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# Investment Policy By Commercial Banks

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**ABSTRACT**

*In the study of the financial institutions, the investment and investment problems will revolve around the concept of managing the surplus financial assets in such a way,that will lead to the wealth maximization and providing a significant further source of income. Thus the investment is the management of the surplus resources in such a way that it works for providing benefits to the supplier of the funds that is the banks. However, the investment needs to be a procedural task. It must follow a definite process, to ensure the formulation of proper investment policy. Banks are disbursing their money as investment in trade business and industry. Therefore, banks should be following the principle of investment for profit. An investment policy should ensure maximum profit and minimum Risk. A huge collection and investment policy plays vital role for the economic development of whole economy. The main focus of this study will be towards the investment practices of the banks. The study suggests the way to the policy makers to improve the management of investment policy and recommends suggestions to raise the profit.*

**KEYWORDS : Investment policy, commercial bank, banking, loans,**

## INTRODUCTION

The Banking Regulations Act of India defines Commercial Banks as "A Bank is a financial institution which accepts money from the public for the purpose of lending or investment repayable on demand or otherwise withdraw able by cheques, drafts or order or otherwise."Commercial banks have to perform a variety of functions which are common to both developed and developing countries. These are known as 'General Banking' functions of the commercial banks. These functions can be broadly divided into two categories: (a) Primary functions and (b) Secondary functions.

### A)Primary Functions:

Primary banking functions of the commercial banks include:

1.Acceptance of deposits
2. Advancing loans
3. Creation of credit
4. Clearing of cheques
5. Financing foreign trade
6. Remittance of funds.

### B)Secondary Functions:

**Secondary banking functions of the commercial banks include:**

1. Agency Services
2. General Utility Services.

A bank is a business organisation engaged in the business of borrowing and lending money. A bank can earn income only if it borrows at a lower rate and lends at a higher rate. The difference between the two rates will represent the costs incurred by the bank and the profit. Bank also provides a number of services to its customers for which it charges commission. This is also an important source of income. The followings are the various sources of a bank's profit:

1. Interest on Loans
2. Interest on Investments
3. Discounts
4. Commission, Brokerage, etc

Commercial banks are considered not merely as dealers in money but also the leaders in economic development. They are not only the store houses of the country's wealth but also the reservoirs of resources necessary for economic development. They play an important role in the economic development of a country. A well-developed banking system is essential for the economic development of a country. Commercial banks also deal in foreign exchange. They sell demand drafts, issue letters of credit and help remittance of funds in foreign countries. They also act as brokers in foreign exchange. The "Industrial Revolution" in Europe in the 19th century would not have been possible without a sound system of commercial banking. In case of developing countries like India, the commercial banks are considered to be the backbone of the economy. Commercial banks can contribute to a country's economic development in the following ways :

1. Accelerating the Rate of Capital Formation
2. Provision of Finance and Credit
3. Monetisation of Economy
4. Supports Innovations by entrepreneurs
5. Implementation of Monetary Policy
6. Encouragement to Right Type of Industries
7. Development of Agriculture
8. Regional Development
9. Promote Industrial Development
10. Promote Commercial Virtues
11. Fulfillment of Socio-economic Objectives.

The financial position of a commercial bank is reflected in its balance sheet. The balance sheet is a statement of the assets and liabilities of the bank.

### BALANCE SHEET OF A COMMERCIAL BANK

| ASSETS | LIABILITIES |
|---|---|
| Reserves | Deposits |
| Cash in bank | Current deposits |
| Deposits at central bank | Fixed deposits |
| Deposits at commercial bank | Savings deposits |
| Cash on collection | Borrowings |
| Loan | Others |
| Securities | |
| Others | Capital account |

The assets of the bank are distributed in accordance with certain guiding principles. These principles underline the investment policy of the bank.

