

Ch-7 Commercial Banks

Good Morning Students,

This lesson is of Class 10th for the subject of Economics. The topic for today is 'Functions of Commercial Banks' which is covered in Ch-7 'Commercial Banks' of your book 'Economics'.

This lesson is being submitted to you on 14-10-2024 and voice is of Mr. Lokesh Arora.

Now, all of you please open page number 164 of your book and listen carefully.

Students, in the previous lesson we had discussed Primary functions of Commercial Banks. Today we will discuss Agency functions and General Utility functions of Commercial Banks.

Agency Functions:

Banks perform certain agency functions for and on behalf of their customers. These are as follows:-

- (i) Collection and making payments for Credit Instruments.
- (ii) Purchase and Sale of Securities
- (iii) Trustee and Executor

(iv) Transfer of funds.

For explanation refer to page 138 of your book.

General Utility Functions!

In addition to agency functions, banks also provide certain general utility services as mentioned below:-

- (i) Locker Facility
- (ii) Use of Cheque System
- (iii) Letter of Credit
- (iv) Facilitate Transportation of Goods.
- (v) Underwriting of Securities
- (vi) Collection of Statistics
- (vii) Foreign Exchange Business.

For explanation refer to page 139-140.

Now, we will discuss advantages of a Bank Account:

Banking services now-a-days have become most essential for all types of people whether individuals or businessmen. The main advantages of a bank account are:-

1. It helps to develop the habit of savings among the people.
2. Payment through cheques are always easier, safer and cheaper.
3. The businessmen can get their bills of exchange discounted easily, if they have an account with the bank.

Teacher: Lakshmi

Ch-7

- (4) A customer can ^{also} avail overdraft facilities from the bank in times of financial crises.
- (5) A customer can make payment of premium to the insurance company, if he has a bank account.
- (6) Most importantly, transactions through a bank account can be produced as an evidence in case of dispute.

Students, before going further in this topic, I will ask you some questions. You may pause the audio for few minutes and write the answers in your note books.

- Qn 1. Explain any two agency functions of Commercial banks.
2. Give any two advantages of opening a bank account.

Next very important function of a Commercial bank is 'Credit Creation'

The word 'Credit' has been derived from the Latin word 'Credo', which means 'I believe'. Thus credit means trust or faith. Credit is the exchange of goods in the present for the payment in future. In

(3)

Simple Words, When some goods or services are given to a person on the condition that he would make its payment in future, it is referred to as credit transaction.

Credit Creation! When a bank advances a loan to its customers, it does not lend in cash but opens an account in the borrower's name and credits (transfer) the amount of loan to this account. Therefore, whenever a bank gives a loan, it creates an equal amount of bank deposit. Creation of such deposits (which are known as secondary or derivate deposits) is called credit creation.

Before we discuss the process of money or credit creation, it is important to know the basic concepts related to credit creation.

(1) **Primary Deposits!** When a customer opens an account in the bank by depositing cash in the bank. This deposit is known as primary deposits.

(2) **Secondary Deposits!** When a bank advances a loan to its customers

Teacher: Lakshmi

CL-7

it does not lend in cash but opens an account in the borrower's name and credit the amount of loan to this account. This type of account is known as secondary or derivative deposits.

(3) Legal Reserve Ratio (LRR)

Legal Reserve Ratio refers to that legal minimum fraction of deposits which the banks are required to keep as cash with themselves so that they are able to meet day to day cash requirements of their customers.

(4) Money Multiplier

In the process of credit creation, the total amount of derivative deposits created by the banks will be a multiple of initial deposits. This multiple by which total deposits increase due to primary deposit is termed as money multiplier. It is the reverse of legal reserve ratio. Thus

$$\text{Money Multiplier} = \frac{1}{\text{LRR}}$$

If LRR is 20%, then money multiplier = $\frac{1}{\frac{20}{100}} = \frac{1 \times 100}{20} = 5$

⑤

Let us now explain the process of Credit creation.

Suppose, commercial banks are legally required to keep 20% of their deposits in cash (i.e. primary deposits). They lend the remaining amount which is called 'excess reserve'. A bank can lend equal to its excess reserve. But the entire banking system can create derivative deposits up to a multiple of the original excess reserves.

We can illustrate the process of credit creation with the help of an example.

Suppose PNB receives a cash deposit of ₹ 1000. Given the cash reserve ratio of 20%, the bank keeps ₹ 200 in reserves and lends ₹ 800 to Mr. Ram Lal. The bank does not lend the customer in cash but opens an account in his name and credits his account by ₹ 800/which is called derivative deposit. Now, the borrower, Mr. Ram Lal pays a cheque of ₹ 800/- to Mr. Sham Lal, who has an account with Canara Bank.

Mr. Sham Lal deposits the cheque in Canara Bank. Now, Canara Bank receives ₹ 800/- as primary deposits and keeps 20% of it. (i.e. ₹ 160)

Class! 10th
Subject! Economics
Teacher! Lokesh Kumar

CL-7

classmate
Date 16/10/2024
Page 7

as cash reserve. Canara Bank now has an excess reserve of ₹ 640 which it lends to Sohan Lal.

Canara Bank does not give cash to Sohan Lal but opens an account in his name and credit his account by ₹ 640.

Sohan Lal now gives the cheque to Mohan Lal who has an account with SBI. Mohan Lal deposits the cheque with SBI. Now SBI keeps

a cash reserve of 20% (i.e. ₹ 128/-) and gives a loan of ₹ 512 (₹ 640 - ₹ 128) to Ajay Kumar.

This process goes on to other bank until the total credit of ₹ 4000 (which is five times of the initial excess reserve of ₹ 800) is created.

The whole process of credit creation is summarised in the following table.

Process of Multiple Credit Creation

Bank	Primary Deposits (₹)	Required Reserve (₹)	Loans (Secondary Deposits)
PNB	1000	200	800 (Ramlal)
Canara	800	160	640 (Sohan Lal)
SBI	640	128	512 (Ajay Kumar)
	-	-	- So on
	-	-	-
Total	5,000	1,000	4,000

7

From the example, we observe that initial deposit of cash was only ₹ 100 whereas total money supply in the economy is increased by ₹ 500. The value of Money Multiplier is here is 5.

Also from Formula, In our example
Legal Reserve Ratio = 20%.

$$\text{So Money Multiplier} = \frac{1}{\text{LRR}\%} = \frac{1}{\frac{20}{100}} = \frac{1 \times 100}{20} = 5$$

Limitations of Credit Creation:

Followings are the limitations in the process of credit creation.

- (i) Amount of Cash
- (ii) Legal Reserve Ratio
- (iii) Cash habit
- (iv) Good Borrowers
- (v) Availability of Good Securities

Refer to page no. 168 for explanation

With this, I am ending my topic here. I will ask you some questions. You are required to write the answers in your note books.

- Q 1. What is Money Multiplier?
2. Explain briefly the process of credit creation.
3. Explain various limitations in the process of credit creation.