DEPARTMENT OF COMMERCE (CA)

Banking (Semester-V)

III-UG Non-Major Elective Sub Code-18BCA5EL

Unit-I

Meaning & definition of Banking-Banking System-Role and importance of banks- Non-Banking Financial Institution.

Introduction

The term 'bank' is derived from the French word '*Banco'* which means a **Bench** or **Money exchange table**. In olden days, European money lenders or money changers used to display (show) coins of different countries in big heaps (quantity) on benches or tables for the purpose of lending or exchanging.
Banking is a business of accepting deposits and lending money. It is carried out by financial intermediaries, which performs the functions of safeguarding deposits and providing loans to the public.
In other words, Banking means accepting for the purpose of lending or investment of deposits of money from public repayable on demand and can be withdrawn by cheque, draft order and so on.
A **banking system** is a group or network of institutions that provide financial services for us. These institutions are responsible for operating a payment **system**, providing loans, taking deposits, and helping with investments.

Banking System – Definitions

Banking systems refer to a structural network of institutions that provide financial in a country. It deals with the ownership of banks, the structure of banking system, functions performed and the nature of business. The elements of the banking system include:

Commercial banks
Investment banks
Central bank. The commercial banks accept deposits and lend loans and advances; the investment banks deal with capital market issues and trading; and the central bank regulates the banking system by setting monetary policies besides many other functions like currency issue.

A banking system also refers a system provided by the bank which offers cash management services for customers, reporting the transactions of their accounts and portfolios, throughout the day.

What is a Bank?

Oxford Dictionary defines a bank as "an establishment for custody of money, which it pays out on customer's order."

According to **Prof. Sayers**, "A bank is an institution whose debts are widely accepted in settlement of other people's debts to each other." In this definition Sayers has emphasized

the transactions from debts which are raised by a financial institution.

According to the Indian **Banking Company Act 1949**, “A banking company means any company which transacts the business of banking. Banking means accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or other wise and withdrawable by cheque, draft or otherwise.”This definition throws light on the three major functions of a bank. They are:

Accepting of deposits and lending loans
Issue and pay cheques,
Collect cheques on behalf of the customers.

A bank is a financial institution that provides banking and other financial services to their customers. A bank is an institution which provides fundamental banking services such as accepting deposits and lending loans. As financial intermediaries, banks stand between depositors who supply capital and borrowers who demand capital. When banks accept deposits its liabilities increase and it becomes a debtor, but when it makes advances its assets increases and it becomes a creditor.

Banks are a subset of the financial services industry. The banks are the main participants of the financial system in India. All the banks safeguard the money and valuables and provide loans, credit, and payment services, such as money orders, and cheques. The banks also offer investment and insurance products.

Due to the emergence of integration among finance industries, some of the traditional distinctions between banks, insurance companies and securities firms have diminished and they have converted themselves into Universal Banks to offer a variety of services under one umbrella.
Example: IDBI Bank and ICICI. In spite of these changes, banks continue to maintain and perform their primary role—accepting deposits and lending funds from these deposits.

Roles and Importance of Banks
To ensure financial stability, central banks have the following main roles:
1. Currency Regulation
The central banks have the monopoly of notes issued, and these notes issued by central banks act as legal tender of money. Each central bank has an issue department that issues coins and notes to commercial banks. Even though these notes and coins are manufactured by the government, they are put into circulation by the central bank. Therefore, the money put in circulation must be monitored to ensure that there is just the right amount in circulation.
2. Control of Commercial Banks
All commercial banks are under the obligation to prepare and submit a report of their undertaking to the central bank after a given period of time. These statistics are important in decision-making in the finance sector. The central bank can influence the activities of the commercial banks through its monetary policies.
3. Banker, Fiscal Agent and Adviser to the Government
The central bank receives deposits on behalf of the government from sources like income tax and foreign aid. It also makes payments on behalf of the government. Moreover, the central bank gives advice to the government on economic and

monetary matters such as inflation and deficit financing. The government also gets short-term loans from it the central bank.

4. Controller of Credit

The control of credit is realized through the use of monetary policy. The central bank controls the credit creation power of commercial banks to curb inflationary and deflationary pressures in the economy.

5. Custodian of Cash Reserves of Commercial Banks

The law requires that commercial banks keep reserves to a particular percentage with the central bank. It is on this basis that the central bank transfers money from one bank to another to facilitate the clearing of cheques. A central bank is, therefore, a bank to commercial banks.

6. Lender of Last Resort

Commercial banks normally borrow from discount houses. However, during times of financial problems, commercial banks can seek funds from the central bank by borrowing at the market rate instead of the bank rates given by discount houses.

Banks are one of the most important economic wings of any country. In this modern time, money and its necessity is very important. A developed financial system of the country ensures to attain development. A bank provides valuable services to a country. To attain development there should be a good developed financial system to support not only the economic but also the society. So, a bank plays a vital role in the socio-economic matters of the country. Some of the important role of banks in the development of a country is briefly showing below.

1. PROMOTE SAVING HABITS OF THE PEOPLE:

Bank attracts depositors by introducing attractive deposit schemes and providing rewards or return in the form of interest. Banks provide different kinds of deposit schemes to its customers. It enables to create banking habits or saving habits among people.

2. CAPITAL FORMATION AND PROMOTE INDUSTRY:

Capital is one of the most important part of any business or industry. It is the life blood of business. Banks increase capital formation by collecting deposits from depositors and convert these deposits in to loans advances to industries.

