BBA-10

Vardhaman Mahaveer Open University, Kota

Banking and Insurance Management

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CONTENTS

Banking and Insurance Management

Unit - 1 : An Introduction to Banking

Structure of Unit:

1.0 Objectives

After completing this unit, you would be able to:

- State the origin and development of banking.
- Understand the meaning and definition of bank.
- Identify the different types of banks.
- Know about various banking system in India.

1.1 Introduction

Modern commercial banking, in its present form, is of recent origin. Though bank is considered to be an ancient institution just like money. It's evolution can be traced in the functions of money lender, the gold-smiths and the merchants.

A bank has been often described as an institution engaged in accepting of deposits and granting loans. It can also be described as an institution which borrows idle resources, makes funds available to. It does not refer only to a place of tending and depositing money, but looks after the financial problems of its consumers.

This era is the age of specialization with the changing situation in the world economy, banking functions have broadened. Financial institutions which are shaped by the general economic structures of the country concerned vary from one country to another. Hence, a rigid classification of banks is bound to the unrealistic.

1.2 Origin and Development of Banking

There seem so be no uniformity amongst the economist about the origin of the word 'Bank'. It has been believed that the word 'Bank' has been derived from the German word 'Bank' which means joint stock of firm or from the Italian word 'Banco' which means a heap or mound.

In India the ancient Hindu scriptures refers to the money - lending activities in vedic period. They performed most of those functions which banks perform in modern times. During Ramayana and Mahabharata eras also banking had become a full-fledged business activity. In other words the development of commercial banking in ancient times was closely associated with the business of money changing.

In simple words, bank refers to an institution that deals in money. This institution accepts deposits from the people and gives loans to those who are in need. Besides dealing in money, bank these days perform various other functions, such as credit creation, agency job and general service. Bank, therefore is such an institution which accepts deposits from the people, gives loans, creates credit and undertakes agency work.

1.3 Meaning and Definition of Banking

Meaning of Banking

You know people earn money to meet their day to day expenses on food, clothing, education of children, having etc. They also need money to meet future expenses on marriage, higher education of children housing building and social functions. These are heavy expenses, which can be met if some money is saved out of the present income. With this practice, savings were available for use whenever needed, but it also involved the risk of loss by theft, robbery and other accidents.

Thus, people were in need of a place where money could be saved safely and would be available when required. Banks are such places where people can deposit their savings with the assurance that they will be able to with draw money from the deposits whenever required.

Bank is a lawful organization which accepts deposits that can be withdrawn on demand. It also tends money to individuals and business houses that need it.

Definitions of Bank

1. **Indian Banking Companies Act -** "Banking Company is one which transacts the business of banking which means the accepting for the purpose of lending or investment of deposits money from the public repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise".
2. **Dictionary Meaning of the Word 'Bank' -**The oxford dictionary defines a bank as "an establishment for custody of money received from or on behalf of its customers. It's essential duty is to pay their drafts on it. It's profits arises from the use of the money left employed by them".
3. **The Webster's Dictionary Defines** a bank as "an institution which trades in money, establishment for the deposit, custody and issue of money, as also for making loans and discounts and facilitating the transmission of remittances from one place to another".
4. **According to Prof. Kinley**, "A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when it required by them for use".

The above definitions of bank reveal that bank is an Business institution which deal in money and use of money. Thus a proper and scientific definition of the bank should include various functions performed by a bank in a proper manner. We can say that any person, institution, company or enterprise can be a bank. The business of a bank consists of acceptance of deposits, withdrawals of deposits, Making loans and advances, investments on account of which credit is exacted by banks.

1.4 Types of Banks

There are various types of banks which operate in our country to meet the financial requirements of different categories of people engaged in agriculture, business, profession etc. on the basis of functions, the banking institution may be divided into following types:

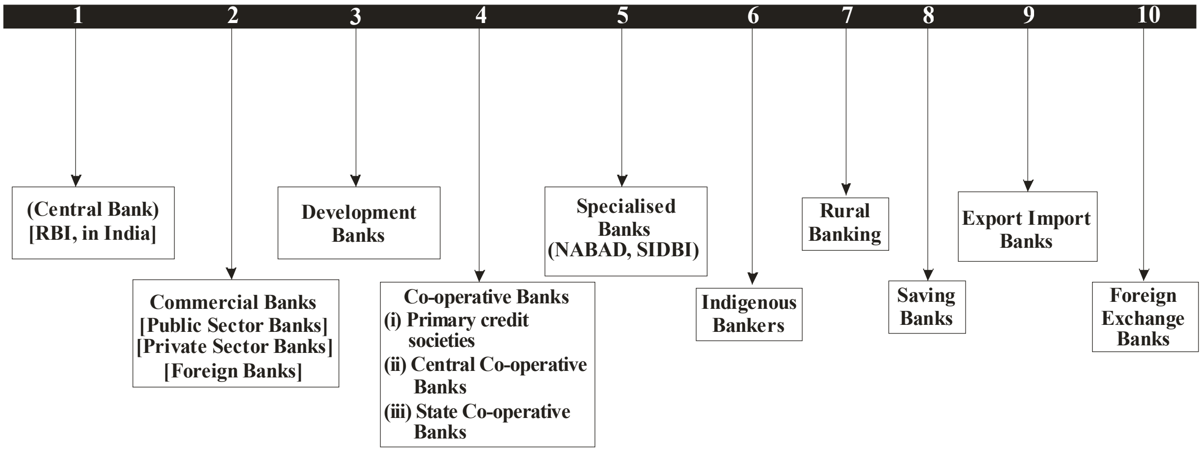

Figure 1.1 : Types of Banks

1. Central Bank

A central bank functions as the apex controlling institution in the banking and financial system of the country. It functions as the controller of credit, banker's bank and also enjoys the monopoly of issuing currency on behalf of the government. A central bank is usually control and quite often owned, by the government of a country. The Reserve Bank of India (RBI) is such a bank within an India.

2. Commercial Banks

It operates for profit. It accepts deposits from the general public and extends loans to the households, the firms and the government. The essential characteristics of commercial banking are as follows:

- Acceptance of deposits from public
- For the purpose of lending or investment
- Repayable on demand or lending or investment.
- Withdrawal by means of an instrument, whether a cheque or otherwise.

Another distinguish feature of commercial bank is that a large part of their deposits are demand deposits withdrawable and transferable by cheque.

3. Development Banks

It is considered as a hybrid institution which combines in itself the functions of a finance corporation and a development corporation. They also act as a catalytic agent in promoting balanced and viable development by assuming promotional role of discovering project ideas, undertaking feasibility studies and also provide technical, financial and managerial assistance for the implementation of project.

In India 'Industrial Development Bank on India' (IDBI) is the unique example of development bank. It has been designated as the principal institution of the country for co-ordinating the working of the institutions engaged in financing, promoting or development of industry.

4. Co-operative Banks

The main business of co-operative banks is to provide finance to agriculture. They aim at developing a system of credit. Agriculture finance is a special field. The co-operative banks play a useful role in providing cheap exit facilities to the farmers. In India there are three wings of co-operative credit system namely - (i) Short term, (ii) Medium-term, (iii) Long term credit. The former has a three tier structure consisting of state co-operative banks at the state level. At the intermediate level (district level) these are central co-operative banks, which are generally established for each district.

At the base of the pyramid there are primary agricultural societies at the village level. The long term exit is provided by the central land development Bank established at the state level. Initially, these banks used to advance loans on mortgage of land for the purpose of securing repayment of loans.

5. Specialised Banks

These banks are established and controlled under the special act of parliament. These banks have got the special status. One of the major bank is 'National Bank for Agricultural and Rural development' (NABARD) established in 1982, as an apex institution in the field of agricultural and other economic activities in rural areas. In 1990 a special bank named small industries development Bank of India (SIDBI) was established. It was the subsidiary of Industrial development Bank of India. This bank was established for providing loan facilities, discounting and rediscounting of bills, direct assistance and leasing facility.

6. Indigenous Bankers

That unorganised unit which provides productive, unproductive, long term, medium term and short term loan at the higher interest rate are known as indigenous bankers. These banks can be found everywhere in cities, towns, mandis and villages.

7. Rural Banking

A set of financial institution engaged in financing of rural sector is termed as 'Rural Banking'. The polices of financing of these banks have been designed in such a way so that these institution can play catalyst role in the process of rural development.

8. Saving Banks

These banks perform the useful services of collecting small savings commercial banks also run "saving bank" to mobilise the savings of men of small means. Different countries have different types of savings bank viz. Mutual savings bank, Post office saving, commercial saving banks etc.

9. Export - Import Bank

These banks have been established for the purpose of financing foreign trade. They concentrate their working on medium and long-term financing. The Export-Import Bank of India (EXIM Bank) was established on January 1, 1982 as a statutory corporation wholly owned by the central government.

10. Foreign Exchange Banks

These banks finance mostly to the foreign trade of a country. Their main function is to discount, accept and collect foreign bulls of exchange. They also buy and self foreign currencies and help businessmen to convert their money into any foreign currency they need. Over a dozen foreign exchange banks branches are working in India have their head offices in foreign countries.

11. International Banks

Activity - A:

1 Make the basic list of those International Banks within India which help the banking sector of India to develop in International market.

1.5 Types of Banking

Banking is described as the business carried on by an individual at a bank. Today, several forms of banking exist, giving consumers a choice in the way they manage their money most people do a combination of at least two banking types. However, the type of banking a consumer uses normally based on convenience. These are different types of banking through which consumer can attach to it-

(A) Walk-in-Banking

It is still a popular type of banking. As, in the past, it still involves bank tellers and specialized bank officers. Consumers must walk into a bank to use this service normally, in order to withdraw money or deposit it, a person must fill out a slip of paper with the account and specific monetary amount and show a form of identification to a bank letter. The advantage of walk in Banking is the face to face connection between the banker and a letter. Also unlike drive thru and ATM banking, a person can apply for a loan and invest money during a walk in.

(B) Drive thru Banking

It is probably the least popular form of banking today, but is still used enough by consumers to create a need for it. It allows consumers to stay in their while and drive up to a machine equipped with container, chute and intercom. This machine is connected to a bank and is run by one or two bank letters. A person can withdraw or deposit money at a drive thru. He must fill out a slip with his account and specific monetary amount and put it in the container. The container travels through the chute to the bank letter, who will complete the banker's request. This is where the intercom comes into play. The bank teller and banker use it to communicate and discuss the specific banking request.

(C) ATM Banking

It is very popular because it gives a person 24 hour access to his bank account. Walk in and drive thru banking does not offer this perk. In order to use an ATM, a person must have an ATM card with personal identification number (PIN) and access to an ATM machine. Any ATM machine can be used, but charges apply if the ATM machine is not affiliated with the bank listed on the ATM card. By sliding an ATM card into an ATM machine, it is activated and then through touching buttons on the machine, a consumer is able to withdraw or deposit money.

(D) Online Banking

It allows a person to get on the internet and sign into their bank. This process is achieved with the use of a PIN, different from the one used for the ATM card. By going website of a bank and entering it, a consumer can get into his account, withdraw money, deposit money, pay bills, request loans and invest money. Online banking is growing in popularity because of its convenience.

These different types of banking give a consumer the power of choice and also give them a comfortable banking system that gives them a convenient choice.

Activity B:

1 According to you why banks differ from the early banks concept within India and do you think that commercialization of banks can develop the economic structure of India.

1.6 Summary

Thus, a bank can play a useful role in promoting the economic development of any country' economy. Banks tending and investment activities lead to changes in the quantity of money in circulation which in turn influence the nature and quality of production.

Therefore, banks have been rightly crowned as 'the nerve' centre of all economic activity. And also play important role in day to day life of every consumer who consumes the banking sector activities.

1.7 Self Assessment Questions

1. What is a bank? Discuss the various types of bank giving their main functions only.
2. Discuss the branches of banking system which of the system or branch would be more suitable for India.
3. Define bank and discuss how banks can contribute to the economic development of a country.
4. Discuss merits and demerits of unit and branch banking. Which of the two systemS would be more suitable for India?

1.8 Books for Further Readings

- Money and Banking, J.K. Tondon and T.N. Mathur
- Banking and Finance, C.M. Choudhary
- Banking and Finance, Sunita Mathur, Bhunesh Vyas and J.P. Yadav
- Money and Banking, T.R. Jain, O.P. Khanna, Sharda Tiwari

Unit - 2 : Functions of Banks

Structure of Unit:

2.0 Objectives
2.1 Introduction
2.2 Functions of Banks
2.3 Importance of Banks
2.4 Summary
2.5 Self Assessment Questions
2.6 Books for Further Readings

2.0 Objectives

After completing this unit, you will be able to :

- Know about introduction of Banks
- Identify different functions of Banks
- Understand the importance of Banks

2.1 Introduction

A bank is an institution which accepts deposits from the general public and extends loans to the households, the firms and the government. Banks are that institutions which operates in money. Thus, they are money traders. With the process of development, functions of banks are also increasing and diversifying. Now, the banks are not nearly the traders of money, they also create credit. Their activities are increasing and diversifying.

Banks, therefore, is such an institution which accepts deposits from the people, given loans creates credit and undertakes agency work.

2.2 Functions of Banks

Modern banks not only deal in money and credit creation, other useful functions management of foreign trade, finance etc. The meaning of modern banks is used in narrow sense of the term as commercial banks. The various functions of banks can be seen from the following figure:

FUNCTIONS OF BANKS

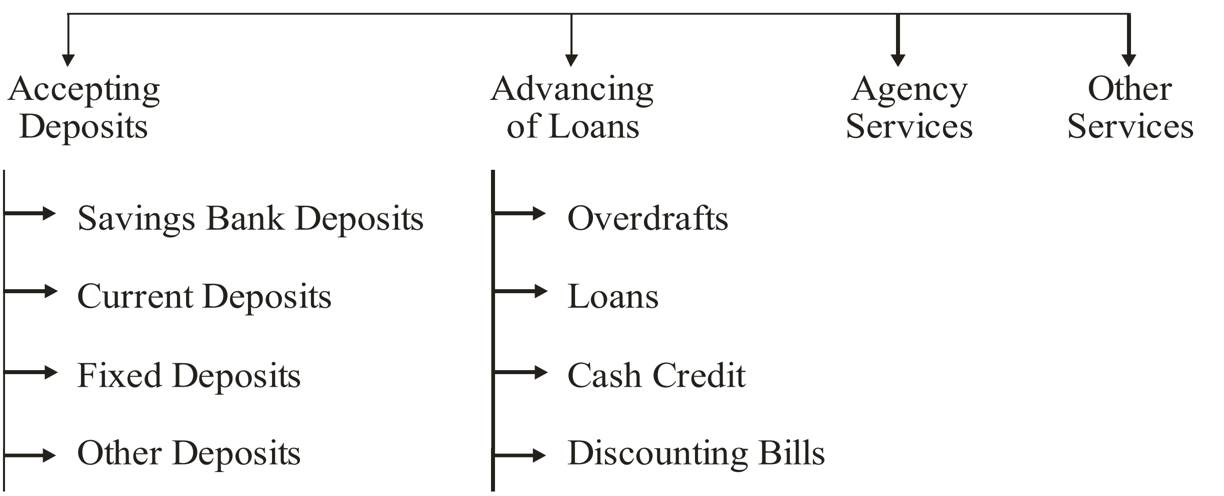

Figure 2.1 : Functions of Banks

I. Accepting Deposits:

The most important function of commercial banks is to accept deposits from public. This is the primary functions of a commercial bank. Banks receives the idle savings of people in the form of deposits and finances the temporary needs of commercial and industrial firms.

A commercial bank accept deposit from public on various account, important deposit account generally kept by bank are :

(i) Saving Bank Deposits – This type of deposits suit to those who just want to keep their small savings in a bank and might need to withdraw them occasionally. One or two withdrawals upto a certain limit of total deposits are allowed in a week. The rate of interest allowed on saving bank deposits is less than that on fixed deposits. Depositor is given a pass book and a cheque book. Withdrawals are allowed by cheques and withdrawal form.

(ii) Current Deposits – This type of account are generally kept by businessmen and industrialists and those people who meet a large number of monetary transactions in their routine. These deposits are known as short term deposits or demand deposits. They are payable demand without notice. Usually no interest is paid on these deposits because the bank cannot utilize these deposits and keep almost cent per cent reserve against them. Overdraft facilities are also available on current account.

(iii) Fixed Deposits – These are also known as time deposits. In this account a fixed amount is deposited for a fixed period of time. Deposits are payable after the expiry of the stipulated period. Customers keep their money in fixed deposits with the bank in order of earn interest. The banks pay higher interest on fixed deposits. The rates depend upon the length of the period and state of money market.

Normally the withdrawals are not allowed from fixed deposits before the stipulated date. If it happens, the depositor entails an interest penalty.

(iv) Other Deposits – Banks also provide deposit facilities to different type of customers by opening different account. They also open. 'Home Safe Account' for housewife or very small savers.

The other accounts are : 'Indefinite Period Deposit a/c'; 'Recurring Deposit' a/c; 'Retirement Scheme' etc.

II. Advancing of Loans:

The second main function of the commercial bank is to advance loans. Money is lent to businessmen and trade for short period only. These banks cannot lend money for long period because they must keep themselves ready to meet the short term deposits. The bank advances money in any one of the following forms :

(i) Overdrafts : Customers of good standings are allowed to overdraw from their current account. But they have to pay interest on the extra amount they have withdrawn. The banks allow 'overdrafts' to their customers just to provide temporary accommodation save the extra amount withdrawn is payable within a period. The amount allowed in 'overdraft' varies from customer to customer depending on this financial condition.

(ii) Loans : Loans are granted by the banks on securities which can be easily disposed off in the market, e.g. Government securities or shares of approved concerns. When the bank has satisfied itself regarding the soundness of the party, the loan is advanced. A borrower seldom wants the whole amount of his loan in cash, so he opens the current account with the bank (and the loan amount) and thus a 'deposit is created' in the books of the name in the bank.

(iii) **Cash Credit :** It is an arrangement by which a bank allows his customers to borrow money upto a certain limit against certain tangible securities as Government securities or shares of approved concerns etc. In this case interest in charged on the actual amount withdrawn by the customer and not on the limit allowed to him.

(iv) **Discounting Bills :** It is another important way of giving loans. The banks purchase bills and immediately pay case for these bills after deducting the discount (interest). After the maturity of the bills, the banks get back its full value. Thus these bills are good liquid assets and moreover this investment is also very safe.

III. Agency Services:

Modern Banks render service to the individual or to the business institutions as an agent. Banks usually charge little commission for doing these services. These services are as follows-

(i) A bank collects cheques, bills and promissory notes and receives their payments.

(ii) A bank collects dividend or interest on stock and shares. It also collects subscriptions and insurance premium.

(iii) A bank also buys and sells securities on behalf of its customers. It also not charges anything from the customers for this but gets some commission from the stock broker.

(iv) A bank acts as trustee or an executor on behalf of its customers in the administration of a will or of settlement.

(v) Lastly a bank helps in the transfer of funds from one bank or branch to another.

IV. Other Services :

A modern bank now a days serves its customers in many other ways :

(i) A bank issues personal and commercial letters of credit. Through these letters of credit customers are able to benefit themselves out of the superior credit of the bank.

(ii) A bank also helps in the transaction of foreign exchange business.

(iii) A bank has 'Safe Deposit Vaults'. It undertakes the safe custody of valuables and important documents. The bank acts as bailee of these goods or documents.

(iv) A few banks also undertake to underwrite loans raised by Government, public or trading corporation.

2.3 Importance of Banks

Banks play an important role in the economic growth of a country. In the modern set up, banks are not to be considered dealers in money but as the leaders of development. The importance of bank for a country's economy can be explained in following ways-

- Banks by playing attractive interest rate on deposits try to promote thrift and savings in an economy. The investment of these savings in productive channel results in capital formation.

- The scattered small savings in the country can be put to optimum use by commercial banks. Banks utilize this amount by giving loans to industrial houses and the government. By providing funds to the entrepreneurs, bank help in increasing productivity of capital.

- Banks help in remitting money from one place to another. The cheque, bank draft, letter of credit, bills, hundies enable traders to transfer large sums of money from one place to another.
- By their ability to create credit, the banks have placed at the disposal of the nation a large amount of money. The bank can increase the supply of money through credit creation.
- With the growth of banking activity, employment opportunity in the country has increased to a considerable extent.
- The banks help in capital formation in the country. A high rate of saving and investment promote capital formation.
- Money deposited in the bank and other precious items are now absolutely safe. For keeping valuables, banks are providing locker facilities. Now people are free from any type of risks.

2.4 Summary

Bank act as payment agents by conducting checking or current accounts for customer, paying cheque drawn by customers on the bank, and collecting cheque deposited to customers current accounts. Banks also enable customer payments via other payment methods such as automated teller machine (ATM), Telegraphic Transfer etc.

Banks borrow money by accepting funds deposited on current accounts, by accepting term deposits, and by issuing debt securities such as banknotes and bonds. Banks lend money by making advances to customers on current accounts, by making installment loans and by investing in marketable debt securities and other forms of money lending.

Banks also provide almost all payment services and a bank account is considered indispensable by most businesses, individuals and governments.

2.5 Self Assessment Questions

1. Describe the main function of Banks. How can banks contribute to economic development of a country?
2. Define bank and discuss various functions of a bank?
3. Describe the different types of banks and their functions.
4. What is a bank? Discuss the various types of banks giving their main functions only.
5. What do you understand by bank? What functions are executed by banks in modern world?

2.6 Books for Further Readings

- Banking and Finance, Dr. B.P. Gupta, Dr V.K. Vashisth, Dr. H.R. Swami
- Money and Banking, J.K. Tondon and T.N. Mathur
- Money and Banking, T.R. Jain, O.P. Khanna, Sharda Tiwari

Unit - 3 : Structure of Banking System

Structure of Unit:

3.0 Objectives

After going through this unit you would be able to:

- Understand the structure of the banking system in India
- Understand the recent developments taking place in Indian banking industry
- Describe the role and functions of Reserve Bank of India
- Describe the Scheduled, Non-scheduled and Licensed bank
- Understand the components that took place in Indian Banking Sector
- Get overview about the Public Sector Banks, Private Sector Banks, Regional Rural Banks, Local Area Banks, Indian Banks, Foreign Banks and Cooperative Banks

3.1 Introduction

The structure of banking varies widely from country to country. Often a country's banking structure is a consequences of the regulatory regime to which it is subjected. The banking system in India works under the constraints that go with social control and public ownership. Nationalization, for instance, was a structural change in the functioning of commercial banks which was considered essential to better serve the needs of development of the economy in conformity with national policy and objectives. Similarly to meet the major objectives of banking sector reforms, government stake was reduced to 51 percent in public sector banks. New private sector banks were allowed and foreign banks were permitted additional branches.

3.2 Indian Banking System

The banking system of a country plays an important role in the economic development of any country. Banking system comprises of the banking institutions functioning in the country. Banking system comprises from the central bank to all banking institutions which are functioning and providing financial facilities to any developmental sector like agriculture, industries, trade, housing etc.

Under the Indian banking structure central bank in the name of the Reserve Bank of India which regulates, directs and controls the banking institutions. Separate institutions are functioning to meet the financial requirement of the different sectors of the economy. Indigenous bankers and moneylenders do dominant in the unorganized sector. Regional Rural Banks are meeting the requirement of the rural population. Cooperatives are working to meet the requirement of medium, short and long-term credit for agriculture sector. Development banks are meeting the business and industrial requirements. Thus, we can say that the structure of Indian banking system has an international level banking system which can meet the economic requirements of globalized world.

The Indian banking structure has a wide and comprehensive form. Apex institutions in the form of banking institutions are playing important role in the country. The chief regulator of banking system in our country is the Reserve bank of India. Industrial Development Bank of India (IDBI) is an apex body in the industrial sector. National Bank of Agriculture and Rural Development (NABARD) has been working as an apex institution for the agriculture and rural development. Import-Export Bank of India (EXIM) is an Apex body of international trade. National Housing Bank (NHB) is an apex institution in field of housing construction. Thus these four apex institutions are accelerating the banking system by providing refinance facilities to commercial banks and other financial institutions along with other banking services.

The major financial institutions of the Indian Banking system can be seen from the figure 3.1

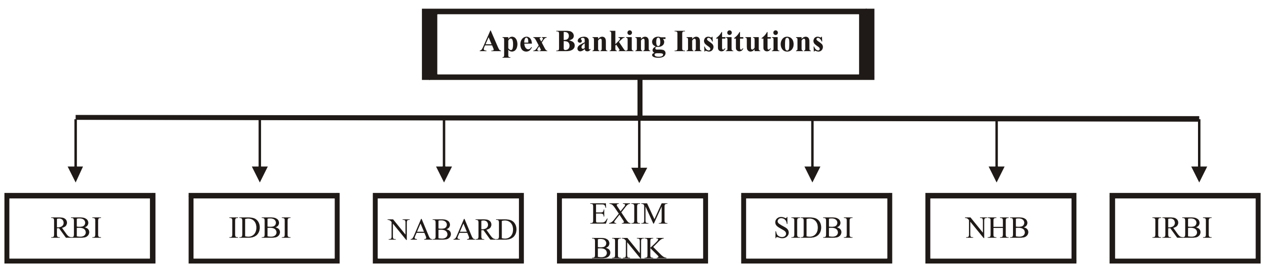

Figure 3.1 : Apex Banking Institutions

3.2.1 Reserve Bank of India (RBI)

The Indian Banking structure has a wide and comprehensive form. Apex Institutions in the form of banking institutions are playing important role in the country. The chief regulator of banking system in our country is the Reserve Bank of India. The Reserve Bank of India (RBI) was established in April 1935 with a share capital of Rs. 5 Crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

The Reserve Bank of India was set up as a private shareholder bank under the Reserve Bank of India Act, 1934 and it started functioning as the central bank since 1st April 1935.

Objectives of RBI: The following were the objectives of RBI when it was set up:

- To manage adequate money and credit in the country
- To maintain the stability of rupee internally and externally
- Balanced and well managed banking development in the country
- To develop well organized money market
- To provide adequate agriculture credit
- Ti manage public debt
- To seek international monetary co-operation
- Centralization of cash reserves of commercial banks
- To set up Government banks
- To set up Government banks
- Publication of data

Functions of RBI: RBI is an apex banking institution of the country. It carries on several functions as a central bank. According to RBI Act, 1934, "the principal function of RBI is to issue notes and maintain reserves, currency and credit to maintain monetary stability in the general interest of the nation."

As a central banking authority RBI carries on the following functions:

1. RBI regulates issue of bank notes above one rupee denomination
2. Undertakes distribution of all currency notes and coins on behalf of the government
3. Acts as the banker to the Government of India and the State governments, Commercial and Cooperative banks
4. Formulates and administers the monetary policy
5. Maintain exchange value of rupee
6. Represent India at the International Monetary Fund (IMF)
7. RBI acts as a banker for all the commercial banks. All scheduled banks come under the direct control of RBI. All commercial as well as schedule bank has to keep a minimum reserve with the RBI. They have to submit weekly reports to RBI about their transactions. By performing 3 functions, the RBI helps the member banks significantly. They are given below such as:
   - It acts as the lender of the last resort.
   - It is the custodian of cash reserves of commercial banks.
   - It clears, transfers the transaction. It acts as the central clearing house.
8. Regulation of Banking system
9. Credit Control

3.2.2 Industrial Development Bank of India (IDBI)

This is an apex institution providing long-term finance to industrial sector. It was set us as a subsidiary of the RBI in 1964. In February, 1976 it was segregated from the RBI. At present its whole of the share capital is owned by the Government of India. IDBI provides financial assistance to industrial concerns by way of variety of products and services which include project finance, equipment finance, asset credit, equipment lease, technology up gradation fund scheme, refinance for medium scale industries and bill finance. It provides as well as for expansion, diversification and modernization of existing industrial enterprises. In response to the changing financial needs of industries, IDBI has also designed other products to meet the short term funding, core working capital and other short term requirements of industrial units. It also offers fee-based services in the area of merchant banking, corporate advisory services, foreign exchange services etc. IDBI has also set up subsidiaries and associates to offer banking products & services, capital market and trusteeship services, as also registrar and transfer services structured to meet customized client requirements.

For meeting fund requirements thereof as well as towards its various other business operations, IDBI raises resources directly from the market (at market-related interest rates) from retail as well as institutional investors – both within India and abroad, through a variety of investor-friendly instruments. IDBI's resources raising efforts have brought it closer to all sections of society.

3.2.3 Small Industries Development Bank of India (SIDBI)

Small Industries Development Bank of India (SIDBI) was established in April 1990 under an Indian Parliament wholly-owned subsidiary of Industrial Development Bank of India (IDBI)

SIDBI's stature provides that it should serve as the principal financial institution for:

- Promotion
- Financing
- Development if industry in the small scale sector and
- Coordinating the functions of other institutions engaged in Similar activities

The Small Scale industry (SSI) sector, which is vibrant and dynamic sub-sector of the India's industrial economy, comprises the area of SIDBI's business. The contribution of the SSI's in term of production, employment and export earnings has been significant. The objectives of Government policy have been to impart vitality and growth impetus to the sector by removing bottlenecks that affect the growth potential. In the liberalized era and emerging economic scenario, the sector is assured of continued support.

3.2.4 National Bank for Agriculture and Rural Development (NABARD)

In order to meet the credit requirement of agriculture and rural development the NABARD was set up in 1982 with the merger of 'Agriculture Credit Department' and Agriculture \Refinance and development Corporation' of the RBI. The bank provides short term and long term credit to agriculture and non agriculture activities namely hand weaving, artisans etc. and coordinate the activities. It provides refinance facilities on the loan given by commercial banks and cooperative for the agriculture and rural development.

Main Function of NABARD

- Refinancing to Cooperative Banks
- Financing to Rural Banks
- Loan facilities for purchase of Shares
- Refinance of Rural Development loans

- Long term Loan Facilities
- Technical Assistance and Advice

3.2.5 Export-Import Bank of India (EXIM)

The Export-Import Bank of India (EXIM Bank) was set in January, 1982 with its headquarters in Mumbai. It Perform the normal banking functions connected with import and export of goods, and several other functions. These major functions include financing of exports from and imports to India, financing joint ventures in foreign countries and financing the export and import of machinery and equipment on lease basis. It also undertakes purchasing, discounting and negotiating of exports bills and thus encourages the exporters.

3.2.6 National Housing Bank (NHB)

The National Housing Bank (NHB) was established on 9th July 1988 under an Act of the Parliament viz. the National Housing Bank Act, 1987 to function as a principal agency to promote Housing Finance Institutions and to provide financial and other support to such institutions. The Act, inter alia, empowers NHB to:

- Issue Directions to housing finance institutions to ensure their growth on sound lines
- Make a loan and advances and render any other form of financial assistance to scheduled banks and housing finance institutions or to any authority established be or under any Central, State of Provincial Act and engaged in slum improvement and
- Formulate schemes for the purpose of mobilization of resource and extension of credit for housing

3.3 Structure of Indian Banking Industry

The Banking industry in India has grown in a specific kind of environment and with some defined objectives. This historicity of this environment and the objectives has a strong bearing on the operations and management of present day. To appreciate any economic dimension of the banking industry in India in a proper perspective, understanding of the path of evolution of the industry must. The origin of banking industry may be tacked back to establishment of Bank of Bengal in Calcutta in 1786. Since then the industry has witnessed substantial growth and radical changes. As on March 2011, Indian banking industry consisted of the 234 Commercial Banks.

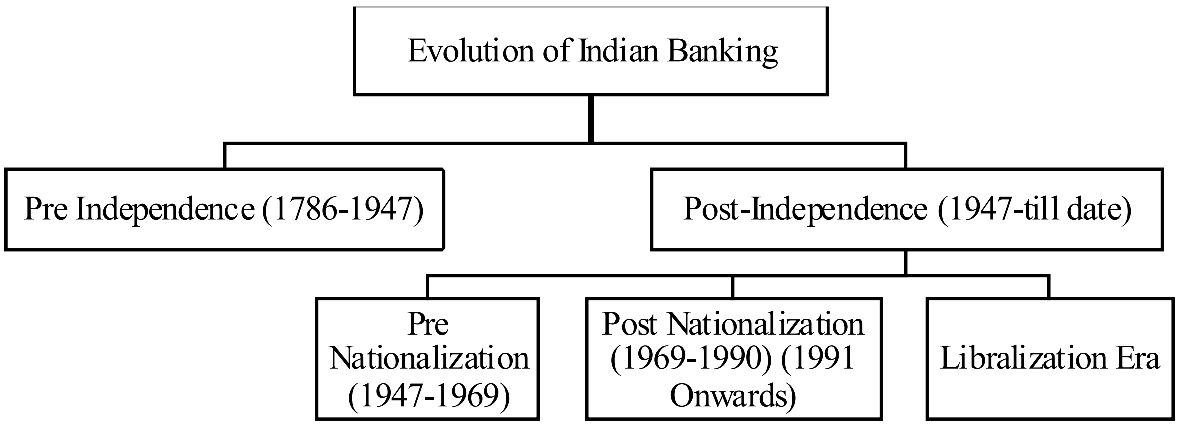

Figure 3.2: Evolution of Indian Banking

The first bank in India, though conservative, was established in 1786. From then till today, the journey of Indian banking system can be classified into three distinct phases:

Phase 1: Early phase from 1786 to 1969 of Indian banks.

Phase 2: Nationalization of Indian bands up to 1991 prior to the Indian banking sector reforms.

Phase 3: New phase of Indian banking system with the advent of Indian Financial and Banking Sector Reforms after 1991.

We shall now discuss these three phase briefly.

3.3.1 PHASE I

The General Bank of India was set up in 1786. Next came the Bank of Hindustan and Bengal Bank. The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called them presidency Banks. These three banks were amalgamated in 1920 and the Imperial Bank of India, which started as private shareholders banks, was established with mostly European shareholders.

In 1865, the Allahbad Bank was established, and, for the first time, exclusively by Indians, Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1923, Banks of India, Central Bank of India, Bank of Baroda, Canara Bank, Indian Bank and Bank of Mysore were set up. The Reserve Bank of India (RBI) was established in 1935.

During the first phase, the growth was very slow and banks also experienced periodic failures between 1923 and 1948. There were approximately 1100 banks, mostly small. As per the Reserve Bank India Act of 1934, the Reserve Bank of India (RBI) was constituted as an apex bank without major government ownership. To streamline the functioning and activities of commercial banks, the Government of India came up the Banking Companies Act, 1949 which was later changed to Banking Regulation Act, 1949. As per the Banking Regulation (Amendment) Act of 1965 (Act No. 23 of 1965), RBI was vested with extensive powers for the supervision of banking in Indian as the Central Banking Authority. During those days, the public confidence in banks was somewhat low and, so, deposit mobilization was slow. Abreast of it the savings banks facility provided by the postal department was comparatively safer. Moreover, funds were largely given to traders.

3.3.2 PHASE II

The government took major steps in the Indian Banking Sector Reforms after independence. In 1955, it nationalized the Imperial Bank of India (the State Bank of India Act) with extensive banking facilities on a large scale, especially in rural and semi-urban areas as the first phase of nationalization. It formed the State Bank of India (SBI) to as the principal agent of RBI and to handle banking transactions of the Union and the State Governments of the Country.

In 1969, seven subsidiary banks of the State Bank of India were nationalized as a major process of nationalization due to the effort of then Prime Minister Mrs. Indira Gandhi, Later in 1969, 14 Major Private Commercial Banks in the country were nationalized. The list of 14 banks nationalized in 1969 was;

1. Central Bank of India
2. Bank of Maharashtra
3. Dena Bank
4. Punjab National Bank
5. Syndicate Bank
6. Canara Bank
7. Indian Bank

8. Indian Overseas Bank
9. Bank of Baroda
10. Union Bank
11. Allahabad Bank
12. United Bank of India
13. UCO Bank
14. Bank of India

The second phase of nationalization of Indian banks was carried out in 1980, with seven more banks being nationalized. This step brought 80 percent of the banking segment in India under government ownership

The Government if India has taken the following steps to regulate banking institutions in the country:

1949: Enactment of Banking Regulation Act

1955: Nationalization of State Bank of India

1959: Nationalization of SBI subsidiaries

1961: Insurance cover extended to deposits

1969: Nationalization of 14 major banks

1971: Creation of Credit Guarantee Corporation

1975: Creation of regional rural banks

1980: Nationalization of seven more banks with deposits over Rs. 200 crore.

After the nationalization of banks, the branches of the public sector banks in India rose to approximately 800 percent in deposits, and advances took a huge jump by 11,000 percent.

Government ownership gave the public implicit faith and immense confidence in the sustainability of public sector banks.

3.3.3 PHASE III

The third phase of development of Indian banking introduced many more products and facilities in the banking sector in its reform measures. In 1991, under the chairmanship of M. Narsimham, a committee was set up under his name, which worked for the liberalization of banking practices.

The country in flooded with foreign banks and their ATM stations. Efforts are being put in to give a satisfactory service to customers. Phone banking and net banking have been introduced. The entire system has become more convenient and swift. Today, time is given more importance than money.

The financial system of India has shown a great deal of resilience. It is sheltered from any crisis triggered by any external macroeconomic shock as other East Asian countries suffered. This is all due to a flexible exchange rate regime, high foreign reserves, the not yet fully convertible capital account, and limited foreign exchange exposure to banks the their customers.

3.4 Present Structure of Indian Banking Industry

The Indian financial system comprises a large number of commercial and cooperative banks, specialized developmental banks for industry, agriculture, external trade and housing, social security institutions, collective investment institutions, etc. The banking system is at the heart of the financial system.

The Indian banking system has the RBI at the apex. It is the central bank of the country under which there are the commercial banks including public sector and private sector banks, foreign banks and local area banks. It also includes regional rural banks as well as cooperative banks. The structure of the Indian banking system is given in figure 3.3

INDIAN BANKING SYSTEM

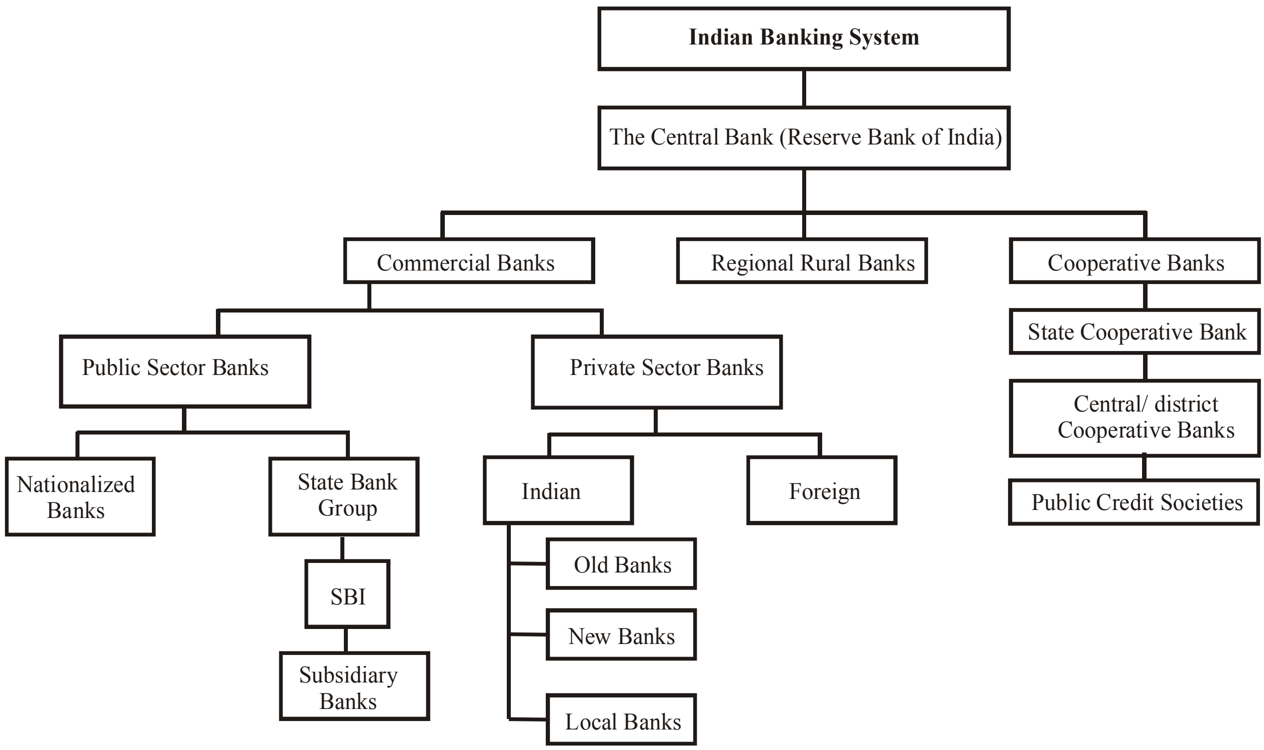

Figure 3.3 : Structure of Indian Banking System

After the overview of the development of the Indian banking sector since 1947, this section focuses on the structure of the banking system as it presents itself today. In many respects the current structure can be directly related to the policies described in the previous sections, including the nationalization of banks in 1969 and 1980 and the opening up of the banking sector for new players after 1991.

In India, the most important intermediaries in the banking system today are scheduled commercial banks, co-operative banks, development financial institutions (DFI) and non-bank financial companies. The large state owned and private sector banks that form part of the scheduled commercial banks are the most visible representatives of the banking system. While the scheduled commercial banks hold more that 80% of the banking system's assets, they represent a minority in term of numbers. The main focus of this study is scheduled commercial banks; however, a brief description of the four most important types of institutions will enable a better overview of the structure of the banking system in India.

3.4.1 Commercial Banks

In the organized sector of the money market, commercial banks and cooperative banks have been in existence for the past several decades. A commercial bank which is run for the benefit of a group of members of the cooperative body, e.g., housing cooperative society. The commercial banks are spread across the length and breadth of the country, and cater to the short term needs of industry, trade and commerce and agriculture unlike the developmental banks which focus on long term needs. These days the commercial banks also look after other needs of their customers including long term credit requirements.

The banking sector has been undergoing drastic metamorphosis. The rapid progress witnessed in the realm of banking services has been engineered by the trends in globalization, liberalization and privatization. The technological revolution and demographic changes have also helped to change the face of banking in India. More banks are switching over virtual banking for the brick and mortar banks, and are providing a vast array of products through very innovative channels and at highly competitive prices. Banks are now free to quote their own interest rates in loan/advances and term deposits. They now have to manage their investments and loans portfolios based on the international norms and practices of risk management including asset liability management.

Commercial banks operating in India may be categorized into public sector, private sector, and Indian or foreign banks depending upon the ownership, management and control. They may also be differentiated as scheduled or non-scheduled, licensed or unlicensed.

Expansion of Bank Offices: The branch expansion of commercial banks has been very fast after independence in the history of India banking. There were 4115 branches of scheduled commercial banks in 1951 which have increased to 8262 in June, 1969, 60190 on 30th June, 1991 and 93080 in 31st March 2011..

Table 3.1 Position of Bank Offices in India

Year	Number of Bank Branches
At the time of Independence	4115
1969	8262
1993	61169
1996	63026
1997	63550
1998	64218
1999	64939
2000	65412
2001	65919
2002	66208
2005	68251
2007	74653
2008	78787
2009	82897
2010	88203
2011	93080

Source: Reserve Bank of India

Table 3.2 : Bank Group-Wise and Population Group-Wise Number of Offices of Scheduled Commercial Banks (As on March 31, 2011)

Bank Group	Population Group				Total office
	Rural	Semi Urban	Urban	Metropolitan	
SBI & Its Associates	6206	5500	3899	3218	18823
Nationalized Banks	14192	10628	10742	10288	45850
Foreign Banks	7	8	62	242	319
Regional Rural Banks	11871	3046	979	138	16034
Private Sector Banks	1312	3841	3460	3388	12001
Local Area Banks	14	25	14	0	53
All Commercial Banks in India	**33602**	**23048**	**19156**	**17274**	**93080**

Source: Reserve Bank of India

3.4.1.1 Scheduled Banks

A scheduled bank means a bank included in the second schedule of the Reserve Bank of India Act, 1934. A bank is included in this schedule if, i.e.

1. It is carrying on the business banking in India.
2. Its paid-up capital and reserves are not less than Rs. 5 lakhs.
3. It is :

i) A state cooperative bank

ii) A company as defined in the Companies Act of 1956.

iii) An institution notified be the central government in this behalf

iv) A corporation or company incorporated be, or under any law in force in any place outside India.

All nationalized banks and almost all the private sector banks are commercial scheduled banks in India. Foreign banks are also scheduled banks in India, e.g., Canara Bank, Syndicate Bank, HDFC, ICICI, ABN Amro, HSBC, etc. Since 1965, the state cooperative banks have also been made eligible to be included in the second schedule. As of March 2011, there were 163 scheduled commercial banks in India. These can be further divided into four group subcategories; public sector banks, private sector banks, foreign banks, and regional rural banks (Figure 3.3).

The 27 public sector banks can further grouped into those banks that were nationalized in 1969 and 1980 and the State Banks of India Group. The 23 Private sector banks comprise the old private sector banks that were in existence before 1994. In 2011, 31 foreign banks held the status of scheduled commercial bank.

With 82 institutions, the regional rural banks form the largest group among the scheduled commercial banks. They were set up from 1975 onwards with the aim of enhancing the availability of credit to set up these institutions together with individual states.

A Schedule bank enjoys certain privileges like becoming eligible for availing the facilities of accommodation from the Reserve bank, dealing in foreign exchange, etc. It also has certain obligations like maintaining statutory reserves with the Reserve Bank.

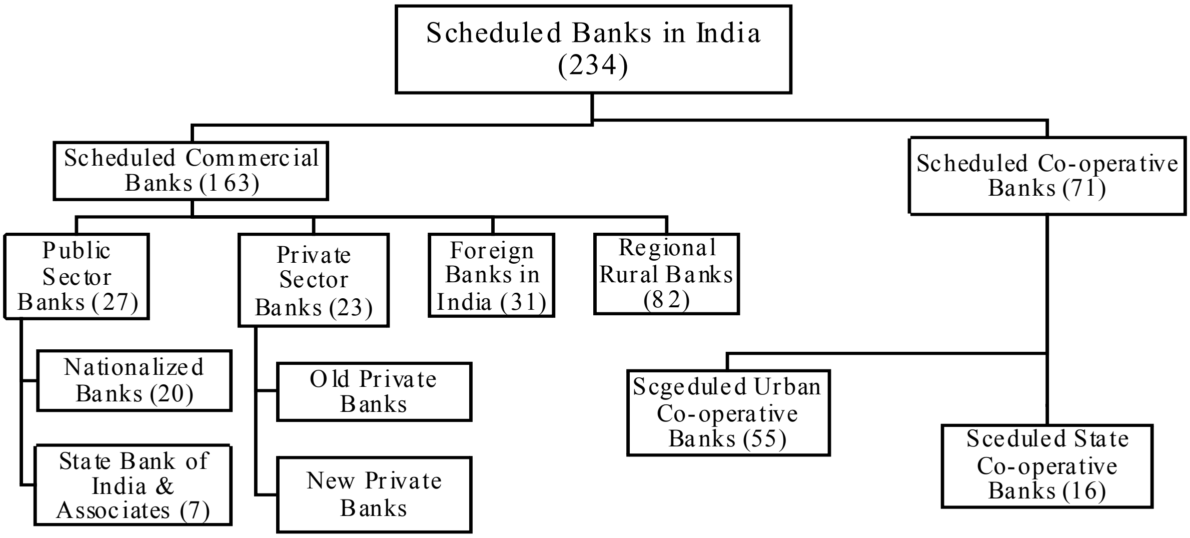

Figure 3.4 : Overview of Scheduled Banks in India

Non-Scheduled Banks

Those banks which are not included in the second schedule of the Reserve Bank of India Act are termed as non-scheduled banks. Usually they are small sized institutions which restrict their activities to local areas. Their paid-up capital and reserves do not aggregate up to more than Rs. 5 Lakhs. Their banking activities are also limited, e.g., they cannot deal in foreign exchange. The classification of Indian commercial banks into scheduled and non scheduled banks had significance prior to nationalization but now almost all commercial unscheduled banks have been weeded out. Their role has become infinitesimally small in term of deposits as well as number of branches. It carries little practical meaning except that of academic interest.

Licensed Banks

No bank can carry on the business of banking unless it holds a license granted by the Reserve Bank of India. Provisions regarding licensing are contained in section 22 of the Banking Regulation Act, 1949. A License is usually granted if the RBI is satisfied that the bank has the capacity to pay its depositors as and when their claims accrue, and that its operations are not detrimental to the interests of the depositors. Licensing is done to ensure that the working of Individual banks improves, and that the weaker and unsound ones can be weeded out. License can be cancelled at any time it the RBI feels that the affairs of a bank are not being carried on in a satisfactory manner.

3.4.2 Public Sector Banks

The public sector banks comprise of 20 nationalized banks, the state Banks of India and its 7 associates. Till 1955 they were used to be only private commercial bank- whether scheduled or non-scheduled, licensed or unlicensed, foreign or India, they were all owned and controlled by private entrepreneurs and shareholders. There were three phases of banks nationalization. The first was in July 1955, when Government of India nationalized the Imperial Bank of India to create the State Bank of India. It was a pioneering attempt in introducing public sector banking in the country. In 1959, eight state banks of erstwhile princely states were also nationalized to form the subsidiaries of the State Bank of India. But now only seven of them are in existence, since the state banks of Bikaner and Jaipur were merged. The Second phase of public sector banking came into existence when 14 major commercial banks were nationalized on July, 1969. This was done with the view to serve the needs of development of the economy in conformity with national priorities and objectives. On April 15, 1980, six more private sector banks were nationalized. This led to the dominance of public sector banks as nearly 90 percent of the banking activity in the country was brought into the public sector. Most people generally rely on nationalized banks backed by the government. The public sector banks were socially controlled and publicly owned. It was done with the objective of giving a professional bent to bank management and provision of adequate credit for agriculture and rural sector, small industries, exports and a new class of entrepreneurs, it also aimed to professionalize bank management through adequate training of bank staff.

In retrospect, it appears that political motives dominated the decision about the two nationalizations. Large-scale branch expansion, mass recruitment of staff to take banking to grass roots level, direct investments and credit programs, administered interest rate regime, credit dispensation towards poverty alleviation programs through loan melas, etc. ruled the roost in the Indian banking scene for over two decades. However, when face with tuff competition from private sector and foreign banks, the public sector banks have reinvented themselves, and have markedly improved their services and operational results.

3.4.3 Private Sector Banks

Private sector banks have existed for over a century in India. Prior to the first major nationalization in 1969, private capital called the shots in commercial banking. The Tatas owned the Central Bank of India, the Birlas – the united Commercial Bank (UCO Bank now), and so on. Following the recommendations of the Narasimham committee on financial sector (1991), the Reserve Bank of India issued guidelines for the setting up of new private sector banks in India in January 1993. It was hoped that these financially viable, technologically sound and professionally managed banks will infuse greater competition and propel the entire banking sector to much higher levels of productivity and efficiency. The guidelines of the RBI for the entry of private sector banks are as follows:

Formation: Such a bank shall be listed as public limited company under the Companies Act, 1956. It will be governed by the provisions of Reserve Bank of India Act and Banking Regulation Act. The decision regarding licensing and inclusion under second schedule of the RBI shall be final. At the time of granting of licenses preference may be given to those banks which propose to have their headquarters located in a centre, which does not have headquarters of any other bank. The voting rights of an individual shareholder shall be governed by the ceiling of one percent (which was raised to 10 percent in 1994)

Capital: The minimum paid-up capital shall be Rs. 100 crore with promoter’s contribution being 25 percent. In case the capital is more that Rs. 100 crore, then the promoter’s contribution shall be 20 percent. NRI participants can to the extent of 40 percent. The shares of the banks should be listed on stock exchanges. The bank shall be subject to prudential norms in respect of banking operations norms for income recognition, asset classification and provisioning as well as capital adequacy of 8 percent of the risk weighted average.

Operations: The banks shall have to observe priority sector lending targets as applicable to other banks, though some modifications in their composition may be allowed by the RBI in the initial three years. RBI instructions with respect to export credit will also have to be complied with. For at least three years after its establishment they will be allowed to set up a subsidiary or mutual fund.

Opening of Branches: Branch licensing shall be governed by the existing policy whereby banks are free to open any branches without prior approval of the RBI, if they satisfy capital adequacy and prudential accounting norms. If the RBI so directs, they might be required to open branches in rural and semi-urban areas.

Revised guidelines issued by the RBI in January 2001 brought in some changes. The major changes are:

- Minimum paid-up capital for a new bank should be Rs. 200 crore which shall be increased to Rs.300 crore in subsequent three years after commencement of business.
- A non-banking financial company (NBFC) may convert into a commercial bank, if it satisfies the prescribed criteria.
- A large industrial house should not promote any new bank
- Preference would be given to promoters with expertise of financing priority area, and in setting up banks specializing in the financing of rural and agro-based industries.

3.4.4 Local Area Banks

To meet the long standing need of developing a decentralized banking system, the union budget 1996-97 announced a very important policy measure regarding the development of commercial banking in India, namely, the setting up to local area banks (LABNKs) as commercial banks in the private sector. It was hoped that the large number of problems faced by RRBs and other commercial and cooperative banks would be addressed by the local area banks especially in the rural areas. These banks were thus set up with two objectives of (i) providing an institutional mechanism for promoting rural and semi-urban savings, and (ii) for providing credit for viable economic activities in the local areas. These banks were established as public by either individual, corporate, trusts or societies. The minimum paid-up capital of such banks was Rs. 5 crore with promoter's contribution at least Rs. 2 crore. Unlike the RRBs which can operate in many districts with large number of banks, the local area banks can operate and open branches in maximum of three geographically contiguous districts. The local area banks are governed by the provisions of the RBI Act, 1934, the Banking Regulation Act, 1949 and other relevant statutes. They are to registered as a public limited company under the Companies Act, 1956. The concept of the local areas banks has remained a non-starter.

3.4.5 Indian Banks

Indian banks operate nationally through a colossal network of branches. Since, they have a large and varied clientele with a diverse spectrum of needs, the Indian banks specialized in different geographical regions-urban, different sectors-industry both large and small, agriculture trade, housing, exports, etc. However, all of them in the organized sector come under the purview of the RBI Act and the Banking Regulation Act.

The main Strength of the Indian banks is their cast number of employees who are well conversant with social and cultural fabric of their customers, the Indian banks by and large focus on core banking operations. They also strictly comply with the RBI guidelines as to liquidity requirements, interest rates and priority sector lending amongst other provisions.

