NPTEL ONLINE CERTIFICATION COURSES

MANAGEMENT OF COMMERCIAL BANKING

PROF. JITENDRA MAHAKUD
DEPARTMENT OF HUMANITIES AND SOCIAL SCIENCES, IIT KHARAGPUR

Module 01: Functions, Regulation, Financial Statements and Performance

Lecture 01 : Importance and Forms of Commercial Banks

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CONCEPTS COVERED

- What is Commercial Bank?
- Importance of commercial bank
- Special role of banks

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What is Commercial Bank?

It is an institution whose current operations consist in granting loans and receiving deposits

Types of commercial banks in India: (i) Public Sector banks (ii) Private sector banks and (iii) Foreign banks

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Commercial Banks and Aggregate Economy

- Payment gateway for all transactions
- Important part of monetary transmission mechanism
- Major source of finance for corporate sector

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Bank Based Economy Versus Market Based Economy

- Bank based economy (BBE) is good in dealing with non-diversifiable risk
- In market oriented economy, investments in equity are more than the bank based economy
- BBE is better in inter-temporal risk sharing
- BBE is NOT good at financing the new technologies

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Why Banks Are Special Among Intermediaries?

- Deal with financial contracts (deposits and loans) which cannot be easily resold like equity and bonds
- Good in reduction of transaction cost due to different transformation
- Economies of scope exists between deposits and credit activities

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Sources of Economies of Scope and Scale

- Large number of products
- Expertise in managing liquidity risk
- Proper diversification

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Major Factors Affecting Banking Activities

- Inflation
- Interest rate changes
- Technology
- Consumer
- Globalization
- Competition

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Leading Competitors with Bank

- Mutual Funds: Sells shares to the public representing an interest in a professionally managed pool of stocks, bonds and other securities
- Hedge Funds: Sell shares mainly to high net-worth investors in a broad group of different kind of assets including the non-traditional investments
- Investment Banks: Provide financial consultancy, merchant banking services, services for acquisition
- Finance Companies: Offer loans to commercial enterprises, individuals and families using funds borrowed in the open market or loans from other financial institutions

CONCLUSION

- There are three types of commercial banks operating in India
- Commercial banks play a significant role in economic growth process
- Banks are special among all the financial intermediaries
- Other financial institutions like mutual funds, finance companies are the major competitors of commercial banks
- Interest rate, inflation, consumer preference, technology etc are the major factors affecting banking activities

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Module 01: Functions, Regulation, Financial Statements and Performance

Lecture 02 : Functions, Goals and Constraints of Commercial Banks

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CONCEPTS COVERED

- Functions of commercial banks
- Major goals of commercial banks
- Constraints faced by the commercial banks

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Broad Classification of Banking Functions

- Offering liquidity and payment services
- Transformation of assets
- Management of risk
- Processing information and monitoring borrowing

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Liquidity and Payment Services

- Shifting from commodity money to fiat money
- Commodity Money: Medium of exchange is commodity itself
- Fiat Money: A system in which medium of exchange is intrinsically useless but its value is guaranteed by some institution so generally accepted as means of payment
- Bank and fiat money management
  - Money change(exchange between currencies)
  - Provision of payment services
  - Payment services include management of clients accounts and guarantee by the bank

Asset Transformation

- Convenience of Denomination
  - ✓ Fiat money is available in different denominations
- Quality Transformation
  - ✓ Bank deposits offer better risk-return characteristics than direct investments to diversify portfolio
  - ✓ Banks have more information than depositors for better investment
- Maturity Transformation
  - ✓ Short maturity deposits to long maturity loans

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Risk Management

- **Credit Risk:**

Probability of default in lending activities

- **Interest Rate Risk:**

Change in the value of assets and liabilities of banks due to change in interest rate

- **Liquidity risk:**

Not able to fulfill the requirements of depositors

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Off Balance Sheet Operations

