

Chapter 12: Commercial Banking

Question: 1

Fill in the blank with appropriate alternatives given below

Deposits from _____ account can be withdrawn without any notice.

Options

- saving
- current
- fixed
- recurring

Solution

Deposits from **current** account can be withdrawn without any notice.

Explanation:

Current account deposits (also known as demand deposits) refer to those deposits that provide the depositor the liberty to withdraw money at any point of time. Such deposits prove useful for businessmen as they are required to deal with many transactions in a single day.

Question: 2

Fill in the blank with appropriate alternatives given below

_____ is a primary function of commercial banks.

Options

- Purchasing and selling securities
- Accepting deposits
- Safe deposit vault
- Letter of credit

Solution

Accepting deposits is a primary function of commercial banks.

Explanation:

Accepting deposits from the general public is the basic function of a commercial bank. A portion of these deposits is then lent out by the banks to the general public as loans at some rate of interest. Other functions of commercial bank include discounting of bills, investing funds, granting loans etc.

Question: 3

Fill in the blank with appropriate alternatives given below

Every loan creates a _____.

Options

- credit
- deposit
- profit
- loss

Solution

Every loan creates a **credit**.

Explanation:

Loans are given out of deposits at a higher interest rate than what is offered on those deposits. The money spent by the borrowers again come back to the bank in the form of deposits (if it is assumed that all transactions are routed through banks). The banks again keep a portion of the deposits with them and lent the rest and so on. In this way loans by commercial banks create credit.

Question: 4

Fill in the blank with appropriate alternatives given below

Facility of E-banking is provided through _____

Options

- telephone
- debit cards
- internet
- credit cards

Solution

Facility of E-banking is provided through **internet**.

Explanation:

With the help of Internet, all the branches of banks and consumers are connected mutually so that they can avail the facilities of banks at anytime and anywhere.

Question: 5

Match the following:

Group A	Group B
1. D-mat account	a. Current account
2. Over draft facility	b. Agency function
3. ATM facility	c. Share brokers
4. Commercial bank	d. General function
5. Credit creation	e. Recurring account
	f. Profit making
	g. Central bank
	h. Commercial bank

Solution

Group A	Group B
1) D-mat account	c. Share brokers
2) Over-draft facility	a. Current account
3) ATM facility	d. General function
4) Commercial banks	f. Profit making
5) Credit creation	h. Commercial banks

Explanations:

1. Dematerialised account (D-mat account) facility is useful for the shareholders. The transactions related to purchase and sale of shares are recorded in this account.

2. Over-draft facility is provided to current account holders which facilitates them to withdraw some amount of money beyond their deposits from the bank. For this facility commercial banks charge some nominal interest on the extra amount drawn.

3. ATM facility is the general function of commercial banks which facilitates

the consumers to withdraw cash at any time without actually visiting the bank.

4. Commercial banks are profit making institutes. They accept deposits from the public and pay interest on it and advance these deposits as loan to seekers at an interest rate higher than that what was offered on deposits. This is how they make profits.

5. By advancing loans out of the deposits, commercial banks create credit in an economy. They channelize surplus money from the public and offer those to the seekers.

Question: 6

State whether the following statement is True or False.

Commercial banks are the backbone of modern economy.

Options

- True
- False

Solution

Commercial banks are the backbone of modern economy. – **True**

Explanation: The above statement is true. By channelizing the surplus money from the public to loan seekers, they create credit in the economy. Credit creation paves the path for the growth of the economy. Also, commercial banks play an important role in controlling money supply in the economy. Thus, commercial banks are considered the backbone of modern economy.

Question: 7

State whether the following statement is True or False.

The saving bank deposit can be opened with a small amount.

Options

- True
- False

Solution

The savings bank deposit can be opened with a small amount. – **True**

Explanation: The above statement is true. A savings bank deposit can be opened with a small amount as specified by the banks. These accounts are generally opened by salaried people who wish to save a proportion of their income. A nominal amount of interest is paid on these deposits.

Question: 8

State whether the following statement is True or False.

Credit money is created by the central bank of a country.