3.4.6 Foreign Banks

Till the 1950s they were called Exchange Banks because they alone transacted most of the import and export financing business of India. The foreign banks are branches of joint stock companies incorporated abroad, but operating in India. They are foreign in origin, and have their head office located in their parent country. Many foreign banks opened their offices, and expanded branches after the opening up of the Indian economy in the 1990s. These banks created an entirely new plying field in the banking sector through their range of products and services including ATMs, electronic services, credit cards and portfolio management. They provide foreign currencies for bona fide purpose like trade, travel or for study abroad.

Most foreign banks have a very strong parent bank commitment, superior technology and provide a very high level of customer service. This has resulted in very strong performances of these banks both in the retail sector (home loans, credit cards, distribution of third party products including mutual funds and insurance services) as well as the corporate sector (derivatives, structures products, other risk management products and debt capital markets).

3.4.7 Regional Rural Banks

Regional Rural Banks were established under the provisions of an Ordinance promulgated on the 26th September 1975 and the RRB Act, 1976 with an objective to ensure sufficient institutional credit for agriculture and other rural sectors. The RRBs mobilize financial resources from rural / semi-urban areas and grant loans and advances mostly to small and marginal farmers, agricultural laborers and rural artisans. The area of operation of RRBs is limited to the area as notified by Government of India covering one or more districts in the State.

The Regional Rural Banks (RRBs) have been set up to supplement the efforts of cooperative and commercial banks to provide credit to rural sector. The following were the reasons or need set up the RRBs:

1. To free the rural poor, small and marginal farmers from the clutches of money lenders
2. To provide credit to small farmers, marginal farmers, rural artisans, landless laborers who do not fulfill the criterion of creditworthiness as per the banking principles.
3. To provide banking services to the rural community at a relatively lower cost by adopting a different staffing pattern, wage structure and banking policies.

3.4.8 Cooperative Banks

Cooperative banks are a part of the set of institutions, which are engaged in financing rural and agriculture development. The other institutions in this set include the RBI, NABARD, commercial banks and regional rural banks, cooperative banking is small-scale banking carried on a no profit, no loss basis for mutual cooperation and help. Cooperative banks were assigned the important role of delivering of fruits of economic planning at the grass roots level. Cooperative banking structure is viewed as a vehicle for democratization of the Indian financial system. They were conceived to supplant moneylender and indigenous bankers by providing adequate short-term and long term institutional credit at reasonable rates of interest.

Cooperative banks originated with enactment of the Cooperative Credit Societies Act of 1904. A new Act was passed in 1912, which provided for the establishment of the cooperative central banks by a union of primary credit societies, or by a union of primary credit society and individuals. After 1991, a number of reforms have taken place under which licensing of UCBs (Urban Cooperative Banks) has been liberalized greatly, lending and deposit rates of all cooperative banks have been completely freed or deregulated, a cooperative development fund has been set up by NABARD for improvement of managerial systems and skills. UCBs have been allowed to invest in equity/bonds of all India Financial Institutions, PSUs, UTI, CDs of scheduled commercial banks subject to certain ceilings.

3.5 Summary

This unit examines the structure of the banking industry in India. Banks in India are organized as commercial banking institutions and cooperative banking societies. Commercial banks are owned by the public sector, private sector and foreign banks. The public sector banks dominate the banking industry both in terms of volumes and reach of branches. The cooperative banking segment of Indian banking is small in comparison to the commercial banking segment. It is also plagued by poor performance. However, it has an important place as a provider of banking services to smaller sections of the society.

This unit also provides an overview of the statutory framework for banking in India. The Banking Regulation Act, 1949 is the most important legislation for banks in India. This act lays down the definition of banking and allowable banking activities. It also gives the RBI wide-ranging regulatory power to control banks in India starting from their licensing.

3.6 Self Assessment Questions

1. Define the structure of Indian Banking System.
2. Describe the structural and operational changes in Indian Banking System after Independence.
3. What were the reasons to initiate banking sector reforms?
4. Explain the salient feature of reforms during Phase I.
5. Give a detailed account of the deferent types of banking institutions all of which constitutes for Indian Banking System.

3.7 Books for Further Readings

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Unit - 4 : Reserve Bank of India

Structure of Unit:

4.0 Objectives

After completing this unit, you would be able to:

- Understand what is central banking;
- Know about the organisation of RBI;
- Point out various functions of RBI;
- Know about various objectives of RBI;
- Learn and appreciate the role of RBI in economic development;
- Understand the regulatory and promotional role of RBI.

4.1 Introduction

Central Bank is an apex financial institution of a country. It is needed to regulate and control the monetary system of an economy. The need for a central bank in India was felt during 18^{th} century. The earliest attempts to set up a central bank dates back to 1773 when Warren Hastings recommended to establish the "General Bank of Bengal and Bihar" as Central Bank of India. In 1913 Lord Keynes also recommended to set up a Central Bank. Later on in 1921, by amalgamating three presidency Banks (Presidency Bank of Bengal, Presidency Bank of Madras and Presidency Bank of Bombay), Imperial Bank of India was set up. Though Imperial Bank of India performed certain central banking function, but the right of Note issue was not given to Imperial Bank of India and Government of India performed the function of credit control. The establishment of a Central Bank that would issue notes and at the same time function as banker to the Government was recommended in 1926 by the Royal Commission in India Currency and Finance (known as the Hilton Young Commission). In 1931, Central Banking inquiry committee also recommended for setting up of a Central Bank in India.

In 1933, the "Round Table Conference" also suggested to set up a Central Bank free from political influence. As a result of all these recommendations and suggestions, a fresh bill was passed by the assembly on December 22, 1933 and got Governor General Ascent on March 6, 1934. Thus the Reserve Bank of India started working since, 1^{st} April, 1935 in accordance with the provision of the Reserve Bank of India Act, 1934.

The pattern of central banking in India was based on the Bank of England. England has a highly developed banking system in which the functioning of the central bank as a banker's bank and their regulation of money supply set the pattern. The central bank's function as 'lender of last resort' was on the condition that the banks maintain stable cash ratios as prescribed from time to time. The effective functioning of the British model depends on an active securities market where open market operations can be conducted at the discount rate. The effectiveness of open market operations however depends on the member bank's dependence on the central bank and the influence it wields on interest rates. Later models, especially those in developing countries showed that central banks play an advisory role and render technical services in the field of foreign exchange, foster the growth of a sound financial system and act as a banker to government.

4.2 What is Central Banking?

The central bank of the country is the Reserve Bank of India (RBI). It was established in April 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

Meaning

Reserve Bank of India is the central bank of the country which was nationalised in the year 1949. It is an apex institution which has been guiding, monitoring, regulating, controlling and promoting the destiny of IFS since its inception. It is oldest among the central banks in the developing countries.

The Central Bank differs from other financial institutions. First, it differs in that it is controlled by the people who are more or less closely connected with other organs of government. Second, it does not exist to secure the maximum profit, which is the principal aim of a commercial bank. Third, the central bank must have a special relation with the commercial banks whereby it may influence the operations of these institutions in the implementation of the government's economic policy.

The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank.

The Bank was constituted for the need of following:

- To regulate the issue of banknotes
- To maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

Organisation

The affairs of the RBI are controlled by the Central Board of Directors, consisting of the following members:

1) One Governor and not more than four Deputy Governors appointed by the Central Government for 5 years.
2) Four Directors nominated by the Central Government. One each from local boards. The term of their office is related to their membership in the local boards.
3) Three other directors, nominated by the central government. These directors hold office for four years and there is a provision in the Act for their retirement by rotation.
4) One government official

Besides the control board there are local boards for four regional areas of the country with headquarters at Mumbai, Kolkata, Chennai and New Delhi. Local Board consists of 5 members. These members are appointed for period of 4 years. They must represent as far as 18 possible territorial and economic interests of co-operative and indigenous banks.

The internal organisational set up of the Bank has been modified and expanded from time to time in order to cope with the increasing volume and range of Bank's activities. In order to perform its various functions, the Bank has been divided and sub divided into a large number of departments. Apart from banking and issue departments, there are at present 20 departments and three training establishments at the central office of the bank.

Functions

The Reserve Bank of India Act of 1934 entrust all the important functions of a central bank the Reserve Bank of India.

1. Issuing Authority: Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right or authority or monopoly of issuing currency notes other than one rupee notes and coins and coins of smaller denominations. Although one rupee coins and notes and coins of smaller denominations are issued by the Government of India, but put into circulation only through RBI. The currency notes issued by the Bank are legal tender everywhere in India. Apart from issuing currency and withdrawing it from circulation, it also exchanges notes and coins of one denomination into those of other denominations as demanded by public. RBI also makes adequate arrangements for holding and distributing the currency notes and coins which ensure its complete and uniform control over the credit and currency system of the economy. RBI issue ntoes against the security of gold coins and gold bullion, foreign securities, government securitiesand bills of exchange and promissory notes. The affairs of the bank relating to note issue and its general banking business are conducted through two separate departments, the Issue and Banking Department.

The Issue Department is liable for the aggregate value of currency notes of Government of India and the currency notes of the Reserve Bank in circulation and it maintains eligible assets for equivalent value. It is responsible for getting its periodical requirements of notes printed from the currency presses of the Government of India, distribution of currency among the public and withdrawal of unserviceable notes and coins from circulation. The Issue Department deals directly with the public in exchange of currency for coins and vice versa and exchange of notes of one denomination for another.

The expansion and contraction of currency in circulation is affected through the Banking Department. Cash deposits and withdrawals by scheduled banks are handled by the Banking Department. The Banking Department replenishes its currency when necessary from the Issue Department against transfer of eligible assets. Similarly, surplus cash is returned to the Issue Department in exchange for equivalent assets.

Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The remaining three-fifths of the assets might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-war period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Ra. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

2. Banker of Government: The second important function of the Reserve Bank of India is to act as banker to the Government of India statutorily and to state governments by virtue of agreements entered into with them. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. It is not entitled to any remuneration for these services.

In addition to these ordinary banking operations the Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The RBI is entitled to charge a commission for these activities. Under public debt management the RBI manages deficit/ surplus in the central and state government by providing money to fill the gap between receipts and payments. It is done in the following ways:

1. For Central Government: The deficit/ surplus in the central government account with the RBI are managed by the creation/ cancellation of ad-hoc treasury bills which are held in the Issue Department and hence the budget deficit/ surplus is monetised.

2. For State Government: The gap between receipts and payments of state governments is by 'ways and means advances'. These advances are of three types:

- Normal/ clean advances which are without any collateral security.
- Secured advances are against the pledge of the central government securities.
- Special advances are granted at the discretion of RBI.

The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. In addition to ways and means advances, the state government also heavily use overdrafts from the RBI. RBI is involved in underwriting government securities. It acts as a principal and as an agent in securities market. It acts as adviser to the Government on all monetary and banking matters.

3. Bankers' Bank and Lender of the Last Resort or Father of Banks: The Reserve Bank of India acts as the bankers' bank. The RBI controls the volume of reserves of the banks and determines their deposit credit creation ability. The banks hold all/ a part of their reserves with the RBI and in times of need, they borrow from the RBI.

According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilities and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

4. Controller of Credit: The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business within India, the licence can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

a) It holds the cash reserves of all the scheduled banks.

b) It controls the credit operations of banks through quantitative and qualitative controls.

c) It controls the banking system through the system of licensing, inspection and calling for information.

d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

5. Custodian of Foreign Reserves: The RBI maintains the external value of the rupee through the regulation of foreign exchange market coupled with domestic policies. In the external sector, the task of RBI has following dimensions:

- To administer 'foreign exchange control'.
- To choose the exchange rate system and fix or manage the exchange rate between the rupee and other currencies.
- To manage exchange reserves.
- To interact with monetary authorities of other countries and with the international financial institutions such as IMF and World Bank.

The RBI administers the exchange control according to the Foreign Exchange Maintenance Act (FEMA) to primarily regulate the demand for foreign exchange within the limits of available supply. The controls are administered through the authorised foreign exchange dealers. In the pre-liberalisation era, the exchange rate of rupee was fixed in terms of 'basket of currencies'. But after the early nineties, as the rupee became fully convertible on current account, the rate has been market related. The controls on foreign exchange are being gradually relaxed. As the custodian of the foreign exchange reserves, the RBI also sees to the investment and utilisation of foreign exchange reserves in the most advantageous manner.

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at lsh.6d. Though there were periods of extreme pressure in favour of or against the rupee. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the I.M.F.

Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

6. Supervisory Functions: To promote a sound and effective banking system, the RBI is vested with wide ranging powers to supervise and control banks. The main powers are:

- To issue licences for the establishment of new banks.
- To issue licences for setting up of bank branches.
- To prescribe for banks, the minimum requirements regarding capital and resources, the transfer of reserve fund and maintenance of cash reserve and other liquid assets.

- To inspect the organisational set up: branch expansion, mobilisation of deposits, investments, credit portfolio management, region wise performance, profit planning, manpower planning, training and so on regarding banks.
- To investigate into complaints, irregularities and fraud in respect of banks.
- To check improper investments and injudicious advances by the banks.
- To control appointment, re-appointment, termination of chairman/ chief executive officer of private sector banks.
- To approve/ force amalgamation.

7. Promotional Functions: With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialised financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962, the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilise savings, and to provide industrial finance as well as agricultural finance.

As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

8. Monetary Planning and Control Functions: The RBI regulates the availability, cost and terms and conditions of credit in the market. It aims at regulating and controlling the money supply as per the requirements of the economy and the monetary policy.

Activity A:

1. RBI is an apex institution which has been guiding, monitoring, regulating, controlling and promoting the destiny of IFS since its inception. Elaborate.

4.3 Objectives of RBI

The Reserve Bank of India Act, 1934 sets out the objectives of the Reserve Bank:

"...to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

The formulation, framework and institutional architecture of monetary policy in India have evolved around these objectives – maintaining price stability, ensuring adequate flow of credit to sustain the growth momentum, and securing financial stability.

The responsibility for ensuring financial stability has entailed the vesting of extensive powers inand operational objectives for the Reserve Bank for regulation and supervision of the financial system and its constituents, the money, debt and foreign exchange segments of the financial markets in India and the payment and settlement system. The endeavour of the Reserve Bank has been to develop a robust, efficient and diversified financial system so as to anchor financial stability and to facilitate effective transmission of monetary policy. In addition, the Reserve Bank pursues operational objectives in the context of its core function of issuance of bank notes and currency management as well as its agency functions such as banker to Government (Centre and States) and management of public debt; banker to the banking system including regulation of bank reserves and the lender of the last resort.

The specific features of the Indian economy, including its socio-economic characteristics, make it necessary for the Reserve Bank to operate with multiple objectives. Regulation, supervision and development of the financial system remain within the legitimate ambit of monetary policy broadly interpreted in India. The role of communication policy, therefore, lies in articulating the hierarchy of objectives in a given context in a **transparent** manner, emphasising a **consultative approach** as well as **autonomy** in policy operations and **harmony** with other elements of macroeconomic policies.

RBI functions within the framework of a mixed economic system. Main objectives of RBI are:

- To maintain monetary stability so that the business and economic life can deliver welfare gains of a properly functioning mixed economy.
- To maintain financial stability so that the monetary stability can be safely pursued and economic units can conduct their business with confidence.
- To maintain stable payment system so that financial transactions can be safely and efficiently executed.
- To promote the development of financial infrastructure of markets and systems and to enable it to operate efficiently.
- To ensure that credit allocation by the financial system broadly reflects the national economic priorities.
- To regulate the overall volume of money and credit in the economy with a view to ensure a reasonable degree of price stability.
- To establish monetary relations with other countries of the world and international financial institutions.

Activity B:

1. Discuss various objectives of Reserve Bank of India?

4.4 Role of RBI in Economic Development

Reserve Bank of India or RBI happens to be the first and foremost monetary authority in the dominion of India and with the exception of this attribute, it does act in the role of bank of the national and state governments. RBI is known to formulate, implement and keep tabs on the monetary policy and it also has to make certain the sufficient flow of credit to productive sectors.

In 1994, the finance minister said that if the government fails to keep control over its deficit the Reserve Bank would be free to dump adhoc treasury bills on the market at the going rate of interest and making the government pay the market related interest on the outstanding debt. This means a rise in interest expenditure and a further rise in the fiscal deficit. But this does not mean that the Reserve bank of India is fully free in formulating and implementing monetary policy. There are two reasons for this. In the first place, the banking system has to adhere to the policy of mandated lending and the structure of administered interest rates; in the second place, there is not yet legislative backing for guaranteeing the independence of the Reserve Bank as in the case with the US Federal Reserve Board [the FED] and the West German Budes Bank [BUBA].

After decades of resistance to international economic integration, India has recently made significant progress in liberalizing trade and access to foreign investment, beginning in 1993. These policy changes reflect widespread concern that Indians past inward orientation inhibited economic growth, especially in comparison with the developing countries of East Asia. The acceptance of economic liberalization and reform has allowed the relaxation of restrictions on foreign direct investment and inward portfolio capital flows. India retains tight controls on outward portfolio capital flows, restricting the access of residents to foreign capital markets and domestic markets in foreign currency-denominated securities. The relaxation of these controls and further liberalization of the capital account remain controversial policy issues for India. For convenience the role of RBI on the economy of India has been dealt under the three areas:

a) RBI on Forex Reserves
b) RBI on Corporate Debt Restructuring
c) RBI on Banking

a) RBI on Forex Reserves

Foreign exchange reserves play an irreplaceable role in many emerging economies. The central, or reserve, bank creates and then uses domestic money to buy foreign exchange. If a central bank creates more domestic money, it can buy more foreign exchange. It does not have to pump iron to build reserves. It does not have to sweat it out. It has to merely pump domestic money into the domestic economy and coolly build foreign exchange reserves. The creation of foreign exchange reserves is wholly a white-collar job.

The Reserve Bank of India (RBI) undertook a review of the main policy and operational matters relating to management of the reserves, including transparency and disclosure and decided to compile and make public half-yearly reports on management of foreign exchange reserves for bringing about more transparency and also for enhancing the level of disclosure in this regard. These reports are being prepared with reference to positions as of 31st March and 30th September each year, with a time lag of about 3 months. The reports talk about the report is a compilation of quantitative information with regard to external reserves, such as, level of foreign exchange reserves, sources of accretion to foreign exchange reserves, external liabilities vis-à-vis foreign exchange reserves, prepayment/repayment of external debt, Financial Transaction Plan (FTP) of IMF, adequacy of reserves, etc.

Adequacy of Reserves: Adequacy of reserves has emerged as an important parameter in gauging its ability to absorb external shocks. With the changing profile of capital flows, the traditional approach of assessing reserve adequacy in terms of import cover has been broadened to include a number of parameters which take into account the size, composition and risk profiles of various types of capital flows as well as the types of external shocks to which the economy is vulnerable. The High Level Committee on Balance of Payments, which was chaired by Dr. C. Rangarajan, erstwhile Governor of Reserve Bank of India, had suggested that, while determining the adequacy of reserves, due attention should be paid to payment obligations, in addition to the traditional measure of import cover of 3 to 4 months.

In 1997, the Report of Committee on Capital Account Convertibility under the chairmanship of Shri S.S.Tarapore suggested four alternative measures of adequacy of reserves which, in addition to trade-based indicators, also included money-based and debt-based indicators. Similar views have been held by the Committee on Fuller Capital Account Convertibility (Chairman: Shri S.S.Tarapore, July 2006). In the recent period, assessment of reserve adequacy has been influenced by the introduction of new measures. One such measure requires that the usable foreign exchange reserves should exceed scheduled amortisation of foreign currency debts (assuming no rollovers) during the following year. The other one is based on a "Liquidity at Risk" rule that takes into account the foreseeable risks that a country could face. This approach requires that a country's foreign exchange liquidity position could be calculated under a range of possible outcomes for relevant financial variables, such as, exchange rates, commodity prices, credit spreads etc. Reserve Bank of India has done exercises based on intuition and risk models in order to estimate "Liquidity at Risk (LAR)" of the reserves. The traditional trade-based indicator of reserve adequacy, viz, import cover of reserves, which fell to a low of 3 weeks of imports at end-December 1990, rose to 11.5 months of imports at end-March 2002 and increased further to 14.2 months of imports or about five years of debt servicing at end-March 2003. At end-March 2004, the import cover of reserves was 16.9 months, which came down to 14.3 months as at end-March 2005 and further to 11.6 months as at end- March 2006. The import cover for reserves was 12.4 months at end-March 2007. The ratio of short-term debt to foreign exchange reserves declined from 146.5 per cent at end-March 1991 to 5.3 per cent as at end-March 2005, but increased slightly to 5.7 per cent as at end-March 2006 and further to 6.0 per cent at end-March 2007. The ratio of volatile capital flows (defined to include cumulative portfolio inflows and short-term debt) to reserves declined from 146.6 per cent as at end-March 1991 to 35.2 per cent as at end-March 2004. However, this ratio increased moderately to 36.9 per cent as at end-March 2005 and further to 43.4 per cent as at end-March 2006 and decreased to 38.2 per cent as at end March 2007.

Investment Pattern and Earnings from Foreign Exchange Reserves: The foreign exchange reserves are invested in multi-currency, multi-asset portfolios as per the existing norms, which are similar to international practices in this regard. As at end-March, 2007, out of the total foreign currency assets of US$ 191.9 billion, US$ 53.0 billion was invested in securities, US $ 92.2 billion was deposited with other central banks, BIS & IMF and US$ 46.8 billion was in the form of deposits with foreign commercial banks.

b) RBI on Corporate Debt Restructuring

The objective of the Corporate Debt Restructuring (CDR) framework is to ensure timely and transparent mechanism for restructuring of the corporate debts of viable entities facing problems, outside the purview of BIFR, DRT and other legal proceedings, for the benefit of all concerned. In particular, the framework will aim at preserving viable corporate that are affected by certain internal and external factors and minimize the losses to the creditors and other stakeholders through an orderly and coordinated restructuring programme.

A Special Group was constituted in September 2004 with Smt.S.Gopinath, Deputy Governor, Reserve Bank of India to undertake a review of the Scheme. The Special Group had suggested certain changes / improvements in the existing Scheme for enhancing its scope and making it more efficient. Based on the recommendations made by the Special Group revised draft guidelines on Corporate Debt Restructuring were prepared and circulated among banks for comments. On the basis of the feedback received the draft guidelines have been reviewed and the revised guidelines on CDR mechanism

The major modifications made in the existing CDR mechanism relate to

a) Extension of the scheme to entities with outstanding exposure of Rs.10 crore or more

b) Requirement of support of 60% of creditors by number in addition to the support of 75% of creditors by value with a view to make the decision making more equitable

c) Discretion to the core group in dealing with wilful defaulters in certain cases other than cases involving frauds or diversion of funds with malafide intentions.

d) Linking the restoration of asset classification prevailing on the date of reference to the CDR Cell to implementation of the CDR package within four months from the date of approval of the package.

e) Restricting the regulatory concession in asset classification and provisioning to the first restructuring where the package also has to meet norms relating to turn-around period and minimum sacrifice and funds infusion by promoters.

f) Convergence in the methodology for computation of economic sacrifice among banks and FIs

g) Limiting RBI's role to providing broad guidelines for CDR mechanism

h) Enhancing disclosures in the balance sheet for providing greater transparency

i) Pro-rata sharing of additional finance requirement by both term lenders and working capital lenders

j) Allowing OTS as a part of the CDR mechanism to make the exit option more flexible and

k) Regulatory treatment of non-SLR instruments acquired while funding interest or in lieu of outstanding principal and valuation of such instruments.

c) RBI on Banking

Though the RBI, as part of its monetary management mandate, had, from the very beginning, been vested with the powers, under the RBI Act, 1934, to regulate the volume and cost of bank credit in the economy through the instruments of general credit control, it was not until 1949 that a comprehensive enactment, applicable only to the banking sector, came into existence. The Banking Regulation Act from March 1966. The Act vested in the Reserve Bank the responsibility relating to licensing of banks, branch expansion, and liquidity of their assets, management and methods of working, amalgamation, reconstruction and liquidation. Important changes in several provisions of the Act were made from time to time, designed to enlarge or amplify the responsibilities of the RBI or to impart flexibility to the relative provisions, commensurate with the imperatives of the banking sector developments.

Branch Authorisation Policy

The RBI announced a new Branch Authorisation Policy in September 2005 under which certain changes were brought about in the authorisation process adopted by the RBI for the bank branches in the country. As against the earlier system, where the banks approached the RBI, piece meal, throughout the year for branch authorisation, the revised system provides for a holistic and streamlined approach for the purpose, by granting a bank-wise, annual aggregated authorisation, in consultation and interaction with each applicant bank. The objective is to ensure that the banks take an integrated view of their branch- network needs, including branch relocations, mergers, conversions and closures as well as setting up of the ATMs, over a one-year time horizon, in tune with their own business strategy, and then approach the RBI for consolidated annual authorisations accordingly.

Operations of Foreign Banks in India

At present, there are 29 foreign banks operating in India with a network of 273 branches and 871 off-site ATMs. Among some circles, a doubt is sometimes expressed as to whether the regulatory environment in India is liberal in regard to the functioning of the foreign banks and whether the regulatory approach towards foreign participation in the Indian banking system is consistent with liberalized environment. Undoubtedly, the facts indicate that regulatory regime followed by the Reserve Bank in respect of foreign banks is non-discriminatory, and is, in fact, very liberal by global standards. Here are a few facts which bear out the contention;

India issues a single class of banking licence to foreign banks and does not require them to graduate from a lower to a higher category of banking licence over a number of years, as is the practice followed in certain other jurisdictions. This single class of licence places them virtually on the same footing as an Indian bank and does not place any restrictions on the scope of their operations. Thus, a foreign bank can undertake, from the very first day of its operations, any or all of the activities permitted to an Indian bank and all foreign banks can carry on both retail as well as wholesale banking business. This is in contrast with practices in many other countries.

No restrictions have been placed on establishment of non-banking financial subsidiaries in India by the foreign banks or of their group companies. Deposit insurance cover is uniformly available to all foreign banks at a non-discriminatory rate of premium. In many other countries there is a discriminatory regime. The prudential norms applicable to the foreign banks for capital adequacy, income recognition and asset classification, etc., are, by and large, the same as for the Indian banks. Other prudential norms such as those for the exposure limits, investment valuation, etc., are the same as those applicable to the Indian banks. Unlike some of the countries where overall exposure limits have been placed on the foreign-country related business, India has not placed any restriction on the kind of business that can be routed through the branches of foreign banks. This has been advantageous to the foreign bank branches as the entire home-country business is generally routed through these branches.

Substantial FII business is also handled exclusively by the foreign banks. In fact, some Indian banks contend that certain amount of positive discrimination exists in favour of foreign banks by way of lower Priority Sector lending requirement at 32 per cent of the adjusted net bank credit as against a level of 40 per cent required for the Indian banks. Unlike in the case of Indian banks, the sub-ceiling in respect of agricultural advances is also not applicable to foreign banks whereas export credit granted by the foreign banks can be reckoned towards priority sector lending obligation, which is not permitted for the Indian banks.

Notably, in terms of our WTO commitment, licences for new foreign banks may be denied when the share of foreign banks' assets in India, including both on- as well as off-balance-sheet items, in the total assets (including both on- and off-balance-sheet items) of the banking system exceeds 15 per cent. However, we have autonomously not invoked this limitation so far to deny licences to the new foreign banks even though the actual share of foreign banks in the total assets of the banking system, including both on- and off-balance-sheet items (on Notional Principal basis), has been far above the limit. This share of foreign banks stood at 49 per cent, as at end-January 2007, as mentioned in the India's Trade Policy Review, 2007

Securitisation Guidelines of the RBI

The RBI had first issued the draft guidelines for securitisation of standard assets in April 2005, for public comments and after an extensive consultative process; the final guidelines were issued in February 2006, in order to facilitate an orderly development of this market. In certain quarters, however, a view has been expressed that these guidelines, tend to negate the benefits envisaged in the very concept of securitisation, and thus, are hindering the growth of securitisation market in the country. Let me attempt to briefly present today the international perspective vis-à-vis RBI guidelines and the thinking and rationale underlying our formulation.

The independence of the Reserve Bank holds the key to effective monetary control. An independent Reserve Bank can hold out threat of a high rate of interest on Government borrowing if the Government indulges in fiscal excesses. As the high rate interests retard the rate of economic growth and adversely affect the chances of the politicians' re-election they behave more responsibly than they otherwise would.

Activity C:

1. RBI is known to formulate, implement and keep tabs on the monetary policy and it also has to make certain the sufficient flow of credit to productive sectors. Discuss.

4.5 Summary

The Central Bank is the apex monetary institution in the money market which acts as the monetary authority of the country, and serves as the government bank as well as the banker's bank. It undertakes the major financial operations of the government; by its conduct of these operations and by other means, it influences the behaviour of financial institutions to ensure that they support the economic policy of the government. The primary focus of the RBI in conduct of money market operations is on ensuring that the liquidity and short-term interest rates are maintained at levels consistent with the monetary policy objectives of maintaining price stability, ensuring adequate flow of credit to productive sectors of the economy and bringing about orderly cinditions in the foreign exchange market.

4.6 Self Assessment Questions

1. What do you mean by "Central Banking". Explain in detail.
2. Discuss the organisation of Reserve Bank of India?
3. What are the various functions of Reserve Bank of India?
4. Write short note on following:
   (i) Ways and means advances
   (ii) Banker's Bank
5. Discuss various objectives of Reserve Bank of India?
6. "Central Bank is an apex financial institution of the country". Elaborate
7. Examine the role played by Reserve Bank of India in our economy.

4.7 Books for Further Readings

- Khan M.Y. (2007); 'Indian Financial System'? Tata Macgraw Hill, Fifth edition.
- Machiraju H R (2009); Indian Financial System', Vikas Publishing House Private Limited, Fifth edition.
- Srivastava R M, Nigam Divya (2009); 'Management of Financial Institutions', Himalaya Publishing House Private Limited, Seventh edition.
- Vashisth V.K., Swami H.R., & Gupta B.P. (2008); 'Banking and Finance', Himalaya Publishing House Private Limited, Fourth edition

Unit - 5 : Methods of Credit Control

Structure of Unit:

5.0 Objectives

After completing this unit, you would be able to:

- Understand what is credit control;
- Know about the objectives of credit control;
- Know about various methods of credit control;
- Understand the qualitative methods of credit control;
- Understand the quantitative methods of credit control.

5.1 Introduction

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business within India, the licence can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

5.2 What is Credit Control?

Meaning

Credit control is a very important function of RBI as the Central Bank of India. For smooth functioning of the economy RBI control credit through quantitative and qualitative methods. Thus, the RBI exercise control over the credit granted by the commercial bank. Detail of this has been discussed as a separate heading.

The reserve Bank is the most appropriate body to control the creation of credit in view if its functions as the bank of note issue and the custodian of cash reserves of the member banks. Unwarranted fluctuations in the volume of credit by causing wide fluctuations in the value of money cause great social & economic unrest in the country. Thus, RBI controls credit in such a manner, so as to bring 'Economic Development with stability'. It means, bank will accelerate economic growth on one side and on other side it will control inflationary trends in the economy. It leads to increase in real national income of the country and desirable stability in the economy.

Objectives

The RBI regulates the availability, cost and terms and conditions of credit in the market. It aims at regulating and controlling the money supply as per the requirements of the economy and the monetary policy. The various objectives of credit control are as follows:

- To obtain stability in the internal price level.
- To attain stability in exchange rate.
- To stabilize money market of a country.
- To eliminate business cycles-inflation and depression-by controlling supply of credit.
- To maximize income, employment and output in a country.
- To meet the financial requirements of an economy not only during normal times but also during emergency or war.
- To help the economic growth of a country within specified period of time. This objective has become particularly necessary for the less developed countries of present day world.

Activity A:

1. Discuss credit control and various objectives of credit control.

5.3 Methods of Credit Control

The methods of credit control are usually categorized into (1) General (or quantitative) methods, and (2) Selective (or qualitative) methods. The Bank Rate Policy, variable reserve requirements, statutory liquidity requirement, and open market operations policy fall in the category of general credit control methods. The various directives issued by the Reserve Bank restricting the quantum and other terms of granting credit against certain specified commodities constitute the selective control method.

The main difference between the general and selective credit control methods is that the former influence the cost and overall volume of credit granted by banks. They affect credit related to the whole economy whereas the selective controls affect the flow of credit to only specified sector of the economy, wherein speculative tendency and rising trend of prices, due to excessive bank credit, is noticed.

The general credit control measures affect the (1) cost, and (2) availability (or quantum) of bank credit. The cost of credit is influenced by the Bank Rate at which the central bank provides refinance to the banks. In the past years, the Reserve bank had relied upon its powers to regulate the interest rates of bank advances and directly regulated the interest rates of banks rather than through the instruments of Bank Rate. Now the interest rates are largely deregulated.

The overall quantum of credit created by banks depends on their cash reserves, comprising cash in hand and balances with the Reserve Bank. The cash reserves increase through (1) a rise in deposit sources of banks, (2) borrowings from the Reserve Bank, or (3) by sale of their investments. Regulation of credit by the Reserve Bank means regulations of the quantum of cash reserves of commercial banks. These control measures exert their influence on the assets pattern of commercial banks. When the reserve Bank desires to control, it adopts various methods whereby the quantum of refinance is restricted and the flow of bank resources to investments and statutory reserves with the Reserve Bank is enhanced, thereby curtailing the availability of loan-able resources with the bank.

Refining Policy of Reserve Bank:

As the central bank of the country, the Reserve bank is the lender of last resort to the banking system. Its refinancing policy, therefore, has great significance to the commercial banks. Changes in this policy are carried out in two ways:

1. By varying the cost of borrowings through a variation in its Bank Rate, and
2. By varying the availability (i.e. quantum) of credit to the banks.

The Bank Rate Policy:

Section 49 of the Reserve Bank of India Act, 1934, defines Bank Rate as the standard rate at which it (the Reserve bank) is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase under this Act. As the provision regarding rediscounting of bills by the Reserve Bank had remained inoperative for a long time in the past, the rate charged by Reserve Bank on its advances to banks has been treated as the Bank Rate.

A change in the Bank Rate – upward or downward — usually has an immediate effect on the costs of credit available to the commercial banks from the central bank. A high Bank rate is intended to raise the cost of Reserve Bank accommodation to banks, which in turn raises their own lending rates to the borrowers. Discouraged by high rate of interests, the borrowers consequently reduce the level of their borrowings from the banks which in turn bring down the level or re-finance secured by them from the central bank. Thus a high Bank rate is intended to result in contraction of bank credit.

Theoretically, the Bank rate happens to be prime rate – it is a pace setter to all other rates of interests in money market, i.e all other rates of interest generally move in the same direction in which then Bank rate moves. When the central bank intends to follow the policy of high cost of money, it raises the Bank rate first, which is followed by rise in all other rates of interest. Such a policy is called the policy of dear money. The objective of such a policy happens to make money scarce and costly so as to restrict its use to the deserving purposes only.

Methods and Instruments of Credit Control:

There are many methods of credit control. These methods can be broadly divided into two categories:

I. Quantitative or General Methods.

II. Qualitative or Selective Methods.

The quantitative methods of credit control aim at influencing the quantity or total volume of credit in an economy during a particular period of time. The qualitative methods of credit control aim at influencing the quality of use of credit with respect to a particular area or field of activity.

Quantitative system of credit control includes following instruments :

1) Bank Rate

2) Open Market Operation (OMO)

3) Cash Reserve Ratio (CRR)

4) Statutory Liquidity Ratio (SLR)

5) Repo and Reverse Repo Rate

Qualitative system consist of the following instruments :

1) Selective Credit control
2) Rationing of Credit
3) Moral Persuasion
4) Publicity
5) Direct Action

5.3.1 Quantitative Methods of Credit Control

1. Bank Rate:

Bank rate is the rate at which central bank grant loans to the commercial banks against the security of government and other approved first class securities. According to section 49 of RBI Act, "Bank rate is the standard rate on which RBI purchase or discount such exchange bills or commercial papers which can be purchased under this act." Reserve Bank of India controls credit by affecting quantity and cost of credit money through its bank rate policy. But this method of credit control would be effective only when there is organized money market and commercial banks depend on reserve bank for their credit.

Reserve Bank adopts cheap or Dear Monetary Policy according to the economic conditions of the country. RBI decreases bank rate to increase the quantity of the credit. This is called cheap monetary policy. Decease in bank rate decreases costs of credit i.e. decrease in interest rate. As a result of this quantity of credit increases. According to dear monetary policy of RBI increases bank rate to decrease quantity of credit in the country. Increase in bank rate increases cost of credit i.e. increase interest rate and this will result in decrease in quantity of credit.

Operation of Bank Rate Policy in India: At the time of establishment of RBI the bank rate was 3.5% which had changed time to time. Till 1951, the bank rate was constant at 3% as Reserve Bank followed Cheap Money Policy during this period.

Since 1951 till now bank rate has continuously changing. In 1991 at the time of higher inflation, bank rate has changed twice and increased from 10% to 11%. On 29 April, 1998, it has reduced from 11% to 9%. It was further reduced to 8% in march, 1999 and 7% in April,2000. it was further reduced to 8% in march,1999 and 7% in April,2000. it was further changed several times and on 23 October, 2001 it reduced to 6.5%.Now

The bank rate policy of credit control has not been succeeding in India. As it is failed to control inflationary trend in the economy. It has failed to influence interest rate in the money market.

The bank rate policy proves inefficient due to following reasons :

- Major part of the credit in the market is made available by non-banking institutions. The interest charged by these institutions have no direct relation with the bank rate.
- Most of the changes in bank rate has been made effective for combating inflationary trends
- Speculative tendencies in the economy carry large premiums in the form of huge margins of profit. A small change in bank rate does not significantly affect the profit margin.
- Priority sector leading has almost become immense to the effect of changes in the bank rate.
- Increasing non-dependence of commercial banks on the central bank for rediscounting facilities is one of the ineffective bank rates in India. Though the bank rate policy has not been effective in

India. Yet the Reserve Bank has been using it more and more as a weapon to control deflationary pressure in the economy.

During the last few years, the bank rate has been reduced several times to combat the deflationary pressures in the economy. But this year it is currently stipulated at 6%.

2. Open Market Operations:

The term 'Open market operation' implies the purchase and sale by the Central Bank not only the Govt. securities but also of other eligible papers. Like bills and securities of private concerns section 17(8) of RBI Act. Empowers Reserve Bank to purchase the securities of central Govt. state Govt. and other autonomous institutions. Apart from this section 17(2)(A) empower Reserve Bank to purchase or sell of short term bills.

Open market operations are used as supporting instrument of bank rate. This method is used to influence the flow of credit. Sale and purchase of Govt. securities influence the cash reserve ratio with the commercial banks and hence these operations control their credit creation power. These operations will have both anti-inflationary and anti-deflationary effects. When the economy is faced with the inflationary pressures, the central bank would like the commercial banks to contract the supply of credit. To achieve this objective the central bank would sell the Govt. securities to the commercial banks. The banks would transfer a part of their cash reserve to the central bank towards the payment for these securities. Consequently the cash reserve with the commercial banks will be reduced. It would lead to a contraction in the credit creation power of the commercial banks. Similarly, open market operations can also be used as anti-deflationary measures. In this situation, the central bank will purchase securities from the commercial banks. In this situation, the central bank will purchase securities from the commercial banks. In the process, the cash reserves with the commercial banks will increase and they would be enabled to create more credit.

The open market operations in India are limited by Reserve Bank. The bank has used this policy only to make successful government debt policy and to maintain price stability of Govt. securities. It is used to fulfill seasonal credit requirements of commercial banks. The multiple objectives of open market operations are as follows:

a. To support government's borrowing plans.
b. To smoothen the seasonal flow of funds in the market.
c. To control the amount of bank credit available in the market by affecting the reserve base of the banks.
d. To affect cost of funds in the market as an increase/ decrease in money supply affects the cost of funds in the market.
e. To reduce government's liability by purchasing securities sold at a higher interest rate and subsequently selling fresh securities at a lower rate. This activity is significant especially in case of declining interest rates.

3. Cash Reserve Ratio (CRR):

The present banking system is called a 'fractional reserve banking system', because the banks need to keep only a fraction of their deposit liabilities in the form of liquid cash. "Cash reserve ratio refers to the cash which banks have to maintain with the RBI as a certain percentage of their demand and time liabilities." Originally the objective was to ensure safety and liquidity of bank deposits. But over years it has emerged as an effective tool of directly regulating the lending capacity of the banks i.e., as an instrument of the monetary policy. RBI has the power to impose penal interest rates on the banks in case of a shortfall in the prescribed CRR. The penal rate is generally higher than the bank rate and it increases if the default is prolonged. RBI can also disallow any fresh access to refinance in such cases.

The RBI controls credit through change in Cash Reserve Ratio of commercial banks. According to section 42(1) of RBI Act every schedule bank has to maintain a certain percentage reserve of its time and demand deposits. This ratio can be varied from 3% to 15% as directed by the Reserve Bank. Reserve Bank itself changed this ratio according to the credit requirement of the economy. It has been changed several times in the history of Reserve Bank of India. The cash reserve ratio affects on the lend able funds of commercial banks. If this ratio increases the credit creation capacity of commercial banks decreases. On the other hand if this ratio decreases the credit creation capacity of commercial banks increases.

On 17 April 2008, the Reserve Bank of India hiked the cash reserve ratio of scheduled commercial banks, regional rural banks, scheduled state co-operative banks and scheduled primary (urban) co-operative banks by 50 basis points to 8 per cent in two stages effective 26 April 2008 and 10 May 2008.

The monetary authority stated that as a result of the above increase in CRR on liabilities of the banking system, an amount of about Rs.18,500 crore of resources of banks would be absorbed. In this context, it may be noted that surplus liquidity in the banking system amounted to Rs.2,43,566 crore as on 4 April 2008. The Reserve Bank's move comes at a time when there are only 12 days left for its monetary policy. The monetary policy is due to be announced on 29 April 2008.The hike in the cash reserve ratio of banks is a measure aimed at reducing liquidity in the banking system thereby reducing the money supply which in turn is expected to help curb inflation. The CRR hike will put margins of banks under a bit of a pressure since they won't be earning anything on the money that they park with the RBI as cash reserve. The CRR hike will put margins of banks under a bit of a pressure since they wont be earning anything on the money that they park with the RBI as cash reserve.

On 29 April 2008, the Reserve Bank of India released its annual monetary policy statement for the year 2008-09. It increased the cash reserve ratio for scheduled commercial banks by 25 basis points to 8.25 per cent with effect from 24 May 2008. It was only less than a fortnight ago that the bank had raised the cash reserve ratio. On 17 April, the monetary authority had announced that the CRR would be raised by 25 basis points with effect from 26 April 2008 and by another 25 basis points with effect from 10 May 2008. The two increases announced on 17 April were expected to suck out Rs.18,500 crore from the banking system.

Recently, RBI has hiked the cash reserve ratio (CRR) by 25 basis points to 9 per cent beginning 30 August 2008. The 25 basis points hike in the cash reserve ratio will suck out about Rs.8,000-8,500 crore of liquidity from the banking system.

4. Statutory Liquidity Ratio (SLR):

Under the Banking Regulation Act (sec 24(2A)) as amended in 1962, banks have to maintain a minimum liquid assets of 25 percent of their demand and time liabilities in India. The assets classified as liquid for fulfilling the SLR requirements are: cash in hand, balance in the current account with SBI and its subsidiaries, gold.

Through SLR, the transfer of banking funds takes place to the government, and a corresponding reduction in the credit availability to private industry. It is therefore another instrument of monetary policy. The main objectives of SLR are summarised as:

1. To restrict/ relax the expansion of bank credit.
2. To augment the investment of banks in government securities.
3. To ensure solvency of the banks.

The Reserve Bank of India is empowered to change this ratio. As on 21, 1997, it was fixed to 25% of the total deposits of Banks. It also influences the credit creation capacity of the banks. The effect of bi\both cash reserve ratio and statutory liquidity ratio on credit expansion is similar. Penalties are levied by RBI for not maintaining these ratios from scheduled banks.

5. Repo Rate and Reverse Repo Rate :

There is two kind of repo and are as under :

I. Inter Bank Repo : Such repos are now permitted only under regulated conditions. Repos are misused by banks/brokers during the 1992 securities scam, they were banned subsequently. With the lifting of the ban in 1995, repos were permitted for restricted, eligible participants and instruments. Initially, repo deals were allowed in T-bills and five dated securities on the NSE. With gradual liberalization over the years, all central govt. dated securities, state Govt. security and T-bills of all maturities have been made eligible for repo. Banks and PDs can undertake repo deals if they are routed through the SGL, accounts maintained by the RBI. Repos are allowed to develop a secondary market in PSU bonds, FIs bonds, corporate bonds and private debt securities if they are held in demat form and the deals are done through recognized stock exchange(s). there are no restrictions regarding a minimum period for inter-bank repo deals. Non-bank participants (i.e., FIs and other specified participants) are allowed to participate only in the reverse repo, that is they can only lend money to other eligible participants. The non-bank entities holding SGL accounts with the RBI can enter into reverse repo transactions with banks/PDs, in all Government securities.

II. RBI Repos : The RBI undertakes repo/reverse repo operations with banks and PDs as part of its OMOs, to absorb/inject liquidity. With the introduction of the LAF, the RBI has been injecting liquidity into the system through repo on a daily basis. The repo auctions are conducted on all working days except Saturdays and are restricted to banks and PDs. This is in addition to the liquidity support given by the RBI to the PDs through refinance/reverse repo facility at a fixed price. Auctions under LAF were earlier conducted on a uniform price basis, that is, there was a single repo rate for all successful bidders. Multiple price auction was introduces subsequently. The weighted average cut-off yield in case of a multiple price auction is released top the public. This, along with the cut-off price, provides a band for call money to operate.

The RBI conducts repo auctions to provide banks with an outlet for managing short-term liquidity; even out short-term liquidity fluctuations in the money market; and optimize returns on short-term surplus liquid funds. The RBI has switched over from discriminatory price auction repo to the daily fixed rate repos auction system. Fixed rate repos are single money market rates, bring about orderly conditions in the forex market and impart stability to short-term interest rates by setting a floor for call money rates. The RBI participants actively in the call money market with LAF repos operations conducted throughout the year to modulate the surplus liquidity in thee market. It also conducts reverse repo operations under the LAF to prevent sudden spurts in the call rates. Both repos and reverse repo operations play an effective role in imparting stability to the market.

The repo rate has become akin to a singling rate, together with the B/R. the repo rate serve the purpose of a floor and the B/R, that of a cap for the money market to operate within an interest corridor. With the introduction of variable repo rates and daily repo auctions, a market-determined benchmark is expected to emerge for the call (overnight) rate. As a result of the conversion of the call/money market into a pure inter-bank call/notice money market, the repo rate, along with the B/R and CRR, emerged as an important tool of liquidity and monetary management.

To sum up, the RBI's regulation of money and credit now comprises of (1) the reactivation of OMOs and introduction of repos, (2) the introduction of LAF and its emergence as one of the significant operating instruments, (3) the reactivation of B/R and the use of repo rate, (4) the continuation of the use of the CRR. The B/R changes, combined with changes in the CRR and LAF repo rates have emerged as active and important tools of liquidity and monetary management. The LAF has developed as an effective tool for absorbing/injecting liquidity on a day to day basis in a flexible manner and for providing a corridor for the call money and other money markets.

On 29 July 2008, the Reserve Bank of India increased the repo rate by 50 basis points to 9 per cent. Banks are aggressively using the repo facility of the RBI since the beginning of July. They borrowed almost Rs.38,900 crore per day from the RBI through its liquidity adjustment facility. Therefore the hike in the repo rate by the RBI will surely put some pressure on the cost of funds of banks.

Table 5.1: Policy Rates, Reserve Ratios, Lending, and Deposit Rates as on 16 June, 2011

Bank Rate	6.0%
Repo Rate	7.50%
Reverse Repo Rate	6.50%
Cash Reserve Ratio (CRR)	6.0%
Statutory Liquidity Ratio (SLR)	24.0%
Base Rate	9.25%/ 10.00%
Savings Bank Rate	4%
Deposit Rate	8.25% - 9.10%

5.3.2 Qualitative Methods of Credit Control

Under section 21 of RBI Act, Reserve Bank is empowered to regulate control and direct the commercial banks regarding their loans and advances. Qualitative methods are used to affect the use, distribution and direction of credit. It is used to encourage such economic authorities as desirable and to discourage those which are injurious for the economy. It also helps to prevent speculative holding with the help of bank credit of certain essential commodities like food grain, sugar, cotton and basic raw materials and thereby checking an undue rise in their price. Reserve bank of India from time to time adopted the following qualitative methods of credit control.

1. Selective Credit Control :

Section 36(1) (a) of the Banking Regulation Act, empowers the RBI to contain or prohibit banking companies generally or any banking company. The objective of these controls is to discourage some forms of activities while encouraging others. Such controls are used in respect of agriculture commodities, which are subject to speculative hoarding and wide price fluctuation. Under section 21 of the banking regulation Act, 1949, the Reserve Bank is empowered to issue directives to banking companies regarding making of advances. These directions may be as follows :

- The purpose for which advances may or may not be made.
- Fixing the margin requirements for advances against each commodity.
- Fixing of maximum limit to be advanced by banks to a particular borrower.
- Fixing of rate of interest and other terms for making advances.
- Fixing of maximum guarantees may be given by the banks on behalf of any firm or company.
- Prohibition on grant of credit against book debts and clean credits.

Some of the elative credit controls are as follows :

(a) Differential Discount Rates: The reserve Bank fixes different discounting rates for the bills of different sectors. The sector for which more credit is to be made available the exchange bills re discounted at a lower rate. On the other hand, if RBI wants to discourage credit for a particular sector, it increases the discount rate for bills or the facility for rediscounting is postponed.

(b) Credit Authorization Scheme*:* This scheme was introduced in November 1965 with the objectives of enforce financial discipline on the larger borrowers and ensure that they did not pre-empt scare bank resources. Through this scheme, the RBI regulates not only the quantum but also the term of credit flows. It had following objectives:

- To regulate credit to control inflation.
- To enforce financial discipline on large borrowers.
- To ensure that end use of credit is for genuinely productive purposes.
- To ensure that large borrowers do not monopolise scarce bank credit.
- To ensure that credit is supplied in accordance with the needs of borrowers and goals of planning.

Under this scheme, commercial banks are required to obtain RBI's permission before sanctioning any fresh credit of Rs. Six crore or more to any single borrower. This limit may be changed time by time.

(c) Fixation of Margin: The commercial banks generally advance loans to their customers against some security or securities offered by the borrowers and acceptable to the banks. The commercial banks do not lend up to the full amount of the value of a security but lend an amount less than its value. The margin requirements against specific securities are determined by the Reserve Bank. RBI changed the margin frequently according to the credit policy. Changes in margin requirements are designed to influence the flow of credit against specific commodities. A rise in the margin requirements results in contraction in the borrowing value of the security and similarly, a fall in the margin requirement results in expansion in the borrowing value of the security. If RBI desires that more loans should be advanced against particular securities, it can lower the margin requirement. Similarly, if RBI desires to check the expansion of credit against particular securities it can raise the margin requirement.

(d) Reserve Bank can also instruct commercial banks charging discriminating rates of interest on certain types of advances.

(e) Reserve Bank from time to time fixes ceiling n amount of credit for certain purposes.

(f) Reserve Bank can ban on advances to specific sector to check inflationary pressures.

2. Rationing of Credit :

In this method the RBI seeks to limit the maximum or ceiling of loans and advances and also in certain cases, fixes ceiling for specific categories of loans and advances. The various methods adopted under this arrangement are:

- Requiring the banks to restrict the drawing power of their borrower under cash credit limit.
- Stipulating certain targets for credit distribution for the priority sector.
- Stipulating a prescribed credit deposit ratio for rural semi urban branches of banks.

If the rationing of credit is done with reference to the total amount, it is a quantitative control, but if it is done with reference to specific types of credit, it assumes a qualitative control. Reserve Bank can also prescribe the minimum ratio between capital and total assets.

3. Moral Persuasion :

Moral persuasion refers to those cases where the Reserve Bank endeavours to achieve its object by making suitable representations to the banking institutions concerned and relying on its moral influence and power of persuasion. Being an apex institution and lender of the last resort, the RBI can use its more pressure and persuade the commercial bank to follow its policy. During inflationary conditions it may request the commercial banks not to press for frequent loans, to refuse loans to the customers and to refrain from investing funds in the unproductive or less productive occupations.

4. Publicity :

The RBI may also follow the policy of publicity in order to make known to the public its views about the credit expansion or contraction. It may issue warning to the people and commercial banks, substantiating its views by facts, figures and statements, through the media of publicity. This method, however, is ineffective in the developing economies where mass illiteracy exists and people do not understand the implications of the policy.

5. Direct Action :

Under Banking Regulations Act, the RBI is empowered to initiate direction action against those commercial banks which ignore its advice. In such cases RBI can impose restriction on sanctioning of loans and advances of concerned banks. Winding up of Bank of Karad in 1992 because of financial irregularities and putting up of certain restrictions on the working of Metropolitan Co-operative Bank are the examples of direct action initiated by RBI. The RBI may refuse rediscounting facilities to the banks who do not cooperative with the policies of the Bank.

Activity B:

1. Discuss various general and selective credit control methods.

5.4 Summary

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business within India, the licence can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

5.5 Self Assessment Questions

1. What do you mean by “Credit Control”? Explain in detail.
2. Discuss various objectives of credit control.
3. What are the various methods of credit control by RBI?
4. Write short note on following:
   a) Bank Rate
   b) Open Market Operations
   c) Credit Rationing

5. Discuss various selective credit control methods used by RBI?

6. Differentiate between quantitative and qualitative methods of credit control.

7. Discuss repo rates and reverse repo rates.

5.6 Books for Further Readings

- Khan M.Y. (2007); ‘Indian Financial System’, Tata Macgraw Hill, Fifth edition.
- Machiraju H R (2009); Indian Financial System’, Vikas Publishing House Private Limited, Fifth edition.
- Srivastava R M, Nigam Divya (2009); ‘Management of Financial Institutions’, Himalaya Publishing House Private Limited, Seventh edition.
- Vashisth V.K., Swami H.R., & Gupta B.P. (2008); ‘Banking and Finance’, Himalaya Publishing House Private Limited, Fourth edition

Unit - 6 : Commercial Banks

Structure of Unit:

6.0 Objectives

After completing this unit, you would be able to:

- Understand the role of commercial banks.
- Classify the commercial banks as scheduled and non schooled banks.
- Know about the various functions of commercial banks.
- Learn about the needs of nationalization of commercial banks
- Point out various advantages and disadvantages of commercial banks.

6.1 Introduction

Commercial Bank are very important component of the money market. They play a very important role in Indian Financial system. Indian banking industry is regulated by Reserve Bank of India. Commercial Bank act as Intermediaries because they accept deposits from savers and lend these funds to borrowers.

