32

Nature and Scope of Banking

32.1 Introduction

You have studied in lessons 7 and 10 that banking is an important aid to industry and trade, and that it also provides a variety of services to the public in general. Indeed banking may be regarded as an indispensable part of the economy of every country. The significance of banking has increased all over the world with the rise in income levels and growth in the volume of financial transactions.

In this lesson, we shall study about the nature and scope of banking and its activities.

32.2 Objectives

After studying this lesson, you will be able to —

1. describe the terms bank and banking;
2. distinguish between banks and money lenders;
3. classify the various types of banks;
4. explain the nature and scope of banking activities;
5. enumerate the advantages of commercial banks;
6. describe how suspension of banking activities will affect trade, commerce and industry.
32.3 Meaning of the terms Bank and Banking

Bank is an institution which deals in money and credit. It accepts deposits from the public and grants loans and advances to those who are in need of funds for various purposes.

Banking is an activity which involves acceptance of deposits for the purpose of lending or investing. In addition to accepting deposits and lending funds, banking also involves providing various other services along with its main banking activity. These are mainly agency services, but include several general services as well.

A banker is one who undertakes banking activities, accepting deposits and lending money for different purposes. The Banking Regulation Act, 1949 defines banking as an activity of accepting funds from the public for the purpose of lending or investment.

The essential features of banking activities are as follows:-

i) accepting deposits from public;

ii) lending or investment of such deposits;

iii) incidental to the activities of accepting deposits for lending or investing, banks undertake activities like –

a) Promoting and mobilizing savings of the public;

b) Providing funds to trade and industry by way of discounting bills, overdraft, cash credit facility, and transfer of funds from one place to another;

c) Providing agency services to customers, such as collection of bills, payment of insurance premium, purchase and sale of securities, etc., and other general services, such as issue of travellers’ cheques, credit cards, locker facility, etc;

Money deposited with the bank is assured as far as its safety is concerned. Further the depositor is allowed to withdraw it whenever required. Banks allow interest on deposits. Such interest helps in the growth of funds deposited with the bank. Thus the rate of interest provided on deposits acts as an incentive to the depositors.
Intext Questions 32.1

Write “T” against the statements which are true and “F” against those which are false.

i) Banks do not deal with public funds.  
T

ii) Banks accept deposits only from businessmen. 
F

iii) Banking is an activity concerned with accepting deposits 
T

iv) Banking Regulation Act 1949 has defined banking in terms of its main activities.
T

v) Banks promote the saving habit of people.
T

vi) A Bank cannot purchase or sell securities for its own customers.
T

vii) Banks do not allow interest on deposits.
T

viii) Only the depositors of money are granted loan by the bank.
F

32.4 Distinction between Banks and Money Lenders

In order to distinguish between banks and money lenders, it is necessary to know who is a money lender. A money lender is an individual who lends money to meet the cash requirements of people. He may or may not be a professional money lender.

A professional money lender is one who is exclusively engaged in money lending activity. He may occasionally accept deposits and provide agency services to his customers. A non-professional money lender, on the other hand, is either a merchant, or a trader, or a member of the business community, whose main activity is not money lending. Such money lenders engage in money lending as a side activity.

A money lender normally meets the cash requirements of the public. He gives loans for consumption purposes such as marriages and other social functions. The rate of interest charged by him is generally very high. He may give loans against the security of jewellery, household items, property and assets as well as against personal security. Practices adopted by money lenders are known to be manipulative in nature. For
instance, they do not furnish receipt of payments made, manipulate books of accounts, and realise more money than the original loan. The money lending practices of money lenders are considered to be exploitative and socially undesirable.

### Distinction between bank and money lender

<table>
<thead>
<tr>
<th>S.No.</th>
<th>Basis</th>
<th>Bank</th>
<th>Money lender</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Entity</td>
<td>Banks are organised institutions</td>
<td>Money lenders are generally individuals.</td>
</tr>
<tr>
<td>2</td>
<td>Nature</td>
<td>Banks are professional organisations</td>
<td>Money lenders may or may not be professionals.</td>
</tr>
<tr>
<td>3</td>
<td>Activity</td>
<td>Banking activities include acceptance of deposits for lending.</td>
<td>Activities of money lenders may not include acceptance of deposits.</td>
</tr>
<tr>
<td>4</td>
<td>Clients</td>
<td>Banks meet the needs of people in general and the business community in particular.</td>
<td>Money lenders meet the cash requirement of agriculturists and the poorer people.</td>
</tr>
<tr>
<td>5</td>
<td>Security</td>
<td>Banks accept tangible and personal security against loans.</td>
<td>Money lenders generally do not give loan against personal security.</td>
</tr>
<tr>
<td>6</td>
<td>Process of recovery of loans</td>
<td>The process of recovery is flexible.</td>
<td>The process of recovery is rigid and strict.</td>
</tr>
<tr>
<td>7</td>
<td>Purpose of loan</td>
<td>Normally banks grant loans for productive purposes.</td>
<td>Money lenders give loans for non-productive purposes</td>
</tr>
<tr>
<td>8</td>
<td>Interest Rate</td>
<td>Interest charged by banks on loan is 12 to 18% p.a.</td>
<td>Rate of Interest charged by money lenders is very high.</td>
</tr>
</tbody>
</table>
(2) Commercial Banks

