Management of Commercial Banking
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Lecture 05
Financial Statements of Commercial Banks - 2

So, after the discussion on the different assets of the commercial banks, we can start the discussion on the other aspects of the balance sheet; the other items in the balance sheet and as well as the other financial statements under the income statement for the commercial banks.

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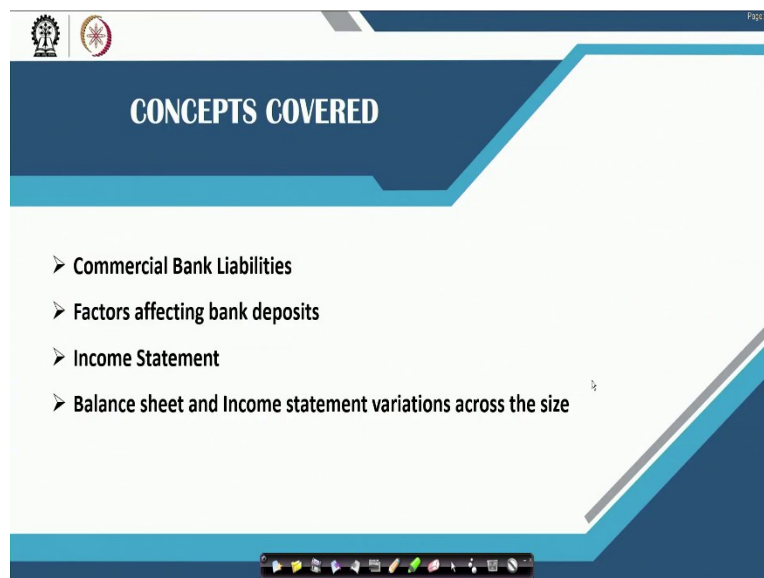

So, in the financial statement, whenever you talk about the balance sheet part, in the previous class we discussed about the different assets which comes under the balance sheet. So, in this session we will be discussing about the different type of liabilities and the factors affecting the bank deposits and the income statement or the profit-loss account of the commercial bank, then how the balance sheet income statement varies across the size of the commercial bank.

So, this is the objective of the discussion. The focus of discussions are based upon these broad 4 themes that commercial bank liabilities and the major factors which are affecting the bank deposits because bank deposit is the major liability of the commercial bank and then how the income statement of the commercial banks looks like, what are those different items comes under this?

Then we have whether the balance sheet and the income statement vary across the size of the commercial banks. So, these are the 4 things what we will be covering up whenever we will be discussing about or in today's discussion we will be covering up this 4 issues.

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Whenever we talk about the liability already I told you the major liability of the commercial bank is the deposits. Because, against the deposits, the commercial bank gives the interest. So, that is why the interest is the cost for them or payment of the interest that bear some cost. So, because of that, the deposits are considered as the liability of the commercial bank. And another, commercial bank also borrow for both short term reason and long term investments. So, whatever borrowings they make for that they have to pay the interest and that is why that they incurred the cost against that. So, that is why borrowings is another major liability of the commercial bank.

Then you have the equity capital or the share capital, because equity capital is again a liability of the commercial big bank because against that they have to pay them the dividends, capital gains and etcetera, so that is why equity capital is also a liability. And in today's context, there are many off-balance sheet items on which the banks basically always rely to generate the revenue and as well as incur huge amount of cost. Then what are those off-balance sheet items basically the commercial banks always use? So, these are basically the major things which will be coming under the liability part of the balance sheet of the commercial bank.

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Bank Deposits

- Demand Deposits

  Current Deposits: These are chequable accounts, there are no restrictions on the amount or the number of withdrawals from these accounts and does not carry any interest

  Savings Deposit: Cheques can be drawn, withdrawn from an account without previous notice are restricted

- Call Deposits : they are accepted from fellow bankers and are repayable on demand. These deposits carry am interest charge .

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So, coming back to the bank deposits, so whenever you talk about the bank deposits, there are broadly there are 2 types of deposits, one is demand deposits, then we have a time deposits and another deposit is basically call deposits and that call deposits basically what, these are basically accepted from the fellow bankers and our repayable on demand.