6.2 Meaning of Commercial Banks

Commercial Banks is financial Institution that accepts deposits for the purpose of lending. In other words, commercial Banks provide services such as accepting deposits, giving business loans and also allow for variety of deposit accounts. They collect money from those who have it to spare and lend to those who require it. Commercial Bank is a banker to the general public. Commercial Banks registered under Indian companies Act, 1936 and are also governed by the Indian Banking Regulation Act, 1949.

Definitions:

Various definitions of a bank have been given by various authors. Some important definitions of a bank listed below.

According to the Indian Companies (Regulation) Act, 1949, “the accepting, for the purpose of lending or Investment, of deposits of money from public, repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise.”

According to Prof. Kinley, "A bank is an establishment which makes to individuals such advances of money as may be required and safety made, and to which individuals entrust money when not required by them for use."

According to John Paget, "No body can be a banker who does not (i) take deposit accounts (ii) take current accounts, (iii) issue and pay cheques, and (iv) Collect cheques- crossed and uncrossed for its customers."

Prof Sayer defines the terms bank and banking clearly. He defines banks as "an institution whose debts (bank deposits) are widely accepted in settlement of other people's debts to each other." According to him, "ordinary banking business consists cash for bank deposits and bank deposits for cash, transferring bank deposits from one person or corporation to another ; giving bank deposits in exchange for bills exchange, government bonds the secured promises of business man to repay and so forth".

In short, we can say that banks are not merely traders in money but also in an important sense manufacturer of money.

6.3 Structure of Commercial Banks

Commercial banks are basically of two types.

1. Scheduled banks
2. Non- scheduled banks.

6.3.1 Scheduled Banks

Scheduled banks are those which have been in II schedule of Reserve Banks of India act, 1934 and following criteria should satisfied.

1. Minimum paid up capital Rs. 5 lakh.
2. It must be a corporation as co-operative society.
3. Any activity of bank will not adversely affect the interest of depositors

Scheduled banks consist public sector banks, private sector banks, foreign banks, and regional rural banks.

1) Public Sector Banks: Public banks are those in which 50% of their capital is provided by central government, 15% by concerned state government and 35% by sponsored commercial banks. In India, there are 27 public sector banks. They includes the state bank of India and its 6 associated banks such as state bank of Hyderabad, state bank of Mysore etc. and 19 nationalized banks and IDBI banks Ltd. Public sector banks mostly situated in rural area than urban area.

2) Private Sector Banks: Private Banks are those in which majority of share capital kept by business house and individual. After the nationalization, entry of private sector banks is restricted. But some of private banks continued to operate such as Jammu & Kashmir bank Ltd. To increase the competition spirit and improve the working of public sector banks, RBI permitted the entry of private sector banks in July, 1993.

3) Foreign Banks: Foreign banks are those which incorporated outside India and open their branches in India. Foreign banks performed all the function like other commercial banks in India. Foreign banks are superior in technology and management than India banks.

They offer different types of products and services such as offshore banking, online banking, personal banks etc. They provide loans for automobiles, small and large businesses. Foreign banks also provide special types of credit card which are nationally and internationally accepted. These banks earn lots of profit and create new ways of investments in the country.

4) **Regional Rural Banks**

Regional rural banks established 1975 with mandate to ensure sufficient credit for agriculture and rural sector. RRB's are jointly owned by government of India, concerned state government and sponsor bank. The capital share being 50 %, 15% and 35% respectively. Now these Days, there are 14,475 regional rural banks in India. NABARD control and prepare the policies for Regional Rural Banks. The basic objective of establishing RRB's in India was to provide the credit to rural sector especially the small and medium farmers, artisans, agricultural labour and even small entrepreneurs.

6.3.2 Non Scheduled Banks: Non scheduled banks in India define in clause (C) of section 5 of Banks regulation Act 1949. Non scheduled banks are those which are not a schedule bank and their paid up capital and reserves less than Rs.5 lakh and are not included in the 2nd schedule of the Reserve Bank of India Act, 1934

6.4 Functions of Commercial Banks

1. Accepting Deposits:

Accepting deposits is one of major function of commercial bank. It is the business of bank to accept deposits so that he can lend it to other and earn interest. Basically, the money is accepted as deposit for safe keeping. Banks also pay interest on these deposits. To attract depositors banks maintain different types of accounts. These are as following.

a) **Fixed Deposit Accounts:** The account which is opened for fixed period by depositing amount is known as fixed deposit account. The money deposited in this account cannot be withdrawn before expiry of period. A high rate of interest is paid on fixed deposits.

b) **Current Deposit Account:** Current deposit accounts are mostly opened by businessmen and traders who withdraw money number of times a day. Banks dose not pay interest on these types of account. The bank collects certain charges from depositors for services rendered by it.

c) **Saving Account:** Saving account is most suited for those people who want to save money for future needs. This types of account can be opened with a minimum initial deposit. A minimum balance has to be maintained in account as prescribed by bank. Some restrictions are imposed on depositor regarding number of deposit withdrawal and amount to be withdrawn in given period.

d) **Recurring Deposit Account:** The purpose of these accounts is to encourage public for regular saving, particularly by fixed income group. Fixed amount is deposit is deposited at regular intervals for a fixed term and repaid on maturity.

2. Grant of Loans and Advances

Besides accepting deposit, the second most important function of commercial bank is advancing of loan to the public. After keeping certain part of deposits received by bank as reserve and the rest of balance given as loan. The different types of loan and advances are given by bank as follow.

a) **Call Money** : There are generally short term credit that range from one day to fort night. There are even one nigh call money advances made available to bank with the help of this market. The rate of interest depends upon the conditions prevailing in money market.

b) **Overdraft :** In over draft, a customer can withdraw money from his current account and available balance below zero. When the amount withdrawn is within the authorized limit then rate of interest charged at agreed rate. Overdraft is allowed normally against the security of negotiable Instrument and credit worthy customers without security.

c) **Cash Credit:** In cash credit, Bank advance loan against the customer current asset or personal guarantee. The borrower has option to withdraw the funds as and when required to extent of his needs but he cannot exceed the credit limit allowed to him. The cash credit limit depends on the debtor's need and as agreed with the bank. The bank charges interest only on money withdrawn from by them.

d) **Discounting of Bills:** Under this type of lending, Bank pay amount before due date of bill after deducting certain rate of discount or commission. The holder of bill get money immediately without waiting for the date of maturity. If bill of exchange dishonored on due date the bank can recover the amount from the customer.

e) **Direct Loan:** A loans granted for a fixed maturity period more then one year. Loans are usually secured against some collateral security. The borrower can withdraw entire money through cheques. The interest is charged on entire amount of loan. Repayment of loan either in installments or in lump sum.

3. Credit Creation

Credit creation is also an important function of commercial Bank. The process of credit creation automatically performed when bank accept deposits and provide loans Prof Sayers says, "Banks are not merely supply of money but in an important sense, they are manufacturers of money". In this process, customers deposit their money in bank. Bank keeps certain amount of deposit as cash reserve and rest of balance givenas loan and advances. Banks not required to keep the entire deposits in cash. The amount of loan does not give directly to borrower. The borrower open a account and then bank deposit money in that account. Here, bank's lends money and process of credit creation starts. The current cash reserve ratio is 6% in 2011.

4. Secondary Functions:- These are as follow:-

1) **Sale and Purchased of Securities**: On the behalf of customer, commercial bank sale and purchase of the securities of private companies as well as government securities.

2) **Transfer of Funds:** Commercial Bank also provide facilities to transfer funds from one place to another place in form Bank draft, cheques, mail transfer etc.

3) **Collection and Payment of Credit Instrument:** Commercial Bank collect and make payment on behalf of their customers Commercial Bank collect and pay negotiable instruments and also pay rent, income tax fees, insurance premium etc.

4) **Locker Facility:** Commercial Banks provides locker facility to their customers. We can keep gold, silver and important documents in locker.

5) **Letter of Credit**: Letter of credit certified the credit worthiness of their customers which issued by commercial banks.

6) **Collection of Information:** Commercial Banks also collect the information relating to Industry, trade, commerce which made available to their customers.

7) **Traveller's Cheque ad Credit Card:** Commercial Banks issue traveller's cheques and credit cards to their customers. They can travel without fear of theft and loss of money. Credit card is used to make payment for purchases so that individual does not have to carry cash.

8) **Foreign Exchange:** Commercial banks provide facility to their customers dealing in foreign exchange. Commercial Banks are authorized dealers in India.

9) **Issuing of Gift Cheques:** Commercial Banks issues the gift cheques like Rs 11,51, 101,501 etc.

10) **Educational Loans**: Commercial Banks also provide educational loan to student for higher studies at reasonable rate of interest.

11) **Consumer Finance:** Commercial Banks provide consumer finance facility for purchase consumer durables like televisions, refrigerators etc.

12) **Automated Teller Machine:** Now a days with the help of ATM, we can deposit or withdraw money from our account any time.

Nationalization of Commercial Banks

The role of public sector banks increased after nationalization of commercial banks. On I July 1955, the government of India took over imperial Bank of India and converted it into the state Bank of India. In India, the major nationalization of commercial banks was done in July 1969 by Prime Minister Mrs Indira Gandhi. 14 Commercial banks were nationalized in July 1969. In April 1980, 7 more bank were nationalized. (See the pervious chapter)

6.5 Need for Nationalization of Commercial Banks

The needs for nationalization of Commercial Banks are given below.

1. Commercial Banks were provide loans to large scale Industries and neglected priority sectors.
2. Before the nationalization financially strong Bank ignored RBI Directives which adversely effected RBI monetary policy.
3. To remove the fear of bank failures from the minds of people.
4. To keep means of generating wealth in public control.
5. To remove regional imbalances and ensure even distribution of banking facilities.
6. To prevent unfair credit distribution by commercial banks

6.6 Advantages of Nationalization of Commercial Banks

Some of the advantages of Nationalization of Commercial Banks are as follows:

1. **To Check on Creation of Industrial Monopoly:** Before nationalization of commercial banks credit was concentrated to few hands and this formed Industrial Monopoly. No person except big Industrialist could get loan and advances. This neglected the other smaller industrialist. So, commercial banks were nationalized to curb the monopolizing tendencies.

2. **Credit Facility to Priority Sector**: Agriculture sector is backbone of India. This sector was neglected at that time. There was no credit facility available to agriculture sector before nationalization.

3. **Reduction of Regional Imbalance:** Regional imbalances had existed in India for a long time in area of banking facilities. After nationalization, branches opened in backward states like Assam,

Bihar, Uttar Pradesh than in developed states like Gujarat, Tamil Nadu etc. These banks reduced the Regional Imbalances.

4. **Collection of Saving:** Before the Nationalization, the banks did not attract more saving from public. Because people did not trust banking system . But After nationalization of commercial Banks, the deposits were increased. Because public believed in public sector Bank then private sector Banks.

5. **To check on Black Money:** In order to avoid income tax, people kept money with banks. For the solution of this problem the banks were nationalized.

6. **Economic Growth:** Before nationalization of banks, economy of country was not growing due to antisocial practices, speculation and hoarding. The country's economy suffered badly. In order to solve this problem banks were nationalized.

7. **Export Promotion:** Commercial Banks also promotes export. Because there is need to promote export for earn Foreign exchange. So, Banks give Finance to Exporter at concessional rates.

8. **Credit Card Facility** Credit card facility is provided by these Banks which has made our life easy. people can buy necessary things through credit card an make payment later on.

9. **Promote Small Scale Industry:** Nationalized commercial Banks encouraged small scale Industry by granting Loans. These bank grant short term and long term loan to purchase machinery and equipment.

6.7 Disadvantages of Nationalization of Commercial Banks

1. **Low performance:** The biggest problem of nationalized banks has been their low performance. Banks are required to keep minimum capital to risk asset ratio which known as capital adequacy ratio. It should be 9%.Most of public sector banks had negative ratio. Only four banks maintained ratio during 1999-2000.

2. **Favouritism:** Another limitation of commercial banks was favouritism in granting loan. They harass certain small industrialist and same time banks grant loan to big industrialist on easy terms and conditions. They follow the policy of partiality which affected the trust of client in banks working.

3. **Unbalanced Distribution of Credit:** In initial years, Agriculture sector got priority and other sector were neglected. Bank do not advance loan to weaker section such as labourers, worker and small trader due to lack of security.

4. **Financial Crisis:** After nationalization, some banks were operating under losses .This is because banks advance loan without adequate security. Banks grant non performing loans which interest has not been received for 180 days. The recovery of loan was poor which lead to losses. This is main reason for failure of banks.

5. **Political Interference:** Another limitation of nationalized commercial banks was increasing the political interference in granting loans, appointment of banks personnel, opening of new branches etc.

6. **Inadequate Facilities:** Nationalized commercial banks have failed to provide adequate facilities and services to population living in rural and sub urban area. Banks failed to mobilize rural deposit.

6.8 Summary

Commercial banks play a very significant role in development of Indian banking system. No country can progress without organized baking system. Commercial banks also promote economic development and social welfare activities in India. These banks provide loan and advances to priority sectors.

6.9 Self Assessment Questions

1 What do you mean by Commercial banks? Explain the functions of Commercial banks.

2 Define Commercial banks. Discuss the advantages and disadvantages of nationalization of commercial banks.

3 Discuss the structure of commercial banks in India.

4 Critically examine the need of nationalization of commercial banks.

6.10 Books for Further Readings

- S.K Misra, V.K Puri 2010 **;** Indian Economy**;** Himalaya Publishing House.
- T.R Jain, Mukesh Trehan, Dr.Rajinder uppal, Raju Trehan**;** Indian economy**;** V.K Global publication Pvt.Ltd.
- M.L. JHINGAN:- “Money, banking, international trade and public finance ; Vrinda publications (P) ltd.
- R.R.Paul**;** “money, banking, international trade”, Kalyani publishers.

Unit - 7 : National Bank for Agriculture and Rural Development

Structure of Unit:

7.0 Objectives

After completing the unit, you would be able to:

- Understand the origin of NABARD
- Know about various objectives of NABARD
- Learn about the sources of funds
- Learn about the management of NABARD
- Understand about role a d function of NABARD

7.1 Introduction

Reserve Bank of India established in 1935 with a Mandate to set up a special Agricultural credit Department (ACD) with expert staff. RBI initiated different measures to develop a healthy rural credit structure and provided guidance to state governments and co-operative credit structure. Agriculture Refinance corporation (ARC) was established in 1963 to support investment credit needs for agricultural development. Consequent to undertaking of development and promotional Functions, ARC was renamed as Agricultural Refinance and Development Corporation (ARDC) in 1972.

RBI, at the instance of Government of India (G.O.I.) appointed a committee to Review arrangement for Institutional credit for agriculture and Rural Development [CRAFICARD] in 1979. The CRAFICARD reviewed the need of integrating short term, medium term and long term agriculture credit structure. The CRAFICARD recommended the establishment of National Bank for Agriculture and Rural Development Act, the Indian Parliament passed 1981 and NARARD was established on 12 July 1982.

7.2 Objectives of NABARD

1) Integrated rural development is main objective of NABARD.
2) To provide training and Research facilities for rural Development.
3) To keep a check on all the projects which are refinanced by NABARD; through timely inspection, monitoring and evaluation.
4) To Act as a coordinator and regulator for rural credit institutions.
5) NABARD was established with a mandate for promotion and development of agriculture, Small Scale industries, cottage and village industries, handicrafts and other rural crafts.
6) To formulate rural credit plans on annual basis for all districts in country.

7.3 Financial Resources

NABARD was established with initial capital of Rs 100 crore having 50:50 Contribution of Government of India and RBI. This authorized capital was increased from time to time. Since 1 February 2001, thisauthorized capital stands at Rs. 5000 crore. But till now the paid up capital remained at Rs. 2000 Crore out of which Rs. 550 Crore subscribed by government of India and Rs. 1450 Crore by RBI. The other resources of NABARD consist of Reserve and surplus, Deposits, National rural credit funds, and borrowings. The financial resources of Nabard increased by 18116 crore to Rs.136292 crore during 2009-10 against Rs.118176 crore during 2008-09.

Table 7.1 : Sources of Fund (Rs. in Crore)

Particulars	31.03.2009	31.03.2010
Capital, Reserve &Surplus	11,535	12,675
NRC(LTO)and (Stab.)Funds	15,571	15,983
Deposits	482	505
Bonds & Debentures	23,699	20,004
STCRC Fund	4622	9622
Borrowings from GOI	354	147
Borrowings from commercial banks	500	500
Certificate of deposits	1,816	379
Commercial paper	181	2,680
Term money borrowings	244	763
RIDF deposits	47023	59,869
Foreign currency loan	498	494
Borrowing under CBLO	-	215
Other liabilities /funds	11,651	12456
Total	1,18,176	1,36,292

Table shows the sources of funds. According to this table, the paid up capital remained at Rs. 2000crore against the authorized capital of Rs.5000crore.But the amount of Reserve and surplus increased by Rs.1140crore from 9535crore to Rs.10, 675crore as at end of current year.

The National Rural credit (Long term operation and Stabilization) Funds Utilized for investment operations and reschedule of short term credit respectively .In current year, an amount of Rs.412crore was contributed to these fund. Deposits also increased by Rs.23crore in current year. These deposits received by tea, coffee, and rubber companies. RIDF deposits stood at 59,869crore as against Rs.47, 023crore at end of previous year, resulting in a net inflow of Rs.12846crore.

To meet the increasing credit demand, NABARD borrow funds in form of bonds, commercial paper, Certificate of deposits, term money borrowings, corporate borrowing, borrowing from government of India and borrowings in foreign currency. No fresh bonds and debenture issued in this year. No borrowing from the government of Indiain2009-2010 but only repayment of Rs.207 crore. There were no borrowings from commercial bank in this year. The outstanding amount of certificate of deposits was Rs.379crore as on 31 March 2010.Term money borrowings of Rs.921.52 crore were raised and Rs.403.09 crore repaid during the year, leaving an outstanding of Rs.763 crore, as on31 march 2010 against Rs.244 crore at end of previous year. NABARD borrow fund under CBLO Rs.215 crore during 2009-2010.An amount of Rs.6.1 crore was drawn under KfW (XI)(UPNRM) which result in borrowing in foreign currency from KfW, Germany aggregating Rs. 494 crore ,as on 31 March 2010.

Table 7.2 : Uses of Funds (Rs. in Crore)

Particulars	31.03.2009	31.03.2010
Cash and Bank Balance	13,975	9,628
Government securities and Investment	2,995	3,785
Production and Marketing credit	16,896	24,023
Conversion of Production credit in MT loan	20	00
Liquidity Support	2591	20
MT and LT Project loan	33,335	35742
LT Non project loan	252	199
Loan out of RIDF	45,616	60255
Co finance loan (Net of provision)	95	84
Other loan(including MT Investment credit)	48	133
Fixed Assets And Other Assets	2353	2373
Total	1,18,176	1,36,292

Table shows the uses of Funds. According to Table B , short term loans advances increased to Rs. 24,073 crore, as on 31 March2010,from Rs16,896 crore at the end of previous year. Cash and Bank Balance decrease to Rs.9,628.Increase in Government securities and Investment. The liquidity support providing short term credit had come down from Rs2591 crore as on 31March 2009 to Rs20 crore at end of the current year. RIDF loans to state government stood at Rs.60255 crore at 31march 2010.The amount outstanding under the non project long term loans granted to state government Rs.199.Refinance assistance of Rs.35,742 crore as on 31 March 2010.Co finance project stood at Rs.84 crore as on 31 march 2010 as against Rs95 crore at the end of previous Year. Other loans stood at Rs.133crore as on 31 March 2010.

7.4 Organisation and Management of NABARD

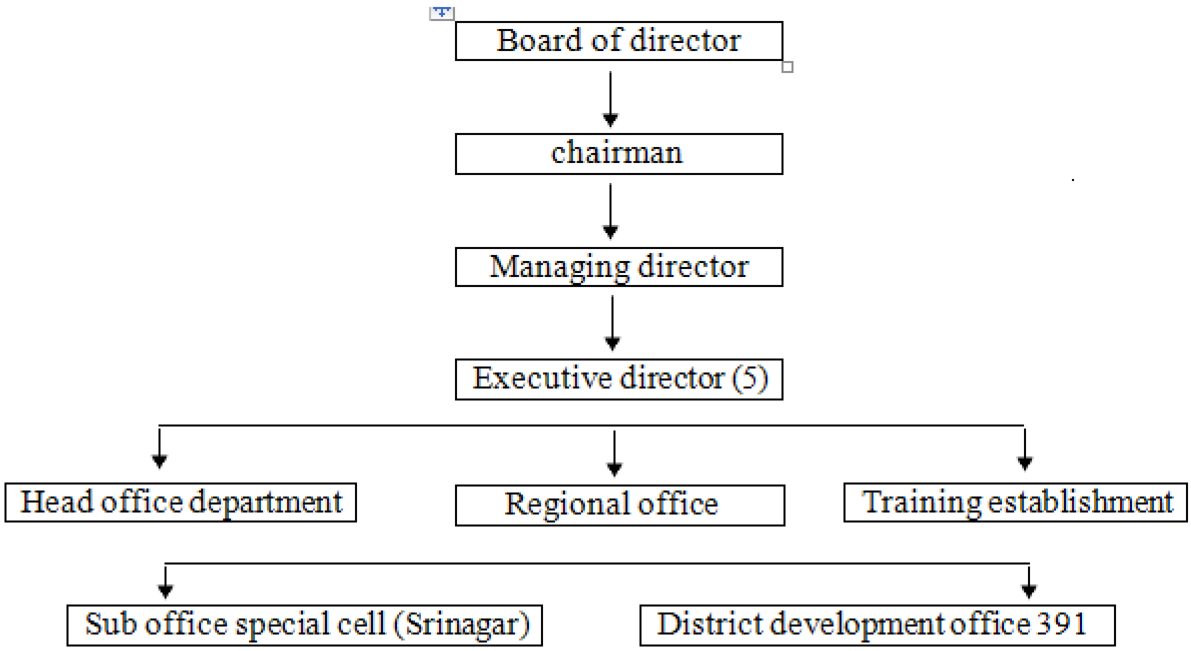


Figure 7.1

NABARD has its head office at Mumbai, India. The NABARD is managed by a 15 member Board of Directors consisting chairman, managing director, two experts of rural economies, three experts from cooperative and commercial banks, three directors from current directors of RBI, three director from government of India and two representing the state government.

NABARD operates throughout the country with 28 regional office and sub office, located in the capital of all states and union territories. Each regional office has a Chief General Manager as it head. The head office has top executive like the executive director, managing director and the chairperson. It has 336 District offices across the country one special cells at Srinagar. It also has 6 training establishment.

7.5 Functions of NABARD

NABARD is an apex development bank which performs following functions.

Credit Function

NABARD prepares credit policy and guideline for rural financial institutions. It provides credit facilities to issuing organizations such as regional rural bank, cooperative banks commercial banks etc. while the ultimate beneficiaries of investment credit can be individuals, partnership concerns, companies, and state owned corporation or co-operative societies. Production credit is generally given to individual. It provides refinance facilities to all small scale industries, agriculture sector and rural development. It also provides credit facilities in the event of natural calamities.

It promotes self help group to act as institutions of micro finance. This helps in spread of credit to the remotes areas.

Development Function

Credit is most important factor in development of agriculture and rural sector which helps in capital formation and technological up gradation. Various initiatives have been taken to strengthen the corporative credit structure and RRBs, So that adequate and timely credit is made available to the needy. NABARD provides credit facilities for developmental activities such as.

1. Provides assistance for self development of RRBs commercial banks and cooperatives banks.
2. Helps to RRBs commercial banks and cooperatives banks by providing training to senior and middle level executives.
3. It uses Vikas Volunteer Vahini and farmers clubs to generate awareness on ethics of repayment.
4. It provides the funds for developments of agriculture and rural developments.
5. Helps in human resource development organization development and agriculture development through various institutions like national bank staff college lucknow, bankers institute of rural development lucknow and college of agriculture banking Pune.

Supervisory Functions

Under provision of banking regulation Act 1949, it undertakes inspection of RRB's and cooperative banks. It also undertakes voluntary inspection of state cooperative agriculture and rural development banks and apex non credit cooperative societies. All RRB's and cooperative banks submitting return to the RBI are required to furnish a copy of return to NABARD. It can ask RRB's and cooperative banks to Submit any information which it needs. All the application for the opening of new branches by RRB,s and stare cooperatives banks which are require to submitted to RBI are routed through NABARD. Board of supervision has been constituted by NABARD under section13 (3) of NABARD Act, 1981 as an internal committee to Board of Directors of NABARD.

7.6 Summary

NABARD promoting sustainable and equitable agriculture and rural development through effective credit support, related services institution development and other innovative initiatives. It also helps the state government in reaching their targets of providing assistance to eligible institution in agriculture and rural development. NABARD provides training and research facilities to eligible financial institutions in the field of agriculture and rural development, it acts as regulator.

7.7 Self Assessment Questions

1. Describe the management and functions of NABARD.
2. What are the objectives of NABARD? Explain the financial resources of NABARD.

7.8 Books for Further Readings

- Ml JHINGAN: - "money, banking, international trade and public finance; Vrinda publications (P) ltd.
- www.nabard.org (website of NABARD)

Unit - 8 : Types of Accounts in Banking System

Structure of Unit:

8.0 Objectives

After completing this unit, you would be able to:

- Get familiar with normal banking system
- Know about different types of bank accounts
- Do general banking
- Know how to open and operate different bank accounts
- Know various services given by bank to different customers
- Differentiate between various type of accounts

8.1 Introduction

The most important and primary function of bank is to accept deposits. Financial intermediation by commercial banks has played a key role in India. When banks mobilize savings, they do it in the form of deposits, which are the money accepted by banks from customers to be held under stipulated terms and conditions. Deposits are thus an instrument of savings. The money deposited in the bank is the money of the people. People do earnings and after spending some part of it, they tend to save remaining part of it for future contingencies and requirements. Saved money at home cannot give returns and a fear of theft always be there.

At the time of depositing money with the bank, a depositor would want to be certain that his/ her money is safe with the bank and at the same time, wants to earn a reasonable return. The safety of depositors' funds, therefore, forms a key area of the regulatory framework for banking. In India, this aspect is taken care of in the Banking Regulation Act, 1949 (BR Act). The RBI is empowered to issue directives/advices on several aspects regarding the conduct of deposit accounts from time to time.

Further, the establishment of the Deposit Insurance Corporation in 1962 (against the backdrop of failure of banks) offered protection to bank depositors, particularly small-account holders. To facilitate these functions easily, banks transact through accounts. Keeping in mind the need and requirement of different customers, bank classifies the account into different types. Customers of different preferences choose their type of accounts and do transactions with bank. In deposit terminology, the term Bank Account refers to a *Financial arrangement between a Depositor or debt holder and a Bank.* Bank Accounts are usually made up of various types of deposit accounts and loan accounts. Money can be added or removed from the account by visiting the bank.

Keeping in mind the nature and requirement of different type of people, banks classify different types of accounts. Bank Deposits serve different purposes for different customers. Some customer wants to save lump sum amount for longer duration while some want to save for short time period. Some keep deposits for safety purposes while some deposits to take benefit of interest rates.

8.2 Classification of Bank Accounts

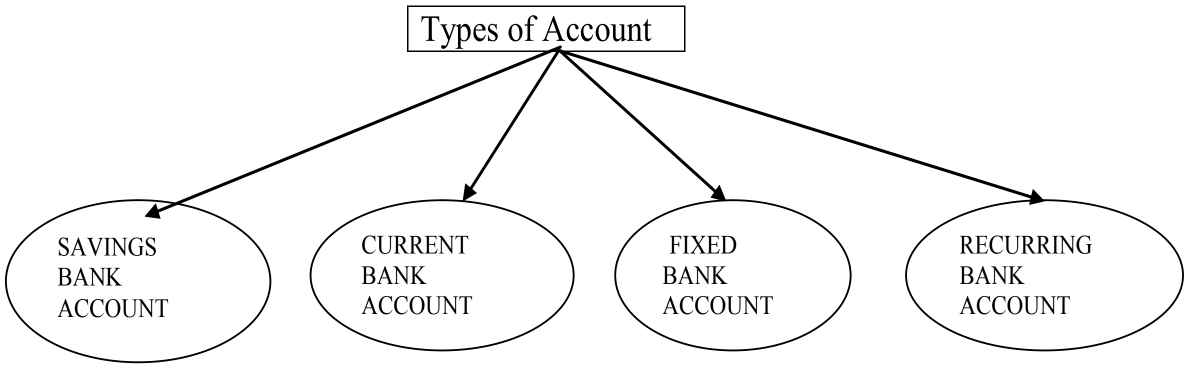


Figure 8.1 : Types of Account

8.3 Savings Bank Account

A bank Savings Account is a type of account designed to simply hold money that we do not need immediate access to these accounts are opened by the persons who want to save some part of their income either to earn interest on deposit or for safety purposes.

Bank deposits are very liquid form of deposits as we can withdraw cash easily. Money can be deposited in this account at any time during the working hours. Withdrawals can be made by various modes which are discussed further in this chapter. However bank puts some restriction on the number of withdrawals from this account. Interest rates paid on deposits vary from bank to bank. This account is very easy to access as we can easily transact with bank.

Who Can Open Savings Bank Account

i) An individual in his/her own name

ii) Minor under the representation of his/her guardian

iii) Jointly with any other person

Advantages of Savings Bank Account

1. Saving account encourages savings habit among salary earners and others who have fixed income.

2. It enables the depositor to earn income by way of interest.
3. It helps the depositor to make payment by way of cheques.
4. The bank offers number of services to the saving bank account holders.

Features of Savings Bank Account

1. The main objective of saving account is to promote savings.
2. There is no restriction on the number and amount of deposits.
3. Withdrawals are allowed subject to certain restrictions.
4. The money can be withdrawn either by cheque or withdrawal slip.
5. The rate of interest payable is very nominal on saving accounts.
6. Saving account is of continuing nature. There is no maximum period.
7. A minimum amount has to be kept on saving account.
8. No loan facility is provided against saving account.

Procedure for Opening a Savings Bank Account

- **Fill up the Prescribed Application Form:-** Person interested in opening an account with any particular bank has to fill up a prescribed form.

  The form generally requires some personal and professional information to be filled. A person can also opens a Joint Savings Account with anyone.

- **Deposit the Form:-** Form is submitted along with the required document to the concerned officer and he checks the form. Required documents are generally address proof, income, age, etc of the customer.

  Customer has to give reference of those customers who are the existing account holders of the bank.

- **Opening an Account :-** Requisite person has to deposit a minimum amount of cash balance in his account and he got his account opened with that particular sum of money. This amount is called 'Minimum Balance'. This amount is generally of Rs.1000. In some banks student's accounts are opened at Zero (0) Balance. This minimum amount is deposited through Pay-in-Slip.

- **Obtaining Pass Book**:- After depositing minimum balance, person gets his account number and his passbook.

- If a person request for a cheque book, he gets it provided.

- For request of ATM cards, we have to fill additional form with the main form. This ATM card is delivered to us within a month.

By this way we can get our account opened with any particular bank. Different banks have different rules and procedures but the above steps are the basic rules which are generally followed by banks. Following is the format of SBI bank account form.

भारतीय स्टेट बैंक
State Bank of India

खाता खोलने का फॉर्म - भाग - I
Account Opening Form - Part - I
व्यक्तियों के लिए (सिर्फ नए ग्राहकों के लिए)
For Individuals (New Customers only)

शाखा / Branch
कूट क्र. / Code No.
दिनांक / Date
सीआइएफ / CIF No.
(कार्यालय प्रयोग के लिए) (for office use)

फॉर्म बड़े / स्पष्ट अक्षरों में भरें और हस्ताक्षर के लिए **काली** स्याही का प्रयोग करें। उपयुक्त खानों में (✓) का निशान लगाएं।
Please fill up in BLOCK letters and use **black** ink for signature. Please tick (✓) the appropriate boxes.

ग्राहक-प्रकार / Customer Type: जनता / Public स्टाफ / Staff

(क) व्यक्तिगत विवरण / (A) Personal details:

पूरा नाम / Full Name (दो शब्दों के बीच एक स्थान छोड़े) *(Leave one space between two words)*
प्रथम / First मध्य / Middle अन्तिम / Last

पिता / पति का नाम / Name of Father / Husband
जन्म-तिथि / Date of Birth
लिंग / Sex पुरुष / Male स्त्री / Female
वैवाहिक स्थिति / Marital Status विवाहित / Married अविवाहित / Unmarried अन्य / Others
माता का विवाह पूर्व नाम / Mother's maiden name

(ख) आवासीय पता / (B) Residential address:

पता - पहली पंक्ति / Address Line 1
पता - दूसरी पंक्ति / Address Line 2
पता - तीसरी पंक्ति / Address Line 3
मुख्य पहचान / Landmark
शहर / City पिन क्रमांक / PIN Code
राज्य / State
फोन नं. / Phone No. मोबाइल नं. / Mobile No.
(एसटीडी कोड सहित) / (with STD Code)
ई मेल पता / E-mail ID: 1. 2.

(ग) कार्यालय / व्यवसाय पता / (C) Office / Business address:

पता - पहली पंक्ति / Address Line 1
पता - दूसरी पंक्ति / Address Line 2
पता - तीसरी पंक्ति / Address Line 3
मुख्य पहचान / Landmark
शहर / City
राज्य / State
पिन क्रमांक / PIN Code
फोन नं. / Phone No. (एसटीडी कोड सहित) / (with STD Code)
फैक्स नं. / Fax No.:

अपना फोटो चिपकाएं
Please paste photograph (2.5 cm X 3.5 cm)
पासबुक में लगाने के लिए एक और फोटो संलग्न करें
(Enclose one more photograph for affixing in passbook)

पत्राचार का पता / Address on which correspondence is required: ख / B ग / C

(घ) (D) i) आयकर पैन या फार्म 60 / 61 (आयकर अधिनियम) / Income Tax PAN or Form 60/61 (IT Act)
ii) राष्ट्रीयता / Nationality

(ग्राहक का हस्ताक्षर / Signature of the Customer)

1

Figure 8.2

Activity A:

1 Visit your nearest bank and obtain a saving bank account form. List the name of documents required to open Savings Bank Account. Try to fill it on your own and get information about further procedure.

Procedure for Depositing Money in Savings Bank Account

- One has to fill a slip obtainable at bank known as Pay-in-Slips. Information required generally include

a) Name of the depositor
b) Account number
c) Sum of amount to be deposited (in words & in figures both)
d) Specimen signature
e) Date
f) Telephone and Mobile number, etc

- This filled slip is to be deposited to the bank's cash counter along with the sum of money.

- Customer in returns gets a signed & sealed slip as a proof of deposited money (left portion of the following figure).

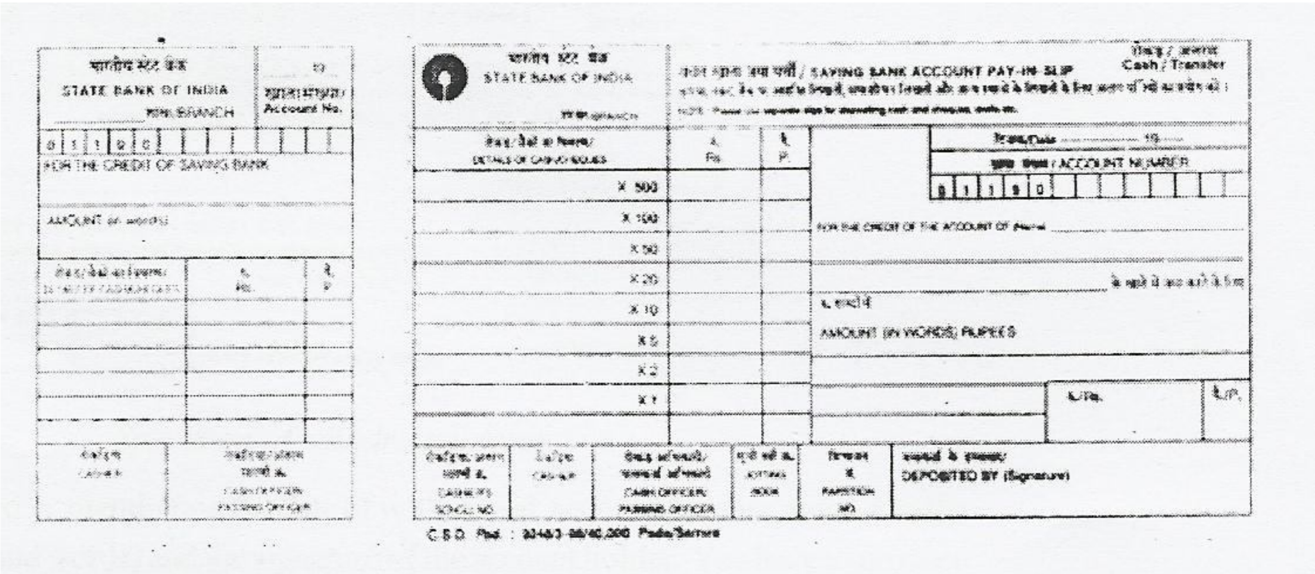

STATE BANK OF INDIA
Account No.
FOR THE CREDIT OF SAVING BANK
AMOUNT (in words)
SAVING BANK ACCOUNT PAY-IN-SLIP
Cash / Transfer
DETAILS OF CASH/CHEQUES
Rs. P.
× 500
× 100
× 50
× 20
× 10
× 5
× 2
× 1
ACCOUNT NUMBER
FOR THE CREDIT OF THE ACCOUNT OF
AMOUNT (IN WORDS) RUPEES
CASHIER
CASH OFFICER
PASSING OFFICER
DEPOSITED BY (Signature)

Figure 8.3 : Pay-in- Slip

- If a person wants to deposit a cheque he can do so by filling the pay in slip and get it signed by the concerning officer and it has to be dropped in a cheque box for further processing.

Procedure for Withdrawing Money From Savings Bank Account

Money can be withdrawn from any of the following method. Customer can choose any mode of withdrawal depending upon his convenience

a) Withdrawal Form
b) ATM
c) Cheque

A) Withdrawal Form:

Any person, who wants to withdraw money, has to fill a ***Withdrawal Form*** which can easily be obtained from bank's counter. After filling required form, one has to deposit it at the cashier's counter. After checking it, cashier gives the required amount to the withdrawing person. A person can withdraw money up to the prescribed limit. In case when person withdraws from minimum balance, he is charged for this and a certain amount of money is withdrawn from his account in the name of the bank whenever the balance is available in the account.

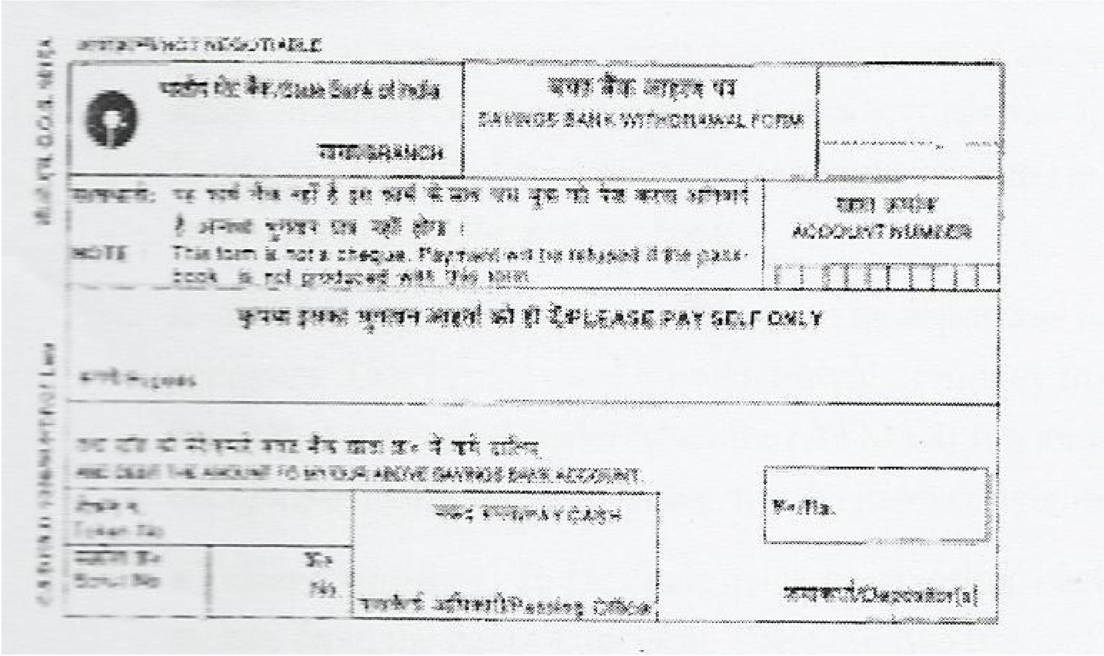
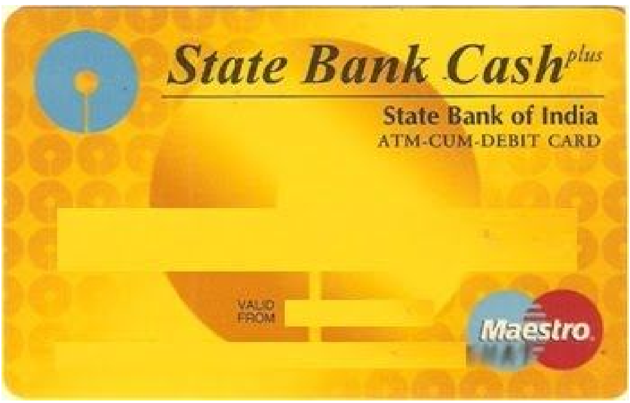

NOT NEGOTIABLE
State Bank of India
SAVINGS BANK WITHDRAWAL FORM
BRANCH
NOTE This form is not a cheque. Payment will be refused if the pass-book is not produced with this form.
ACCOUNT NUMBER
PLEASE PAY SELF ONLY
Rupees
THE AMOUNT TO MY/OUR ABOVE SAVINGS BANK ACCOUNT
Token No
Scroll No
PAY CASH
Rs.
Passing Officer
Depositor(s)

Figure 8.4

Automated Teller Machine:

ATM cards are the most convenient form of withdrawing money. It is a magnetic card having a secret PIN (Personal Identification Number) which is kept to be confidential by the user to prevent it from misuse. One can easily get money withdrawal by simply inserting ATM cards into ATM with confidential pin code. These cards are also known as *ATM- CUM DEBIT* card. Nowadays ATM is serving more than just withdrawing machines. A minimum balance of Rs.1000 is compulsory to withdraw. ATM card of any bank can be access in any bank's ATM



ATM CARD

ATM Machine

Figure 8.5

How to Avail ATM Facility

1. This facility is for everyone who has Savings, Current or Cash Credit account.
2. To get ATM Facility on your account you have to fill up form provided by bank.
3. ATM card holder has to maintain minimum balance of Rs.1000/-
4. No any additional charges for this facility.

How ATM Works

1. Swipe Card : The card reader in the machine reads and stores the bank account account information recorded on the magnetic strip of the card.
2. Enter Pin : The machine converts PIN into an encryption and sends it to the host processor compares the PIN with the recorded information for verification.
3. Request Amount : ATM sends the request to the host processor which forwards it to the networks(Visa/Master Cards) for approval.
4. Account Check : The network asks the bank to authorize withdrawal which is done after checking the customer's account.
5. Saying Yes : An electronic fund transfer takes place from the bank to the host processor account. The host sends an approval code to the bank.
6. Bill Count : An electronic eye counts out bills from cash cartridges located either at the bottom or behind the computer screen and pushes it out of the cash slot.

Other Uses of ATM Card:

- 24 hours Service
- Cash withdrawals
- Changing ATM PIN
- To know about available balance
- Paying routine bills, fees (utilities, phone bills, etc)
- Mini bank statement (last 10 transaction)
- One can deposit cheque

Protecting Your Card

1. Keep your card in a safe place to avoid damage.
2. Memorize your Personal Identification Number (PIN). Never write the PIN down on anything in our wallet or on the card itself. Never tell your PIN to any other person, whether to family member, office staff.
3. When selecting a PIN, avoid numbers and letters that relate to your personal information. For example, don't use your initials, birthday, telephone or vehicle number, if you have such a number, contact your bank and get a new PIN issued. In most of ATM, you can change your ATM pin yourself.
4. Immediately report a lost or stolen card to your financial institution.
5. To help guard against fraud, keep your ATM receipts until you check them against your monthly statement.

Safety Tips at the Time of Withdrawal

1. Observe your surroundings before using an ATM. If the machine is obstructed from view or poorly lit, visit another ATM.
2. Take a friend with you - especially at night.
3. Have your card out and ready to use.
4. Shield the screen and keyboard so anyone waiting to use the ATM cannot see you enter your PIN or transaction amount.

5. Put your cash, card and receipt away immediately. Count your money later, and always keep your receipt.
6. If you see anyone or anything suspicious, cancel your transaction and leave immediately. If anyone follows you after making a transaction, go to a crowded, well-lit area and call the police.
7. When using an enclosed ATM that requires your card to open the door, avoid letting strangers follow you inside.
8. Check with your financial institution to determine what the daily limit of funds that can be withdrawn from your account is.
9. Use swap ATM machine, Machine which take ATM card inside are risky and some time they ate your ATM card, due to input of wrong ATM pin, withdrawal amount given is more than balance and for other reason.
10. Use Your own Bank machine ,where ever possible, the reason is that if there is a problem in transaction then problem can be solved by your bank directly but if other bank's ATM is used then to solve dispute you have to contact two bank branches.
11. If your card jammed in ATM, report this immediately to the bank.

Activity B:

1. Follow the following instructions of withdrawing money from the ATM with your card for practical knowledge.

C) Cheque

We can also withdraw money by filling a cheque along with specimen signature. Cheque can also be used to make payments to other parties which are discussed further in this chapter. Cheque is a very common form of negotiable instrument. If you have a savings bank account or current account in a bank, you can issue a cheque in your own name or in favor of others, thereby directing the bank to pay the specified amount to the person named in the cheque. Therefore, a cheque may be regarded as a bill of exchange; the only difference is that the bank is always the drawee in case of a cheque. The Negotiable Instruments Act, 1881 defines a cheque as a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand. Actually, a cheque is an order by the account holder of the bank directing his banker to pay on demand, the specified amount, to the order of the person named therein or to the bearer.

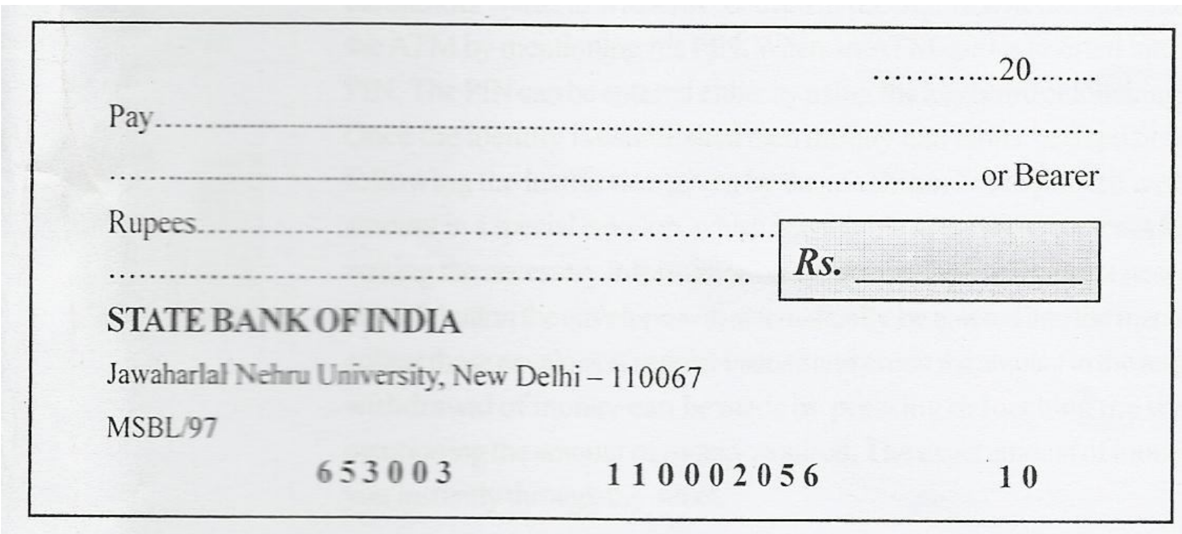

............20........
Pay..
.... or Bearer
Rupees..
.... **Rs.** ________
STATE BANK OF INDIA
Jawaharlal Nehru University, New Delhi – 110067
MSBL/97
653003 110002056 10

Figure 8.6 : Specimen of cheque

- **Types of Cheque**

a) **Open Cheque:** A cheque is called 'Open' when it is possible to get cash over the counter at the bank. The holder of an open cheque can do the following:

   i. Receive its payment over the counter at the bank,

   ii. Deposit the cheque in his own account.

   iii. Pass it to someone else by signing on the back of a cheque.

b) **Crossed Cheque**: Since open cheque is subject to risk of theft, it is dangerous to issue such cheques. This risk can be avoided by issuing other types of cheque called 'Crossed cheque'. The payment of such cheque is not made over the counter at the bank. It is only credited to the bank account of the payee. A cheque can be crossed by drawing two transverse parallel lines across the cheque, with or without the writing 'Account payee' or 'Not Negotiable'.

c) **Bearer Cheque**: A cheque which is payable to any person who presents it for payment at the bank counter is called 'Bearer cheque'. A bearer cheque can be transferred by mere delivery and requires no endorsement.

d) **Order Cheque**: An order cheque is one which is payable to a particular person. In such a cheque the word 'bearer' may be cut out or cancelled and the word 'order' may be written. The payee can transfer an order cheque to someone else by signing his or her name on the back of it.

8.4 Fixed Deposit Account

This is another form of saving our money. The term 'fixed deposit' means that the deposit is fixed and is repayable only after a specific period is over. As the name says, the amount deposited is for fixedperiod say one, two, three or may be more years. Because of this nature, it is also called Term Deposit. Amount deposited is payable back after its maturity or at the expiry of the period with interest. Interest payable on FD is little higher as compared to Savings Account because the money deposited in savings accounts can be withdrawn at anytime up to the limit of amount available in the account. Amount deposited in FD account is free for use by the banks as it is non withdrawable money. If one wishes to take credit on FDs, he can do so by fulfilling further formalities. After the date of maturity it is compulsory that either the amount should be withdrawn or the account has to be renewed by the customer because in the absence of these two condition banks are not liable to pay interest on such deposits after the date of maturity.

Who Can Open Fixed Deposit Account

i) An individual in his/her own name

ii) Minor under the representation of his/her guardian

iii) Jointly with any other person

Features of Fixed Deposit Account

1. The main purpose of fixed deposit account is to enable the individuals to earn a higher rate of interest on their surplus funds (extra money).
2. The amount can be deposited only once. For further such deposits, separate accounts need to be opened.
3. The period of fixed deposits ranges between 15 days to 10 years.
4. A high interest rate is paid on fixed deposits. The rate of interest may vary as per amount, period and from bank to bank.

5. Withdrawals are not allowed. However, in case of emergency, banks allow to close the fixed account prior to maturity date. In such cases, the bank deducts 1% (deduction percentage many vary) from the interest payable as on that date.
6. The depositor is given a fixed deposit receipt, which depositor has to produce at the time of maturity. The deposit can be renewed for a further period.

Advantages of Fixed Deposit Account

1. Fixed deposit encourages savings habit for a longer period of time..
2. Fixed deposit account enables the depositor to earn a high interest rate. The rate of interest on fixed deposits is paid on given rate of interest after the date of maturity but if customer requests, quarterly interest can also be paid.
3. The depositor can get loan facility from the bank.
4. On maturity the amount can be used to make purchases of assets.
5. The bank can get the funds for a longer period of time.
6. The bank can lend such funds for short term loans to businessmen.
7. Fixed deposits indirectly boost economic development of the country.
8. The bank can also invest such funds in profitable areas.
9. This account can be opened joint account also.

How to Open an FD account

By obtaining a form from the bank and filing it with required information, we can easily open our account. Information required is the specimen signature of the depositor, amount to be deposited, date of maturity. This account is transferable in the name of the other person by the consent of the depositor after fulfilling certain formalities.

Activity C:

1. Analyze the interest rate given by different banks for different time period on FDs.

8.5 Current Account

This account is opened by businessmen and traders. Businessmen have to transact many times in a day with their customers. Facilitating them with the facility of Current account, bank allows traders to withdraw them as many times they require withdrawing. Customers are generally given paper checks to carry out day-to-day transactions, like paying bills, making purchases, or transferring money to another account. ATM (Automated Teller Machine) facility is also provided to the customers. Because of this frequency, bank cannot use their money and pays no interest on deposits. Holder of this account are also facilitate with Overdraft Facility. This account can be opened in name of individual, partners and firms. Minimum balance is different in different banks but generally it is Rs. 5000.

How to Open a Current Account

- A prescribed form is available at bank's counter which is to be filled by the user.
- If a firm or partners are registered, they have to show the address proof and seal to the bank.
- After verifying documents submitted, banks allot account number and issues a pass book to the user.

Features of Current Account

1. The main objective of current bank account is to enable the businessmen to conduct their business transactions smoothly.
2. There is no restriction on the number and amount of deposits. There is also no restriction on the withdrawals.
3. Generally banks do not pay any interest on current account. Nowadays, some banks do pay interest on current accounts.
4. Current account is of continuing nature and as such there is no fixed period.

Advantages of Current Account

1. Current account enables businessmen to conduct his business transactions smoothly.
2. The businessmen can withdraw any amount at any time from their current accounts. There are also no restrictions on withdrawals.
3. The businessmen can make direct payment to their creditors with the help of cheques.
4. The bank collects money on behalf of its customers and credits the same to their accounts.
5. Current account enables the account holder to obtain overdraft facility.
6. The creditors of the account holder can get credit-worthiness information of the account holder through interbank connection.
7. Current account facilitates the industrial progress of the country. Without the help of this account, businessmen would have faced a number of difficulties in running their business.

8.6 Recurring Deposit Account

This type of account is suitable for those who expect to earn a fair return on deposit. In this, customer has to agree to deposit fixed installments on monthly basis for a fixed period. After the maturity of the fixed period customer gets his deposit alongwith interest. It is also called 'Cumulative Account' because its deposit mode is on monthly basis. Customers are allowed to close the account in between if he desires to do so. This account can be opened by individual and jointly. Recurring deposit account is generally opened for a purpose to be served at a future date.

How to Open a Recurring Deposit Account

After fulfilling prescribed form, this account is operated on the monthly basis. Depositor has to deposit money till the last day of the month. The transactions are recorded in the pass book which is kept by the depositor as a proof of deposit.