(3) Industrial Banks

(4) Foreign Exchange Banks

(5) Development Banks

(6) Regional Rural Banks

(7) Co-operative Banks

Reserve Bank of India (Central Bank)

In every country, the bank which is entrusted with the responsibility of guiding and regulating the banking system is known as the Central Bank.

In India the central banking authority is the Reserve Bank of India. The Reserve Bank does not deal directly with the members of public. It acts as bankers’ bank maintaining deposit accounts of all other banks and advances money to banks whenever needed. It regulates the volume of currency and credit, and has powers of control and supervision over all banking institutions.

The Reserve Bank also acts as government banker and maintains the record of government receipts, payments and borrowings under various heads. It advises the government on monetary and credit policy, besides deciding on the rate of interest on bank deposits and bank loans. It is the custodian of currency reserves consisting of foreign exchange, gold and other securities. Another important function of the Reserve Bank is the issue of currency notes and regulation of the money supply.

Commercial banks

Commercial banks are banking institutions which accept deposits from the public and grant short-term loans and advances to their customers. In India, there are nationalised (public sector) commercial banks as well as private sector banks which are corporate organisations. The largest commercial bank is the State Bank of India which was established in 1955 under a special Act. The main source of income of commercial banks is the difference between the interest they charge on loans and
the interest they allow on deposits. Commercial banks generally grant short-term loans repayable within one year. But they also meet the medium-term and long-term requirements of business enterprises. Besides accepting deposits and lending money, commercial banks provide other services such as issue of bank drafts, traveller’s cheques and letters of credit, collection of bills, dividends and interest safe keeping of valuables, transfer of money from one place to another, payment of insurance premium etc.

All these functions are discussed in the next lesson under the head “Functions of Banks”.

**Industrial Banks**

Industrial Banks are corporate organisations which specialise in providing industrial capital by subscribing to the share and debenture issues of public companies. Industrial banks normally meet the long term requirements of funds for purchase of land, plant and machinery, and financing of expansion and diversification activities of industrial companies. These banks generally secure representation on the board of directors, and provide technical guidance in the management of industrial companies.

**Foreign Exchange Banks**

Business firms engaged in foreign trade receive and make payment through foreign currency. In order to facilitate such transactions and also help exporters and importers, there are banking institutions which primarily engage in transactions involving foreign exchange. These are known as Foreign Exchange Banks. In India, Export and Import Bank of India (EXIM Bank) has been set up by the Government to help export and import trade and other related activities. Such activities are also undertaken by the foreign exchange division of commercial banks. Exchange banks which are foreign in origin have their head offices located outside India. Besides financing foreign trade, the exchange banks also render services incidental to their main function, such as acting as referees, collecting and supplying information about the foreign customers, providing remittance facilities. They engage in other kinds of banking business as well, like acceptance of deposits, grant of loans and advances, etc.
However, financing foreign trade remains their field of specialisation. Licensing of these banks is required under the Banking Regulation Act 1949. Their operations are subject to general control of the Reserve Bank of India. Regarding their foreign exchange transactions, these banks are governed by the Exchange Control Regulations.

**Development Banks**

Development banks are special financial institutions which provide long-term capital to industry. Rapid development of industries in India after independence requiring huge financial investment and promotional efforts led to the establishment of these institutions. Development banks assist the promotion, expansion and modernisation of industries. Besides providing long-term finance, these banks also subscribe to the capital issues of industrial undertakings, if the public subscription falls short of the total issue. Thus they act as underwriters as well. Moreover, these banks provide technical advice and assistance, if needed.

Development banks which have been established and functioning in India are:

- Industrial Finance Corporation of India (I.F.C.I)
- State Finance Corporation (S.F.Cs.)
- Industrial Credit and Investment Corporation of India (ICICI)
- Industrial Development Bank of India (I.D.B.I.)
- Industrial Reconstruction Bank of India (I.R.B.I.)