Options

- True
- False

Solution

Credit money is created by the central bank of a country. – **False**

Explanation: The above statement is false. Credit is created by the commercial banks of a country. People deposit their money with the commercial banks. A portion of these deposits (after keeping the reserves) is then further lent out to the general public as loans. The money spent by the borrowers again come back to the bank in the form of deposits (if it is assumed that all transactions are routed through banks). The banks again keep a portion of the deposits with them and lent the rest and so on. In this way the commercial banks create credit. Note that as central bank does not accepts deposits and lends to the general public, it cannot create credit.

Question: 9

State whether the following statement is True or False.

There is no difference between primary deposit and secondary deposit of a commercial bank.

Options

- True
- False

Solution

There is no difference between primary deposit and secondary deposit of a commercial bank. - **False**

Explanation: The above statement is false. Primary deposits are simply cash deposits made by the general public in the bank, while secondary deposits are that part of cash deposits keeping aside the mandatory reserve as specified by the central bank. The secondary deposits are used to create credit through loans.

Question: 10

Define explain the following concept.

Fixed deposits

Solution

Fixed deposits: Fixed account deposits (also known as time deposits) refer to those deposits that are held for a fixed (specific) period of time (called maturity period). These deposits cannot be withdrawn before the maturity period. Hence, these are not payable on demand. Also, these deposits are non-cheque able deposits. However, due to the longer lock-in period involved in the fixed account deposits, these deposits involve a higher rate of interest than that earned on the savings account deposits.

Question: 11

Define explain the following concept.

Cash credit

Solution

Cash credit: In the system of cash credit, the banks first estimate the value of the assets held by the borrower. Based on this estimation, a credit limit is then decided by the bank for the borrower. The credit limit decided by the bank is the upper limit for the borrowings by the borrower. However, the actual utilization of credit by the borrower depends on his/her withdrawing power. The borrower is liable to pay interest only on the withdrawn portion of the credit.

Question: 12

Define explain the following concept.

Safe deposit vault

Solution

Safe deposit vault: Safe deposit vault facility is the general utility service offered by commercial banks. Under this service, consumers are allowed to retain their valuables such as shares, bonds, gold and silver ornaments etc. in the lockers at a payment of a fixed rent. This service provides the customers with privacy and easy access to their valuables.

Question: 13

Define explain the following concept.

Discounting of bills

Solution

Discounting of bills: The commercial banks provide financial assistance to the business community by discounting bills of exchange. A bill of exchange is a document that acknowledges the amount of money that is owed by the debtors as against the goods and services received by them. The banks purchase these bills produced by the customers after deducting interest on the face-value of the bill.

Question: 14

Give reason or explain the following statement:

Commercial banks provide agency functions to earn profits.

Solution

Commercial banks provide agency functions to earn profits.

Explanation: Commercial banks provide several agency functions to their customers besides the major functions of acceptance of deposits and granting of loans. These functions may include:

- 1) Easy and cheap flow of funds from one place to another via mail transfers, demand drafts etc.
- 2) Collection and payment of funds on behalf of their customers through bills, cheques etc.
- 3) Purchase and sale of securities and foreign exchange.
- 4) Providing the facility of underwriting the sale of new shares.

These services are provided by the bank in return for some fee. Hence, the bank earns profits through these services.

Question: 15

Give reason or explain the following statement:

Overdraft facility is provided to current account holders.

Solution

Overdraft facility is provided to current account holders.

Explanation: Overdraft facility is one of the primary functions of commercial banks. Overdraft facility is generally given to current account holders. Under this facility, commercial banks allow their customers to withdraw the amount from a bank in excess of their balance. The bank specifies the maximum limit of overdraft. Rate of interest is charged on the amount overdrawn.

Question: 16

Give reason or explain the following statement:

Saving account deposits are usually opened by salaried class.

Solution

Saving account deposits are usually opened by salaried class.

Explanation: Savings account is generally opened by salaried people. This account can be opened with a small amount and it helps the people to save their extra income. The amount from this account can be withdrawn anytime subject to some limitation. Banks also provide some interest on these deposits.

Question: 17

Give reason or explain the following statement:

Rate of interest on fixed deposit is high.

Solution

Rate of interest on fixed deposit is high.

Explanation: Under the fixed deposit system, one has to save money for a fixed period of time. Till the maturity of the period, the customer promises not to demand that money from the bank unless necessary. So, banks are more liberal in loaning out that fund to the seekers from such deposits. As the they are deposited for a comparatively long period of time, the rate of interest offered on such deposits is very high.

