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BANKING LAWS

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CHAPTER 03

ROLE OF BANKS IN AN ECONOMY

VOLUME - 01

Banks and Banking Business

SECTION - 01

Preliminary Understanding of Banking

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B. Banks as Institutions of 'Payments'
C. Credit Creation by Banks
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CHAPTER 03

ROLE OF BANKS IN AN ECONOMY

A.] What 'Banks' do?

In the words of **International Monetary Fund (IMF)**, although banks perform many functions in an economy, their primary function is to act as an **intermediary** between the depositors (who lend money to the bank) and borrowers (to whom banks lend money). Additionally, the **Bank of International Settlements (BIS)** considers that the banks have a major role in extension of credit and have continued to remain its main source. Banks are also considered as important institutions in an economy which provide safe place for individuals (called as retailers) and businesses to store their money, offering loans to stimulate economic activity, and facilitating a wide range of financial transactions. They also play a critical role in resource allocation, economic growth, and maintenance of financial stability. **One may think that why banks get related to the economic activities?** The answer to this question lies in the fact that in order to carry out any economic activity, '**capital**' is required as a very important resource. In the simple set of conditions, there may be people willing to conduct an economic activity but due to lack of the required capital, they might not be able to pursue their objectives. This is where **intermediation** by banks connects the depositors to the borrowers.

In addition to the function of banks as discussed above, banks are also instrumental in implementation of the monetary policy. For the sake of simplicity in understanding, monetary policy could be meant to mean a set of actions decided by the government through its central bank to control the amount of money in circulation and cost of its borrowing. Readers might have come across the phrase 'through banking channels only' in their day-to-day dealings but might have seldom thought about the meaning attached to it. When a financial transaction is performed through banking channels, it gets accounted in the eyes of law and therefore would not be considered as '**money laundering**' under **Section 3** read with **Section 2 (r)(rb)** of **Prevention of Money Laundering Act, 2002**. Regulator of the banking system needs to keep a check on the quantum of currency in circulation so that the value of currency could be assured at all of time and in cases where huge amounts of unaccounted currency comes to circulation, it may lead to decrease in its value, economically called as '**inflation**'.

Other functions performed by banks can be broadly clubbed under the head of 'services' to retail individuals as well as institutions (including industries). Such services range from 'Direct Benefit Transfers' under government schemes to credit of salaries of employees of various organizations. It would also include issuance of cheques, maintenance of term deposits, credit-cards, debit-cards, over-draft facilities, micro-credits and various others known by their distinguished names. Services spectrum of banks would be discussed in detail in Volume 04 of this series.

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B.] Banks as Institutions of 'Payments'

One of the most pursued purposes through banks is doing payments. Legally, payments are recognized mechanisms which help in discharge of payment obligations which are created on the payor by the payee. Bank as an institution authorized to perform payments on behalf of their

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various contributory factors which are important to consider for a successful and legal discharge of payment liabilities. In situations where such a discharge of payment obligation could not be ousted successfully, an incidental claim relating to breach of contract may be filed with appropriate court of law for adjudication of compensation to be paid by the party approaching it due to such a breach in performance of obligations.

In addition to the regular methods of doing payments such as bank transfers which are conducted by the banks on specific mandates of their customers, banks also deal with

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Banks are most preferred for the processing of payments due to their network with other banks and by virtue of them being member of the nation's settlement/clearing/netting system. Banks do not merely support with the processing of negotiable instruments but equally account for the record-keeping of transactions being performed through '**movement of accounts**' which serves as evidence under **Bankers' Books Evidence Act, 1891**.

Banks are constituent units of a country's entire banking system which makes movement of money easy and transparent. For example, every bank in India is a member of the payment system operated by Reserve Bank of India under Section 7 of the **Payments and Settlement Systems Act, 2007**. In order to conduct payments and settlements on a nation-wide scale, the banks need to adhere to the guidelines issued by RBI under **Section 17** of the above-mentioned Act. In this perspective, the banks serve as important institutions of conducting payments and their settlements with necessary record-keeping on behalf of both the payor as well as their recipients. It is significant to note here that all settlements and netting transactions are governed by **Section 23** of the Payments and Settlement Systems Act, 2007.

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Summarily therefore, the only legal way to arrive at discharge of payment obligations is to conduct a payment transaction through the authorized banking channels. In addition to such payments, banks also offer multifarious payment solutions by offering **add-on services** which are linked to their savings/ current accounts maintained by the customers such as debit-cards,

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of payment mechanisms operated by the banks, transparency in banking system is a major area of concern and is governed through directions of the regulator (RBI) and other corporate governance initiatives carried out with that very specific purpose.