Features of RD Account

1. The main objective of recurring deposit account is to develop regular savings habit among the public.
2. The period of deposit is minimum six months and maximum ten years. When duration of deposit is less than three months, no interest is paid by banks.
3. The rate of interest is higher.
4. No withdrawal is allowed. However, the bank may allow closing the account before the maturity period. 5. The bank provides the loan facility. The loan can be given upto 75% of the amount standing to the credit of the account holder.

Advantages of RD Account

- Recurring deposit encourages regular savings habit among the people.
- Recurring deposit account holder can get a loan facility.
- The bank can utilize such funds for lending to businessmen.
- The bank may also invest such funds in profitable areas.

8.7 Difference between Savings Bank Account & Current Bank Account

S.NO.	BASIS	SAVINGS BANK ACCOUNT	CURRENT BANK ACCOUNT
1	PREFERENCE	Preferred by individuals for interest	Preferred by businessman for daily transaction
2	OVERDRAFT	Overdraft not allowed	Overdraft allowed
3	INTEREST	Interest is payable on minimal monthly balance deposit	No interest is payable on deposit
4	MINIMUM BALANCE	Minimum balance requirement	No minimum balance
5	ACCESSIBILITY	Limited Transaction	Unlimited number of transactions on your account.

8.8 Difference between Fixed Deposit Account and Recurring Deposit Account

S.NO	BASIS	FIXED DEPOSIT ACCOUNT	RECURRING DEPOSIT ACCOUNT
1	PREFERENCE	Suitable for someone, who has some lump-some amount to invest	Suitable for those who has regular income every month (say a salaried individual) and want to save a certain fixed amount for a specific time interval.
2	DEPPOSIT	Deposited once at the time of opening account	Invested in bank on monthly basis for a fixed rate of return.
3	TDS	TDS (Tax Deductible at Source) applicable on maturity amount, if the interest paid on deposit exceeds Rs.10000/- per year. This is fixed by government to be 10% of interest amount plus 3% Education Cess.	As per Income Tax Rules, there is no TDS (Tax Deductible at Source) applicable.
4	WITHDRAWL FACILITY	Premature and partial withdrawal facilities are available, but not without some penalty, that one has to pay at the time of withdrawal.	Partial withdrawal is not allowed nor we can pay more than the decided amount.

8.9 Other Facilities Given by Banks

Nomination Facility:

This facility was given to the customers after a provision was made in the Banking Laws (Amendment) Act of 1983. This facility is provided on every Deposit Account. Nomination means a person who is liable to receive deposited amount in case of death of the original depositor. Nominee is the person who is selected for the nomination facility. The nomination facility can be availed at the time of opening the deposits account or later. Nominee can be changed in future if the depositor desires to do so.

Procedure for Availing Nomination Facility

1. Depositor has to fill up a prescribed form available at the time of opening of account. Depositor has to mention if he is not willing to avail such facility.
2. If the depositor dies, nominee has to file the claim in the prescribed format alongwith the proof of death of the depositor.
3. After verifying documents, banks make payment according to the provision.

Locker Facility:

Bank provides this facility to those customers who want to keep their important documents and valuable jewelleries safe. Lockers are small boxes which have a pair of keys. One pair is with the bank and the other is with the customer. Unless both keys are used simultaneously the locker won't open. Also, these lockers are kept in a room that is guarded heavily and has solid iron doors or concrete walls around it. It is literally impossible to force our way into the locker room without having the key to the doors. Each customer is charged an annual fee for holding the locker with the bank. These things are safer in the custody of the bank rather than keeping them at home. By filling a form, bank allot us a locker and its key. We can operate our locker during working hours of the bank.

Internet Banking:

Internet banking (or E-banking) means any user with a personal computer and a browser can get connected to his banks website to perform any of the virtual banking functions. In internet banking system the bank has a centralized database that is web-enabled. All the services that the bank has permitted on the internet are displayed in menu. Any service can be selected and further interaction is dictated by the nature of service. The traditional branch model of bank is now giving place to an alternative delivery channels with ATM network. Once the branch offices of bank are interconnected through terrestrial or satellite links, there would be no physical identity for any branch. It would a borderless entity permitting anytime, anywhere and anyhow banking. The network which connects the various locations and gives connectivity to the central office within the organization is called intranet. These networks are limited to organizations for which they are set up

Procedure of Doing Internet Banking:

1. We need to enter Internet Banking User Id and password each time to access internet banking account. Since access is protected by this password it is very important that protect password, by making it known only to you.
2. The system prompts you to change the password on first time login. It is recommended to change both login and transaction password.
3. Your password should be at least 8 characters long.

4. Do not use your date of birth, telephone number, address, your name or the name of a friend or relative in your password.
5. Your internet banking account is locked in case you enter wrong user id and password 3 times.
6. Change your password regularly.
7. Ensure that you are not observed while entering the password.
8. Never leave your computer unattended while you are logged in to.
9. Always logoff from Internet Banking upon completion of your session. Use the Logout button for closing the session. It is preferable not to shut the window to log off.
10. Disable the option on browsers for storing user names and passwords. You can refer to the help section available on your browser for instructions

Use of Internet Banking

We can facilitate payment of electricity and telephone bills, mobile phone, credit card and insurance premium bills as each bank has tie-ups with various utility companies, service providers and insurance companies, across the country. To pay your bills, all you need to do is complete a simple one-time registration for each biller. You can also set up standing instructions online to pay your recurring bills, automatically. Generally, the bank does not charge customers for online bill payment.

Funds Transfer

Funds can be transferred from one account to another of the same or any another bank. Customers can send money anywhere in India. Once you login to your account, you need to mention the payee's account number, his bank and the branch. The transfer will take place in a day or so, whereas in a traditional method, it takes about three working days.

Credit Card Customers

With Internet banking, customers can not only pay their credit card bills online but also get a loan on their cards. If you lose your credit card, you can report lost card online.

Investing Through Internet Banking

You can now open an FD online through funds transfer. Now investors with interlinked demat account and bank account can easily trade in the stock market and the amount will be automatically debited from their respective bank accounts and the shares will be credited in their demat account. Moreover, some banks even give the facility to purchase mutual funds directly from the online banking system. Nowadays, most leading banks offer both online banking and demat account. However if you have your demat account with independent share brokers, then you need to sign a special form, which will link your two accounts.

Recharging Your Prepaid Phone

Now just top-up your prepaid mobile cards by logging in to Internet banking. By just selecting your operator's name, entering your mobile number and the amount for recharge, your phone is again back in action within few minutes.

Shopping

With a range of all kind of products, you can shop online and the payment is also made conveniently through your account. You can also buy railway and air tickets through Internet banking.

Advantage of Internet Banking :

Through Internet banking, you can check your transactions at any time of the day, and as many times as you want to. Where in a traditional method, you get quarterly statements from the bank. If the fund transfer has to be made outstation, where the bank does not have a branch, the bank would demand outstation charges. Whereas with the help of online banking, it will be absolutely free for customers.

Mobile Banking:

This Facility is available to the account holders of Current account, Saving account, Loan account, and Fixed Deposit account. The service is available on java enabled /Android mobile phones (with or without GPRS) where the user is required to download the application on the mobile handset. The service can also be availed via WAP on all phones (java/non java) with GPRS connection. The Service is free of charge.

The following functionalities are available:

- Funds transfer (within and outside the bank)
- Interbank Mobile Payment Services (IMPS)
- Enquiry services (Balance enquiry/ Mini statement)
- Cheque book request
- Demat Enquiry Service
- Bill Payment (Utility bills, credit cards, Insurance premium), Donations, Subscriptions
- Mobile Top up

Inter-City Transaction:

We can deposit and withdraw inter-city cheques, demand deposits etc. We can deposit cheque of another bank in our bank and it get cleared in 24 hrs. if it is a local cheque and it takes 2 days for inter city transaction.

Activity D:

1 Register your mobile number to the bank and avail the facility of Mobile Banking.

8.10 Summary

There are mainly four types of accounts which are provided to the customers viz., Savings Account, Fixed Deposit Account, Current Account and Recurring Deposit Account. Depending upon the nature and type of requirement customer can choose any type of account. Different bank accounts are classified for different users such as for salaried person, businessperson etc. Every account has its own advantages and features. Although every deposit account has some restrictions regarding transaction. Banks also provide various different facilities like locker, e-banking, mobile banking, ATM cards etc. Above mentioned modern banking facilities allow us to do general banking transaction with banks easily even sitting at home. Earlier banks were considered safest mode of depositing money but nowadays they are serving more than that. Modernization and use of advanced technology in banking facilities, allow customers to do their transaction more easily. 24 hour facility at ATM allows us to withdraw at anytime, anywhere unlike earlier days when customers had to transact only during working hours. This also reduces burden at bank's counter. Different modes of transaction like Demand Draft , Cheques and other Negotiable Instruments helps customers a lot while doing intercity or interstate transactions.

Key Words

ATM: An automated teller machine or automatic teller machine (ATM), is a Computerized telecommunications device that provides the clients of a financial Institution with access to financial transactions in a public space without the need for a cashier, human clerk or bank teller.

Bank: An institution which collects money from those who have it to spare or who are saving it out of their income, and lends this money out to those who require it.

Bills of Exchange: An unconditional order issued by a person or business which directs the recipient pay a fixed sum of money to a third party at a future date. The future date may be either fixed or negotiable. A bill of exchange must be in writing and signed and dated also called draft.

Current Deposit: These accounts are mainly used by businessmen and are not generally used for the

Account: Purpose of investment. There are no limits for number and amount of transactions in a day

Fixed Deposit: Fixed Deposit refers to a savings account or certificate of deposit that pays a fixed rate of

Account: Interest until a given maturity date. Funds placed in a Fixed Deposit usually cannot be withdrawn prior to maturity or they can perhaps only be withdrawn with advanced notice and/or by having a penalty assessed.

Recurring Deposit: Recurring Deposits are a special kind of Term Deposits offered by banks in India which

Account: Help people with regular incomes to deposit a fixed amount every month into their Recurring Deposit account and earn interest at the rate applicable to Fixed Deposits. This deposit matures on a specific date in the future along with all the deposits made every month.

Saving Bank: These accounts let customers set aside a portion of their liquid assets while Account earning a monetary return. A deposit account held at a bank or other financial institution that provides principal security and a modest interest rate.

TDS: TDS is one of the modes of collection of taxes, by which a certain percentage of amount are deducted by concerned authority at the time of making crediting certain specific nature of payment to the other person and deducted amount is remitted to the Government Account.

8.11 Self Assessment Questions

1 Explain different types of bank accounts in detail.

2 What is the procedure of opening a Saving Bank account? Describe the main characteristics of a savings bank account.

3 What type of customer chooses Current account and why? Explain with its features and advantages.

4 What are the various uses of ATM cards? What are the precautions to be taken while using it?

5 Figure out the differences between

a. Savings Deposit Bank Account and Current Deposit Bank Accounts
b. Fixed Deposit Bank Account and Recurring Deposit Bank Accounts .

6 Discuss the other facilities provided by the banks to different types of the customers.

8.12 Books for Further Readings

- N.S. Toor (2006); 'Hand book of Banking Information'; Skylark Publication, New Delhi
- Jain, Rathi, Sharma(2010); 'Banking Services Operations', RBD Professional publication, Jaipur-New Delhi
- Trivedi, Chaudhary, Kumar(2010); 'Indian Banking System', Ramesh Book Depot, Jaipur-New Delhi
- www.nios.ac.in
- www.gktoday.in
- www.banknetindia.com

Unit - 9 : Loans and Advances

Structure of Unit:

9.0 Objectives

After completing this unit, you would be able to:

- Enlist the utility of granting loans and advances by commercial banks
- Differentiate borrowing rates from lending rates;
- Uses and application of loans and advances
- Enumerate the ways of lending money
- Distinguish between long-term and short-term loans;
- Point out the nature of security provided for loans; and
- Outline the procedure for grant of cash credit, overdraft and
- Discounting of bills of exchange.

9.1 Introduction

Lending money is one of the primary functions of the bank. Lending of funds to individuals, traders, businessmen and industrial enterprises, is one of the important activities of commercial banks. Interest earns on these loans and advances are the major source of income of the banks. Interest given on deposits is lower than the interest received on such loans and advances. Amount deposited by the customers forms the main source of loans and advances. Banks lend money in various forms for various purposes. Operation and expansion of business and commercial activities depend a great deal on the availability of loans/advances from commercial banks. The term 'loan' refers to the amount borrowed by one person from another. The amount is in the nature of loan and refers to the sum paid to the borrower. Thus from the view point of borrower, it is 'borrowing' and from the view point of bank, it is 'lending'. Loan may be regarded as 'credit' granted where the money is disbursed and its recovery is made on a later date. It is a debt for the borrower. While granting loans, credit is given for a definite purpose and for a predetermined period. Interest is charged on the loan at agreed rate and intervals of payment. 'Advance' on the other hand, is a 'credit facility' granted by the bank. Banks grant advances largely for short-term purposes, such as purchase of goods traded in and meeting other short-term trading liabilities. There is a sense of debt in loan, whereas an advance is a facility being availed of by the borrower. However, like loans, advances are also to be repaid. Thus a credit facility-repayable in installments over a period is termed as loan while a credit facility repayable within one year may be known as advances. However, in the present lesson these two terms are used interchangeably.

9.2 Merits of Granting Loans and Advances

Loans and advances granted by commercial banks are highly beneficial to individuals, firms, companies and industrial concerns. The growth and diversification of business activities are effected to a large extent through bank financing. Loans and advances granted by banks help in meeting short-term and long term financial needs of individual and business enterprises. Followings are roles played by the uses of borrowed funds for different nature of borrowers:-

1. For Banks

Banks earn through loans and advances. When bank accept deposit, they collect money from various customers. On these deposits, bank gives interest. Now, keeping some part of their deposits as Statutory Liquidity Ratio (SLR),as per the guidelines of the RBI, bank can lend or circulate remaining part to the borrower. Bank charges interest on these advances which is higher than the interest rate given on deposits. This process is called Credit Creation. This difference between lending interest rates and borrowing interest rate creates profit for the banks. By these loans and advances, not only banks are benefited but customers also get benefited as they get their need fulfilled through such loans.

2. For Business Entities, Traders and Industrial Concerns

- Loans and advances can be arranged from banks in keeping with the flexibility in business operations. Traders may borrow money for day to day financial needs availing of the facility of cash credit, bank overdraft and discounting of bills. The amount raised as loan may be repaid within a short period to suit the convenience of the borrower. Thus business may be run efficiently with borrowed funds from banks for financing its working capital requirements.
- Loans and advances are utilized for making payment of current liabilities, wages and salaries of employees, and also the tax liability of business.
- Loans and advances from banks are found to be 'economical' for traders and businessmen, because banks charge a reasonable rate of interest on such loans/advances. For loans from money lenders, the rate of interest charged is very high. The interest charged by commercial banks is regulated by the Reserve Bank of India which is comparatively low.
- Bank loans and advances are found to be convenient as far as its repayment is concerned. This facilitates planning for future and timely repayment of loans. Otherwise business activities would have come to a halt.

Banks generally do not interfere with the use, management and control of the borrowed money. But it takes care to ensure that the money lent is used only for business purposes. Loans and advances by banks generally carry element of secrecy with it. Banks are duty-bound to maintain secrecy of their transactions with the customers. This enhances people's faith in the banking system.

3. For Individuals: For individual loans serve various purposes such as

a. For children Education

b. For Children Marriage

c. For House Building

d. For Purchasing of Car, Jewellery, Furniture, Land and Other Assets

e. For Investing Somewhere Else in Profitable Avenues

4. Others:

Overall development of the society, depends on the these loans and advances to a great extent. Consumption pattern of the consumer has been increased positively, which is possible because of the credit available on easy terms from banks. Loans and Advances allow domestic traders to trade in a global market. Dealing in international markets requires a huge capital outlay which can be obtainable from banks on specified terms and conditions. It encourages commercial progress which is essential for the development of the economy.

Activity A:

1. Visit nearby branches of different bank and enquire about the prevailing interest rates on lending loans and advances and interest rates on different deposit accounts. .

9.3 Principles of Lending

Banks should follow some basic principles at the time of lending. This ensures efficient and long term working of the banks. Some of the basic principles of lending are as follows

1. Safety:

The most important rule for granting/lending loans is the safety of funds. This is so because the banks earn income through these loans and advances. In case the bank does not get back the loans granted by it, it might fail. A bank cannot and must not sacrifice the safety of its funds to get higher rate of interest. Banks must ensure the creditworthiness of the borrower before lending

2. Liquidity:

The second important principle of granting loan is liquidity. Liquidity means possibility of converting loans into cash without loss of time and money. Funds with the bank out of which he lends money are payable on demand or short notice. As such a bank cannot afford to block its funds for a long time. Hence the bank should lend only for short-term requirements like working capital. The bank cannot and should not lend for long-term requirements, like ûxed capital.

3. Return or Profitability

Return or profitability is another important principle. The funds of the bank should be invested to earn highest return, so that it may pay a reasonable rate of interest to its customers on their deposits, reasonably good salaries to its employees and a good return to its shareholders. However, a bank should not sacrifice either safety or liquidity to earn a high rate of interest.

4. Diversification:

'One should not put all his eggs in one basket' is an old proverb which very clearly explains this principle. A bank should not invest all its funds in one industry. In case that industry fails, the banker will not be able to recover his loans. Hence, the bank may also fail. According to the principle of diversification, the bank should diversify its investments in different industries and should give loans to different borrowers in one industry. It is less probable that all the borrowers and industries will fail at one and the same time.

5. Object of Loan:

A banker should thoroughly examine the object for which his client is taking loans. This will enable the bank to assess the safety and liquidity of its investment. A banker should not grant loan for unproductive purposes.

The bank may grant loan to meet working capital requirements. However, after nationalisation of banks, the banks have started granting loans to meet long-term requirements.

6. Security:

A banker should grant secured loans only. In case the borrower fails to return the loan, the banker may recover his loan after realizing from the sale of security. In case of unsecured loans, the chances of bad debts will be very high. Security conditions are different in different banks..

7. Margin Money:

In case of secured loans, the bank should carefully examine and value the security. There should be sufficient margin between the amount of loan and the value of the security. If adequate margin is not maintained, the loan might become unsecured in case the borrower fails to pay the interest and return the loan. The amount of loan should not exceed 60 to 70% of the value of the security. If the value of the security is falling, the bank should demand further security without delay. In case he fails to do so, the loan might become unsecured and the bank may have to suffer loss on account of bad debt.

8. National Interest:

Banks were nationalised in India to have social control over them. As such, they are required to invest a certain percentage of loans and advances in priority sectors viz., agriculture, small scale and tiny sector, and export-oriented industries etc. Again, the Reserve Bank also gives directives in this respect to the scheduled banks from time to time. The banks are under obligations to comply with those directives.

9. Character of the Borrower:

Last but not the least, the bank should carefully examine the character of the borrower. Character implies honesty, integrity, credit-worthiness and capacity of the borrower to return the loan. In case he fails to verify the character of the borrower, the loans and advances might become bad debts for the bank.

The above are thus the basic principles of sound lending observed by commercial banks. Basic principles must be reviewed and modified as per the need and requirement of the current scenario.

9.4 Types of Loan

Commercial banks lend money in four different ways:

I. Loans

Loan is the amount borrowed from bank. The nature of borrowing is that the money is disbursed and recovery is made in installments. While lending money by way of loan, credit is given for a definite purpose and for a pre-determined period. Depending upon the purpose and period of loan, each bank has its own procedure for granting loan. However the bank is at liberty to grant the loan requested or refuse it depending upon its own cash position and lending policy. There are two types of loan available from banks:

(a) ***Demand Loan***:- A Demand Loan is a loan which is repayable on demand by the bank. In other words, it is repayable at short-notice. The entire amount of demand loan is disbursed at one time and the borrower has to pay interest on it. The borrower can repay the loan either in lump sum (one time) or as agreed with the bank. Such loans are normally granted by banks against security. The security may include materials or goods in stock, shares of companies or any other asset. Demand loans are raised normally for working capital purposes, like purchase of raw materials, making payment of short-term liabilities.

(b) ***Term Loans*** : Medium and long term loans are called term loans. Term loans are granted for more than a year and repayment of such loans is spread over a longer period. The repayment is generally made in suitable instalments of a fixed amount. Term loan is required for the purpose of starting a new business activity, renovation, modernization, expansion/ extension of existing units, purchase of plant and machinery, purchase of land for setting up of a factory, construction of factory building or purchase of other immovable assets. These loans are generally secured against the mortgage of land, plant and machinery, building and the like.

II. Cash Credit

Cash credit is a flexible system of lending under which the borrower has the option to withdraw the funds as and when required and to the extent of his needs. Under this arrangement, the banker specifies a limit of loan for the customer (known as cash credit limit) up to which the customer is allowed to draw. The cash credit limit is based on the borrower's need and as agreed with the bank. Against the limit of cash credit, the borrower is permitted to withdraw as and when he needs money subject to the limit sanctioned.

It is normally sanctioned for a period of one year and secured by the security of some tangible assets or personal guarantee. If the account is running satisfactorily, the limit of cash credit may be renewed by the bank at the end of year. The interest is calculated and charged to the customer's account. Cash credit, is one of the types of bank lending against security by way of pledge or /hypothetication of goods. 'Pledge' bailment of goods as security for payment of debt. Its primary purpose is to put the goods pledged in the possession of the lender. It ensures recovery of loan in case of failure of the borrower to repay the borrowed amount. In 'Hypothetication', goods remain in the possession of the borrower, who finds himself under the agreement to give possession of goods to the banker whenever the banker requires him to do so. So hypothetication is a device to create a charge over the asset under circumstances in which transfer of possession is either inconvenient or impracticable.

III. Overdraft

Overdraft facility is more or less similar to 'cash credit' facility. Overdraft facility is the result of an agreement with the bank by which a current account holder is allowed to draw over and above the credit balance in his/ her account. It is a short-period facility. This facility is made available to current account holders who operate their account through cheques. The customer is permitted to withdraw the amount of overdraft allowed as and when he/she needs it and to repay it through deposits in the account as and when it is convenient to him/her. Overdraft facility is generally granted by a bank on the basis of a written request by the customer. Sometimes the bank also insists on either a promissory note from the borrower or personal security of the borrower to ensure safety of amount withdrawn by the customer. The interest rate on overdraft is higher than is charged on loan. The following are some of the benefits of cash credits and overdraft :-

(i) Cash credit and overdraft allow flexibility of borrowing which depends upon the need of the borrower.

(ii) There is no necessity of providing security and documentation again and again for borrowing funds.

(iii) This mode of borrowing is simple, elastic and meets the short term financial needs of the business.

IV. Discounting of Bills

Apart from sanctioning loans and advances, discounting of bills of exchange by bank is another way of making funds available to the customers. Bills of exchange are negotiable instruments which enable debtors to discharge their obligations to the creditors. Such Bills of exchange arise out of commercial transactions both in inland trade and foreign trade. When the seller of goods has to realize his dues from the buyer at a distant place immediately or after the lapse of the agreed period of time, the bill of exchange facilitates this task with the help of the banking institution. Banks invest a good percentage of their funds in discounting bills of exchange. These bills may be payable on demand or after a stated period. In discounting a bill, the bank pays the amount to the customer in advance, i.e. before the due date. For this purpose, the bank charges discount on the bill at a specified rate. The bill so discounted, is retained by the bank till its due date and is presented to the drawer on the date of maturity. In case the bill is dishonoured on due date the amount due on bill together with interest and other charges is debited by the bank to the customers.

9.5 Nature of Loan

Commercial banks grant loans for different periods- term for different purposes. According to their nature banks Loan and Advances can be divided into following categories

(1) **Short-Term Loans**

Short term loans are granted by banks to meet the working capital needs of business. The working capital needs refer to financial needs for such purposes as, purchase of raw materials, payment of wages, electricity bill, taxes etc. Such loans are granted by banks to its borrowers to be repaid within a short period of time not exceeding 15 months. Short term loans are normally granted against the security of tangible assets like goods in stock, shares, debentures, etc.

(2) Long Term Loans

Medium and long term loans are generally known as 'term loans'. These loans are granted for more than 15 months. In case of medium term loan, the period ranges from 15 months to less than 5 years. Medium term loans are generally granted for repairs, expansion of existing units, modernization/renovation etc. Such loans are sanctioned against the security of immovable assets.

9.6 Procedure of Obtaining Loans and Advances

We have studied in this unit that banks provide financial assistance to its customers in the form of loans, advances, cash credit, overdraft and through the discounting of bills. The procedure of applying for and sanction of loans and advances differs from bank to bank. However, the steps which are generally to be taken in all cases are as follow:–

(I) Filling Up of Loan Application Form

Each bank has separate loan application forms for different categories of borrowers. When you want to borrow money from a bank, you will have to fill up a loan application form available with the bank free of cost. The loan application form contains different columns to be filled in by the applicant. It includes all information required about the borrower, purpose of loan, nature of facility (cash-credit, overdraft etc) required, period of repayment, nature of security offered, and the financial status of the borrower. A running business limit may be required to furnish additional information in respect of :

- Assets and liabilities
- Profit and loss for the last 2 to 3 years.
- The names and addresses of three persons

(which may include borrowers, suppliers, customers and bankers) for reference purposes.

(II) Submission of Form Along With Relevant Documents

The loan application form duly filled in should be submitted to the bank along with the relevant documents.

(III) Sanctioning of Loan

The bank scrutinizes the documents submitted and determines the credit worthiness of the applicant. If it is found to be feasible, the loan is sanctioned. If the loan is for Rs 5000 or less, normally the Branch Manager himself can take the decision and sanction the loan. In case the amount of loan is more than Rs

5000, the application is considered at regional, zonal or head office level, depending on the amount of loan.

(IV) Executing the Agreement

When the loan is sanctioned by the bank and the borrower is informed about it,he will have to execute an agreement with the bank regarding terms and condition for the amount of loan raised.

(V) Arrangement of Security for Loan

The borrower will now arrange for security against the loan. These securities may be immovable properties, shares, debentures, fixed deposit receipts, and other documents, like Kisan Vikas Patra, National Savings Certificate, as per agreement. When the borrower completes all the formalities, he is allowed to get the amount of loan/advance/ over draft as sanctioned by the bank. In case of 'discounting of bills', the bank credits the amount of bill to the customer's account before the realization of the bill and thus, makes available the fund. In case, the bill is dishonoured on due date, the amount due on the bill together with interest and other charges are payable by the party whose bill is discounted.

Activity B:

1 Familiarize yourself with the important documents, like application form for loan, including procedure involved in getting Short term and long-term loan.

9.7 Classification of Loan

Due to the unequal distribution of wealth, India has arrived at a situation where the affluent class gets richer and richer and the underprivileged becomes poorer. To bridge this financial gap and to satisfy their day to day requirements, Bank plays a vital role by offering various loans to the finance seekers. Hence every borrower should have prior knowledge on the various Bank Loans in India, which are eligible for meeting their financial objectives.

I. Personal Loans

A personal loan is a short-term loan to assist you with your finances. This payday loan is secured against a future pay check. These loans have become quite popular today, and now this is the main way to get financial assistance in the form of a cash advance. A personal loan is a type of debt which is made for personal, family, or household use, and which is neither a business loan nor a long-term mortgage loan. The lender loans money to the borrowers. The borrowers pay back this amount, usually but not always in regular installments. This service is generally provided at a cost, which is referred to as interest on the debt. With a personal loan one can meet his financial requirements. Be it any ceremony in the family, a surprise gift or a grand vacation, personal loans provide a helping hand. The personal loan helps to take care of all kinds of expenses in a short time period. This type of loan usually covers travel expenses, holiday expenses, medical expenses, marriage expenses, honeymoon expenses or any other personal type expenses. A personal loan can be further classified into a secured and an unsecured loan. The main difference between the two is that one is obtained with collateral and the other without the collateral. But the purpose of the loan remains the same that is to realize personal needs.

Types of Personal Loans

There are basically two types of Personal Loans. They are:

Secured Loan: - Wherein the loan involves the attachment of collateral - say, your property or any fixed/ movable asset- against the sum of money borrowed. Secured loan is obtained by pledging collateral such as a house, a car, property or anything of value, on failure of repayment of loan amount the borrower runs the risk of confiscation of the collateral. But at the same time a secured personal loan will come to a borrower at a low APR(Annual Percentage Rate) and a larger amount of loan will be sanctioned due to the collateral laid out to the lender in the form of security. Since the lender has some amount of security to claim back on his loan amount he easily offers loan to the borrower. The higher the value of collateral, the higher amount of loan can be obtained from bank. Risk of losing our pledged asset or security is only our responsibility, in case when we unable to pay installments which are decided by bank.

Unsecured Loan*:* - When the loan is not secured against any collateral or security. But consequently the lender would charge a higher rate of interest, taking into account the high risk involved in lending the sum without security. If borrower fails to make regular payments of installments, bank can follow the prescribed legal procedure for recovering the loan amount.

Points to Kept in Mind before Taking Short Term Personal Loans

- The rate of interest involved is usually high. This is because the period of repayment is usually for a short time.
- This type of short term funding is often utilized to help individuals who are in need of varying sums of money for a short period.
- Banks, while giving this type of short term personal loan, usually require collateral, before disbursing the same.
- Because of the negative and positive aspects of short term personal loans, it is recommended that the individual does his research thoroughly, before applying for funding.

II. Home Loans

To buy a dream home is the dream of every person. Home Loan has helped in changing every Indian's dream into reality. However, the every increasing property rates and escalating rates of interest sometimes act as an obstacle. Therefore, before opting for a home loan it is advisable to check every prospect of the product. Food, clothing and shelter are the basic necessities of life and we have evolved from the cave dwelling times. Today, our houses are more for comfort than for survival. So it is every individual's desire to build the coziest nest to live in. This is where Home Loans come in.

III. Business Loans

Before starting a business, the entrepreneur should be mentally and financially prepared to encounter the fiscal setbacks during the process. To bail the companies out from the fiscal crunch, several banks in India offers business loans both for meeting urgent official growth and expenses.

IV. Car Loans

Every individual want to own a car. Hence, the need for car loans emerges at some point or the other. While selecting a car loan it is always wise to scrutinize the various options accessible in the market besides analyzing its fiscal suitability.

V. Education Loans

Education Loans offered by various banks in India provide much required assistance to fund your child's education when all other resources of finance get exhausted. Education Loans are offered by almost every Indian bank thus providing ample opportunity to students to undergo higher education both in India and abroad.

Activity C:

1. Chart out the procedure for getting loans and advances from bank with the important documents required and other formalities to be completed.

9.8 Determining Creditworthiness

An assessment of the possibility that a borrower will pay the amount due on him timely. It is based upon factors, such as their history of repayment and their credit score in case of companies. In simple words we can say that Creditworthiness is the repaying capacity of the borrower. Banks and other lending institutions generally consider the availability of assets and extent of borrowing to determine the probability of repaying the borrowed amount. Creditworthiness has to do with the ability of a borrower to pay current debt in a timely manner. Within the context of the ability, several other basic factors are considered. An evaluation of the creditworthiness of a borrower involves identifying the presence of resources that may be used to repay debts, the willingness of the debtor to use those resources for repaying debt, and a history of choosing to repay debt obligations in a timely manner. When creditors choose to extend credit to an individual or business, that extension of credit is based on the understanding that the borrower will have resources that can be used to repay the debt. This is where the past credit history of the individual or business becomes important. When the borrower has a history of paying outstanding debt within terms, this is a strong sign of past creditworthiness. Using past history as an indicator, a creditor can reasonably assume the borrower will be able to repay in the future. Credit is given on mutual trust and faith.

9.9 Role of RBI in Development Through Loans and Advances

Rural Credit

The Reserve Bank's role has been to ensure timely and adequate credit to the agricultural sector at affordable cost. Section 54 of the RBI Act, 1934 states that the Bank may maintain expert staff to study various aspects of rural credit and development and in particular, it may tender expert guidance and assistance to the National Bank (NABARD) and conduct special studies in such areas as it may consider necessary to do so for promoting integrated rural development.

Lead Bank Scheme

The Reserve Bank introduced the Lead Bank Scheme in 1969. Here designated banks were made key instruments for local development and were entrusted with the responsibility of identifying growth centers, assessing deposit potential and credit gaps and evolving a coordinated approach for credit deployment in each district, in concert with other banks and other agencies. The Reserve Bank has assigned a Lead

District Manager for each district who acts as a catalytic force for promoting financial inclusion and smooth working between government and banks. Special Agricultural Credit Plan With a view to augmenting the flow of credit to agriculture, Special Agricultural Credit Plan (SACP) was instituted and has been in operation for quite some time now. Under the SACP, banks are required to fix self-set targets showing an increase of about 30 per cent over previous year's disbursements on yearly basis (April – March). The public sector banks have been formulating SACP since 1994. The scheme has been extended to Private Sector banks as well from the year 2005-06.

Kisan Credit Cards

The Kisan Credit Card (KCC) Scheme was introduced in the year 1998-99 to enable the farmers to purchase agricultural inputs and draw cash for their production needs. On revision of the KCC Scheme by NABARD in 2004, the scheme now covers term credit as well as working capital for agriculture and allied activities and a reasonable component for consumption needs. Under the scheme, the limits are fixed on the basis of operational land holding, cropping pattern and scales of finance. Seasonal sub-limits may be fixed at the discretion of the banks. Limits may be fixed taking into account the entire production credit needs along with ancillary activities relating to crop production, allied activities and also non-farm short term credit needs (consumption needs). Limits are valid for three years subject to annual review. Security, margin and rate of interest are as per RBI guidelines issued from time to time.

Natural Calamities – Relief Measures

In order to provide relief to bank borrowers in times of natural calamities, the Reserve Bank has issued standing guidelines to banks. The relief measures include, among other things, rescheduling / conversion of short-term loans into term loans; fresh loans; relaxed security and margin norms; treatment of converted/ rescheduled agriculture loans as 'current dues'; non-compounding of interest in respect of loans converted / rescheduled; and moratorium of at least one year.

Micro, Small and Medium Enterprises Development

With the enactment of the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, the services sector has also been included in the definition of micro, small and medium enterprises, apart from extending the scope to medium enterprises. The Act sought to modify the definition of micro, small and medium enterprises engaged in manufacturing or production and providing or rendering of services. Some of the major measures by RBI/ GOI to improve the credit flow to the MSE sector are as under:

Institutions to Meet Needs of the Evolving Economy

Recognizing the important role of exports in maintaining the viability of external sector and in generating employment, the Reserve Bank had sought to ensure adequate availability of concessional bank credit to exporters. It took the lead role in setting up the Export Import Bank of India (EXIM Bank) in January 1982. In recent years, with the liberalization of real and financial sectors of the economy, interest rates on export credit have been rationalized. When India embarked upon the era of planned development, the primary need was to facilitate adequate flow of credit to the industrial and other sectors according to the Plan priorities. A major task undertaken by the Reserve Bank was to put in place the necessary institutional mechanism to complement the planning efforts. This was crucial especially in the context of an underdeveloped and evolving financial system. In the absence of a well-developed capital market, the Reserve Bank played a proactive role in setting up a number of specialized financial institutions at the national and regional level to widen the facilities for term finance to industry and for institutionalization of savings – a novel departure for a central bank. The institutions set up included:

- 1962: Deposit Insurance Corporation
- 1963: Agricultural Refinance Corporation
- 1964: Unit Trust of India
- 1964: Industrial Development Bank of India
- 1969: National Institute of Bank Management
- 1971: Credit Guarantee Corporation
- 1978: Deposit Insurance and Credit Guarantee Corporation (The DIC and CGC were merged and renamed as DICGC)
- 1982: National Bank for Agriculture and Rural Development
- 1982: Export-Import Bank of India
- 1987: Indira Gandhi Institute of Development Research
- 1988: Discount and Finance House of India
- 1988: National Housing Bank
- 1990: Small Industries Development Bank of India
- 1994: Securities Trading Corporation of India
- 1995: Bharatiya Reserve Bank Note Mudran Private Limited
- 1996: Institute for Development & Research in Banking Technology
- 2001: Clearing Corporation of India Limited
- 2008: National Payments Corporation of India

Export Credit.

In order to provide adequate credit to exporters on a priority basis, the Reserve Bank has also prescribed a minimum proportion of banks' adjusted net bank credit to be lent to exporters by foreign banks. Post liberalization and deregulation of the financial sector within the country, it was observed that banking industry has shown tremendous growth in volume and range of services provided while making significant improvements in financial viability, profitability and competitiveness. However, banks had not been reaching and bringing vast segments of the population, especially the underprivileged sections of society, into the fold of basic banking services to the desired extent. This prompted the need for the RBI to develop a specific focus towards Financial Inclusion for inclusive growth. The Reserve Bank established Working Groups in Bihar, Uttaranchal, Chhattisgarh, Lakshadweep, Himachal Pradesh and Jharkhand between July 2006 and October 2007 with a view to improving the outreach of banks and their services, promoting financial inclusion and supporting the development plans of the State Governments. The reports examined the adequacy of banking services, made constructive suggestions towards enhancing the outreach of banks and promoting financial inclusion as well as revitalizing Regional Rural Bank (RRBs) in the respective regions. To improve banking penetration in the North-East, the Reserve Bank of India established a Committee on Financial Sector Plan (CFSP) for North Eastern Region in January 2006. The report includes, among other things, suggestions for expanding the banking outreach, simplification of system and procedures for opening bank accounts, land collateral substitutes, currency management, funds transfer and payment facilities and revised human resources incentives in the region. The Report addressed important issues pertaining to financial inclusion, improving CD ratio, providing hassle-free credit. The Reserve Bank has also formulated scheme for setting-up banking facilities (currency chests, extension of foreign exchange and Government business facilities) at centers in the North-Eastern region, which are not found to be commercially viable by banks. The State Governments would make available necessary premises and other infrastructural support. The Reserve Bank, as its contribution, would bear the one time capital cost and recurring costs for a limited period of five years.

Financial Inclusion

The Reserve Bank's approach to customer service focuses on protection of customers' rights, enhancing the quality of customer service, and strengthening the grievance redressal mechanism in banks and also in the Reserve Bank. The Reserve Bank's initiatives in the field of customer service include the setting up of a Customer Redressal Cell, creation of a Customer Service Department and the setting up of the Banking Codes and Standards Board of India (BCSBI), an autonomous body for promoting adherence to self-imposed codes by banks. In order to strengthen the institutional mechanism for dispute resolution, the Reserve Bank in 1995 introduced the Banking Ombudsman (BO) scheme. The BO is a quasi-judicial authority for resolving disputes between a bank and its customers. The scheme covers grievances of the customers against commercial banks, urban cooperative banks and regional rural banks. In 2006, the RBI introduced a revised BO scheme. Under the revised scheme, the BO and the attached staff are drawn from the serving employees of the Reserve Bank. The new scheme is fully funded by the RBI and covers grievances related to credit cards and activities of the selling agents of banks also. Under the BO scheme, both the complainant and the bank, if unsatisfied with the decision of the BO, can appeal against the decisions of the BO to the appellate authority within the Reserve Bank.

9.10 Summary

The main activities of a commercial bank include acceptance of deposits that is mobilization of funds, and lending these funds to people who require it for various purpose. On the deposits received the bank pays interest to the depositors at a specified rate. This is known as the 'Borrowing Rate'. When the Reserve Bank of India lends money to commercial banks, the rate of interest it charges is known as 'Bank rate'. The other important activity of a bank is that of granting loans and advances to the public. The rate of interest at which commercial banks lend money to the people is known as 'Lending rate'. The borrowing rates and lending rates are subject to change from time to time. There are four different ways of lending money by banks; viz.

(a)Direct loans; (b) Cash credits; (c) Overdraft, and (d) Discounting of bills.

Bank loans may also be classified into 3 categories i.e. Short term loan, medium term loan and Long-term loan. Short-term loans are granted by banks to meet the working capital needs of business. Medium term loans and long-terms loans are generally known as 'Term loans'. These loans are granted for more than one year for heavy repairs, expansion of units, modernisation/renovation etc. Such loans are sanctioned against the security of permanent, immovable assets. To ensure the safety of the funds lent, banks require the security of tangible assets owned by the owner, both in the case of short-term and term loans. Unsecured loans are those granted against the personal security of the borrowers. There are various types of securities which are acceptable by banks against loans and advances. For getting a loan sanctioned by any bank, one has to apply for it with relevant documents. The bank verifies the application and determines the creditworthiness of the applicant. If it is feasible, the loan is sanctioned. After the sanction of loan the borrower has to enter into an agreement with the bank regarding terms and conditions of the loan. The last step is to arrange for the security for the loan granted by bank. After completing these formalities the borrower is allowed to draw money against the loan.

Key Words

Loans: A loan is a type of debt. the borrower initially receives or *borrows* an amount of money, called the *principal*, from the lender, and is obligated to *pay back* or *repay* an equal amount of money to the lender at a later time. Typically, the money is paid back in regular *installments* or partial repayments

Promissory Note: A promissory note is a negotiable instrument, wherein one party (the *maker* or *issuer*) makes an unconditional promise in writing to pay a determinate sum of money to the other (the *payee*), either at a fixed or determinable future time or on demand of the payee, under specific terms

Negotiable: A transferable, signed document that promises to pay the bearer a sum ey at Instrument date or on demand. Examples include bills of exchange, and promissory notes

Short Term: Short term means period of time not exceeding 15 months.

Long Term: Long term means period of time exceeding for more than 15 months.

9.11 Self Assessment Questions

1 What do you mean by Loans and Advances? How various deposits form the base of loans and advances?

2 Loans and Advances serve various purpose for Banks as well as for Society. Explain.

3 Classify different categories of loan on the basis of nature and their utilities.

4 Discuss in brief the role of RBI in developing our economy through loans and advances.

9.12 Books for Further Readings

- N.S. Toor (2006); 'Hand book of Banking Information'; Skylark Publication, New Delhi
- Jain, Rathi, Sharma (2010); 'Banking Services Operations', RBD Professional publication, Jaipur-New Delhi
- Trivedi, Chaudhary, Kumar (2010); 'Indian Banking System', Ramesh Book Depot, Jaipur-New Delhi
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Unit - 10 : Bank Services

Structure of Unit:

10.0 Objectives

After reading this unit you should be able to understand:

- The services provided by banks
- Meaning of advances
- Different forms of advances
- Different types of bank instruments
- Negotiable Instruments
- Bank remittance services
- Types of accounts available for NRI's
- What are safe custody vaults

10.1 Introduction: Bank Services

When we talk about bank services, we as a customer make it a hallmark if the basic services are provided conveniently and in a good manner by a genuine banker . Though there is a wide range of services which a bank offers, that defining each one is difficult but some of the basic and traditional services are illustrated here:

1. To keep a record of customer deposits
2. To collect cheques drawn on other banks by customers
3. Payment of self drawn cheques of customers
4. To provide remittance facilities by issue of drafts, mail transfer and telegraphic transfers
5. To issue performance and financial guarantees

Other than these there are certain other services which a bank has to provide:

- Advances: E.g. Overdraft, cash credits etc
- Deposits: E.g. Saving a/c, current a/c, etc
- Financial services: Providing foreign currency, travellers cheques etc
- Money Transmission: Funds transfer etc.
- Services of place or time: ATM Services.
- Status: Debit Cards, Credit Cards, etc.

10.2 Advances

Every business is run with an objective of earning profits. Even the banks are profit oriented and they also invest their funds to earn profits. Advances are credit provided by banks to their customers, traders, businessmen and industrialists against security of assets or on the basis of personal security of the borrower.

Advances can be broadly classified into two heads.

- Unsecured Advances
- Secured Advances.

10.2.1 Unsecured Advances :

According to Banking regulations Act-5 (i) (n) "Unsecured Advances or loans means a loan or advances not secured" In such kind of advances the customer is not required to offer bank any tangible security.

These kind of advances are given to those customers who have sound financial backing, high business reputation and capacity to manage business, because general capacity of such customers act as a security itself for the bank. To be on a safer side and avoid unsecured creditors and default by the customers a bankers provides these advances by taking guarantee of one or more person. The bankers should have confidence in the customers and to judge this confidences he has to consider 3C's.

- Character
- Capacity
- Capital

i) Character:

The best asset of a man is his character. A person who carries qualities like honesty, promptness reputation, responsibility and goodwill is consider a man of character and bank can extent advance to such a man without hesitation.

ii) Capacity:

When we talk about capacity of an entrepreneur, it refers to his ability to manage his business. How often he takes initiatives, his interest in his business, his experience and managerial abilities adds to the success of the business. A man with all these skills can be granted advances by banks. Now-a-day nationalized banks judge the capacity of the borrower not only by these skills but also on the basis of economic viability of the project when a project manufacturers goods at lower cost and leaves sufficient profits to meet commitment of loan the project is considered as economically viable.

iii) Capital:

Capital is the amount invested by a proprietor in his business. With the help of capital of a proprietor purchases goods and machinery and plant. A banks fulfills the working capital requirement of a business.

Dr. C.B. Memoria has evolved a formula for banks to judge soundness of man before lending advances.

a) **Character + Capacity +Capital = Safe Credit**
b) **Character + Capacity + Insufficient capital=Fair credit risk**
c) **Character + Capacity – Capital = Limited success**
d) **Character + Capacity – Impaired character = Doubtful credit risk**
e) **Capital + Capacity –Character = Dangerous risk**
f) **Character + Capital – Insufficient capacity = Fair credit risk**
g) **Character + Capital – Capacity = Inferior credit risk**

h) Character – Capital – Capacity = Fraudulent one

10.2.2 Secured Advances:

Secured advances are those which can be taken against certain security of tangible assets like land building etc.

According to banking regulation Act 1949 Sec. 5(i) (n) " Secured loand or advances means a loan or advance made on the security of assets the market value of which is not at any time less than the amount of loans or advances".

This definition highlights two essential features of secured advances

- Advances must be made against tangible security.
- Market value of security must not be less than the amount of loan granted.

Type of security offered varies from place to place like agricultural produce is considered as security in agricultural centers. In metros government bonds and stock exchange securities are offered

TYPE OF SECURITIES:

Primary Security | **Collateral securities**

Figure 10.1 : Types of Securities

Primary Security : Asset which has been bought with the help of bank finance

Collateral Securities: In narrow sense collateral securities can be said as securities deposited by third party to secure advance for the borrower and in wider sense – any type of security on which the creditor has a personal right of action on debtor in respect of advance.

10.3 Forms of Advances

Advances can be broadly classified into four types:-

1) Loan:

When a banker provides a lump sum amount for a certain period of time at an agreed rate of interest, it is term as loan. The ensure amount is given by bank in cash or by credit in account of the concerned person and the person has to repay this loan in installment with the predefined rate of interest.

Loan can be of two types:

Demand Loan: - It is for a short period of time and usually granted to meet working capital needs of the borrower.

Terms Loans: - These are for medium term or long term and are for purchase of vehicle and meet capital expenditures respectively.

2) Cash Credit:

It is an arrangement by which the customer is allowed to borrow money upto a certain limit on a permanent basis. Customer need not to draw the whole amount at once instead he can withdraw the amount according to his requirement as and when he need. He also has liberty of putting back the excess amount. The interest is charged on the amount withdrawn.

Cash credit provides an elastic form of borrowing since the limit fluctuates accordingly to the need of the business.

3) Overdraft:

Unlike cash credit, overdraft is a facility provides by a banker to his customer on a temporary basis. In this a customer can withdraw over and above the credit balance of his current Account. The interest is charges only on the withdrawn amount.

4) Bill Purchase and Discounted:

In this form of advances; bank grants advances by discounting bills of exchange or prenote. The amount after deducting the interest from the amount of the instrument is credited in the account of the customer. In such a situation banks receives interest in advance.

Bills which are accompanies by documents of title to goods such as bills of lading or railways receipts are purchase by bankers instead of the discounting.

10.4 Bank Instruments/ Negotiable Instruments

Bank instruments or negotiable instruments are those documents which are freely used in commercial transactions. Simply by endorsement and delivery the legal title of these can be transferred. That is why these negotiable instruments are transferable and not assignable.

Negotiable Instruments ACT:

According to negotiable instruments Act of 1881 Sec.13 "Negotiable instruments means promissory note bill of exchange or cheques payable either to order or to bearer". As per this law three man types of negotiable instruments are recognised.

- Cheques
- Bills of exchange
- Promissory note

With the passage of time certain new categories of NI have emerged which is of great use for mercantile and custom. These are:-

- Warrant
- Bearer Bond
- Dividend
- Bearer scrip's
- Debenture payable to bearer
- Treasury bills
- Share warrant to bearer

According to Wills "Negotiable Instruments is one in which the property is acquired by any one, who take it bonafied and for value notwithstanding any defects of the title in the person from whom he took it.

Features of a Negotiable Instruments:

- **Free Transfer***:* - It can be very easily transferred from one person to another either by mere delivery or by endorsement and delivery.
- **Transfer Free from Defects**: - If the transferor has a bad title to the instrument he can still pass on a good title to any holder who takes it in a good faith and without negligence and for valuable considerations. Thus it cuts off prior defences in instruments.
- **Right to Sue***:*- the holder has the right to sue in his own name when needed.
- **Now notice to Transfer:-** The transferor of NI can simply transfer the document without serving any notice of transfer to the party who is liable on the instrument to pay.
- **Presumptions as to Negotiable Instruments:-** Sec.118 & 119 of NI Act deals with certain presumptions which are applicable only to are NI e.g. It is presumed that the instrument has been always obtained for consideration
- **Credit of the Party**:- These instruments will never be dishonoured as credit of the party who sings the instruments is pledged to the instruments.

Depriving of the Quality of Negotiability:

The drawer or any holder of NI can take away the negotiable quality of instrument by means of:

- Drawing a cheque payable only to the order of a certain person.
- Crossing it 'Not negotiable' or A/C payee.

Type of Negotiable Instruments:

Negotiable Instruments can be classified in the two categories:

- Instruments Negotiable by law
- Instruments Negotiable by custom or usage of trade.

In India we recognize instruments negotiable by law. These are of Three types:

1. **Promissory Note**: - According to Sec. 4of Negotiable Instruments " Promissory Note is an Instruments in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker to pay a certain sum of money only to the order of a certain person or to the bearer of the instruments". Thus a promissory note contains a promise by the debtor to the creditor to pay a certain sum of money after a certain date. Hence is always drawn by the debtor. He is called the 'Maker" of the Instruments.
2. **Bills of Exchange**:- Section-5 of Negotiable Instruments act defines Bill of Exchange as "An Instruments in writing containing an unconditional orde3r, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person or the bearer of the instruments. Bill is always drawn by the creditor on the debtor the person who draws it is called the "drawer" and the person on whom it is drawer is called the "drawer" or "acceptor" and the person to whom the amount is payable is called "payee".
3. **Cheques:-** Section-6 of Negotiable instruments defines a cheque as "A bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand".

As per this definition we can say that "All cheques are bills of exchange but all bills of exchange are not cheques.

Features of Bills of Exchange, Promissory Note and Cheques:

- Instruments in Writing: - Bills, Cheques and promissory note are always in written.
- Unconditional order/Promise: - There should be no conditions in order and promise as it may affect the validity of the instruments.
- Drawn on a Certain Person: - Bill is always drawn on a certain person generally by a seller on his customer.
- A Certain sum of Money: - The amount of money to be paid should be definite.
- Payee to be certain:- A bill or promissory note is drawn payable to a certain person or to his order or to the bearer of the instrument.
- Payable on Demand or after certain date.
- Signed by drawer/maker.

10.5 Bank Remittance Services

A **remittance** is a transfer of money by a foreign worker to his or her home country. In 19th century word remittance was used for a person exiled overseas. He was allowed to sent an allowance to his family on a condition that he will not return home. He was called as black sheep.

Money sent home by migrants constitutes the second largest financial inflow to many developing countries, exceeding international aid. Remittances contribute to economic growth and to the livelihoods of people worldwide. Moreover, remittance transfers can also promote access to financial services for the sender and recipient, thereby increasing financial and social inclusion. Remittances also foster, in the receiving countries, a further economic dependence on the global economy instead of building sustainable, local economies.

In India there are certain facilities provide to Non Residential Indians (NRI) and Persons of Indian origin (PIO)

Different Types of Account NRI Can Maintain:-

If a person is NRI or PIO, he/she can, without the permission from the Reserve Bank, open, hold and maintain the different types of accounts mentioned with an Authorized Dealer in India, i.e., a bank authorized to deal in foreign exchange**. NRO Savings accounts can also be maintained with the Post Offices in India**. However, individuals/ entities of Bangladesh and Pakistan require the prior approval of the Reserve Bank.

Types of Accounts Which Can be Maintained By an NRI / PIO in India

A. Non-Resident (Ordinary) Rupee Account (NRO Account)

NRO accounts may be opened / maintained in the form of current, savings, recurring or fixed deposit accounts.

- Savings Account - Normally maintained for crediting legitimate dues /earnings / income such as dividends, interest etc. The interest rates on NRO Savings deposits shall be at the rate applicable to domestic savings deposits. Currently the interest rate is 3.5 per cent.

- Term Deposits - Banks are free to determine the interest rates.
- Account should be denominated in Indian Rupees.
- Permissible credits to NRO account are transfers from rupee accounts of non-resident banks, remittances received in permitted currency from outside India through normal banking channels, permitted currency tendered by account holder during his temporary visit to India, legitimate dues in India of the account holder like current income like rent, dividend, pension, interest, etc., sale proceeds of assets including immovable property acquired out of rupee/foreign currency funds or by way of legacy/ inheritance.
- Eligible debits such as all local payments in rupees including payments for investments as specified by the Reserve Bank and remittance outside India of current income like rent, dividend, pension, interest, etc., net of applicable taxes, of the account holder.
- NRI/PIO may remit from the balances held in NRO account an amount not exceeding USD one million per financial year, subject to payment of applicable taxes
- The limit of USD 1 million per financial year includes sale proceeds of immovable properties held by NRIs/PIO.
- The accounts may be held jointly with residents and / or with non-resident Indian.
- The NRO account holder may opt for nomination facility.
- NRO (current/savings) account can also be opened by a foreign national of non-Indian origin visiting India, with funds remitted from outside India through banking channel or by sale of foreign exchange brought by him to India. The details of this facility are given in the FAQs on "Accounts opened by Foreign Nationals and Foreign Tourists" available on the RBI website.
- Loans to non-resident account holders and to third parties may be granted in Rupees by Authorized Dealer / bank against the security of fixed deposits subject to certain terms and conditions.

