Management of Commercial Banking
Professor Jitendra Mahakud
Department of Humanities and Social Sciences
Indian Institute of Technology Kharagpur
Lecture 02
Functions, Goals and Constraints of Commercial Banks

So, after the discussion on the importance of the commercial banks and how exactly the commercial banks plays the significant role in the economy growth process today will be discussing about the function, the goals and constraints towards the commercial banks face whenever they operate in an economy system.

So, if you see that we know that there are many practical functions always commercial banks has, they provide deposits services to the customers, that means we keep the money in the bank for the safety and as well as to get some returns. We get the loans from the commercial banks. Commercial banks provide some kind of risk management or the services and all but in a theoretical point of view or in a broad classification if you make, the function are defined in different ways.

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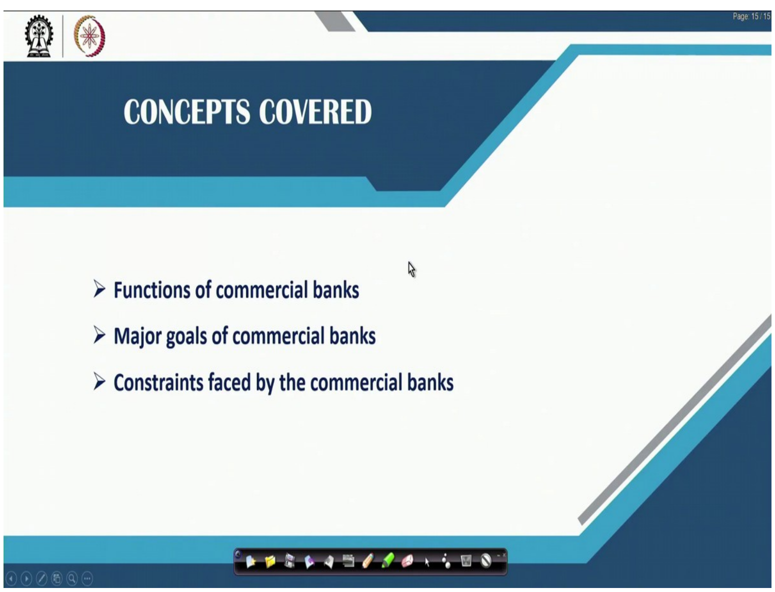

So, how these functions are basically defined that will be discuss in today, so today what are those things we will be covering up. One is your functions of commercial banks. What exactly the commercial banks do in a broader prospective? What are those major goals the commercial banks have? What really the objective of the commercial banks and what are those constraints basically they face? So, one is the functions, second one is the goals and third one is the constraints. So, these are the 3 major issues what we are going to discuss today.

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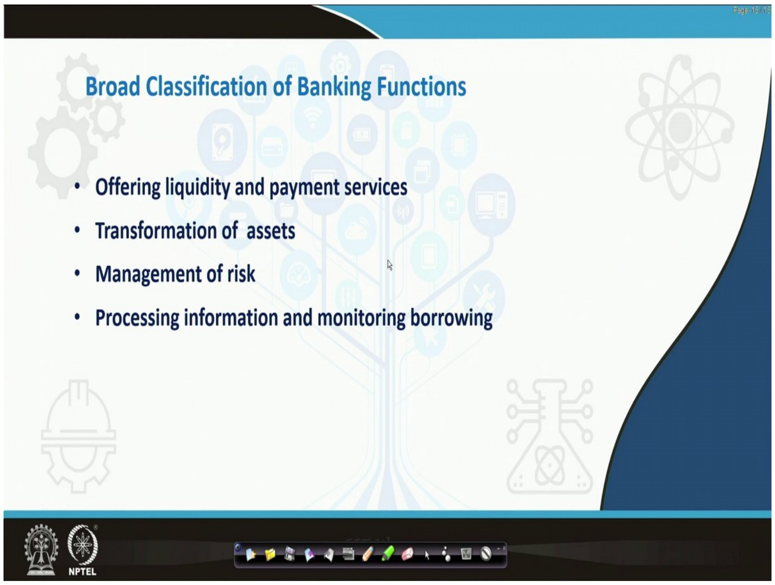

So, if you classify the banking functions broadly there are 4 different kinds of functions the commercial banks provides. You see that what are those major functions the commercial banks provide. The commercial banks provide the liquidity and also the payments services.