Question: 18

Distinguish between:

Call loans and long term loans

Solution

Basis	Call loans	Long term loans
Time-	They are provided for a period	They are provided for a period

period	of 7-15 days.	of more than 5 years.
Interest rate charged	They charge lowest interest rates.	They charge highest interest rates.
Users	They are mostly availed to by bill-brokers and stock brokers.	They are mostly availed by big private companies and PSU companies.
Recall of loan	These loans can be recalled by the banks at any time from the borrower.	These loans can be recalled only after giving a prior notice to the borrower.

Question: 19

Distinguish between:

Current account and saving account

Solution

Basis	Current account	Savings account
Definition	Current accounts are those accounts which facilitate their consumers to carry out day to day transactions.	Savings accounts encourage their consumers to save.
Interest rate offered	These accounts offer minimal interest rates or no interest.	These accounts offer comparatively higher interest rates.
Users	They are mostly created by big companies, businessmen, traders etc.	They are mostly created by the salary class, farmers etc.
Overdraft facility	This facility is available for a current account.	This facility is not available for a savings account.

Question: 20

Distinguish between:

Cash credit and overdraft facility

Solution

Bases	Cash credit	Overdraft facility
Definition	A loan taken in the form of cash by anyone from the bank	Commercial banks allow their customers to withdraw an

	against some securities is called cash credit.	amount from the bank in excess of their balance.
Drawers	Anyone can take a cash loan from banks against some securities.	Only current account holders can avail this facility.
Interest rate charged	They charge higher rates of interest against a cash loan.	They charge minimal rates of interest against an overdraft.

Question: 21

Write short note on:

Derivative deposit

Solution

Derivative deposits also known as secondary deposits are the deposits in excess of the minimum cash reserves to be held by the banks. These deposits are used to grant loans to the borrowers. In this way, derivative deposits form the basis of credit creation by the commercial banks.

Question: 22

Write short note on:

E-banking facility

Solution

Electronic banking is a new form of banking facility provided by commercial banks to their customers. Under this facility, with the use of internet, all banks and their customers are interlinked. Customers using the e-banking facility can make payments or transfer funds from their accounts to others accounts at any point of time and from anywhere. For providing such facilities, banks charge some commission from their customers.

Question: 23

Write short note on:

D-mat account

Solution

A D-mat account refers to the account opened for electronic transactions of securities (used for purchase and sale of shares and debentures, futures, options and other securities) and keeping securities in the electronic form

instead of in the form of a paper document (physical form). Transactions of a D-mat account are made through an investment broker.

Question: 24

Write short note on:

Long term loans

Solution

These are the loans provided by the commercial banks to the borrowers for a period of more than 5 years. The rate of interest charged on this kind of loan is the highest as compared to short term and medium term loans. These are taken for the purposes of buying buildings, plants and machinery etc.

Question: 25

Answer the following question:

Explain various types of deposits.

Solution

There are two types of deposits.