Industrial Development Bank of India acts as an apex organisation to co-ordinate and assist in long term industrial finance by other institutions.

**Regional Rural Banks**

Commercial and industrial banks cater to the financial needs of trade and industry. In rural areas, there are small farmers, farm labourers, artisans and small entrepreneurs, who need financial assistance. To meet their financial needs, a separate category of banks known as Regional Rural Banks have been set up in India. These banks are financed
by nationalised banks. The central government specifies the local limits within which regional rural banks shall operate. The banks are allowed to establish their own branches or agencies within the specified area. They grant loans at lower rates of interest than the rates charged by other banks. These banks are rural based, rural oriented and organised like commercial banks. The purpose of these banks is to finance agricultural operations and provide employment to rural educated youth who possess the requisite orientations.

Regional Rural Banks have been conceived to combine the strong points of both the co-operative and commercial banks eliminating the weaknesses of both. The Regional Rural Banks have been included in the second schedule of the Reserve Bank of India Act and, therefore, they enjoy the same privileges and facilities as the scheduled banks, including access to the Reserve Bank for financial accommodation.

**Co-operative Banks/Society**

Co-operative Banks in India are established under the provisions of the Co-operative Societies Act 1912. These are organised on co-operative basis. It was with a view to provide adequate credit at economical rates of interest to the farmers, that co-operative credit societies were first, organised in villages for providing financial help to agriculturist and rural artisans.

Co-operatives banks are organised both at primary and district level. Co-operative Credit Societies (banks) at the primary level/local level are members of central co-operative banks at the district level. Similarly, at the state level, there are state co-operative bank, which finance, co-ordinate and control the central co-operative banks in each state. Thus the structure of co-operative banks in India is pyramidal in nature.

A co-operative credit society (bank) at the primary level can be formed by the local people having common interest and common purposes.

The co-operative banks generally grant loans for productive purposes but they can also do so for other purposes. The rate of interest charged is very moderate. The mode of recovery of loan is not very rigid.
Unorganised Banking Sector

The unorganised sector of banking in India consists of money lenders and indigenous bankers known as shroffs, sahukars, mahajans, chettis, etc. These are individuals doing banking business, along with trading and commission business in many cases. Their activities are not organised. They follow rules of their own. But they are trusted people in their own locality. The people of the area deposit their savings with them. They lend money to people who need it for purchasing fertilisers, seeds, agricultural equipments or even for social obligations. Loans are given on the security of jewellery and other valuable assets. The rate of interest charged by them is very high. Besides, money lenders manipulate the book of accounts. They realize more money than what they had lent. In most of the cases the poor borrowers are unable to repay the loans and lose their valuables kept as security. Inspite of these, people borrow money from sahukars or money lenders as they are easily approachable. However, their significance is gradually declining due to the spread of modern banking institutions.

Intext Questions 32.3

A. Write “T” against the statements which are true and “F” against those which are false-

a) Banks are meant for industrial development only.

b) Banks are located only in urban areas.

c) Banks can be established only by the Govt. of India.

d) Reserve Bank of India is the central bank of India.

e) Exchange banks do not accept deposits from customers.

f) State co-operative banks control the central co-operative banks.

g) Reserve Bank of India is a bankers’ bank.

h) Industrial banks subscribe to shares issued by public companies.
i) Reserve bank of India cannot issue new currency notes in India.

j) Generally commercial banks grant long-term loans only.

B. Write full form of the followings


32.6 Nature and Scope of Banking Activities

Banking activities are considered to be the life blood of the national economy. Without banking services, trading and business activities cannot be carried on smoothly. Banks are the distributors and protectors of liquid capital which is of vital significance to a developing country.

Efficient administration of the banking system helps in the economic growth of the nation. Banking is useful to trade and commerce.

Banking activities are useful to trade and industry in the following ways.

a) Money deposited in a bank remains safe. Precious articles too can be kept in the safe custody of banks in lockers.

b) Banks provide credit facilities to their customers. Customers with bank accounts also enjoy better credit in the business world.

c) Banks encourage the habit of saving and thrift among people. They mobilise savings and invest them in productive activities. Thus, they help in increasing the rate of savings and investment in the country.

d) Banks provide a convenient and safe means of transferring money from one place to another and facilitate business dealings/transactions.

e) Banks collect and realise bills, cheques, interest and dividend warrants etc. on behalf of their customers.

f) Foreign trade is facilitated considerably with the help of banks.
which receive and make payments, provide credit and deal in foreign exchange. They protect importers from the risk of loss on account of exchange rate fluctuations. They issue letter of credit and provide information on the credit worthiness of importers. They also act as referees of their customers.

g) Banks meet the financial needs of small-scale business units which are located in economically backward areas.

h) Farmers and artisans in rural areas can also avail of bank credit for financing their activities.

i) Commercial banks provide many other services to the general public which include locker facility, issue of traveller’s cheques and gift cheques, payment of insurance premium, etc.