The payment services in the previous session I have discussed with you that what do you mean by the payment services because for all types of transactions the payments are made through commercial banks only. Then how the liquidity comes and what do you mean by liquidity? The liquidity is how fast we can convert a particular instrument into the cash. And the liquidity is basically related to the policy in this context.

Because the commercial banks plays a significant role in the monetary policy process, the money which is basically always floated to the market, all those money which comes to the market that basically comes through the commercial banks only because they are the only payments gateway system in the economy. And they are able to transform the asset that we will discuss and elaborate.

They are able to manage the different type of risk. They manage the risk because for better functioning of the system, because bank face many types of risk and the commercial bank have the ability to manage those risk in an effective manner. And they are very good in processing the information and monitoring the borrower. In comparison to other entities they have the expertise for processing, the information what they need or what they have and as well as the monitoring the borrower who have basically taken the money from them for the different type of activities. So, these are the things, basically the broad things what we can observe whenever you talk about the banking functions.

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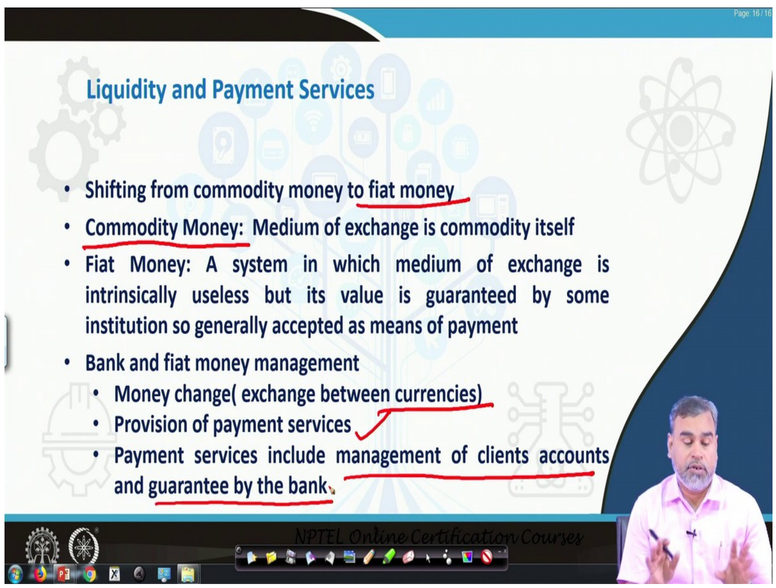

So, one by one if you discuss, you see the liquidity and payment services. How the banks are basically able to provide? You go back to the barter system, that time what was happening? The medium of the exchange is commodity itself. Somebody is producing wheat and somebody is making pots, you gave them the wheat and get the pots from them and that person basically need wheat that is why he takes the wheat from you and give you the pot.

So, the medium of exchange if you see that was commodity only so because of that at that time we call this is the commodity money. So, there was, there is no general medium of exchanges but over the period of time there has been a shift from commodity money to fiat money. The commodity can be anything, the commodity can be barter system, it can be any commodity, over the period it has been converted into silver, gold and all these thing the medium of exchange was that, any kind of precious metals and all.

But after that in today's modern era we are dealing with the fiat money. And what do you mean by this fiat money? A fiat money is basically what? It is basically a system in which the medium of exchange is intrinsically useless, but its value is guaranteed by some institution so generally accepted as means of payment.

Why we call that intrinsically useless? You see take the 2000 rupees note, if you see the 2000 rupees note, the 2000 rupees note, it is a small paper. The in the literary sense what is the cost for making that particular 2000 rupees note? It is very minimal that mean the intrinsic value of that particular note is very less, it is hardly 2 rupees, 3 rupees cost.

