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B.Com Honours | Semester I | Calicut University

Foundations of Modern Banking

Course Code: COM1MN106 • Module 1 Notes

1. Concept, Evolution, and Significance of Banking

Banking is the lifeline of a modern economy, serving as the primary financial intermediary that bridges the gap between surplus-budget units (savers) and deficit-budget units (borrowers). By providing a secure repository for public savings and allocating capital to commerce, industry, and infrastructure, the banking sector drives national capital formation and economic development. This module introduces the fundamental concepts of banking, its historical evolution in India, the regulatory framework governing the system, functions of commercial banks, and the characteristics of negotiable instruments.

Defining Banking

The term "banking" has been defined legally under Indian statute to reflect its core intermediary functions:

- **Banking Regulation Act (1949):** Section 5(b) defines banking as "the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise."
- **Core Concept:** A banker must perform dual functions: accepting deposits and lending or investing those funds. A financial institution that only lends but does not accept public deposits withdrawable by cheque is not a bank.

Significance of Banking in Economic Development

The banking sector supports macroeconomic growth in several ways:

- **Mobilization of Savings:** It encourages thrift among the public, converting idle household savings into active capital.
- **Credit Creation:** By multiplying credit, banks increase the money supply, supporting industrial and trade expansions.
- **Balanced Regional Growth:** Channeling credit to agriculture, small businesses, and backward regions under priority sector mandates.
- **Financial Inclusion:** Bringing the unbanked population into the formal financial fold, facilitating direct benefit transfers (DBT).

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Evolution of Banking in India

The Indian banking sector has evolved through three distinct historical phases:

- **Pre-Independence Era (Pre-1947):** Dominated by private and presidency banks (which merged to form the Imperial Bank of India, later SBI). Rigged with high failures and limited credit reach to agriculture.
- **Nationalization Era (1969 & 1980):** To direct credit to priority sectors, the government nationalized 14 major commercial banks in 1969 and 6 more in 1980. This led to massive branch expansion in rural areas.
- **Liberalization & Digital Era (Post-1991):** Following Narasimham Committee recommendations, the RBI allowed new private banks (e.g., HDFC, ICICI), introduced technology (Core Banking Solutions, ATMs), and initiated reforms leading to today's Fintech and digital banking landscape.

Structure of the Indian Banking System

The Indian banking system consists of several categories of banks overseen by the Reserve Bank of India (RBI):

Commercial & Co-operative

Commercial banks include Public Sector, Private Sector, and Foreign Banks. Co-operative banks operate on cooperative principles, supporting local urban and rural credit.

Specialized & Development

Regional Rural Banks (RRBs) serve rural credit needs. Development banks (e.g., SIDBI, NABARD, NHB) provide refinance and long-term project finance for specific sectors.

Differentiated Banks

Small Finance Banks (supply credit to small business units, micro farmers) and Payment Banks (provide basic savings and remittance services without lending, e.g., Paytm Payments Bank).

2. Functions of Commercial Banks

Commercial banks perform a variety of functions, broadly classified into primary and secondary activities:

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Function Class	Specific Function	Details & Examples
Primary Functions	Accepting Deposits	Offering Savings accounts (for retail savings), Current accounts (for businesses, with overdrafts), Fixed Deposits (FDs), and Recurring Deposits (RDs).
Primary Functions	Granting Loans & Advances	Providing Cash Credit (CC against stock), Overdrafts (OD on current accounts), Term Loans (for machinery/housing), and Discounting Bills of Exchange.
Secondary Functions	Agency Services	Collecting cheques, paying bills/insurance premiums under standing instructions, acting as executor/trustee, and buying/selling securities.
Secondary Functions	General Utility Services	Providing safe deposit lockers, issuing letters of credit, issuing traveler's cheques, and underwriting securities.

Credit Creation and Liquidity Management

Credit Creation: Commercial banks create credit (deposit money) through the lending process. When a bank grants a loan, it does not pay cash; it credits the borrower's deposit account. Based on the **Cash Reserve Ratio (CRR)**, a bank keeps a fraction of deposits with the RBI and lends the remainder, multiplying the initial deposit into multiple bank credits.

Liquidity Management: Banks must maintain sufficient cash to meet depositor withdrawals while maximizing loans. They manage this through cash reserves, SLR investments, and borrowing in the interbank call money market.

3. Negotiable Instruments

Negotiable instruments are transferrable documents that represent a financial claim, serving as a substitute for money in commercial transactions. They are regulated by the **Negotiable Instruments (NI) Act, 1881**.

Key Characteristics

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- **Easy Transferability:** Can be transferred from one person to another by delivery (for bearer instruments) or by endorsement and delivery (for order instruments).
- **Defect-free Title:** The holder in due course gets a clean title to the instrument, free from any defects in the title of the transferor.
- **Right to Sue:** The holder can sue in their own name if the instrument is dishonored.

Types of Negotiable Instruments

Promissory Note

Section 4: An unconditional undertaking in writing signed by the maker, promising to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer. Contains two parties: Maker and Payee.

Bill of Exchange

Section 5: An unconditional order in writing, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer. Contains three parties: Drawer, Drawee, and Payee.

Cheque

Section 6: A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand. Includes electronic image cheques. Special features: Crossing (general, special) to prevent theft and ensure payment via bank account.

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