Service activities of banks

Service activities of banks may be categorised as follows:

i) Agency services

ii) General services

Agency services

Banks undertake/ various agency services for their customers. These are outlined below.

a) Collection of cheques, drafts, and bills of exchange on behalf of customers.

b) Collection of dividend and interest warrants of customers.

c) Collection of pension of government employees.

d) Purchase and sale of securities on the instructions of customers.

e) Executing standing orders for payment of rent, electricity bill, insurance premium etc.

f) Acting as correspondent or representative of customers in dealing with other banks.

g) Acting as trustee or executor when so nominated.
General Services

A commercial bank also performs the following services of general utility to the public:

a) Issue of letters of credit, traveller’s cheques and circular notes.

b) Safe custody of valuables like gold, jewellery and important documents in safe deposit vaults (lockers) available on hire.

c) Supply of trade information.

d) Acting as a referee as regards financial status of customers.

e) Acceptance of bills of exchange on behalf of customers.

f) Underwriting loans floated by government and public bodies.

Intext Questions 32.4

A. Write “T” against the statements which are true and “F” against those which are false –

a) Banking activities may be regarded as the life blood of the national economy.

b) Banking activities are useful only to trade and commerce.

c) Money deposited in a bank cannot be withdrawn then and there.

d) Banks encourage the habit of saving and thrift among people.

e) Banks collect and realise bills, cheques etc. on behalf of their customers.

f) Foreign trade cannot be carried on smoothly without the help of banks.

g) Money can be easily transferred from one place to another with the help of a bank.
B. Fill in the blanks with suitable words

 a) Banks collect cheques, drafts and bills on ________ of customers.

 b) Banks purchase and sell securities on the ________ of customers.

 c) Banks provide locker facility to customers on ________.

 d) Banks help in increasing the rate of ________ and ________ in the country.

32.7 Advantages of Commercial Banks

In view of their functions and services, commercial banks play a crucial role in the development of business activities. Business activities cannot run smoothly without banking services. Following are the advantages of commercial banks in a modern society.

(1) Money deposited in commercial banks can be withdrawn on demand by cheque. Payments can also be made by cheque. Thus, business firms are not required to maintain large cash balances with them. They are also not required to make large payments in cash. Moreover, payment by cheque provide documentary proof of the transaction.

(2) Financial assistance is provided by commercial banks by way of cash credit, overdraft, loans and advances on discounting of bills of exchange. Availability of short-term funds help business enterprises to overcome the problem of liquidity due to the time lag between current expenses and realisation of sale proceeds.

(3) Various agency services provided by commercial banks are prompt and reliable. For all these services banks charge only a nominal fee or commission. Trade and industries get the benefit of these services available at a reasonable charge.

(4) Banks offer attractive rates of interest for savings by the public which help to mobilize funds for lending and investment. Banks encourage the habit of thrift among people, and attract deposits,
whereby scattered household savings of the people are pooled and made available for productive purposes.

5) Many general utility services are available to the public through banks, such as acting as referee, accepting bills of exchange, providing locker facility, etc. These are of great advantage in meeting recurrent as well as occasional needs of business firms and individuals.

6) Foreign trade cannot be carried on smoothly without banking services. Banks receive and make payments, provide credit and deal in foreign exchange. Most commercial banks currently have separate foreign exchange divisions.

**Intext Questions 32.5**

Write “T” against the statements which are True and “F” against those which are false -

a) Commercial Banks play a crucial role in financing business activities.  

T

b) Banking helps business to be run without large cash balances.  

T

c) Those engaged in import and export trade cannot operate smoothly without banking services.  

T

d) Banks cannot do much to increase savings by people.  

T

e) Bank collect and realise bills, interest warrants, etc. and charge heavily for the service.  

T

f) Payment by cheque does not provide documentary proof of the transaction.  

F

g) Banks offer attractive rates of interest for savings.  

T

h) Banks ensure the liquidity of business without involving cash transactions.  

T

i) Cheque system has reduced the volume of currency in circulation.  

T
Effect of suspension of banking activities on Trade Commerce and Industry

As a result of economic growth, increase in money supply, growth of banking habits, and control and guidance by Reserve Bank of India, the Indian banking system has achieved a record progress over the years. Banking activities in our economy have become so imperative and important for the trading community and even for the general public, that even a temporary halt in banking activities may vitally affect trade, commerce and industry. This position can be explained briefly as follows.