But the market value of that particular 2000 rupees note is 2000 rupees and why it is so, why the market value is 2000 rupees because it is guaranteed by some institution and in our case it is guaranteed by Reserve Bank of India. The Reserve Bank of India has given the guarantee that this value of that particular small paper is 2000 rupees and this 2000 rupees note will be accepted by everybody, it has a general acceptability that the value of this particular paper is 2000 rupees in the markets.

So, you can use it for transactions and whoever and wherever you are going to use it, the value is the same. So, therefore whenever the fiat money has come in to the existence, then who will provide, who will guarantee, and which particular organization will be dealing with this kind of transactions, this kind of fiat money.

So, in that particular context what has happened, the importance of the commercial banks or the major job of the commercial bank is to provide that services. So, the money which coming from the Reserve Bank of India or any central bank, that has been transacted through the commercial bank and in terms of fiat money. So, that fiat money is utilized in the market for all type of transaction purpose.

So, that is what, that is why they provide the liquidity in the system and how they provide the system, how they manage it? You see whenever we talk about this kind of transaction, if you observe, first one is through that in the globalize scenario, we can exchange between the different currencies. Let us somebody went to US, they want dollar, somebody coming from US to India, they need rupee. So, in that sense who are basically responsible entities, responsible organizations who provide these kind of services, that means exchange between the currencies.

That is basically provided by the commercial banks. The major job of the commercial banks is to provide that services. Already I told you payment services, they provide. And what do you mean by the payment services? The payment services include management of the client's account and guarantee by the bank. What does it mean? The depositor is a client in the commercial bank. The person who has taken the loan, they are also the client of the bank.

So, they maintain both the depositor's account and the loan's account and sometimes at the times of requirement they provide very unique services, like they provide the guarantee on behalf of the client for some future transactions, that we will over the session, different sessions will discuss and elaborate but whenever we talk about this, the different products whenever the commercial bank provide or different services they provide through that it facilitate the payment systems or payment services in the economy.

Not only they maintain the deposit and loan accounts they provide also the other services which are not provided by any other financial institutions, which are existing in the economy. So, therefore it has its own significance, this is basically in terms of liquidity and payment services.

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Then next one is asset transformation. The major job or major function of the commercial bank is asset transformation. The asset, what do you mean by the asset transformation? The asset transformation can be defined in many ways. First of all the convenience of denomination, I was talking about the 2000 rupees note. You have 2000 rupees note, you have 500 rupees note you have, 200 rupees note, you have 100 rupees note, you have 50 rupees note, you have 20 rupees note, 10 rupees note, 10 rupees coin, 5 rupees coin, there are many denominations.

And why this denominations are available? Because the requirement of the different clients are different and that basically helps the clients for the better transaction in the market. So, who basically provides that kind of services? That services is provided by commercial banks only. If you want a change you go to bank, get your money encashed or get the change from them. So, like that the fiat money which is available in the system in the different denominations, that is basically possible because the commercial bank provides that service number one.

Number two, if you minutely observe there is another service that provide that is called quality transformation. What is quality transformation? The quality transformation is, because the bank deposits offer better risk-return characteristics than direct investment to diversify the portfolio. You see many people are not inclined to take more risk or if you are only relying upon the direct investments in equity market or bond market, you may not exactly get on the basis the return on the basis of your expectations.

But with the bank deposit, there are variety of deposits what the bank provides. Because of availability of that you can have a combination, you can put some money in the bank deposits, you can put some money in the corporate debt market, you can put some money in the equity market, by that what happen, what generally happens your portfolio is really in the true sense can be diversify.

A minimum amount of return can be guaranteed, which is basically we call it the quality transformation. Because of availability of the many deposits products or many loan products, your total portfolio of the individual can be properly diversified. And another thing is the banks are always enjoy more information than depositors, you see whenever I am depositing the money, I have, I may not have that much financial expertise to know about the market in a better way but banks have.