- Loan commitments, guarantee etc
- Offer of derivative investments like swap hedging contracts and underwriting
- Objectives of off balance sheet operations
  - ✓ Increase in non-interest income
  - ✓ Decreasing leverage
  - ✓ Tax relaxation

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Monitoring and Information Processing

- Long-term relationship
- Mitigation of the effect of the moral hazard

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Bank Goals and Constraints

- **Maximization of shareholder wealth**
  - ✓ **Maximization of market value if bank's stock and cash dividend paid**
  - ✓ **Factors affecting market value:**
    - i. **Amount of cash flow**
    - ii. **Timing of cash flow**
    - iii. **Risk of cash flow**
  - **Constraints**
    - i. **Competition**
    - ii. **Social**
    - iii. **Regulatory: (a) Investment Constraints (b) Consumer Protection**

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CONCLUSION

- Commercial Banks Provide liquidity and plays a significant role in payment mechanism, good in management of risk
- Major objective of the commercial banks is to maximize shareholder's value
- The constraints of commercial banks include social, regulatory and market structure

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- Bank management & financial services by Rose, P. S., & Hudgins, S. C., McGraw-Hill Education, 2008.
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Module 01: Functions, Regulation, Financial Statements and Performance

Lecture 03 : Regulation of Commercial Banks

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CONCEPTS COVERED

- Why commercial banks are regulated?
- Reasons for failure of commercial banks
- Regulation of commercial banks in India

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Reasons for Regulation of Banks

- To reduce the risk of large-scale failure in the economic system
- To avoid systematic risk and contagious effect in global economy
- To guard against deposit insurance losses
- To achieve the desired social goal
- To promote an efficient and effective banking system that finances economic growth, impartially allocates credit and meets the customer needs

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Why Banks Fail?

- Credit Risk
  - ✓ Banks keep reserves for expected losses
  - ✓ If losses > reserves then the excess amount of losses are deducted from bank capital
  - ✓ Importance of bank capital
- Maximization of the utility of all the stakeholders; i.e. shareholders, managers, employees, customers, communities
- Changes in macro economic conditions
- Financial repression: excess government intervention
- Inadequate diversification of loans

Why Banks Fail? Contd…

- **Bank Runs**
  - ✓ It occurs when depositors and other creditors fear for the safety or availability of their funds and large number of depositors try to withdraw their funds at the same time
  - ✓ It reflects the heard behavior of depositors to obtain the limited amount of cash that is available
- **Silent Run**
  - ✓ It occurs when large creditors such as banks and investment companies withdraw their funds in order to protect them

Example A: Credit Risk

Asset (Million)		Liabilities (Million)	
Loans	102	Deposits	90
Interest Rate	8%	Interest Rate	6%
Loan loss reserve	-2	Stockholder's equity:	10
Net loans	100	Total	100

Net Income: 8.16 - 5.4 = INR 2.76
Return on Assets: 2.76/100 = 2.76%
Equity/total Assets = 10/100 = 10%
(Bank is well capitalised)

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Example B: Credit Risk

Bank raises additional INR 10 million in deposits and invests in two loans of INR 5 million each. No additional loan losses required

Asset (Million)		Liabilities (Million)	
Loans	102	Deposits	100
Interest Rate	8%	Interest Rate	6%
Loan	5	Stockholder's equity:	10
Loan	5		
Loan reserve	-2		
Net loans	110	Total	110

Net Income: 8.96 - 6 = INR 2.96
Return on Assets: 2.96/110 = 2.69%
Equity/total Assets = 10/110 = 9.09%
(Bank is adequately capitalised)

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Example C: Credit Risk

One of INR 5 million loan goes into default

Asset (Million)		Liabilities (Million)	
Loans	102	Deposits	100
Interest Rate	8%	Interest Rate	6%
Loan	5	Stockholder's equity:	7
Loan default	-5		
Loan reserve	2		
Net loans	107	Total	107