## LITERATURE REVIEW

Sharma, M.P. & Bhatt, M.P. (2002), in their article "Priority receiver sector" has present "The commercial banks should take care of board national interest & they showed not confine their lending activities only to commercial area providing quick interest if some proportion could be directed to the area conclusive to build economic infrastructures of the country it would create atmosphere conductive to their investment in future. In our society where ignorance & literacy is in wild scale, it is necessary that the banks search entrepreneurs instead of entrepreneurs searching book. So, they have opinioned that the priority sector program is a timely & opportunities there by increasing production & the general living standard or rural poor. Shrestha (2004) conducted a study on "Nepal Rastra Bank Guidelines on Investment policy of commercial banks in Nepal (A case study of Nepal Investment Bank)". The main findings of the study are:1.Bank is in good position to meet the daily cash requirement as bank has maintained the average cash & bank balance in respect to total deposit.2.The performance ofNIBL regarding deposit collection granting loan & advance & investment is quite satisfactory but doesn't seem to follow definite policy.3.NIBL has not efficiently utilized its equity capital hence return on equity is not satisfactory because of lack of sound investment policy for mobilization of its equity capital. Chen Ping, Yang Hailiang, Yin George (11) (2008) conducted study on"Markowitz's mean-variance asset-liability management with regime switching: A continuous-time model" This paper analyzed an asset-liability management (ALM) problem under a continuous-time Markov regime-switching model. By adopting the techniques of Zhou, X.Y., Yin, G. Markowitz's mean variance portfolio selection with regime switching: A continuous-time model. SIAM J., they investigated the feasibility, obtain the optimal strategy, delineate the efficient frontier, and establish the associated mutual fund theorem. Bernanke and Blinder(1988) first established a theoretical macroeconomic model with the bank lending channel. They used innovations to federal funds rate as a measure of changes in policy. They found that monetary policy impulses affects the composition of investments of assets in their investment policy. Kashyap et al(1993) and Gertler and Gilchrist(1993,1994) have similar view points too. Wu(1999), Abram sane Settle(2003), and Chiades and Gimbacorta(2004) analysed the monetary policy transmission mechanism and its changes adhere to the fixed exchange rates. Thornton(1994) shows that there is a positive and statically significant relationship between Federal reserve actions and the lending and deposits but the effect of that is very small. However ramsey(1993) claims that the credit variables play an insignificant role in the impact of monitery policy in output in most cases.

## SCOPE OF STUDY

This study was to determine an innovative investment policy for the commercial banks in order to improve our nation's economy and to reduce the inflation rate prevailing in our country.This study will also reveal the present investment policy and the basic functions of the commercial bank.

## INVESTMENT POLICY OF COMMERCIAL BANKS

A bank makes investments for the purpose of earning profits. First it keeps primary and secondary reserves to meet its liquidity requirements.This is essential to satisfy the credit needs of the society by granting short-term loans to its customers. Whatever is left with the bank after making advances is invested for long period to improve its earning capacity.

Before discussing the investment policy of a commercial bank, it is instructive to distinguish between a loan and an investment because the usual practice is to regard the two as synonymous. The bank gives a loan to a customer for a short period on condition of repayment.

It is the customer who asks for the loan. By advancing a loan, the bank creates credit which is a temporary source of fund for the bank. An investment by the bank, on the other hand, is the outlay of its funds for a long period without creating any credit. A bank makes investments in government securities and in the stocks of large reputed industrial concerns, while in the case of a loan the bank advances money against recognised securities and bills. However, the goal of both is to increase its earnings.

The investment policy of a bank consists of earning high returns on its unloaned resources. But it has to keep in view the safety and liquidity of its resources so as to meet the potential demand of its customers.

Since the objective of profitability conflicts with those of safety and liquidity, the wise investment policy is to strike a judicious balance among them. Therefore, a bank should lay down its investment policy in such a manner so as to ensure the safety and liquidity of its funds and at the same time maximise its profits. This requires adherence to certain principles.

In compliance of the instructions issued by the Reserve Bank of India, the revised Investment Policy of the Bank will be as under:-

1. Mandatory Investment

In terms of mandatory requirement of Banking Regulation Act, it is compulsory to invest minimum 3% as Cash Reserve Fund (CRR) & 25% as Statutory Liquid Reserve (SLR- investment in Govt. & other asset will be treated normal. Up to 31.03.2011, SLR will be 15% and from 01.04.2011, it will be necessary to maintain upto 25%

2. Loans & Advances

Bank can invest upto 75% of own funds and upto 70% of total deposits in loans & advances, out of which, after observing the prescribed norms for priority sector & weaker section of the society, remaining portion can be advanced as per Loan Policy of the Bank keeping in view the ceiling of maximum amount of advance to a single person, similar type of business & on similar type of securities to minimize the risk involved.