Because banks have better information than clients and depositors and other peoples, then they are a better judge to decide that where the money should put. So, because of that what happens sometimes rely more on the banks or we have lot of reliance on the banks that if the bank has approved that particular project then putting the money in that project is not risky because our reliance, our faith in the banks is better because banks enjoys or banks have always more information than the clients because they are good in that.

Another is maturity transformation. What do you mean by maturity transformation? The maturity transformation is basically you might have observe you see whenever we have the deposits, our deposit maturity period is not very long, because the fixed deposit maximum period is 3 years, people do not keep money more than that. And saving deposit there is no maturity but whenever we take loans, you take a house loan the loan period maybe 20 years, 15 years like that. You take a vehicle loan which is 7 years, 5 years, etcetera.

But how the bank provide long loans out of short term deposit, because the deposit can be demanded at any point of time. The costumer can go to the bank, and they can withdraw their money at any point of time, but that is why the banks are basically really competent enough to transform that short maturity deposit to the long maturity loans. They manage their asset which is a major focus of this particular subject that how the banks are really manage their asset and liabilities.

By that they are not basically suffering from any kind of bigger losses or any kind of misbalance between asset and liabilities in the adverse conditions. And that is basically why they are able to transform that short maturity deposits into the long maturity loans which may not be possible by the other entities in the financial system. So that is the way basically the asset are transformed by the commercial banks in terms of quality and as well as in terms of the maturity. This is what basically always happens in the financial system, particularly in the commercial banks in general.

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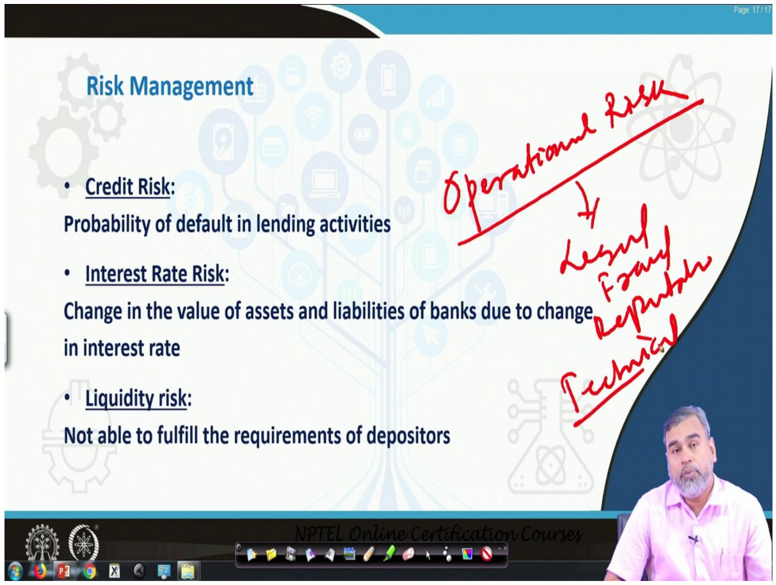

They are also good in providing risk management. They manage the risk in a better way. There are many types of risk we have, one is credit risk, interest rate risk, liquidity risk and now-a-days also we have another risk which is not mentioned here, we have also the operational risk, right? So, operational risk includes your legal risk, fraud, reputation, etcetera many thing, technical risk, etcetera.

So, the banks are really good in managing those risks. What do you mean by credit risk if the probability of default in lending activities. Interest rate risk means the change in the value of assets and liabilities due to the change in interest rate. Liquidity means that any point of time depositor can go to the bank and can wants to withdraw the money, if the bank is not able to pay them, then that creates certain kind of negative sentiment in the mind of the clients and that again lead to some kind of bigger implications in the market.

So, because of that the banks also manage their position in such a way that this kind of situation never arise in the system. So, operational risk obviously, this is basically related to efficiency and all this things, that banks always try to manage. So, the banks are always managing the risk in a different way or in a better way than the other kind of institutions which exist in the systems.