These are very short term in nature. This deposits also carry certain interest that is on the basis of call money rate. So, there is a typo error, here there is a problem in the, this deposits carry the interest charge. So, these are you keep in the mind. So, whenever you talk about one by one, the different type of deposits that we have the current deposits. So, what do we mean by this current deposits, the current deposits are basically what, you might have idea about this.

So, this current deposits does not carry any kind of interest. So, if anybody has the business units, has a current deposits account in a commercial bank. So, in that against that the banks do not have to pay any interest. Number one, and number two, but another thing is in the current accounts, there is no restrictions in terms of the number of withdrawals. That means for n number of times as much as you want, the particular current account holder can withdraw the money and this money is chequeable.

You can issue the check against your current account deposits. But whenever we talk about the saving deposits, again cheques can be drawn, but withdrawn from an account without the

previous notice are restricted. That means there is a limitations, you can withdraw your money but the question here is above that particular limit. There is a limit for that. So, if you want to go for more withdrawn from this particular account then prior notice has to be given to the commercial banks.

So, here it carries the interest rate also, the banks basically pay the interest against the savings deposits. So, carry the interest, this withdrawal limit is there, then as well as if it is going beyond this particular limit, then what basically happens that prior notice to the bank has to be given and call deposits already I have explained to you.

So, these are basically the deposits which are made by the other fellow banks in that particular accounts. So, these are the different ways.

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Bank Deposits Contd….

- Time Deposits: Usually carry a fixed maturity and stipulated interest rate
- Recurring Deposits: Fixed amount of money deposited in an uniform interval for a stipulated fixed period and carry a stipulated interest rate

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And another type of deposits is the time deposits, and the time deposits that usually carry a fixed maturity and stipulated interest rate. You might have heard about the fixed deposits, the fix deposits is a time deposit.

So, if anybody opens this fixed deposit account in the bank, then there is a maturity period for this let 1 year, 2 year, 3 years like this and the interest rate is already mentioned that how much interest rate this particular fixed deposit will carry. So, even if within that period if there is any change in the interest rate that is not going to affect the interest payments against that particular fixed deposits or the time deposits.

And there is a maturity period for this. And that maturity period will arise after 2 years or 3 years depending upon the period what already defined in that particular certificate. The fixed deposit certificate what you receive from the commercial banks. Then we have another type of deposit account that is called the recurring deposits. So, what do you mean by this recurring deposit?

The recurring deposit is, there is a fixed amount of money deposited in a uniform interval, let here also there is a fixed maturity period, the maturity period is fixed that, you have opened it for 5 years. Then in a frequent interval, time interval, the fixed amount of money has to be paid, let your value is 1000, so 1000 rupees will be deposited let the period is monthly, every month this 1000 rupees will be deposited in the bank up to the 5 years and there is a fixed interest rate which already mentioned in that particular document.

This we have recurring deposits. So, that is why there is a stipulated fixed period carrier stipulated interest rate and the money also deposited in that account that is also fixed in the interval basis that amount will be fixed. So, and generally the interest rate on the recurring deposits are more than the selling deposits; the RD interest rate is more than the saving deposits interest rates. The RD interest rate is more than the saving deposits interest rates.

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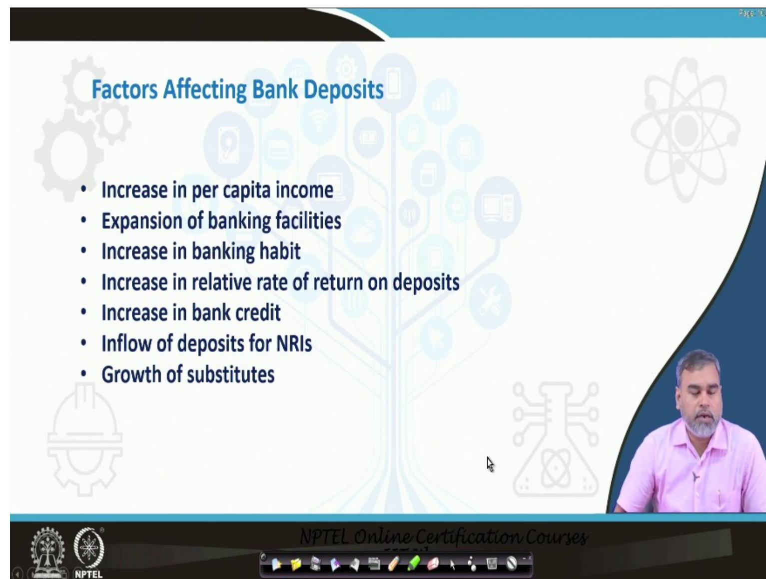

