SYLLABUS

B.B.A. V SEM

Subject – Banking & Insurance

UNIT – I	RISK AND INSURANCE — Defining risk, nature and types of risk, risk management process, Risk and its relation with insurance. Concept and significance of insurance, classification of insurance life and non life, general principles of insurance.
UNIT – II	LIFE INSURANCE — Life - principles, products term insurance endowment, insurance, pensions, Group Insurance, IRDA.
UNIT – III	OVERVIEW OF BANKING INDUSTRY: - Banking structure in India- RBI, Commercial, Rural and Cooperative banks their role and significance, functions, SLR, CRR: Concepts, Banking Ratios.
UNIT – IV	GENERAL INSURANCE: principles, products fire, marine, motor vehicles, public utility, third party insurance, group insurance, burglary insurance. Claims Settlements
UNIT – V	BANKING RISKS AND RECENT DEVELOPMENTS —Credit, liquidity, market, operation, interest rate solvency, Universal Banking, E-banking, Mobile banking. ALM Process. AMI.
UNIT – VI	BASEL I & 2.

Unit – 1

RISK

The chance that an investment's actual return will be different than expected. Risk includes the possibility of losing some or all of the original investment. Different versions of risk are usually measured by calculating the standard deviation of the historical returns or average returns of a specific investment. A high standard deviation indicates a high degree of risk.

A fundamental idea in finance is the relationship between risk and return. The greater the amount of risk that an investor is willing to take on, the greater the potential return. The reason for this is that investors need to be compensated for taking on additional risk.

Financial risk is an umbrella term for multiple types of risk associated with financing, including financial transactions that include company loans in risk of default. Risk is a term often used to imply downside risk, meaning the uncertainty of a return and the potential for financial loss. In addition to financial risks, there are five broad categories of investment risks known as five risks.

NATURE OF RISK:

i. Uncertainty
ii. Directly proportional to return.

iii. Temporal Dimension
iv. Variable in character.
v. Related to growth and development.
vi. Quantitative and Qualitative both.
vii. Omnipresent.
viii. Cannot be nil.
ix. Insurable and Non-Insurable
x. Fundamental and Particular Risk
xi. Dynamic and Static Risk
xii. Speculative and Pure Risk
xiii. Systematic and Unsystematic Risk.

<u>TYPES OF RISK</u>:

Risk implies the extent to which any chosen action or an inaction that may lead to a loss or some unwanted outcome. The notion implies that a choice may have an influence on the outcome that exists or has existed.

However, in <u>financial management</u>, risk relates to any material loss attached to the project that may affect the productivity, tenure, legal issues, etc. of the project.

In finance, different types of risk can be classified under two main groups, viz.,

1. <u>Systematic risk</u>.
2. <u>Unsystematic risk</u>.

The meaning of systematic and unsystematic risk in finance:

1. Systematic risk is uncontrollable by an <u>organization</u> and macro in nature.
2. Unsystematic risk is controllable by an organization and micro in nature.

A. Systematic Risk

Systematic risk is due to the influence of external factors on an organization. Such factors are normally uncontrollable from an organization's point of view.

It is a macro in nature as it affects a large number of organizations operating under a similar stream or same domain. It cannot be planned by the organization.

The types of systematic risk are depicted and listed below.

1. Interest rate risk,
2. Market risk and
3. Purchasing power or inflationary risk.

Now let's discuss each risk classified under this group.

1. Interest rate risk

Interest-rate risk arises due to variability in the interest rates from time to time. It particularly affects debt securities as they carry the fixed rate of interest.

The types of interest-rate risk are depicted and listed below.

1. Price risk and
2. Reinvestment rate risk.

The meaning of price and reinvestment rate risk is as follows:

1. Price risk arises due to the possibility that the price of the shares, commodity, investment, etc. may decline or fall in the future.
2. Reinvestment rate risk results from fact that the interest or dividend earned from an investment can't be reinvested with the same rate of return as it was acquiring earlier.

2. Market risk

Market risk is associated with consistent fluctuations seen in the trading price of any particular shares or securities. That is, it arises due to rise or fall in the trading price of listed shares or securities in the stock market.

The types of market risk are depicted and listed below.

1. Absolute risk,
2. Relative risk,
3. Directional risk,
4. Non-directional risk,
5. Basis risk and
6. Volatility risk.

The meaning of different types of market risk is as follows:

1. Absolute risk is without any content. For e.g., if a coin is tossed, there is fifty percentage chance of getting a head and vice-versa.
2. Relative risk is the assessment or evaluation of risk at different levels of business functions. For e.g. a relative-risk from a foreign exchange fluctuation may be higher if the maximum sales accounted by an organization are of export sales.
3. Directional risks are those risks where the loss arises from an exposure to the particular assets of a market. For e.g. an investor holding some shares experience a loss when the market price of those shares falls down.
4. Non-Directional risk arises where the method of trading is not consistently followed by the trader. For e.g. the dealer will buy and sell the share simultaneously to mitigate the risk
5. Basis risk is due to the possibility of loss arising from imperfectly matched risks. For e.g. the risks which are in offsetting positions in two related but non-identical markets.
6. Volatility risk is of a change in the price of securities as a result of changes in the volatility of a risk-factor. For e.g. it applies to the portfolios of derivative instruments, where the volatility of its underlying is a major influence of prices.

3. Purchasing power or inflationary risk

Purchasing power risk is also known as inflation risk. It is so, since it emanates (originates) from the fact that it affects a purchasing power adversely. It is not desirable to invest in securities during an inflationary period.

The types of power or inflationary risk are depicted and listed below.

1. Demand inflation risk and
2. Cost inflation risk.

The meaning of demand and cost inflation risk is as follows:

1. Demand inflation risk arises due to increase in price, which result from an excess of demand over supply. It occurs when supply fails to cope with the demand and hence cannot expand anymore. In other words, demand inflation occurs when production factors are under maximum utilization.
2. Cost inflation risk arises due to sustained increase in the prices of goods and services. It is actually caused by higher production cost. A high cost of production inflates the final price of finished goods consumed by people.

B. Unsystematic Risk

Unsystematic risk is due to the influence of internal factors prevailing within an organization. Such factors are normally controllable from an organization's point of view.

It is a micro in nature as it affects only a particular organization. It can be planned, so that necessary actions can be taken by the organization to mitigate (reduce the effect of) the risk.

The types of unsystematic risk are depicted and listed below.

1. Business or liquidity risk,
2. Financial or credit risk and
3. Operational risk.

Now let's discuss each risk classified under this group.

1. Business or liquidity risk

Business risk is also known as liquidity risk. It is so, since it emanates (originates) from the sale and purchase of securities affected by business cycles, technological changes, etc.

The types of business or liquidity risk are depicted and listed below.

1. Asset liquidity risk and
2. Funding liquidity risk.

The meaning of asset and funding liquidity risk is as follows:

1. Asset liquidity risk is due to losses arising from an inability to sell or pledge assets at, or near, their carrying value when needed. For e.g. assets sold at a lesser value than their book value.
2. Funding liquidity risk exists for not having an access to the sufficient-funds to make a payment on time. For e.g. when commitments made to customers are not fulfilled as discussed in the SLA (service level agreements).

2. Financial or credit risk

Financial risk is also known as credit risk. It arises due to change in the capital structure of the organization. The capital structure mainly comprises of three ways by which funds are sourced for the projects. These are as follows:

1. Owned funds. For e.g. share capital.
2. Borrowed funds. For e.g. loan funds.
3. Retained earnings. For e.g. reserve and surplus.

The types of financial or credit risk are depicted and listed below.

1. Exchange rate risk,
2. Recovery rate risk,
3. Credit event risk,
4. Non-Directional risk,
5. Sovereign risk and
6. Settlement risk.

The meaning of types of financial or credit risk is as follows:

1. Exchange rate risk is also called as exposure rate risk. It is a form of financial risk that arises from a potential change seen in the exchange rate of one country's currency in relation to another country's currency and vice-versa. For e.g. investors or businesses face it either when

they have assets or operations across national borders, or if they have loans or borrowings in a foreign currency.

2. Recovery rate risk is an often neglected aspect of a credit-risk analysis. The recovery rate is normally needed to be evaluated. For e.g. the expected recovery rate of the funds tendered (given) as a loan to the customers by banks, non-banking financial companies (NBFC), etc.
3. Sovereign risk is associated with the government. Here, a government is unable to meet its loan obligations, reneging (to break a promise) on loans it guarantees, etc.
4. Settlement risk exists when counterparty does not deliver a security or its value in cash as per the agreement of trade or business.

3. Operational risk

Operational risks are the business process risks failing due to human errors. This risk will change from industry to industry. It occurs due to breakdowns in the internal procedures, people, policies and systems.

The types of operational risk are depicted and listed below.

1. Model risk,
2. People risk,
3. Legal risk and
4. Political risk.

The meaning of types of operational risk is as follows:

1. Model risk is involved in using various models to value financial securities. It is due to probability of loss resulting from the weaknesses in the financial-model used in assessing and managing a risk.
2. People risk arises when people do not follow the organization's procedures, practices and/or rules. That is, they deviate from their expected behavior.
3. Legal risk arises when parties are not lawfully competent to enter an agreement among themselves. Furthermore, this relates to the regulatory-risk, where a transaction could conflict with a government policy or particular legislation (law) might be amended in the future with retrospective effect.
4. Political risk occurs due to changes in government policies. Such changes may have an unfavorable impact on an investor. It is especially prevalent in the third-world countries.

Following three statements highlight the gist of risk:

1. Every organization must properly group the types of risk under two main broad categories viz.,
    a. Systematic risk and
    b. Unsystematic risk.
2. Systematic risk is uncontrollable, and the organization has to suffer from the same. However, an organization can reduce its impact, to a certain extent, by properly planning the risk attached to the project.
3. Unsystematic risk is controllable, and the organization shall try to mitigate the adverse consequences of the same by proper and prompt planning.

<u>RISK MANAGEMENT PROCESS</u>:

Risk management is a 5 stage process. These processes go simultaneously. These steps are to be followed for having a good risk management. These steps are listed and explained below:-

1- Risk Identification:-
This is the first and the most important step of risk management. One cannot do anything with the risk unless and until that risk has been clearly identified. Risk identification starts from where the problem originates. Risk identification can be objective based, scenario based, taxonomy based and common risk checking.

2- Risk Analysis:-
Risk analysis includes analyzing the risk and measuring its vulnerability or its impact. Frequency and severity of the risk will be analyzed as well. Risk management can be quantitative as well as qualitative. Numerically determining the probabilities of various adverse events and expected extent of losses if any unexpected event occurs is a **Quantitative Analysis** where as defining the various threats, devising countermeasures and determining the extent of vulnerabilities is referred to as **Qualitative Risk Analysis**.

3- Risk Control:-
After analyzing the risk then decided that how can the risk be controlled. If the risk can be controlled by in house then well and good, if not then decide on how to transfer that risk. Risk control is the entire process of procedures, systems, policies an organization needs to manage prudently for all the risks which are arising.

4- Risk Transfer:-
If the risk is not manageable and one cannot retain that risk, then we have to transfer that risk to a third party. This is the stage where insurance comes in action. Insurance will be willing to take on those risks which the organization can't handle.

5- Risk Review:-
Risk review is the last step in which all the above mentioned steps are evaluated. Review must be regular as the conditions and the circumstances of the business and organizations changes continuously. It should be monitored that the desired results of the risk management are being

achieved or not and if not then identifying that where the problem occurred and then reviewing all the steps and making the changed in the management according to scenario.

RISK AND INSURANCE:

How Insurance Works

Insurance is an agreement where, for a stipulated payment called the *premium*, one party (the insurer) agrees to pay to the other (the policyholder or his designated beneficiary) a defined amount (the *claim payment* or *benefit*) upon the occurrence of a specific loss. This defined claim payment amount can be a fixed amount or can reimburse all or a part of the loss that occurred.

The insurer considers the losses expected for the insurance pool and the potential for variation in order to charge premiums that, in total, will be sufficient to cover all of the projected claim payments for the insurance pool. The premium charged to each of the pool participants is that participant's share of the total premium for the pool. Each premium may be adjusted to reflect any special characteristics of the particular policy. As will be seen in the next section, the larger the policy pool, the more predictable its results.

Normally, only a small percentage of policyholders suffer losses. Their losses are paid out of the premiums collected from the pool of policyholders. Thus, the entire pool compensates the unfortunate few. Each policyholder exchanges an unknown loss for the payment of a known premium.

Under the formal arrangement, the party agreeing to make the claim payments is the insurance company or the *insurer*. The pool participant is the policyholder. The payments that the policyholder makes to the insurer are premiums. The insurance contract is the policy. The risk of any unanticipated losses is transferred from the policyholder to the insurer who has the right to specify the rules and conditions for participating in the insurance pool.

The insurer may restrict the particular kinds of losses covered. For example, a *peril* is a potential cause of a loss. Perils may include fires, hurricanes, theft, and heart attack. The insurance policy may define specific perils that are covered, or it may cover all perils with certain named exclusions (for example, loss as a result of war or loss of life due to suicide).

Hazards are conditions that increase the probability or expected magnitude of a loss. Examples include smoking when considering potential healthcare losses, poor wiring in a house when considering losses due to fires, or a California residence when considering earthquake damage.

In summary, an insurance contract covers a policyholder for economic loss caused by a peril named in the policy. The policyholder pays a known premium to have the insurer guarantee payment for the unknown loss. In this manner, the policyholder transfers the economic risk to the insurance company. Risk is the variation in potential economic outcomes. It is measured by the variation between possible outcomes and the expected outcome: the greater the standard deviation, the greater the risk.

Insurability:

Risk which can be insured by private companies typically shares seven common characteristics:[2]

1. **Large number of similar exposure units**: Since insurance operates through pooling resources, the majority of insurance policies are provided for individual members of large classes, allowing insurers to benefit from the law of large numbers in which predicted losses are similar to the actual losses. Exceptions include Lloyd's of London, which is famous for insuring the life or health of actors, sports figures, and other famous individuals. However, all exposures will have particular differences, which may lead to different premium rates.

2. **Definite loss**: The loss takes place at a known time, in a known place, and from a known cause. The classic example is death of an insured person on a life insurance policy. Fire, automobile accidents, and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory. Occupational disease, for instance, may involve prolonged exposure to injurious conditions where no specific time, place, or cause is identifiable. Ideally, the time, place, and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements.

3. **Accidental loss**: The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be pure, in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements, such as ordinary business risks or even purchasing a lottery ticket, are generally not considered insurable.

4. **Large loss**: The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses, these latter costs may be several times the size of the expected cost of losses. There is hardly any point in paying such costs unless the protection offered has real value to a buyer.

5. **Affordable premium**: If the likelihood of an insured event is so high, or the cost of the event so large, that the resulting premium is large relative to the amount of protection offered, then it is not likely that the insurance will be purchased, even if on offer. Furthermore, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, then the transaction may have the form of insurance, but not the substance.

6. **Calculable loss**: There are two elements that must be at least estimable, if not formally calculable: the probability of loss, and the attendant cost. Probability of loss is generally an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.

7. **Limited risk of catastrophically large losses**: Insurable losses are ideally independent and non-catastrophic, meaning that the losses do not happen all at once and individual losses are not severe enough to bankrupt the insurer; insurers may prefer to limit their exposure to a loss from a single event to some small portion of their capital base. Capital constrains insurers' ability to sell earthquake insurance as well as wind insurance in hurricane zones. In the US, flood risk is insured by the federal government. In commercial fire insurance, it is possible to find single properties whose total exposed value is well in excess of any individual insurer's capital constraint. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market.

(SECTION-B)

<u>CONCEPT OF INSURANCE</u>:

On the one hand, human life is subject to various risks—risk of death or disability due to natural or accidental causes. Humans are also prone to diseases, the treatment of which may involve huge expenditure. On the other hand, property owned by man is exposed to various hazards, natural and man-made.

When human life is lost or a person is disabled permanently or temporarily, there is a loss of income to the household. The family is put to hardship. Sometimes survival itself is at stake for the dependants.

When it comes to property, loss or damage to property results in either whole or partial loss in income to the person or entity.

Risk has the element of unpredictability. Death/disability or loss/damage could occur at anytime. Losses can be mitigated through insurance. Insurance is a commodity which offers protection against various contingencies.

Insurance products available for life and non-life are many. In non-life, apart form personal covers such as accident covers and health insurance, there are products covering liabilities under a particular law and or common law. The various products are designed to cater to different needs of an individual or industry such as fire insurance policy on multi-storeyed building, householder's policy.

An insurance contract promises to make good to the insured a certain sum in consideration for a payment in the form of premium from the insured.

Human life cannot be valued. Hence the sum assured (or the amount guaranteed to be paid in the event of a loss) is by way of a 'benefit' in the case of life insurance. Life insurance products provide a definite amount of money to the dependants of the insured in case the life insured dies during his active income earning period or becomes disabled on account of an accident causing reduction/complete loss in his income earnings. An individual can also protect his old age when he ceases to earn and has no other means of income by purchasing an annuity product.

A Personal Accident cover is also for protection. In the event of death or disability, permanent or temporary, of the insured, it provides for compensation which is either the whole or a percentage of the Capital Sum Insured depending on the kind of loss.

In the case of Health Insurance, the policy seeks to cover expenses towards of treatment of diseases and or injury upto the Sum Insured opted for by the insured.

In respect of insurance relating to property, there are many products available. Property may be covered against fire and perils of nature including flood, earthquake etc. Machinery may be insured for breakdown. Goods in transit can be insured under a marine cargo insurance cover. Insurance covers are also available for ships and other vessels. A motor insurance policy covers third party damage as well as damage to the vehicle.

Insurance of property is based on the principle of indemnity. The idea is to bring the insured to the same financial position as he /she was before the loss occurred. It safeguards the investment in the property. Where there is no insurance, losses can mar a project or an industry. General Insurance offers stability to the economy and to the society.

Insurance offers security and so peace of mind to the individual. The concept of insurance is that the losses of a few are made good by contribution from many. It is based on the law of large numbers. It stemmed from the need of man to find a solution for mitigation of losses. It also reflects the nature of man to find a solution collectively.

It is important for all to understand the various products that life and general insurance companies offer before they make a choice as to the product they want to buy.