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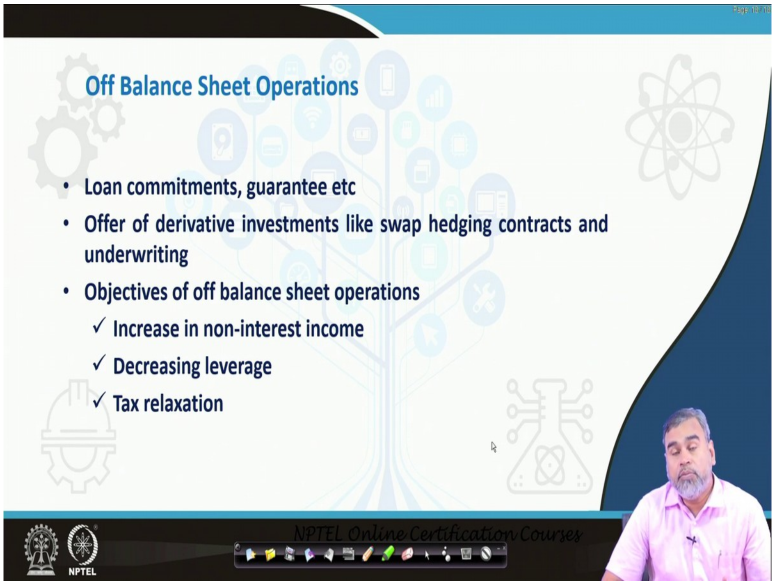

You see that whenever you talk about this we have also another thing, we have call it off balance sheet operations. Banks also apart from this kind of services, like taking deposits and providing loans. They also provide other type of services like they can have a commitments, they can provide the overdrafts facility, they can have some kind of commitment to some kind of persons and some kind of stake holder that they will pay on behalf of you there is some kind of situation or some kind of default arises.

They provide guarantees that so and so will pay the money in future that is what bank is the guarantor, and if that person does not pay then the bank will pay. So, for that banks charges very minimal money but this kind of services banks provide. These are not the part of balance sheet, these are the off balance sheet items. Banks also now-a-days putting the money in the different derivative instruments like a swap like underwriting services like your options, the futures and all this things.

So, that is another way they can generate some revenue. Although they are all the risky propositions, those kind of process is relatively risky, but still the banks basically wants to provide this kind of services. And what is the objective? Why the banks do that? The banks basically do that because in this scenario there are 2 major sources of income of the bank, one is through interest and another one is through, there are some non-interest income.

And now-a-days the scenario is going to change because of the dynamics or the globalization or the process or the requirement and the attitude of the investors or the market participants and as well as the complexity in the system has grown up. The banks are also now-a-days able to maximize their turn or maximize their income through the non-interest related activities or basically majority person also banks can generate and increase their revenue through the non-interest income.

So, these are the different sources through which the non-interest income can be enhanced. They can reduce the leverage; leverage means the equity to the total assets what the bank has because through this income they can increase the return earnings. So, if those things will happen then they can also, they are able to decline the leverage which is basically part of the liability of the commercial banks.

And also they can invest in such a way by that some kind of relaxation in terms of tax also they can enjoy. So, the off balance sheet items are quite important from bank operation point of view or banking point of view, which gives you the idea that how the off balance sheet operation of the commercial banks help the banks to improve their performance and as well as the revenue.