1) Demand Deposits

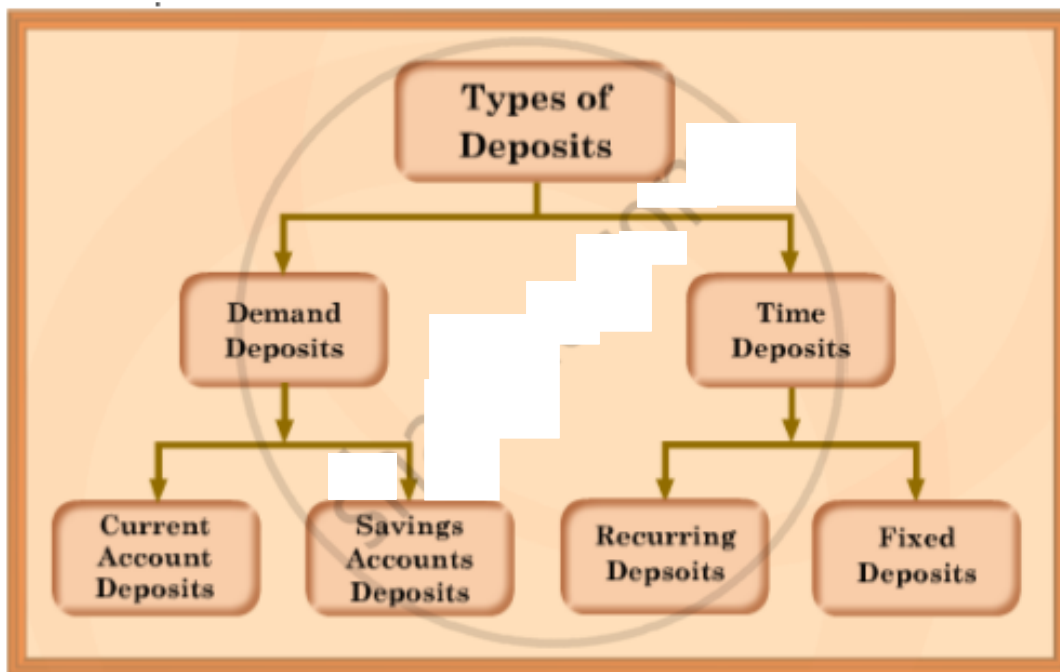
i. Current account deposits

ii. Saving accounts deposits

2) Time Deposits

i. Recurring deposits

ii. Fixed deposits



i. Demand deposits: These are the deposits which can be withdrawn as and when demanded i.e. the withdrawal is not timebound. Demand deposits are of following types.

a. Saving account deposits: A savings account caters to the needs of those individuals who wish to save a part of their income and earn interest on the amount saved. Such deposits are payable on demand i.e. such deposits can be withdrawn by the depositor subject to some limitations.

b. Current account deposits: Current account deposits refer to those deposits that provide the deposit or the liberty to withdraw money at any point of time. Generally, current account deposits prove useful for businessmen as they are required to deal with many transactions in a single day. Such deposits do not offer any rates of interest.

ii. Time deposits: These are the deposits which can be withdrawn only after a certain period of time. Unlike demand deposits, they are not payable as and when demanded. These are of two types

a. Recurring deposits: Under this account, the customer deposits a fixed amount periodically up to a certain period. The amount keeps on getting accumulated. An interest is provided on these deposits and the amount can be withdrawn only after the end of a particular period of time.

b. Fixed deposits: Fixed account deposits refer to those deposits that are held for a fixed (specific) period of time (called the maturity period). These deposits cannot be withdrawn before the maturity period. Hence, they are not payable on demand. Also, these deposits are non-cheque able deposits. However, due to the longer lock-in period involved in the fixed account

deposits, these deposits involve a higher rate of interest than that earned on the savings account deposits.

Question: 26

Answer the following question:

What are the different types of loans provided by commercial banks?

Solution

The following are the different types of loans and advances made by the commercial banks.

1. Loans: Loans can be of the following types:

a. Call loans: These are the loans granted by the commercial banks for a very short period of time, say about 5-7 days. The interest charged is the lowest in these kinds of loans. These are usually taken by stock brokers.

b. Short term loans: These are the loans provided for a period of not more than 2 years of time. Interest rate is higher than on the call loans but lower than the ones on medium term loans.

c. Medium term loans: These are the loans provided for a period of 2-5 years. The interest rate on these is higher than the ones on short term loans but not higher than those on the long term loans.

d. Long term loans: These are the loans provided for a period of more than 5 years. The interest rates on these are the highest of all the other loans.

2. Cash credit: In the system of cash credit, the banks first estimate the value of the assets held by the borrower. Based on this estimation, a credit limit is then decided by the bank for the borrower. The credit limit decided by the bank is the upper limit for the borrowings by the borrower. However, the actual utilization of credit by the borrower depends on his/her withdrawing power. The borrower is liable to pay interest only on the withdrawn portion of the credit.

3. Overdraft: Overdraft is a facility provided by commercial banks to the current account holders. Under this facility, commercial banks allow their customers to withdraw the amount from banks in excess of their account balance. The bank specifies the maximum limit of overdraft. A rate of interest is charged on the amount overdrawn.

4. Discounting of bills: The commercial banks provide financial assistance to the business community by discounting bills of exchange. A bill of exchange is a document that acknowledges the amount of money that is owed by the debtors as against the goods and services received by them.

The banks purchase these bills produced by the customers after deducting interest on the face-value of the bill.

Question: 27

State with reason whether you agree or disagree with the following statement.