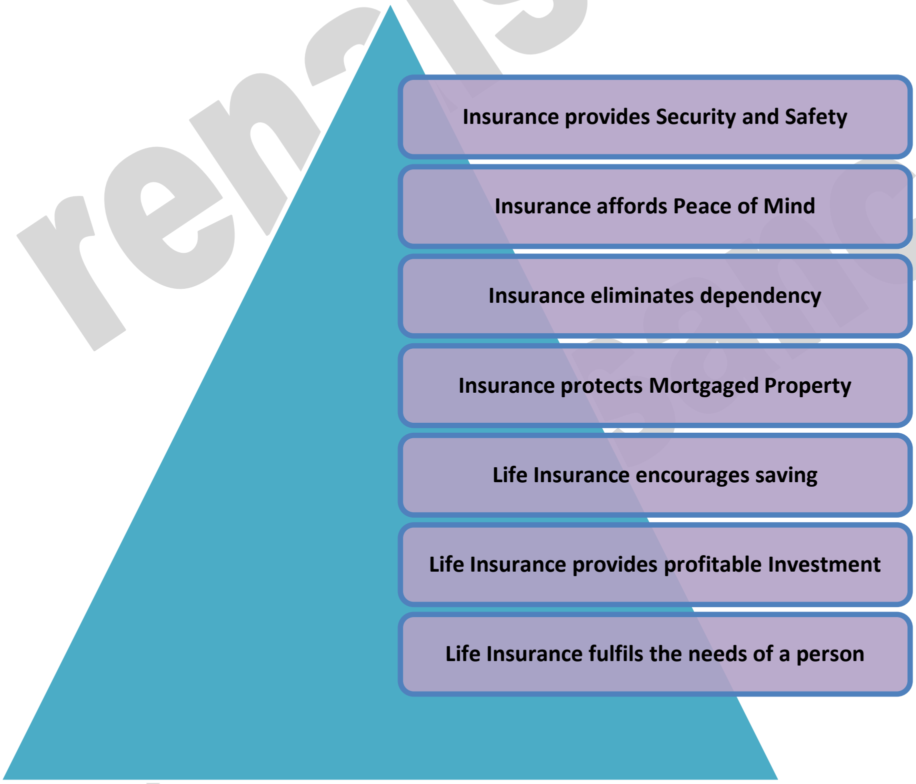
As per regulations, insurers have to give the various features of the products at the point of sale. The insured should also go through the various terms and conditions of the products and understand what they have bought and met their insurance needs. They ought to understand the claim procedures so that they know what to do in the event of a loss.

SIGNIFICANCE OF INSURANCE:

The process of insurance has been evolved to safeguard the interests of people from uncertainty by providing certainty of payment at a given contingency. The insurance principle comes to be more and more used and useful in modern affairs.

Not only does it serve the ends of individuals, or of special groups of individuals, it tends to pervade and to transform our modern social order, too. The role and importance of insurance, here, has been discussed in three phases: (i) uses to individual, (ii) uses to a special group of individuals, viz., to business or industry, and (iii) uses to the society.

Uses to an individual:



1. Insurance provides Security and Safety:
The insurance provides safety and security against the loss on a particular event. In case of life insurance payment is made when death occurs or the term of insurance is expired. The loss to the family at a premature death and payment in old age are adequately provided by insurance. In other words, security against premature death and old age sufferings are provided by life insurance.

Similarly, the property of insured is secured against loss on a fire in fire insurance. In other insurance, too, this security is provided against the loss at a given contingency.

The insurance provides safety and security against the loss of earning at death or in golden age, against the loss at fire, against the loss at damage, destruction or disappearance of property, goods, furniture and machines, etc.

2. Insurance affords Peace of Mind:
The security wish is the prime motivating factor. This is the wish which tends to stimulate to more work, if this wish is unsatisfied, it will create a tension which manifests itself to the individual in the form of an unpleasant reaction causing reduction in work.

The security banishes fear and uncertainty, fire, windstorm, auto-mobile accident, damage and death are almost beyond the control human agency and in occurrence of any of these events may frustrate or weaken the human mind. By means of insurance, however, much of the uncertainty that centers about the wish for security and its attainment may be eliminated.

3. Insurance protects Mortgaged Property:
At the death of the owner of the mortgaged property, the property is taken over by the lender of money and the family will be deprived of the uses of the property. On the other hand, the mortgagee wishes to get the property insured because at the damage or destruction of the property he will lose his right to get the loan replayed.

The insurance will provide adequate amount to the dependents at the early death of the property-owner to pay off the unpaid loans. Similarly, the mortgagee gets adequate amount at the destruction of the property.
4. Insurance eliminates dependency:
At the death of the husband or father, the destruction of family needs no elaboration. Similarly, at destruction of, property and goods, the family would suffer a lot. It brings reduced standards of living and the suffering may go to any extent of begging from the relatives, neighbors or friends.

The economic independence of the family is reduced or, sometimes, lost totally. What can be more pitiable condition than this that the wife and children are looking others more benevolent than the husband and father, in absence of protection against such dependency? The insurance is here to assist them and provides adequate amount at the time of sufferings.

5. Life Insurance encourages saving:
The elements of protection and investment are present only in case of life insurance. In property insurance, only protection element exists. In most of the life policies elements of saving predominates. These policies combine the programs of insurance and savings.

The saving with insurance has certain extra advantages:

(i) Systematic saving am possible because regular premiums are required to be compulsorily paid. The saving with a bank is voluntary and one can easily omit a month or two and then abandon the program entirely.

(ii) In insurance the deposited premium cannot be withdrawn easily before the expiry of the term of the policy. As contrast to this, the saving which can be withdrawn at any moment will finish within no time.

(iii) The insurance will pay the policy money irrespective of the premium deposited while in case of bank-deposit; only the deposited amount along with the interest is paid. The insurance, thus, provides the wished amount of insurance and the bank provides only the deposited amount,

(iv)The compulsion or force to premium in insurance is so high that if the policy-holder fails to pay premiums within the days of grace, he subjects his policy to causation and may get back only a very nominal portion of the total premiums paid on the policy.

For the preservation of the policy, he has to try his level best to pay the premium. After a certain period, it would be a part of necessary expenditure of the insured. In absence of such forceful compulsion elsewhere life insurance is the best media of saving.

6. Life Insurance provides profitable Investment:
Individuals unwilling or unable to handle their own funds have been pleased to find an outlet for their investment in life insurance policies. Endowment policies, multipurpose policies, deferred annuities are certain better form of investment.

The elements of investment i.e., regular saving, capital formation, and return of the capital along with certain additional return are perfectly observed, in life insurance.

In India the insurance policies carry a special exemption from income-tax, wealth tax, and gift tax and estate duty. An individual from his own capacity cannot invest regularly with enough of security and profitability. The life insurance fulfils all these requirements with a lower cost. The beneficiary of the policy-holder can get a regular income from the life-insurer; if the insured amount is left with him.

7. Life Insurance fulfils the needs of a person:
The needs of a person are divided into (A) Family needs, (B) Old-age needs, (C) Re-adjustment needs, (D) Special needs, (E) The clean-up needs.

(A) Family Needs:
Death is certain, but the time is uncertain. So, there is uncertainty of the time when the sufferings and financial stringencies may be fall on the family. Moreover, every person is responsible to provide for the family.

It would be a more pathetic sight in the world to see the wife and children of a man looking for someone more considerate arid benevolent than the husband or the father, who left them unprovoked.

Therefore, the provision for children up to their reaching earning period and for widow up to long life should he made. Any other provision except life insurance will not adequately meet this financial requirement of the family. Whole life policies are the better means of meeting such requirements.

(B) Old-age heeds:
The provision for old-age is required where the person is surviving more than his earning period. The reduction of income in old-age is serious to the person and his family.

If no other family member starts earning, they will be left with nothing and if there is no property, it would be more piteous state. The life insurance provides old age funds along with the protection of the family by issuing various policies.

(C) Re-adjustment Needs:
At the time of reduction in income whether by loss of unemployment, disability, or death, adjustment in the standard of living of family is required. The family members will have to be satisfied with meager income and they have to settle down to lower income and social obligations.

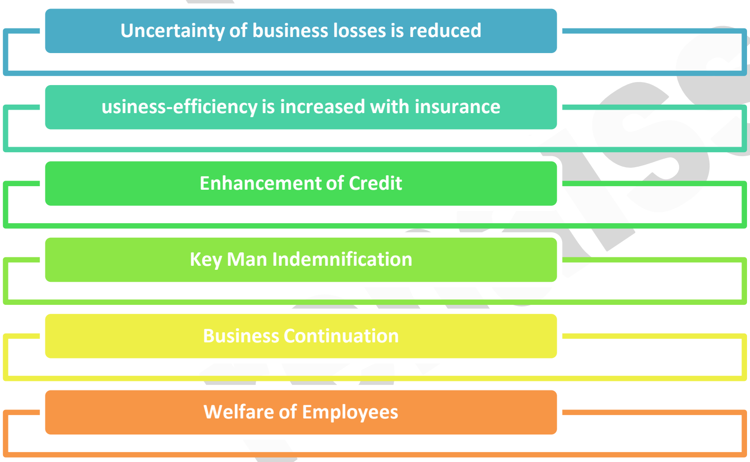
Before coming down to the lower standard and to be satisfied with that, they require certain adjustment income so that the primary obstacles may be reduced to minimum. The life insurance helps to accumulate adequate funds. Endowment policy anticipated endowment policy and guaranteed triple benefit policies are seemed to be a good substitute for old age needs.

(D) Special Needs:
There is certain special requirement of the family which is fulfilled by the earning member of the family. If the member becomes disable to earn the income due to old age or death, those needs may remain unfulfilled and the family will suffer.

(i) Need for Education. There are certain insurance policies, and annuities which are useful for education of the children irrespective of the death or survival of the father or guardian.
(ii) Marriage. The daughter may remain unmarried in case of father's death or in case of inadequate provision for meeting the expenses of marriage. The insurance can provide funds for the marriage if policy is taken for the purpose.

(iii) Insurance needs for settlement of children. After education, settlement of children takes time and in absence of adequate funds, the children cannot be well placed and all the education go to waste.
(E) Clean-up funds:
After death, ritual ceremonies, payment of wealth taxes and income taxes are certain requirements which decrease the amount of funds of the family member. Insurance comes to help for meeting these requirements. Multipurpose policy, education and marriage policies, capital redemption policies are the better policies for the special needs.

Uses to business :
The insurance has been useful to the business society also. Some of the uses are discussed below:



1. Uncertainty of business losses is reduced:
In world of business, commerce and industry a huge number of properties are employed. With a slight slackness or negligence, the property may be turned into ashes. The accident may be fatal not only to the individual or property but to the third party also. New construction and new establishment are possible only with the help of insurance.

In absence of it, uncertainty will be to the maximum level and nobody would like to invest a huge amount in the business or industry. A person may not be sure of his life and health and cannot continue the business up to longer period to support his dependents. By purchasing policy, he can be sure of his earning because the insurer will pay a fed amount at the time of death.

Again, the owner of a business might foresee contingencies that would bring great loss. To meet such situations they might decide to set aside annually a reserve, but it could not be accumulated due to death. However, by making an annual payment, to secure immediately, insure policy can be taken.

2. Business-efficiency is increased with insurance:
When the owner of a business is free from the botheration of losses, he will certainly devote much time to the business. The care free owner can work better for the maximisation of the profit. The new as well as old businessmen are guaranteed payment of certain amount with the insurance policies at the death of the person; at the damage, destruction or disappearance of the property or goods.

The uncertainty of loss may affect the mind of the businessmen adversely. The insurance, removing the uncertainty, stimulates the businessmen to work hard.

3. Key Man Indemnification:
Key man is that particular man whose capital, expertise, experience, energy, ability to control, goodwill and dutifulness make him the most valuable asset in the business and whose absence will reduce the income of the employer tremendously and up to that time when such employee is not substituted.

The death or disability of such valuable lives will, in many instances, prove a more serious loss than that by fire or any hazard. The potential loss to be suffered and the compensation to the dependents of such employee require an adequate provision which is met by purchasing adequate life-policies.

The amount of loss may be up to the amount of reduced profit, expenses involved in appointing and training, of such persons and payment to the dependents of the key man. The Term Insurance Policy or Convertible Term Insurance Policy is more suitable in this case.

4. Enhancement of Credit:
The business can obtain loan by pledging the policy as collateral for the loan. The insured persons are getting more loans due to certainty of payment at their deaths. The amount of loan that can be obtained with such pledging of policy, with interest thereon will not exceed the cash value of the policy. In case of death, this value can be utilised for setting of the loan along with the interest.

If the borrower is unwilling to repay the loan and interest, the lender can surrender the policy and get the amount of loan and interest thereon repaid. The redeemable debentures can be issued on the collateral of capital redemption policies. The' insurance properties are the best collateral and adequate loans are granted by the lenders.

5. Business Continuation:

In any business particularly partnership business may discontinue at the death of any partner although the surviving partners can restart the business, but in both the cases the business and the partners will suffer economically.

The insurance policies provide adequate funds at the time of death. Each partner may be insured for the amount of his interest in the partnership and his dependents may get that amount at the death of the partner.

With the help of property insurance, the property of the business is protected against disasters and the chance of disclosure of the business due to the tremendous waste or loss.

6. Welfare of Employees:
The welfare of employees is the responsibility of the employer. The former are working for the latter. Therefore, the latter has to look after the welfare of the former which can be provision for early death, provision for disability and provision for old age.

These requirements are easily met by the life insurance, accident and sickness benefit, and pensions which are generally provided by group insurance. The premium for group insurance is generally paid by the employer. This plan is the cheapest form of insurance for employers to fulfill their responsibilities.

The employees will devote their maximum capacities to complete their jobs when they are assured of the above benefits. The struggle and strife between employees and employer can be minimised easily with the help of such schemes.

Uses of society:
Some of the uses of insurance to society are discussed in the following sections.

1. Wealth of the society is protected :
The loss of a particular wealth can be protected with the insurance. Life insurance provides loss of human wealth. The human material, if it is strong, educated and care-free, will generate more income.

Similarly, the loss of damage of property at fire, accident, etc., can be well indemnified by the property insurance; cattle, crop, profit and machines are also protected against their accidental and economic losses.
With the advancement of the society, the wealth or the property of the society attracts more hazardous and, so new types of insurance are also invented to protect them against the possible losses.

Each and every member will have financial security against old age, death, damage, destruction and disappearance of his wealth including the life wealth. Through prevention of economic losses, instance protects the society against degradation.

Through stabilization and expansion of business and industry, the economic security is maximized. The present, future and potential human and property resources are well-protected. The children are getting expertise education, working classes are free from botherations and older people are guiding at ease. The happiness and prosperity are observed everywhere with the help of insurance.

2. Economic Growth of the Country:
For the economic growth of the country, insurance provides strong hand and mind, protection against loss of property and adequate capital to produce more wealth. The agriculture will experience protection against losses of cattle, machines, tools and crop.

This sort of protection stimulates more production hi agriculture, in industry, the factory premises, machines, boilers and profit insurances provide more confidence to start and operate the industry welfare of employees create a conducive atmosphere to work: Adequate capital from insurers accelerate the production cycle.

Similarly in business, too, the property and human material are protected against certain losses; capital and credit are expanded with the help of insurance. Thus, the insurance meets all the requirements of the economic growth of a country.

3. Reduction in Inflation:
The insurance reduces the inflationary resource in two ways. First, by extracting money in supply to the amount of premium collected and secondly, by providing sufficient funds for production narrow down the inflationary gap.

With reference to Indian context it has been observed that about 5.0 per cent of the money in supply was collected in form of premium.

The share of premium contributed to the total investment of the country was about 10.0 per cent. The two main causes of inflation, namely, increased money in supply and decreased production are properly controlled by insurance business, Insurance Need and Selling.

TYPES OF INSURANCE:

The insurance can be divided from two angles: first, from the business point of view and the second, from the risk point of view.

Business Point of View:
The insurance can be classified into three categories from business point of view: (i) Life Insurance, (ii) General Insurance, and (iii) Social Insurance.

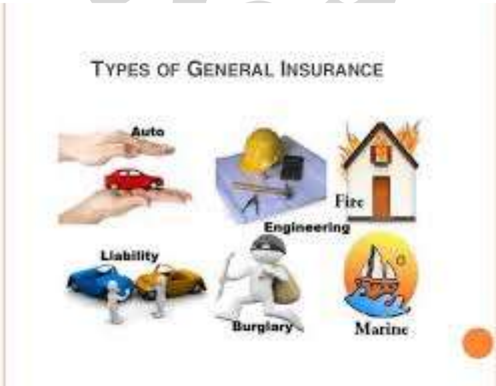
(i) Life Insurance:
Life Insurance is different from other insurance in the sense that, here, the subject matter of insurance is life of human being. The insurer will pay the fixed amount of insurance at the time of death or at the expiry of certain period.

At present, life insurance enjoys maximum scope because the life is the most important property of the society or an individual. Each and every person requires the insurance.

This insurance provides protection to the family at the premature death or gives adequate amount at the old age when earning capacities are reduced. Under personal insurance a payment is made at the accident.

The insurance is not only a protection but is a sort of investment because a certain sum is returnable to the insured at the death or at the expiry of a period. The business of life insurance is wholly done by that Life insurance Corporation of India.

(ii) General Insurance :
The general insurance includes property insurance, liability insurance and other forms of insurance. Fire and marine insurances are strictly called property insurance. Motor, theft, fidelity and machine insurances include the extent of liability insurance to a certain extent.



The strictest form of liability insurance is fidelity insurance, whereby the insurer compensates the loss to the insured when he is under the liability of payment to the third party.

(iii) Social Insurance:
The social insurance is to provide protection to the weaker section of the society who is unable to pay the premium for adequate insurance. Pension plans, disability benefits, unemployment benefits, sickness insurance and industrial insurance are the various forms of social insurance.

With the increase of the socialistic ideas, the social insurance is an obligatory duty of the nation. The Government of a country must provide social insurance to its masses.

Risk Point of View:

Insurance is divided into property liability and other form from high point of view

A. Property Insurance:

Under the property insurance property of person/persons are insured against a certain specified risk. The risk may be fire or marine perils, theft of property or goods, damage to property at accident.

(a) Marine Insurance:

Marine insurance provides protection against loss of marine perils. The marine perils are collision with rock, or ship attacks by enemies, fire and capture by pirates, etc. These perils cause damage, destruction or disappearance of the ship and cargo and non-payment of freight.

