S. S. Jain Subodh Management Institute

MBA IVth Semester, (Model Paper & Suggested Answers)

Subject: Banking & Insurance

Paper Code: M-411

Time: 1 Hour **Max Marks: 10**

All questions are compulsory

Q 1. What are the different sources and uses of bank funds? (5)

Q 2. State in detail the objectives of monetary policy. (5)

MODEL ANSWER PAPER

Sol 1: [Students are expected to tell the different sources and uses of bank funds in detail]

A commercial bank is a retail financial institution that helps community members open savings accounts and manage money market accounts. It also provides customers with deposit, withdrawal and transfer services. Bank customers can also carry out retail banking business through an automatic teller machine (ATM) or online. Beyond the everyday services, commercial banks also offer customers loans to buy a house, an automobile or a boat. And the banks help business owners manage their accounts, including current, savings and loans.

The sources of funds in commercial banks are varied like:

1. **Deposits**

Deposits remain the main source of funds for a commercial bank. The money collected can go toward paying on interest-bearing accounts, completing customer withdrawals and other transactions. Savings account deposits are especially important to banks. Currently, the law mandates that account holders can perform six transfers per month in the form of online, telephone or overdraft transfers. This allows banks to use the accounts' funds and still meet the withdrawal needs of the customer.

2. **Reserve Funds**

A commercial bank builds a reserve fund with deposits so it can pay interest on accounts and complete withdrawals. Ideally, a bank's reserve fund should be equal to its capital. A bank builds its reserve fund by accumulating surplus profits during healthy financial years so that the funds can be used in leaner times. On average, a bank tries to accumulate approximately 12 percent of its net profit to build and maintain its reserve fund.

3. **Shareholders Capital**

Some commercial banks that trade on the stock exchange can use shareholders' capital to receive the money it needs to stay in business. For example, if a company sells shares on the market, it increases both its cash flow and its share capital. This process is also known as equity financing. Banks can only report the amount of capital that was initially on their balance sheet. Appreciation and depreciation of shares do not count toward the total sum of a shareholder's capital.

Each time a bank makes a profit it can generally make two choices that include paying dividends to their shareholders or reinvesting the money back into the bank. Most banks utilize both options as they will retain a portion of the profit and pay the remainder to their shareholders. The amount reinvested into the bank typically depends on the company's policy and the condition of the stock market.

4. **Retained Earnings**

A lot of commercial banks earn retained earnings or fees to help fund their business. A retained earning can be collected through overdraft fees, loan interest payments, securities and bonds. Banks also charge fees for providing customers with services such as maintaining an account, offering overdraft protection and also monitoring customers' credit scores.

5. **Liabilities Management**

Another important source of fund for commercial bank is liabilities management. They have to manage it very carefully to minimize risk and achieve goal. The various items included in the liabilities of commercial banks are equity, reserves, borrowings, deposits, new account, money market liabilities, deposit account, wholesale and retail certificate of deposits, negotiable instructs, brokered deposits, interest paying liabilities, short term loan, bills payable and other outstanding expenses.

6. **Repurchase agreement**

This represents the temporary borrowing in money market, mainly from excess required reserves loaned to it by other banks or the bank has borrowed fund collateralize by some of its own securities from other bank or a large corporate customer.

7. **Mortgage loans**

Long term loans taken generally for constructing building and building under construction serves as collateral are mortgage loans. The principal source of long term borrowing include real estate mortgage and this type of loan may have maturity upto thirty years.

8. **Capital funds**

It refers to the long term funds contributed to a bank primarily by its owners. It represents the owner's equity interest in the bank. From the regulator point view, bank capital is divided into two groups - tier 1 and tier 2 capital. Tier 1 capital is known as core or primary capital and tier 2 capital is known as supplementary capital. Under this fund includes common stocks, suppliers, retained earnings and undivided profit.

Uses of Fund in commercial Bank:

Whatever the funds raised by commercial banks should be properly channelized into investment earning asset because without such earnings bank cannot survive in the long run to compute in the challenging financial market. The uses of funds are as follows:

1. **Assets Management**

   It is to be considered that whatever liabilities undertaken from various sources become useless these liabilities are converted into earning assets. So it is the allocation of funds into loans and investments with due consideration for the maintenance of liquidity. The various items included in assets of commercial banks are cash in hand, cash at bank, investment, loans, leases, bank's earnings assets vault cash, leases, deposits at central bank, cash items in process of collecting, fixed assets and other current assets.

2. Commercial banks use most of their funds either to provide loans or **to purchase debt securities**. In both cases they serve as creditors, providing credit to those borrowers who need funds. They provide commercial loans to firms, make personal loans to individuals, and purchase debt securities issued by firms or government agencies. Most firms rely heavily on commercial banks as a source of funds.

3. Some of the more popular means by which commercial banks extend credit to firms are term loans, lines of credit, and investment in debt securities issued by firms. Term loans are provided by banks for a medium-term period to finance a firm's investment in machinery or buildings. For example, consider a manufacturer of toys that plans to produce toys and sell them to retail stores. It will need funds to purchase the machinery for producing toys, to make lease payments on the manufacturing facilities, and to pay its employees. As time passes, it will generate cash flows that can be used to cover these expenses. However, there is a time lag between when it must cover these expenses (cash outflows) and when it receives revenue (cash inflows). The term loan can enable the firm to cover its expenses until a sufficient amount of revenue is generated.

4. Commercial banks can also provide credit to a firm by offering a **Line of Credit,** which allows the firm access to a specified amount of bank funds over a specified period of time. This form of bank credit is especially useful when the firm is not certain how much it will need to borrow over the period.

Sol. 2: [Students are expected to explain in detail the definition and objectives of Monetary Policy].

Meaning of Monetary Policy:-

Monetary policy refers to the measures which the central bank of the country takes in controlling the money and credit supply in the country with a view to achieving certain specific economic objectives.

Objectives of Monetary Policy:-

The objectives of monetary policy differ from country to country according to their economic conditions. In the developing countries like India or Pakistan its objective may be the maintenance of monetary stability and help in the process of economic development. In the developed countries, its objective may be to achieve full employment, without inflation. Anyhow following are the main objectives of the monetary policy:

1. Control of Inflation and Deflation:-

Inflation and deflation both are not suitable for the economy. If the price level is reasonable and there is an adjustment between the price and cost, rate of output can increase. Monetary policy is used to coordinate the cost and price. So price stability is achieved through the monetary policy.

2. Exchange Stability:-

Monetary policy second objective is to achieve the stable foreign exchange rate. If the rate of exchange is stable it shows that economic condition of the country is stable.

3. Economic Development:-

Monetary policy plays very effective role in promoting economic growth by providing adequate credit to productive sectors.

4. **Increase in the Rate of Employment :-**

Monetary policy another objective is to achieve full employment but without inflation.

5. Equal Distribution of Credit:-

Monetary policy should also ensure that distribution of credit should be equitable and purposeful. The credit priority should be given to backward areas.

6.Improvement in Standard of Living :-

It is also the major objective of the monetary policy that it should improve the quality of life in the country.