There are many factors which operate the bank deposits. The one is your per capita income, if the income of the person is increasing, then this deposit possibility that the surplus money can be deposited in the bank. Expansion of banking facilities. If the branch expansion is happening and the banking services are available to everybody, then the deposit may increase. Increase in banking habits.

So, if somebody is really interested to go for the or maybe trying to get this banking services, then there is a possibility that it will affect the bank deposits. So, the banking habit have a positive influence on the bank deposits and increase in the relative rates of return on deposits, there are many alternatives available in the market. So, instead of going for the bank deposits somebody can put the money in other financial assets.

So, if the relative return on bank deposits are better, then instead of going for other financial assets, they can put the money in the bank deposits. Increase in bank credit that means the banks

are giving more loans, that also attracts the more customers to the bank. So, for every credit account, there is a deposit account, first you have to open that then finally, the money will be disburse to the client's account through that particular deposit account.

So, that is why increase in bank credit also have a positive impact on the bank deposits. The inflow of deposits from NRIs, if more people more NRIs will be interested to send back their money to the home countries, then there is a possibility that money is again deposited in the banks only or that money will be channelized to the banks only. So, that will have a positive impact on the bank deposits. And the growth of the substitutes. There are many other substitutes which are available in the market.

And within the bank deposits also, there are many types of alternatives which are available, then depending upon the substitutes, the customer or the clients can decide that which one, which alternative is better for their further investment. So, by that what happens that either due to the economies of scale in terms of the products of this deposit services or the other alternatives which are available in the bank that also decide that whether the demand for bank deposits will increase or not. So, these are the different factors which are affecting the deposits of the commercial banks.

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Borrowings for Non Deposit Resources

- Borrowing from money market
- Borrowing from Central Bank through repo operations
- Borrowings from other banks apart from regular money market
- Subordinate debts
- It has grown due to lesser cost
- These are highly volatile

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Then the other important liability we have that is the borrowings. Then what basically the, there are many sources from which the commercial banks borrow the money. The sources can be

money market, which is the ultimate source for the commercial banks for overnight basis, for short term requirements. There are some lenders, there are some borrowers in the commerce, in the call money market from where the money can be borrowed.

The particular banks who have the surplus money, they will lend and the banks who have the deficit they want to borrow it from that particular lenders to fulfill the requirements for the overnight basis or little bit longer maturity also they can borrow the money from the call money market. They can borrow the money from the central bank through the repo operation. Already we know that because if anytime the commercial banks need the money so they can borrow it from Reserve Bank of India, through the repo rate.

Repo rate is basically an instrument through which or is interest rate what the commercial banks always pay to the Reserve Bank of India, whenever they borrow the money from the central bank. The Reserve Bank of India basically gets the interest, some amount of interest and commercial banks pay that to them because they borrow the money from them for some specific purpose or it is a part of the monetary policy also.

Borrowing from other banks, apart from the regular money market, if there is any, not necessarily that always we have to rely upon only on the call money market for this. So, apart from this, for any kind of long term purpose, if there is a possibility, then they can borrow it from the other banks. They can also borrow this money in terms of the long term debts from the different corporates and others that is called the subordinate debts, which are highly insecure, it is not backed by any kind of securities, but the time to maturity is very long, there is a longer term maturity bonds.