So, marine insurance insures ship (Hull), cargo and freight. Previously only certain nominal risks were insured but now the scope of marine insurance had been divided into two parts: (i) Ocean Marine Insurance and (ii) Inland Marine Insurance.

The former insures only the marine perils while the latter covers inland peril which may arise with the delivery of cargo (goods) from the godown of the insured and may extend up to the receipt of the cargo by the buyer (importer) at his godown.

(b) Fire Insurance:

Fire insurance covers risks of fire. In the absence of fire insurance, the fire waste will increase not only to the individual but to the society as well. With the help of fire insurance, the losses, arising due to fire are compensated and the society is not losing much.

The individual is protected from such losses and his property or business or industry will remain approximately in the same position in which it was before the loss. The fire insurance does not protect only losses but it provides certain consequential losses also. War risk, turmoil, riots, etc., can be insured under this insurance, too.

(c) Miscellaneous Insurance:

The Property, goods, machine, furniture, automobile, valuable articles, etc., can be insured against the damage or destruction due to accident or disappearance due to theft. There are different forms of insurances for each type of the said property whereby not only property insurance exists but liability insurance and personal injuries are also insured.

B. Liability Insurance:

I he general insurance also includes liability insurance thereby the insured is liable to pay the damage of property or to compensate the less of personal injury or death. This insurance is seen in the form of fidelity insurance, automobile insurance and machine insurance, etc.

C. Other Forms:

Besides the property and liability insurances, there are certain other insurances which are included under general insurance. The examples of such insurances are export-credit insurances, State employees insurance, etc., whereby the insurer guarantees to pay certain amount at the certain events. This insurance is extending rapidly these days.

1. Personal Insurance:

The personal insurance includes insurance of human life which may suffer loss due to death, accident and disease. Therefore, the personal insurance is further sub-classified into life insurance, personal accident insurance and health insurance.

2. Property Insurance:

The property of an individual and of the society is insured against the loss of fire and marine perils, the crop is insured against unexpected decline in production, unexpected death of the animals engaged in business, break-down of machines and theft of the property and goods.

3. Liability Insurance:

The liability insurance covers the risks of third party, compensation to employees, liability of the automobile owners and reinsurances.

4. Guarantee Insurance:

The guarantee insurance covers the loss arising due to dishonesty, disappearance and disloyalty of the employers or second. The party must be a party of the contract. His failure causes loss to the first party. For example, in export insurance, the insurer will compensate the loss at the failure of the importers to pay the amount of debt.

GENERAL PRINCIPLES OF INSURANCE:

(i) Principles of Co-operation:

Insurance is a co-operation device. If one person is providing for his own losses, it cannot be strictly insurance because in insurance, the loss is shared by a group of persons who are willing to co-operate. In ancient period, the persons of a group were willingly sharing the loss to a member of the group. They used to share the loss to a member of the group.

They used to share the loss at the time of damage. They collected enough funds from the society and paid to the dependents of the deceased or the persons suffering property losses. The mutual co-operation was prevailing from the very beginning up to the era of Christ in most of the countries. Lately, the cooperation took another form where it was agreed between the individual and the society to pay a certain sum in advance to be a member of the society.

The society by accumulating the funds, guarantees payment of certain amount at the time of loss to any member of the society. The accumulation of funds and charging of the share from the member in advance became the job of one institution called insurer.

Now it became the duty and responsibility of the insurer to obtain adequate funds from the members of the society to pay them at the happening of the insured risk. Thus, the shares of loss took the form of premium. Today, all the insured give a premium to join the scheme of insurance. Thus, the insured are co-operating to share the loss of an individual by payment of a premium in advance.

(ii) Principles and Theory of Probability:
The loss in the shape of premium can be distributed only on the basis of theory of probability. The chances of loss are estimated in advance to affix the amount of premium. Since the degree of loss depends upon various factors, the affecting factors are analysed before determining the amount of loss. With the help of this principle, the uncertainty of loss is converted into certainty.

The insurer will have not to suffer loss as well have to gain windfall. Therefore, the insurer has to charge only so much of amount which is adequate to meet the losses. The probability tells what the chances of losses are and what will be the amount of losses.

The inertia of large number is applied while calculating the probability. The larger the number of exposed persons, the better and the more practical would be the findings of the probability. Therefore, the law of large number is applied in the principle of probability.

In each and every field of insurance the law of large number is essential. These principles keep in account that the past events will incur in the same inertia. The insurance, on the basis of past experience, present conditions and future prospects, fixes the amount of premium.
Without premium, no co-operation is possible and the premium cannot be calculated without the help of theory of probability, and .consequently no insurance is possible. So these two principles are the two main legs of insurance.

(iii) Indemnity

A contract of insurance contained in a fire, marine, burglary or any other policy (excepting life assurance and personal accident and sickness insurance) is a contract of indemnity. This means that the insured, in case of loss against which the policy has been issued, shall be paid the actual amount of loss not exceeding the amount of the policy, i.e. he shall be fully indemnified. The object of every contract of insurance is to place the insured in the same financial position, as nearly as possible, after the loss, as if he loss had not taken place at all. It would be against public policy to allow an insured to make a profit out of his loss or damage.

(iv) Utmost Good Faith

Since insurance shifts risk from one party to another, it is essential that there must be utmost good faith and mutual confidence between the insured and the insurer. In a contract of insurance the insured knows more about the subject matter of the contract than the insurer. Consequently, he is duty bound to disclose accurately all material facts and nothing should be withheld or concealed. Any fact is material, which goes to the root of the contract of insurance and has a bearing on the risk involved. It is only when the insurer knows the whole truth that he is in a position to judge (a) whether he should accept the risk and (b) what premium he should charge.
If that were so, the insured might be tempted to bring about the event insured against in order to get money.

(v) Insurable Interest - A contract of insurance effected without insurable interest is void. It means that the insured must have an actual pecuniary interest and not a mere anxiety or sentimental interest in the subject matter of the insurance. The insured must be so situated with regard to the thing insured that he would have benefit by its existence and loss from its destruction. The owner of a ship run a risk of losing his ship, the charterer of the ship runs a risk of losing his freight and the owner of the cargo incurs the risk of losing his goods and profit. So, all these persons have something at stake and all of them have insurable interest. It is the existence of insurable interest in a contract of insurance, which distinguishes it from a mere watering agreement.

(vi) Causa Proxima - The rule of causa proxima means that the cause of the loss must be proximate or immediate and not remote. If the proximate cause of the loss is a peril insured against, the insured can recover. When a loss has been brought about by two or more causes, the question arises as to which is the causa proxima, although the result could not have happened without the remote cause. But if the loss is brought about by any cause attributable to the misconduct of the insured, the insurer is not liable.

(vii) Risk - In a contract of insurance the insurer undertakes to protect the insured from a specified loss and the insurer receive a premium for running the risk of such loss. Thus, risk must attach to a policy.

(viii) Mitigation of Loss - In the event of some mishap to the insured property, the insured must take all necessary steps to mitigate or minimize the loss, just as any prudent person would do in those circumstances. If he does not do so, the insurer can avoid the payment of loss attributable to his negligence. But it must be remembered that though the insured is bound to do his best for his insurer, he is, not bound to do so at the risk of his life.

(ix) Subrogation - The doctrine of subrogation is a corollary to the principle of indemnity and applies only to fire and marine insurance. According to it, when an insured has received full indemnity in respect of his loss, all rights and remedies which he has against third person will pass on to the insurer and will be exercised for his benefit until he (the insurer) recoups the amount he has paid under the policy. It must be clarified here that the insurer's right of subrogation arises only when he has paid for the loss for which he is liable under the policy and this right extend only to the rights and remedies available to the insured in respect of the thing to which the contract of insurance relates.

(x) Contribution - Where there are two or more insurance on one risk, the principle of contribution comes into play. The aim of contribution is to distribute the actual amount of loss among the different insurers who are liable for the same risk under different policies in respect of the same subject matter. Any one insurer may pay to the insured the full amount of the loss covered by the policy and then become entitled to contribution from his co-insurers in proportion to the amount which each has undertaken to pay in case of loss of the same subject-matter.

In other words, the right of contribution arises when (I) there are different policies which relate to the same subject-matter (ii) the policies cover the same peril which caused the loss, and (iii) all the policies are in force at the time of the loss, and (iv) one of the insurers has paid to the insured more than his share of the loss.

UNIT-2

CONCEPT:

Life insurance provides a monetary benefit to a decedent's family or other designated beneficiary, and may specifically provide for income to an insured person's family, burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity. In most states, a person cannot purchase a policy on another person without their knowledge.

Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies, are regulated as insurance, and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pensions that pay a benefit for life are sometimes regarded as insurance against the possibility that a retiree will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.

Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed.

PRODUCTS

Life-based contracts tend to fall into two major categories:

- Protection policies – designed to provide a benefit in the event of specified event, typically a lump sum payment. A common form of this design is term insurance.
- Investment policies – where the main objective is to facilitate the growth of capital by regular or single premiums. Common forms (in the US) are whole life, universal life and variable life policies.

Types of Life Insurance:

The life insurance policies are of many types. The principal types of policies are discussed below:

(1) Whole life Policy :

Under this policy premiums are paid throughout life and the sum insured becomes payable only at the death of the insured. The policy remains in force throughout the life of the assured and he continues to pay the premium till his death. This is the cheapest policy as the premium till his death. This is the cheapest policy as the premium charged is the lowest under this policy. This is also known as 'ordinary life policy'. This policy is suitable to persons who want to provide for payment of estate duty, make bequeathments for charitable purposes and to provide for their families after their death.

(2) Limited payment life policy:

In the case of whole life policy there is one disadvantage in that the assured must continue to pay the premium even during his old age when he is no more employed. Under the limited payment life policy premiums are payable for a selected number of years or until death, if, earlier. The assured knows how much he will be required to payable only at the how long he lives. The sum insured becomes payable only at the how long he lives. The sum insured becomes payable only at the death of the insured. It is a suitable policy to meet the family needs.

(3) Endowment policy:

It runs only for a limited period or up to a particular age. Under this policy the sum assured becomes payable if the assured reaches a particular age or after the expiry of a fixed period called the endowment period or at the death of the assured whichever is earlier. The premium under this policy is to be paid up to the maturity of the policy, i.e., the time when the policy becomes payable. Premium is naturally a little higher in the case of this policy than the whole life policy. This is a very popular policy these days as it serves the dual purpose of family and ole age pension.

(4) Double endowment policy:

Under this policy the insurer agrees to pay to the assured double the amount of the insured sum if he lives on beyond the date of maturity of the policy. This policy is suitable for persons with physical disability who are otherwise not acceptable for other classes of assurance at the normal tabular rates. Premiums are to be paid for a selected term of years or until death, if earlier.

(5) Joint Life Policy:

This policy covers the risk on two lives and is generally available to partners in business. Policies are however, issued on the lives of husband and wife under specified circumstances. Sum assured becomes payable at the end of the selected term or on the death of either of the two lives assured, if earlier.

(6) With or without profit policies:

Under the "with profit or participating policies," the policy holder is allowed a share in the profits of the corporation in the form of bonus and it is added to the total sum assured and paid at the time of maturity of the policy. In the case of 'without profit or non-participating policies, no such profit is allowed. Premium in the first case is higher and is lower in the later case.

(7) Convertible whole life policy:

This policy initially provides maximum insurance protection at minimum cost and offers a flexible contract which can be altered at the end of five years from the commencement of the policy to an endowment insurance.

(8) Convertible term assurance policy:

This policy meets the needs of those who are initially unable to pay the larger premium required for a whole life or endowment assurance policy but hope to be able to do so within a few years. It would also enable such persons to take final decision at a later date about the plan suitable for their future needs.

(9) Fixed term (marriage) Endowment policy & education annuity policy:

It is a policy suitable for making provisions for the marriage or education of children. Premiums are payable for a selected term or till prior death. The benefits are payable for selected term or till prior death. The benefits are payable only at the end of selected term. In case of the marriage endowment, the sum assured is paid in lump sum, but in case of the educational annuity, it is paid in equal half-yearly installments over a period of five years.

(10) Annuities:
It is a policy under which the insured amount is payable to the assured by monthly or annual installments after he attains a certain age. The assured may pay the premium regularly over a certain period or he may pay the premium regularly over a certain period or he may pay a lump sum of money at the outset. These policies are useful to persons who wish to provide a regular income for themselves and their dependants.

(11) Sinking fund policy:
Such a policy is taken with a view to providing for the payment of liability or replacement of an asset.

(12) Multipurpose policy :
This policy meets several insurance needs of a person – like provision for himself in old age, income for his family and provision for the education, marriage or the start in life of his children. It gives maximum protection to the beneficiaries in the event of the early death of the assured, as it provides:
i) Regular monthly income during the unexpired term;
ii) Additional monthly income for a period of two years from the date of death;
iii) Payment of a part of the sum assured on death and
iv) Payment of the balance sum assured at the end of the selected period

On maturity the assured may get the sum assured in cash, in the form of monthly pension, or an increased sum payable on death. Premiums are payable during the selected term or till death, it earlier.

TERM LIFE INSURANCE:

Term life insurance or **term assurance** is life insurance which provides coverage at a fixed rate of payments for a limited period of time, the relevant term. After that period expires, coverage at the previous rate of premiums is no longer guaranteed and the client must either forgo coverage or potentially obtain further coverage with different payments or conditions. If the insured dies during the term, the death benefit will be paid to the beneficiary. Term insurance is the least expensive way to purchase a substantial death benefit on a coverage amount per premium dollar basis over a specific period of time.

Term life insurance is the original form of life insurance and can be contrasted to permanent life insurance such as whole life, universal life, and variable universal life, which guarantee coverage at fixed premiums for the lifetime of the covered individual. Term insurance is not generally used for estate planning needs or charitable giving strategies but is used for pure income replacement needs for an individual. Term insurance functions in a manner similar to most other types of insurance in that it satisfies claims against what is insured if the premiums are up to date and the contract has not expired, and does not provide for a return of premium dollars if no claims are filed. As an example, auto insurance will satisfy claims against the insured in the event of an accident and a home owner policy will satisfy claims against the home if it is damaged or destroyed by, for example, a fire. Whether or not these events will occur is uncertain. If the policy holder discontinues coverage because he has sold the insured car or home, the insurance company will not refund the premium. This is purely risk protection.

Usage:
Because term life insurance is a pure death benefit, its primary use is to provide coverage of financial responsibilities for the insured or his or her beneficiaries. Such responsibilities may include, but are not limited to, consumer debt, dependent care, university education for dependents, funeral costs, and

mortgages. Term life insurance is generally chosen in favor of permanent life insurance because term insurance is usually much less expensive (depending on the length of the term. For example, an individual might choose to obtain a policy whose term expires near his or her retirement age based on the premise that, by the time the individual retires, he or she would have amassed sufficient funds in retirement savings to provide financial security for the claims.

ENDOWMENT PLAN:

An endowment policy is a combination of insurance and investment: The life of the individual taking the policy is insured for a certain amount. This life cover is referred to as the sum assured. A certain part of the premium gets allocated towards this sum assured. Some portion of the premium is allocated towards the administrative expenses of the insurance company selling the policy. The remaining portion of the premium gets invested.

An endowment policy may declare a bonus every year: The money that is invested generates a certain return every year. This return may be declared as a bonus. The bonus is typically generated as a certain proportion of sum assured or life cover as it is popularly known. So if an individual taking the policy has a policy of sum assured Rs 10 lakh (Rs 1 million) and the company declares a bonus of Rs 50 per thousand of sum assured, then the bonus works out to be Rs 50,000.

The bonus declared is not payable immediately: Like is the case with a stock dividend or a mutual fund dividend which is payable immediately after it is declared, the bonus declared accumulates and is payable only when the policy matures or in case the policy holder dies.

The bonus declared does not compound it, only accumulates: Let us take the case of a 35 year old individual who takes a policy with a sum assured of Rs 10 lakh with a term of 20 years.

The premium for this would be around Rs 49,000 per year. At the end of the first year, the insurance company declares a bonus of Rs 50 per thousand of sum assured or 5% of sum assured. This amounts to Rs 50,000. This Rs 50,000 remains Rs 50,000 for the next nineteen years till the end of the policy. The same thing happens to the bonuses declared for the remaining period of the policy as well.

Since the bonus declared does not compound returns are low: Extending the example taken above, let us assume that the insurance company declares an average bonus of 5% every year. What this means is that every year on an average a bonus of Rs 50,000 is declared. So at the end of twenty years, the total accumulated bonus would amount to Rs 10 lakh (Rs 50,000 x 20).

Chances of an insurance company declaring an average bonus of more than 5% over a period of twenty years are very less. This is primarily because endowment policies largely invest in government securities and after taking into account the administrative expenses of the insurance companies, a greater bonus is highly unlikely.

So at the end of twenty years, the individual gets Rs 10 lakh of accumulated bonus and Rs 10 lakh of sum assured, making a total of Rs 20 lakh (Rs 2 million).

On this he has been paying a premium of Rs 49,000 every year. This amounts to a return of 6.39% per annum, which is not great. If the individual expires during the period the policy his nominee gets the Rs 10 lakh of sum assured as well the accumulated bonus till that point of time.

Take a term insurance policy and invest in the public provident fund: A better way out for an individual is to take a term insurance policy. A term insurance policy is a pure insurance policy.

If the policy holder dies during the period of the policy, his nominee gets the amount of the sum assured. If he survives the period of the policy, he does not get anything. Given this, the premiums on a term insurance policy tend to be the least among all insurance policies and they provide an adequate life cover.

A term insurance policy for a period of 20 years, for a 35 year old individual, would cost around Rs 4,600 per annum. So instead of taking an endowment policy it makes more sense to take a term policy of Rs 10 lakh.

The remaining money i.e. the difference between what needs to be paid on taking an endowment policy of similar sum assured and the premium on the term policy, can be invested in the public provident fund (PPF). The difference in the example taken here works out to Rs 44,400 every year.

If this is invested every year into the PPF, at the current interest rate of 8%, the individual is likely to accumulate Rs 21.94 lakh (Rs 2.194 million) at the end of 20 years, which is nearly Rs 2 lakh (Rs 200,000) more than Rs 20 lakh he is likely to accumulate in case of the endowment insurance policy. Also the bonus on the insurance policy is not guaranteed whereas PPF guarantees an interest of 8% every year.