3. Investment with other Citizen Cooperative Banks

Bank will not make any investment with these Banks except undertaking normal transactions in the accounts opened for clearing and transfer of funds purpose.

4. Investment in other Banks

Bank may invest its surplus funds in any commercial, private & cooperative Banks but if any such bank provides considerably higher rate of interest then its financial position has to be analysed. Investment of the liquid surplus funds from time to time has to be made in such a way that there should not be any difficulty in meeting out the funds requirement for daily clearing adjustment as well as payment of the deposits on due dates of maturity.

5. Investment in non- SLR Debt Securities

In compliance of the instructions issued by the Reserve Bank of India from time to time and also keeping in view the additional income on investment and safety of surplus funds, investment may be made in Liquid Funds enjoying good market credit rating and also trading in Government Securities. In this connection Board of Directors keeping in view the circumstances prevailing at that time may fix a limit for the purpose, take a decision in the matter of investment and delegate powers to the Managing Director for investment to a certain extent at one time. Investment will be made with the institutions which are enjoying AAA credit rating. Such investment will not exceed 10% of the total deposits of the Bank.

6. Investment in other Institutions, Corporations & Companies

Bank will not invest its surplus funds in any other institution, company , corporation etc whatsoever be the attractive rate of interest.

7. Investment in share money of Cooperative institutions

Bank may invest 2% of its personal funds in the share money of the Cooperative Institutions but it will be in accordance of the directives of the Reserve Bank of India.

8. Investment in private companies

Bank will not make any investment in private companies or in Shares / Debentures of other institutions other than Cooperative Institutions.

9. Investment in Government Securities

"Government Securities" will mean securities issued by the Central & State Governments.

10. Cash Management

Except in abnormal conditions, cash balance in the Bank will be kept within the fixed limit as excess cash will affect the profitability of the

Bank.

11. Besides above, day to day asset, liability management should be prepared in such a way that after complying the mandatory requirements, Bank should earn maximum profit.

12. No amendments/ modification in the provisions of the sanctioned Investment policy will be made without the Board of Directors.

13. In the process of investment, in no circumstances provisions of the Reserve Bank of India will be violated.

## SUGGESTION FOR SOUND INVESTMENT POLICY

A sound lending & investment policy is not only prerequisite for a bank's profitability but also crucially significant for the promotion of commercial savings of a developing country like India. Therefore, the following principles or features of investment policy must be abided by the commercial banks in order to achieve the goals.

### 1.Safety and security:

Commercial banks must pay a special attention to the principle of safety and security. In a developing country like India in case there is any kind of loss than it will lead to decrease in public faith towards banks and impacts the overall deposits of the banks. So, the banks must ensure investing the amount in safe and secure sectors. Investment in unsafe and insecure sectors with the hope of getting more returns is to compromise with the security of capital.

### 2.Profitability:

The profit of commercial bank mainly depends on the interest rate, volume of loan, its time period and nature of investment in different securities. It is a fact that a commercial bank can maximize its volume of wealth through maximization of return on their investment and lending so, they must invest their funds to gain maximum profit. Ambition of profit to commercial bank seems reasonable as the bank has to cover all the expenses and make payment in the forms dividend to the shareholders who contribute to building up of bank's capital and interest to the depositors. For this the bank calculates the cost of fund and likely return..

### 3.Diversification:

"A bird should not lay all its eggs in the same basket." This saying is very important to the bank and it should be always careful not to grant loan in only one sector. To minimize risk, a bank must diversify its investment on different sectors. Diversification of loan helps to sustain loss according to the law of average; if the security of a company is divided off there may be an appreciation in the securities of other companies

## CONCLUSION

From the above discussion, undoubtedly, we can say that, commercial banks form the most important part of financial intermediaries. Banks form a significant part of the infrastructure essential for breaking vicious circle of poverty and promoting economic growth. So from my study, it is known that the banks are not investing in the private company. My innovate idea is that it can be allowed up to 10%of its deposits to be invested in those sector too. It will induce the production level of many industries. And it also boosts up the operating profit. It helps in Industrial development and it increases standard of living. And this investment is must for the developing country like us for our development. It will also bring down the inflation rate prevailing in our country. So the money value will increase.This will enhance the development of our country in the nearby future.

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