So, they can also borrow the money through that. So, these are major 4 sources of the borrowings for the commercial bank. But what basically has been observed over the time, the looking at the balance sheet of the commercial banks across the globe. It is observed that the percentage of the borrowings in the balance sheet particularly to the total liabilities is growing and why it is growing because sometimes due to the availability of the different type of organization, different kinds of alternative sources and for this we can give the credit to the globalization or the financial market integration.

So, because of that the availability has increased and that availability basically compels or not compels, we can say that it will be easier for the commercial banks to borrow the money at a lesser cost. But, another thing is that the amount what basically we have observed in the balance sheet in terms of borrowing, these are highly volatile, because the borrowings also depends upon the market conditions. So, because of that, there may be high volatility in terms of the borrowings whatever the commercial banks make. So, these are the different characteristics in terms of the borrowings of the commercial bank, which is one of the major items in the balance sheet or major liability items in the balance sheet.

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Equity Capital

- Preferred Stock: It gives its holder an fixed annual dividend before common shareholders receive any dividend payment. It is not tax deductible (less preferred)
- Common Stock Outstanding
- Retained Earnings

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Then the other important liability is the equity capital. Equity capital already we know that there are 3 types of equity capital, one is preferred stock, another one is common stock another one is retained earnings. Then whenever you talk about the stock, we have our equity. We have 2 types of equity, one is internal another one is external. And the external equity is basically the common stocks where the people put the money in the commercial banks and we have return earnings which comes under the internal equity. So, bank can invest their own money, own stocks into their, and the money can be put on their own stocks.

So, that is why there are 3 things or 3 types of equity capital what we can say, one is preferred. Preferred stock means it gives the holder the fixed annual dividend before the common shareholders receive the dividend payment, and it is not tax deductible. So, if any money is given

against that, so the commercial banks may not get any tax benefit that is why it is less preferred. So, it is better to go for debt, because this interest payments under debt is tax deductible in nature, but still that is the equity capital which is involved, and we have the common shares already we know that, then we have the retained earnings. So, these are the 3 items comes under the equity capital.

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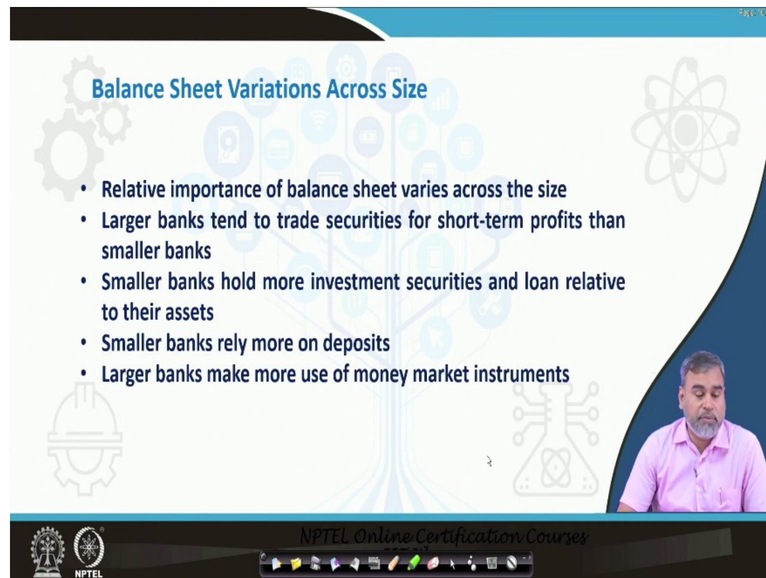

Then which has been observed that the balance, there is a variation in the balance sheet across the size of the commercial banks. And how the variations basically work and what kind of observations we have, we have got? The relative importance of the balance sheet varies across the size. What does it mean? What is observed is that the large banks tends to trade securities for short term profits than the smaller banks.

That means the capital market exposition or we can say that larger banks are more exposed to the capital market, or they prefer to maximize their gain in the short term basis than the smaller banks, who needs relatively steady growth and the profit relatively sustainable for a longer period of time. So, that is why these certain banks hold more investment securities and loan relative to their assets.