(i) In the event of suspension of banking activities, people would neither be able to deposit their savings in banks, nor be able to withdraw money from banks. Savings are then likely to decline with a corresponding increase in consumption expenditure.

(ii) Non-availability of bank loans and credit facilities will adversely affect industrial production. The volume of trade will shrink. Limited cash in hand and inadequate currency in circulation may not permit cash transactions in buying and selling of all goods. With reduced production and rising consumption expenditure prices would tend to rise. Traders may exploit the situation by hoarding and blackmarketing of essential goods.

(iii) Farmers and small business units will suffer badly if banking operations are suspended. They will be forced to go to money lenders to borrow money at high rates of interest when bank finance is not available.

(iv) Foreign trade will be badly affected in the absence of facilities regarding issue of letter of credit and foreign exchange transactions.

(v) Business firms as well as the public will have to depend on postal services and private agencies for remittance of money and on other agencies for collection of bills, interest and dividend warrants. Heavy expenses will have to be incurred for the services.
People will have to go to courts of law for recovery of their jewellery and other valuable articles from bank lockers.

We cannot think of any day without the use of banking services such is the importance of banking in our daily life.

**Intext Questions 32.6**

Write “T” against the statements which are true and “F” against those which are false.

i) Banking activities in our economy are very important for the trading community and general public. 

ii) The suspension of banking activities may lead to severe adverse effects on trade, commerce and industry.

iii) In the event of suspension of bank activities, people will deposit their savings with traders.

iv) If there is suspension of bank services people will be allowed to withdraw money from banks.

v) With the suspension of bank activities, collecting of cheques and payment by cheque would not be possible.

vi) Discounting of trade bills may be easily possible even without banks.

vii) Even with suspension of bank activities, all business transactions may be undertaken easily with available cash.

viii) Traders can easily finance each other in case bank finance is not available.

ix) Absence of banking services will not affect the general public at all.

x) In the absence of banking activities we cannot use locker facility.
32.8 What You Have Learnt

A bank is an institution which accepts deposits from the public and grants loans and advances. Banking is an activity which involves acceptance of deposits for the purpose of lending or investing. A banker is one who undertakes banking activities.

The essential features of banking activities are: accepting deposits, lending money, mobilising savings, financing trade and industry, and undertaking several agency services as well as general utility services.

Banks are organised institutions whereas money lenders are mostly individuals, who may or may not accept deposits and engage in trade or other activities besides money lending.

Banking intsitutions in India may be divided into the following types: Reserve Bank of India (Central Bank), Commercial Banks, Industrial Banks, Exchange Banks, Development Bank, Regional Rural Banks and Co-operative banks. The various types of banks have distinct functions although some of the functions are common to all.

Banking activities may be regarded as the life blood of an economy. These activities are extremely useful to trade, industry and business as well as to the general public. Service activities of banks include agency services and general utility services. There are several advantages of commercial banks in a modern society. Supension of banking activities may have adverse effects not only on industry, trade and commerce, but also on farmers and small business units in rural areas. Savings by the public may decline. Productive activities may suffer.

32.9 Terminal Exercise

1. Define the terms Bank and Banking.

2. Explain the different types of banks.

3. Differentiate between banks and money lenders.

4. What do you mean by industrial bank?

5. State briefly the function of foreign exchange banks.
6. Define commercial banks.

7. What type of services do banks provide as agent of their customers?

8. Explain the utility of banking services to business.

9. Describe the services of a commercial bank to the business community.

10. How do banks help foreign trade?

11. Explain the role of banking in modern society.

12. Describe the possible effects of suspension of banking activities.

13. Do banks provide services other than accepting deposits and lending money? Discuss

14. Write brief notes on:

   (a) Reserve Bank of India

   (b) Co-operative Banks

   (c) Development Banks

**Answers to Intext Questions**

32.1 True iii) iv) v)

   False i) ii) vi) vii) viii)

32.2 A. i) institutions iii) organised,

   ii) tangible iv) lower

   B. True iii) iv) vi)

   False i) ii) v) viii)

32.3 A. True d) f) g) h)

   False a) b) c) e) i) j)

   B. Industrial Finance Corporation of India
Industrial Credit and Investment Corporation of India

Industrial Development Bank of India.

Industrial Reconstruction Bank of India

32.4 A. True a) c) e) f) g)
False b) d)

B. a) behalf b) instructions
c) hire d) saving, investment

32.5 True a) b) c) g) h) i)
False d) e) f)

32.6 True i) ii) v) x)
False iii) iv) vi) vii) viii) ix)