PENSION:

A **pension** is a contract for a fixed sum to be paid regularly to a person, typically following retirement from service. There are many different types of pensions, including defined benefit plans, defined contribution plans, as well as several others. Pensions should not be confused with severance pay; the former is paid in regular installments, while the latter is paid in one lump sum.

The terms retirement plan and superannuation refer to a pension granted upon retirement of the individual. Retirement plans may be set up by employers, insurance companies, the government or other institutions such as employer associations or trade unions. Called *retirement plans* in the United States, they are commonly known as *pension schemes* in the United Kingdom and Ireland and *superannuation plans* (or *super* in Australia and New Zealand. Retirement pensions are typically in the form of a guaranteed life annuity, thus insuring against the risk of longevity.

A pension created by an employer for the benefit of an employee is commonly referred to as an occupational or employer pension. Labor unions, the government, or other organizations may also fund pensions. Occupational pensions are a form of deferred compensation, usually advantageous to employee and employer for tax reasons. Many pensions also contain an additional insurance aspect, since they often will pay benefits to survivors or disabled beneficiaries. Other vehicles (certain lottery payouts, for example, or an annuity) may provide a similar stream of payments.

The common use of the term *pension* is to describe the payments a person receives upon retirement, usually under pre-determined legal or contractual terms. A recipient of a retirement pension is known as a *pensioner* or *retiree*.

GROUP INSURANCE:

Group insurance' is an insurance that covers a group of people, usually who are the members of societies, employees of a common employer, or professionals in a common group. Group coverage can help reduce the problem of adverse selection by creating a pool of people eligible to purchase insurance who belong to the group for reasons *other than* for the purposes of obtaining insurance. In other words, people belong to the group not because they possess some high-risk factor which makes them more apt to purchase insurance (thus increasing adverse selection); instead they are in the group for reasons unrelated to insurance, such as all working for a particular employer.

Investopedia defines Group Life Insurance as "Life insurance offered by an employer or large-scale entity (i.e. association or labor organization) to its workers or members. Group life insurance is typically offered as a piece of a larger employer or membership benefit package.By purchasing coverage through a provider on a "wholesale" basis for its members, the coverage costs each individual worker/member much less than if they had to purchase an individual policy. . People who elect coverage through the group policy receive a "certificate of credible coverage," which will be necessary to provide to a subsequent insurance company in the event that the individual leaves the company or organization and terminates their coverage."

From the above paragraphs we can infer the following are the characteristics of Group Life Insurance

a. there must be a group of people to be insured which should have something in common other than the purpose of obtaining insurance

b. there must be a Master Policy Holder who will retain the contract on the behalf of the member and the carriers
c. Such covers are typically available at a discount to the respective individual rates.

Insurable Groups can broadly be classified as mainly two types - " employer - employee " groups where all members work for the employer proposing to cover them or "affinity" groups, whose members have a commonality other than employment - say deposit holders of a bank.

The Master Policy Holder of a Group Life Insurance Plan in the case of an "Employer Employee Group" is basically the Employer and for other groups would be the entity that has an insurable interest in the lives of its members. So in the case of a bank it could be said to have an insurable interest in the lives of its members who hold a deposit or have taken a loan. The Master Policy Holder also ensures each member gets their certificate of coverage stating the details of the premium paid, cover available, term of the cover and the claims process.

A feature which is sometimes common in group insurance is that the premium cost on an individual basis is not individually risk-based. Instead it is the same amount for all the insured persons in the group. So, for example, in the United States, often all employees of an employer receiving health or life insurance coverage pay the same premium amount for the same coverage regardless of their age or other factors. In contrast, under private individual health or life insurance coverage in the U.S., different insured persons will pay different premium amounts for the same coverage based on their age, location, pre-existing conditions, etc.Group policies are also attractive to consumers because the average price per policy is often lower. Carriers are interested in gaining customers and will cut prices a bit to accommodate members of group. Data shows that, for example, drivers save 29% on average by attaching themselves to a group policy.

All members for whom the premium is paid for the period and the risks in respect of such members accepted by the underwriters of the insurance company are generally eligible to purchase or renew coverage all whilst he or she is a member of the group subject to certain conditions. Again, using U.S. health coverage as an example, under group insurance a person will normally remain covered as long as he or she continues to work for a certain employer and pays the required insurance premiums, whereas under individual coverage, the insurance company often has the right to non-renew a person's individual health insurance policy when the policy is up for renewal, which it may do if the person's risk profile changes (though some states limit the insurance company's ability to non-renew after the person has been under individual coverage with a given company for a certain number of years).

In Canada group insurance is usually purchased through larger brokerage firms because brokers receive better rates than individual companies or unions. There may be slight differences in terms of administration and market related practices world wide, even though the concept may be the same. For example, In India, broker procured group term insurance, unlike Canada, does not intrinsically have any price advantage to the buyer i.e. the Master Policy Holder.

Group Life Insurance covers may be either compulsory - in which case every member has no say in opting for the cover or voluntary where all eligible members may decide within an enrolment window to opt for the available Group Insurance. This is irrespective of who pays the premium.

Since compulsory covers offer no scope for adverse selection they come with far relaxed underwriting requirements than voluntary covers, Underwriting requirements even for Voluntary Group Life Covers are far lower than the respective requirements for individual lives.

Group Health Insurance is also provided in India. It provides healthcare coverage to a group of people belonging to a common community (typically as employees of a company). These plans are generally uniform in nature, offering the same benefits to all employees or members of the group.

Most professionally run companies today provide Group Health Insurance as a part of their Employee Welfare program. Each company however gets the plan customized based on the employee demographics.

INSURANCE REGULATORY DEVELOPMENT AUTHORITY:

Insurance Regulatory and Development Authority (IRDA) is an autonomous apex statutory body which regulates and develops the insurance industry in India. It was constituted by a Parliament of India act called *Insurance Regulatory and Development Authority Act, 1999* and duly passed by the Government of India.

The agency operates its headquarters at Hyderabad, Andhra Pradesh where it shifted from Delhi in 2001. The Insurance regulatory and Development Authority (IRDA), batted for a hike in the foreign direct investment (FDI) limit to 49 per cent in the sector from the present 26 per cent.

The *IRDA Act, 1999* was passed as per the major recommendation of the *Malhotra Committee* report (1994) which recommended establishment of an independent regulatory authority for insurance sector in India. Later, It was incorporated as a statutory body in April, 2000. The *IRDA Act, 1999* also allows private players to enter the insurance sector in India besides a maximum foreign equity of 26 per cent in a private insurance company having operations in India. The FDI limit in insurance sector was raised to 49% in July 2013. It serves as an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith. IRDA role is to protect rights of policy holders & they provides registration certification to life insurance companies & responsible for renewal, modification, cancellation & suspension of this registered certificate.

Organizational structure

IRDA is a ten member body consisting of:

- A Chairman,
- Five whole-time members and
- Four part-time members.

All members are appointed by the Government of India

Duties, Powers and Functions:

Section 14 of the IRDA Act, 1999 lays down the duties, powers and functions of IRDA.

- Registering and regulating insurance companies
- Protecting policyholders' interests
- Licensing and establishing norms for insurance intermediaries
- Promoting professional organisations in insurance
- Regulating and overseeing premium rates and terms of non-life insurance covers
- Specifying financial reporting norms of insurance companies
- Regulating investment of policyholders' funds by insurance companies
- Ensuring the maintenance of solvency margin by insurance companies
- Ensuring insurance coverage in rural areas and of vulnerable sections of society

UNIT 3

Overview of banking industry

History of banking in India

Colonial era

During the period of British rule merchants established the Union Bank of Calcutta in 1869, first as a private joint stock association, then partnership. Its proprietors were the owners of the earlier Commercial Bank and the Calcutta Bank, who by mutual consent created Union Bank to replace these two banks. In 1840 it established an agency at Singapore, and closed the one at Mirzapore that it had opened in the previous year. Also in 1840 the Bank revealed that it had been the subject of a fraud by the bank's accountant. Union Bank was incorporated in 1845 but failed in 1848, having been insolvent for some time and having used new money from depositors to pay its dividends.

The Allahabad Bank, established in 1865 and still functioning today, is the oldest Joint Stock bank in India, it was not the first though. That honour belongs to the Bank of Upper India, which was established in 1863, and which survived until 1913, when it failed, with some of its assets and liabilities being transferred to the Alliance Bank of Simla.

Foreign banks too started to appear, particularly in Calcutta, in the 1860s. The Comptoir d'Escompte de Paris opened a branch in Calcutta in 1860, and another in Bombay in 1862; branches in Madras and Pondicherry, then a French possession, followed. HSBC established itself in Bengal in 1869. Calcutta was the most active trading port in India, mainly due to the trade of the British Empire, and so became a banking centre.

The first entirely Indian joint stock bank was the Oudh Commercial Bank, established in 1881 in Faizabad. It failed in 1958. The next was the Punjab National Bank, established in Lahore in 1894, which has survived to the present and is now one of the largest banks in India.

Post-Independence

The partition of India in 1947 adversely impacted the economies of Punjab and West Bengal, paralysing banking activities for months. India's independence marked the end of a regime of the Laissez-faire for the Indian banking. The Government of India initiated measures to play an active role in the economic life of the nation, and the Industrial Policy Resolution adopted by the government in 1948 envisaged a mixed economy. This resulted into greater involvement of the state in different segments of the economy including banking and finance. The major steps to regulate banking included:

- The Reserve Bank of India, India's central banking authority, was established in April 1935, but was nationalised on 1 January 1949 under the terms of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948 (RBI, 2005b).
- In 1949, the Banking Regulation Act was enacted which empowered the Reserve Bank of India (RBI) "to regulate, control, and inspect the banks in India".
- The Banking Regulation Act also provided that no new bank or branch of an existing bank could be opened without a license from the RBI, and no two banks could have common directors.

Nationalization in the 1960s

Despite the provisions, control and regulations of the Reserve Bank of India, banks in India except the State Bank of India (SBI), continued to be owned and operated by private persons. By the 1960s, the Indian banking industry had become an important tool to facilitate the development of the Indian economy. At the same time, it had emerged as a large employer, and a debate had ensued about the nationalization of the banking industry. Indira Gandhi, the then Prime Minister of India, expressed the intention of the Government of India in the annual conference of the All India Congress Meeting in a paper entitled *"Stray thoughts on Bank Nationalization."* The meeting received the paper with enthusiasm.

Thereafter, her move was swift and sudden. The Government of India issued an ordinance ('Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969') and nationalised the 14 largest commercial banks with effect from the midnight of 19 July 1969. These banks contained 85 percent of bank deposits in the country.[17] Jayaprakash Narayan, a national leader of India, described the step as a *"masterstroke of political sagacity."* Within two weeks of the issue of the ordinance, the Parliament passed the Banking Companies (Acquisition and Transfer of Undertaking) Bill, and it received the presidential approval on 9 August 1969.

A second dose of nationalisation of 6 more commercial banks followed in 1980. The stated reason for the nationalisation was to give the government more control of credit delivery. With the second dose of nationalisation, the Government of India controlled around 91% of the banking business of India. Later on, in the year 1993, the government merged New Bank of India with Punjab National Bank.[18] It was the only merger between nationalised banks and resulted in the reduction of the number of nationalised banks from 20 to 19. After this, until the 1990s, the nationalised banks grew at a pace of around 4%, closer to the average growth rate of the Indian economy.

Liberalization in the 1990s

In the early 1990s, the then government embarked on a policy of liberalization, licensing a small number of private banks. These came to be known as *New Generation tech-savvy banks*, and included Global Trust Bank (the first of such new generation banks to be set up), which later amalgamated with Oriental Bank of Commerce, UTI Bank (since renamed Axis Bank), ICICI Bank and HDFC Bank. This move, along with the rapid growth in the economy of India, revitalised the banking sector in India, which has seen rapid growth with strong contribution from all the three sectors of banks, namely, government banks, private banks and foreign banks.

The next stage for the Indian banking has been set up with the proposed relaxation in the norms for foreign direct investment, where all foreign investors in banks may be given voting rights which could exceed the present cap of 10% at present. It has gone up to 74% with some restrictions.

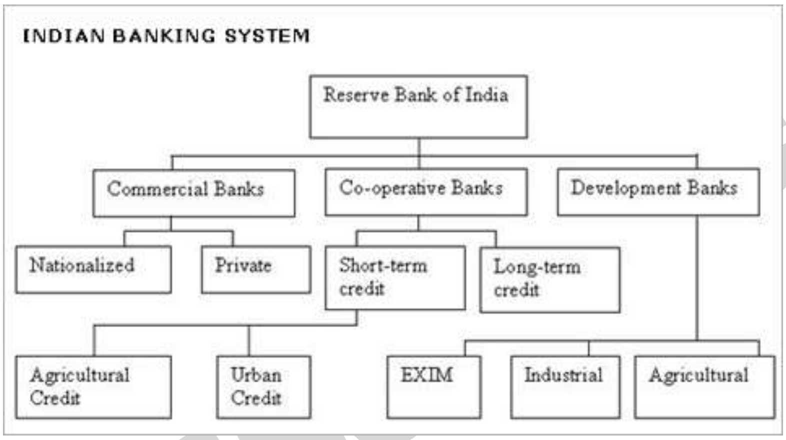
The new policy shook the Banking sector in India completely. Bankers, till this time, were used to the 4–6–4 method (borrow at 4%; lend at 6%; go home at 4) of functioning. The new wave ushered in a modern outlook and tech-savvy methods of working for traditional banks. All this led to the retail boom in India. People demanded more from their banks and received more.

Current period

The Indian banking sector is broadly classified into scheduled banks and non-scheduled banks.All banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934 are Scheduled Banks. These banks comprise Scheduled Commercial Banks and Scheduled Co-operative Banks. Scheduled Co-operative Banks consist of Scheduled State Co-operative Banks and Scheduled Urban Cooperative Banks.Scheduled Commercial Banks in India are categorized into five different groups according to their ownership and/or nature of operation:

- State Bank of India and its Associates
- Nationalised Banks
- Private Sector Banks
- Foreign Banks
- Regional Rural Bank.

Banking structure in India



The banking system in India is significantly different from other countries.
1. Reserve Bank of India:
Reserve Bank of India is the Central Bank of our country. It was established on 1st April 1935 under the RBI Act of 1934. It holds the apex position in the banking structure. RBI performs various developmental and promotional functions.
It has given wide powers to supervise and control the banking structure. It occupies the pivotal position in the monetary and banking structure of the country. In many countries central bank is known by different names.
For example, Federal Reserve Bank of U.S.A, Bank of England in U.K. and Reserve Bank of India in India. Central bank is known as a banker's bank. They have the authority to formulate and implement monetary and credit policies. It is owned by the government of a country and has the monopoly power of issuing notes.
2. Commercial Banks:
Commercial bank is an institution that accepts deposit, makes business loans and offer related services to various like accepting deposits and lending loans and advances to general customers and business man.
These institutions run to make profit. They cater to the financial requirements of industries and various sectors like agriculture, rural development, etc. it is a profit making institution owned by government or private of both.

Commercial bank includes public sector, private sector, foreign banks and regional rural banks:
a. Public sector banks:
It includes SBI, seven (7) associate banks and nineteen (19) nationalised banks. Altogether there are 27 public sector banks. The public sector accounts for 90 percent of total banking business in India and State Bank of India is the largest commercial bank in terms of volume of all commercial banks.
b. Private sector banks:
Private sector banks are those whose equity is held by private shareholders. For example, ICICI, HDFC etc. Private sector bank plays a major role in the development of Indian banking industry.
c. Foreign Banks:
Foreign banks are those banks, which have their head offices abroad. CITI bank, HSBC, Standard Chartered etc. are the examples of foreign bank in India.
d. Regional Rural Bank (RRB):
These are state sponsored regional rural oriented banks. They provide credit for agricultural and rural development. The main objective of RRB is to develop rural economy. Their borrowers include small

and marginal farmers, agricultural labourers, artisans etc. NABARD holds the apex position in the agricultural and rural development.

3. Co-operative Bank:

Co-operative bank was set up by passing a co-operative act in 1904. They are organised and managed on the principal of co-operation and mutual help. The main objective of co-operative bank is to provide rural credit.

The cooperative banks in India play an important role even today in rural co-operative financing. The enactment of Co-operative Credit Societies Act, 1904, however, gave the real impetus to the movement. The Cooperative Credit Societies Act, 1904 was amended in 1912, with a view to broad basing it to enable organisation of non-credit societies.

Three tier structures exist in the cooperative banking:

i. State cooperative bank at the apex level.

ii. Central cooperative banks at the district level.

iii. Primary cooperative banks and the base or local level.

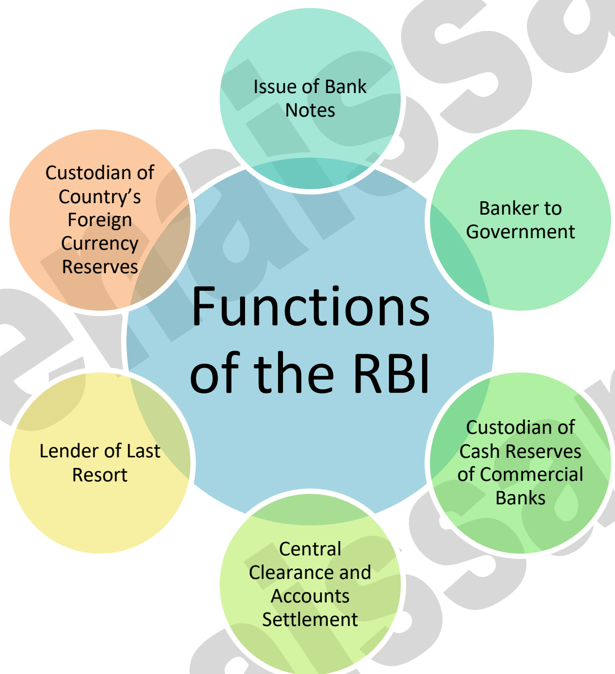
4. Scheduled and Non-Scheduled banks:

A bank is said to be a scheduled bank when it has a paid up capital and reserves as per the prescription of RBI and included in the second schedule of RBI Act 1934. Non-scheduled bank are those commercial banks, which are not included in the second schedule of RBI Act 1934.