Because of that, the smaller banks hold more investment securities and loan relative to their assets. So, if you see the composition of the assets of a small bank and large bank, you will find that smaller banks hold more investment securities and loans relative to their assets. And smaller

banks also rely more on deposits, because of their existence is relatively less in the market, maybe they are existing in the market for a short period of time, they do not have any other alternatives.

So, for any kind of operations, they rely more on the deposits. But the large banks make more use of the money market instruments, because the money markets with the interbank market because of the reputation, because of their existence, the larger banks specifically always try to use the money market instruments more than the smaller banks. So, this is the observations what has been made by analyzing the balance sheet across the different countries that according to the size, the composition of the balance sheet changes.

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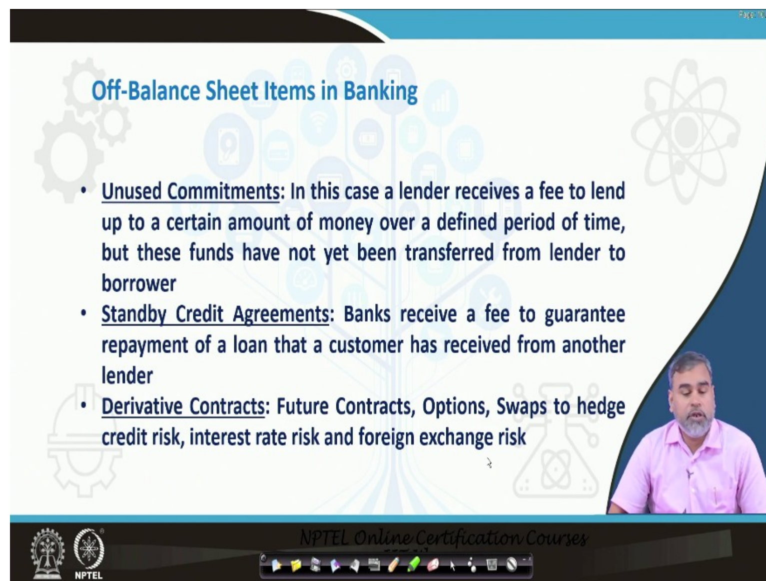

There are some off-balance sheet items. We have unused commitments. We have standby credit agreement and we have also some derivatives contracts. In the unused commitments we have the lender receives a fee to lend out a certain amount of money over a defined period of time. But these funds have not been transferred to the lender yet, from the lender to the borrower, they have committed to give that loan but the loan is not here to dispose.

So, these are basically the unused commitment what the bank has made. Then we have the standby credit agreements, the banks receive basically a fee to guarantee the repayment of the loan that a customer has received from another lender that if somebody has taken a loan that

from another kind of another agency or another lender, some commercial bank can give the guarantee that if that particular customer will not repay the loan, then this bank will be responsible to repay the loan.

So, against that they get some fee from that particular client, who has taken the loan from another lender. Then we have the derivatives contracts, what nowadays are popularly used by the banks to manage the risk and as well as sometimes also they use it for maximizing the return or the profits. You have the future contracts, you have options, you have the swaps and mostly those instruments are used to manage the interest rate risk, credit risk, exchange rate risk, etcetera for the commercial banks.

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Income Statement

- It indicates the amount of revenue received and expenses incurred over a specific period of time
- Close correlation between the balance sheet items and income statement
- Assets usually account for the majority of operating revenues and liabilities generate bank's operating expenses

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Then we will come to the income statement. Already I told you that income statement is basically, is nothing but it shows the amount of revenue received and expenses which are incurred over a period of time, the balance sheet was showing the financial position for a particular point of time, but income statement is showing the position of the company over a period of time and that is a close correlation between the balance sheet items and the income statement, because the assets usually account for the majority of operating revenues, and liability basically generates the bank's operating expenses. So, that is why there is a close link between the balance sheet and the income statement for the commercial banks.

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Revenue and Expenditure Items

- Interest Income: Interest earned from loans and security investments
- Non-Interest income: fees, commissions etc
- Interest expenses: Interest on deposits, interest owed on short term borrowings in the money market, long term borrowings
- Non- Interest Expenses: Cost of equity capital, salary, wages, benefits paid to employees, overhead expenses, funds set aside for possible loan losses and taxes owed.