B. Non-Resident (External) Rupee Account (NRE Account)

- NRE account may be in the form of savings, current, recurring or fixed deposit accounts. Such accounts can be opened only by the non-resident himself and not through the holder of the power of attorney.
- NRE accounts cannot be held jointly with residents
- Account will be maintained in Indian Rupees.
- Balances held in the NRE account are freely repatriable.
- Accrued interest income and balances held in NRE accounts are exempt from Income tax and Wealth tax, respectively.
- Authorised dealers/authorised banks may at their discretion/commercial judgement allow for a period of not more than two weeks, overdrawings in NRE savings bank accounts, up to a limit of Rs.50,000 subject to the condition that such overdrawings together with the interest payable thereon are cleared/ repaid within a period of two weeks, out of inward remittances through normal banking channels or by transfer of funds from other NRE/FCNR accounts.
- *Savings* **-** The interest rates on NRE Savings deposits shall be at the rate applicable to domestic savings deposits. Currently the interest rate is 3.5%.

- *Term deposits* – The interest rates are stipulated by the Department of Banking Operations and Development, Reserve Bank of India. At present, with effect from the close of business in India on November 15, 2008, interest rates on NRE deposits for one to three years should not exceed the LIBOR/SWAP rates plus 175 basis points, as on the last working day of the previous month, for US d*ollar of corresponding matures.*The interest rates as determined above for three year deposits will also be applicable in case the maturity period exceeds three years.
- Permissible credits to NRE account are inward remittance to India in permitted currency, proceeds of account payee cheques, demand drafts / bankers' cheques, issued against encashment of foreign currency, where the instruments issued to the NRE account holder are supported by encashment certificate issued by AD Category-I / Category-II, transfers from other NRE / FCNR accounts, interest accruing on the funds held in such accounts, interest on Government securities/dividends on units of mutual funds purchased by debit to the NRE/FCNR(B) account of the holder, certain types of refunds, etc.
- Eligible debits are local disbursements, transfer to other NRE / FCNR accounts of person eligible to open such accounts, remittance outside India, investments in shares / securities/commercial paper of an Indian company, etc.
- Loans up to Rs.100 lakh can be extended against security of funds held in NRE Account either to the depositors or third parties.
- Such accounts can be operated through power of attorney in favour of residents for limited purpose of withdrawal of local payments or remittances through normal banking channels to the account holder himself.

C. Foreign Currency Non Resident (Bank) Account – FCNR (B) Account

- FCNR (B) accounts are only in the form of term deposits of 1 to 5 years
- All debits / credits permissible in respect of NRE accounts are permissible in FCNR (B) accounts also.
- Account can be in Pound Sterling, US Dollar, Japanese Yen, Euro, Canadian Dollar and Australian Dollar
- In case the depositor with any convertible currency other than designated currency desires to place a deposit in these accounts, authorized dealers may undertake with the depositor a fully covered swap in that currency against the desired designated currency. Such a swap may also be done between two designated currencies.
- Loans up to Rs.100 lakh can be extended against security of funds held in FCNR (B) deposit either to the depositors or third parties.
- The interest rates are stipulated by the Department of Banking Operations and Development, Reserve Bank of India. At present, in respect of FCNR (B) deposits of all maturities contracted effective from the close of business in India as on November 15, 2008, interest shall be paid within the ceiling rate of LIBOR / SWAP rates plus 100 basis points for the respective currency/corresponding maturities (as against LIBOR/SWAP rates plus 25 basis points effective from close of business on October 15, 2008).On floating rate deposits, interest shall be paid within the ceiling of SWAP rates for the respective currency / maturity plus 100 basis points. For floating rate deposits, the interest reset period shall be six months.
- When an account holder becomes a person resident in India, deposits may be allowed to continue till maturity at the contracted rate of interest, if so desired by him.

- Terms and conditions as applicable to NRE accounts in respect of joint accounts, repatriation of funds, opening account during temporary visit, operation by power of attorney, loans/overdrafts against security of funds held in accounts, shall apply mutatis mutandis to FCNR (B).

A part from this a citizen of India can borrow money from his close relative upto the limit of US$250000 ,on which he is not required to pay any interest and the minimum maturity period is of one year.

There are certain other facilities provided to NRI's . These are:-

1. Investment Facilities for NRIs

NRI May, without Limit, Purchase on Repatriation Basis:

- Government dated securities / Treasury bills
- Units of domestic mutual funds;
- Bonds issued by a public sector undertaking (PSU) in India.
- Non-convertible debentures of a company incorporated in India.
- Perpetual debt instruments and debt capital instruments issued by banks in India.
- Shares in Public Sector Enterprises being disinvested by the Government of India, provided the purchase is in accordance with the terms and conditions stipulated in the notice inviting bids.
- Shares and convertible debentures of Indian companies under the FDI scheme (including automatic route & FIPB), subject to the terms and conditions specified in Schedule 1 to the FEMA Notification No. 20/2000- RB dated May 3, 2000, as amended from time to time.
- Shares and convertible debentures of Indian companies through stock exchange under Portfolio Investment Scheme, subject to the terms and conditions specified in Schedule 3 to the FEMA Notification No. 20/2000- RB dated May 3, 2000, as amended from time to time.

NRI May, without Limit, Purchase on Non-repatriation Basis :

- Government dated securities / Treasury bills
- Units of domestic mutual funds
- Units of Money Market Mutual Funds
- National Plan/Savings Certificates
- Non-convertible debentures of a company incorporated in India
- Shares and convertible debentures of Indian companies through stock exchange under Portfolio Investment Scheme, subject to the terms and conditions specified in Schedules 3 and 4 to the FEMA Notification No. 20/2000- RB dated May 3, 2000, as amended from time to time.
- Exchange traded derivative contracts approved by the SEBI, from time to time, out of INR funds held in India on non-repatriable basis, subject to the limits prescribed by the SEBI.

Note : NRIs are not permitted to invest in small savings or Public Provident Fund (PPF).

2. Investment in Immovable Property

- NRI / PIO[4] / Foreign National **who is a person resident in India (**citizen of Pakistan, Bangladesh, Sri Lanka, Afghanistan, China, Iran, Nepal and Bhutan would require prior approval of the Reserve

Bank) may acquire immovable property in India other than agricultural land/ plantation property or a farm house out of repatriable and / or non-repatriable funds.

- The payment of purchase price, if any, should be made out of

  (i) funds received in India through normal banking channels by way of inward remittance from any place outside India or

  (ii) funds held in any non-resident account maintained in accordance with the provisions of the Act and the regulations made by the Reserve Bank.

  Note : No payment of purchase price for acquisition of immovable property shall be made either by traveller's cheque or by foreign currency notes or by other mode other than those specifically permitted as above.

- NRI may acquire any immovable property in India other than agricultural land / farm house plantation property, by way of gift from a person resident in India or from a person resident outside India who is a citizen of India or from a person of Indian origin resident outside India
- NRI may acquire any immovable property in India by way of inheritance from a person resident outside India who had acquired such property in accordance with the provisions of the foreign exchange law in force at the time of acquisition by him or the provisions of these Regulations or from a person resident in India
- An NRI may transfer any immovable property in India to a person resident in India.
- NRI may transfer any immovable property other than agricultural or plantation property or farm house to a person resident outside India who is a citizen of India or to a person of Indian origin resident outside India.

In respect of such investments, NRIs are eligible to repatriate:

- The sale proceeds of immovable property in India if the property was acquired out of foreign exchange sources i.e. remitted through normal banking channels / by debit to NRE / FCNR (B) account.
- The amount to be repatriated should not exceed the amount paid for the property in foreign exchange received through normal banking channel or by debit to NRE account (foreign currency equivalent, as on the date of payment) or debit to FCNR (B) account.
- In the event of sale of immovable property, other than agricultural land / farm house / plantation property in India, by NRI / PIO, the repatriation of sale proceeds is restricted to not more than two residential properties subject to certain conditions.
- If the property was acquired out of Rupee sources, NRI or PIO may remit an amount up to USD one million per financial year out of the balances held in the NRO account (inclusive of sale proceeds of assets acquired by way of inheritance or settlement), for all the bonafide purposes to the satisfaction of the Authorized Dealer bank and subject to tax compliance.
- Refund of (a) application / earnest money / purchase consideration made by house-building agencies/ seller on account of non-allotment of flats / plots and (b) cancellation of booking/deals for purchase of residential/commercial properties, together with interest, net of taxes, provided original payment is made out of NRE/FCNR (B) account/inward remittances.

Repayment of Housing Loan of NRI / PIOs by close relatives of the borrower in India

Housing Loan in rupees availed of by NRIs/ PIOs from ADs / Housing Financial Institutions in India, can be repaid by the close relatives in India of the borrower.

C. Facilities to Returning NRIs/PIO

- Returning NRIs/PIO may continue to hold, own, transfer or invest in foreign currency, foreign security or any immovable property situated outside India, if such currency, security or property was acquired, held or owned when resident outside India

Foreign Currency Account

- A person resident in India who has gone abroad for studies or who is on a visit to a foreign country may open, hold and maintain a Foreign Currency Account with a bank outside India during his stay outside India, provided that on his return to India, the balance in the account is repatriated to India. However, short visits to India by the student who has gone abroad for studies, before completion of his studies, shall not be treated as his return to India.

- A person resident in India who has gone out of India to participate in an exhibition/trade fair outside India may open, hold and maintain a Foreign Currency Account with a bank outside India for crediting the sale proceeds of goods on display in the exhibition/trade fair. However, the balance in the account is repatriated to India through normal banking channels within a period of one month from the date of closure of the exhibition/trade fair.

Resident Foreign Currency Account

- Returning NRIs /PIOs may open, hold and maintain with an authorised dealer in India a Resident Foreign Currency (RFC) Account to transfer balances held in NRE/FCNR(B) accounts.
- Proceeds of assets held outside India at the time of return, can be credited to RFC account.
- The funds in RFC accounts are free from all restrictions regarding utilisation of foreign currency balances including any restriction on investment in any form outside India.
- RFC accounts can be maintained in the form of current or savings or term deposit accounts, where the account holder is an individual and in the form of current or term deposits in all other cases.

A Non Resident Indian (NRI) is a person resident outside India, who is a citizen of India or is a person of Indian origin.

A Person of Indian Origin (PIO) for this purpose is defined in Regulation 2 of FEMA Notification ibid as a citizen of any country other than Bangladesh or Pakistan, if (a) he at any time held Indian passport; or (b) he or either of his parents or any of his grandparents was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955 (57 of 1955); or (c) the person is a spouse of an Indian citizen or a person referred to in sub-clause (a) or (b).

'A Person of Indian Origin' means an individual (not being a citizen of Pakistan or Bangladesh or Sir Lanka or Afghanistan or China or Iran or Nepal or Bhutan) who (i) at any time, held an Indian Passport or (ii) who or either of whose father or mother or whose grandfather or grandmother was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955 (57 of 1955).

10.6 Safe Custody Vaults (SCV)

Safe Custody is a service offered by the bank in which customers can store valuable items at a branch. The contents are housed in either packets or boxes and are not disclosed to the bank. A customer may access their contents at any time during bank hours.

Safe Custody is offered by a select number of branches A safe deposit locker is located in a vault, which is built in accordance with the Reserve Bank of India guidelines. It is the safest place to keep your valuables and offers confidentiality and privacy

While booking your locker with a bank, you may not only have to open a Savings Bank Account, but will also have to go in for a Fixed Deposit. However, in case of booking an ISVL (India Safe Vault Limited) safe deposit locker, the procedures are very simple.

Size of the Lockers :

Lockers in banks are very small in size. However, India Safety Vaults Ltd. offers 9 sizes from 4.5" height to 6" width to one with 15.5" height and 20" width. The depth of the lockers is standard at 18.5".

Items that Can Be Kept in Lockers

All items which are valuable and irreplaceable: like jewellery, gold, silver articles, medals, stamps, currency notes, negatives of irreplaceable photographs, important videos and pictures, heritage art collections, important papers such as insurance policies, family records like Birth, Marriage & Death certificates; Inheritance Wills, title deeds of properties, mortgage agreements, original lease agreements are some of the items which you make like to keep in a safe deposit locker.

The RBI has laid down specifications for banks on the building of vaults. These guidelines categorize the specifications in 4 ways, with the first specification being the highest or most stringent :

- Currency Chest 'A' Class
- Currency Chest 'B' Class
- Currency Chest 'C' Class
- Safe Deposit Vault Specification

If a vault is built to these specifications, then one can be assured that the locker inside these vaults are fire, burglary and theft resistant ISVL meets the currency Chest 'A' specification, which surpass the vault specification of RBI.

10.7 Summary

- Bank services are the basic services provided by the bank for convenience of the customers.
- Advances and Loans are the major source of earning profits for the banks.
- Unsecured Advances are those in which the customer is not required to provide any asset for mortgage.
- Secured advances are those in which tangible assets are kept as security.
- Bank instruments or negotiable instruments are those documents which are freely used in commercial transactions.
- Negotiable instruments means promissory note bill of exchange or cheques payable either to order or to bearer.
- Bank Remittance means the facility through which NRI's transfer money to their family living in INDIA.
- Safe custody Vault is a facility provided by banks to their customers in which they can place their valuable items in the custody of banks.

10.8 Self Assessment Questions

1. What are bank services?
2. Define advances and explain its types.
3. Explain negotiable instruments.
4. Explain difference between cheques and bills of exchange.
5. Write short notes on:

   a) Bank Remittance
   b) Safe Custody Vaults

10.9 Books for Further Readings

– N.S. Toor (2006); 'Hand book of Banking Information'; Skylark Publication, New Delhi

– Jain, Rathi, Sharma(2010); 'Banking Services Operations', RBD Professional publication, Jaipur-New Delhi

– Trivedi, Chaudhary, Kumar(2010); 'Indian Banking System', Ramesh Book Depot, Jaipur-New Delhi

– Various Bulletins of Reserve Bank of India

Unit - 11 : Banking Instruments

Structure of Unit:

11.0 Objectives

After completing this unit, you must be able to

- Understand how negotiable instrument can serve to convey value constituting at least part of the performance of a contract.
- The power to demand payment.
- Meaning of bearer instrument.
- The Importance of Banking Instruments in International Trade Transactions.

11.1 Introduction

Banking has become internationalized and globalized in the wake of the liberalization of the financial markets; changes have taken place in customer structure and behavior. These factors have resulted in a pressing need emergence of instantaneous Trans world interbank fund transfers. For banks to adapt its organizational structures in its domestic and international fields of operations and make them future oriented. New offices and branches abroad increased bank's presence.

Globalization has touched banking mainly in terms of: 1) the growth of Trans border deposits; 2) the advent of Trans border bank lending; 3) the expansion of Trans border branch networks; 4) the emergence of instantaneous trans world interbank fund transfers.

11.2 What is Negotiable Instrument?

Negotiable Instruments are money/cash equivalents. These can be converted into liquid cash subject to certain conditions. They play an important role in the economy in settlement of debts and claims. The transactions involving the Negotiable Instruments in our country are regulated by law and the framework of the Statute which governs the transaction of these instruments is known as The Negotiable Instruments Act. This act was framed in our country in the year 1881 when the British ruled our country. Prior to 1881 the transactions governing Negotiable Instruments were regulated under the cover of Indian Contract Act 1872. This act has been amended as many as 23 times to meet the needs of the time. The last amendment was made in 2002.

Negotiable Instrument-

A **negotiable instrument** is a

(1) **Written** instrument,

(2) **Signed** by the maker or drawer of the instrument,

(3) That contains an **unconditional** promise or order to pay

(4) A **fixed amount** of money (with or without interest in a specified amount or at a specified rate)
(5) **On demand** or at an **exact future time**
(6) To a **specific person**, or to **order**, or to its **bearer**

Negotiable: Writing & Signature

- **Written Form:** A negotiable instrument must be
  (1) Written on material that lends itself to **permanence**, and
  (2) **Portable**.

- **Signature:** Any symbol
  (1) Made manually or by means of a device or machine,
  (2) Using any **name**, including a trade or assumed name, **word**, **mark**, or **symbol**
  (3) Executed or adopted by the signer with a present **intention to authenticate** writing.

- A negotiable instrument must be signed by
  (a) The **maker**, or her authorized agent, if the instrument is a **note** or a **certificate of deposit**, or
  (b) The **drawer**, or his authorized agent, if the instrument is a **draft** or a **check**.

Negotiable:: Unconditionality

- **Promise or Order:** A negotiable instrument must contain an express **order or promise** to pay.
- A mere acknowledgment of a debt is not sufficient without evidence of an affirmative undertaking on the part of the debtor to repay the debt.
- The exception to this rule is a **certificate of deposit**.
- **Unconditionally of Promise or Order:** A promise or order is conditional (and, therefore, not negotiable) if it states
  - ➢ An **express condition** to payment,
  - ➢ That the promise or order is **subject to or governed by** another writing, or
  - ➢ That the rights or obligations with respect to the promise or order are **stated in** another writing.

Factors Not Affecting Negotiable

- The fact that an instrument is **undated** does not affect its negotiability, unless the date of the instrument is necessary to understand the payment term;
- **Postdating** or **antedating** an instrument does not affect its negotiability;
- **Interlineations** and other written or typewritten **alterations** need not affect negotiability;
- Handwritten terms "trump" typewritten terms, and typewritten terms "trump" printed terms.
- **Words "trump" figures**, unless the words are ambiguous in and of themselves; and
- If the instrument fails to specific the applicable interest rate, the **judgment rate of interest** (defined by statute) becomes the interest rate on the instrument.
- Notations that an instrument is "nonnegotiable" or "not governed by Article 3" do not affect the negotiability of a check but may make other instruments nonnegotiable.

11.3 Types of Negotiable Instruments

- Negotiable instruments by Statue are of three types, cheques, bills of exchange and promissory note.
- Negotiable instruments by custom or usage :- Some other instruments have acquired the character of negotiability by the the custom or usage of trade. Section 137 of Transfer of Property Act 1882 also recognizes that an instrument may be negotiable by Law or Custom. Thus in India Govt. Promissory notes, Shah Jog Hundis, Delivery Orders, Railway Receipts, Bill of Lading etc. have been held negotiable by usage or custom. These can be said as quasi statutory Negotiable Instruments.

(A) Cheque

Cheque is a very common form of negotiable instrument. If you have a savings bank account or current account in a bank, you can issue a cheque in your own name or in favor of others, thereby directing the bank to pay the specified amount to the person named in the cheque. A cheque is an instrument drawn on a specified banker and not expressed to be payable otherwise than on demand Therefore, a cheque may be regarded as a bill of exchange; the only difference is that the bank is always the drawee in case of a cheque. The maker of a cheque is called the 'drawer', and the person directed to pay is the 'drawee'. The person named in the instrument, to whom or to whose order the money is, by the instrument directed, to be paid, is called the 'payee'

The Negotiable Instruments Act, 1881 defines a cheque as a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand.

From the above dentition it appears that a cheque is an instrument in writing, containing an unconditional order, signed by the maker, directing a specified banker to pay, on demand, a certain sum of money only to, to the order of, a certain person or to the bearer of the instrument.. Actually, a cheque is an order by the account holder of the bank directing his banker to pay on demand, the specified amount, to or to the order of the person named therein or to the bearer

SAMPLE OF CHEQUE

Figure 11.1

Features of Cheques

1. **An Instrument in Writing:** A cheque must be in writing. It can be written in ink pen, ball point pen, typed or even printed. Oral orders are not considered as cheques.

2. **Cheque Contains an Unconditional Order:** Every cheque contains an unconditional order issued by the customer to his bank. It does not contain a request for payment. A cheque containing conditional orders is dishonoured by the bank.

3. **Cheque is Drawn by a Customer on His Bank:** A cheque is always drawn on a specific bank mentioned therein. Cheque drawn by stranger is of no meaning. Cheque book facility is made available only to account holder who are supposed to maintain certain minimum balance in the account.

4. **Cheque Must be Signed By Customer:** A cheque must be signed by customer (Account holder) . Unsigned cheques or signed by persons other than customers are not regarded as cheque.

5. **Cheque Must be Payable on Demand:** A cheque when presented for payment must be paid on demand. If cheque is made payable after the expiry of certain period of time then it will not be a cheque.

6. **Cheque Must Mention Exact Amount to Be Paid:** Cheque must be for money only. The amount to be paid by the banker must be certain. It must be written in words and figures.

7. **Payee Must be Certain to Whom Payment is Made:** The payee of the cheque should be certain whom the payment of a cheque is to be made i.e. either real person or artificial person like joint stock company. The name of the payee must be written on the cheque or it can be made payable to bearer.

8. **Cheque Must be Duly Dated By Customer of Bank:** A cheque must be duly dated by the customer of bank. The cheque must indicate clearly the date, month and the year. A cheque is valid for a period of six months from the date of issue.

9. **Cheque has 3 Parties : Drawer, Drawee & Payee:** 1. Drawer : A drawer is a person, who draws a cheque. 2. Drawee : A drawee is a bank on whom a cheque is drawn. 3. Payee : A payee is a person in whose favour a cheque is drawn

10. **Deliveries- Delivery of the Cheque is Essential**

11. **The Cheque Must Bear a Date Otherwise it is Invalid and Shall Not Be Honoured By the Bank**

Types of Cheque

Cheques are of four types.

a) **Open Cheque:** A cheque is called 'Open' when it is possible to get cash over the counter at the bank. The holder of an open cheque can do the following:
   I. Receive its payment over the counter at the bank,
   ii. Deposit the cheque in his own account
   iii. Pass it to someone else by signing on the back of a cheque.

b) **Crossed Cheque:** Since open cheque is subject to risk of theft, it is dangerous to issue such cheques. This risk can be avoided by issuing other types of cheque called 'Crossed cheque'. The payment of such cheque is not made over the counter at the bank. It is only credited to the bank account of the payee. A cheque can be crossed by drawing two transverse parallel lines across the cheque, with or without the writing 'Account payee' or 'Not Negotiable'.

c) **Bearer Cheque:** A cheque which is payable to any person who presents it for payment at the bank counter is called 'Bearer cheque'. A bearer cheque can be transferred by mere delivery and requires no endorsement.

d) **Order Cheque:** An order cheque is one which is payable to a particular person. In such a cheque the word 'bearer' may be cut out or cancelled and the word 'order' may be written. The payee can transfer an order cheque to someone else by signing his or her name on the back of it.

There is another categorization of cheques which is discussed below:

1. **Anti-dated Cheques:** Cheque in which the drawer mentions the date earlier to the date of presenting if for payment. For example, a cheque issued on 24th March 2011 may bear a date 4th March 2011.

2. **Stale Cheque:** A cheque which is issued today must be presented before at bank for payment within a stipulated period. After expiry of that period, no payment will be made and it is then called 'stale cheque'

3. **Mutilated Cheque:** In case a cheque is torn into two or more pieces and presented for payment, such a cheque is called a mutilated cheque. The bank will not make payment against such a cheque without getting confirmation of the drawer. But if a cheque is torn at the corners and no material fact is erased or cancelled, the bank may make payment against such a cheque.

4. **Post-dated Cheque:** Cheque on which drawer mentions a date which is subsequent to the date on which it is presented, is called post-dated cheque. For example, if a cheque presented on 8th May 2003 bears a date of 27th March 2011, it is a post-dated cheque. The bank will make payment only on or after 27th March 2011.

The Advantages of Using a Cheque:

- More Secure form of transaction.
- Can't be cashed at unsecure area.
- Only person that is signatory of cheque can cash it.

The Disadvantages of Using a Cheque:

- It can be only cashed in Bank so Must wait for bank to open.
- There might be a certain time line or duration when you can cheque it
- Only person that is signed to can cash it so physical presence is nedded.
- It has been reported lost or stolen
- The cheque is a forgery or counterfeit
- A court has ordered it not be paid

M.I.C.R.Cheques/Drafts

In MICR (Magnetic Ink Character Recognition) cheques:

- First six number indicate the cheque number
- Next three numbers indicate city code
- Next three numbers indicate Bank code
- Next three numbers indicate Branch code

(B) Bill of Exchange

A bill of exchange or "draft" is a written order by the drawer to the drawee to pay money to the payee. A common type of bill of exchange is the cheque (check in American English), defined as a bill of exchange drawn on a banker and payable on demand. Bills of exchange are used primarily in international trade, and are written orders by one person to his bank to pay the bearer a specific sum on a specific date.

An unconditional order issued by a person or business which directs the recipient to pay a fixed sum of money to a third party at a future date. The future date may be either fixed or negotiable. A bill of exchange must be in writing and signed and dated.


SPACE BELOW FOR ACCEPTANCE STAMP

Drawn under Korean Commercial Bank
L/C 5702 / 6789
Royal Bank of Canada International
TRade Centre L/C 1234567

Due
January 21 19

AT SIGHT FOR VALUE RECEIVED PAY TO THE ORDER OF THE
ROYAL BANK OF CANADA THE SUM OF
Fifty Thousand U. S. DOLLARS $ 50,000.00

To Royal Bank of Canada
International Trade Centre
Any City, Any Province

BCD Exports Ltd.

DRAWER'S OR FORWARDING BANK'S NUMBER

RECEIVING BANK'S NUMBER 1234567

Figure 11.2

Some Special Terms

1. **Bills Receivable:** A bill of exchange which the creditor (seller) Who will receive the money at the agreed date? It is similar to the Debtor's Account. It is a current asset in the Balance Sheet.
2. **Bills Payable:** A bill of exchange which the debtor(Buyer) will pay the money at the agreed date. It is similar to a Creditor's Account. It is a current liability in the Balance Sheet.
3. **Drawer:** The creditor (seller) who draws (prepares) the bill.
4. **Drawee:** The debtor (buyer) who will pay the bill.
5. **Acceptor:** the debtor who has agreed to pay the bill.
6. Maturity date The date which the bill will be settled.
7. **Discounting Charges:** The charge made by the bank for cash the bill at an earlier date. It is charged against the creditor (seller). It is treated as an Expense in the Profit and Loss Account.
8. **Dishonoured Bill:** The debtor (buyer) could not pay the bill on due date.
9. **Noting Charges:** It is a penalty charge for dishonoring the bill. The debtor (buyer) has the responsibility to pay the noting charges to the bank.
10. **Contingent Liability:** A possible liability which may not occur.

    At the Balance Sheet date, if the Bills Receivable has not matured, it is a kind of Contingent Liability because the debtor may not pay the bill although it is recorded as a Current Asset.

Features

A bill of exchange has the following features:

- A bill of exchange is an instrument in writing.
- It must be signed by the maker or drawer. Unsigned document will not be legally valid.
- It contains an unconditional order. There is no condition attached to it.
- The order must be to pay money and money only.
- The sum payable must be specific.
- The money must be payable to a definite person or to his order or to the bearer.

Advantages

The following are the advantages of a bill of exchange:

- Bill of exchange fixes the date of payment. The creditor knows when to expect his money and the debtor also knows when he will be required to make payment.
- A bill of exchange is a negotiable instrument and can be used in settlement of debts.
- It is a written and signed acknowledgement of debt and affords conclusive proof of indebtedness.
- A debtor is free from worries and enjoys full period of credit, as he can never be called upon to pay the amount of the bill before the due to date.
- A creditor can convert the bill into cash by getting it discounted with the bank.
- A bill of exchange provides a legal acknowledgement that a debt exists.
- It can provide easy access to the legal systems in the event of non-payment.

Disadvantages

- You may not be able to invest to the exact maturity date that you require as terms are subject to the bank bills on issue;
- You cannot benefit from increase in market interest rate that may occur during the term of the Bank bill as your interest rate is fixed for the term.
- Requests to the bank for a repurchase are subject to the bank Discretion ; and
- In the event of a repurchase , You may receive back less than your Purchase price

(C) Promissory Note

Promissory Note, in the law of negotiable instruments, written instrument containing an unconditional promise by a party, called the maker, who signs the instrument, to pay to another, called the payee, a definite sum of money either on demand or at a specified or ascertainable future date. The note may be made payable to the bearer, to a party named in the note, or to the order of the party named in the note.

A promissory note differs from an IOU (An IOU (abbreviated from the phrase "I owe you") is usually an informal document acknowledging debt) in that the former is a promise to pay and the latter is a mere acknowledgement of a debt. A promissory note is negotiable by endorsement if it is specifically made payable to the order of a person.

In other words, we can say that a promissory note is an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay on demand to the payee, or at fixed or determinable future time, certain in money, to order or to bearer. (see Sec.194) Bank note is frequently referred to as a promissory note, a promissory note made by a bank and payable to bearer on demand

According to section 4 of the Negotiable Instruments Act, 1881, a promissory note means **"Promissory Note is an instrument in writing (not being a bank-note or a currency-note) containing an unconditional undertaking signed by the maker, to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of the instrument."**

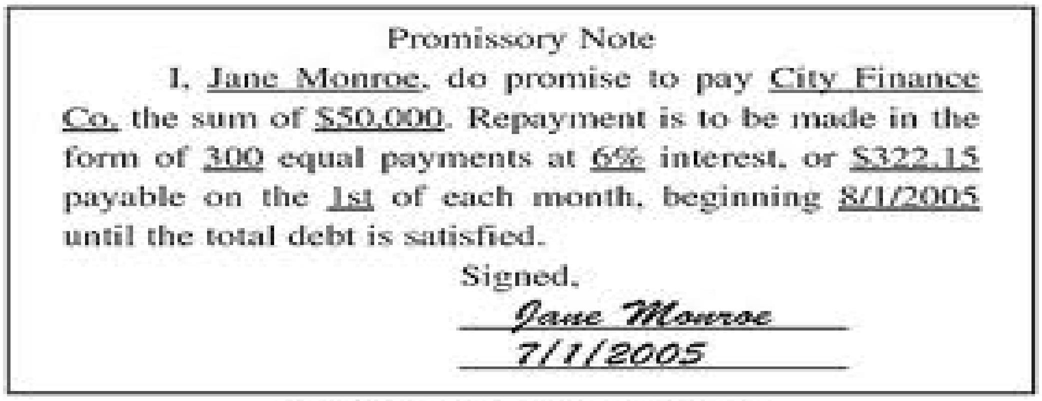
Promissory Note Payable on Demand

Rs. ...

Place,
date.

On demand I promise to pay Mr.______ or order the sum of Rs. _____ with interest @ __ % p.a.

Sd/-
Name
(address)


Promissory Note

I, Jane Monroe, do promise to pay City Finance Co. the sum of $50,000. Repayment is to be made in the form of 300 equal payments at 6% interest, or $322.15 payable on the 1st of each month, beginning 8/1/2005 until the total debt is satisfied.

Signed,
Jane Monroe
7/1/2005

Figure 11.3

Features of a Promissory Note

- **The Promissory Note Must Be in Writing-** Mere verbal promises or oral undertaking does not constitute a promissory note. The intention of the maker of the note should be signified by writing in clear words on the instrument itself that he undertakes to pay a particular sum of money to the payee or order or to the bearer
- **It Must Contain an Express Promise or Clear Undertaking to Pay-** The promise to pay must be expressed. It cannot be implied or inferred. A mere acknowledgment of indebtness is not enough.
- **The Promise to Pay must be Definite and Unconditional-** The promise to pay contained in the note must be unconditional. If the promise to pay is coupled with a condition, it is not a promissory note.

- **The Maker of the Pro-note Must Be Certain-** The instrument should show on the fact of it as to who exactly is liable to pay. The name of the maker should be written clearly and ascertainable on seeing the document.
- **It Should be Signed By the Maker-** Unless the maker signs the instrument, it is incomplete and of no legal effect. Therefore, the person who promises to pay must sign the instrument even though it might have been written by the promisor himself.
- **The Amount Must Be Certain-** The amount undertaken to be paid must be definite or certain or not vague. That is, it must not be capable of contingent additions or subtractions.
- **The Promise Should Be to Pay Money-** The promissory note should contain a promise to pay money and money only, i.e., legal tender money. The promise cannot be extended to payments in the form of goods, shares, bonds, foreign exchange, etc.
- **The Payee Must Be Certain-** The money must be payable to a definite person or according to his order. The payee must be ascertained by name or by designation. But it cannot be made payable either to bearer or to the maker himself.
- **It Should Bear the Required Stamping-** The promissory note should, necessarily, bear sufficient stamp as required by the Indian Stamp Act, 1889.
- **It Should Be Dated-** The date of a promissory note is not material unless the amount is made payable at particular time after date. Even then, the absence of date does not invalidate the pro-note and the date of execution can be independently proved. However to calculate the interest or fixing the date of maturity or lm\imitation period the date is essential. It may be ante-dated or post-dated. If post-dated, it cannot be sued upon till ostensible date.
- **Demand-** The promissory note may be payable on demand or after a certain definite period of time.
- **The Rate of Interest-** It is unusual to mention in it the rated of interest per annum. When the instrument itself specifies the rate of interest payable on the amount mentioned it, interest must be paid at the rate from the date of the instrument.

Characteristics of Promissory Note:

- **Promissory Notes Are Legally Binding:** The biggest advantage of a promissory note is that it is a legally binding contract. If you are the one loaning the money, a promissory note makes the borrower obligated by law to repay the amount in full plus interest. If the debt is ever taken to a small claims court, having a promissory note that is correctly executed will increase the odds of the judge ruling in the lender's favor.
- **Promissory Notes Give Time to Repay:** As a borrower, a promissory note gives you a specified date to repay. This will give you time to earn and save enough money to repay the sum owed plus interest. As the lender, promissory notes ensure you will be repaid by a specific date unless the borrower defaults.
- **Promissory Notes Can Be Flexible:** Another advantage to promissory notes is that there are several repayment options that can be arranged between the lender and the borrower. The loan may be repaid in full by a specified date or may be broken up into monthly instalments.

- **Finding a Borrower Can Be Difficult:** A major disadvantage of promissory notes for lenders is that you must find the borrower before repayment can occur. If a borrower moves out of state or finds another way to disappear, you may not be able to collect the money you are owed.
- **Going to Court Can Be Costly:** In some cases, lenders have no choice but to take a borrower to small claims court in order to receive their repayment. This can be a hassle and also costly as you will need to pay court fees and possibly a lawyer.

(D) Demand Draft

- A method used by individuals to make transfer payments from one bank account to another. A Demand Draft is an instrument that signifies the availability of cash till the amount specified in the DD. It is similar to a cheque in appearance and usage with the difference that a cheque may or may not get cashed but a DD is guaranteed payment.

  While issuing a cheque you need not have cash in your account but still issue it. But in case of a DD you must have cash and that amount would be debited the moment you issue a DD and the payment would happen when the customer deposits the DD.

- Demand drafts are marketed as a relatively secure method for cashing checks. The major difference between demand drafts and normal checks is that demand drafts do not require a signature in order to be cashed. Also known as "remotely created checks".

  Demand drafts were originally designed to benefit legitimate telemarketers who needed to withdraw funds from customer checking accounts. However, the lack of a signature required to authorize the transfers have left demand drafts open to fraudulent use. The only information needed to create a demand draft is a bank account number and a bank routing number - this information is found on a standard check.

  Accepting payment through DD is safer than accepting payment through cheque because Cheque may dishonor in case of in-sufficient balance in drawer's account while DD is pre-paid.

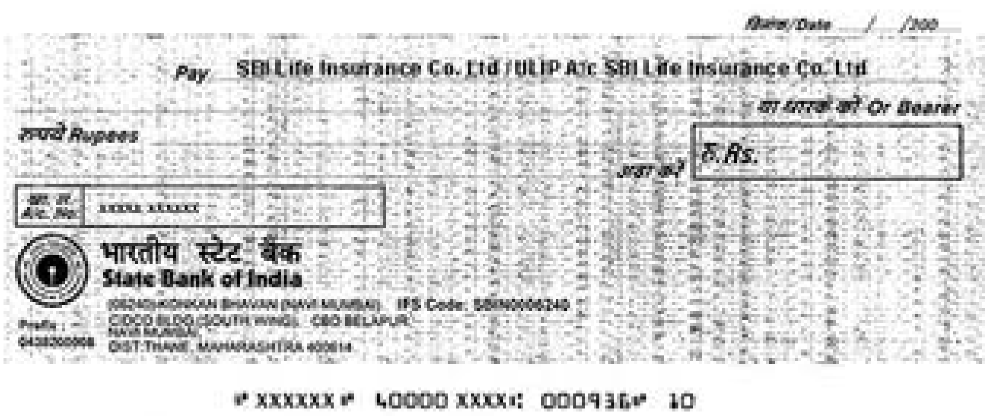


Figure 15.4

(E) Hundi

A Hundi is a negotiable instrument written in an oriental (vernacular) language. The term 'Hundi' includes all indigenous negotiable instruments whether they are in the form of notes or bills. But they are mostly of the nature of bills of exchange. They are virtually inland bills of exchange and recognized by custom and law in India. The term comes from the Sanskrit word Hund which means to collect. It means that Hundis were used as means of collection of debts. Hundis are very popular among the Indian merchants and indigenous bankers from ancient times.

The Negotiable Instruments act does not apply to Hundis. Hundis are governed by the custom and usages of the locality in which they are intended to be used. In case there is no customary rule known as to a certain point, the court can apply the rules of the Negotiable Instruments Act. It is also open to the parties to exclude expressively the applicability of any custom relating to Hundis by agreement and include the provision of the Negotiable Instrument Act.

A Hundi is a negotiable instrument by usage. It is often in the form of a bill of exchange drawn in any local language in accordance with the custom of the place. Sometimes it can also be in the form of a promissory note. A hundi is the oldest known instrument used for the purpose of transfer of money without its actual physical movement. The provisions of the Negotiable Instruments Act shall apply to hundis only when there is no customary rule known to the people.

Types of Hundis

There are a variety of hundis used in our country. Let us discuss some of the most common ones.

1. **Shah-jog Hundi:** This is drawn by one merchant on another, asking the latter to pay the amount to a Shah. Shah is a respectable and responsible person, a man of worth and known in the bazaar. A shah-jog hundi passes from one hand to another till it reaches a Shah, who, after reasonable enquiries, presents it to the drawee for acceptance of the payment.

2. **Darshani Hundi:** This is a hundi payable at sight. It must be presented for payment within a reasonable time after its receipt by the holder. Thus, it is similar to a demand bill.

3. **Muddati Hundi:** A muddati or miadi hundi is payable after a specified period of time. This is similar to a time bill. There are few other varieties like Nam-jog hundi, Dhani-jog hundi, Jawabee hundi, Jokhami hundi, Firman-jog hundi, etc.

The payment instruments described above are all paper based and require to be tendered at specific banks for payment either in person or through another bank in clearing or through collection. Under the N.I. Act, 1881, the cheque or the instrument has to be presented to the drawer. The chief disadvantage with the cheque and the demand draft is that these instruments have to be physically presented, often leading to delays in payment. To overcome delays, fund transfers through the medium of Telex were introduced. The Telegraphic Transfers represent payment instructions sent in a telex mode to an upcountry branch of the same bank or to a correspondent bank branch to credit the beneficiary's account with a given amount. A cipher code is appended to the text of the message to ensure its integrity and authenticity during transit.

11.4 Summary

Until the contrary is proved, the following presumptions shall be made :— (a) of consideration - that every negotiable instrument was made or drawn for consideration, and that every such instrument, when it has been $ accepted, indorsed, negotiated or transferred, was accepted, indorsed, negotiated or transferred for consideration; - - (b) as to date - that every negotiable instrument bearing a date was voided or drawn on such date; - - (c) as to time of acceptance - that every accepted bill of exchange was accepted within a reasonable time after its date and before its maturity; - - (d) as to time of transfer - - that every transfer of a negotiable instrument was made before its maturity; - - (e) as to order of endorsements - that the endorsements appearing upon a negotiable instrument were made in the order in which they appear thereon; (f) as to stamps -that a lost promissory note, bill of exchange or cheque was duly stamped; - - (g) that holder is a holder in due course - that the holder of a negotiable instrument is a holder in due course : provided that, where the instrument has been obtained from its lawful owner, or from any person in lawful custody thereof, by means of an offence or fraud, or has been obtained from the maker or acceptor thereof by means of an of-fence or fraud, or for unlawful consideration, the burden of proving that the holder in due course lies upon him.

11.5 Self Assessment Questions

1. What is Negotiable Instrument? Explain in detail the various types of Negotiable Instruments

2. What is Negotiable? What is the factors not affecting negotiability?

3. Write short notes on:
   (A) Cheque
   (B) Bill of exchange
   (C) Promissory note
   (D) Demand Drafts
   (E) Hundi

11.6 Books for Further Readings

- Lewis, Wayne K and. Resnicoff, Steven H (Dec 6, 2007), **Negotiable Instruments and Other Payment Systems: Problems and Materials,** LEXISNEXIS, December 6, 2007.

- Singh, Avatar, **Laws Of Banking & Negotiable Instrument,** Eastern Book Company.

Unit - 12 : Merchant Banking

Structure of Unit:

12.0 Objectives

After completing this unit, you would be able to understand

- The management of the customers securities
- The management of the portfolio,
- The management of projects and counseling as well as appraisal
- The management of underwriting of shares and debentures
- The circumvention of the syndication of loans
- Management of the interest and dividend etc

12.1 Introduction

The Notification of the Ministry of Finance defines merchant banker as "Any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities as manager-consultant, advisor or rendering corporate advisory services in relation to such issue management"

The Amendment Regulation specifies that issue management consist of Prospectus and other information relating to issue, determining financial structure, tie-up of financiers and final allotment and refund of the subscriptions, underwriting and portfolio management services.

In the words of Skully "A Merchant Bank could be best defined as a financial institution conducting money market activities and lending, underwriting and financial advice, and investment services whose organization is characterized by a high proportion of professional staff able to able to approach problems in an innovative manner and to make and implement decisions rapidly."

12.2 Nature and Characteristics of Merchant Banking

Merchant banking is skill based activities and involves serving every financial need of every client. It requires focused skill-base to provide for the requirements of the client. SEBI has made the quality of man-power as one of the criteria for registration as merchant banker. These skills should not be concentrated in issue management and underwriting alone, which may have an adverse impact on business. Merchant bankers can turn to any of the activities mentioned above depending upon resources, such as capital, foreign tie-ups for overseas activities and skills. The depth and sophistication in merchant banking business are improving since the avenues for participating in capital market activities have widened from issue management and underwriting to private placement, bought out deals (BODS), buy-back of shares, mergers and takeovers.

The services of merchant bank cover project counseling, pre investment activities, feasibility studies, project reports, design of capital structure, issue management, underwriting, loan syndication, mobilization of funds from Non-Resident Indians, foreign currency finance, mergers, amalgamation, takeover, venture capital, buy back and public deposits. A Category-1 merchant banker can undertake issue management only. Separate registration is not necessary to carry on the activity as underwriter.

Main Characteristics of Merchant Banking:

- High proportion of decision makers as a percentage of total staff.
- Quick decision process.
- High density of information.
- Intense contact with the environment.
- Loose organizational structure.
- Concentration of short and medium term engagements.
- Emphasis on fee and commission income.
- Innovative instead of repetitive operations.
- Sophisticated services on a national and international level.
- Low rate of profit distribution.
- High liquidity ratio.

12.3 Travellers Cheques - Meaning and Objectives

A travellers cheque is a cheque that is issued by a financial institution that can be used as a form of payment. Travellers cheques are most often used by those travelling because they are widely accepted as payment in many parts of the world, yet can be replaced if lost or stolen by the issuing financial institution. Travellers cheques are issued in a variety of monetary denominations such as the US Dollar, Euro, Japanese Yen, Canadian Dollar, Australian Dollar, and British Pound.

Traveller's cheques are bought by a traveller that are valid for use at home or abroad, but are generally cashed in a foreign country. Only a countersignature is required from the holder for verification. Released by financial institutions as a means of check, a traveller's cheque can be used as a convenient mode of payment. Widely accepted the world over as a form of payment, traveller's cheques are mostly preferred by travellers

A travellers' cheque are the equivalent to cash but are more secure in that the person using them will be refunded if they are stolen. They have a value in the currency they were issued. Travellers' cheques are issued by financial institutions such as Banks, Building and Saving Societies, Post Offices etc. and by some travel agents.

People use travellers' cheques rather than carry around large quantities of cash because of the reduce security risk.

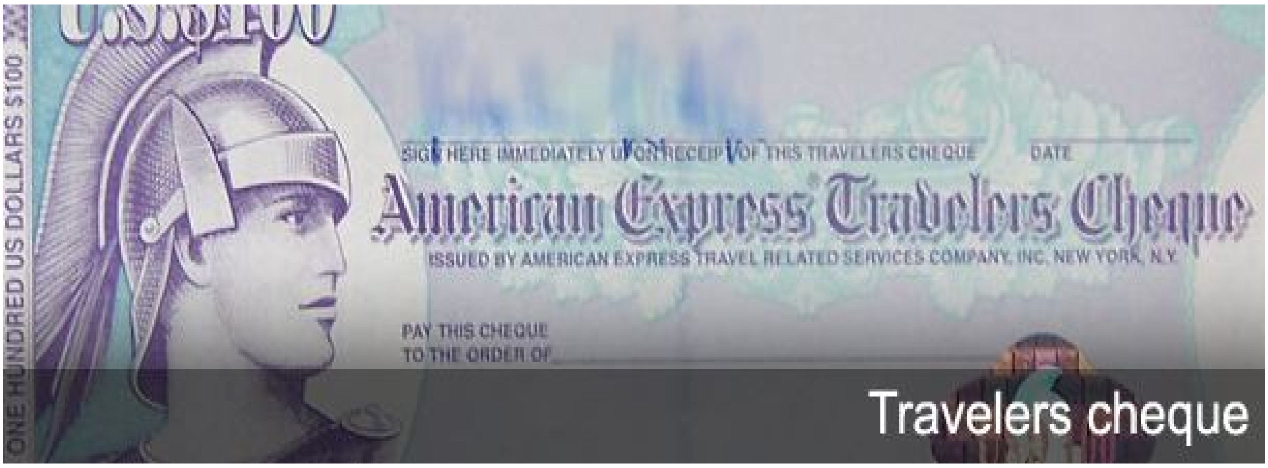


Figure 12.1

History of Traveller's Cheque

Travellers cheques were first issued in the late 1700s by the London Credit Exchange Company, and Thomas Cook, founder of the British travel agency, issued notes similar to travellers checks in 1874, but the modern travellers cheque was invented in 1891 by an employee of American Express. The then-president of American Express, J.C. Fargo, was frustrated when he could not cash checks during a trip to Europe and sought to find a solution. Marcellus F. Barry came up with the idea of the counter signature feature on the check to ensure merchants and users that the cheque was indeed genuine. The idea quickly gained in popularity and was an immediate financial success for American Express.

Over time other companies offered their own versions of the travellers cheque and as advanced in transportation made travel easier and less expensive for the masses, travellers cheques were the preferred form of money for travellers. However the increased use of credit cards, debit cards and the prevalence of automated teller machines (ATMs) worldwide have led to a decrease in the popularity of travellers cheques today.

At the time of purchase, the customer should be provided with a listing of the serial numbers of the cheques that were purchased. If any cheques are reported lost or stolen, most banks will require the customer to provide the serial numbers of the missing cheques. This allows the bank to verify the validity of the claim and the checks.

Even though travellers cheques can be replaced if lost or stolen, it is recommended that the user treat them as carefully as they would cash. The user should keep track of the cheques that are used as they are redeemed. The customer should also keep the travellers cheques purchase agreement and listing of the serial numbers separately from the cheques themselves.

Using a travellers cheque is a fairly simple process. The customer simply provides the travellers cheque to the merchant as payment. The customer will then need to sign the travellers cheque in the presence of the merchant. Once the merchant verifies that both signatures on the check match, any applicable change is given back to the customer and the transaction is completed.

12.4 Classification of Merchant Banking

Classification of Merchant Banks:

(1) Public Sector Merchant Banks:

Commercial Banks (public)

National Financial Institutions

State Financial Institutions

(2) Private Sector Merchant Banks:

Foreign Banks

Indian Private Banks

Leasing Banks

Finance and investment companies

12.5 Functions/ Services Offered by Merchant Bankers

Project Appraisal: This service helps corporates in analyze the soundness of a project, which may be setting up a new unit/expansion/modernization etc. It is a process of examining the technical, commercial, financial and economic viability of a project to ensure that it generates sufficient returns on the resources invested in it. The study of viability involves detached verification of project's ability to stand the tests of technical, financial and commercial feasibilities and management's capabilities to successfully implement and run the project. A service project report will be prepared for the company, including finalization of capital structure. Project appraisal includes:

(a)Financial appraisal (liquidity analysis, capital structure analysis, profitability analysis etc

(b) Technical appraisal (factors of production, technology, civil works, site location etc)

(c) Economic appraisal (also known as cost-benefit analysis, social cost, impact on employment, impact of the economy)

Syndication of Loan: Merchant Bankers arrange short, medium and long term loans for their clients. They analyze the pattern of clients cash flows, based on which the terms of borrowing can be defined. It then prepares a detailed loan memorandum which is circulated to various banks and financial institutions and they are invited to participate in the syndicate. The merchant banks then negotiate the terms of lending based on which the final allotment is done. It also arranges for raising foreign exchange loans and external commercial borrowings for import of capital.

Issue Management: This is the primary function of merchant bankers. It refers to the management of securities offering of corporates to the general public and existing shareholders on rights basis. Merchant bankers act as lead managers and assists companies in arriving at quantum and nature of issue and obtaining consent/clearance from various statutory authorities, preparing draft prospectus, obtaining approval from appropriate authorities etc. it also assists companies in tying up with underwriters for the issue, appoint other intermediaries like brokers, bankers, advertising agents, registrar to the issue and co-ordinates the activities of these agencies and institutions from the successful flotation of the issue. It also helps in listing the securities in stock exchange, finalizing basis of allotment, arranging for refund, handling investor complaints etc.

Merchant banks help companies raise funds by selling shares to the public by issuing prospectus, Shares may be issued at par, premium or discount. SEBI guidelines for pricing of public issues are as follows:

- New Co. set up by entrepreneurs without a track record = can issue shares only at par
- New Co. set up by an existing co with a 5-year track record of consistent profitability = is free to price its issue provided promoting company takes atleast 50% of the equity and the issue price is offered to all new investors uniformly.

- An existing private/closely held co with 3-year track record of consistent profitability is allowed to freely price the issue.
- Existing listed co. can freely price further issue.

Process of public issues:

- Vetting of prospectus (by SEBI)
- Appointment of underwriters, bankers, registrars and brokers
- Filing and prospectus with registrar of companies
- Printing and dispatch of prospectus and application forms
- Filing of initial listing application (within 10 days of filing prospectus with ROC: initial listing application be made to concerned stock exchange)
- Promotion of issue
- Statutory announcement (opening and closing dates, announcement to be made atleast 10 days before opening subscription list)
- Collection of application
- Processing of allocation (by registrar to the issue)
- Establishing liability of underwriters (if issue is undersubscribed)
- Allotment of shares (after formal approval by concerned stock exchange)
- Listing of issue (with concerned stock exchange)

Underwriting of Issues: In order to ensure full subscription or the stipulated minimum subscription of 90% of the issue, companies enter into an agreement with financial institutions, banks, brokers and bankers to underwrite the issue amount. Merchant bankers can underwrite issues and assist companies in tying up with other underwriters

Corporate Counseling: Endearing assistance to corporate clients on various aspects of business operations in the areas of financial planning, performance budgeting, restructuring capital, and other aspects of financial management and monitoring systems and operations.

Bankers to the Issue: Collection of subscription money/application money for an issue from the investors, acknowledgement, proper accounting of the money received, sending reports/certificates, informing collection details are the services provided in the banker to the issue role.

Investment Counseling: This activity involved assisting firms, companies, trusts, funds and associations in the choice of shares and stocks for investment depending upon the needs and the risk-return trade-off, as well as taxation and time considerations.

Portfolio Management Services: A portfolio is a collection of different kinds of investments. Merchant bankers provide portfolio management services.

Registrar and Transfer Agent: Transfer agency work involves carrying out transfer work in respect of securities after complying with stipulated formalities/procedures. Preparation and printing of dividend warrants and dispatching them to share holders is also covered here. Other services include attending to complaints of applicants/investors, coding and verification of applications, allotment, processing and dispatching allotment letters, providing various documents and certificates etc.

Mergers, Amalgamations and Acquisitions: Some companies desire to restructure themselves in order to effectively meet competition. Merchant bankers provide all requisite guidance and services for restructuring, to prepare due diligence, necessary clearance from statutory bodies like SEBI, ROC etc as per the statutory stipulations, for the process of mergers, acquisitions and amalgamations.

Venture Capital: Merchant Bankers help co obtaining venture capital for financing their new and innovative strategies. (add points from FSM chapter on "venture capital")

Leasing Finance: (elaborate by using points from the FSM chapter on "Leasing")

Non-resident Investment: Merchant bankers provide investment advisory services to attract NRI investment in primary and secondary markets, undertake buying and selling securities on their behalf, secure clearances from RBI under FEMA for repatriation of interest and dividends etc.

Joint Ventures: Merchant Bankers help corporates with joint ventures in India and abroad.

Registration of Merchant Bankers/Pre-requisites for Merchant Bankers:

Registration with SEBI is mandatory to carry out the business of merchant banking in India. An applicant should comply with the following norms:

- Applicant should be a body corporate
- Applicant should have minimum net worth of Rs. 5 crore.
- Applicant must have atleast 2 employees with prior experience of merchant banking.
- Applicant should have necessary infrastructure like office space, equipment, manpower etc
- Applicant should not carry on any business other than those connected with the securities market and must have necessary experience in the same.
- Applicant should not have been involved in any securities scam, proved guilty for any offense or been accused of moral turpitude.
- Any associate co, group co, subsidiary or inter-connected co of applicant should not have been a registered merchant banker.

12.6 Scope for Merchant Banking in India

Growth of New Issues Market: The growth of new issue market is unprecedented since 1990-1991. Merchant banking can help with the further sophistication and penetration of the new issues market.

Entry of Foreign Investors: Foreign institutional investors were allowed to invest in the primary and secondary market in 1992 and also, Indian companies were allowed to directly tap foreign capital through euro issues. Further, foreign direct investment by NRIs has risen considerably due to number of incentives offered to them. They need the services of merchant bankers to advise them for their investment in India. The increasing number of joint ventures abroad by Indian companies also requires expert services of merchant bankers.

Changing Policy of Financial Institutions: The policy of decentralization, increase in demand for technical and financial services and encouragement of small and medium industries, requires the services of merchant bankers.

Development of Debt Market: The development of debt market will offer tremendous opportunity to Merchant Bankers.

Innovations in Financial Instruments: The Indian capital market has witnessed innovations in the introduction of financial instruments. This has further extended the role of merchant bankers as market makers for these instruments.

Corporate Restructuring: Due to liberalization and globalization, competition in the corporate sector is becoming intense. To survive and thrive, companies need new strategies, structures and methods of functioning. This has led to corporate restructuring including mergers, acquisitions, etc. These developments offer a good opportunity to merchant bankers to extend their area of operations.

Disinvestment: The government of India has raised Rs. 2000 crores through disinvestment of equity shares of selected public sector undertakings in 93-94. Merchant Bankers can help in the disinvestment process.