5. Development banks and other financial institutions:

A development bank is a financial institution, which provides a long term funds to the industries for development purpose. This organisation includes banks like IDBI, ICICI, IFCI etc. State level institutions like SFC's SIDC's etc. It also includes investment institutions like UTI, LIC, and GIC etc.

<u>Functions of RBI</u>



Major functions of the RBI are as follows:

1. Issue of Bank Notes:

The Reserve Bank of India has the sole right to issue currency notes except one rupee notes which are issued by the Ministry of Finance. Currency notes issued by the Reserve Bank are declared unlimited legal tender throughout the country.

This concentration of notes issue function with the Reserve Bank has a number of advantages: (i) it brings uniformity in notes issue; (ii) it makes possible effective state supervision; (iii) it is easier to control and regulate credit in accordance with the requirements in the economy; and (iv) it keeps faith of the public in the paper currency.

2. Banker to Government:

As banker to the government the Reserve Bank manages the banking needs of the government. It has to-maintain and operate the government's deposit accounts. It collects receipts of funds and makes payments on behalf of the government. It represents the Government of India as the member of the IMF and the World Bank.

3. Custodian of Cash Reserves of Commercial Banks:

The commercial banks hold deposits in the Reserve Bank and the latter has the custody of the cash reserves of the commercial banks.

4. Custodian of Country's Foreign Currency Reserves:

The Reserve Bank has the custody of the country's reserves of international currency, and this enables the Reserve Bank to deal with crisis connected with adverse balance of payments position.

5. Lender of Last Resort:

The commercial banks approach the Reserve Bank in times of emergency to tide over financial difficulties, and the Reserve bank comes to their rescue though it might charge a higher rate of interest.

6. Central Clearance and Accounts Settlement:

Since commercial banks have their surplus cash reserves deposited in the Reserve Bank, it is easier to deal with each other and settle the claim of each on the other through book keeping entries in the books of the Reserve Bank. The clearing of accounts has now become an essential function of the Reserve Bank.

7. Controller of Credit:

Since credit money forms the most important part of supply of money, and since the supply of money has important implications for economic stability, the importance of control of credit becomes obvious. Credit is controlled by the Reserve Bank in accordance with the economic priorities of the government.

Role & functions of NABARD and Rural Co-operative Bank

Though the co-operative credit movement was made a special responsibility of the MI right from the latter's birth in 1935, much was not accomplished in this sphere till about the mid- 1950s. The real turning point in the Bank's role in the movement came only after the Bank's All-India Rural Credit Survey Committee submitted its monumental report in 1954.

The Survey Committee had found that while the co-operative societies and government provided only 3% each of the loans raised by the cultivator, the private credit agencies (the moneylender and the trader) lent more than 70% of what the cultivator borrowed. The moneylender changed very high rates of interest and did not concern himself with the purpose of the loan.

The Survey Committee summed up the position of agricultural credit thus It fell short of the right quantity, was not of the right type, did not serve the right purpose and often failed to go to the right people It also said that 'co-operation had failed but co-operation must succeed'.

For this success, the Survey Committee recommended an 'integrated scheme of rural credit', of which the main features were:

(i) State partnership in co-operative credit institutions through contribution to their share capital;

(ii) Full co-ordination between credit and other economic activities especially marketing and processing; and

(iii) Administration through adequately trained and efficient personnel, responsive to the needs of the rural population.

The RBI was assigned a crucial role in the scheme of integrated credit and in the building up of the co-operative credit organization. The consequent steps taken by the RBI in pursuance of the recommendations of the Survey Committee and later committees like the Committee on Cooperative Credit (1960) transformed the Bank's role from that of a conventional central banker to that of an active agency that takes all necessary measures for enabling the co-operative system to provide a growingly larger share of rural credit.

The adoption of special programmes for increasing agricultural production and the spread of green revolution based largely on intensive use of fertilisers, water, better seeds, and machine power have enhanced the RBI's responsibilities further. The RBI had also started offering greater financial assistance to co-operatives for credit facilities to small farmers and other weaker sections and for minimising disparities in the flow of credit to various regions.
With the setting up of the National Bank for Agriculture and Rural Development (NABARD) in July 1982, the RBI's functions relating to the co-operative movement have been taken over by the NABARD.

Now, the RBI's role is primarily restricted to the provision of finance to the NABARD through its contributions to the two national rural credit funds, already transferred to the NABARD, and additional loans and advances to the latter. Besides, the RBI still offers loans and advances to SCBs.
The NABARD measures are basically a continuation of the RBI measures.
They are studied below under two main heads:
(A) Provision of finance and
(B) Building up of the co-operative credit structure.
(A) Provision of Finance:
All the NABARD finance is provided to the co-operative sector through the SCBs. The bulk (almost 90%) of it goes to finance agriculture. The finance is of all the three types, viz., short-term, medium-term, and long-term.
(i) Short-term Agricultural Finance:
This is given primarily for seasonal agricultural operations which are interpreted to include mixed farming activities, i.e., animal husbandry and allied activities jointly undertaken with agricultural operations.
(ii) Medium-term Agricultural Finance:
The NABARD provides medium-term loans to SCBs for periods of 3 to 5 years. These loans are provided for (a) agricultural purposes (purchase of agricultural machinery, sinking and repair of wells and tube wells, etc.), animal husbandry, poultry farming and for purchase of shares of cooperative sugar factories and other processing societies by agriculturists, and (b) conversion of short-term agricultural loans into medium term loans whenever such conversion becomes necessary on account of wide-spread crop failure as a result of drought, floods or other natural calamities. All medium-term loans are fully guaranteed as to e repayment of the principal and the payment of interest by the state government concerned.
(iii) Long-term Agricultural Credit:
Long-term credit for agriculture is provided mainly through investment in the debentures of SLDBs. In addition, the National Bank makes long-term loans to state governments for contribution to the share capital of co-operative credit institutions, most of which goes to strengthen co-operative credit for agriculture. The financial accommodation of all kinds indicated above is provided at concessional rates of interest which vary between the Bank Rate and up to 3% below the Bank Rate.
(iv) Non- agricultural finance:

The NABARD also provides short- term finance for:

(i) The production and marketing activities of selected cottage and small-scale industries (mostly handloom weavers' co-operative societies) and
(ii) The purchase and distribution of fertilisers.
The loans are generally provided through SCBs against guarantees of the state governments. However, all such finance has constituted a small proportion (5 to 7 per cent) of the total Reserve Bank short-term finance to cooperatives: the bulk of it goes to agricultural co-operatives.
During 1994-95, the total amount of financial assistance sanctioned by NABARD was about Rs. 5,300 crore. Of this, about Rs. 4,800 crore were short-term credit and Rs. 500 crore were medium-term credit. The outstanding amount of financial assistance was about Rs. 3,700 crore.
(B) Building up of the Co-operative Credit Structure:
From around 1951 the RBI made efforts to (a) strengthen the co-operative credit structure at all the three levels and (b) reorient the operational policies of cooperative banks in more purposive directions. Under the former, the RBI had taken steps to get SCBs established in such states that did not have them and strengthen them where they were weak. The RBI had also tried for the rehabilitation of weak CCBs by prescribing action to recover over dues, strengthen the bad debts reserves and improve the quality of the administrative and supervisory staff.
Similarly, the Bank played an active role in the reorganization of primary societies. The Bank had also made arrangements for the training of personnel of co-operative departments and institutions and undertaken periodical inspection of SCBs, CCBs, and SLDBs to promote healthy and sound growth of co-operative banking in the country. All these functions are now being performed by the NABARD.

<u>Concept of Banking ratios</u>

What is Bank Rate ? : This is the rate at which central bank (RBI) lends money to other banks or financial institutions. If the bank rate goes up, long-term interest rates also tend to move up, and vice-versa. Thus, it can said that in case bank rate is hiked, in all likelihood banks will hikes their own lending rates to ensure that they continue to make profit.

What is CRR : CRR means Cash Reserve Ratio. Banks in India are required to hold a certain proportion of their deposits in the form of cash. However, actually Banks don't hold these as cash with themselves, but deposit such case with Reserve Bank of India (RBI) / currency chests, which is considered as equivlanet to holding cash with RBI. This minimum ratio (that is the part of the total deposits to be held as cash) is stipulated by the RBI and is known as the CRR or Cash Reserve Ratio. Thus, When a bank's deposits increase by Rs100, and if the cash reserve ratio is 6%, the banks will have to hold additional Rs 6 with RBI and Bank will be able to use only Rs 94 for investments and lending / credit purpose. Therefore, higher the ratio (i.e. CRR), the lower is the amount that banks will be able to use for lending and investment. This power of RBI to reduce the lendable amount by increasing the CRR, makes it an instrument in the hands of a central bank through which it can control the amount that banks lend. Thus, it is a tool used by RBI to control liquidity in the banking system
RBI uses CRR either to drain excess liquidity or to release funds needed for the growth of the economy from time to time. Increase in CRR means that banks have less funds available and money is sucked out of circulation. Thus we can say that this serves duel purposes i.e.(a) ensures that a portion of bank deposits is kept with RBI and is totally risk-free, (b) enables RBI to control liquidity in the system, and thereby, inflation by tying the hands of the banks in lending money.

What are Repo rate and Reverse Repo rate?
Repo (Repurchase) rate is the rate at which the RBI lends shot-term money to the banks against securities. When the repo rate increases borrowing from RBI becomes more expensive. Therefore, we can say that in case, RBI wants to make it more expensive for the banks to borrow money, it increases the repo rate; similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate

Reverse Repo rate is the rate at which banks park their short-term excess liquidity with the RBI. The banks use this tool when they feel that they are stuck with excess funds and are not able to invest anywhere for reasonable returns. An increase in the reverse repo rate means that the RBI is ready to borrow money from the banks at a higher rate of interest. As a result, banks would prefer to keep more and more surplus funds with RBI.

Thus, we can conclude that Repo Rate signifies the rate at which liquidity is injected in the banking system by RBI, whereas Reverse repo rate signifies the rate at which the central bank absorbs liquidity from the banks

Unit 4

GENERAL INSURANCE

Principles:

The seven principles of insurance are :-

1. Principle of Uberrimae fidei (Utmost Good Faith)
Principle of *Uberrimae fidei* (a Latin phrase), or in simple english words, the Principle of **Utmost Good Faith**, is a very basic and first primary principle of insurance. According to this principle, the insurance contract must be signed by both parties (i.e insurer and insured) in an absolute good faith or belief or trust.

The person getting insured must willingly disclose and surrender to the insurer his complete true information regarding the subject matter of insurance. The insurer's liability gets void (i.e legally revoked or cancelled) if any facts, about the subject matter of insurance are either omitted, hidden, falsified or presented in a wrong manner by the insured.

The principle of **Uberrimae fidei** applies to all types of insurance contracts.

2. Principle of Insurable Interest
The principle of insurable interest states that the person getting insured must have insurable interest in the object of insurance. A person has an insurable interest when the physical existence of the insured object gives him some gain but its non-existence will give him a loss. In simple words, the insured person must suffer some financial loss by the damage of the insured object.

For example :- The owner of a taxicab has insurable interest in the taxicab because he is getting income from it. But, if he sells it, he will not have an insurable interest left in that taxicab.

From above example, we can conclude that, ownership plays a very crucial role in evaluating insurable interest. Every person has an insurable interest in his own life. A merchant has insurable interest in his business of trading. Similarly, a creditor has insurable interest in his debtor.

3. Principle of Indemnity
Indemnity means security, protection and compensation given against damage, loss or injury.

According to the principle of indemnity, an insurance contract is signed only for getting protection against unpredicted financial losses arising due to future uncertainties. Insurance contract is not made for making profit else its sole purpose is to give compensation in case of any damage or loss.

In an insurance contract, the amount of compensations paid is in proportion to the incurred losses. The amount of compensations is limited to the amount assured or the actual losses, whichever is less. The compensation must not be less or more than the actual damage. Compensation is not paid if the specified loss does not happen due to a particular reason during a specific time period. Thus, insurance is only for giving protection against losses and not for making profit.

However, in case of **life insurance**, the principle of indemnity does not apply because the value of human life cannot be measured in terms of money.

4. Principle of Contribution

Principle of Contribution is a corollary of the principle of indemnity. It applies to all contracts of indemnity, if the insured has taken out more than one policy on the same subject matter. According to this principle, the insured can claim the compensation only to the extent of actual loss either from all insurers or from any one insurer. If one insurer pays full compensation then that insurer can claim proportionate claim from the other insurers.

For example :- Mr. John insures his property worth $ 100,000 with two insurers "AIG Ltd." for $ 90,000 and "MetLife Ltd." for $ 60,000. John's actual property destroyed is worth $ 60,000, then Mr. John can claim the full loss of $ 60,000 either from AIG Ltd. or MetLife Ltd., or he can claim $ 36,000 from AIG Ltd. and $ 24,000 from Metlife Ltd.

So, if the insured claims full amount of compensation from one insurer then he cannot claim the same compensation from other insurer and make a profit. Secondly, if one insurance company pays the full compensation then it can recover the proportionate contribution from the other insurance company.

5. Principle of Subrogation

Subrogation means substituting one creditor for another.

Principle of Subrogation is an extension and another corollary of the principle of indemnity. It also applies to all contracts of indemnity.

According to the principle of subrogation, when the insured is compensated for the losses due to damage to his insured property, then the ownership right of such property shifts to the insurer.
This principle is applicable only when the damaged property has any value after the event causing the damage. The insurer can benefit out of subrogation rights only to the extent of the amount he has paid to the insured as compensation.

For example :- Mr. John insures his house for $ 1 million. The house is totally destroyed by the negligence of his neighbour Mr.Tom. The insurance company shall settle the claim of Mr. John for $ 1 million. At the same time, it can file a law suit against Mr.Tom for $ 1.2 million, the market value of the house. If insurance company wins the case and collects $ 1.2 million from Mr. Tom, then the insurance company will retain $ 1 million (which it has already paid to Mr. John) plus other expenses such as court fees. The balance amount, if any will be given to Mr. John, the insured.

6. Principle of Loss Minimization

According to the Principle of Loss Minimization, insured must always try his level best to minimize the loss of his insured property, in case of uncertain events like a fire outbreak or blast, etc. The insured must take all possible measures and necessary steps to control and reduce the losses in such a scenario. The insured must not neglect and behave irresponsibly during such events just because the property is insured. Hence it is a responsibility of the insured to protect his insured property and avoid further losses.

For example :- Assume, Mr. John's house is set on fire due to an electric short-circuit. In this tragic scenario, Mr. John must try his level best to stop fire by all possible means, like first calling nearest fire department office, asking neighbours for emergency fire extinguishers, etc. He must not remain inactive and watch his house burning hoping, "Why should I worry? I've insured my house."

7. Principle of Causa Proxima (Nearest Cause)

Principle of *Causa Proxima* (a Latin phrase), or in simple english words, the Principle of Proximate (i.e Nearest) Cause, means when a loss is caused by more than one causes, the proximate or the nearest or the closest cause should be taken into consideration to decide the liability of the insurer.

The principle states that to find out whether the insurer is liable for the loss or not, the proximate (closest) and not the remote (farest) must be looked into.

For example :- A cargo ship's base was punctured due to rats and so sea water entered and cargo was damaged. Here there are two causes for the damage of the cargo ship - (i) The cargo ship getting punctured beacuse of rats, and (ii) The sea water entering ship through puncture. The risk of sea water is insured but the first cause is not. The nearest cause of damage is sea water which is insured and therefore the insurer must pay the compensation.

However, in case of life insurance, the principle of **Causa Proxima** does not apply. Whatever may be the reason of death (whether a natural death or an unnatural death) the insurer is liable to pay the amount of insurance.

FIRE INSURANCE

A contract of Fire Insurance is a contract by which the insurance company or the underwriter or the insurer undertakes for a consideration in the form of a payment of money, either in a lump sum or in installments, to indemnify the insured against the consequences of a fire, or the loss or injury arising there from during an agreed a period and up to a certain amount.

The contract is to be found embodied in a document known as the 'Policy of Fire Insurance.' As in the case of life insurance an insurable interest is necessary here also. It has been held in various English cases that it is not necessary to have an actual formal policy in order to constitute a valid contract of fire insurance.

A slip by a broker with a view to the preparation of a policy may be taken as a contract of insurance, and it has also been held that a mere proposal to of insurance, and it has also been held that a mere proposal to insure followed by an acceptance of the proposal in itself constitutes a valid contract of fire insurance even though no payment by way of fire insurance premium has been made.

The general practice is that after the proposal by the owner of the property for insurance and after its acceptance a document called the 'Cover Note' is handed to the insured. This cover note is sufficient to enable the holder to claim damages in cases fire occurred during the interval.

In short, the cover note or an interim protection note constitutes a binding contract for the time mentioned therein. Fire insurance is also a contract uberrimae fidei i.e. of utmost good faith.

The Risk
The risk on a fire policy commences from the moment of time the cover note or the deposit receipt of the interim protector act of insurance. It is the practice to allow a certain number of days as days of grace within which a fire policy may e renewed after the expiration of the term.
In such a case, if a fire occurs within such a time the insured would be entitled to recover the damages. If, however, it is expressly stipulated in the policy that unless the renewal premium is paid and the renewal risk is accepted the insurance will expire the insured would not be able to recover damages in a case where fire occurred after the expiration of the term and before the acceptance by the fire insurance company of a proposal for further insurance.

Loss by Fire
The question as to what is the meaning of the expression Loss by Fire' has frequently arisen. Of course, the literal meaning viz. Damage, loss or deterioration through ignition is included, but much more than that is covered. In India the special Municipal Acts of the different states lay down that damage by fire within the meaning of policies in India would include any damage done in the exercise of powers, in case of an outbreak of fire, by a magistrate or members or secretaries of committees, or members, of fire brigades, by way or breakage, pulling down of premises, and through any measures that may have to be taken in case of fire to preserve lives or property.

It would also include the damage to a property caused through heating, which heat has been engendered by some property near it which has caught fire. Or course, pure and simple heating without any ignition of the property itself of anything near it, would not be covered by the expression 'Loss or Damage by Fire.'

In the case of lighting, if an actual fire has been caused by it, it would of course be covered by the ordinary risk of damage by fire; but not otherwise, unless specifically provided for in the policy. In short, losses directly caused through fire, i.e. those that are direct consequences of fire- are covered.

The others are not covered unless specifically provided for. If the loss is caused through the malicious act of the insured himself, he would not be able to recover damages. But it would be no excuse for the underwriter to say that the fire was caused through the negligence of the insured.

