These particular factors is not confined to a particular economy. These factors are important for all the commercial banks which are operating in any of the economies in the world, whether it is a developed economy or developing economy. So, these are the major conclusions what you can draw from this discussion.

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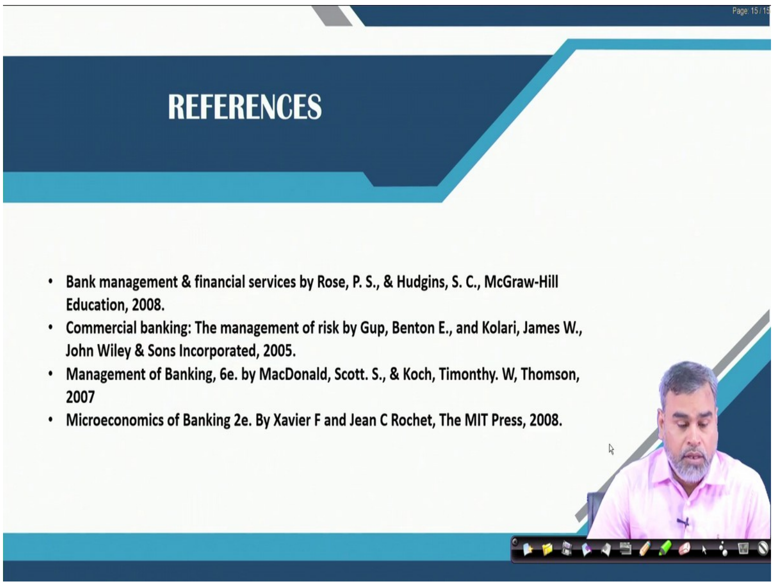

These are the references you can go through for the detailed analysis or maybe you can read out more about those issues whatever we have discussed and you can come to know that how the banks really play a significant role in the economic growth process. Thank you.