12.7 Letter of Credits

A letter of credit is a promise to pay. Banks issue letters of credit as a way to ensure sellers that they will get paid as long as they do what they've agreed to do.

Letters of credit are common in international trade because the bank acts as an uninterested party between buyer and seller. For example, importers and exporters might use letters of credit to protect themselves. In addition, communication can be difficult across thousands of miles and different time zones. A letter of credit spells out the details so that everybody's on the same page.

Letters of credit are a payment mechanism, particularly used in international trade. The Seller gets paid, not after the Buyer has inspected the goods and approved them, but when the Seller presents certain documents (typically a bill of lading evidencing shipment of the goods, an insurance policy for the goods, commercial invoice, etc.) to his bank. The bank does not verify that the documents presented are true, but only whether they "on their face" appear to be consistent with each other and comply with the terms of the credit. After examination the bank will pay the Seller (or in LC terms the beneficiary of the letter of credit).

Elements of Letter of Credit:

- A payment undertaking given by a bank (issuing bank)
- On behalf of a buyer (applicant)
- To pay a seller (beneficiary) for a given amount of money
- On presentation of specified documents representing the supply of goods
- Within specified time limits
- Documents must conform to terms and conditions set out in the letter of credit
- Documents to be presented at a specified place

Beneficiary

The beneficiary is entitled to payment as long as he can provide the documentary evidence required by the letter of credit. The letter of credit is a distinct and separate transaction from the contract on which it is based. All parties deal in documents and not in goods. The issuing bank is not liable for performance of the underlying contract between the customer and beneficiary. The issuing bank's obligation to the buyer, is to examine all documents to insure that they meet all the terms and conditions of the credit. Upon requesting demand for payment the beneficiary warrants that all conditions of the agreement have been complied with. If the beneficiary (seller) conforms to the letter of credit, the seller must be paid by the bank.

Issuing Bank

The issuing bank's liability to pay and to be reimbursed from its customer becomes absolute upon the completion of the terms and conditions of the letter of credit. Under the provisions of the Uniform Customs and Practice for Documentary Credits, the bank is given a reasonable amount of time after receipt of the documents to honor the draft.

The issuing banks' role is to provide a guarantee to the seller that if compliant documents are presented, the bank will pay the seller the amount due and to examine the documents, and only pay if these documents comply with the terms and conditions set out in the letter of credit.

Typically the documents requested will include a commercial invoice, a transport document such as a bill of lading or airway bill and an insurance document; but there are many others. Letters of credit deal in documents, not goods.

Advising Bank

An advising bank, usually a foreign correspondent bank of the issuing bank will advise the beneficiary. Generally, the beneficiary would want to use a local bank to insure that the letter of credit is valid. In addition, the advising bank would be responsible for sending the documents to the issuing bank. The advising bank has no other obligation under the letter of credit. If the issuing bank does not pay the beneficiary, the advising bank is not obligated to pay.

Confirming Bank

The correspondent bank may confirm the letter of credit for the beneficiary. At the request of the issuing bank, the correspondent obligates itself to insure payment under the letter of credit. The confirming bank would not confirm the credit until it evaluated the country and bank where the letter of credit originates. The confirming bank is usually the advising bank.

Characteristics of Letter of Credit

Negotiability: Letters of credit are usually negotiable. The issuing bank is obligated to pay not only the beneficiary, but also any bank nominated by the beneficiary. Negotiable instruments are passed freely from one party to another almost in the same way as money. To be negotiable, the letter of credit must include an unconditional promise to pay, on demand or at a definite time. The nominated bank becomes a holder in due course. As a holder in due course, the holder takes the letter of credit for value, in good faith, without notice of any claims against it. A holder in due course is treated favorably under the UCC.

The transaction is considered a straight negotiation if the issuing bank's payment obligation extends only to the beneficiary of the credit. If a letter of credit is a straight negotiation it is referenced on its face by "we engage with you" or "available with ourselves". Under these conditions the promise does not pass to a purchaser of the draft as a holder in due course.

Revocability: Letters of credit may be either revocable or irrevocable. A revocable letter of credit may be revoked or modified for any reason, at any time by the issuing bank without notification. A revocable letter of credit cannot be confirmed. If a correspondent bank is engaged in a transaction that involves a revocable letter of credit, it serves as the advising bank.

Once the documents have been presented and meet the terms and conditions in the letter of credit, and the draft is honored, the letter of credit cannot be revoked. The revocable letter of credit is not a commonly used instrument. It is generally used to provide guidelines for shipment. If a letter of credit is revocable it would be referenced on its face.

The irrevocable letter of credit may not be revoked or amended without the agreement of the issuing bank, the confirming bank, and the beneficiary. An irrevocable letter of credit from the issuing bank insures the beneficiary that if the required documents are presented and the terms and conditions are complied with, payment will be made. If a letter of credit is irrevocable it is referenced on its face.

Transfer and Assignment:

The beneficiary has the right to transfer or assign the right to draw, under a credit only when the credit states that it is transferable or assignable. Credits governed by the Uniform Commercial Code (Domestic) maybe transferred an unlimited number of times. Under the Uniform Customs Practice for Documentary Credits (International) the credit may be transferred only once. However, even if the credit specifies that it is nontransferable or nonassignable, the beneficiary may transfer their rights prior to performance ofconditions of the credit.

Sight and Time Drafts: All letters of credit require the beneficiary to present a draft and specified documents in order to receive payment. A draft is a written order by which the party creating it, orders another party to pay money to a third party. A draft is also called a bill of exchange.

There are two types of drafts: sight and time. A sight draft is payable as soon as it is presented for payment. The bank is allowed a reasonable time to review the documents before making payment.

A time draft is not payable until the lapse of a particular time period stated on the draft. The bank is required to accept the draft as soon as the documents comply with credit terms. The issuing bank has a reasonable time to examine those documents. The issuing bank is obligated to accept drafts and pay them at maturity.

Example:

1) Buyer and Seller sign a purchase contract that stipulates payment by letter of credit. It is good practice to agree already in the purchase contract which documents the Seller/Beneficiary has to present.

2) The Buyer/Applicant goes to his bank (so called issuing bank) opening the credit to the benefit of the Seller, in particular the Buyer tells his bank which documents the Beneficiary has to present, where and how, and the amount of the credit and details of payment (by sight, deferred sight payment, against acceptance or negotiation of drafts).

3) The Issuing Bank, which is normally located in a foreign country, advises the Beneficiary through a correspondence bank located in the country of the Beneficiary of the credit. So in step # 3, the Issuing Bank issues the L/C and forwards it to the Advising Bank.

4) The Advising Bank checks the apparent authenticity of the L/C and advises the L/C to the Beneficiary

5) The Seller/Beneficiary checks if the L/C complies with the commercial agreements and if all terms and conditions specified in the L/C can be satisfied, then the Seller ships the goods

6) The Beneficiary assembles the documents specified in the L/C, checks the documents for discrepancies with the L/C, draws the draft and presents the draft and the documents to the Advising Bank

and presents the necessary documents to his local bank which pays him after examining them.

7) The Advising Bank bears the draft and the documents against terms and conditions of the L/C and forwards them to the Issuing Bank

8) The Issuing Bank checks if the documents comply with the L/C and makes a payment immediately (if the L/C is available by sight) or on a certain date (if L/C is available by deferred payment).

1.7.3 Types of Letter of Credit

There are five commonly used types of letter of credit. Each has different features and some are more secure than others. The most common types are:

- Irrevocable
- Revocable
- Unconfirmed
- Confirmed
- Transferable

Other types include:

- Standby
- Revolving
- Back-to-back

Sometimes a letter of credit may combine two types, such as 'confirmed' and 'irrevocable'.

Irrevocable and Revocable Letters of Credit: A revocable letter of credit can be changed or cancelled by the bank that issued it at any time and for any reason.

An irrevocable letter of credit cannot be changed or cancelled unless everyone involved agrees. Irrevocable letters of credit provide more security than revocable ones.

Confirmed and Unconfirmed Letters of Credit: When a buyer arranges a letter of credit they usually do so with their own bank, known as the issuing bank. The seller will usually want a bank in their country to check that the letter of credit is valid.

For extra security, the seller may require the letter of credit to be 'confirmed' by the bank that checks it. By confirming the letter of credit, the second bank agrees to guarantee payment even if the issuing bank fails to make it. So a confirmed letter of credit provides more security than an unconfirmed one.

Transferable Letters of Credit: A transferable letter of credit can be passed from one 'beneficiary' (person receiving payment) to others. They're commonly used when intermediaries are involved in a transaction.

Standby Letters of Credit: A standby letter of credit is an assurance from a bank that a buyer is able to pay a seller. The seller doesn't expect to have to draw on the letter of credit to get paid.

Revolving Letters of Credit: A single revolving letter of credit can cover several transactions between the same buyer and seller.

Back-to-back Letters of Credit: Back-to-back letters of credit may be used when an intermediary is involved but a transferable letter of credit is unsuitable.

12.8 Different Types of Debit & Credit Cards

Credit Cards

A credit card is a system of payment named after the small plastic card issued to users of the system. A credit card is different from a debit card in that it does not remove money from the user's account after every transaction. In the case of credit cards, the issuer lends money to the consumer (or the user). It is also different from a charge card (though this name is sometimes used by the public to describe credit cards), which requires the balance to be paid in full each month. In contrast, a credit card allows the consumer to 'revolve' their balance, at the cost of having interest charged. Most credit cards are the same shape and size, as specified by the ISO 7810 standard.

Figure 12.2

Credit Card Features

Do you know anyone who doesn't have a mailbox overflowing with credit card offers? Open any of them up and you'll find in large print just what makes this card perfect for you. At first glance, this all looks good on paper, but it's the small print that you don't pay attention to that will come back and bite you in the end. All credit cards offer a variety of features. Knowing and understanding these features will help you to decide which card is right for you.

Fees: Most credit cards charge fees for various things, and it is important to know what these fees are and how to avoid them.

The Annual fee: Some credit card companies charge you an annual fee just for using their card. Because of stiff competition, you can often negotiate this fee away if you call and speak to a customer service representative.

Cash Advance Fee: Most credit card companies charge you a fee for cash advances. These fees can vary but are usually somewhat hefty. Not only will they charge you a one-time fee, but the interest rate for this money will be at a considerably higher rate. Plus, unlike a regular purchase, where interest begins accruing after some grace period passes, cash advances accrue interest charges from day one.

Many card companies are competing for your business and are now offering an introductory cash advance and balance transfer rates for a specific amount of time. This lower rate can be applied to any balances you may wish to transfer from another card. Although it sounds good, some companies will charge you a fee for the transfer. Know what the fee is before you transfer any balances.

Miscellaneous Fees: Things like late-payment fees, over-the-credit-limit fees, set-up fees, and return-item fees are all quite common these days and can represent a serious amount of money out of your pocket if you get whacked for any of these fees.

Incentives: Since there are so many credit card companies, competition is stiff. Adding incentives to their offers is one of the more popular ways to tip the scales in their favor. Incentives like rebates on purchases, frequent flyer miles on certain airlines, and extended warranties on purchases are just a few of the bonuses that card companies will now offer.

For those of you who collect and use your frequent flyer miles, they also have added incentives like travel insurance and car rental insurance for your convenience. Of course, they are hoping that with all this travelling, you are using their card to foot at least some of the bill.

Rewards: Many card companies are looking to keep your business and are therefore making it worth your while to use their card. Just simply by using their card you can accumulate points that will in turn earn you rewards. What kind of reward depends solely on the amount of points you accumulate. Since you can't accumulate these points without charging things on your card, this is a classic case of 'you have to spend money to save money.'

Bottom line is this: Know what you need and what you don't. No sense in paying for any features that you won't use.

Different Types of Credit Cards

Different types of credit cards offer several different options, depending on what your needs are. Some are geared toward individual consumers, while others are set up in ways that work best for small business needs. To know what type of credit card fits your needs, let's review a few of your options.

- **Business Credit Cards:** A business credit card offers the business owner the opportunity to keep business and personal expenses separate. The credit card may offer special business rewards and saving opportunities that go above and beyond what the individual credit card owner may have. Since money management is essential in successfully running a business, the card may offer an expense management service that will allow you to keep track of the outgoing money. You can obtain additional credit cards for employees who may need them for travel expenses and such as well as have a higher credit limit than you normally would on an individual credit card.
- **Student Credit Cards :** Many credit card companies will issue student credit cards that have lower credit limits and fewer incentives to help keep their spending in check. Still, take note. Many college students graduate with a credit balance that averages between $3,000 and $7,000 and with interest rates, this can be a real problem when trying to pay them off.
- **Prepaid Debit Cards :** Prepaid debit cards are one type of credit card that has grown significantly in recent years. Although they work like a traditional credit card when making a purchase, that is where the similarities end. With prepaid debit cards, you have actually prepaid and set the credit limit by depositing money onto the debit card. Depending on how much you have deposited into the debit card's account depends on how much credit limit you want on that card. This is a great way to have the convenience of a credit card without the chance of charging more than you can afford to pay off.
- **Credit Cards for Bad Credit :** It is possible, even with bad credit to obtain a credit card. These cards will come with some restrictions not typically found on other types of credit cards. Your credit limit will be lower and your interest rate higher. Some may require you to have a secured credit card, meaning you have to maintain a savings or some other type of account that will cover the expenses on the credit card. Once you have established that you will be responsible, some, if not all, of your restrictions may be lifted.
- **Cash Back Credit Cards** : Many credit cards will now offer you cash back incentives for using their credit cards. Depending on how much your balance is and how often you use the credit card,

you can earn cash back for your purchases. Some companies offer 1% off your balance while others, like Sears, will offer you cash off purchases made in their store. Either way, if you are planning on using a credit card, finding one that will offer you a cash incentive is a smart choice.

Debit card

A debit is an accounting item that diminishes the overall value of an asset.

debit card (also known as a bank card or check card) is a plastic card which provides an alternative payment method to cash when making purchases. Functionally, it can be called an electronic check, as the funds are withdrawn directly from either the bank account (often referred to as a check card), or from the remaining balance on the card. In some cases, the cards are designed exclusively for use on the Internet, and so there is no physical card.

Debit cards are similar to credit cards, except debit cards pull money out of your checking or brokerage account. Debit cards do not create or increase a loan like credit cards do.

Use of debit cards has become widespread in many countries and has overtaken the cheque, and in some instances cash transactions by volume. Like credit cards, debit cards are used widely for telephone and Internet purchases.

History of Debit Cards

Two decades ago, the number of debit cards in circulation was approximately 19 million. This figure is projected to cross 34.4 million by 2016. The history of debit cards shows that they have largely been used to pay for food and drinks

Where to Use Debit Cards

You can use debit cards very much like a plain old credit card. Many retailers will allow you to use a debit card at checkout just like a credit card. You just swipe it and you're done. However, sometimes you have to let the retailer know you're using a debit card.

When you open a bank account, you may be issued with a debit card that can be used to purchase items at any outlet or restaurant that allows electronic transactions. Instead of carrying cash, many people increasingly use debit cards for security purposes. A debit card typically requires use of a personal identification number (PIN) to make a purchase or withdraw money from an automated teller machine (ATM). Unlike cash, if lost or stolen, a debit card could be replaced by the bank.

Figure 12.3

What are the Features of the US Debit Card?

Magnetic-Stripe Card

Issuance "on-the-spot," Host-to-host, or Over the Internet

PIN Protection

Immediate Activation

No Bank Account Requirement

Use at ATM, POS, Phone, etc.

Multilingual Interactive Voice Response

Card Cancellation Anytime

Reports and Statements Available Online

24/7 Customer Service

Multiple Card Access of the Same Pool of Funds

A debit card is an electronic check—money is deducted instantly. A credit card is similar to a debit card, but with the former, you borrow money to be paid back later at a fee called an interest rate.

The other difference is that when you use a credit card to make a purchase, an identification code is not required. That is why at times it is easier for someone to use a stolen credit card than a debit card. Unlike debit cards, credit card transactions float long after the transaction. It takes a few days for the money to transit from the credit card company to the business where a transaction was conducted.

Debit Cards and Bad Credit

For those with bad credit, debit cards are a very useful tool. You can function as if you had a credit card, meaning you don't have to carry cash around with you. However, because a debit card pulls against money in the bank, you can typically qualify for one if your credit has some blemishes. However, they don't help you build credit.

Bank Debit Cards: Types

Debit cards are offered by banks in the following forms:

- Online Card
- Prepaid Card
- Offline Card
- Electronic Purse Debit Card
- Debit Cards for telephone, mail and internet transactions.

Debit Cards: Benefits

Debit cards offer the following benefits:

- They help people to be disciplined financially, since one cannot splurge with the limited amount of funds deposited for the card.

- A person with poor credit can obtain a debit card without too much trouble.
- Debit cards can be used to make online purchases and payments.
- They provide freedom from carrying cash and checks while traveling, thereby offering more safety.
- Debit cards do not charge high interest rates or fees on card transactions.

Disadvantages of Debit Cards

Debit cards, however, do entail certain limitations, such as:

- Debit cards come with lesser fraud protection facilities than credit cards.
- Some transactions cannot be carried out with a debit card, such as renting a car in a foreign country.
- You can only use as many funds as you have available. Therefore, in case of an emergencies where credit is urgently needed beyond your account balance, a debit card will not be enough to meet your needs.

12.9 ATM & It's Benefits

ATM Services provide cost-effective, highly scalable network based solutions for Carriers and Service Providers to meet their customers' Wide Area transmission needs. Our robust and diversely-routed 5.0 Gbit/s ATM network provides connectivity to all major markets in the Asia-Pacific region as well as Europe and the Americas for fast and reliable delivery of a broad range of voice, video and data applications.

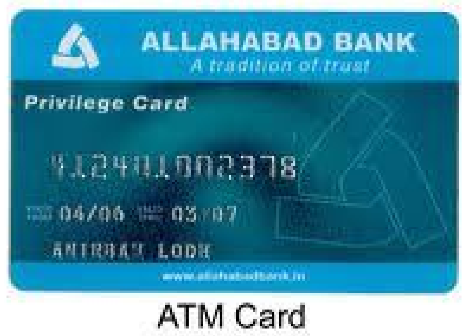


Figure 12.4 : ATM Card

Features4 different classes of services including CBR, VBR real-time, VBR non real-time and UBR Soft PVC switching Diverse cable paths and dynamic routing between REACH ATM nodes and dual access nodes Connectivity to all major market in the Asia-Pacific region as well as Europe and the Americas Supports interworking function with ATM Competitive Service Level Guarantee on service availability, network round-trip delay and service activation lead-time. Centralised network management and Global Customer Care support team available 24 hours a day, seven days a week. REACH's Online Service Center (OCS)

Usefullness of ATM Cards

- Allows customers to tailor the service to meet specific traffic requirements thus increasing bandwidth efficiency
- Ensure services are automatically re-routed around the primary route to the backup path to provide optimum performance

- Provides the highest level of resilience and diversity
- Enables carriers and service providers to extend their global coverage without heavy CAPEX investment
- Provides a single integrated network for smaller Frame Relay sites and larger ATM locations
- Demonstrates REACH's commitment to quality and reliability
- Highest service quality is maintained
- Provides a web-based network monitoring tool for customers to view and analyse network performance data

Advantages of Automated Teller Machines (ATMs)

1. **ATM Provides 24 Hours Service:** ATMs provide service round the clock. The customer can withdraw cash upto a certain a limit during any time of the day or night.
2. **ATM Gives Convenience to Bank's Customers:** ATMs provide convenience to the customers. Now-a-days, ATMs are located at convenient places, such as at the air ports, railway stations, etc. and not necessarily at the Bank's premises. It is to be noted that ATMs are installed off-site. (away from bank premises) as well as on site (installed within bank's premises). ATMs provide mobility in banking services for withdrawal.
3. **ATM Reduces the Workload of Bank's Staff:** ATMs reduce the work pressure on bank's staff and avoid queues in bank premises.
4. **ATM Provide Service Without Any Error:** ATMs provide service without error. The customer can obtain exact amount. There is no human error as far as ATMs are concerned.
5. **ATM is Very Beneficial for Travellers:** ATMs are of great help to travellers. They need not carry large amount of cash with them. They can withdraw cash from any city or state, across the country and even from outside the country with the help of ATM.
6. **ATM May Give Customers New Currency Notes:** The customer also gets brand new currency notes from ATMs. In other words, customers do not get soiled notes from ATMs.

12.10 Summary

Merchant banking is skill based activities and involves serving every financial need of every client. It requires focused skill-base to provide for the requirements of the client. SEBI has made the quality of man-power as one of the criteria for registration as merchant banker. These skills should not be concentrated in issue management and underwriting alone, which may have an adverse impact on business. Merchant bankers can turn to any of the activities mentioned above depending upon resources, such as capital, foreign tie-ups for overseas activities and skills. The depth and sophistication in merchant banking business are improving since the avenues for participating in capital market activities have widened from issue management and underwriting to private placement, bought out deals (BODS), buy-back of shares, mergers and takeovers.

The services of merchant bank cover project counseling, pre investment activities, feasibility studies, project reports, design of capital structure, issue management, underwriting, loan syndication, mobilization of funds from Non-Resident Indians, foreign currency finance, mergers, amalgamation, takeover, venture capital, buy back and public deposits. A Category-1 merchant banker can undertake issue management only. Separate registration is not necessary to carry on the activity as underwriter.

12.11 Self Assessment Questions

1. What is merchant banking? Explain its Nature and characteristics.
2. What is Travellers Cheques? Explain its Meaning and Purpose
3. Write an essay on Classification of Merchant Banking.
4. Explain various Functions/ Services offered by Merchant Bankers
5. Put a light on the Scope for Merchant Banking in India
6. Write short notes on following:
   (i) Letter of Credits
   (ii) Different Types of Debit & Credit Cards
   (iii) ATM & It's benefits

12.12 Books for Further Readings

- http://letterofcreditforum.com/content/introduction-letters-credit
- http://holidaytravelmoney.co.uk/travellers-cheque/travellers-cheques-meaning-and-purpose.php
- http://www.cookeryonline.com/mealexperience/Site01/Payment/TravellersCheque.html
- http://www.wisegeek.com/what-is-a-travellers-cheque.htm
- http://www.web-source.net/web_development/credit_card_types2.htm
- http://www.web-source.net/web_development/credit_card_features.htm
- http://www.ehow.com/about_6544412_meaning-debit-card_.html
- http://www.economywatch.com/debit-card/
- http://www.fms.treas.gov/debitcard/features.html
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Unit - 13 : Insurance: An Introduction

Structure of Unit:

13.0 Objectives

After studying this unit you should be able to understand:

- About the insurance:
- History of insurance
- Meaning and definition of insurance
- Importance and benefits of insurance
- Nature and types of insurance
- To trigger long term strategic planning and Principles of insurance
- Limitation of insurance

13.1 Introduction

Once Frank H Knight said "Risk is uncertainty and uncertainty is one of the fundamental facts of life" and in the current situations of the world there is uncertainty of our life, we do not have any idea what will happen in our future. Therefore Insurance is the modern method by which men make the uncertain certain and the unequal, equal. It is the means by which risk is always guaranteed covered by insurance. Insurance has become one of the great ways to secure our future. The idea of insurance is very simple. It can simply be defined as an instrument used for managing the possible risks of the future. Throughout our life we may face many kinds of risks such as failing health, financial losses, accidents and even fatalities. Insurance addresses all these uncertainties on financial terms. So one should understand the importance of insurance in their life.

As insurance covers risks against financial losses, it should not be taken as an investment instrument. There a need of insurance in every stage of our life and risks always increases with the changing environment of our life. Insurance is essentially a mechanism that eliminates risks primarily by transferring the risk from the insured to the insurer. In simple words we can say that insurance is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment or we can say that also collective bearing of risks is insurance.

13.2 Origin and Development of Insurance

The earliest traces of insurance in the ancient world are found in the form of marine trade loans or carriers' contracts which included an element of insurances. The first methods of transferring or distributing risk were practiced by Chinese and Babylonian traders as long ago as the 3rd and 2nd millennia BC, respectively.[1] Chinese merchants travelling treacherous river rapids would redistribute their wares across many vessels to limit the loss due to any single vessel's capsizing. The Babylonians developed a system which was recorded in the famous Code of Hammurabi, c. 1750 BC, and practiced by early Mediterranean sailing merchants. If a merchant received a loan to fund his shipment, he would pay the lender an additional sum in exchange for the lender's guarantee to cancel the loan should the shipment be stolen.

Achaemenian monarchs were the first to insure their people and made it official by registering the insuring process in governmental notary offices. A thousand years later, the inhabitants of Rhodes created the 'general average', which allowed groups of merchants to pay to insure their goods being shipped together. The collected premiums would be used to reimburse any merchant whose goods were jettisoned during transport, whether to storm or sink age.

The ancient Athenian "maritime loan" advanced money for voyages with repayment being cancelled if the ship was lost. In the 4th century BC, rates for the loans differed according to safe or dangerous times of year, implying an intuitive pricing of risk with an effect similar to insurance.

The Greeks and Romans introduced the origins of health and life insurance c. 600 BCE when they created guilds called "benevolent societies" which cared for the families of deceased members, as well as paying funeral expenses of members. Guilds in the middle Ages served a similar purpose. The Talmud deals with several aspects of insuring goods. Before insurance was established in the late 17th century, "friendly societies" existed in England, in which people donated amounts of money to a general sum that could be used for emergencies.

In early days in India, Rigveda, the most sacred book of India, references were made to the concept 'Yogakshema' more or less akin to the well-being and security of the people. The codes of Hummurabi and of Manu had recognized the advisability of provision for sharing the future losses. The marine insurance is the oldest form of insurance after that fire insurance, life insurance and miscellaneous insurance took the present shape at the later part of nineteenth century but in India, modern concept of insurance came into being with the advent of the east India Company in 18th century.

Marine Insurance in India: There is evidence that marine insurance was practiced in India some three thousand years ago. In earlier days travellers by sea and land were exposed to risk of losing their vessels and merchandise because of piracy on the open seas. Moreland has maintained that the practice of insurance was quite common during the rule of Akbar to Aurangzeb, but the nature and coverage of insurance in this period is not well-known. It was the British insurers who introduced general insurance in India, in its modern form. The Britishers opened general insurance in India around the year 1700. The first company, known as the Sun Insurance Office Ltd. Was set up in calcutta in the year 1710.

Fire Insurance in India: In India, the fire insurance developed after the marine insurance. The general insurer started working since 1850 with the establishment of the Triton Insurance, Calcutta but the general insurance in India could not progress much. The slow growth of joint – Stock enterprise and mechanized production was another reason for the low level of general insurance business.

Life Insurance in India: The British companies started life insurance business in India, by issuing policies exclusively on the lives of Europena soldiers and civilians. They sometimes issued policies on the lives of Indians by charging extra charges. The first Indian company named as Bombay Mutual Life Insurance Society Ltd was formed in December 1870. By 1971, the total numbers of companies working in India were 15, out of which 7 were Indian and the remaining were British Companies. After several changes have been made for the period from 1930 to1938, the Government of India passed Insurance Act, 1938.

Miscellaneous Insurance in India: Due to the increasing demands of the time, the miscellaneous insurance took the present shape in nineteenth century. The development of accidental insurance, theft and dacoit, fidelity insurance etc. in the twentieth century, many types of social insurance started operating; viz, unemployment insurance, crop and cattle insurance etc. In the last we can say that Insurance becomes an inseparable part of human development.

Activity A:

1. Write the name of the government and private insurance companies.

13.3 Meaning and Definition

In simple words, Insurance is defined as a co-operative device to spread the loss caused by a particular risk over a number of persons who are exposed to it and who agree to ensure themselves against that risk.

The insurance is also defined as a social device to accumulate funds to meet the uncertain losses arising through a certain risk to a person insured against the risk. The various definition of insurance can be classified into the following three categories:

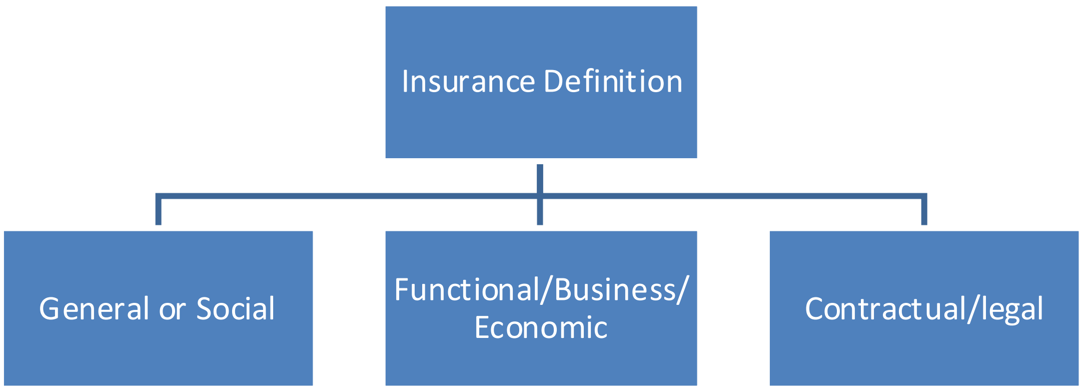

Figure 13.1

General or Social Definition: the general definitions are given by the social scientists. Some of such definitions are given below:

1. "The collective bearing of risks is insurance". **-Sir William Bevridges**
2. "Insurance is a substitution for a small known loss for a large unknown loss by which may or may not occur". **- Boon and Kurtz**.
3. "Insurance is a cooperative form of distributing a certain risk over a group of persons who are exposed to it". **- Ghosh and Agarwal**

Thus, the insurance mean in the social sense is:

- A co-operative device to spread the risk.
- The system to spread the risk over a number of persons who are insured against the risk.

- The principles to share the loss of each member of the society on the basis of probability of loss to their risk.
- The method to provide security against losses to the insured.

Fundamental Definitions: These definitions are based on business oriented since it is a device providing financial compensation against risk or misfortune.

1. "Insurance as a social device providing financial compensation for the effect of misfortune, the payments being made from the accumulated contributions of all parties in the scheme". — **D.S.Hansell**
2. "Insurance is a social device whereby the uncertain risks of individuals may be combined in a group and thus made more certain, small periodic contributions by the individuals providing a fund, out of which, those who suffer losses may be reimbursed". **–Riegel and Miller**

For Example: In a particular colony there are 700 houses each having a worth of Rs 40,000. Every year there is a probability of 4 houses getting burnt. The resultant loss per houses is 40,000 and total loss being Rs 1, 60,000. If all the 700 homes owners pool Rs 200 each to the pool the unfortunate people whose houses were burnt can be easily paid. It is the example of Economic Definition of Insurance.

Contractual Definition: It is a contractual relationship to secure against risks. Some of such definitions are:

1. "Insurance is a contract whereby one person, called the insurer, undertakes in return for the agreed consideration called premium, to pay to another person called the insured, a sum of money or its equivalent on specified event". **– Justice Channel**
2. Insurance is a contract in which a sum of money is paid to the assured as consideration of insurer's incurring the risk of paying a large sum upon a given contingency". **-Justice Tindall**

Figure 13.2

Thus, the insurance mean in the legal or contractual sense is:

- Certain sum, called premium, is charged in consideration.
- Against the said consideration, a large sum is guaranteed to be paid by the insurer who received the premium.

- The payment will be made in a certain definite sum.
- The payment is made only upon contingency.

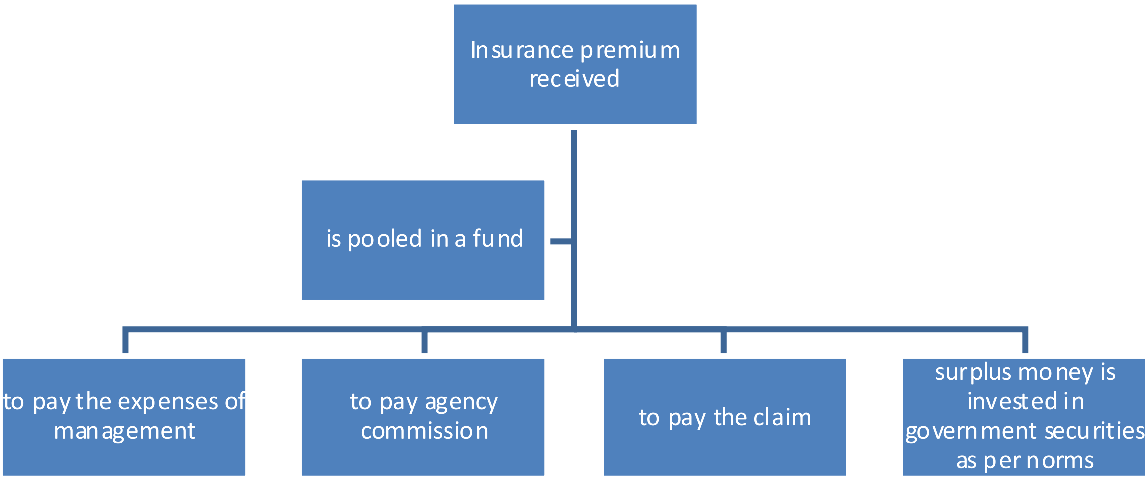

Figure 13.3

13.4 Nature or Characteristics of Insurance

1. Insurance is a cooperative device to share the burden of risk which may fall on happening of some unforeseen events. Its most important nature is sharing of risks.
2. The most important feature of every insurance plan is the higher degree of cooperation for mutual benefits and distributing a certain risk over a group of persons who are exposed to it.
3. For the purpose of ascertaining the insurance premium, the volume of risk is evaluated, which forms the basis of insurance contract.
4. The amount of payment in indemnity insurance depends on the nature of losses occurred, subject to a maximum of the sum insured.
5. On the happening of specified event or in contingency the insurance company is bound to make payment to the insured.

   For example: In life insurance, a fixed amount is paid on the happening of some uncertain event or on the maturity of the policy but in the case of fire, marine or accidental insurance, it is not necessary. In such cases, the insurer is not liable for payment of indemnity.
6. Insurance is a protection device to avoid or reduce economic risks or losses.
7. Insurance is a plan which spreads the risks and losses of few people among a large number of people.
8. Insurance is a device to transfer some economic losses.
9. Insurance is a device of ascertaining of losses. By taking a life insurance policy, one can ascertain his future losses in term of money.
10. Insurance is not charity because charity pays without consideration but in the case of insurance, premium is paid by the insured to the insurer in consideration of future payment.
11. To spread the loss immediately, smoothly and cheaply, large number of persons should be insured against similar risk, thus keeping the premium rate at the minimum.

12. Insurance is a legal contract between the insurer and insured. Insurer promises to compensate the insured financially within the scope of insurance policy and the insured promises to pay a fixed rate of premium to the insurer.

13. Insurance is a plan of social welfare and protection of interests of the people.

14. Insurance based upon fundamental principles like good-faith, insurable interest, contribution, indemnity, cause proximal, subrogation etc.

15. The government of every country enacts the law governing insurance business so as to regulate and control its activities for the interest of the people. In India life insurance Act 1956 and General insurance Act 1972 are the major enactments in this direction.

Some others natures are:

1. Insurance is not a gambling.
2. Insurance only for pure risks.
3. Based on mutual good- faith.
4. Institutional Set Up.
5. Insurance has a wider scope.

13.5 Functions of Insurance

The functions of insurance can be classified into three parts:

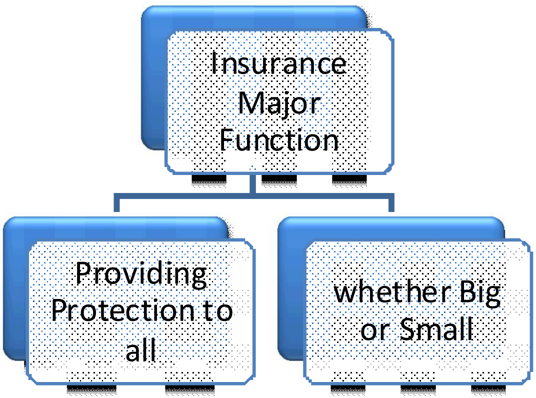

Figure 13.4

I Primary Functions:

1. **Insurance Provides Protections:** The main function of the insurance is to provide protection against the probable chances of loss, future risk, accidents and uncertainty. The insurance cannot check the happening risk but can provide for losses at the happening of the risk.

2. **Volume or Evaluation of Risk:** Insurance determines the probable volume of risks by evaluating various factors that gives rise to risk. The risk is also evaluated on the basis of premium rate.

3. **Provide Certainty Against Risk**: Insurance provides certainty of payment at the uncertainty of loss. The uncertainty of loss can be reduced by better planning and administration. But, the insurance relieves the person from such difficult task. Insurance removes all these uncertainty and the assured is given certainty of payment of loss. This may the reason that Riegel and Miller observe and then write that “the function of insurance is primarily to decrease the uncertainty of events”.

4. **Spreading of Risk:** Insurance is a plan which spreads the risks and losses of few people among a large number of people. John Magee writes," Insurance is a plan by which a large number of people associate them and transfer to the shoulders of all, risks attached to individuals".

5. **Risk Sharing or Collective bearing of Risk:** Insurance is a device to share the financial loss of few among many others. The risk sharing in ancient time was done only at time of damage or death; but today, on the basis of probability of risk, the share is obtained from each and every insured in the shape of premium without which protection is not guaranteed by the insurer.

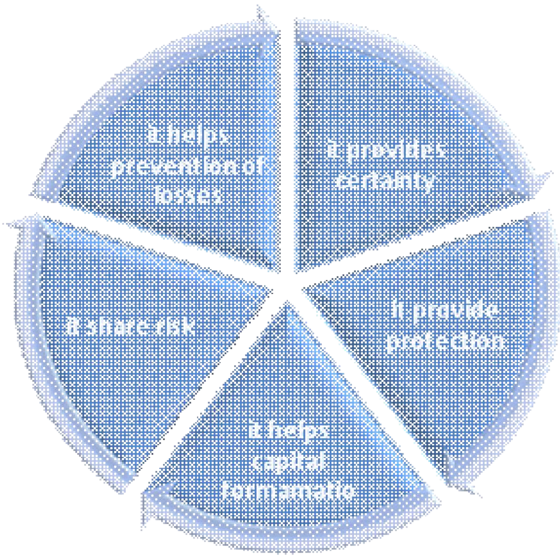

Figure 13.5

II Secondary Functions:

1. **It Improves Efficiency:** The insurance eliminates worries and miseries of losses at death and destruction of property. The carefree person can devote his body and soul together for better achievement. It improves not only his efficiency, but the efficiencies of the masses are also advanced.

2. **It Provides Capital:** The insurance provide capital to the society. The accumulated funds are invested in productive channel. Dinsdale observes, insurance relieves the businessmen and others from security investments, by paying small amount of premium against larger risk and uncertainty. There is no need for them to invest separately for security purpose and this money can be invested in other activities.

3. **It Helps Economic Progress:** The insurance by protecting the society from huge losses of damage, destruction and death, provides and initiative to work hard for the betterment of the masses. The next factor of economic progress, the capital, is also immensely provided by the masses. The property, the valuable assets, the man, the machine and the society cannot lose much at the disaster.

4. **Prevention of Loss:** Insurance cautions individuals and businessmen to adopt suitable device to prevent unfortunate consequences of risk by observing safety instructions; installation of automatic sparkler or alarm systems, etc. Prevention of losses cause lesser payment to the assured by the insurer and this will encourage for more savings by way of premium. Reduced rate of premiums stimulate for more business and better protection to the insured.

III Other Functions:

There are some indirect or others functions of insurance which indirectly provide economy benefit to the insured people.

1. Insurance serves as compulsory way of savings or investment and it restricts the unnecessary expenses by the insured.
2. The country can earn foreign exchange by way of issue of marine insurance policies.
3. Insurance makes the foreign trade risk free through different types of policies.
4. Insurance provide social security to people not only at the time of death but also provide assistance to the insured at the time of sickness, old age, maternity etc.

13.6 Principles of Insurance

1. **Principle of Cooperation:** It is a voluntary device to share the risks and uncertainties collectively. In insurance, a common fund is created by the contributions of a large number of people. On happening loss to a member of the fund, he is compensated from the fund. This way, the contribution made by one for all and the contribution of all are used for compensating any one of them. 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.

2. **Principle of Probability:** Probability throws light on the uncertain events and it is the important determinant of insurance premium. It is a mathematical assumption that there will be probability of happenings which had happened in the past. It is necessary for the insurer to ascertain the probability of happenings that had happened in the past. There are two methods of ascertain the probability of any future events; viz, analysis of past data and application of statistical methods.

3. **Principle of Good- Faith:** Utmost good faith refers that the parties to the contract (insured and insurer) are legally bound to reveal to each other all information about the subject matter which would influence each other's decision.

4. **Principle of Indemnity:** "Indemnity" means, "make good the loss". This means that the assured, in the case of loss against which the policy has been made, shall be indemnified subject to the value of the policy. A contract of insurance, however, ceases to be a contract of indemnity if the insurer promises to pay a fixed sum on the happening of the event insured against whether the assured has suffered any loss or not.

$$\textbf{Amount of Indemnity} = \frac{\textbf{Policy Amount x Actual Loss}}{\textbf{Market Value of the subject Matter on the date of loss}}$$

This principle is applied to all other contracts of insurance except life insurance, personal accident and sickness insurance.

5. **Principle of Insurable Interest:** In this principle the assured must have an actual interest in the subject matters of insurance, either in full or in part.

In the words of Mehr and Cammack, "In property insurance, insurable interest is any financial interest based upon some legal right in the preservation of the property. In life insurance and insurable interest is any reasonable, expectation of financial loss arising from the death of the person whose life is assured".

6. **Principle of Warranties:** According to Section35 of Marine Insurance Act 1963," A warranty means a promissory warranty by which the assured undertakes that some particular thing shall or shall not be done or that some conditions shall be fulfilled or whereby he affirms or negatives the existence of a particular state of facts".

7. **Principle of Contribution:** According to Federation of Insurance Institute, Mumbai," Contribution is the right of an insurer who has paid a loss under a policy , to recovers as a proportionate amount from other insurer who are liable for the loss". This principle ensures equitable distribution of losses between different insurers. A policy holder is not entitled to claim from each insurer more than the rate able proportion of the loss to which one is liable.

   Calculation of Contribution:

   = Sum assured with individual insurer/Total sum assured x Total Loss

   This principle is applicable in all types of insurance contracts, except life insurance.

8. **Principle of Proximate Cause:** Proximate cause means the active efficient cause that acts in motion a chain of events which brings about a result, without intervention of any force started and working actively from a new and independent sources or we can say in simple words proximate means the time that elapses between cause and result may be long or short, but will not affect the cause and effect.

   According to this principle, if the real cause of loss is insured, the insurer is liable to compensate the loss; otherwise the insurer may not be responsible for loss.

9. **Principle of Doctrine of Subrogation:** It refers to the right of the insurer to stand in the place of the insured, after settlement of a claim, in so far as the insured's right of recovery from and alternative sources is involved. If the insured is in a position to recover the loss in full or in part from a third party due to whose negligence the loss may have been precipitated, his right of recovery is subrogated to the insurer on settlement of the claim. The insurers, thereafter, recover the claim from the third party. The right of subrogation may be exercised by the insurer before payment of loss.

10. **Principle of Mitigation of Loss:** This principle makes the insured be more careful to protect the subject matter from any possible loss. If he fails to act in such a manner, the insurer can avoid the claim of the insured, on the ground of negligence on the part of insured.

Activity B:

1 A insures a building against fire with three fire insurance companies A,B and C with Rs 50,000, Rs.40,000, and Rs.30,000 respectively. A fire took place during the period of insurance and a total loss of Rs. 70,000 was calculated. Calculated the contribution from A, B and C.

13.7 Kinds of Insurance

Broadly, insurance may be classified into the following categories:

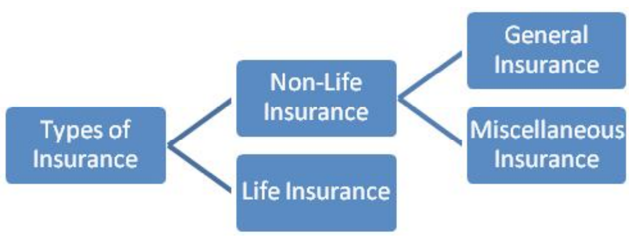

Figure 13.6

I. Life Insurance:

Life insurance is different from other insurance in the sense that, here, the 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.

Life insurance may be defined as a contract in which the insurer, in consideration of a certain premium, either in a lump sum or by other periodical payments, agrees to pay the assured, or to the person for whose benefit the policy is taken, the assured sum of money, on the happening of a specified event contingent on the human life.

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.

II. Non-Life Insurance:

In the non-life insurance included general and miscellaneous insurance like fire insurance, marine insurance, cattle insurance, crop insurance and flood insurance etc.

Figure 13.7

1. **General Insurance:** General insurance business refers to fire, marine and etc insurance business whether carried on singly or in combination with one or more of them, but does not include capital redemption business and annuity certain business.

   Marine Insurance: Marine insurance provides protection against loss of marine perils. The marine perils are collision with rock, or ship, attacks by enemies, fire, robbers, thieves, captures, jettisons, barratry and etc. These perils cause damage, destruction or disappearance of the ship and cargo and non-payment of freight. There are different types of marine policies known by different names according to the manner of their execution or the risk they cover. They are: voyage policy, time policy, and valued policy, unvalued policy, floating policy, wager or honors policy.

   Fire Insurance: Fire insurance is a contract to indemnity the insured for distribution of or damage to property caused by fire. The insurer undertakes to pay the amount of insured's loss subject to the maximum amount stated in the policy. Fire insurance is essentially a contract of indemnity, not against accident, but against loss caused by accident. War risk, turmoil, riots, etc, can be insured under this insurance too.

   Social Insurance: Social insurance has been developed to provide economic security to weaker sections of the society who are unable to pay the premium for adequate insurance. Some are these sickness insurance, death insurance, disability insurance, unemployment insurance and old age insurance.

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.

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

2. **Miscellaneous Insurances**: The process of fast development in the society gave rise to a number of risks or hazards. To provide security against such hazards, many others types of insurance also have been developed. The important among them are:

- Crop Insurance
- Burglary Insurance
- Fidelity Insurance
- Flood Insurance
- Cattle Insurance
- Cash in Transit Insurance
- Vehicle Insurance
- Personal accidents Insurance
- Legal liability Insurance

Activity C:

1. List the types of insurance which you will prefer for your family and business.

13.8 Role and Importance of Insurance

The role and importance of insurance, here, it has been discussed in three phases:

1. Uses to Individual :

- Insurance provides security and safety
- Insurance affords peace of mind
- Insurance protects mortgaged property
- Insurance eliminates dependency
- Life insurance encourage saving
- Life insurance provides profitable investment
- Life insurance fulfils the needs of a person like family needs, old age needs, re-adjustment needs, need for education, marriage, insurance needs for settlement of children and clean up funds.

2. Uses to Business or Industry:

- Uncertainty of business losses is reduced
- Key man indemnification
- Enhancement of credit

- Business continuation
- Welfare of employees

3. Uses to Society:

- Wealth of the society is protected
- Economic growth of the country
- Reduction in inflation

13.9 Limitation of Insurance

Insurance has certain limitations and on account of such limitations, the benefits of insurance could not be availed in full. These limitations are:

1. Only pure risks can be insured and speculative risks are not insurable.
2. Due to higher premium rates certain category of people cannot avail the advantage of insurance.
3. It is difficult to control over moral hazards in insurance because some people mis- utilize the insurance plans for their self- interest by claiming false claims from insurance companies.
4. In certain cases like unemployment insurance, insolvency of banks etc. cooperation of government is required.
5. All the pure risks are also not insured. For example insurer does not take any interest to accept a proposal of a person whose suffer from cancer.
6. The private insurers are not permitted to insure specified types of risks like bankruptcy of banks, unemployment etc.
7. Insurance against the risk of a single individual or a small group of persons are not advisable since it is not practicable due to higher cost involved.
8. The event cannot be valued in terms of money, such risks are not insurable.
9. Insurance is possible only when the insured has insurable interest in the term of financial interest in the subject matter of insurance.
10. Main object of insurance is to provide security against the risks. It is not a profitable investment.

13.10 Summary

Insurance in the modern form originated in the Mediterranean during 13/14th century. The earliest references to insurance have been found in babylonia, the Greeks and the Romans. In India, modern concept of insurance came into being with the advent of the East India Company in 18th century.

The role of insurance for the development of commerce and industry of a country is very basic and it is known fact that the origin of insurance was for the development of business. Insurance is a system of protection against financial loss in which risk is shifted to a professional risk bearer; an insurance company in exchange for a certain sum of money (the insurance premium), the insurer agrees to pay the insured if losses occur. Insurance is a business and based upon some principles like cooperation, probability, insurable interest, good faith and etc but this principles doesnot apply to life insurance. There are different types of insurance in the world like life, fire, marine, sickness, property, automobile and etc and the aim of all types of insurance is to make provision against dangers or risks.

Finally we can say that the insurance is provision which a prudent man makes against for the loss or inevitable contingencies.

Key Words

- **Insured:** The party of the individual who seeks protection against a specified risk and entitled to receive payment from insurer. Normally policy holder of insurance is an insured people.
- **Insurer:** The party which promise to pay indemnity the insured on the happening of any contingency.
- **Policy:** The term 'policy' is derived from the Italian word 'polizza' which means 'receipt'.
- **Premium:** The amount which is paid to the insurer by the insured in consideration to insurance contract is known as premium.
- **Insured sum:** The sum for which the risk is insured is called the insured sum.
- **Peril:** A peril is an event that causes a personal or property loss, by fire, windstorm, explosion etc.
- **Assurance:** This term is used only in life insurance contract and the word indicates certainty.
- **Insurance:** It is a social device to reduce or eliminate risks of loss to life and property.
- **Fidelity Guarantee Insurance:** This kind of insurance is frequently adopted as a precautionary measure in cases where new and untrained employees are given positions of trust and confidence.

13.11 Self Assessment Questions

1 State briefly a suitable definition of insurance and what are the various functions of insurance?

2 'Insurance is not to prevent risk, but to indemnify the losses arising from a certain risk' Comment.

3 Describe the main kinds of insurance and examine briefly the nature of risks protected by each kind of insurance.

4 'Proximate cause is not very essential in case of life insurance contract'. Explain in detail.

5 "The collective bearing of risks is insurance". Discuss this statement and explain the principles of insurance.

6 Write an essay on the origin and development of insurance.

7 "It is impossible to carry on trade without insuring". Comment

13.12 Books for Further Readings

- Insurance Principles and Practice Dr.L.Nolakha
- Insurance Principles and Practice M.J.Mathew
- Insurance Principles and Practice M.N.Mishra

Unit - 14 : Regulatory Framework for Insurance

Structure of Unit:

14.0 Objectives

After completing this unit, you would be able to:

- Understand the meaning of IRDA
- Know the important features of IRDA
- Know about the functioning of IRDA
- Learn the other regulatory developments

14.1 Introduction

IRDA (Insurance Regulatory and Development Authority) is established to regulate, promote and ensure orderly growth of the Insurance industry in India and also to protect the interests of the holders of insurance policies.

Meaning

The **IRDA (Insurance Regulatory and Development Authority**) is the national regulatory body for Insurance industry (both Life and Non-Life Insurance Companies) under the auspices of

Government of India, situated at Hyderabad. **IRDA** was established by an act enacted in Indian Parliament known as IRDA Act 1999 and was amended in 2002 to incorporate some emerging requirements as well as to overcome some deficiencies in the entire process of insurance sector.

Features

Features of the **1999 IRDA Act** are as follows

a) Protection to the interests of the policyholders.

b) Promotion, regulation and ensuring orderly growth of the insurance industry and for matters connected therewith.

c) To conduct the insurance businesses across India in an ethical manner.

d) To amend the Insurance Act, 1938

e) To amend Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalization) Act, 1972."

Milestones of Insurance Regulations in the 20th Century

1912 First piece of insurance regulation promulgated – Indian Life Insurance Company Act, 1912

1928 Promulgation of the Indian Insurance Companies Act

1938 Insurance Act 1938 introduced, the first comprehensive legislation to regulate Insurance business in India

1956 Nationalization of life insurance business in India

1972 Nationalization of general insurance business in India

1993 Setting-up of the Malhotra Committee

1994 Recommendations of Malhotra Committee released

1995 Setting-up of Mukherjee Committee

1996 Setting-up of an (interim) Insurance Regulatory Authority (IRA)

1997 Mukherjee Committee Report submitted but not made public

1997 The Government gives greater autonomy to LIC, GIC and its subsidiaries with regard to the restructuring of boards and flexibility in investment norms aimed at channelling funds to the infrastructure sector 1998 The cabinet decides to allow 40% foreign equity in private insurance companies – 26% to foreign companies and 14% to non-resident Indians (NRIs), overseas corporate bodies (OCBs) and foreign institutional investors (FIIs)

1999 The Standing Committee headed by Murali Deora decides that foreign equity in private insurance should be limited to 26%. The IRA Act was renamed the Insurance Regulatory and Development Authority (IRDA) Act

1999 Cabinet clears IRDA Act

2000 President Gives assent to the IRDA Act

Malhotra Committee's Recommendations

The formation of the Malhotra Committee in 1993 initiated reforms in the Indian insurance sector. The aim of the Malhotra Committee was to assess the functionality of the Indian insurance sector.

Malhotra Committee submitted its report in January 1994 recommending that private insurers be allowed to co-exist along with government companies like LIC and GIC companies. Recommendation had been prompted by several factors such as need for greater deeper insurance coverage in the economy, and a much a greater scale of mobilization of funds from the economy, and a much a greater scale of mobilization of funds from the economy for infrastructural development. Liberalization of the insurance sector is at least partly driven by fiscal necessity of tapping the big reserve of savings in the economy. Committee's recommendations were as follows:

- Private sector is granted to enter insurance industry with a minimum paid up capital of Rs.100crores.
- Foreign insurance be allowed to enter by floating an Indian company preferably a joint venture with Indian partners.
- Steps are initiated to set up a strong and effective insurance regulatory in the form of a statutory autonomous board on the lines of SEBI.
- Limited number of private companies to be allowed in the sector. But no firm is allowed in the sector. But no firm is allowed to operate in both lines of insurance (life or non-life).

- Tariff Advisory Committee (TAC) is delinked form GIC to function as a separate statuary body under necessary supervision by the insurance regulatory authority.
- All insurance companies be treated on equal footing and governed by the provisions of insurance Act. No special dispensation is given to government companies.
- Setting up of a strong and effective regulatory body with independent source for financing before allowing private companies into sector.

14.3 Functioning of IRDA

The Authority has notified 27 Regulations on various issues which include Registration of Insurers, Regulation on Licensing, insurance agents, Solvency Margin, Re-insurance, Obligation of Insurers to Rural and Social sector, Investment and Accounting Procedure, Protection of policy holders' interest etc.