Fire policies usually cover loss through the fire whether caused through lighting, explosion of boils used for domestic purpose or explosion of gas used for domestic purposes or in a building not used as gas work. They do not include loss through fire caused by spontaneous fermentation, earthquakes, subterranean fire, riot, civil commotion, foreign enemy, military or usurped power, rebellion or insurrection.

Assignment
A fire policy can, according to the English Common Law, be assigned only with the consent of the insurer or the insurance company. It is said to be contract of a personal nature, and therefore a policy of insurance does not pass with the sale or assignment of the property on which it is affected. A transfer or assignment with the consent of the insurance office, as stated above, would only give an effective right to the assignee.

In connection with our Indian law, section 135 and 49 of the Transfer of Property Act, 1882, are important inasmuch as they show that these policies of fire insurance are assignable in India.

Claims and Average in Fire Insurance
On an outbreak of fire the insured must give notice to the insurance company. The claim should be for the exact value of the goods damaged or destroyed at the date of the fire. When goods are party destroyed or damaged, details as to the value of that in good condition and in damaged condition should be furnished to the insurance company.

When the damage is to buildings, a sum amounting to the cost of repairs of the damage, with due allowance for the greater value of the new premises over the old, should be the basis of the claim. This is, of course, applicable where the policy covers the full value of the property; but in fire insurance company cannot, in case the property is partially insured, claim to pay only a proportional loss, i.e. irrespective of the value of the whole property; e.g. if a property is worth Rs. 50,000 and is insured for Rs. 20,000 and the damage has been caused to the extent of Rs. 5,000 the insured can recover his full Rs. 5,000.
Policies, however, counteract this advantage from the point of view of the insured by inserting clauses known as "average clauses" under which it is expressly provided that in such cases the loss in proportion to the risk covered on the property can only be claimed. These average clauses have now developed into a number of variations suitable to various circumstances. Fire offices by inserting a clause called "reinstatement clause" reserve to themselves the right to reinstate the property instead of paying in money. This clause goes a long way in practice, to prevent rapacious and fraudulent claims being presented.

The Doctrine of Subrogation in Fire Insurance
Subrogation is a doctrine, applicable both to fire and marine insurance, by which the insurer or the underwriter becomes entitled to claim all advantages of every right of the insured on his paying compensation to the insured, against third parties who may be proved to be responsible for that loss, owing to such third parties 'negligence, default, etc. To take an instance, it often happens that a lessee takes the lease of premises for a long period, which lease covers the repairs to premises.

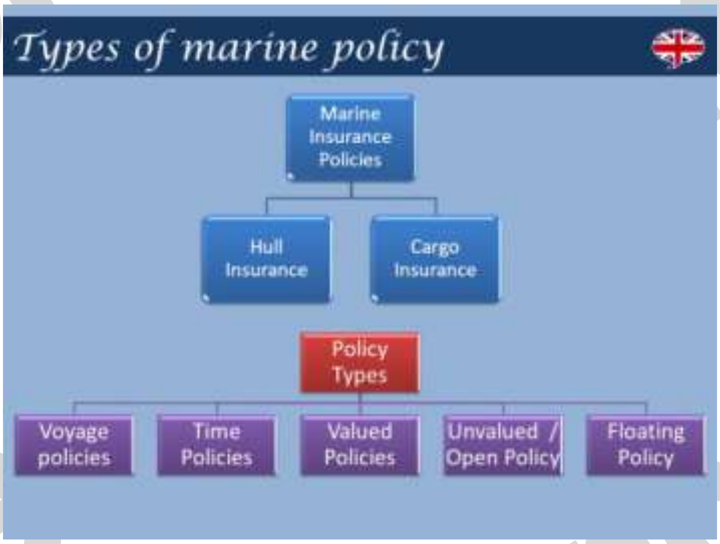
The lessee under this covenant would be bound to repair the premises even in the case of damage by fire, Now, if the premises have been insured by the landlord and a fire breaks out, the landlord can recover the loss immediately from the insurance, company and the insurance company in turn, can recover the amount from the lessee because, on their having paid the loss to the lesser, i.e. the landlord, the landlord's rights are subrogated to the insurer, in other words, the insurance company on satisfying the claim steps into the shoes of the insured.

MARINE INSURANCE

'Marine Insurance is a contract whereby the insurer or underwriter undertakes to indemnify the assured in the manner and to the extent thereby agreed, against marine losses, that is to say, losses incidental to marine adventure.'

The instrument in which the contract of marine insurance is recorded is called a policy. The insurer in marine insurance is known as the underwriter and the person who is thereby indemnified is called the insured.

Type of Marine Policies



A policy of insurance may e of the following types:-

i. Time Policy which covers the risk up to a stated amount for a fixed time;
ii. A Valued Policy, i.e. a policy which specifies the agreed valued of the subject matter insured;
iii. Mixed Policy which covers voyages between specified places within a specified time.
iv. Floating Policy which describes the insurance in general terms and leaves the name of the ship or ships or other particulars to be defined by subsequent disclosures;
v. Open Policy which does not specify the value of the subject matter insured, which has, therefore, to be ascertained subsequently at the time the claim arises; and
vi. Voyage Policy which covers a particular voyage.

Reinsurance

An underwriter or an insurance company may, when the risk is considered too great, get a part reinsured with another underwriter or insurance company. This reinsurance does not affect the position of the original insured, for the original insurance remains a distinct contract by itself and the reinsurance in its turn forms an equally distinct contract, between the second set of parties.

The original insured therefore has no claim on the reinsurance contract, but can only claim from his own underwriter wishes to reinsure half the risk, he may reinsure with C for say Rs. 5,000.

In case of loss A can only put in a claim against B, but the has no right against C. B has to pay his claim and in his turn claim half the loss from C. If, therefore, B were to fail and A's claim is not paid, A cannot claim the reinsured amount from the underwriter C with whom the reinsurance was effected. C is liable to pay in such an event only to B's trustee in bankruptcy.

MOTOR VEHICLES INSURANCE

Motor insurance got recently a great momentum. In the older times, persons, who were injured or killed through the negligence of the motorists, could not get financial redress either to them or to their legal' .airs because no scheme of insurance was present at that time.

To mitigate the financial hardship caused to the persons, the Motor Vehicles Act, 1939, as amended from time to time, has made it compulsory for the motorists to insure against the risk of liability to third parties.

The rate of premium is standardised because the business is tariff. No insurer can charge lower rates than the tariff rates and no insurer can grant benefits exceeding than those prescribed by the tariff.

Vehicles for the purpose of insurance are classified as below:
(i) Private Cars (not used for carrying passengers for hire or reward).
(ii) Commercial vehicles such as goods carrying vehicles, passenger vehicles, tractors and others.
(iii) Motor cycles, scooters and auto cycles.
The policies under motor insurance are as follows:
(i) Act Liability only.
(ii) Third Party only.
(iii) Comprehensive Policy.

1. Act Policies :
This policy is designed to meet the requirements of Motor Vehicles Act, 1939, which provides for compulsory insurance in regard to liabilities arising out of use of motor vehicles in a public place.

This kind of policy is limited to bodily injury or death of the third parties. Section 95(2) of the Motor Vehicles Act lays down that a policy of insurance shall cover any liability incurred in respect of anyone accident up to the following limits:

(i) Goods Vehicle:

Rs. 50,000 in all is including the liabilities if arising under the W.C. Act, 1923, in respect of death of or bodily injury to employees (other than the driver) not exceeding six in number being carried in the vehicle.

This means that liabilities if any towards driver and employees (above six) being carried in the vehicle under W.C. Act in addition to Rs. 50,000.

(ii) Passenger Vehicles:

Vehicles in which passengers are carried:
(a) For hire or reward.
(b) By reason of or in pursuance of contract of employment.
(1) In respect of persons other than passengers carried for hire or reward-Rs. 50,000 in all.
(2) In respect of passengers.

Rs. 50,000 in all where the vehicle is registered to carry not more than 30 passengers;
Rs. 75,000 in all where the vehicle is registered to carry not less than 30 but not more than 60 passengers;
Rs. 1,00,000 in all where the vehicles are registered to carry more than 60 passengers; and Subject to the limit aforesaid, Rs. 10,000 for each individual passenger where the vehicle is a motor car (used to carry not more than 6 passengers excluding the driver) and Rs. 5,000 for each individual passenger in any other case.

(iii) Other Vehicles:

The amount of liability incurred except as provided otherwise. The Act Policy besides the cover as required under the Motor Vehicles Act provides for indemnification of the claimants costs and expenses which the insured shall become legally liable to pay as also costs and expenses incurred with the written consent of the insurer.

The policy may extend to indemnify any driver who is driving the motor vehicles on the Insured's order or with his permission provided, he is not entitled to indemnify under any other policy.

2. Third Party Policy :

This policy covers the liabilities of the third parties who suffered less in connection with the damage of property and personal injury or death.

Thus, this policy indemnifies the insured against his legal liability in respect of damage to property of third parties over and above 2000. The limit of liability is as follows:
(a) Private Car-Unlimited.
(b) Commercial Vehicle.
(i) Goods or passenger-carrying vehicles-Rs. 20,000.
(ii) Other miscellaneous or special type of vehicles Rs. 50,000. Motor cycle Unlimited.
The policy may be extended to include:
(a) Fire,
(b) Theft risks,
(c) Legal liabilities to persons employed in connection with the operation and/or maintenance and/ or loading and/or unloading of motor vehicles.

The private car policy extends to indemnify the insured (individual only) against legal liabilities incurred by him subject to limitations of indemnity whilst personally driving a private motor car.
Private car policy covers legal liability of the insured to passengers (not for hire or reward) in the car although under the passengers (not for hire or reward) in the car although under the Motor Vehicles Act, it is not required to be covered.

Liabilities arising while the motor cat is being used in private places is covered. The policy covers bodily injury or death, property damage and medical expenses.

Due to the amendment to the Motor Vehicles Act, 1994, liability on third party claims has gone up as 'No fault' liability compensation has been enhanced and Structured Compensation has been introduced.

3. Comprehensive Policy :
The comprehensive policy covers the following risks
1. Damage to car parts or body.
2. Removal charges for repairs.
3. Third Party Liabilities.
4. Costs and Expenses incurred with risk.
5. Repair Charges.
6. Medical expenses.

At the payment of extra premiums, the following risks are also insured:
(i) Death or injury to family members who are above 16 years and below 65 years.
(ii) Riots, strikes, thefts, larceny, etc.
(iii) Loss of Rugs.
Jald Rahat Yojna (Pre-litigation Settlements) has been introduced to help claimants to get payment of compensations without approaching courts. Structured Compensation formula has been used for quick settlements of claims.

PUBLIC LIABILITY INSURANCE

Liability insurance is a part of the general insurance system of risk financing to protect the purchaser (the "insured") from the risks of liabilities imposed by lawsuits and similar claims. It protects the insured in the event he or she is sued for claims that come within the coverage of the insurance policy. Originally, individuals or companies that faced a common *peril*, formed a group and created a self-help fund out of which to pay compensation should any member incur loss (in other words, a mutual insurance arrangement). The modern system relies on dedicated carriers, usually for-profit, to offer protection against specified perils in consideration of a premium. Liability insurance is designed to offer specific protection against third party insurance claims, i.e., payment is not typically made to the insured, but rather to someone suffering loss who is not a party to the insurance contract. In general, damage caused intentionally as well as contractual liability are not covered under liability insurance policies. When a claim is made,[1] the insurance carrier has the duty (and right) to defend the insured. The legal costs of a defense normally do not affect policy limits unless the policy expressly states otherwise; this default rule is useful because defense costs tend to soar when cases go to trial.

Industry and commerce are based on a range of processes and activities that have the potential to affect third parties (members of the public, visitors, trespassers, sub-contractors, etc. who may be physically injured or whose property may be damaged or both). It varies from state to state as to whether either or both employer's liability insurance and public liability insurance have been made compulsory by law. Regardless of compulsion, however, most organizations include public liability insurance in their insurance portfolio even though the conditions, exclusions, and warranties included within the standard policies can be a burden. A company owning an industrial facility, for instance, may buy pollution insurance to cover lawsuits resulting from environmental accidents.

Many small businesses do not secure general or professional liability insurance due to the high cost of premiums. However, in the event of a claim, out-of-pocket costs for a legal defense or settlement can far exceed premium costs. In some cases, the costs of a claim could be enough to shut down a small business.

Businesses must consider all potential risk exposures when deciding whether liability insurance is needed, and, if so, how much coverage is appropriate and cost-effective. Those with the greatest public liability risk exposure are occupiers of premises where large numbers of third parties frequent at leisure including shopping centers, pubs, clubs, theaters, sporting venues, markets, hotels and resorts. The risk increases dramatically when consumption of alcohol and sporting events are included. Certain industries such as security and cleaning are considered high risk by underwriters. In some cases underwriters even refuse to insure the liability of these industries or choose to apply a large deductible in order to minimize the potential compensations. Private individuals also occupy land and engage in potentially dangerous activities. For example, a rotten branch may fall from an old tree and injure a pedestrian, and many people ride bicycles and skateboards in public places. The majority of states require motorists to carry insurance and criminalise those who drive without a valid policy. Many also require insurance companies to provide a default fund to offer compensation to those physically injured in accidents where the driver did not have a valid policy.

In many countries claims are dealt with under common law principles established through a long history of case law and, if litigated, are made by way of civil actions in the relevant jurisdiction.

THIRD PARTY INSURANCE

If the beneficiary of a policy is someone other than the two parties involved in the contract, it is called 'third-party' cover.

Definition: Motor third-party insurance or third-party liability cover, which is sometimes also referred to as the 'act only' cover, is a statutory requirement under the Motor Vehicles Act. It is referred to as a 'third-party' cover since the beneficiary of the policy is someone other than the two parties involved in the contract (the car owner and the insurance company). The policy does not provide any benefit to the insured. However, it covers the insured's legal liability for death/disability of third-party loss or damage to the third-party property.

Description: Since the third-party insurance cover is mandatory, all non-life insurance companies have an obligation to provide this cover. In the Indian context, automobile dealers arrange for a comprehensive insurance cover along with vehicle registration. This comprehensive cover is an add-on to the mandatory third party cover and protects the car owner from financial losses, caused by damage or theft of the vehicle.

The cost of a comprehensive cover is several times that of a stand-alone third-party cover, since damage claims are more frequent than third-party claims. Until now, the premium for motor third-party insurance was calculated on the basis of a schedule of rates provided by the Tariff Advisory Committee, an arm of IRDA, the insurance regulator. But IRDA has done away with the motor tariff. The compensation to the victim is largely decided by the earning capacity of the accident victim.

GROUP INSURANCE

Group insurance' is an insurance that covers a group of people, usually who are the members of societies, employees of a common employer, or professionals in a common group. Group coverage can help reduce the problem of adverse selection by creating a pool of people eligible to purchase insurance who belong to the group for reasons *other than* for the purposes of obtaining insurance. In other words, people belong to the group not because they possess some high-risk factor which makes them more apt to purchase insurance (thus increasing adverse selection); instead they are in the group for reasons unrelated to insurance, such as all working for a particular employer.

Investopedia defines Group Life Insurance as "Life insurance offered by an employer or large-scale entity (i.e. association or labor organization) to its workers or members. Group life insurance is typically offered as a piece of a larger employer or membership benefit package.By purchasing coverage through a provider on a "wholesale" basis for its members, the coverage costs each individual worker/member much less than if they had to purchase an individual policy. . People who elect coverage through the group policy receive a "certificate of credible coverage," which will be necessary to provide to a subsequent insurance company in the event that the individual leaves the company or organization and terminates their coverage." (Source : Investopedia)

From the above paragraphs we can infer the following are the characteristics of Group Life Insurance

a) there must be a group of people to be insured which should have something in common other than the purpose of obtaining insurance

b) there must be a Master Policy Holder who will retain the contract on the behalf of the member and the carriers

c) Such covers are typically available at a discount to the respective individual rates.

Insurable Groups can broadly be classified as mainly two types - " employer - employee " groups where all members work for the employer proposing to cover them or "affinity" groups, whose members have a commonality other than employment - say deposit holders of a bank.

The Master Policy Holder of a Group Life Insurance Plan in the case of an "Employer Employee Group" is basically the Employer and for other groups would be the entity that has an insurable interest in the lives of its members. So in the case of a bank it could be said to have an insurable interest in the lives of its members who hold a deposit or have taken a loan. The Master Policy Holder also ensures each member gets their certificate of coverage stating the details of the premium paid, cover available, term of the cover and the claims process

A feature which is sometimes common in group insurance is that the premium cost on an individual basis is not individually risk-based. Instead it is the same amount for all the insured persons in the group. So, for example, in the United States, often all employees of an employer receiving health or life insurance coverage pay the same premium amount for the same coverage regardless of their age or other factors. In contrast, under private individual health or life insurance coverage in the U.S., different insured persons will pay different premium amounts for the same coverage based on their age, location, pre-existing conditions, etc.Group policies are also attractive to consumers because the average price per policy is often lower. Carriers are interested in gaining customers and will cut prices a bit to accommodate members of group. Data shows that, for example, drivers save 29% on average by attaching themselves to a group policy.

All members for whom the premium is paid for the period and the risks in respect of such members accepted by the underwriters of the insurance company are generally eligible to purchase or renew coverage all whilst he or she is a member of the group subject to certain conditions. Again, using U.S. health coverage as an example, under group insurance a person will normally remain covered as long as he or she continues to work for a certain employer and pays the required insurance premiums, whereas under individual coverage, the insurance company often has the right to non-renew a person's individual health insurance policy when the policy is up for renewal, which it may do if the person's risk profile changes (though some states limit the insurance company's ability to non-renew after the person has been under individual coverage with a given company for a certain number of years).

In Canada group insurance is usually purchased through larger brokerage firms because brokers receive better rates than individual companies or unions. There may be slight differences in terms of administration and market related practices world wide, even though the concept may be the same. For example, In India, broker procured group term insurance, unlike Canada, does not intrinsically have any price advantage to the buyer i.e. the Master Policy Holder.

Group Life Insurance covers may be either compulsory - in which case every member has no say in opting for the cover or voluntary where all eligible members may decide within an enrolment window to opt for the available Group Insurance. This is irrespective of who pays the premium.