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Which are those items which comes under revenue and expenditure of the commercial banks? The major part or major revenue for the commercial bank is interest income. And interest income is nothing but the interest earned from the loans and investments. Security investments particularly: Security investment in the sense we are talking about the bonds particularly issued by the banks and mostly it is a bonds issued by the banks whether it is a secured bond or unsecured bond, mostly the banks bonds are the secured bonds.

Then the non interest income, the non interest income means, apart from the regular banking services or only this lending activities and investment activities, banks also provide the consulting services, provide some kind off-balancing sheet services, against that they charge some fees and commissions and that is basically a part of the non-interest income. And what are those interest expenses?

Interest expenses the major thing is interest paid on deposits. The interest would owed on short term borrowings from the money market, if some banks have borrowed the money from the money market, they have to pay the interest to the another bank from where they have borrowed the money and also the long term borrowings whatever they have made.

So, these are basically the different parts of the interest expenses. And what are those non-interest expenses. Non-interest expenses is the dividend payments, the cost of equity, salaries, wages, whatever benefits they have given to the employees, then overhead expenses and there are some funds, they also keep aside reserves or loan loss reserves they keep for a possible loan losses and the taxes whenever they pay.

So, these are all coming under the non-interest expenses. So, the major income sources interest income which is coming from the loans or the security investments and non-interest income is fees and commissions and interest expenses already you know that the major thing is the deposits and the borrowings from the money market. And non-interest expenses are many, you have the return on equity or we can say that the cost of equity or the proxy you can use it as a dividend payments against that and wages, salaries etcetera these are coming under the non interest expenses.

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Revenue and Expenditure Items Cont...

- Net interest income = Interest income – Interest expenses
- Net Income = Total Revenue – Total Expenses
- Pre tax Net Operating Income= Net interest income + Net Non-interest Income
- Pre tax Net Operating Income – Tax + Securities gains or losses + Extraordinary Income = Net Income

So, from this we can calculate the non interest income, which is nothing but interest income minus interest expenses. Net income if you say that is nothing but total revenue minus total expenses, then pre-tax, net operating income that is a net interest income plus net non-interest income. Then pre-tax net operating income minus tax plus securities gain or losses if there is any loss plus some extraordinary income, extra income means if sometimes the bank sells their existing holdings securities in the market, then they can generate some extra income into that,

that basically will give you the idea on the net income. So, these are different ways we can calculate the financial performance from the income statements of a particular commercial bank.

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Income Statement Ratios and Bank Size

- Large banks receive more income from non-interest income
- Small banks rely more on deposits than money market instruments.

We also observed that there is a variation of the income statements across the size of the banks. And what kind of observations we have realized? We have seen that the large bank received more income from non-interest activities. Non-interest income percentage is relatively more by the larger banks. What is the reason? The reason is that, because of their existence, because of their reputations because of their expertise, the fees commission, the consulting services, risk management services, the investment banking services and all these things, these are mostly available to the larger banks.

The smaller banks are not that competent enough to do these kind of services for a longer period of time. Or maybe they do not have that much expertise to do that. If they do not have the expertise to do that, then their reliance more on the conventional banking activities. The conventional banking activities means that includes the, what we can say the giving the loans taking the deposits and investing in the different kind of government securities or other securities and as well as equity market and all.

So, because of that, the percentage of non-interest income reasonably is higher for the larger banks than the smaller banks, there are reasons for that. These are the possible reasons for this

and the small banks rely more on deposits, then the money market instruments. The same logic also because the influence or the use of the money market for specific reasons, these are easy for the larger banks, the larger banks are more.

Maybe it is convenient for them, or they are more conversant to the use of the money market. than the smaller banks, because the smaller banks is not at all compatible to the requirements of the money market instruments at that particular point of time. So, because of this we can say that the small banks rely more on deposits for their regular banking activities than the, we can say that large banks which are existing in the financial system. So, that is why the on the basis of size, the income statement also a little bit different for the small and large banks.