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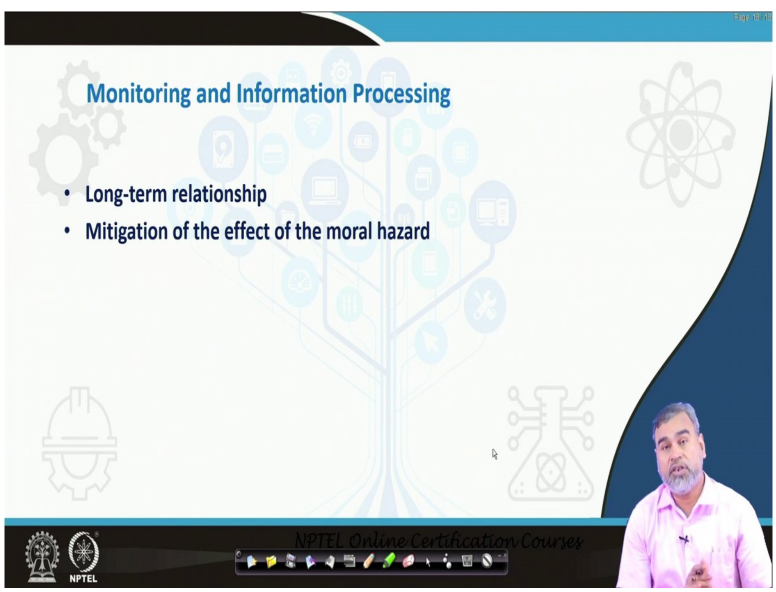

Then another important thing is already I told you they are good in monitoring and information processing. You see how the bank are really able to maintain that, the major reason or major point in this particular context is the client and bank's relationship is very long term. Because of long term relationship with the clients the banks are able to extract more information or relevant information from the clients in a better way.

And banks have the ability to analyze that information in such a way that any kind of problem, if there is a probability of problem in the future is there, then the bank can realise these things from the beginning. That's why the because of their economies of scale, the availability of the banks are more because they have the expertise in terms of assessing the information and getting the information in a better way, and because they maintain a long term relationship with the clients, they are able to monitor the borrower in an effective way.

And because of the monitoring and assessing the information and analyzing the information in a effective or better way, it is easy for the banks to manage the risk, to manage any kind of adverse situations in an effective manner than any kind of financial system or any kind of financial institutions which operate in the financial system as a whole. You know we have a moral hazard problem always operate or we observe in the financial system.

What do you mean by moral hazard? We are doing something which is morally correct but it is hazardous to somebody else or to some other kind of stake holders. For example, and why the moral hazard happens? Moral hazard happens because of adverse selection. I can give you example, let bank has given the loan, if the bank has given a loan to somebody and the person is really not eligible to get the loan, but to provide that loan to somebody has relaxed the criteria.

Then what has happened, they have adversely selected that individual. If they have adversely selected that individual, then the probability of default of that particular person maybe higher in the future, if really this particular person or particular organization does not repay the loan then that will be consider as an NPA and that NPA does not affect only to the bank, it also has the implication on the other clients of the bank, because if the bank performance goes down then it will have a kind of spiral impact on the different other entities, other stake holders which are linked to the bank.

So, that is why because they are able to access the data in a better way and they are able to analyze the data in a better way, they always try to reduce that adverse selection problem and the moral hazard issues. So, that is why they follow a very stringent and a conservative approach, loan (operate) loan processing data whatever they get or the credit appraisal whenever they make, those thing basically they make it in a very stringent way.

We will discuss and elaborate what exactly the credit appraisal processes and all in the coming session. But you see because of that expertise what happens, they are able to mitigate this kind of moral hazard problem in the system which supposed to create a bigger problem for the clients and as well as stake holder which are linked to this commercial bank.