Since compulsory covers offer no scope for adverse selection they come with far relaxed underwriting requirements than voluntary covers, Underwriting requirements even for Voluntary Group Life Covers are far lower than the respective requirements for individual lives.

Group Health Insurance is also provided in India. It provides healthcare coverage to a group of people belonging to a common community (typically as employees of a company). These plans are generally uniform in nature, offering the same benefits to all employees or members of the group.

Most professionally run companies today provide Group Health Insurance as a part of their Employee Welfare program. Each company however gets the plan customized based on the employee demographics.

<u>BURGLARY INSURANCE</u>

Burglary Insurance is one of the major classes of business underwritten in the miscellaneous department and accounts for a sizeable portion of the department's premium income.

For the business house Burglary insurance is as essential as Fire insurance, as it enables them to recoup the losses suffered by them consequent on burglary or house breaking. In addition to the burglary policy, other types of policies giving wider covers have also been devised by the burglary department. The main types of policies are as follows:

(i) Business Premises Policy,
(ii) Private Dwelling Policy,
(iii) Jewellary and Valuable Policy,
(iv) All Risk Policy, and
(v) Money in Transit Policy

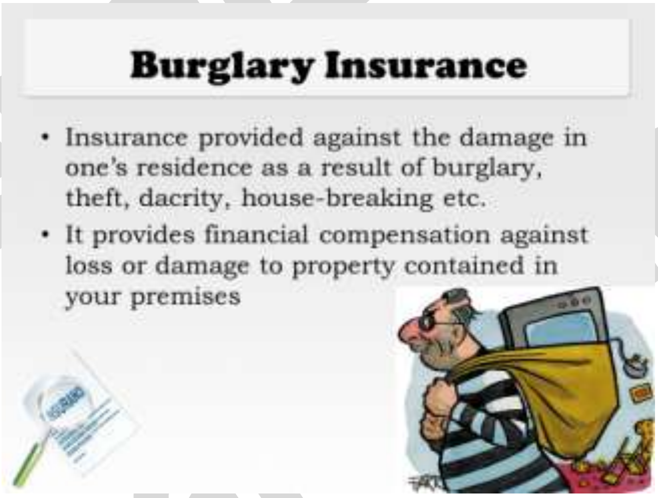
Definitions:

Burglary:

The criminal law of the country does not speak of an offence called burglary. Hence it becomes necessary for the insurers to lay down in the policy the definition of the term. As normally understood burglary is:

(a) Theft of property from the premises following upon felonious entry of the said premises by violent and forcible means.

(b) Theft by a person in the premises who subsequently breaks out by violent and forcible means provided there shall be visible marks made upon the premises at the place of such entry or exit by tools, explosives, electricity or chemicals. Use of force may be against property and person.



Theft:

Indian Penal Code in Section 378 defines theft as follows: "whoever intending to take is honestly any movable property out of the possession of any person without the consent of that person or of any person having for that purpose authority, moves that property in order to such taking is said to commit theft."

House-breaking:

The word in practice is equal to 'Burglary'. Section 445 of the Indian Penal Code has laid down a definition of the term.

A person is said to commit housebreaking who commits house trespass if he effects his entrance into the house (or any part of it), or if being in the house (or any part of it) for the purpose of committing an offence, or having committed an offence therein he quits the house, such entrance or exit being made by use of force in one of the six ways as described in the Indian Penal Code.

Robbery:
Section 390 of the Indian Penal Code laid down, "If in order to the commission of or in committing of the theft or in carrying away property obtained by theft, the offender, for that end, voluntarily causes (or attempts to cause) to any person death or hurt or wrongful restraint or fear of instant death or hurt or wrongful restraint or fear of instant death or hurt or wrongful restraint".

Dacoits:
Section 391 of the Indian Penal Code states dacoits as "where five or more persons conjointly commit or attempt to commit a robbery or are present and aid such commission or attempt, every one of them is said to commit dacoits"

Coverage:
Business premises are generally covered against burglary and house breaking only. Mere theft without the use of force and violence is not covered, robbery and dacoits being aggravated forms of theft.
It also covers risk of holdup. Burglary and house breaking fall within the scope of this cover. Under policies issued for private dwellings, the contents are covered against burglary, house-breaking and theft risks. Similarly Jewellery and valuables are also insured in the same manner.

Money in Transit:
Policies, as a matter of rule, cover robbery, hold-up and dacoits in addition to burglary, housebreaking and theft.

Business Premises Insurance Policies:
Policies issued to business premises cover stock-in-trade, goods in trust or on commission, fixtures and fittings, tools of trade such as typewriters, calculators and other similar property and cash and currency notes in locked safe against the risk of burglary and house-breaking.

Loss or damage to contents or to any part of the building caused by burglary or any attempt therefore is also covered. In regard to stock-in-trade and other goods the policy may be issued on full value basis or on "first loss" basis.

A "First Loss" 'Policy insures the property up to a specified amount only which is calculated to be the maximum likely loss on any one occasion. This type of policy is taken where a total loss is a physical impossibility.
First loss policies are usually taken for bulk commodities. The amount insured is always specified as a certain percentage of the full value, say, 10% or 12.5% of the full value.

The amount of premium-loss reinsurance was Rs. 16.60 crores by New India in 1994-95. It has got profit of Rs. 12.12 crores in that year.

Cash-in-Safe Insurance:
The cover includes only when the cash is secured in a safe and is granted only if the safe is burglar proof and is of an approved make and design. Safe which is permanently installed in the premises is a better risk than a safe which can be shifted. The cover is granted subject to the following two clauses.

(a) The loss of cash obstructed from the safe following the use of the key to the said safe or any duplicate these of belonging to the insured is not covered unless such key has been obtained by violence or through means of force.
The use of force need not necessarily be against the person or an individual. It can be against property as well. Thus cupboard is removed after forcing open the cupboard, the loss is covered by the policy.

(b) A complete list of the amount of cash in safe should be kept secure in some places other than the safe and the liability of the insurer is limited to the amount actually shown by such records.

All Risks (Jewellery and Valuables) Insurance:
Policies under this form of insurance cover risks in respect of jewellery, plate, watches, personal ornaments and other valuables. Loss or damage by any accident or misfortune including fire, theft, robbery from the person, defective settings or fastening and accidental damage are thus covered. The policies do not, however, cover loss or damage:

i. Occasioned by or in consequence of war, invasion, act of foreign enemy, hostilities, civil war, noting, rebellion, revolution, insurrection, military or usurped power, riot, civil commotion, earth-quake or other convulsions of nature;
ii. caused by or arising from any process of repairing, restoring or renovating any property insured;
iii. Due to moth, wilder, wear or other deterioration or inherent defect in any property insured. The insurance is applicable in all places within the geographical limits provided for in the policy.

Exclusions :
The exceptions peculiar to a burglary (business premises) policy are:
(i) Loss or damage where any member of the insured's household or his business staff is concerned as principal or accessory or resulting from any act committed by any other person lawfully on the premises wherein the property may happen to be;

(ii) Loss or damage which can be insured against by a fire or a plate glass or a motor insurance policy;

(iii) loss of or damage to deeds, bonds, bills of exchange, promissory notes, cash, treasury, bank notes, cheques, securities for money, stamps, stamp collections, books of accounts, manuscripts, documents of any kind and medals and coins, unless specially mentioned and agreed to be covered.

Extension under the Policy:
An extension of the policy frequently sought is in respect of riot and strike damage which is a common exclusion in all policies. Riot as included in the policy is deemed to mean riot as defined in the Indian Penal Code.

Extension (Infidelity of Employees):
The normal policy does not cover loss to the insured arising through the acts of dishonesty by the employees entrusted with the carrying of the money.

The policy is extended at additional premium to cover any loss to the insured of the property insured by any act of fraud or dishonesty committed by the employees or employees carrying the property. This is known as 'Infidelity Extension'.

<u>GENERAL INSURANCE CLAIM PROCESS</u>

All insurance contracts are based on the information provided by the insured in the proposal form. The proposal form forms the basis of insurance contracts.

Some important points, which would help you in the claims procedure, are:-

- The loss or damage should be reported to the insurer immediately.
- On receipt of claim intimation, the insurer will forward a claim form.
- Submit the completed claim form along with an estimate of the loss to the insurer. It is preferable to submit an itemized estimate with separate values.
- The insurer will arrange for inspection of the damaged items to assess the loss. In case of major losses, a specialist-licensed surveyor is deputed.
- The insured has to provide the required documents to substantiate the extent of loss.
- In case the cause of loss is not established, it is for the insured to prove that the loss or damage has occurred due to an insured peril.
- On agreement of claim amount between the insured and the insurer, the claim is settled.
- Average Clause - As per the terms and conditions of the insurance policy.
- Excess as stated as per the Policy terms and condition will be deducted from the claim payable.

In view of varied nature of policies, certain points distinct to individual policies, in addition to the above, are listed below (documents mentioned are indications and based on the circumstances of the claim, insurer may request additional documents).

Unit 5
Banking risks & recent developments

Types of Risk

Credit risk

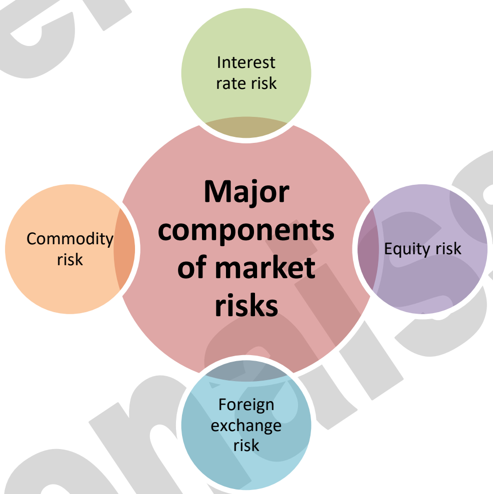
The Basel Committee on Banking Supervision (or BCBS) defines credit risk as the potential that a bank borrower, or counter party, will fail to meet its payment obligations regarding the terms agreed with the bank. It includes both uncertainty involved in repayment of the bank's dues and repayment of dues on time.

Market risk

The Basel Committee on Banking Supervision defines market risk as the risk of losses in on- or off-balance sheet positions that arise from movement in market prices. Market risk is the most prominent for banks present in investment banking. These investment banks include Goldman Sachs (GS), Morgan Stanley (MS), JPMorgan (JPM), Bank of America (BAC), and other investment banks in an ETF like the Financial Select Sector SPDR Fund (XLF). This is because they are generally active in capital markets.

Major components of market risks

The major components of market risk include:



Interest rate risk

It's the potential loss due to movements in interest rates. This risk arises because a bank's assets usually have a significantly longer maturity than its liabilities. In banking language, management of interest rate risk is also called asset-liability management (or ALM).

Equity risk

It's the potential loss due to an adverse change in the stock price. Banks can accept equity as collateral for loans and purchase ownership stakes in other companies as investments from their free or investible cash. Any negative change in stock price either leads to a loss or diminution in investments' value.

Foreign exchange risk

It's the potential loss due to change in value of the bank's assets or liabilities resulting from exchange rate fluctuations. Banks transact in foreign exchange for their customers or for the banks' own accounts. Any adverse movement can diminish the value of the foreign currency and cause a loss to the bank.

Commodity risk

It's the potential loss due to an adverse change in commodity prices. These commodities include agricultural commodities (like wheat, livestock, and corn), industrial commodities (like iron, copper, and zinc), and energy commodities (like crude oil, shale gas, and natural gas). The commodities' values fluctuate a great deal due to changes in demand and supply. Any bank holding them as part of an investment is exposed to commodity risk.

Market risk is measured by various techniques such as value at risk and sensitivity analysis. Value at risk is the maximum loss not exceeded with a given probability over a given period of time. Sensitivity analysis is how different values of an independent variable will impact a particular dependent variable.

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Liquidity risk

Liquidity by definition means a bank has the ability to meet payment obligations primarily from its depositors and has enough money to give loans. So liquidity risk is the risk of a bank not being able to have enough cash to carry out its day-to-day operations.

Provision for adequate liquidity in a bank is crucial because a liquidity shortfall in meeting commitments to other banks and financial institutions can have serious repercussions on the bank's reputation and the bank's bond prices in the money market.

Reputational risk

Reputational risk is the risk of damage to a bank's image and public standing that occurs due to some dubious actions taken by the bank. Sometimes reputational risk can be due to perception or negative publicity against the bank and without any solid evidence of wrongdoing. Reputational risk leads to the public's loss of confidence in a bank.

Universal Banking – Meaning, advantages & disadvantages

Meaning : Universal banking is a combination of Commercial banking, Investment banking, Development banking, Insurance and many other financial activities. It is a place where all financial products are available under one roof. So, a universal bank is a bank which offers commercial bank functions plus other functions such as Merchant Banking, Mutual Funds, Factoring, Credit cards, Housing Finance, Auto loans, Retail loans, Insurance, etc.

Universal banking is done by very large banks. These banks provide a lot of finance to many companies. So, they take part in the Corporate Governance (management) of these companies. These banks have a large network of branches all over the country and all over the world. They provide many different financial services to their clients.

ln India, two reports in 1998 mentioned the concept of universal banking. They are, the Narasimham Committee Report and the S.H. Khan Committee Report. Both these reports advised to consolidate (bring together) the banking industry through mergers and integration of financial activities. That is, they advised a combination of all banking and financial activities. That is, they suggested a Universal banking.

In 2000, ICICI asked permission from RBI to become a universal bank. RBI wants some big domestic financial institutions to become universal banks.

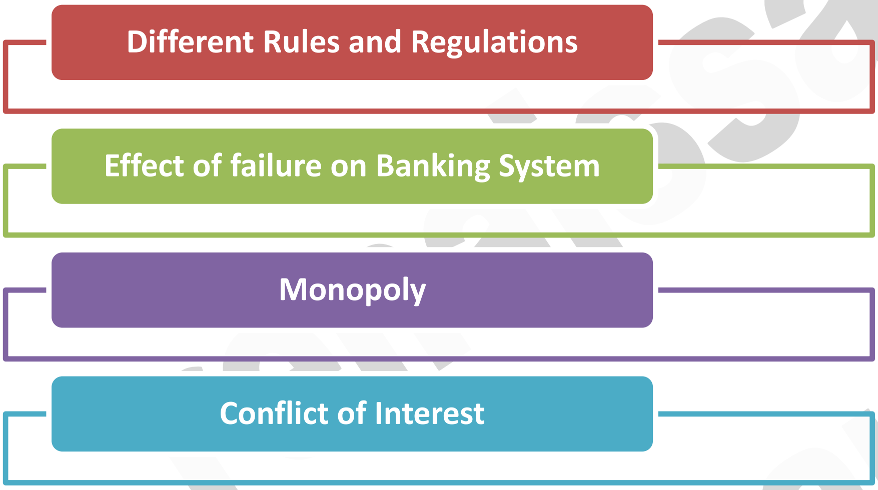
Advantages of Universal Banking

The **benefits** or advantages of universal banking are:-

1. **Investors' Trust** : Universal banks hold stakes (equity shares) of many companies. These companies can easily get other investors to invest in their business. This is because other investors have full confidence and faith in the Universal banks. They know that the Universal banks will closely watch all the activities of the companies in which they hold a stake.
2. **Economics of Scale** : Universal banking results in economic efficiency. That is, it results in lower costs, higher output and better products and services. In India, RBI is in favour of universal banking because it results in economies of scale.

3. **Resource Utilisation** : Universal banks use their client's resources as per the client's ability to take a risk. If the client has a high risk taking capacity then the universal bank will advise him to make risky investments and not safe investments. Similarly, clients with a low risk taking capacity are advised to make safe investments. Today, universal banks invest their client's money in different types of Mutual funds and also directly into the share market. They also do equity research. So, they can also manage their client's portfolios (different investments) profitably.
4. **Profitable Diversification** : Universal banks diversify their activities. So, they can use the same financial experts to provide different financial services. This saves cost for the universal bank. Even the day-to-day expenses will be saved because all financial services are provided under one roof, i.e. in the same office.
5. **Easy Marketing** : The universal banks can easily market (sell) all their financial products and services through their many branches. They can ask their existing clients to buy their other products and services. This requires less marketing efforts because of their well-established brand name. For e.g. ICICI may ask their existing bank account holders in all their branches, to take house loans, insurance, to buy their Mutual funds, etc. This is done very easily because they use one brand name (ICICI) for all their financial products and services.
6. **One-stop Shopping** : Universal banking offers all financial products and services under one roof. One-stop shopping saves a lot of time and transaction costs. It also increases the speed or flow of work. So, one-stop shopping gives benefits to both banks and their clients.

Disadvantages of Universal Banking



The **limitations** or disadvantages of universal banking are:-

1. **Different Rules and Regulations** : Universal banking offers all financial products and services under one roof. However, all these products and services have to follow different rules and regulations. This creates many problems. For e.g. Mutual Funds, Insurance, Home Loans, etc. have to follow different sets of rules and regulations, but they are provided by the same bank.
2. **Effect of failure on Banking System** : Universal banking is done by very large banks. If these huge banks fail, then it will have a very big and bad effect on the banking system and the confidence of the public. For e.g. Recently, Lehman Brothers a very large universal bank failed. It had very bad effects in the USA, Europe and even in India.
3. **Monopoly** : Universal banks are very large. So, they can easily get monopoly power in the market. This will have many harmful effects on the other banks and the public. This is also harmful to economic development of the country.

4. **Conflict of Interest** : Combining commercial and investment banking can result in conflict of interest. That is, Commercial banking versus Investment banking. Some banks may give more importance to one type of banking and give less importance to the other type of banking. However, this does not make commercial sense.

E-banking

What is E-Banking ? Online Banking

E-banking refers to electronic banking. It is like e-business in banking industry. E-banking is also called as "Virtual Banking" or "**Online Banking**".