I. Licensing

The IRDA Act, 1999, sets out details of registration of an insurance company along with renewal requirements. The minimum capital requirement for direct non-life and life insurance business is 100 crores (ie INR 1 billion). The entry and exit of companies are also regulated by IRDA with capital norms, and maintains a strict watch on the equity and solvency situation of insurers. When an application is rejected, the applicant will have to wait for a minimum of two years to make another proposal, which will have to be with a new set of promoters and for a different class of business. For renewal, it stipulates a fee of one-fifth of one percent of total gross premiums written direct by an insurer in India during the financial year preceding the renewal year. It also seeks to give a detailed background for each of the following key personnel: chief

executive, chief marketing officer, appointed actuary, chief investment officer, chief of internal audit and chief finance officer. Details of the sales force, activities in rural business and projected values of each line of business are also required.

The Act also sets out the reinsurance requirement for (general) insurance business. For all general insurance a compulsory cession of 20%, regardless of the line of business, to the General Insurance Corporation (the designated national reinsurer) is stipulated. Currently, India allows foreign insurers to enter the market in the form of a joint venture with a local partner, while holding no more than 26% of the company's shares. Compared to the other regional markets, India has more stringent restrictions on foreign access.

II. Duties, Powers and Functions of IRDA

Under Section 14 of IRDA Act, 1999 duties, powers and functions of IRDA have been specified

(i) Issuing a certificate of registration to the applicant as well as modify, renew, withdraw, suspend or cancel any such registration that is deemed unfit.

(ii) Protecting the interests of the holders of insurance policy in matters concerning assigning of insurance policy, nomination by policyholders, settlement of insurance claim, insurable interest, surrender value of policy and other terms and conditions based on contracts of insurance.

(iii) Specifying requisite qualifications, practical training and code of conduct for insurance intermediaries, insurance brokers and agents.

(iv) Specifying the code of conduct for inspectors and loss assessors.

(v) To take steps of efficiency in the conduct of insurance business.

(vi) Promoting and regulating professional organizations working for the insurance and re-insurance business in India.

(vii) Introduction of fees, commission and other recoveries for carrying out the objectives of this Act.

(viii) Calling for data or information from, undertaking inspection of, conducting enquiries and investigations, conducting audit of the insurers, intermediaries, insurance intermediaries and other organizations connected with the insurance business.

III. Composition of Authority

The Authority shall consist of the following members, namely:-

(a) Chairperson;

(b) not more than five whole-time members;

(c) not more than four part-time members

These members are to be appointed by the Central Government according to the required ability, integrity and standing with having knowledge or experience in life insurance, general insurance, actuarial science, finance, economics, law, accountancy, administration or any other discipline which would, in the opinion of the Central Government, be useful to the Authority:

IV. Tenure of Office of Chairperson and Other Members

(1) The Chairperson and every other whole-time member shall hold office for a term of five years from the date on which he enters upon his office and shall be eligible for reappointment:
(a)Provided that no person shall hold office as a Chairperson after he has attained the age of sixty-five years:
(b) Provided further that no person shall hold office as a whole-time member after he has attained the age of sixty two years of age;

(2) A part-time member shall hold office for a term not exceeding five years from the date on which he enters upon his office.

(3) Notwithstanding anything contained in sub-section (1) or sub-section (2), a member may
(a) Relinquish his office by giving in writing to the Central Government notice of not less than three months; or
(b) be removed from his office in accordance with the provisions of section

V. Removal from Office

(1) The Central Government may remove from office any member who-
(a) is, or at any time has been, adjudged as an insolvent; or
(b) has become physically or mentally incapable of acting as a member; or
(c) has been convicted of any offence which, in the opinion of the Central Government, involves moral turpitude; or
(d) has acquired such financial or other interest as is likely to affect prejudicially his functions as a member; or
(e) has so abused his position as to render his continuation in office detrimental to the public interest.

(2) No such member shall be removed under clause (d) or clause (e) of sub-section (1) unless he has been given a reasonable opportunity of being heard in the matter

VI. Salary and Allowances of Chairperson and Members

(1) The salary and allowances payable to, and other terms and conditions of service of, the members other than part-time members shall be such as may be prescribed.

(2) The part-time members shall receive such allowances as may be prescribed.

(3) The salary, allowances and other conditions of service of a member shall not be varied to his disadvantage after appointment

VII. Bar on Future Employment of Members.

The Chairperson and the whole-time members shall not, for a period of two years from the date on which they cease to hold office as such, except with the previous approval of the Central Government, accept-

(a) any employment either under the Central Government or under any State Government; or

(b) any appointment in any company in the insurance sector.

VIII. Administrative Powers of Chairperson

The Chairperson shall have the powers of general superintendence and direction in respect of all administrative matters of the Authority.

IX. Meetings of Authority

(1) The Authority shall meet at such times and places and shall observe such rules and procedures in regard to transaction of business at its meetings (including Quorum at such meetings) as may be determined by the regulations.

(2) The Chairperson, or if for any reason he is unable to attend a meeting of the Authority, any other member chosen by the members present from amongst themselves at the meeting shall preside at the meeting.

(3) All questions which come up before any meeting of the Authority shall be decided by a majority of votes by the members present and voting, and in the event of an equality of votes, the Chairperson, or in his absence, the person presiding shall have a second or casting vote.

(4) The Authority may make regulations for the transaction of business at its meetings.

X. Vacancies, etc., not to Invalidate Proceedings of Authority

No act or proceeding of the Authority shall be invalid merely by reason of -

(a) any vacancy in, or any defect in the constitution of, the Authority; or

(b) any defect in the appointment of a erson acting as a member of the Authority; or

(c) any irregularity in the procedure of the Authority not affecting the merits of the case.

XI. Officers and Employees of Authority

(1) The Authority may appoint officers and such other employees as it considered necessary for the efficient discharge of its function under this Act.

(2) The terms and other conditions of service of officers and other employees of the Authority appointed under sub-section (1) shall be governed by regulations made under this Act.

14.4 Other Regulatory Developments

The following are a few new features of the regulatory regime introduced by the IRDA:

- Insurance agents are governed by the Licensing of Insurance Agents Regulations 2000 and the Licensing of Insurance Regulations (amendment) 2002. To ensure professional standards, the IRDA has fixed minimum educational qualifications for all agents, together with training and examination requirements.

- Policyholder protection was enhanced through the enactment of the Protection of Policyholders' Interests Regulations, 2002. It stipulates the responsibility of insurance companies to spell out clearly the terms and conditions of insurance policies as well as other details.

- Exemption to banks/ financial institutions to enter into insurance fields:

  The Reserve Bank of India (RBI) has taken a decision to permit banks and other financial institutions to enter into the field of insurance. For this purpose, amendments have been made in banking (regulation) Act.

Implication of Liberalization in Insurance Sector

Various implications of liberalization in insurance sector can be categorized in two ways. These are:

I Positive Implications

II Negative Implications

I Positive Implications

Advantages to Economy:

(1) It becomes possible to develop insurance market globally widen with healthy competition in the insurance sector.

(2) The liberalization will bring higher employment opportunity for the people in the country and gradually per capita income will also increase.

(3) It is expected to increase capital information in the country due to more employment, income and savings.

(4) With the development of global market for insurance companies can get more business from foreign countries also. Moreover, foreign companies also invest capital in India.

(5) Development of basic facilities in the country can be faster by investing premium income for the development of roads, railways, water supply schemes and electricity generation, telecommunication, setting up of industrial colonies, construction of dams, canals, etc.

(6) As a result of liberation the people will get better and cheap insurance services.

(7) The liberalization process in insurance sector will help faster development of knowledge based industries in the country.

(8) The liberalization in insurance sector facilities heavy investments in social sector.

(9) The international co-operation also will develop.

(10) The liberalization in insurance also will help in promoting international goodwill.

(11) It has been estimated that insurance sector growth more than 3 times the growth of economy in India. So business or domestic firms will attempt to invest in insurance sector. Moreover, growth of insurance business in India is 13 times the growth insurance in developed countries. So it is natural, that foreign companies would be fostering a very strong desire to invest something in Indian insurance business.

2. Positive Implications to Industry:

(1) The liberalization helps transfer of technology in the field of insurance. New techniques and methods can e used for assessment of risks, fixations of reasonable premium and provide new investment opportunity.

(2) The liberalization can help in adopting a flexible price policy on new insurance policies developed and introduced now onwards.

(3) The process of liberalization of insurance can make available in all countries of the world the services of efficient management and financial experts.

(4) The liberalization can help in the development of knowledge in insurance business.

(5) The liberalization of insurance sector can extend the scope of insurance.

(6) The productivity as well as efficiency will increase as a result of liberalization.

(7) The competing ability will also increase due to liberation of insurance sector.

(8) All categories of employs serving in insurance sector will get more job satisfaction through good opportunities for training, higher opening in jobs, and higher income.

Positive Implications/Advantages to the Public/Customers: The general public is also benefited from liberalization of insurance sector. These benefits include:

(1) They can get better choice of selection of policy as well as insurer.

(2) When there are large numbers of policy holders the insured is able to select the insurer whose premium rate is lesser.

(3) Social security schemes include the plans like gratuity schemes medical claims, pension schemes, etc. may be provided by different insurers. In this way consumers can avail benefits.

(4) When a number of new companies are coming in the field of insurance good employment opportunity is there for general public.

II Negative Implications

There are certain negative implications arising out of liberalization process in insurance sector. These include:

(1) End of Government Monopoly: New companies are coming in insurance sector. This brings an end to the government monopoly in this sector.

(2) Cut throat Competition: liberalization will create cut throat competition in insurance market among public and private companies.

(3) Dominance of Foreign Companies: With new technology, knowledge and expertise foreign companies will capture insurance sector. It would be difficult for Indian companies to survive in competition.

(4) Policies of Big Amount: This is also a critics that the insurance companies issue policies for large amount of money. Where the sum assured against a policy becomes very heavy, economically backward classes of people cannot avail the benefit of insurance.

(5) Negligence of Rural Area: Private companies will give attention to the urban people only. The people living in rural area will be neglected from domestic as well as foreign companies.

(6) **Employees Fear:** While implementing liberalization measures, companies can retrench certain number of employees who are excess in need. This is a main reason of fear of employees working in insurance sector.

(7) **Lack of Government Guarantee on Policies:** The insurance policies issued by private sector companies would not carry Central Governments' guarantee. In this way insured will remain unsecured.

(8) **Attraction for Employees from Outside Sources:** there is a possibility of drainage of expert employees from the two corporations (LIC & GIC) to the private companies. This is because the private companies offer more lucrative salaries and packages to their employees. Keeping this in mind, the IRDA has come out with regulations for high cadre employees that they can't leave the corporation easily, to join other places.

14.5 Summary

Liberalization and privatization in insurance sector have positive and negative implications for Indian economy. But the effective regulatory measures can help in avoiding or minimizing the risk factors. The establishment of an authority like Insurance Regulation and Development authority by the Central Government is a good step. IRDA over the last decade has brought into

force a number of regulations which are well conceived. The mission of the insurance sector in India should be to extend the insurance coverage over a larger section of the population. The regulatory framework in relation to

the insurance companies seeks to take care of three major concerns – (a) protection of consumers' interest, (b) to ensure the financial soundness of the insurance industry, and (c) to help the healthy growth of the insurance market. In the life sector, insurers will need to increase efforts to design new products that are suitable for the market and make use of innovative distribution channels to reach a broader range of the population.

14.6 Self Assessment Questions

1. What do mean by IRDA. Discuss its scope.
2. Describe the measures taken by Indian Government for effective functioning in insurance sector.
3. Examine the positive and negative implication of liberalization in insurance sector.
4. Write a note on functioning of IRDA.

14.7 Books for Further Readings

- Jain AK (2004). J. Insurance Inst. India 30: 53.
- Economic Survey of India, 2005-2009
- Why We Should Oppose the Opening of the Insurance Sector
- 'Yogeakshema' Journal May 2008 LIC of India.
- Mathew M.J. Insurance (Principles and Practice) RBSA Publishers, Jaipur.
- Dr. P. Periasamy Principles Practice of Insurance, Himalaya Publishing House.
- Website IRDA.

Unit - 15 : Life Insurance

Structure of Unit:

15.0 Objectives

After completing this unit, you would be able to :

- To acquaint with the different aspects of life insurance.
- To know growth and development of life insurance.
- To know about basic principles of life insurance.
- Understanding, topic on classification of life risks.
- Understand life insurance policies are explained in a lucid style.
- To know about various aspects of settlement of life insurance policy claims.

15.1 Introduction

What Is Life Insurance?

Life insurance is a contract that pledges payment of an amount to the person assured (or his nominee) on the happening of the event insured against. The contract is valid for payment of the insured amount during:

- The date of maturity.
- Specified dates at periodic intervals.
- Unfortunate death, if it occurs earlier.

Definition

According to Life Insurance Act,1938, Life insurance is a contract between an insurance policy holder and an insurer, where the insurer promises to pay a designated beneficiary a sum of money (the "benefits") upon the death of the insured person.

Parties to Contract

There is a difference between the insured and the policy owner, although the owner and the insured are often the same person. For example, if A buys a policy on his own life, he is both the owner and the insured. But if B, his wife, buys a policy on A's life, she is the owner and he is the insured. The policy owner is the guarantor and he will be the person to pay for the policy. The insured is a participant in the contract, but not necessarily a party to it. Also, most companies allow the payer and owner to be different, e. g. a grandparent paying premiums for a policy on a child, owned by a grandchild.

The beneficiary receives policy proceeds upon the insured person's death. The owner designates the beneficiary, but the beneficiary is not a party to the policy. The owner can change the beneficiary unless the policy has an irrevocable beneficiary designation. If a policy has an irrevocable beneficiary, any beneficiary changes, policy assignments, or cash value borrowing would require the agreement of the original beneficiary.

15.2 History and Development of Life Insurance in India

History of Life Insurance

The story of insurance is probably as old as the story of mankind. The same instinct that prompts modern businessmen today to secure themselves against loss and disaster existed in primitive men also. They too sought to avert the evil consequences of fire and flood and loss of life and were willing to make some sort of sacrifice in order to achieve security. Though the concept of insurance is largely a development of the recent past, particularly after the industrial era – past few centuries – yet its beginnings date back almost 6000 years.

Life Insurance in its modern form came to India from England in the year 1818. Oriental Life Insurance Company started by Europeans in Calcutta was the first life insurance company on Indian Soil. All the insurance companies established during that period were brought up with the purpose of looking after the needs of European community and Indian natives were not being insured by these companies. However, later with the efforts of eminent people like Babu Muttylal Seal, the foreign life insurance companies started insuring Indian lives. But Indian lives were being treated as sub-standard lives and heavy extra premiums were being charged on them. Bombay Mutual Life Assurance Society heralded the birth of first Indian life insurance company in the year 1870, and covered Indian lives at normal rates. Starting as Indian enterprise with highly patriotic motives, insurance companies came into existence to carry the message of insurance and social security through insurance to various sectors of society. Bharat Insurance Company (1896) was also one of such companies inspired by nationalism. The Swadeshi movement of 1905-1907 gave rise to more insurance companies. The United India in Madras, National Indian and National Insurance in Calcutta and the Co-operative Assurance at Lahore were established in 1906. In 1907, Hindustan Co-operative Insurance Company took its birth in one of the rooms of the Jorasanko, house of the great poet Rabindranath Tagore, in Calcutta. The Indian Mercantile, General Assurance and Swadeshi Life (later Bombay Life) were some of the companies established during the same period. Prior to 1912 India had no legislation to regulate insurance business. In the year 1912, the Life Insurance Companies Act, and the Provident Fund Act were passed. The Life Insurance Companies Act, 1912 made it necessary that the premium rate tables and periodical valuations of companies should be certified by an actuary. But the Act discriminated between foreign and Indian companies on many accounts, putting the Indian companies at a disadvantage.

The first two decades of the twentieth century saw lot of growth in insurance business. From 44 companies with total business-in-force as Rs.22.44 crore, it rose to 176 companies with total business-in-force as Rs.298 crore in 1938. During the mushrooming of insurance companies many financially unsound concerns were also floated which failed miserably. The Insurance Act 1938 was the first legislation governing not only life insurance but also non-life insurance to provide strict state control over insurance business. The demand for nationalization of life insurance industry was made repeatedly in the past but it gathered momentum in 1944 when a bill to amend the Life Insurance Act 1938 was introduced in the Legislative Assembly. However, it was much later on the 19th of January, 1956, that life insurance in India was nationalized. About 154 Indian insurance companies, 16 non-Indian companies and 75 provident were operating in India at the time of nationalization. Nationalization was accomplished in two stages; initially the management of the companies was taken over by means of an Ordinance, and later, the ownership too by means of a comprehensive bill.

The Parliament of India passed the Life Insurance Corporation Act on the 19th of June 1956, and the Life Insurance Corporation of India was created on 1st September, 1956, with the objective of spreading life insurance much more widely and in particular to the rural areas with a view to reach all insurable persons in the country, providing them adequate financial cover at a reasonable cost.

The business of life insurance in India in its existing form started in India in the year 1818 with the establishment of the Oriental Life Insurance Company in Calcutta. Some of the important milestones in the life insurance business in India are given in the table 1.

Table 15.1 : Milestone's in the life Insurance Business in India

Year	Milestones in the life insurance business in India
1818	Oriental Life Insurance Company, the first life insurance company on Indian soil started functioning.
1870	Bombay Mutual Life Assurance Society, the first Indian life insurance company started its business.
1912	The Indian Life Assurance Companies Act enacted as the first statute to regulate the life insurance business
1928	The Indian Insurance Companies Act enacted to enable the government to collect statistical information about both life and non-life insurance businesses
1938	Earlier legislation consolidated and amended to by the Insurance Act with the objective of protecting the interests of the insuring public.
1956	245 Indian and foreign insurers and provident societies taken over by the central government and nationalized. LIC formed by an Act of Parliament, viz. LIC Act, 1956, with a capital contribution of Rs. 5 crore from the Government of India.

Growth and Development

The process of opening up the insurance sector was initiated against the background of Economic Reform process which commenced from 1991. For this purpose Malhotra Committee was formed during this year who submitted their report in 1994 and Insurance Regulatory Development Act (IRDA) was passed in 1999. Resultantly Indian Insurance was opened for private companies and Private Insurance Company effectively started operations from 2001

The insurance sector is now opened up for private participation. For years now, the private players are active in the liberalized environment. The insurance market have witnessed dynamic changes which includes presence of a fairly large number of insurers both life and non-life segment. Most of the private insurance companies have formed joint venture partnering well recognized foreign players across the globe.

There are now 29 insurance companies operating in the Indian market – 14 private life insurers, nine private non-life insurers and six public sector companies. With many more joint ventures in the offing, the insurance industry in India today stands at a crossroads as competition intensifies and companies prepare survival strategies in the present scenario.

There is pressure from both within the country and outside on the Government to increase the foreign direct investment (FDI) limit from the current 26% to 49%, which would help JV partners to bring in funds for expansion.

There are opportunities in the pensions sector where regulations are being framed. Less than 10 % of Indians above the age of 60 receive pensions. The IRDA has issued the first license for a standalone health company in the country as many more players wait to enter. The health insurance sector has tremendous growth potential, and as it matures and new players enter, product innovation and enhancement will increase. The deepening of the health database over time will also allow players to develop and price products for larger segments of society.

State Insurers Continue To Dominate

There may be room for many more players in a large underinsured market like India with a population of over one billion. But the reality is that the intense competition in the last five years has made it difficult for new entrants to keep pace with the leaders and thereby failing to make any impact in the market.

Also as the private sector controls over 26.18% of the life insurance market and over 26.53% of the non-life market, the public sector companies still call the shots.

The country's largest life insurer, Life Insurance Corporation of India (LIC) had 5 zonal offices, 33 divisional offices and 212 branch offices, apart from its corporate office in the year 1956. Since life insurance contracts are long term contracts and during the currency of the policy it requires a variety of services need was felt in the later years to expand the operations and place a branch office at each district headquarter. Re-organization of LIC took place and large numbers of new branch offices were opened. As a result of re-organization servicing functions were transferred to the branches, and branches were made accounting units. It worked wonders with the performance of the corporation. It may be seen that from about 200.00 crores of New Business in 1957 the corporation crossed 1000.00 crores only in the year 1969-70, and it took another 10 years for LIC to cross 2000.00 crore mark of new business. But with re-organization happening in the early eighties, by 1985-86 LIC had already crossed 7000.00 crore Sum Assured on new policies.

Today LIC functions with 2048 fully computerized branch offices, 109 divisional offices, 8 zonal offices, 992 satellite offices and the corporate office. LIC's Wide Area Network covers 109 divisional offices and connects all the branches through a Metro Area Network. LIC has tied up with some Banks and Service providers to offer on-line premium collection facility in selected cities. LIC's ECS and ATM premium payment facility is an addition to customer convenience. Apart from on-line Kiosks and IVRS, Info Centres have been commissioned at Mumbai, Ahmedabad, Bangalore, Chennai, Hyderabad, Kolkata, New Delhi, Pune and many other cities. With a vision of providing easy access to its policyholders, LIC has launched its SATELLITE SAMPARK offices. The satellite offices are smaller, leaner and closer to the customer. The digitalized records of the satellite offices will facilitate anywhere servicing and many other conveniences in the future.

LIC continues to be the dominant life insurer even in the liberalized scenario of Indian insurance and is moving fast on a new growth trajectory surpassing its own past records. LIC has issued over one crore policies during the last year and posting a healthy growth rate of 16.67% over the corresponding period of the previous year.

From then to now, LIC has crossed many milestones and has set unprecedented performance records in various aspects of life insurance business. The same motives which inspired our forefathers to bring insurance into existence in this country inspire us at LIC to take this message of protection to light the lamps of security in as many homes as possible and to help the people in providing security to their families.

Apart from Life Insurance Corporation, the public sector life insurer, there are 23 other private sector life insurers, most of them joint ventures between Indian groups and global insurance giants.

Life Insurer in Public Sector

1. Life Insurance Corporation of India

Life Insurers in Private Sector

1. SBI Life Insurance
2. Metlife India Life Insurance
3. ICICI Prudential Life Insurance
4. Bajaj Allianz Life
5. Max New York Life Insurance
6. Sahara Life Insurance
7. Tata AIG Life
8. HDFC Standard Life
9. Birla Sunlife
10. Kotak Life Insurance
11. Aviva Life Insurance
12. Reliance Life Insurance Company Limited - Formerly known as AMP Sanmar LIC
13. ING Vysya Life Insurance
14. Shriram Life Insurance
15. Bharti AXA Life Insurance Co Ltd
16. Future Generali Life Insurance Co Ltd
17. IDBI Fortis Life Insurance
18. AEGON Religare Life Insurance
19. DLF Pramerica Life Insurance
20. CANARA HSBC Oriental Bank of Commerce LIFE INSURANCE
21. India First Life insurance company limited
22. Star Union Dia-ichi Life Insurance Co. Ltd
23. Edelweiss Tokio Life Insurance Company Ltd

15.3 Basic Principles

The Main Principles of Insurance are:

1. Principle of Uberrimae fidei (Utmost Good Faith),
2. Principle of Insurable Interest,
3. Principle of Indemnity,
4. Principle of Contribution,
5. Principle of Subrogation,

6. Principle of Loss Minimization, and

7. Principle of Causa Proxima (Nearest Cause).

15.4 Classification of Life Risks

Life Insurance Risk Factors

Insurance is an important facet of finances that can help protect money and provide for families in when unexpected events occur. Life insurance pays money the beneficiaries of policyholders if they happen to pass away. The cost of life insurance is based the amount of coverage as well as a variety risk factors that insurance companies can use to estimate the likelihood that a person will die.

Age

Age is one of the most important risk factors that affect the cost of life insurance. All else held equal, the holder a person is, the more likely they are to die within a given number of years. Therefore, life insurance policies tend to be less expensive for younger workers, especially if the term is short. For instance, a 20-year-old worker is not very likely to die within 10 years, so they could likely buy a 10 year life insurance policy at a good price.

Weight

Weight is an important health factor that can influence the cost of life insurance. Obesity is strongly correlated with a variety of serious health problems such as diabetes, heart disease and high cholesterol. The combination of health problems that can result from obesity cause life insurance translate to higher premiums for those who are overweight.

Smoking

Smoking is a habit that is known to cause health problems and is an important risk factor that life insurance companies use to classify the risk level of policyholders. Smoking is liked to increased chances of suffering of life-threatening conditions such as throat cancer, lung cancer and heart attack.

Other Health Issues

Personal health history and family health history are other factors that life insurance companies use to assess risk. If family has a history of heart disease, cancer, or other serious health problems, especially at young ages, it may impact an insurance company's assessment of one's fitness. Following conditions are health factors that could affect life insurance: high blood pressure, asthma, depression, sleep apnea and previous use of nicotine.

Occupational Hazards:

These hazards are defined in a policy based upon what hazards an insured faces due to their job. These hazards could increase the likelihood of being injured, becoming ill, or even causing death. Occupational hazards can influence whether an insurance applicant is insurable. For instance, a race car driver would have a harder time getting life insurance and will pay a larger premium because they face such a large risk of death or serious injury due to their job. The insurance company is more likely to pay out sooner than regularly expected and/or before the applicant has paid a significant amount of premium, meaning the insurer is facing more of a financial loss. Obviously, these hazards can greatly affect insurability and the cost of life insurance.

There are some occupations, activities and hobbies that insurers put on the too-risky list. These are many and varied and should be checked in the exclusions section of the product disclosure statement if you are unsure of where you stand.

Risky or dangerous jobs to set off alarm bells, for instance, would include:

- Working at heights
- Working with explosives/dangerous chemicals
- Working underground
- Working with firearms
- Working in the armed forces
- Working as, say, a journalist or news cameraman in a war zone

Sports, hobbies and pastimes which raise concern include:

- Motor sport
- Hunting, racing, polo
- Hang gliding, bungee jumping
- Mountaineering, rock climbing
- Unqualified scuba diving without an instructor
- Pro Sports

Moral Hazards:

In insurance markets, moral hazard occurs when the behavior of the insured party changes in a way that raises costs for the insurer, since the insured party no longer bears the full costs of that behavior. Because individuals no longer bear the cost of medical services, they have an added incentive to ask for pricier and more elaborate medical service—which would otherwise not be necessary. In these instances, individuals have an incentive to over consume, simply because they no longer bear the full cost of medical services.

Two types of behavior can change. One type is the risky behavior itself, resulting in a before the event moral hazard. In this case, insured parties behave in a more risky manner, resulting in more negative consequences that the insurer must pay for.

A second type of behavior that may change is the reaction to the negative consequences of risk, once they have occurred and once insurance is provided to cover their costs. This may be called ex post (after the event) moral hazard. In this case, insured parties do not behave in a more risky manner that results in more negative consequences, but they do ask an insurer to pay for more of the negative consequences from risk as insurance coverage increases. For example, without medical insurance, some may forgo medical treatment due to its costs and simply deal with substandard health. But after medical insurance becomes available, some may ask an insurance provider to pay for the cost of medical treatment that would not have occurred otherwise.

Sometimes moral hazard is so severe it makes insurance policies impossible. Coinsurance, co-payments, and deductibles reduce the risk of moral hazard by increasing the out-of-pocket spending of consumers, which decreases their incentive to consume. Thus, the insured have a financial incentive to avoid making a claim.

Classifications of Risk:

Risks may be classified in many ways; however, there are certain distinctions that are particularly important for our purposes. These include the following:

1. Financial and Non-financial Risks:

In its broadest context, the term risk includes all situations in which there is an exposure to adversity. In some cases this adversity involves financial loss, while in others it does not. There is some element of risk in every aspect of human endeavor, and many of these risks have no or only incidental financial consequences.

2. Static and Dynamic Risks:

Dynamic risks are those resulting from changes in the economy. Changes in the price level, consumer tastes, income and output, and technology may cause financial loss to members of the economy. These dynamic risks normally benefit society over the long run, since they are the result of adjustments to misallocation of resources. Although these dynamic risks may be affected a large number of individuals, they are generally considered less predictable than static risks, since they do not occur with any precise degree of regularity.

Static risks involve those losses that would occur even if there were no changes in the economy, if we could hold consumer tastes, output and income, and the level of technology constant, some individuals would still suffer financial loss. These losses arise from causes other than the changes in the economy, such as the perils of nature and the dishonesty of other individuals. Unlike dynamic risks, static risks are not a source of gain to society. Static losses involve either the destruction of the asset or a change in its possession as a result of dishonesty or human failure. Static losses tend to occur with a degree of regularity over time and, as a result, are generally predictable. Because they are predictable, static risks are more suited to treatment by insurance than are dynamic risks.

3. Fundamental and Particular Risks

The distinction between fundamental and particular risks is based on the difference in the origin and consequences of the losses.

Fundamental risks involve losses that are impersonal in origin and consequence. They affect large segments or even all of the population. Particular risks involve losses that arise out of individual events and are felt by individuals rather than by entire group. They may be static or dynamic. Unemployment, war, inflation, and floods are all fundamental risks. The burning of a house and the robbery of a bank are particular risks.

Since fundamental risks are caused by conditions more or less beyond the control of the individuals who suffer the losses and since the y are not the fault of anyone in particular, it is held that society rather than the individual has a responsibility to deal with them. Although some fundamental risks are dealt with private insurance, it is an inappropriate tool for dealing with most fundamental risks. Usually, some form of social insurance or other government transfer program is used to deal with fundamental risks. Unemployment and occupational disabilities are fundamental risks treated through social insurance. Flood damage or earthquakes make a district a disaster area eligible for federal funds.

Particular risks are considered to be the individual's own responsibility, inappropriate subjects for action by society as a whole. They are dealt with by the individual through the use of insurance, loss prevention, or some other technique.

4. Pure and Speculative Risks

One of the most useful distinctions is that between pure risk and speculative risk. Speculative risk describes a situation where there is a possibility of loss, but also a possibility of gain. Gambling is a good example of a speculative risk. In a gambling situation, risk is deliberately created in the hope of gain. The person wagering rs.100 on the outcome of a game faces the possibility of loss, but this is accompanied by the possibility of gain. The entrepreneur or capitalist faces speculative risk in the quest for profit. The investment made may be lost if the product is not accepted by the market at a price sufficient to cover costs, but this risk is borne in return for the possibility of profit. The term pure risk, in contrast, is used to designate those situations that involve only the chance of loss or no loss.

The distinction between pure and speculative risks is an important one, because normally only pure risks are insurable. Insurance is not concerned with the protection of individuals against those losses arising out of speculative risks. Speculative risk is voluntary accepted because of its two-dimensional nature, which includes the possibility of gain. Not all pure risks are insurable, and a further distinction between insurable and uninsurable pure risks may also be made.

Classifications of Pure Risk

While it would be impossible to list all the risks confronting an individual or business, we can briefly outline the nature of the various pure risks that we face. For the most part, these are also static risks. Pure risks that exist for individuals and business firms can be classified under one of the following:

Personal Risks

These consist of the possibility of loss of income or assets as a result of the loss of the ability to earn income. In general, earning power is subject to four perils:

- Premature Death,
- Dependant Old Age,
- Sickness or Disability, and
- Unemployment

Liability Risks

The basic peril in the liability risk is the unintentional injury of other persons or damage to their property through negligence or carelessness; however, liability may also result from intentional injuries or damage. Under our legal system, the laws provide that one who has injured another, or damaged another's property through negligence or otherwise, can be held responsible for the harm caused. Liability risks therefore involve the possibility of loss of present assets or future income as a result of damage assessed or legal liability arising out of either intentional or unintentional torts, or invasion of the rights of others.

Risks Arising from Failure of Others

When another person agrees to perform a service for you, he or she undertakes and obligation that you hope will be met. When the person's failure to meet this obligation would result in your financial loss, risk exists. Examples of risks in this category would include failure of a contractor to complete a construction project as scheduled, or failure of debtors to make payments as expected.

15.5 Policies

The insurance policy is generally an integrated contract, meaning that it includes all forms associated with the agreement between the insured and insurer.

Types of Policies

Life insurance may be divided into two basic classes: temporary and permanent; or the following subclasses: term, universal, whole life and endowment life insurance.

1. Term Insurance Policy: This policy is pure risk cover with the insured amount will be paid only if the policy hold dies in the period of policy time. The intention of this policy is to protect the policy holder's family in case of death. For example, a person who takes term policy of Rs.500000 for 20 years, if he dies before 20 years then his family will get the insured amount. If he survives after 20 years then he will not get any amount from the insurance company. It is the reason why term policies are very low cost. So, this type of policy is not suitable for savings or investment.

2. Whole Life Policy : As the name itself says, the policy holder has to pay the premium for whole life till his death. This policy doesn't address any other needs of the policy holder. Because of these reasons this kind of policy is not very popular or insurance company not suggesting to take this policy.

3. Endowment Policy: It is the most popular Life Insurance Plans among other types of policies. This policy combines risk cover with the savings and investment. If the policy holder dies during the policy time, he will get the assured amount. Even if he survives he will receive the assured amount. The advantage of this policy is if the policy holder survives after the completion of policy tenure, he receives assured amount plus additional benefits like Bonus from the insurance company. In this kind of policy, policy holder receives huge amount while completing the tenure.

In addition to the basic policy, insurers offer various benefits such as double endowment and marriage/ education **endowment plans**. The cost of such a policy is slightly higher but worth its value.

4. Money Back Policy: Money Back Policy is to provide money on the occasions when the policy holder needs for his personal life. The occasions may be marriage, education, etc. Money will be paid back to the policy holder with the specified duration. If the policy holder dies before the policy term, the sum assured will be given to his family. A portion of the sum assured is payable at regular intervals. On survival the remainder of the sum assured is payable.

LIC offers a wide range of insurance policies and the policies offered by it are classified under the following main categories:

- Joint life plan
- Team assurance plans
- Whole life plans
- Special money back plan for women
- Money back plans
- Endowment assurance plans
- Plans for handicapped dependents
- Children plans
- Bima account plans
- Endowment plans

5. Health Insurance Schemes: An individual is subject to uncertainty regarding his health. He may suffer from ailments, diseases, disability caused by stroke or accident, etc. For serious cases the person may have to be hospitalized and intensive medical care has to be provided which can be very expensive. It is here that medical insurance is helpful in reducing the financial burden.

These days the vulnerability to lifestyle diseases such as heart, cancer, neurotic, and pollution based, etc are on the increase. So it makes sense for an individual to go for medical insurance cover.

6. Joint Life Policy: This policy is taken on the lives of two or more persons simultaneously. Under this policy the sum assured becomes payable on the death of any one of those who have taken the joint life policy. The sum assured will be paid to the survivor(s). For example, a joint life policy may be taken on the lives of husband and wife, sum assured will be payable to the survivor on the death of the spouse.

7. With Profit and Without Profit Policy: Under with profit policy the assured is paid, in addition to the sum assured, a share in the profits of the insurer in the form of bonus. Without profit policy is a policy under which the assured does not get any share in the profits earned by the insurer and gets only the sum assured on the maturity of the policy. With profit and without profit policies are also known as participating and non –participating policies respectively.

8. Double Accident Benefit Policy: This policy provides that if the insured person dies of any accident, his beneficiaries will get double the amount of the sum assured.

9. Annuity Policy: Under this policy, the sum assured is payable not in one lump sum payment but in monthly, quarterly and half-yearly or yearly installments after the assured attains a certain age. This policy is useful to those who want to have a regular income after the expiry of a certain period e.g. after retirement. Annuity is paid so long as the assured survives. In annuity policy medical checkup is not required. Annuity is paid so long as the assured survives.

10. Policies for Women: Women, now a days are free to take life assurance policies. However, some s specially designed policies suit their needs in a unique manner; the synopsis of some these policies are as follows :

(a) Jeevan Sathi is also known a Life Partner plan where the husband and wife are covered under this endowment policy, which gives the following benefits.

i. On maturity, provided both are alive, full sum assured with bonus is paid.

ii. On the death of one of the assured during the period of the policy, basic sum assured is paid to the surviving partner, who is not required to pay any further premiums.

iii. The surviving partner remains covered for the full sum assured. If she/he dies, then the sum assured is paid to the nominee, but this is before the maturity date.

iv. The surviving partner will be paid sum assured with bonuses if he survives till the maturity date. Hence this policy gives a comprehensive family protection.

(b). Jeevan Sukanya is highlighted by the following points.

i. Only female child aged between 1 to 12 years is covered in this plan.

ii. band is automatically covered under the policy after marriage.

iii. Risk of the child starts either after 2 years of taking the policy or not before the age of 7, whichever is early.

iv. Premium paying period is 20 years minus age at entry.

v. On surviving the age of 20, the life assured receives the sum assured as survival benefit and the policy continues to cover the life assured till maturity date when vested bonus will be paid only. If life assured dies before maturity, sum assured with bonuses will be paid.

11. Group Insurance: Group life insurance is a plan of insurance under which the lives of many persons are covered under one life insurance policy. However, the insurance on each life is independent of that on the other lives. Usually, in group insurance, the employer secures a group policy for the benefit of his employees. Insurer provides coverage for many people under single contract.

12. Policies for Children: Policies for children are meant for the various needs of the children such as education, marriage, security of life etc. Some of the major children policies are:

(1) Children's deferred assurances
(2) Marriage endowment and educational annuity plans
(3) Children endowment policy

Policy Conditions

A condition is a stipulation essential to be main purpose of an insurance contract. A number of conditions are attached with life insurance policies. These may be relating to:

I. Risk

1. **Conditions as to Commencement of Risk:** On the part of insurer the risk commences when the insurer accepts the proposal and the proposer deposits the first premium.

2. **Dating Back the Policies:** Where the policy is executed prior to a date of acceptance the proposal, it is called dating back the policies. Sometimes the insured would like to date back his policy with the object of affecting the policy at the younger age so that the premium rate may comparatively low.

3. **Conditions as to Proof of Age:** The rates of premium are directly related to the age of assured at the time of commencement of policy. It is more important in endowment policies were the policy amount becomes payable to the assured after attaining certain age.

II. Conditions and Privileges Relating to Premium

1. **Payment of Premium:** An insurance policy contains conditions as to the rate of premium payable and the tenure of the policy.

2. **Days of Grace:** Days of grace are thee extra days allowed for remitting premiums after the due date.

3. **Notice of Premium:** The notice of is assured by the LIC, when the premium become due.

III Conditions and Privileges Relating to Continuance of Policy

1. **Lapsing of Policy:** A policy can be lapsed or terminated on account of non-payment of premiums at any time when the premiums are overdue.

2. **Indisputability of the Policy:** According to section 45 of insurance act, 1938, a separate clause has to be included in the policy by the insurer

3. **Revival of Policy:** Revival refers to renovation of contract of insurance.

4. **Alteration in Policy:** Generally no change in the policy is possible. However, if the assured wants to change certain conditions of the policy, he may request for the same to the insurer.

5. **Loss of Policy:** Insurance policy is an important document to be surrendered at the time of final claim or at the time of taking loan against the policy.
6. **Theft of the Policy:** In case the policy is lost by theft, the duplicate copy can be issued.
7. **Destruction or Mutilation of the Policy:** Policy may be destroyed or mutilated by the effect of fire, water or any other destroyable substances.
8. **Loan against Policy:** Loan facility is available on certain types of policies.
9. **Suicide by the Insured:** The LIC policies usually contain a clause providing for non-payment of claim in case of the assured commits suicide.
10. **Double Accident Benefit:** Under the conditions of insurance policy, accidental benefit is also be given to the insured if he really met with an accident, leading to death or permanent disability.

Settlement of Claims

The easy and timely settlement of a valid claim is an important function of an insurance company. The yardstick to judge insurance company's efficiency is as to how quick the claim settlement is. The speed, kindness and fairness with which an insurer handles claims show the maturity of the company and may lead to great satisfaction of the client.

In every insurance company claim handling is of immense importance. It is the liability of the insurance company to honor valid and legal claims. At the same the company must identify the fraudulent and invalid claims. A claim may arise:

i) On maturity, i.e. after expiry of the endowment period specified in the policy contract when the policy money becomes payable

ii) On death of Policyholder before the maturity date.

Certain features are common to all life insurance claims. These are:

1. Policy must be in force at the time of claims.
2. Insured must be covered by the policy.
3. Nothing was outstanding to the insurer at the time of claim.
4. Claim is covered by the policy.

I. Maturity Claims

If the life insured survives to the full term, then basic sum assured is payable. This payment by the insurer to the insured on the date of maturity is called maturity payment. The amount payable at the time of the maturity includes a sum assured and bonus/incentives. The insurer sends in advance the intimation to the insured with a blank discharge form for filling various details in it. It is to be returned to the office along with

- Original Policy document
- Age proof if age is not already submitted
- Assignment /reassignment, if any. .

Legally no claim is acceptable in respect for a lapsed policy or death of the Life assured happening within 3 years from the date of beginning of the policy. However, some concessions are given and payment of claims is made:

- If the Life assured had paid at least 3 years' premiums and thereafter if premiums have not been paid, the nominees/life assured get proportionate paid up value.
- In the event of the death of' the Life assured within 3 years and the policy is under the lapsed position, nothing is payable.

2. Procedure of the Maturity Claims

Settlement procedure for maturity claim is simple after receipt of completed and stamped discharge form from the person entitled to the policy money along with policy documents, claim amount will be paid by account payee cheque.

- If the life assured is reported to have died after the date of maturity but before the receipt is discharged, the claim is to be treated as the maturity claim and paid to the legal heirs. In this case death certificate and evidence of title is required.
- Where the assured is known to be mentally deranged, a certificate from the court of law under the Indian Lunacy Act appointing a person to act as guardian to manage the properties of the lunatic should be called.

Certain features are common to all life insurance claims. These are:

1. Policy must be in force at the time of claims.
2. Insured must be covered by the policy.
3. Nothing was outstanding to the insurer at the time of claim.
4. Claim is covered by the policy.

II. Death Claims

1. Intimation of Death

The death of the life assured has to be intimated in writing to the insurer. It can be done by the Assignee or nominee under the policy or from a person representing such Assignee or Nominee or when there is no nomination or assignment by a relative of the life assured, the employer, the agent or the development officer. Where policy is assigned to a creditor or a bank for valuable consideration, intimation of death may be received from such assignee. Sometimes, the office need not wait till the intimation of claim is received.

The concerned agent, newspaper reports in case of accidents or air crashes, obituary columns may give information and claim action can be started. However, the identity of the deceased should be established carefully.

The intimation of the death of the life assured by the claimant should contain the following particulars: (1) his or her relationship with the deceased, (2) the name of the policyholder, (3) the number/s of the policy/policies, (4) the date of death (5) the cause of death and (6) sum assured etc. If any of these particulars are missing the claimant can be asked to furnish the same to the insurer. The intimation must satisfy two conditions (1) It must establish properly the identity of the deceased person as the life assured under the policy, (2) It must be from a concerned person.

2. Proof of Death and Other Documents

In case of claim by death, after the receiving the intimation of death the insurance company ensures that the insurance policy has been in force for the sum assured on the date of death and the intimation has been received from assignee, nominee or other claimant.

The following documents are required:

(i) Certificate of death.

(ii) Proof of age of the life assured (if not already given).

(iii) Deeds of assignment / reassignments.

(iv) Policy document.

(v) Form of discharge.

If the claim has accrued within three years from the beginning of the policy, the following additional requirements may be called for:

(i) Statement from the hospital if the deceased had been admitted to hospital.

(ii) Certificate of medical attendant of the deceased giving details of his/her last illness.

(iii) Certificate of cremation or burial to be given by a person of known character and responsibility present at the cremation or burial of the body of the deceased.

(iv) Certificate by employer if the deceased was an employee.

Proof of death and other documents to be submitted will depend upon the cause of death and circumstances of each case.

(1) In case of an air crash the certificate from the airline authorities would be necessary certifying that the assured was a passenger on the plane. In case of ship accident a certified extract from the logbook of the ship is required. In case of sudden cardiac arrest, murder the doctors' certificate may not be available.

(2) The insurance may waive strict evidence of title if the sum assured of the policy is small and there is no dispute among the survivors of the policy moneys.

(3) If the life assured had a death due to accident, suicide or unknown cause the police inquest report, panchanama, post mortem report, etc would be required.

If by any chance policy contract is lost, advertisement of the lost of policy is to be given. Payment can be made on the basis of an indemnity given by the policyholder.

If the deceased has taken out policies with more than one branch and the claimant has produced proof of death to any one of them and desires that maybe the other branch or branches, act on the same proof, his request ought to be complied with. The Branch requiring proof of death should directly call for the certified copies from the branch concerned.

III. Net Payable Amount of Claim

After receiving the required documents the company calculates the amount payable under the policy. For this purpose, a form is filled in which the particulars of the policy, assignment, nomination, bonus etc. should be entered by reference to the Policy Ledger Sheet. If a loan exists under the policy, then the section dealing with loan is contacted to give the details of outstanding loan and interest amount, which is deducted from the gross policy amount to calculate net payable claim amount. The net amount of claim payable is calculated and is called payment voucher. In the case of 'in force' policy unpaid premiums if any due before the Assuror's death with late fee where necessary and the premium falling due in the policy year current at the time of death should be deducted from the claim amount.

15.6 Summary

Life insurance is a contract between an insurance policy holder and an insurer, where the insurer promises to pay a designated beneficiary a sum of money (the "benefits") upon the death of the insured person. Life insurance policies are legal contracts and the terms of the contract describe the limitations of the insured events. Life insurance may be divided into two basic classes: temporary and permanent; or the subclasses: term, universal, whole life and endowment life insurance. When there is an unforeseen death, there are a few things that need to be done prior to claiming the life insurance settlements. A claim may arise: On maturity and on death. . It is the liability of the insurance company to honor valid and legal claims.

15.7 Self Assessment Questions

1. What is the principle of indemnity? Why life insurance contract is not a contract of indemnity?
2. Write an essay on origin and development of life.
3. Describe the various types of insurance policies.
4. Write notes on:
   (a) Moral hazards
   (b)Physical hazards
   (c) Methods of handling risk
5. Describe the claim settlement procedure of death and maturity claims. Methods of handling risk.
6. What are the various details, which policy contract contains?
7. Describe in brief the important principles of life insurance.

15.8 Books for Further Readings

- Insurance by Lord Chobley
- Life Insurance Today, Various Issues (2000-01 to 2009-10)
- Avtar Singh, Insurance Management,
- Mishra M.N., Life Insurance, Administration and Management, 1977.

Unit -16 : Marine Insurance

Structure of Unit:

16.0 Objectives

After completing this unit, you would be able to:

- To acquaint with the different aspects of marine insurance.
- To know the history and development of marine insurance.
- To impart knowledge about marine insurance policies
- To understand the classification of marine insurance.

16.1 Marine Insurance

Definition

The law relating to Marine Insurance is found in the Marine Insurance Act 1963. Marine insurance is an agreement under which, the insurer undertakes to indemnify the insured in the manner and to the extent thereby agreed, against marine losses, incidental to marine adventures. It may be defined as a form of insurance covering loss or damage to vessels or to cargo during transportation to the high seas. [Sec. 3 of the Act]

"A contract whereby one party for an agreed consideration, undertakes to indemnify the other against loss arising from certain perils and sea risks to which a shipment merchandised and other interest in a maritime adventure may be exposed during a certain voyage or certain period of time."-**Arnold**

Meaning

The marine insurance is a contract between the insured and the insurer. The insured may be a cargo owner or a ship owner or a freight receiver. The insurer is known as the underwriter. The document in which the contract is incorporated is called "Marine policy". The insured pays a particular sum, which is called premium, in exchange for an undertaking from the insurer to indemnify the insured against loss or damage caused by certain specified perils.

The **main features** of marine insurance are:

1. Essentials of valid contract.
2. It is a contract of indemnity based on utmost good faith.
3. It compensates for actual loss caused by sea risks up to the amount of contract.

4. The insurable interest in marine insurance should exist at the time of loss.
5. Ship, cargo and freight can be insured.
6. The insurance can be for single journey, multiple journeys or a particular period of time.
7. The compensation is paid in cash only.
8. Warranties

Scope of Marine Insurance

Scope of marine insurance may be categorized in two ways:

1. Narrow Concept of Marine Insurance: At the beginning of the marine insurance the scope of marine insurance was narrow. Under the marine insurance, only risks caused by perils of sea were covered. Risks caused by shipping goods from land to the different parts were not covered under the marine insurance and also was not responsible to provide for goods being shipped on land. Insurance company provided compensation to the insured against the loss caused by perils of sea only. This is the old concept.

***2.* Wide Scope of Marine Insurance:** In the earlier time marine insurance was narrow. Gradually marine insurance was developed. When marine insurance was being progressed slowly, new types of marine insurance companies were established and the scope of marine insurance was also widened. It helped in the growth and development of Marine Insurance. Nowadays marine insurance covers not only marine risks but also land risks of course. Thus possible risks caused by shipping goods from land to port or by shipping goods from port to land are also included under the marine insurance. Therefore we can say that all types of risks related to marine trip are covered under the marine insurance. This is the modern scope of today's marine insurance.

The subject matter of the scope of marine insurance is:

1. **Hull Insurance:** Hull means the ship. The hull is insured against sea risks. The insurance can be for a particular journey or for a particular period of time. It can be for a single vessel or fleet.
2. **Cargo Insurance** The insured amount is payable to the cargo owner in case of loss. Cargo means goods carried in ship to various destinations. Cargo is insured to cover risk of loss during transportation
3. **Freight Insurance:** Freight is charges payable for transportation of goods. Freight payable at destination is insured to cover risk of loss of freight to shipping company.

Importance of Marine Insurance

In the present modern age marine insurance has become most important insurance in the field of insurance. The importance of marine insurance is as follows:

1. Importance of Marine Insurance for the Individual: An individual has to import goods from another country. It may be located on the other side of sea for his business. While carrying goods from other side of sea businessman may have to face dacoits. Goods may be damaged because of sinking of ship into the water. So businessman has to experience economic loss. By the result of loss person may be discouraged to engage in business. But when one person insures his/her property in marine insurance, does not have to face economic problem as marine insurance provides compensation to the insured against the loss of property and goods.

2. Importance of marine Insurance for Ship-owner: Marine insurance is important insurance for ship-owner. While going on the marine venture expensive ship may be destroyed due to different types of risks. Ship-owner may have to experience with larger amounts of loss due to the destruction of the ship. Marine insurance provides compensation of loss to the ship-owner.

3. Importance of Marine Insurance for Cargo Owner: A businessman wants to be secured for his goods. Especially countries which are located on the other side of sea, businessman may have to use marine venture. Marine insurance is beneficial for them as it keeps them away from worry and fear. All responsibility of cargo owner is transferred to the hand of insurance company that provides compensation to the cargo owner if loss occurs.

4. Importance of Marine Insurance for Freight: Freight insurance is also included under the marine insurance. Marine insurance is very important for the freight. Freight refers to the fee received for the carriage of goods in the ship for transportation of goods from one part to another. If businessman does not pay freight of his goods to the ship-owner, ship-owner may have to experience economic loss. If such types of loss occur insurance company indemnifies the ship-owner. In this way Marine insurance is very important for the freight.

5. Importance of Marine Insurance for the Government: Marine insurance is also important for the growth of International trade. As international trade increases government also can receive economic profit. Government increases revenue by including extra income tax. Thus marine insurance is important for the government also.

Principles of Marine Insurance

Marine insurance is based on the basis of certain principles like other insurance. Marine insurance cannot run away from these certain principles because marine insurance is also a contract between insurer and insured. These principles are:

1. Principle of Insurance Interest
2. Principle of Indemnity
3. Principle of Utmost Good Faith
4. Principle of Subrogation
5. Principle of Warranties
6. Principle of Causa Proxima

Activity A:

1. Explain the significance of insurable interest in marine insurance.

16.2 History and Development of Marine Insurance

Maritime insurance was the earliest well-developed kind of insurance, with origins in the Greek and Roman maritime loan. Separate marine insurance contracts were developed in Genoa and other Italian cities in the fourteenth century and spread to northern Europe. Premiums varied with intuitive estimates of the variable risk from seasons and pirates.

The oldest form of insurance was that of marine insurance. This seems to have originated in Rhodes, to have been adopted by the commercial cities of Italy and by the towns of the Hanseatic League between the twelfth and fourteenth centuries, and to have been introduced into England in the sixteenth century. The law of insurance was a branch of the law merchant and very greatly out of harmony with the principles of the common law. Early insurance cases were generally either submitted to the arbitration of a merchant court or tried before a special court created for that purpose in the first year of the seventeenth century. Only about fifty cases had come before the common law courts up to the middle of the eighteenth century. The business of marine insurance was in its early stages mainly conducted at Lloyd's Coffee House in London, and it was here that much of the law and custom governing marine insurance was developed.

It is known that Lloyd's Coffee House, an inn kept by one Edward Lloyd on Tower Street in London, was, as early as 1688, a popular resort for seafaring men and merchants engaged in foreign trade. It became the custom among those who gathered at Lloyd's to make their gathering an occasion for arranging their mutual contracts of insurance against the sea. In making such contracts it was the custom for the person desiring the insurance to pass around among the company assembled a slip upon which was written a description of the vessel and its cargo, with the name of the master and the character of his crew, and the voyage contemplated. Those desiring to become insurers of the ventures so described would write beneath the description on this slip their names or initials, and opposite thereto the amount which each was willing to be liable for as an insurer. When the total amount of insurance desired by the owner of the vessel was thus underwritten, the contract was complete. From this practice, among those congregating at Lloyd's, is derived the term 'underwriters,' as now applied to insurers. The business of insurance carried on in this informal way at Lloyd's seems to have increased rapidly, and the commercial importance of the house required that it should be removed to a more commodious and convenient site, which was found on Lombard Street, whither Lloyd removed his house in 1692. Both the importance of this coffee house in commercial circles, and the enterprise of its proprietor, were shown by the establishment in 1696 of a newspaper, giving information of commercial transactions and of the movement of shipping throughout the world. While this newspaper was shortly afterwards suppressed by reason of some indiscretion on the part of its publisher, it was yet the progenitor of 'Lloyd's Lists,' the publication of which was begun in 1726, and which continues up to this day as the most important publication in the shipping and commercial world. After various removals, Lloyd's finally found permanent quarters in the Royal Exchange, where it is now located, and remains, probably the greatest and most important single commercial factor in the mercantile world."

Marine insurance as we know it today can be described as mother of all insurances. It is believed to have originated in England owing to the frequent movement of ships over high seas for trade. In India, insurance has been in vogue for several centuries. History holds proof that these people had a system of pooling their contributions, if any one of their clan were to meet tragedy in their voyages. Today marine insurance has assumed a vast canvas due to the expanding trade across the globe, which involves large shipping companies that require protection for their fleet against the perils of the sea.