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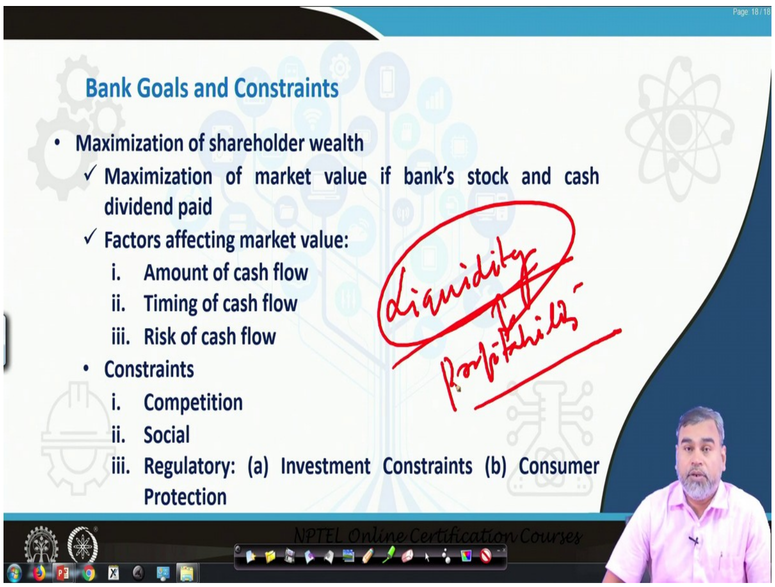

If you see about the different goals of the, what basically the commercial banks want? You see everybody knows that organization has a common goal, they want to maximize the shareholder's wealth. But there are some other goals also. For banks you see another major goal is bank wants to maintain the liquidity also because for a company prospective, liquidity is not very important. But for banking prospective liquidity is important.

Because they have to fulfil the requirement of the costumers but another thing you remember the profitability, your profitability and liquidity, they do not go together. If you want to increase the profitability to satisfy your stakeholders, satisfy your equity holders then your liquidity gets hampered, because you want to invest your money and you do not have to keep them reserve. If you keep the reserve to maintain the liquidity requirements, then your profitability gets hampered.

So, but still the banks are good in that. They maintain both in a very effective way. By that both profitability and liquidity of the commercial banks are maintained. So, that is why the banking business is relatively tricky or more complex than the business in the corporate sector, in general other nonfinancial company.

So, if you talk about this whenever they want to maximize the shareholder’s wealth, what basically they want to do? They want to maximize the market value of the bank stock and the dividend if they are paying to the stakeholders or to the equity holders. What are those factors which affect that? The amount of cash flow, the timing of the cash flow and the risk of the cash flow.

What does it mean? There are many factors which affect these dividends and as well as the capital gain, which is a component of this particular return. There are many external factors and there are many internal factors, which are specific to the bank itself. So, bank has to take a cautious of move that what is the timing? When this particular cash flow should be there? And how the cash flow out, both inward and outward cash flow can be maximized depending upon the different market conditions.

So, because the inflation, interest rate etcetera, they also affect the cash flow of that particular segments. So, the bank should take a cautious move or basically their strategy should be made in such a way by that the value of the bank stock and as well as dividend can be maximized and the probability of default against that particular loans and all of these things should be less, by that the profitability can be increased or can be enhanced and as well as the liquidity can be maintained, by that the shareholder’s wealth can be maximized.

But to fulfil that bank faces lot of competition. There are many constraints they face. First one is competition. You see all of you know that if the banking structure or the industry is perfectly competitive then profit will be less, because in the perfectly competitive market we always get a normal profit. Super normal profit is not available in this particular segment or we are not able to derive that in this particular segment, because there are many.

Why it is competitive? Because there are many banks or there are many buyers and many sellers which exits in this systems. So, because of that we have to be seen that in what kind of market structure the bank is operating. There are some social constraints. There are many types of banking we have. We have Islamic banking, we have other type of banking. The social constraint, the social factors includes many. We can say that the social factors also includes, both social and economy factors.

The economy factors includes the disposal income of the consumer. It also affects the conditions of the economy at that particular point of time. It also includes the religion, it also includes the customs, traditions and all these things. These are all affecting the banking activities. So, these are the different constraint what always banks always face. So, the bank has to always consider that how those types of constraint can be tackled to maximize the profit and as well as the shareholder's value and the major constraint bank face that is called the regulatory constraint. What do you mean by the regulatory constraint?