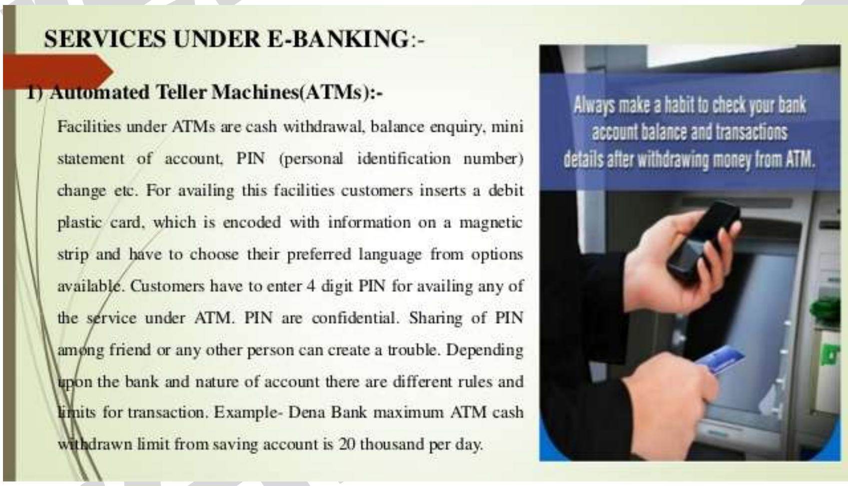
E-banking is a result of the growing expectations of bank's customers.

E-banking involves information technology based banking. Under this I.T system, the banking services are delivered by way of a Computer-Controlled System. This system does involve direct interface with the customers. The customers do not have to visit the bank's premises.

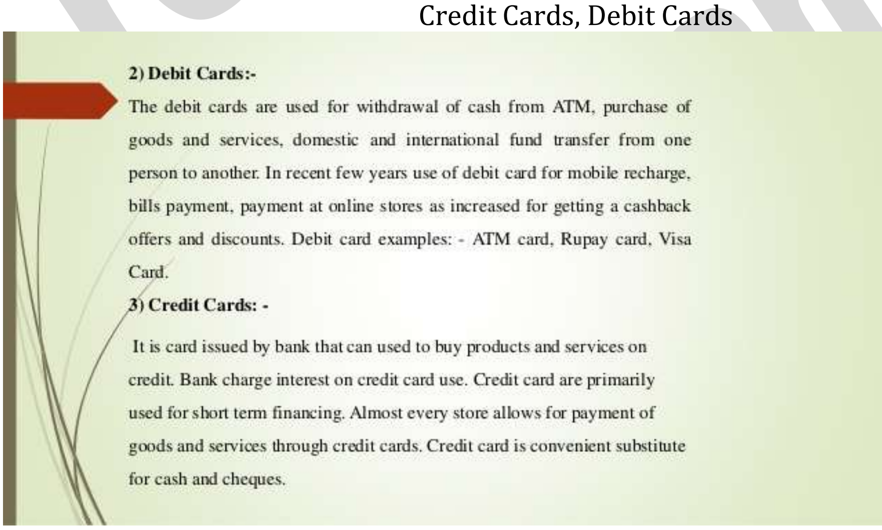
Popular services covered under E-Banking

The popular services covered under E-banking include :-

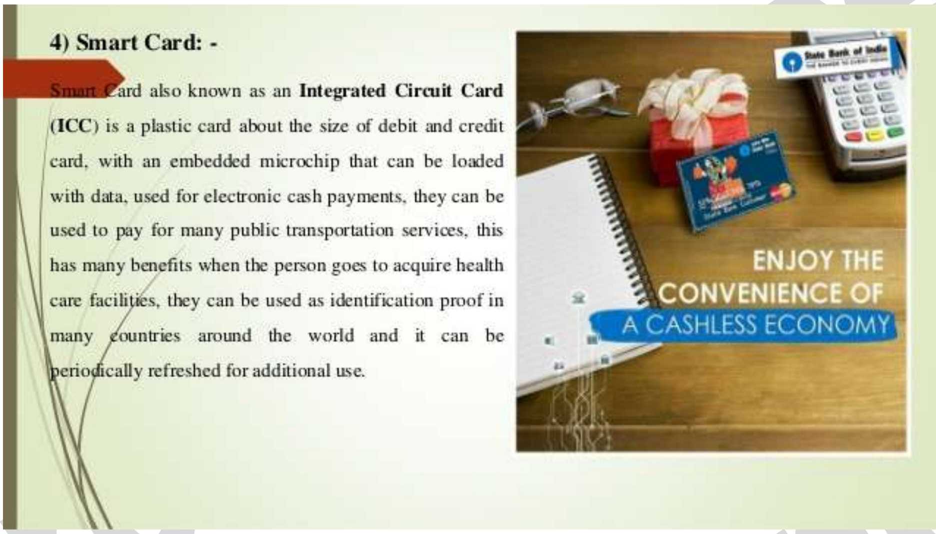
Automated Teller Machines



Credit Cards, Debit Cards



Smart Cards,



1. Electronic Funds Transfer (EFT) System,
2. Cheques Truncation Payment System,
3. Mobile Banking,

4. Internet Banking,

5. Telephone Banking, etc.

Advantages of E-Banking

The main advantages of E-banking are :-

1. The operating cost per unit services is lower for the banks.
2. It offers convenience to customers as they are not required to go to the bank's premises.
3. There is very low incidence of errors.
4. The customer can obtain funds at any time from ATM machines.
5. The credit cards and debit cards enables the Customers to obtain discounts from retail outlets.
6. The customer can easily transfer the funds from one place to another place electronically.

Mobile banking

Mobile banking is a service provided by a bank or other financial institution that allows its customers to conduct some financial transactions remotely using a mobile device such as a mobile phone or tablet. Mobile banking differs from mobile payments, which involves the use of a mobile device to pay for goods or services either at the point of sale or remotely,[1] analogously to the use of a debit or credit card to effect an EFTPOS payment.

History

The earliest mobile banking services used SMS, a service known as SMS banking. With the introduction of smart phones with WAP support enabling the use of the mobile web in 1999, the first European banks started to offer mobile banking on this platform to their customers.[2]

Mobile banking has until recently (2010) most often been performed via SMS or the mobile web. Apple's initial success with iPhone and the rapid growth of phones based on Google's Android (operating system) have led to increasing use of special client programs, called apps, downloaded to the mobile device. With that said, advancements in web technologies such as HTML5, CSS3 and JavaScript have seen more banks launching mobile web based services to complement native applications. A recent study (May 2012) by Mapa Research suggests that over a third of banks[3] have mobile device detection upon visiting the banks' main website. A number of things can happen on mobile detection such as redirecting to an app store, redirection to a mobile banking specific website or providing a menu of mobile banking options for the user to choose from.

A mobile banking conceptual

In one academic model,[4] mobile banking is defined as:

Mobile Banking refers to provision and availment of banking- and financial services with the help of mobile telecommunication devices.The scope of offered services may include facilities to conduct bank and stock market transactions, to administer accounts and to access customised information."

According to this model mobile banking can be said to consist of three inter-related concepts:

- Mobile accounting
- Mobile brokerage
- Mobile financial information services

Most services in the categories designated *accounting* and *brokerage* are transaction-based. The non-transaction-based services of an informational nature are however essential for conducting transactions - for instance, balance inquiries might be needed before committing a money remittance. The accounting and brokerage services are therefore offered invariably in combination with information services. Information services, on the other hand, may be offered as an independent module.

Mobile banking may also be used to help in business situations as well as financial

Mobile banking services

Typical mobile banking services may include:

Account information

1. Mini-statements and checking of account history
2. Alerts on account activity or passing of set thresholds
3. Monitoring of term deposits
4. Access to loan statements
5. Access to card statements
6. Mutual funds / equity statements
7. Insurance policy management

Transaction

1. Funds transfers between the customer's linked accounts
2. Paying third parties, including bill payments and third party fund transfers(see, e.g., FAST)
3. Check Remote Deposit

Investments

1. Portfolio management services
2. Real-time stock quotes
3. Personalized alerts and notifications on security prices

Support

1. Status of requests for credit, including mortgage approval, and insurance coverage
2. Check (cheque) book and card requests
3. Exchange of data messages and email, including complaint submission and tracking
4. ATM Location

<u>ALM process</u>

What is Asset Liability Management or What is ALM ?

Asset liability management (ALM) can be defined as the comprehensive and dynamic framework for measuring, monitoring and managing the financial risks associated with changing interest rates, foreign exchange rates and other factors that can affect the organisation's liquidity.

ALM relates to management of structure of balance sheet (liabilitiesand assets) in such a way that the net earning from interest is maximised within the overall risk-preference (present and future) of the institutions.

Thus the ALM functions includes the tools adopted to mitigating liquidly risk, management of interest rate risk / market risk and trading risk management. In short, ALM is the sum of the financial risk management of any financial institution.

In other words, ALM is all about managing three central risks:

1) Interest Rate Risk
2) Liquidity Risk
3) Foreign currency risk

For banks with forex operations, it also includes managing

4) Currency risk

Through ALM banks try to match the assets and liabilities in terms of Maturities and Interest Rates Sensitivities so as to minimize the interest rate risk and liquidity risk.

Evolution of ALM in Indian Banking System:

1) In view of the regulated environment in India in 1970s to early 1990s, there was no interest rate risk as the interest rate were regulated and prescribed by RBI. Spreads between deposits and lending rates were very wide. At that time banks Balance Sheets were not being managed by banks themselves as they were being managed through prescriptions of the regulatory authority and the government. With the deregulation of interest rates, banks were given a large amount of freedom to manage their Balance sheets. Thus, it became necessary to introduce ALM guidelines so that banks can be prevented from big losses on account of wide ALM mismatches.

2) Reserve Bank of India issued its first ALM Guidelines in February 1999, which was made effective from 1 st April 1999. These guidelines covered, inter alia, interest rate risk and liquidity risk measurement/ reporting framework and prudential limits. Gap statements were required to be prepared by scheduling all assets and liabilities according to the stated or anticipated re-pricing date or maturity date. The Assets and Liabilities at this stage were required to be divided into 8 maturity buckets (1-14 days; 15-28 days; 29-90 days; 91-180 days; 181-365 days, 1-3 years and 3-5 years and above 5 years), based on the remaining period to their maturity (also called residual maturity).. All the liability figures were to be considered as outflows while the asset figures were considered as inflows.

3) As a measure of liquidity management, banks were required to monitor their cumulative mismatches across all time buckets in their statement of structural liquidity by establishing internal prudential limits with the approval of their boards/ management committees. As per the guidelines, in the normal course, the mismatches (negative gap) in the time buckets of 1-14 days and 15-28 days were not to exceed 20 per cent of the cash outflows in the respective time buckets

Later on RBI made it mandatory for banks to form ALCO (Asset Liability Committee) as a Committee of the Board of Directors to track, monitor and report ALM.

4) It was in September, 2007, in response to the international practices and to meet the need for a sharper assessment of the efficacy of liquidity management and with a view to providing a stimulus for development of the term-money market, RBI fine tuned these guidelines and it was provided that the banks may adopt a more granular approach to measurement of liquidity risk by splitting the first time bucket (1-14 days at present) in the Statement of Structural Liquidity into three time buckets viz., 1 day (called next day) , 2-7 days and 8-14 days. Thus, banks were asked to put their maturing asset and liabilities in 10 time buckets.

5) Thus as per October 2007 RBI guidelines, banks were advised that the net cumulative negative mismatches during the next day, 2-7 days, 8-14 days and 15-28 days should not exceed 5%, 10%, 15% and 20% of the cumulative outflows, respectively, in order to recognize the cumulative impact on liquidity. Banks were also advised to undertake dynamic liquidity management and prepare the statement of structural liquidity on a daily basis. In the absence of a fully networked environment, banks were allowed to compile the statement on best available data coverage initially but were advised to make conscious efforts to attain 100 per cent data coverage in a timely manner. Similarly, the statement of structural liquidity was to be reported to the Reserve Bank, once a month, as on the third Wednesday of every month. The frequency of supervisory reporting of the structural liquidity position was increased to fortnightly, with effect from April 1, 2008. Banks are now required to submit the statement of structural liquidity as on the first and third Wednesday of every month to the Reserve Bank.

6) Board's of the Banks were entrusted with the overall responsibility for the management of risks and required to decide the risk management policy and set limits for liquidity, interest rate, foreign exchange and equity price risks.

7) Asset-Liability Committee (ALCO), the top most committee to oversee the implementation of ALM system is to be headed by CMD /ED. ALCO considers product pricing for both deposits and advances, the desired maturity profile of the incremental assets and liabilities in addition to monitoring the risk levels of the bank. It will have to articulate current interest rates view of the bank and base its decisions for future business strategy on this view.

Progress in Adoption of Techniques of ALM by Indian Banks :
ALM process involve in identification , measurement and management of risk Parameter. In its original guidelines RBI asked the banks to use traditional techniques like Gap analysis for monitoring interest rates and liquidity risk. At that RBI desired that Indian Banks slowly move towards sophisticated techniques like duration , simulation and Value at risk in future. Now with the passage of time, more and more banks are moving towards these advanced techniques.

Unit 6

Basel 1&2

Meaning of basel: Basel is a city in Switzerland which is also the headquarters of Bureau of International Settlement (BIS). BIS fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations. Currently there are 27 member nations in the committee. Basel guidelines refer to broad supervisory standards formulated by this group of central banks- called the Basel Committee on Banking Supervision (BCBS). The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord. The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses. India has accepted Basel accords for the banking system.

Basel I

In 1988, BCBS introduced capital measurement system called Basel capital accord, also called as Basel 1. It focused almost entirely on credit risk. It defined capital and structure of risk weights for banks. The minimum capital requirement was fixed at 8% of risk weighted assets (RWA). RWA means assets with different risk profiles. For example, an asset backed by collateral would carry lesser risks as compared to personal loans, which have no collateral. India adopted Basel 1 guidelines in 1999.

Requirements for Basel I and Classifications
The Basel I classification system groups a bank's assets into five risk categories, classified as percentages: 0%, 10%, 20%, 50%, and 100%. A bank's assets are placed into a category based on the nature of the debtor.

The 0% risk category is comprised of cash, central bank and government debt, and any Organization for Economic Cooperation and Development (OECD) government debt. Public sector debt can be placed in the 0%, 10%, 20% or 50% category, depending on the debtor.

Development bank debt, OECD bank debt, OECD securities firm debt, non-OECD bank debt (under one year of maturity), non-OECD public sector debt and cash in collection comprises the 20% category. The 50% category is residential mortgages, and the 100% category is represented by private sector debt, non-OECD bank debt (maturity over a year), real estate, plant and equipment, and capital instruments issued at other banks.

The bank must maintain capital (Tier 1 and Tier 2) equal to at least 8% of its risk-weighted assets. For example, if a bank has risk-weighted assets of $100 million, it is required to maintain capital of at least $8 million.

Benefits of Basel I

Although some will argue that the Basel accords hamper bank activity, Basel I was developed to mitigate risk to both the consumer and the institution. Basel II, brought forth some years later, lessened the requirements for banks. This came under criticism from the public but, since Basel II did not supersede Basel II, many banks proceeded to operate under the original Basel I framework, supplemented by Basel III addendums.

Basel I lowered most banks' risk profiles, which in turn drove investment back into banks that were rightfully distrusted following the sub-prime mortgage collapse of 2008. The public needed, —perhaps even more than the protections Basel offered — to trust banks with their assets again. Basel I was the driving force behind that much-needed capital influx to the banks.

Perhaps the greatest contribution of Basel I was that it contributed to the ongoing adjustment of banking regulations and best practices, paving the way for additional measures that protect banks, consumers, and their respective economies.

Basel II

In 2004, Basel II guidelines were published by BCBS, which were considered to be the refined and reformed versions of Basel I accord. The guidelines were based on three parameters. Banks should maintain a minimum capital adequacy requirement of 8% of risk assets, banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks that is credit and increased disclosure requirements. Banks need to mandatorily disclose their risk exposure, etc to the central bank. Basel II norms in India and overseas are yet to be fully implemented.

Understanding Basel II

Basel II is a second international banking regulatory accord that is based on three main pillars: minimal capital requirements, regulatory supervision and market discipline. Minimal capital requirements play the most important role in Basel II and obligate banks to maintain minimum capital ratios of regulatory capital over risk-weighted assets. Because banking regulations significantly varied among countries before the introduction of Basel accords, a unified framework of Basel I and, subsequently, Basel II helped countries alleviate anxiety over regulatory competitiveness and drastically different national capital requirements for banks.

Minimum Capital Requirements

Basel II provides guidelines for calculation of minimum regulatory capital ratiosand confirms the definition of regulatory capital and 8% minimum coefficient for regulatory capital over risk-weighted assets. Basel II divides the eligible regulatory capital of a bank into three tiers. The higher the tier, the less subordinated securities a bank is allowed to include in it. Each tier must be of a certain minimum percentage of the total regulatory capital and is used as a numerator in the calculation of regulatory capital ratios.

Tier 1 capital is the most strict definition of regulatory capital that is subordinate to all other capital instruments, and includes shareholders' equity, disclosed reserves, retained earnings and certain innovative capital instruments. Tier 2 is Tier 1 instruments plus various other bank reserves, hybrid instruments, and medium- and long-term subordinated loans. Tier 3 consists of Tier 2 plus short-term subordinated loans.

Another important part in Basel II is refining the definition of risk-weighted assets, which are used as a denominator in regulatory capital ratios, and are calculated by using the sum of assets that are multiplied by respective risk weights for each asset type. The riskier the asset, the higher its weight. The notion of risk-weighted assets is intended to punish banks for holding risky assets, which significantly increases risk-weighted assets and lowers regulatory capital ratios. The main innovation of Basel II in comparison to Basel I is that it takes into account the credit rating of assets in determining risk weights. The higher the credit rating, the lower risk weight.

Regulatory Supervision and Market Discipline
Regulatory supervision is the second pillar of Basel II that provides the framework for national regulatory bodies to deal with various types of risks, including systemic risk, liquidity risk, and legal risks. The market discipline pillar provides various disclosure requirements for banks' risk exposures, risk assessment processes, and capital adequacy, which are helpful for users of financial statements.

Basel III

In 2010, Basel III guidelines were released. These guidelines were introduced in response to the financial crisis of 2008. A need was felt to further strengthen the system as banks in the developed economies were under-capitalized, over-leveraged and had a greater reliance on short-term funding. Also the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk. Basel III norms aim at making most banking activities such as their trading book activities more capital-intensive. The guidelines aim to promote a more resilient banking system by focusing on four vital banking parameters viz. capital, leverage, funding and liquidity.

Comparison of Basel norms

Basel 1 - Covered only Credit Risk
Basel 1.1 Covered credit risk and Market Risk

Basel 2 Covered Credit Risk, Market Risk, Operational Risk,
Basel 3 Covered Credit Risk, Market Risk, Operational Risk, liquidity Risk