Default loan of INR 5MM exceeds loan loss reserve by INR 3MM, which is deducted from shareholder's equity

Net Income: 8.56 - 6 = INR 2.56

Return on Assets: 2.56/107 = 2.39%

Equity/total Assets = 7/107 = 6.54%

(Bank not adequately capitalised (<8%))

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Bank Regulations in India

- Banking Regulation Act (1949)
- Disclosure norms: Annual report, asset quality, liquidity, earning
- KYC norms
- Anti Money Laundering Act (AML) & Countering Financing of Terrorism (CFT)
- Protection of small investors (Deposit insurance and credit guarantee corporation)
- Prudential Norms: income recognition, asset classification and provisioning, capital adequacy, investment and capital market exposure
- Licensing: Branch authorization policy
- Regulation of Interest Rate: Deposits of NRIs, small loans upto 2 lakh, export credit
- Statutory Pre-emptions: CRR and SLR
- Corporate Governance: Fit and proper criteria; director should have knowledge about banking

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CONCLUSION

- **Banks are regulated to make an efficient and sound banking system.**
- **Credit risk, macroeconomic condition, inadequate diversification, bank run are the major reasons for bank failure.**
- **Many regulatory reforms have been taken to make the Indian banking sector stable and efficient.**

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- Bank management & financial services by Rose, P. S., & Hudgins, S. C., McGraw-Hill Education, 2008.
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CONCEPTS COVERED

- Balance Sheet
- Assets of Commercial Banks
- Approaches to Bank Lending

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Balance Sheet

- The Balance sheet of commercial bank shows the financial position (assets, liabilities, equity etc) at a given point of time usually the last day of the quarter or year
- It is also viewed as a list of financial inputs (i.e. sources of funds) and outputs (i.e. uses of funds) at a point of time

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Assets in Commercial Banks

- Cash
- Security holdings/ Investments
- Loans
- Miscellaneous Assets

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Cash Assets

- It includes cash and deposits due from banks
- Items include:
  - ✓ Cash in treasury or vault cash
  - ✓ Deposits with other banks
  - ✓ Cash in process of collection
  - ✓ Reserve account with Central Bank
- It is called Primary Reserves

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Securities or Investments

- Short term Securities (Liquidity Position and Secondary Reserves)
  - ✓ Short term government securities
  - ✓ Money market securities i.e. (i) interest bearing time deposits & (ii) commercial papers
- Securities for Investment (Income generating position of Securities)
  - ✓ Government dated securities
  - ✓ Corporate bonds and other holdings

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Investments Contd…

Trading Account Assets

- Securities purchased to provide short term profits from short term price movements
- Amount recorded in the trading account is valued in market

Government funds and Reverse Repurchase Agreement

- It is one type of loan account
- Generally overnight loan
- Government fund sold : funds come from the deposits at central bank
- Reverse Repo

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Loan Accounts

- Commercial and industrial loans
- Consumer loans
- Real estate loans
- Financial institution loans
- Priority Sector Lending

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Approaches to Bank Lending

- **Liquidation Approach:**
  It considers the assets of the borrower as security for a loan. It implies a short-term rather than a long term view of the borrower's prospects

- **Going Concern Approach:**
  It gives greater emphasis on the borrower's ability to repay the loan out of future cash flow rather than his ability to offer some tangible assets as security for the loan

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Specific and General Reserves

- Specific Reserves: Set aside to cover a particular loan
- Remaining are called General Reserves
- Determined by management, taxes and government regulations

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Miscellaneous Assets

- Fixed Assets
- Indirect and direct investment in real estate
- Goodwill and other intangibles

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CONCLUSION

- The balance sheet represents the financial position of commercial banks at a particular point of time
- Loans, Investments, cash are the major assets of commercial banks
- There are two approaches of bank lending: Liquidation and Going concern