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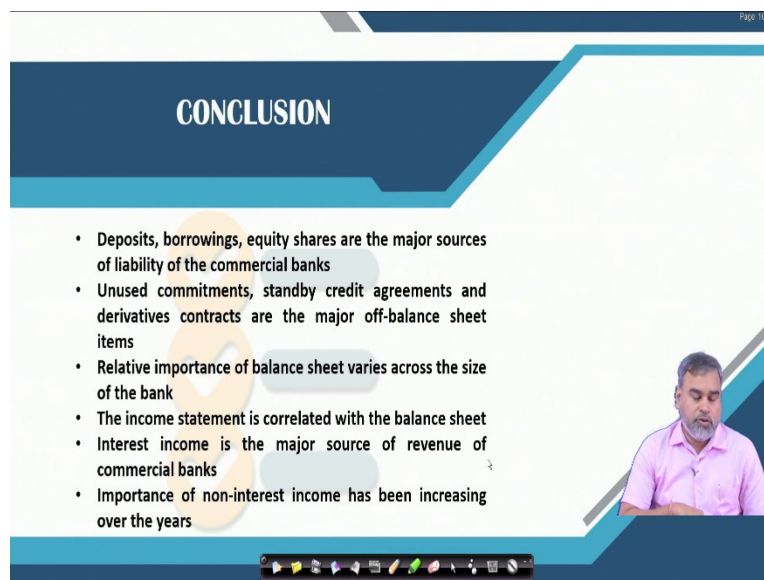

So, after this discussion, what basically we find that or if you summarize this thing, then what are those things we can derive from this particular discussions. The deposits, borrowings, equity shares are the major sources of liability of the commercial banks. Unused commitments, standby credit guarantees, credit agreements and derivatives contracts are the major off-balance sheet items. Relative importance of the balance sheet varies across the size of the bank that is what just now we have discussed.

The income statement is correlated with the balance sheet and there are certain sources, the uses and the sources, these are coming from the balance sheet size. And again from there we are

generating the income and as well as the expenditure for preparing this income statement. And in interest income is the major source of revenue for the commercial banks.

But whenever you talk about non-interest income, that importance is increasing due to the globalization financial market integration and all and the percentages of the non-interest income is always higher, the percentage of the non-interest income is always higher for the larger banks than the smaller banks. And the reliance of the money market is more by the larger banks than the smaller banks. So, these are the conclusions or we can say that major points whatever we can derive from this particular discussions.

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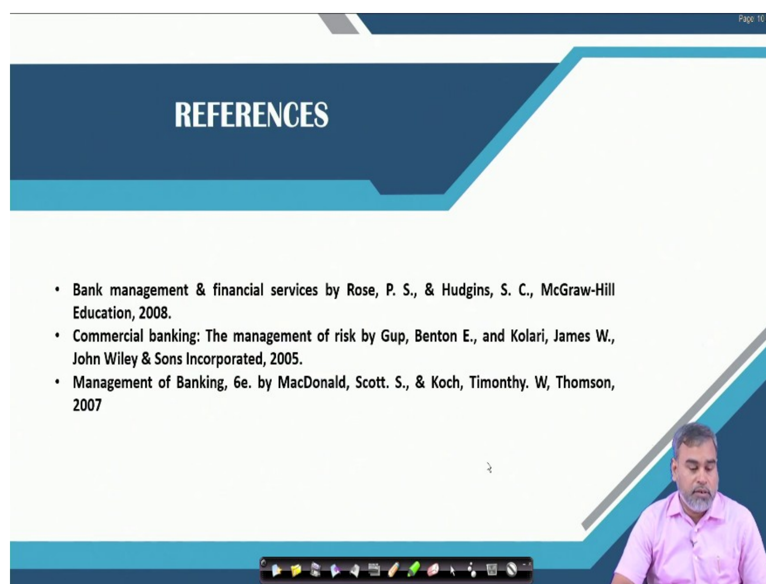

And these are the references what you can go through for the detailed discussion on the different liabilities or the income statements of the commercial bank. And further we will be discussing about using this kind of statements, how the performance of the commercial banks are measured or what are those different ratios and different ways the performance can be assessed. Thank you!