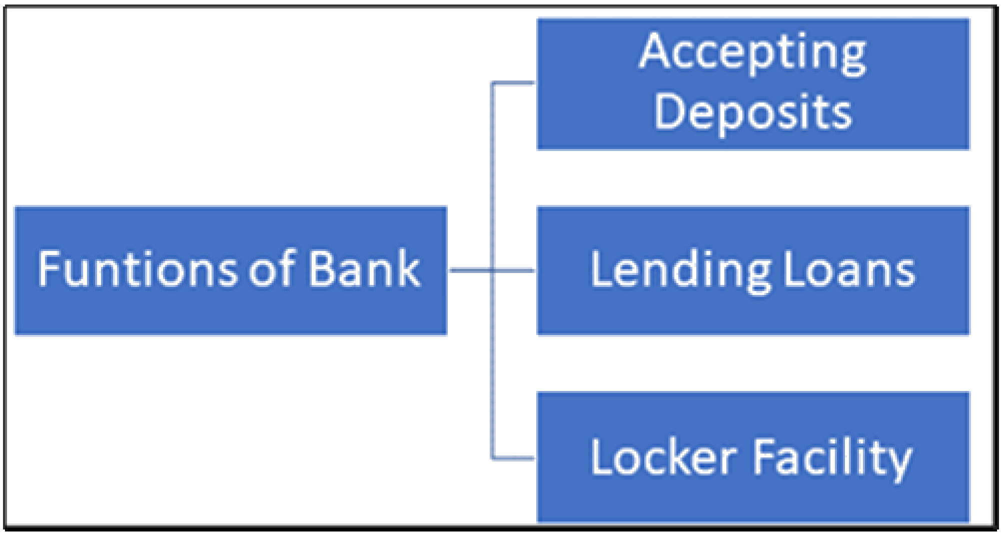
Economics: Banking and Credit: Meaning and Functions of Bank (For CBSE, ICSE, IAS, NET, NRA 2022)

Meaning

- A bank is an institution which accepts money from public as deposits and gives loans to them when needed.
- Banking can be defined as the business activity of accepting and safeguarding money owned by other individuals and entities, and then lending out this money in order to earn a profit.

Functions of Bank

The basic or primary functions of bank are as follows:



Accepting Deposits

The primary function of a bank is to accept deposit from the public and to pay interest on that deposit depending on the terms and nature of deposit. Before depositing money with the bank, the individual or group of individuals has to open an account with the bank. Then bank gives an account number to the depositor. Whenever they want to deposit or withdraw amount from bank, they have to mention this number so that bank will deposit or withdraw that money from that account. The bank issues cheque books to its depositors. Cheques are used by the depositors to withdraw money from the bank and making payments to any party through the bank.

Lending Money

The bank lends money to the public to fulfill their needs when they need it or apply for it. They individual or group of individuals can borrow money to fulfill their present need and repay the same amount with interest in future.

Locker Facility

There is another function performed by a bank. The bank also keeps valuable things of people such as jewelry, property documents etc. Normally, people want to keep valuables in safe custody which is provided by the bank in the form of 'locker facility' .

The Process of Credit Creation

Credit is an agreement whereby a financial institution agrees to lend a borrower a maximum amount of money over a given period of time. This means that the bank can claim the money from the borrower in future. Accordingly, the bank is able to expand its deposits. This is called credit creation by the bank. So, we can say that credit is created through the act of lending and borrowing. When people deposit money in form of cash with the bank these deposit are withdrawable by the depositors. It is assumed that all depositors will not withdraw whole cash at the same time. So, a part of these deposits are kept by the bank to meet the demand for cash of the depositors. This is termed as minimum cash reserves or cash reserve ratio. The percentage of money to kept as a reserve is already prescribed by the bank. The deposit which is left over after deducting cash reserve from the total deposits is used for lending loans to borrowers. From here the process of credit creation starts. Let us describe the process of credit creation step by step through the following example.

Steps in Credit Creation

According to banking authority the bank must create a cash reserve of 20 % of current deposit in the form of cash to make payments to persons who come to withdraw money.

- Step 1. - A person 'A' deposit ₹ 100 in bank. As per rule bank keeps 20 % of 100 as cash i.e.. , ₹ 20 to make the payments and remaining amount i.e.. , ₹ 80 can use to give loan.
- Step 2. - A person 'B' approaches the bank to take a loan of ₹ 80. After the bank gives this loan, it can claim the amount from B in future. Means, the bank can create another deposit of ₹ 80. Now the total deposit with the bank is of ₹ 180 (₹ 100 of A + ₹ 80 given loan to B) .
- Step 3. - Another person 'C' wants a loan from bank. As per rule bank has to keep 20 % of 80 as cash before giving further loan to anybody. 20 % of 80 = 16. So, the bank will now keep ₹ 16 as cash and give the rest of the amount as loan. 80 – 16 = 64. So, the bank can give ₹ 64 as loan to C. Again, by claiming this amount from C, the bank can create another deposit of ₹ 64 and this chain will continue for some time till the balance with bank becomes zero. Accordingly, we can give the following formula for credit creation

Total Credit = Initial Increase in Deposit × 1/Cash Reserve Ratio.

$$500 = 100 \times 1/20\ \%$$

Suppose the total deposit of ₹ 500 can be divided in the following manner

$$\text{Cash Reserve} = 20\ \%\ \text{of}\ 500 = ₹\ 100$$

$$\text{Loan Amount} = 500 - 100 = ₹\ 400$$

Now we can present the various steps (or rounds) of credit creation in the following manner.

Steps	Increase in deposits	Cash reserve	Loan
1	100	20	80
2	80	16	64
3	64	12.8	51.2
4	51.2	10.24	40.96
5	40.96	8.19	32.77
…	…	…	…
Total	**500**	**100**	**400**

The Various Steps (Or Rounds) of Credit Creation

In the process of credit creation two types of deposits are recorded. The first one is called Primary Deposit. Primary deposit is the initial increase in the bank deposit resulted when the bank receives a new deposit from public. The second type of deposit is called Secondary Deposit. The deposits created due to the loans given by the bank in each round are called secondary deposits. Credit creation is possible due to the increases in the secondary deposits.