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- Bank management & financial services by Rose, P. S., & Hudgins, S. C., McGraw-Hill Education, 2008.
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CONCEPTS COVERED

- Commercial Bank Liabilities
- Factors affecting bank deposits
- Income Statement
- Balance sheet and Income statement variations across the size

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Liabilities of Commercial Banks

- Deposits
- Borrowings from non-deposit sources
- Equity Capital
- Off-balance sheet items

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Bank Deposits

- **Demand Deposits**

  Current Deposits: These are chequable accounts, there are no restrictions on the amount or the number of withdrawals from these accounts and does not carry any interest

  Savings Deposit: Cheques can be drawn, withdrawn from an account without previous notice are restricted

- **Call Deposits : they are accepted from fellow bankers and are repayable on demand. These deposits carry am interest charge**

Bank Deposits Contd….

- **Time Deposits: Usually carry a fixed maturity and stipulated interest rate**

- **Recurring Deposits: Fixed amount of money deposited in an uniform interval for a stipulated fixed period and carry a stipulated interest rate**

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Factors Affecting Bank Deposits

- Increase in per capita income
- Expansion of banking facilities
- Increase in banking habit
- Increase in relative rate of return on deposits
- Increase in bank credit
- Inflow of deposits for NRIs
- Growth of substitutes

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Borrowings for Non Deposit Resources

- Borrowing from money market
- Borrowing from Central Bank through repo operations
- Borrowings from other banks apart from regular money market
- Subordinate debts
- It has grown due to lesser cost
- These are highly volatile

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Equity Capital

- **Preferred Stock: It gives its holder an fixed annual dividend before common shareholders receive any dividend payment. It is not tax deductible (less preferred)**
- **Common Stock Outstanding**
- **Retained Earnings**

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Balance Sheet Variations Across Size

- Relative importance of balance sheet varies across the size
- Larger banks tend to trade securities for short-term profits than smaller banks
- Smaller banks hold more investment securities and loan relative to their assets
- Smaller banks rely more on deposits
- Larger banks make more use of money market instruments

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Off-Balance Sheet Items in Banking

- Unused Commitments: In this case a lender receives a fee to lend upto a certain amount of money over a defined period of time, but these funds have not yet been transferred from lender to borrower
- Standby Credit Agreements: Banks receive a fee to guarantee repayment of a loan that a customer has received from another lender
- Derivative Contracts: Future Contracts, Options, Swaps to hedge credit risk, interest rate risk and foreign exchange risk

Income Statement

- It indicates the amount of revenue received and expenses incurred over a specific period of time
- Close correlation between the balance sheet items and income statement
- Assets usually account for the majority of operating revenues and liabilities generate bank's operating expenses

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Revenue and Expenditure Items

- Interest Income: Interest earned from loans and security investments
- Non-Interest income: fees, commissions etc
- Interest expenses: Interest on deposits, interest owed on short term borrowings in the money market, long term borrowings
- Non- Interest Expenses: Cost of equity capital, salary, wages, benefits paid to employees, overhead expenses, funds set aside for possible loan losses and taxes owed.

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Revenue and Expenditure Items Cont…

- Net interest income = Interest income – Interest expenses
- Net Income = Total Revenue – Total Expenses
- Pre tax Net Operating Income= Net interest income + Net Non-interest Income
- Pre tax Net Operating Income – Tax + Securities gains or losses + Extraordinary Income = Net Income

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Income Statement Ratios and Bank Size

- Large banks receive more income from non-interest income
- Small banks rely more on deposits than money market instruments.

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CONCLUSION

- Deposits, borrowings, equity shares are the major sources of liability of the commercial banks
- Unused commitments, standby credit agreements and derivatives contracts are the major off-balance sheet items
- Relative importance of balance sheet varies across the size of the bank
- The income statement is correlated with the balance sheet
- Interest income is the major source of revenue of commercial banks
- Importance of non-interest income has been increasing over the years

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