A commercial bank create credit on the basis of primary deposit.

Solution

No, we disagree with the given statement. Commercial banks can create credit only out of derivative deposits. Derivative deposit is the amount of deposits left after deducting the cash reserve from primary deposits. Suppose bank A receives a total deposit of Rs.10, 000, with mandatory cash reserve of 10%, then after keeping a sum of Rs.1000, he can loan out the remaining Rs. 9000 to others. Suppose, he gave the credit to a person who deposits it in bank B.

Bank B also kept 10% of Rs. 9000 i.e. it kept Rs. 900 as a reserve and loaned out the remaining sum (Rs. 8100) to an individual who deposits it in bank C. Bank C further loaned out Rs. 7290, after keeping Rs. 810 as reserve. In this way, it can go on an infinite number of times and the credit goes on being created. Hence, we can say that the commercial bank creates credit from the derivative deposit and not from the primary deposits.

Question: 28

State with reason whether you agree or disagree with the following statement.

Commercial banks perform many general utility services.

Solution

Yes, I agree with the given statement. Apart from providing primary services and agency services to their customers, banks also provide some general utility services. For providing such services, banks charge some commission.

These utility services include:

- i. Commercial banks provide safe deposit vault/ locker facility to its customers to keep their valuables.
- ii. Remittance of funds through mail transfer, demand draft, mail transfers, etc.

iii. The facility of letters of credit by commercial banks enables the traders to purchase goods on credit.

iiii. Commercial banks provide reference/ status report with respect to financial standing, frequency of payment.

v. Underwriting facility for shares and debentures is another function performed by commercial banks.

Question: 29

Answer in detail:

What are the primary functions of commercial banks?

Solution

Accepting deposits from the general public and granting loans to the borrowers are the two primary functions of commercial banks.

i. Accepting deposits: Accepting deposits from the general public is the basic function of a commercial bank. The banks also provide some interest on these deposits. The interest rate depends upon the type of deposit.

ii. Advancing loans: Granting loans and advances to the investors is the second most important function performed by the commercial banks. The deposits received by the banks from the public are not kept idle. Rather, the commercial banks keep only a fraction of the deposits with themselves as reserves and extend the rest as loans and advances to the borrowers for various productive purposes. The bank charges interest on these loans. The interest charged on the loans is higher than the interest provided on the deposits.

Question: 30

Answer in detail:

Explain the process of credit creation.

Solution

Commercial banks play an important role in 'credit creation' in the economy. They have the capacity to generate credit through demand deposits. These demand deposits make more credit than the initial deposits. The process of money creation can be explained by taking an example of a bank XYZ. A depositor deposits Rs 10,000 in his savings account, which will become the demand deposit of the bank.

Based on the assumption that not all customers will turn up the same day to withdraw their deposits, the bank maintains a minimum cash reserve of

10 % of the demand deposits i.e. maintains a reserve of Rs.1000. It lends the remaining amount of Rs 9000 in the form of credit to other customers. This further creates deposits for the bank XYZ. Keeping the minimum cash deposits, the banks again lent the remaining and so on.

With the cash reserve of Rs.1000, the credit creation is worth Rs.10, 000. This is given by the credit multiplier as: $\text{Credit multiplier} = 1 / \text{CRR} = 1 / 10\% = 10$ The money supply in the economy will increase by the amount (times) of credit multiplier.

Question: 31

Answer in detail:

What are the secondary functions of commercial banks?

Solution

The agency functions and the general utility functions are classified as the secondary functions of commercial banks.

Agency functions

The commercial banks perform various agency functions with the primary purpose of acceptance of deposits and granting of loans. Their functions include:

- i. Transfer of funds – The banks provide an easy flow of funds from place to place via mail transfers, demand drafts etc.
- ii. Collection of funds – The banks also collect funds on behalf of their customers through bills, cheques etc.
- iii. Banks collect insurance premiums, dividends, interest on debentures etc.
- v. Banks assist in the process of tax payment by the account holders.
- vi. Banks also play the roles of trustees or executors.

General utility functions These include:

- i. Providing locker facility
- ii. Underwriting of shares and debentures
- iii. Purchase and sale of foreign exchange
- iv. ATM, debit card and credit card facility
- v. Providing information and statistical data useful to customers