3. SMOOTHING OF TRADE AND COMMERCE FUNCTIONS:

In this modern era trade and commerce plays vital role between any countries. So, the money transaction should be user friendly. A bank helps its customers to send funds to anywhere and receive funds from anywhere of the world. A well-developed banking system provides various attractive services like mobile banking, internet banking, debit cards, credit cards etc. these kinds of services fast and smooth the transactions. So, bank helps to develop trade and commerce

4. GENERATE EMPLOYMENT OPPORTUNITY:

Since a bank promote industry and investment, they automatically generate employment opportunity. So, a bank enables an economy to generate employment opportunity.

5. SUPPORT AGRICULTURAL DEVELOPMENT:

Agricultural sector is one of the integral part of any economy. Food self-sufficiency is the major challenge and goal of any country. Bank promote agricultural sector by providing loans and advances with low rate of interest compared to other loans and advances schemes.

6. APPLYING OF MONITORY POLICY:

Monitory policy is an important policy of any government. The major aim of

monitory policy is to stabilize financial system of the country from the dangerous of inflation, deflation, crisis etc… The recent increase in repo rate to 6.5% is just an example of the same.
7. BALANCED DEVELOPMENT:
Modern banks are spreading its operations throughout the world. We can see number of big banks like Citi bank, Baroda bank etc. It helps a country to spread banking activities in rural and semi urban areas. With the spread of banking operations around the country bank helps to attain balanced development by promoting rural areas. It plays vital role in the socio- economic development of the country. A developed banking system enables the country to attain balanced development without any special consideration of rich and poor, cities and rural areas etc.
So, in a developing country like India, banking sector holds a major responsibility towards stabilizing the socio-economic conditions of the country!!!

Nonbanking financial institution
A nonbanking financial institution (NBFI) is a financial institution that does not have a full banking license and cannot accept deposits from the public. However, NBFIs do facilitate alternative financial services, such as investment (both collective and individual), risk pooling, financial consulting, brokering, money transmission, and check cashing. NBFIs are a source of consumer credit (along with licensed banks). Examples of nonbank financial institutions include insurance firms, venture capitalists, currency exchanges, some microloan organizations, and pawn shops. These non-bank financial institutions provide services that are not necessarily suited to banks, serve as competition to banks, and specialize in sectors or groups.
Risk pooling institutions
Insurance companies underwrite economic risks associated with death, illness, damage to or loss of property, and other risk of loss. They provide a contingent promise of economic protection in the case of loss. There are two main types of insurance companies: life insurance and general insurance. General insurance tends to be short-term, while life insurance is a longer contract, ending at the death of the insured. Both types of insurance, life and property, are available to all sectors of the community. Because of the nature of the insurance industry (companies must access a plethora of information to assess the risk in each individual case), insurance companies enjoy a high level of information efficiency.
Life insurance companies insure against economic loss of the insured’s premature death. The insured will pay a fixed sum as an insurance premium every term. Because the probability of death increases with age while premiums remain constant, the insured overpays in the earlier stages and underpays in the later years. The overpayment in the early years of the agreement is the cash value of the insurance policy.
General insurance is further divided into two categories: market and social insurance. Social insurance is against the risk of loss of income due to sudden unemployment, disability, illness, and natural disasters. Because of the unpredictability of these risks, the ease at which the insured can hide pertinent information from the insurer, and the presence of moral hazard, private insurance companies frequently do not provide social insurance, a gap in the insurance industry which government usually fills. Social insurance is more prevalent in industrialized Western societies where family networks and other organic social support groups are not as prevalent.
Market insurance is privatized insurance for damage or loss of property. General insurance companies take a single premium payment. In return, the companies will

make a specified payment contingent on the event that it is being insured against. Examples include theft, fire, damage, natural disaster, etc.

Contractual savings institutions

Contractual savings institutions (also called institutional investors) provide the opportunity for individuals to invest in collective investment vehicles in a fiduciary rather than a principle role. Collective investment vehicles invest the pooled resources of the individuals and firms into numerous equities, debt, and derivatives promises. The individual, however, holds equity in the CIV itself rather what the CIV invests in specifically. The two most popular examples of contractual savings institutions are mutual funds and private pension plans.

The two main types of mutual funds are open-end and closed-end funds. Open-end funds generate new investments by allowing the public buy new shares at any time. Shareholders can liquidate their shares by selling them back to the open-end fund at the net asset value. Closed-end funds issue a fixed number of shares in an IPO. The shareholders capitalize on the value of their assets by selling their shares in a stock exchange.

Mutual funds can be delineated along the nature of their investments. For example, some funds make high-risk, high return investments, while others focus on tax-exempt securities. Still others specialize in speculative trading (i.e. hedge funds), a specific sector, or cross-border investments.

Pension funds are mutual funds that limit the investor's ability to access their investment until after a certain date. In return, pension funds are granted large tax breaks in order to incentivize the working public to set aside a percentage of their current income for a later date when they are no longer amongst the labor force (retirement income).

Other non-bank financial institutions

Market makers are broker-dealer institutions that quote both a buy and sell price for an asset held in inventory. Such assets include equities, government and corporate debt, derivatives, and foreign currencies. Once an order is received, the market maker immediately sells from its inventory or makes a purchase to offset the loss in inventory. The difference in the buying and selling quotes, or the bid-offer spread, is how the market-maker makes profit. Market makers improve the liquidity of any asset in their inventory.

Specialized sectoral financiers provide a limited range of financial services to a targeted sector. For example, leasing companies provide financing for equipment, while real estate financiers channel capital to prospective homeowners. Leasing companies generally have two unique advantages over other specialized sectoral financiers. They are somewhat insulated against the risk of default because they own the leased equipment as part of their collateral agreement. Additionally, leasing companies enjoy the preferential tax treatment on equipment investment.

Reference

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