C.] 'Credit Creation' by Banks

One of the primary purposes and importance of banks is that they are the authorized institutions for creation of credit. The process of credit creation involves supplying money for circulation in the economy and assisting to meet several of the money requirements in order to carry out various economic activities. Credit creation is the result of 'financial intermediation' which is also the primary role of banks in an economy. At first, the depositors approach banks to deposit their surplus money (which they intend to keep with the bank). Such deposits are classified in two groups: **1.) Term Deposits (TDs)** which are deposits made for a fixed or pre-determined period of time. (*Such TDs are also commonly known as 'Fixed Deposits'*); and **2.) Demand Deposits (DDs)** which is any amount of money kept the depositor with a bank subject to its irrevocable repayment on demand.[1] While TDs offer greater amount of flexibility for credit creation, DDs are often less involved in credit creation in comparison to the TDs.

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When such cheques are deposited with the same or some other bank, it again drops in the cycle of demand deposits and the cycle keeps running till reserves of the banks become zero.

The amount of credit credited by a bank is influenced by '**credit multiplier coefficient**' which is achieved by dividing 1 by the CRR at any given point of

[1] From the banks perspective, consolidated sum of TDs and DDs is known as 'Net Time and Demand Liabilities (NTDL) which is the basis for laying down CRR and SLR as components of monetary policy by the central bank.

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time. The credit multiplier coefficient and the resultant credit could be understood with the help of illustration given below:

Illustration 01: Credit Multiplier Coefficient (CMC)

CMC = 1 / r , where r is the Cash Reserve Ratio (CRR)

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Total Credit Created = D × CMC

If Deposit is 10,000 then credit created would be:

CC = 10,000 × 10 = 1,00,000

It can be inferred from the illustration given above that;

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There are however certain limitations attached to the process of credit creation by banks. From the discussion made hereinabove, one can easily conclude that credit creation by banks is directly dependent upon the amount of deposits which the banks receive through public. There may be decrease in the amount of surplus due to control mechanisms being exercised by the central banks, which are known as CRR and SLR. There may be operational insufficiencies which may also impact the credit creation possibilities in banks.

It has been rightly said by Culbertson that 'commercial banks are the institutions that make short term loans to the businesses and in the process create money'. An interesting fact to note here is that although credit creation by multiplier effect is performed by the participating banks in an economy, there is no resultant change in the books of the central bank

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book entries (book money) without any collateral deposit being made any of its customers but such a mechanism would refute the primary function of banks which is intermediation. Book money is also created when banks engage themselves in buying/selling of securities which is a different set of function altogether.

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D.] Implementation of Monetary Policy

Central banks in an economy perform the most important function of implementation of monetary policy for the purposes of ensuring monetary stability and regulate flow of money in the economy.

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compliance of the CRR, are not entitled for payment of any interest thereupon since 31 March, 2007. In order to ensure strict and timely compliance by the banks, **Section 43 (3)** provides power to RBI for imposition of penalties on the defaulting banks.

Practically, CRR is the only effective tool of ensuring monetary stability by maintaining reserves in proportion to the total time and demand liabilities falling incumbent on the participating banks. The requirement of maintaining CRR is not applicable to all

becomes costly which is known as increase in the interest rates on borrowing. Conversely, lowering the CRR would increase credit creation and thereby lower the interest rates.

The other important tool of monetary policy is the **Statutory Liquidity Ratio** (SLR). SLR could be prescribed by RBI in specified assets, in furtherance of the amendment made to **Section 24 of the Banking Regulation Act, 1949** through the **Banking Regulation (Amendment) Act, 2007** which replaced the Regulation (Amendment) Ordinance, 2007. SLR is a percentage of a bank's NTDL as on last Friday of the second preceding fortnight.[3] SLR is not maintained with the central bank but is kept by the bank itself in either of the forms as indicated below:

I. Cash
II. Gold valued at a price not exceeding the market value
III. Investments in specified securities[4]

Banks are being continuously guided upon the classification and valuation of approved securities which

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...eir SLR component in gold where value appreciates over a period of time and banks earn money out of the

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[2] Presently, it is 6% of NTDL for the commercial banks.

[3] Notification DBOD.No.Ret.91/12.02.001/2010-11 dated May 09, 2011

[4] Master Circular RBI/2010-11/70 DBOD.No.Ret.BC.23/12.01.001/2010-11 dated July 01, 2010

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increase in market prices of the gold. As per the present directive, banks may consider investments in the following categories of securities:

I. Dated Securities
II. Treasury Bills of the Government of India

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V. instrument as may be notified by the Reserve Bank of India

SLR as a tool is made mandatory to ensure solvency of the banks at all points of time which ultimately minimizes the systemic risk which may spread to the entire banking system in the event of failure of any participating bank. SLR is kept both in the form of **cash and/or liquid assets** within the bank whereas CRR is kept only in the form of cash with the reserve bank. Banks utilize such liquid assets by converting them into cash under the **Marginal Standing Facility** window. It is clear from the discussion made in this section that monetary policy as an economic tool could only be implemented by active involvement of the banks and their strict compliance of the guidelines/instructions issued in that behalf.[5]

Questions for 'Thinking'

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[5] For example, Master Direction - Reserve Bank of India [Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)] Directions - 2021

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OTHER CHAPTERS IN SECTION 01

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