UNIT – II

Money market and commercial banks

Money market · Credit creation · Commercial-bank functions

Explanatory Lecture Slides

Money, Banking & International Trade · Major-2 · Semester II

MONEY, BANKING & INTERNATIONAL TRADE

LEARNING OBJECTIVES

Topics covered in this unit

01 **Define money market and its components**

02 **State functions of commercial banks**

03 **Explain credit creation with a simple multiplier**

04 **Limits on credit creation**

05 **Place NBFCs at the edge**

06 **Link to DICGC and regulation**

UNIT II · SYLLABUS MAP

How this unit is organised

01	02	03	04	05	06
Money market	Features	Bank functions	Credit creation	Limits	NBFCs

Money market

Market for short-term funds (usually < 1 year): call money, T-bills, CP, CD, repo.

- Features: wholesale, low risk, institutional, RBI at the centre.
- PYQ: features of money market; components (2021, 2022).
- Not the capital market (shares, long bonds).
- Legal: Government Securities Act; RBI repos; SEBI for CP in some windows.

Money market

INSTRUMENTS

- T-bills.
- Call/notice.
- Repo / reverse repo.
- CP, CD.

PLAYERS

- RBI.
- Banks.
- PDs.
- Mutual funds.
- Government.

Functions of commercial banks

Accept deposits, lend, agency (bills, lockers, remittance), credit creation, now digital payments.

- PYQ: functions of commercial banks (2021, 2023, 2023 Oct).
- Balance-sheet: deposits are liabilities; loans are assets.
- Public-sector banks + private + small finance + payments banks — a mixed market.
- Banker–customer: a debtor-creditor relation (Foley v Hill) plus fiduciary overlays (KYC, secrecy).

Functions of commercial banks

PRIMARY

- Deposits.
- Loans and discounts.

AGENCY / GENERAL

- Payments.
- Lockers.
- Forex.
- Advisory.

Credit creation

A bank lends a fraction of deposits; the loan returns as a deposit in the system; the multiple is 1/CRR (simplified).

- PYQ: credit creation method (2023).
- Requires: cash reserve, willingness to lend, willingness to borrow, no leak into currency.
- This is why a banking crisis is a money-supply crisis.

Credit creation

SIMPLE MULTIPLIER

- $\Delta D = \Delta R / r$

STORY

- Loan → deposit → loan… until required reserves bind.

Limits on credit creation

CRR, SLR, capital adequacy (Basel / RBI), demand for credit, leakages, prudential norms, moral suasion.

- Legal limits: Banking Regulation Act powers of RBI (s.21, s.35A, s.36).
- IAC / SMA / NPA rules constrain ‘willingness to lend’.
- A 6-mark if you list five limits and stop.

Limits on credit creation

STOCK OF CASH

- CRR + vault cash.

BEHAVIOUR

- Borrowers may not want funds.
- Banks may fear NPAs.

Banker and customer — the law inside the function

The economic function sits on contract plus statute.

- Relation: Foley v Hill — debtor-creditor, not strictly bailment of money.
- Duty of secrecy: Tournier; exceptions: compulsion of law, duty to the public, bank’s interest, express/implied consent.
- KYC / PMLA — statutory duties that override a pure private relation.
- Garnishee: Order 21 CPC; bank as judgment-debtor’s debtor.

Banker and customer — the law inside the function

CONTRACT

- Mandate.
- Overdraft as a loan.

STATUTE

- BR Act.
- PMLA.
- Negotiable Instruments Act.

NBFCs and the edge of banking

Not every lender is a bank. Deposit-taking is the bright line RBI polices.

- Peerless; Sahara; PMC / DHFL episodes as cautionary tales — one line each if at all.
- A law student should not confuse an NBFC with a scheduled bank.
- Deposit insurance (DICGC) is for banks, not for every scheme.

NBFCs and the edge of banking

BANK

- Demand deposits.
- Credit creation.
- CRR/SLR.
- DICGC.

NBFC

- No demand deposit (in the bank sense).
- RBI registration.
- No CRR in the same way.

Limits on credit creation

CRR, SLR, capital adequacy (Basel / RBI), demand for credit, leakages, prudential norms, moral suasion.

- Legal limits: Banking Regulation Act powers of RBI (s.21, s.35A, s.36).
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- A 6-mark if you list five limits and stop.

LANDMARK AUTHORITIES

Cases a KSLU answer should name

CASE

Foley v Hill

(1848) 2 HLC 28

Banker–customer is debtor–creditor. The economic ‘deposit’ is a loan to the bank.

CASE

Tournier v National Provincial

[1924] 1 KB 461

Duty of secrecy and its four exceptions.

CASE

Peerless General Finance v RBI

(1992) 2 SCC 343

RBI may restrain deposit-like businesses.

STATUTE / SECTION MAP

Provisions & materials to quote

Banking Regulation Act	Licence, regulation, directions.
RBI Act 1934	Bank of issue and banker to banks.
NI Act 1881	Cheques, payment in due course.
PMLA 2002	KYC and suspicion reports.
DICGC Act 1961	Deposit insurance — a limit on panic.

WRITE IT IN THE HALL

10 / 16-mark frames from this unit

Q1 What is a money market? Discuss its features and components.

Q2 Describe the functions of commercial banks.

Q3 Explain how commercial banks create credit. What are the limits?

Q4 Distinguish a bank from an NBFC with statutory hooks.

BEFORE YOU CLOSE THE FILE

Unit recap

1. Money market = short-term wholesale funds.
2. Banks take deposits and make loans — that is credit creation.
3. Multiplier is limited by CRR, SLR, capital and demand.
4. Foley v Hill: deposit is the bank’s debt.
5. DICGC is not a blanket for every scheme.