There are many regulatory constraints. The permanent constraint are: First one is investment constraint because bank cannot invest their money wherever they want. There are some restrictions imposed by the regulator. Number one - They cannot invest unlimited money in the equity market and all because there is a restriction on this. And there are many consumer protection laws which is also made by the regulatory and to protect that thing they have to also do certain kind of business which may not be profitable. But still the bank is bound to do that for the larger interest or may be for the societal benefit at a large.

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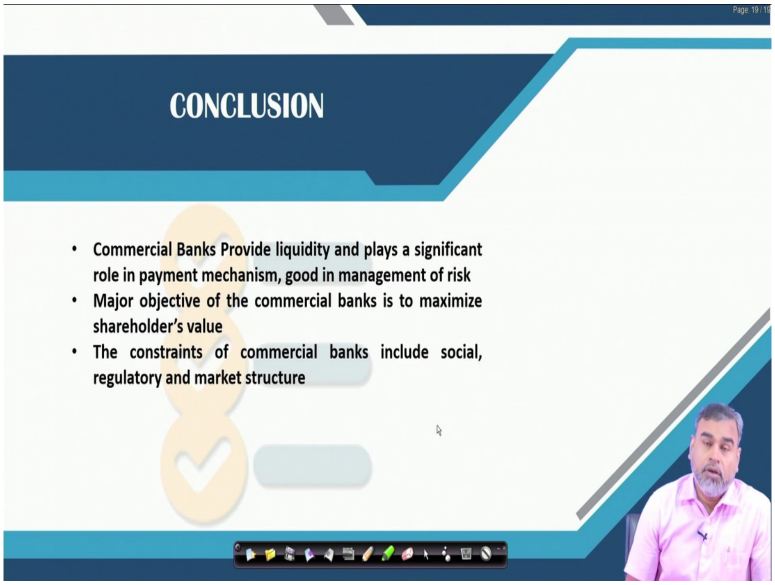

So, going through this discussion what is the summary or the conclusion we can draw from this? Commercial banks provides liquidity and plays a significant role in the payment mechanism and they are good in management of risk. And the major objective of the commercial banks is basically to maximize the shareholder's value as well as managing the liquidity and the profitability.

And the constraints of the commercial banks include both social regulatory and the market structure. Market structure means weather it is a monopolistic market or monopoly market or corporately competitive market. So, this is the way the, because of that sometimes the banks may not be achieving the actual goal what they have because of certain constraint which may not be actually predicted from the beginning what is going to happen in the future.

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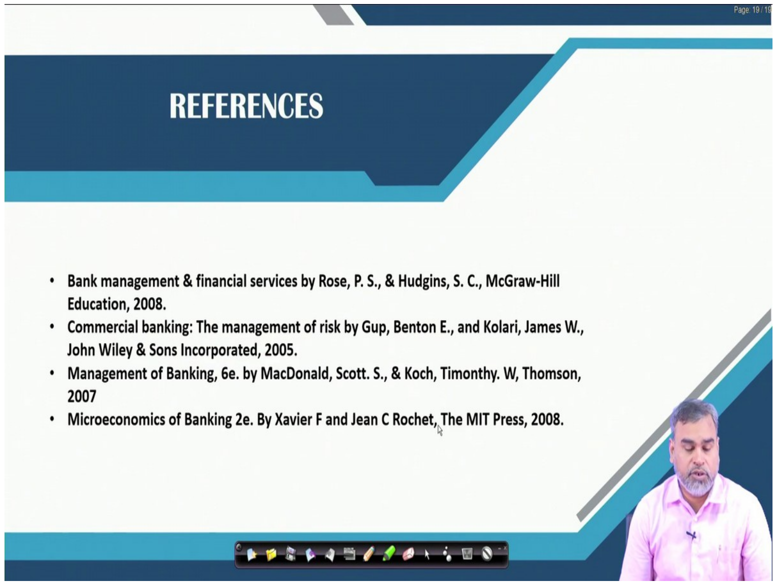

So, this is what basically our discussion today. So these are the different references, you can go through for the detail analysis on this. Thank you.