The modern origins of marine insurance law in English law were in the law merchant, with the establishment in England in 1601 of a specialized chamber of assurance separate from the other Courts. Lord Mansfield, Lord Chief Justice in the mid-eighteenth century, began the merging of law merchant and common law principles. The establishment of Lloyd's of London, competitor insurance companies, a developing infrastructure of specialists (such as shipbrokers, admiralty lawyers, and bankers), and the growth of the British Empire gave English law a prominence in this area which it largely maintains and forms the basis of almost all modern practice. The growth of the London insurance market led to the standardization of policies and judicial precedent further developed marine insurance law. In 1906 the Marine Insurance Act was passed which codified the previous common law; it is both an extremely thorough and concise piece of work. Although the title of the Act refers to marine insurance, the general principles have been applied to all non-life insurance.

In the 19th century, Lloyd's and the Institute of London Underwriters (a grouping of London company insurers) developed between them standardized clauses for the use of marine insurance, and these have been maintained since. These are known as the Institute Clauses because the Institute covered the cost of their publication.

Within the overall guidance of the Marine Insurance Act and the Institute Clauses parties retain a considerable freedom to contract between themselves.

Marine insurance is the oldest type of insurance. Out of it grew non-marine insurance and reinsurance. It traditionally formed the majority of business underwritten at Lloyd's. Nowadays, Marine insurance is often grouped with Aviation and Transit (cargo) risks, and in this form is known by the acronym "MAT".

Marine Adventure and Maritime Perils Defines:

(1) Subject to the provisions of the Marine Insurance Act, every lawful marine adventure may be the subject of a contract of marine insurance.

(2) In particular there is a marine adventure where—

(a) Any ship goods or other moveable are exposed to maritime perils. Such property is in this Act referred to as "insurable property";

(b) The earning or acquisition of any freight, passage money, commission, profit, or other pecuniary benefit, or the security for any advances, loan, or disbursements, is endangered by the exposure of insurable property to maritime perils;

(c) Any liability to a third party may be incurred by the owner of, or other person interested in or responsible for, insurable property, by reason of maritime perils.

"Maritime perils" means the perils consequent on, or incidental to, the navigation of the sea, that is to say, perils of the seas, fire, war perils, pirates, rovers, thieves, captures, seisures, restraints, and detainments of princes and peoples, jettisons, barratry, and any other perils, either of the like kind or which may be designated by the policy.

16.3 Classification of Subject Matter of Marine Insurance

The insured may be the owner of the ship, owner of the cargo or the person interested in freight. In case the ship carrying the cargo sinks, the ship will be lost along with the cargo. The income that the cargo would have generated would also be lost. Based on this we can classify the marine insurance into three categories:

(a) Hull Insurance

Hull refers to the ocean going vessels (ships trawlers etc.) as well as its machinery. The hull insurance also covers the construction risk when the vessel is under construction. A vessel is exposed to many dangers or risks at sea during the voyage. Insurance affected to indemnify the insured for such losses is known as Hull insurance.

(b) Cargo Insurance

Cargo refers to the goods and commodities carried in the ship from one place to another. The cargo transported by sea is also subject to manifold risks at the port and during the voyage. Cargo insurance covers the shipper of the goods if the goods are damaged or lost. The cargo policy covers the risks associated with the transhipment of goods. The policy can be written to cover a single shipment. If regular shipments are made, an open cargo policy can be used that insures the goods automatically when a shipment is made.

(c) Freight Insurance

Freight refers to the fee received for the carriage of goods in the ship. Usually the ship owner and the freight receiver are the same person. Freight can be received in two ways- in advance or after the goods reach the destination. In the former case, freight is secure. In the latter the marine laws say that the freight is payable only when the goods reach the destination port safely. Hence if the ship is destroyed on the way the ship owner will lose the freight along with the ship. That is why, the ship owners purchase freight insurance policy along with the hull policy.

(d) Liability Insurance

It is usually written as a separate contract that provides comprehensive liability insurance for property damage or bodily injury to third parties. It is also known as protection and indemnity insurance which protects the ship owner for damage caused by the ship to docks, cargo, illness or injury to the passengers or crew, and fines and penalties.

Different Risks Covered Under Marine Insurance

The marine insurance policy should clearly specify the risks covered under it. These may be:

1. Perils of Sea: They are accidents at sea. They are unexpected and extraordinary and damages during voyages of the ship. They can be:

(1) Heavy rain, Sea storm, cyclone, tsunami, heavy

(2) Iceberg, Collision with rocks or another ship

2. Fire: The fire may damage the ship and its cargo. Fire may occur from:

i) Explosion due to chemical reaction or accidents

(ii) Inflammable events such as coal, oil, electricity

(iii) Natural events such as lightning, thunder, friction

3. Jettison: It is throwing away goods from the ship to reduce the weight in the ship. It is deliberately done to avoid worst situation.

4. Theft: Cargo may be stolen by sea dacoits and outsiders for personal profit. The theft should not be done by the persons inside the ship. They are captain, crew members and passengers of ship.

5. War Risks: The war situation between two countries may create risks of loss to ships, cargo and freight. Enemies may capture the ship and cargo.

- Cargo can be subject to land risks during transportation. Marine policy also covers land risks.

6. Barratry: It is cheating. It is mischievous and willful action of captain and crew to cause loss. It can be:

- Theft of ship or cargo
- Setting ship and cargo on fire
- Illegal sales of cargo

16.4 Types of Policies

There are different types of marine policies known by different names according to the manner of their execution or the risk they cover. They are:

1. Voyage Policy: Under the policy, the subject matter is insured against risk in respect of a particular voyage from a port of departure to the port of destination, e.g. Mumbai to New York. The risk starts from the departure of ship from the port and it ends on its arrival at the port of destination. This policy covers the subject matter irrespective of the time factor. This policy is not suitable for hull insurance as a ship usually does not operate over a particular route only. The policy is used mostly in case of cargo insurance.

2. Time Policy: It is one under which the insurance is affected for a specified period of time, usually not exceeded twelve months. Time policies are generally used in connection with the insurance of ship. Thus if the voyage is not completed within the specified period, the risk shall be covered until the voyage is completed or till the arrival of the ship at the port of call.

3. Mixed Policies: It is one under which insurance contract is entered into for a certain time period and for a certain voyage or voyages, e.g., Kolkata to New York, for a period of one year. Mixed Policies are generally issued to ships operating on particular routes. It is a mixture of voyage and time policies.

4. Open Policy: An open policy is issued for a period of 12 months and all consignments cleared during the period are covered by the insurer. This form of insurance Policy is suitable for big companies that have regular shipments. It saves them the tedious and expensive process of acquiring an insurance policy for each shipment. The rates are fixed in advance, without taking the total value of the cargo being shipped into consideration. The assured has to declare the nature of each shipment, and the cover is provided to all the shipments. The assured also deposits a premium for the estimated value of the consignment during the policy period.

5. Valued Policies: It is one under which the value of subject matter insured is specified on the face of the policy itself. This kind of policy specifies the settled value of the subject matter that is being provided cover for. The value which is agreed upon is called the insured value. It forms the measure of indemnity in the event of loss. Insured value is not necessarily the actual value. It includes (a) invoice price of goods (b) freight, insurance and other charges (c) ten to fifteen percent margin to cover expected profits.

6. Unvalued Policy: It is the policy under which the value of subject matter insured is not fixed at the time of effecting insurance but has to be ascertained wherever the subject matter is lost or damaged.

7. Floating Policy: A merchant who is a regular shipper of goods can take out a 'floating policy' to avoid botheration and waste of time involved in taking a new policy for every shipment. This policy stands for the contract of insurance in general terms. It does not include the name of the ship and other details. The other details are required to be furnished through subsequent declarations. Thus, the insured takes a policy for a huge amount and he informs the underwriter as and when he makes shipment of goods. The underwriter goes on recording the entries in the policy. When the sum assured is exhausted, the policy is said to be "fully declared" or "run off".

8. Block Policy: This policy covers other risks also in addition to marine risks. When goods are to be transported by ship to the place of destination, a single policy known as block policy may be taken to cover all risks. E.g. when the goods are dispatched by rail or road transport for shipment, a single policy may cover all the risks from the point of origin to the point of destination.

16.5 Main Clauses

A policy of marine insurance may contain several clauses. Some of the clauses are common to all marine policies while others are included to meet special requirements of the insured. Hull, cargo and freight policies have different standard clauses. There are standard clauses which are invariably used in marine insurance. Firstly, policies are constructed in general, ordinary way and later on, specific clauses are added to them according to terms and conditions of the contract. Some of the important clauses in a marine policy are mentioned below:

1. Valuation Clause: If the value is written at the time of affecting the policy, it is called valued policy. This clause states the value of the subject matter insured as agreed upon between both the parties.

2. Sue and Labor Clause: This clause authorizes the insured to take all possible steps to avert or minimize the loss or to protect the subject matter insured in case of danger. The insurer is liable to pay the expenses, if any, incurred by the insured for this purpose.

3. Waiver Clause: This clause is an extension of the above clause. The clause states that any act of the insured or the insurer to protect, recover or preserve the subject matter of insurance shall not be taken to mean that the insured wants to forgo the compensation, nor will it mean that the insurer accepts the act as abandonment of the policy.

4. Touch and Stay Clause: This clause requires the ship to touch and stay at such ports and in such order as specified in the policy. Any departure from the route mentioned in the policy or the ordinary trade route followed will be considered as deviation unless such departure is essential to save the ship or the lives on board in an emergency.

5. Warehouse to Warehouse Clause: This clause is inserted to cover the risks to goods from the time they are dispatched from the consignor's warehouse until their delivery at the consignee's warehouse at the port of destination.

6. Negligence Clause: This clause is included in the policy to provide wider scope of security to insured, which are not covered by the ordinary policy.

This clause covers the loss or damage caused to the ship or machinery by the negligence of the master of the ship as well as by explosives or latent defect in the machinery or the hull.

7. F.P.A. and F.A.A. Clause: The F.P.A. (Free of Particular Average) clause relieves the insurer from particular average liability. The F.A.A. (free of all average) clause relieves the insurer from liability arising from both particular average and general average.

8. Lost or Not Lost Clause: Under this clause, the insurer is liable even if the ship insured is found not to be lost prior to the contact of insurance, provided the insurer had no knowledge of such loss and does not commit any fraud. This clause covers the risks between the issue of the policy and the shipment of the goods.

9. Running down Clause: This clause covers the risk arising out of collision between two ships. The insurer is liable to pay compensation to the owner of the damaged ship. This clause is used in hull insurance.

10. Free of Capture and Seizure Clause: This clause relieves the insurer from the liability of making compensation for the capture and seizure of the vessel by enemy countries. The insured can insure such abnormal risks by taking an extra 'war risks' policy.

11. Continuation Clause: This clause authorizes the vessel to continue and complete her voyage even if the time of the policy has expired. This clause is used in a time policy. The insured has to give prior notice for this and deposit a monthly prorate premium.

12. Barratry Clause: This clause covers losses sustained by the ship owner or the cargo owner due to willfull conduct of the master or crew of the ship.

13. Jettison Clause: Jettison means throwing overboard a part of the ship's cargo so as to reduce her weight or to save other goods. This clause covers the loss arising out of such throwing of goods. The owner of jettisoned goods is compensated by all interested parties.

14. "At and From" Clause: This clause covers the subject matter while it is lying at the port of departure and until it reaches the port of destination. It is used in voyage policies. If the policy consists of the word 'from' only instead of 'at and from', the risk is covered only from the time of departure of the ship.

15. Name of Ship Cause: The name of the ship in which the cargo is boarded is written in this clause.

16. Name of Captain Clause: The name of the captain of the ship is written in this clause.

16.6 Marine Losses

A loss arising in a marine adventure due to perils of the sea is a marine loss.

Marine loss may be classified into two categories:

1) Total Loss

A total loss implies that the subject matter insured is fully destroyed and is totally lost to its owner. Total losses may be subdivided in two classes:

(a) Actual Total Loss

In actual total loss subject matter is completely destroyed or so damaged that it ceases to be a thing of the kind insured. e.g. sinking of ship, complete destruction of cargo by fire, etc.

(b) Constructive Total Loss

In case of constructive total loss the ship or cargo insured is not completely destroyed but is so badly damaged that the cost of repair or recovery would be greater than the value of the property saved. e.g. a ship dashed against the rock and is stranded in a badly damaged position. If the expenses of bringing it back and repairing it would be more than the actual value of the damaged ship, it is abandoned.

2) Partial Loss

Losses other than total losses are partial losses. A partial loss occurs when the subject matter is partially destroyed or damaged. Partial loss can be general average or particular average. General average refers to the sacrifice made during extreme circumstances for the safety of the ship and the cargo. This loss has to be borne by all the parties who have an interest in the marine adventure e.g. A loss caused by throwing overboard of goods is a general average and must be shared by various parties. Partial losses are of two types:

(a) Particular Average Loss

Particular average may be defined as a loss arising from damage accidentally caused by the perils insured against. Such a loss is borne by the underwriter who insured the object damaged. e.g. If a ship is damaged due to bad weather the loss incurred is a particular average loss.

(b) General Average Loss

General average refers to the sacrifice made during extreme circumstances for the safety of the ship and the cargo. This loss has to be borne by all the parties who have an interest in the marine adventure e.g. A loss caused by throwing overboard of goods is a general average and must be shared by various parties.

Activity B:

1. What are the effects of marine losses on the insured and the insurer?

Warranties and Conditions

According to section 35 of marine insurance Act, a Warranty is an undertaking by the assured that some condition shall be fulfilled or that a certain thing shall be or shall not be done or whereby he confirms or negatives the existence of a particular state of facts.

A peculiarity of marine insurance and insurance law generally, is the use of the terms **condition** and **warranty**. In English law, a condition typically describes a part of the contract that is fundamental to the performance of that contract, and, if breached, the non-breaching party is entitled not only to claim damages but to terminate the contract on the basis that it has been repudiated by the party in breach.

By contrast, a warranty is not fundamental to the performance of the contract and breach of a warranty, while giving rise to a claim for damages, does not entitle the non-breaching party to terminate the contract. The meaning of these terms is reversed in insurance law. Indeed, a warranty if not strictly complied with will automatically discharge the insurer from further liability under the contract of insurance. A warranty may be of two types.

Implied Warranties

(a) Sea worthiness
(b) Legality of voyage
(c) Non deviation

Expressed Warranties

(a) warranty of neutrality
(b) warranty of goods safety

16.7 Summary

In marine insurance, the insurer undertakes to indemnify the insured against the losses incidental to marine adventure. Then we have seen characteristics of general insurance, common to marine insurance. The meaning of marine perils, different marine insurance policies, types of marine insurance and types of losses, Clauses and Warranties are also explained. We have tried to understand how the concept of marine insurance evolves specially in India.

16.8 Self Assessment Questions

1. Define marine insurance. What are the essential features of a marine insurance contract?

2. Discuss the main clauses of marine policies.

3. Enumerate the various types of marine insurance policies.

4. Describe the various types of marine losses briefly.

5. Write notes on
   (a) Touch and stay clause
   (b) Waiver clause

6. What do you mean by warranty in marine insurance? Explain the various types of warranties.

16.9 Books for Further Readings

- The Principles of Marine Insurance - A.Primer by Harold Turner
- Marine Insurance Claims by Leslie.J.Buglass, Marine Insurance Claims by J.K Goodcare
- The Principles of marine Insurance by A Primer by Harold Turner,
- Controlling Cargo theft byTyska Fennely, Inland Marine Insurance –Roderick McNamma , Arnould on
- law of Marine Insurance by Lord Chobley
- Singh B.P. & Chhabra T.N., (2004), Business Organization and Management, Dhanpat Rai & Co., New Delhi
- Gupta P. K., (2005), Insurance and Risk management, Himalaya Publishing House, New Delhi

Unit - 17 : Health Insurance

Structure of Unit:

17.0 Objectives

After completing this unit, you would be able to:

- Understand the meaning of health insurance;
- Know a brief about health care system in India;
- Have an understanding of various schemes of health insurance in India;
- Know about major developments in health insurance sector;
- Identify the significance of health insurance policy;
- Know how to process a health insurance claim.

17.1 Introduction

17.1.1 Health Care System in India

The health care system in India is characterised by multiple systems of medicine, mixed ownership patterns and different kinds of delivery structures. Public sector ownership is divided between central and state governments, municipal and Panchayat local governments. Public health facilities include teaching hospitals, secondary level hospitals, first-level referral hospitals (CHCs or rural hospitals), dispensaries; primary health centres (PHCs), sub-centres, and health posts. Also included are public facilities for selected occupational groups like organized work force (ESI), defence, government employees (CGHS), railways, post and telegraph and mines among others. The private sector (for profit and not for profit) is the dominant sector with 50 per cent of people seeking indoor care and around 60 to 70 per cent of those seeking ambulatory care (or outpatient care) from private health facilities. While India has made significant gains in terms of health indicators - demographic, infrastructural and epidemiological (See Tables 1 and 2), it continues to grapple with newer challenges. Not only have communicable diseases persisted over time but some of them like malaria have also developed insecticide-resistant vectors while others like tuberculosis are becoming increasingly drug resistant. HIV / AIDS has of late assumed extremely virulent proportions. The 1990s have also seen an increase in mortality on account of non-communicable diseases arising as a result of lifestyle changes. The country is now in the midst of a dual disease burden of communicable and non communicable diseases. This is coupled with spiralling health costs, high financial burden on the poor and erosion in their incomes. Around 24% of all people hospitalized in India in a single year fall below the poverty line due to hospitalization (World Bank, 2002). An analysis of financing of hospitalization shows that large proportion of people; especially those in the bottom four income quintiles borrow money or sell assets to pay for hospitalization (World Bank, 2002).

This situation exists in a scenario where health care is financed through general tax revenue, community financing, out of pocket payment and social and private health insurance schemes. India spends about 4.9% of GDP on health (WHR, 2002). The per capita total expenditure on health in India is US$ 23, of which the per capita Government expenditure on health is US$ 4. Hence, it is seen that the total health expenditure is around 5% of GDP, with breakdown of public expenditure (0.9%); private expenditure (4.0%). The private expenditure can be further classified as out-of-pocket (OOP) expenditure (3.6%) and employees/community financing (0.4%). It is thus evident that public health investment has been comparatively low. In fact as a percentage of GDP it has declined from 1.3% in 1990 to 0.9% as at present. Furthermore, the central budgetary allocation for health (as a percentage of the total Central budget) has been stagnant at 1.3% while in the states it has declined from 7.0% to 5.5%.

Table 17.1 : Socio Economic Indicators of India

Land area	**2% of world area**
Burden of disease (%)	21% of global disease burden
Population	16% of world population
Urban : Rural	28:72
Literacy rate (%)	65.38
Sanitation (%)	Rural – 9.0; Urban – 49.3
Safe drinking water supply (%)	Rural – 98; Urban – 90.2
Poverty (%)	Below poverty line – 26 Rural – 27.09; Urban – 23.62
Poverty line (Rs.)	Rural – 327.56; Urban – 454.11

In light of the fiscal crisis facing the government at both central and state levels, in the form of shrinking public health budgets, escalating health care costs coupled with demand for health-care services, and lack of easy access of people from the low-income group to quality health care, health insurance is emerging as an alternative mechanism for financing of health care.

17.1.2 Health Insurance

Insurance may be described as a social device to reduce or eliminate risk of life and property. Under the plan of insurance, a large number of people associate themselves by sharing risk, attached to individual insurance plan that *exclusively* covers healthcare costs and is called *Health Insurance*.

Since the past two decades, there has been a phenomenal surge in acceleration of healthcare costs. This has compelled individuals to have a re-look on their actual monthly expenditures, spending patterns and simultaneously allocate a proportion of their income towards personal healthcare. This has resulted in individuals availing healthcare insurance coverage not only for themselves but also for their family members including their dependants. In short, healthcare insurance provides a cushion against medical emergencies.

The concept of **insurance** is closely concerned with security. **Insurance** acts as a shield against risks and unforeseen circumstances. In general, by and large, Indians are traditionally *risk-averse* rather than *risk lovers* by nature.

Also known as medical insurance, accident and health insurance or sickness and accident insurance, it covers all types of disability, loss of income, medical expense and accidental death. It can be defined as "any form of insurance whose payment is contingent on the insured incurring additional expenses or losing income because of incapacity or loss of good health." In medical insurance, benefits become payable on disability as a result of accident or sickness. Health insurance can address the problems related to rising medical expenses.

Some major health insurance companies in India include National Insurance Company, New India Assurance, United India Insurance, ICICI Lombard, Tata AIG, Royal Sundaram, Star Allied Health Insurance, Cholamandalam DBS, Bajaj Allianz Apollo, AG Health Insurance Company among others.

17.2 What is Health Insurance?

17.2.1 Meaning

Health Insurance, also known as medical insurance is a form of insurance which covers the expenses incurred on medical treatment and hospitalisation. It covers the individual and family against any financial constraints arising from medical emergencies. In case of sudden hospitalisation, illness or accident, health insurance takes care of the expenses on medicines, oxygen, ambulance, blood, hospital room, various medical tests and almost all other costs involved. Thus, by insuring one's health, he ensures that if he pays an amount of health insurance premium every year depending on the person's age, then till a certain limit of medical expenses, he/ she would be covered by the insurance company and will not have to spend it from his own pocket.

Basically, since medical expenses are increasing every year, it becomes difficult for someone to suddenly pay about Rs. 2,00,000 to Rs. 3,00,000 towards medical emergencies. Since medical emergencies cannot be postponed or neglected, this unforeseen expense becomes inevitable if health insurance has not been availed. Thus by paying a nominal amount of premium of say Rs. 1,200 per annum, a 35 year old man can get covered till Rs. 1,00,000 of medical expenses per annum. Thus, a sudden expense of Rs. 1,00,000 may seem very high for the individual; however a nominal amount of Rs. 1,200 per annum, i.e. Rs. 100 per month may seem to be a very reasonable cost. This amount however, has to be paid every year; otherwise the cover ceases to exist.

The term **health insurance** is generally used to describe a form of insurance that pays for medical expenses. It is sometimes used more broadly to include insurance covering disability or long-term nursing or custodial care needs. It may be provided through a government-sponsored social insurance program, or from private insurance companies. It may be purchased on a group basis (e.g., by a firm to cover its employees) or purchased by individual consumers. In each case, the covered groups or individuals pay premiums or taxes to help protect themselves from high or unexpected healthcare expenses. Similar benefits paying for medical expenses may also be provided through social welfare programs funded by the government.

Healthcare insurance or health insurance is a contract between a policyholder and a third-party payer or government program to reimburse the policyholder for all or a portion of the cost of medically necessary treatment or preventive care provided by healthcare professionals.

By estimating the overall risk of healthcare expenses, a routine finance structure (such as a monthly premium or annual tax) can be developed, ensuring that money is available to pay for the healthcare benefits specified in the insurance agreement. The benefit is administered by a central organization, most often either a government agency or a private or not-for-profit entity operating a health plan.

Activity A:

1. According to you what is Health Insurance? Throw some light on the health care system of our country.

17.2.2 Major Development in Health Insurance

Since the early 1900s, when solo practices prevailed, managed care and group practices have increased in number, and health care services (like other aspects of society in this country) have undergone tremendous changes.

Table 17.2 Glossary of Health Insurance Terms

GLOSSARY OF HEALTH INSURANCE TERMS	
Group health insurance	Traditional healthcare coverage subsidized by employers and other organizations whereby part or all of premium costs are paid for and/ or discounted group rates are offered to eligible individuals.
Individual health insurance	Private health insurance policy purchased by individuals or families who do not have access to group health insurance coverage. Applicants can be denied coverage, and they can also be required to pay higher premiums due to age, gender and/ or pre-existing medical conditions.
Public health insurance	Federal and state government health programs (e.g., Medicare, Medicaid, SCHIP, TRICARE) available to eligible individuals.
Single payer plan	Centralized healthcare system adopted by some Western nations and funded by taxes. The government pays for each resident's health care, which is considered a basic social service.
Socialized medicine	A type of single-payer system in which the government owns and operates healthcare facilities and providers receive salaries. The VA healthcare program is a form of socialized medicine.
Universal health insurance	The goal of providing every individual with access to health coverage, regardless of the system implemented to achieve that goal.

Activity B:

1. Analyze major developments in health insurance in India.

17.2.3 Categories of Health Insurance

Indian Health Insurance is primarily classified into 2 categories:

- Cashless Hospitalization
- Medical Reimbursement

• **Cashless Hospitalization:** Cashless hospitalization is a specialized service provided by an insurer wherein an individual is not required to pay the hospitalization expenses at the time of discharge from the concerned hospital. The settlement is done directly by the insurance company (or insurer). However, prior approval is a must from the TPA (Third Party Administrator) before availing the benefits under this option.

Cashless hospitalization can be of two types:

- **Planned Hospitalization:** This is a planned hospitalization wherein the insured is aware of the hospitalization in advance. This duration period may vary from case to case. Examples include: FTND (Full Term Normal Delivery), Chemotherapy treatment for carcinoma (cancer), for cataract surgery, tonsillectomy (removal of tonsils).

• **Emergency Hospitalization:** It is a sudden hospitalization that may be either an emergency or due to unforeseen circumstances. In short, hospitalization is not anticipated in advance. Examples include RTA (Road Traffic Accident), Myocardial infarction (heart attack), Acute Appendicitis.

2. Medical Reimbursement: Re-imbursement means to repay or to compensate. Thus, Medical Re-imbursement means to repay the products/services availed during hospitalization and more importantly after the completion of the treatment.

Under this procedure, the insured has to bear the entire expenses incurred during hospitalization. After getting discharged from hospital, the insured/policy holder can claim medical reimbursement. For availing benefits under this option, the insured has to approach the concerned TPA under which he/she is covered, fill the requisite form and satisfy all the requirements as mentioned. This includes submission of TPA card, policy paper, discharge summary, prescriptions, diagnostic laboratory reports, OPD treatment details etc. A sum is granted as reimbursement for treatment expenses.

A recent survey conducted in 2008 showed that only 3% of the entire Indian population has availed some sort of insurance policy and enjoys benefits included under its coverage. This miniscule percentage constitutes both – **PSUs** (Public Sector Undertakings) and **Private insurance companies**. Since, the general public are by and large ignorant about the benefits of availing healthcare insurance policies, there lies an urgent need to educate the masses regarding the *importance* of Healthcare Insurance and the *benefits* derived on account of it.

There are numerous reasons for not availing health insurance. There is a lack of knowledge regarding the existing insurance products/services in the markets. On top of it, there are numerous misconceptions about Insurance prevalent in the Indian Markets. Also there are numerous fly-by-night agents out to fleece the gullible Indian public.

In India, public funded healthcare is available only to a miniscule section of BPL (Below Poverty Line) groups, low-income groups and to government employees. The Indian Government has formulated Employee State Insurance Scheme (ESIS) that focuses on the public healthcare policy for low-income groups. The government employees can avail Central Government Health Scheme (CGHS) that offers medical treatment at a subsidized cost.

With the opening up of insurance sector for private participation, numerous players have entered the healthcare segment, but in spite of the entry of private sector, penetration of insurance coverage in India is abysmally low. Recently a legislature has been passed in the Indian Parliament allowing 49% of FDI in insurance industry.

Activity C:

1. Examine various categories of health insurance in India?

17.3 Schemes of Health Insurance in India

Health insurance in a narrow sense would be 'an individual or group purchasing health care coverage in advance by paying a fee called premium.' In its broader sense, it would be any arrangement that helps to defer, delay, reduce or altogether avoid payment for health care incurred by individuals and households. Given the appropriateness of this definition in the Indian context, this is the definition, we would adopt. The health insurance market in India is very limited covering about 10% of the total population. The existing schemes can be categorized as:

(1) Voluntary Health Insurance Schemes or Private-for-profit Schemes;
(2) Employer-based Schemes;
(3) Insurance Offered By NGOs / Community Based Health Insurance, and
(4) Mandatory Health Insurance Schemes or Government Run Schemes (Namely ESIS, CGHS).

(1) Voluntary Health insurance Schemes or Private-for-profit Schemes

In private insurance, buyers are willing to pay premium to an insurance company that pools people with similar risks and insures them for health expenses. The key distinction is that the premiums are set at a level, which provides a profit to third party and provider institutions. Premiums are based on an assessment of the risk status of the consumer (or of the group of employees) and the level of benefits provided, rather than as a proportion of the consumer's income.

In the public sector, the General Insurance Corporation (GIC) and its four subsidiary companies (National Insurance Corporation, New India Assurance Company, Oriental Insurance Company and United Insurance Company) and the Life Insurance Corporation (LIC) of India provide voluntary insurance schemes. The Life Insurance Corporation offers *Ashadeep Plan II and Jeevan Asha Plan II.* The General Insurance Corporation offers Personal Accident policy, *Jan Arogya policy*, *Raj Rajeshwari policy*, *Mediclaim policy*, *Overseas Mediclaim policy*, *Cancer Insurance policy*, *Bhavishya Arogya policy* and *Dreaded Disease policy (Srivastava 1999 as quoted in Bhat R & Malvankar D, 2000.*

Of the various schemes offered, Mediclaim is the main product of the GIC. The Medical Insurance Scheme or Mediclaim was introduced in November 1986 and it covers individuals and groups with persons aged 5 – 80 yrs. Children (3 months – 5 yrs) are covered with their parents. This scheme provides for reimbursement of medical expenses (now offers cashless scheme) by an individual towards hospitalization and domiciliary hospitalization as per the sum insured. There are exclusions and pre-existing disease clauses. Premiums are calculated based on age and the sum insured, which in turn varies from Rs 15 000 to Rs 5 00 000. In 1995/96 about half a million Mediclaim policies were issued with about 1.8 million beneficiaries (Krause Patrick 2000). The coverage for the year 2000-01 was around 7.2 million.

Another scheme, namely the Jan Arogya Bima policy specifically targets the poor population groups. It also covers reimbursement of hospitalization costs up to Rs 5 000 annually for an individual premium of Rs 100 a year. The same exclusion mechanisms apply for this scheme as those under the Mediclaim policy. A family discount of 30% is granted, but there is no group discount or agent commission. However, like the Mediclaim, this policy too has had only limited success. The Jan Arogya Bima Scheme had only covered 400 000 individuals by 1997.

The year 1999 marked the beginning of a new era for health insurance in the Indian context. With the passing of the Insurance Regulatory Development Authority Bill (IRDA) the insurance sector was opened to private and foreign participation, thereby paving the way for the entry of private health insurance companies. The Bill also facilitated the establishment of an authority to protect the interests of the insurance holders by regulating, promoting and ensuring orderly growth of the insurance industry. The bill allows foreign promoters to hold paid up capital of up to 26 percent in an Indian company and requires them to have a capital of Rs 100 crore along with a business plan to begin its operations.Currently, a few companies such as Bajaj Alliance, ICICI, Royal Sundaram, and Cholamandalam among others are offering health insurance schemes.

Main players of this field are.

- **Bajaj Allianz:** Bajaj Alliance offers three health insurance schemes namely, Health Guard, Critical Illness Policy and Hospital Cash Daily Allowance Policy.

- The Health Guard scheme is available to those aged 5 to 75 years (not allowing entry for those over 55 years of age), with the sum assured ranging from Rs 100 0000 to 500 000. It offers cashless benefit and medical reimbursement for hospitalization expenses (pre and post-hospitalization) at various hospitals across India (subject to exclusions and conditions). In case the member opts for hospitals besides the empanelled ones, the expenses incurred by him are reimbursed within 14 working days from submission of all the documents. While pre-existing diseases are excluded at the time of taking the policy, they are covered from the 5th year onwards if the policy is continuously renewed for four years and the same has been declared while taking the policy for the first time. Other discounts and benefits like tax exemption, health check-up at end of four claims free year, etc. can be availed of by the insured.

  -The Critical Illness policy pays benefits in case the insured is diagnosed as suffering from any of the listed critical events and survives for minimum of 30 days from the date of diagnosis. The illnesses covered include: first heart attack; Coronary artery disease requiring surgery: stroke; cancer; kidney failure; major organ transplantation; multiple sclerosis; surgery on aorta; primary pulmonary arterial hypertension, and paralysis. While exclusion clauses apply, premium rates are competitive and high-sum insurance can be opted for by the insured.

  - The Hospital Cash Daily Allowance Policy provides cash benefit for each and every completed day of hospitalization, due to sickness or accident. The amount payable per day is dependent on the selected scheme. Dependant spouse and children (aged 3 months – 21years) can also be covered under the Policy. The benefits payable to the dependants are linked to that of insured. The Policy pays for a maximum single hospitalization period of 30 days and an overall hospitalization period of 30/60 completed days per policy period per person regardless of the number of confinements to hospital/nursing home per policy period.

- **ICICI Lombard:** ICICI Lombard offers Group Health Insurance Policy. This policy is available to those aged 5 – 80 years, (with children being covered with their parents) and is given to corporate bodies, institutions, and associations. The sum insured is minimum Rs 15 000/- and a maximum of Rs 500 000/-. The premium chargeable depends upon the age of the person and the sum insured selected. A slab wise group discount is admissible if the group size exceeds 100. The policy covers reimbursement of hospitalization expenses incurred for diseases contracted or injuries sustained in India. Medical expenses up to 30 days for Pre-hospitalization and up to 60 days for post-hospitalization are also admissible. Exclusion clauses apply. Moreover, favourable claims experience is recognized by discount and conversely, unfavourable claims experience attracts loading on renewal premium. On payment of additional premium, the policy can be extended to cover maternity benefits, pre-existing diseases, and reimbursement of cost of health check-up after four consecutive claims-free years.

- **Royal Sundaram Group**: The *Shakthi* Health Shield policy offered by the Royal Sundaram group can be availed by members of the women's group, their spouses and dependent children. No age limits apply. The premium for adults aged up to 45 years is Rs 125 per year, for those aged more than 45 years is Rs 175 per year. Children are covered at Rs 65 per year. Under this policy, hospital benefits up to Rs 7 000 per annum can be availed, with a limit per claim of Rs 5 000. Other benefits include maternity benefit of Rs 3 000 subject to waiting period of nine months after first enrolment and for first two children only. Exclusion clauses apply *(Ranson K & Jowett M, 2003.*

- **Cholamandalam General Insurance**: The benefits offered (in association with the Paramount Health Care, a re-insurer) in case of an illness or accident resulting in hospitalization, are cash-free hospitalization in more than 1 400 hospitals across India, reimbursement of the expenses during pre- hospitalization (60 days prior to hospitalization) and post- hospitalization (90 days after discharge) stages of treatment. Over 130 minor surgeries that require less than 24 hours hospitalization under day care procedure are also covered. Extra health covers like general health and eye examination, local ambulance service, hospital daily allowance, and 24 hours assistance can be availed of. Exclusion clauses apply.

(2) Employer-based Schemes

Employers in both the public and private sector offers employer-based insurance schemes through their own employer-managed facilities by way of lump sum payments, reimbursement of employee's health expenditure for outpatient care and hospitalization, fixed medical allowance, monthly or annual irrespective of actual expenses, or covering them under the group health insurance policy. The railways, defence and security forces, plantations sector and mining sector provide medical services and / or benefits to its own employees. The population coverage under these schemes is minimal, about 30-50 million people.

(3) Insurance Offered by NGOs / Community-based Health Insurance

Community-based funds refer to schemes where members prepay a set amount each year for specified services. The premium are usually flat rate (not income-related) and therefore not progressive. Making profit is not the purpose of these funds, but rather improving access to services. Often there is a problem with adverse selection because of a large number of high-risk members, since premiums are not based on assessment of individual risk status. Exemptions may be adopted as a means of assisting the poor, but this will also have adverse effect on the ability of the insurance fund to meet the cost of benefits.

Community-based schemes are typically targeted at poorer populations living in communities, in which they are involved in defining contribution level and collecting mechanisms, defining the content of the benefit package, and / or allocating the schemes, financial resources (International Labour Office Universities Programme 2002 as quoted in Ranson K & Acharya A, 2003). Such schemes are generally run by trust hospitals or nongovernmental organizations (NGOs). The benefits offered are mainly in terms of preventive care, though ambulatory and in-patient care is also covered. Such schemes tend to be financed through patient collection, government grants and donations. Increasingly in India, CBHI schemes are negotiating with the for profit insurers for the purchase of custom designed group insurance policies. However, the coverage of such schemes is low, covering about 30-50 million (Bhat, 1999). A review by Bennett, Cresse et al. (as quoted in Ranson K & Acharya A, 2003) indicates that many community-based insurance schemes suffer from poor design and management, fail to include the poorest-of-the poor, have low membership and require extensive financial support. Other issues relate to sustainability and replication of such schemes.

Some examples of community-based health insurance schemes are discussed herein.

- **Self-Employed Women's Association (SEWA), Gujarat**: This scheme established in 1992, provides health, life and assets insurance to women working in the informal sector and their families. The enrolment in the year 2002 was 93 000. This scheme operates in collaboration with the National Insurance Company (NIC). Under SEWA's most popular policy, a premium of Rs 85 per individual is paid by the woman for life, health and assets insurance. At an additional payment of Rs 55, her husband too can be covered. Rs 20 per member is then paid to the National Insurance Company (NIC) which provides coverage to a maximum of Rs 2 000 per person per year for hospitalization. After being hospitalized at a hospital of one's choice (public or private), the insurance claim is submitted to SEWA. The responsibility for enrolment of members, for processing and approving of claims rests with SEWA. NIC in turn receives premiums from SEWA annually and pays them a lumpsum on a monthly basis for all claims reimbursed. (Ranson K & Acharya A, 2003).

- Another CBHI scheme located in Gujarat, is that run by the **Tribhuvandas Foundation (TF),** Anand. This was established in 2001, with the membership being restricted to members of the AMUL Dairy Cooperatives. Since then, over 1 00 000 households have been enrolled under this scheme, with the TF functioning as a third party insurer.
- **The Mallur Milk Cooperative** in Karnataka established a CBHI scheme in 1973. It covers 7 000 people in three villages and outpatient and inpatient health care are directly provided.
- A similar scheme was established in 1972 at Sewagram, Wardha in Maharashtra. This scheme covers about 14 390 people in 12 villages and members are provided with outpatient and inpatient care directly by Sewagram.
- The Action for Community Organization, Rehabilitation and Development (ACCORD), Nilgiris, Tamil Nadu was established in 1991. Around 13 000 Adivasis (tribals) are covered under a group policy purchased from New India Assurance.
- Another scheme located in Tamil Nadu is Kadamalai Kalanjia Vattara Sangam (KKVS), Madurai. This was established in 2000 and covers members of women's self-help groups and their families. Its enrolment in 2002 was around 5 710, with the KKVS functioning as a third party insurer.
- The Voluntary Health Services (VHS), Chennai, Tamil Nadu was established in 1963. It offers sliding premium with free care to the poorest. The benefits include discounted rates on both outpatient and inpatient care, with the VHS functioning as both insurer and health care provider. In 1995, its membership was 124 715. However, this scheme suffers from low levels of cost recovery due to problems of adverse selection.
- Raigarh Ambikapur Health Association (RAHA), Chhatisgarh was established in 1972, and functions as a third party administrator. Its membership in the year 1993 was 72 000.

(4) Mandatory Health Insurance Schemes or Government Run Schemes (Namely the ESIS, CGHS)

Social insurance is an earmarked fund set up by government with explicit benefits in return for payment. It is usually compulsory for certain groups in the population and the premiums are determined by income (and hence ability to pay) rather than related to health risk. The benefit packages are standardized and contributions are earmarked for spending on health services

The government-run schemes include the Central Government Health Scheme (CGHS) and the Employees State Insurance Scheme (ESIS).

Central Government Health Scheme (CGHS)

Since 1954, all employees of the Central Government (present and retired); some autonomous and semi-government organizations, MPs, judges, freedom fighters and journalists are covered under the Central

Government Health Scheme (CGHS). This scheme was designed to replace the cumbersome and expensive system of reimbursements (GOI, 1994). It aims at providing comprehensive medical care to the Central Government employees and the benefits offered include all outpatient facilities, and preventive and promotive care in dispensaries. Inpatient facilities in government hospitals and approved private hospitals are also covered. This scheme is mainly funded through Central Government funds, with premiums ranging from Rs 15 to Rs 150 per month based on salary scales. The coverage of this scheme has grown substantially with provision for the non-allopathic systems of medicine as well as for allopathy. Beneficiaries at this moment are around 432 000, spread across 22 cities.

The CGHS has been criticized from the point of view of quality and accessibility. Subscribers have complained of high out-of-pocket expenses due to slow reimbursement and incomplete coverage for private health care (as only 80% of cost is reimbursed if referral is made to private facility when such facilities are not available with the CGHS).

Employee and State Insurance Scheme (ESIS)

The enactment of the Employees State Insurance Act in 1948 led to formulation of the Employees State Insurance Scheme. This scheme provides protection to employees against loss of wages due to inability to work due to sickness, maternity, disability and death due to employment injury. It offers medical and cash benefits, preventive and promotive care and health education. Medical care is also provided to employees and their family members without fee for service. Originally, the ESIS scheme covered all power-using non-seasonal factories employing 10 or more people. Later, it was extended to cover employees working in all non-power using factories with 20 or more persons. While persons working in mines and plantations, or an organization offering health benefits as good as or better than ESIS, are specifically excluded. Service establishments like shops, hotels, restaurants, cinema houses, road transport and news papers printing are now covered. The monthly wage limit for enrolment in the ESIS is Rs. 6 500, with a prepayment contribution in the form of a payroll tax of 1.75% by employees, 4.75% of employees' wages to be paid by the employers, and 12.5% of the total expenses are borne by the state governments. The number of beneficiaries is over 33 million spread over 620 ESI centres across states. Under the ESIS, there were 125 hospitals, 42 annexes and 1 450 dispensaries with over 23 000 beds facilities. The scheme is managed and financed by the Employees State Insurance Corporation (a public undertaking) through the state governments, with total expenditure of Rs 3 300 million or Rs 400/- per capita insured person.

The ESIS programme has attracted considerable criticism. A report based on patient surveys conducted in Gujarat *(Shariff, 1994 as quoted in Ellis R et a, 2000)* found that over half of those covered did not seek care from ESIS facilities. Unsatisfactory nature of ESIS services, low quality drugs, long waiting periods, impudent behaviour of personnel, lack of interest or low interest on part of employees and low awareness of ESI procedures, were some of the reasons cited.

Activity D:

1. Identify various schemes of health insurance in India?

17.4 Key Features of Health Insurance Policy

Key Features of a Health Insurance Policy

Over and above the basic benefit of health insurance (also called mediclaim) i.e. covering the unforeseen medical expenses, there are few other features and benefits in most of the products offered in the market.

Some of them are listed below:

Family Floater Policies: Most health insurance plans give the flexibility of covering up to 4 members of the family under the same plan with a slightly higher premium than an individual health insurance policy. It gives the flexibility of choosing say 4 or 5 lakhs of cover for the entire family. If one member in the family is hospitalized and uses about Rs. 2 lakhs for his treatment, then the rest 3 lakhs can be availed by others. It is very unlikely that more than 1 or 2 members would require hospitalisation in the same year. Hence the family floater serves the purpose whoever in the family falls ill.

Hospitalisation Cash Benefits: This benefit entitles the customer to cash benefits for every completed day of hospitalisation, which helps him to take care of the increased financial burden incurred at the time of hospitalisation, such as loss of earnings away from work and other expenses.

Cashless Facility: There is a network of hospitals tied up with each insurance company which accepts the insured's medical identity card (issued by the insurance company) for providing cashless facility to the insured. Hence either part or entire expenses are covered by the policy and the individual doesn't need to spend from his pocket.

Pre-hospitalisation and Post-hospitalisation Benefits: Some mediclaim policies provide for up to 60 to 90 days of pre-hospitalisation and post-hospitalisation benefits, i.e. the cost of medical tests, medicines, scans, etc. This is usually provided under maternity benefits and treatments which do not require hospitalisation.

Ambulance Charges: In most cases the ambulance charges are taken up by the policy and the policy holder usually doesn't have to bear the burden of the same.

Health Check Up: Some health insurance policies have a facility of free health check-up for the well being of the individual if there is no claim made for certain number of years.

Cover for Pre-existing Diseases: Some health insurance policies have a facility of covering pre-existing diseases after 3 or 4 years of continuously renewing the policy, i.e. if someone has diabetes, then after completion of 3 or 4 years of continuous renewal with the same insurer (depending on the plan offered and his age), any hospitalisation due to diabetes will also be covered.

No-Claim Bonus: Some health insurance policies provide a no-claim bonus. If there has been no claim in the previous year, i.e. if the person covered has not availed any hospitalisation benefit, then a bonus is declared; either by reducing the premium or by increasing the sum assured by a certain percentage of the existing premium.

Tax Benefits of taking a Health Insurance Policy: Under Section 80D of the Income Tax Act, income tax benefit is provided to the customer for the premium amount till a maximum of Rs. 15,000 for regular and Rs. 20,000 for senior citizen respectively.

17.5 Significance of Health Insurance

Benefits:

The following are the benefits offered under Health Insurance:

1. **Medical Expense Cover:** in which basic hospitalization expenses are reimbursed. It covers payment of expenses related with hospitalization and also for the services rendered by the doctor and the nursing home.
2. **Major Medical Expense Cover/ Long Term Care Insurance:** covers expenses related to major surgery or operations, due to serious illness or disease. Major medical coverage continues protection after basic medical expense insurance benefits have exhausted.

3. **Disability income cover:** is primarily aimed at providing for the lost income in the disability period or in the treatment period. It tries to replace the income that cannot be earned due to sickness of the assured. The benefit is usually paid as a percentage of the capital sum insured, and is paid weekly. It is basically an indirect protection to the insured. The period for such compensation is short.

Additional Benefits of Health Insurance

Apart from providing protection to the insured, health insurance provides benefits as a long term savings tool and reduces undue mental tension at the time of critical illness or disability. Taking this into consideration, the benefits of health insurance can be underlined as follows:

Savings Tool: people may prefer to save in various saving instruments than buying a health policy. But these savings involve a lot of time and may not be available at short notice and at the time of need.

Safe and Beneficial Instrument: A health insurance policy can be used as an accumulation plan. In addition to this, tax benefits are also available on the health policies, which increase its attractiveness as a saving tool.

Minimizes Worry: A health insurance policyholder need not worry about the medical expenses incurred or loss of income in case of disability. The health policy takes care of all this and thus reduces undue tension on the part of the individual and his family.

The notable ones among Health Insurance schemes are 'Mediclaim', 'Bhavishya Arogya', 'Personal Accident Insurance' and 'Senior citizens unit plan'.

Hence the importance of Health Insurance can never be undervalued for the following reasons:

- Provides security to human life which is of prime importance to any individual.
- Closely bonds Insurance Companies, Hospitals, Policyholders and TPAs together for the benefit of Indian masses.
- An answer to the solution of uncertainties and risks that are prevalent and ever-pervading in human life.
- Prevention and minimization of unforeseen losses.
- Access to quality healthcare.
- Means of savings and a safe investment option.
- Provides *financial stability* in life.
- A tax-saving instrument that significantly contributes in reduction of tax deductions.
- Reduces tensions and stress caused on account of hospitalization.
- Greatly contributes in leading a stress-free life.

Activity E:

1. "Apart from providing protection to the insured, health insurance provides benefits to the insured in many ways." Elaborate.

17.6 Process of Insurance Claim

Essential Guidelines for Availing Individual Health Insurance Policy:

The following points should be borne in mind while purchasing an individual health policy:

- **Understanding the Policy Coverage:** The policyholder should be able to clearly comprehend the extent of medical coverage being offered under the particular health insurance policy before opting for it. The individual should check whether pre-existing diseases and its resultant complications are covered or not, as well as the extent of the coverage under that particular policy.
- **Keeping an Eye for Medical Expenses That are Not Covered/Reimbursable Under the Policy:** Before availing a particular health insurance policy, the prospective policyholder should note the medical expenses not covered under that Insurance policy. It is important to note that deductibles are a part and parcel of any insurance coverage and the expenses incurred as part of the medical treatment need to be borne by the individual. Generally this list includes aprons, sterilization charges, gloves, Dettol, etc.
- **To Understand whether it is a Co-insurance Policy:** Before availing a health policy, the prospective customer should understand whether it is a co-insurance policy or not. It is advisable to get an individual health insurance policy with a co-insurance payment option. The maximum amount does not exceed 15% of the entire medical coverage for a particular disease.
- **Understanding and Updating Oneself about Expiry Period Regarding the Policy Cover:** An individual health insurance cover entails regular premium payments on a monthly, half yearly or annual basis before the expiry of a particular policy. Non-payment of premium within the stipulated time results in the lapsing of the policy with subsequent break in the policy coverage of the concerned individual. Even though the concerned individual holds policy with an Insurance company for many years together, a break in the policy coverage (which generally does not exceed more than 15 days) is treated as a ***fresh policy cover***.

  A health insurance policy is a contract between an insurance company and an individual or his sponsor (e.g. an employer). The contract can be renewable annually or monthly. The type and amount of health care costs that will be covered by the health insurance company are specified in advance, in the member contract or "Evidence of Coverage" booklet. The individual insured person's obligations may take several forms:

- **Premium:** The amount the policy-holder or his sponsor (e.g. an employer) pays to the health plan each month to purchase health coverage.
- **Deductible:** The amount that the insured must pay out-of-pocket before the health insurer pays its share. For example, a policy-holder might have to pay a $500 deductible per year, before any of their health care is covered by the health insurer. It may take several doctor's visits or prescription refills before the insured person reaches the deductible and the insurance company starts to pay for care.
- **Copayment:** The amount that the insured person must pay out of pocket before the health insurer pays for a particular visit or service. For example, an insured person might pay a $45 copayment for a doctor's visit, or to obtain a prescription. A copayment must be paid each time a particular service is obtained.

- **Coinsurance:** Instead of, or in addition to, paying a fixed amount up front (a copayment), the co-insurance is a percentage of the total cost that insured person may also pay. For example, the member might have to pay 20% of the cost of a surgery over and above a co-payment, while the insurance company pays the other 80%. If there is an upper limit on coinsurance, the policy-holder could end up owing very little, or a great deal, depending on the actual costs of the services they obtain.
- **Exclusions:** Not all services are covered. The insured person is generally expected to pay the full cost of non-covered services out of their own pocket.
- **Coverage Limits:** Some health insurance policies only pay for health care up to a certain dollar amount. The insured person may be expected to pay any charges in excess of the health plan's maximum payment for a specific service. In addition, some insurance company schemes have annual or lifetime coverage maximums. In these cases, the health plan will stop payment when they reach the benefit maximum, and the policy-holder must pay all remaining costs.
- **Out-of-pocket Maximums:** Similar to coverage limits, except that in this case, the insured person's payment obligation ends when they reach the out-of-pocket maximum, and the health company pays all further covered costs. Out-of-pocket maximums can be limited to a specific benefit category (such as prescription drugs) or can apply to all coverage provided during a specific benefit year.
- **Capitation:** An amount paid by an insurer to a health care provider, for which the provider agrees to treat all members of the insurer.
- **In-Network Provider:** (U.S. term) A health care provider on a list of providers preselected by the insurer. The insurer will offer discounted coinsurance or copayments, or additional benefits, to a plan member to see an in-network provider. Generally, providers in network are providers who have a contract with the insurer to accept rates further discounted from the "usual and customary" charges the insurer pays to out-of-network providers.
- **Prior Authorization:** A certification or authorization that an insurer provides prior to medical service occurring. Obtaining an authorization means that the insurer is obligated to pay for the service, assume it matches what was authorized. Many smaller, routine services do not require authorization.
- **Explanation of Benefits:** A document sent by an insurer to a patient explaining what was covered for a medical service, and how they arrived at the payment amount and patient responsibility amount.

Activity F:

1. Discuss essential guidelines for availing individual health insurance policy.

17.7 Major Differences

Health Plan vs. Health Insurance

Historically, HMOs tended to use the term "health plan", while commercial insurance companies used the term "health insurance". A health plan can also refer to a subscription-based medical care arrangement offered through HMOs, preferred provider organizations, or point of service plans. These plans are similar to pre-paid dental, pre-paid legal, and pre-paid vision plans. Pre-paid health plans typically pay for a fixed number of services (for instance, $300 in preventive care, a certain number of days of hospice care or care in a skilled nursing facility, a fixed number of home health visits, a fixed number of spinal manipulation charges, etc.) The services offered are usually at the discretion of a utilization review nurse who is often contracted through the managed care entity providing the subscription health plan. This determination may be made either prior to or after hospital admission (concurrent utilization review).

Comprehensive vs. Scheduled

Comprehensive health insurance pays a percentage of the cost of hospital and physician charges after a deductible (usually applies to hospital charges) or a co-pay (usually applies to physician charges, but may apply to some hospital services) is met by the insured. These plans are generally expensive because of the high potential benefit payout — \$1,000,000 to 5,000,000 is common — and because of the vast array of covered benefits.[10]

Scheduled health insurance plans are not meant to replace a traditional comprehensive health insurance plans and are more of a basic policy providing access to day-to-day health care such as going to the doctor or getting a prescription drug. In recent years, these plans have taken the name mini-med plans or association plans. These plans may provide benefits for hospitalization and surgical, but these benefits will be limited. Scheduled plans are not meant to be effective for catastrophic events. These plans cost much less than comprehensive health insurance. They generally pay limited benefits amounts directly to the service provider, and payments are based upon the plan's "schedule of benefits".

17.8 Self Assessment Questions

1. What is Health Insurance? Discuss health care system of our country.
2. Analyze major developments in health insurance in India.
3. Examine various categories of health insurance in India?
4. Identify various schemes of health insurance in India?
5. "Apart from providing protection to the insured, health insurance provides benefits to the insured in many ways." Elaborate.
6. Discuss various schemes offered by health insurance companies in India.
7. Write short note on cashless hospitalization.
8. Discuss essential guidelines for availing individual health insurance policy.
9. "Apart from providing protection to the insured, health insurance provides benefits to the insured in many ways." Elaborate.

17.9 Books for Further Readings

– Mathew M. J. (2009) 'Risk Management and Insurance'; R B S A Publisher 2009, Jaipur.

– ICFAI University, Management of financial institutions, 2004

– Bhat Ramesh & Mavlankar Dileep (2000), 'Health Insurance in India: Opportunities, Challenges and Concerns', Indian Institute of Management, Ahmedabad.

– Bhat Ramesh (1999), 'A note on policy initiatives to protect the poor from high medical costs', Indian Institute of Management, Ahmedabad.

Unit - 18 : Fire Insurance and Other Miscellaneous Insurance

Structure of Unit:

18.0 Objectives

After completing this unit, you would be able to:

- Understand the meaning of fire and fire insurance;
- Classify the different types of policies;
- Identify the scope of fire insurance policy;
- Know about various conditions laid down on fire insurance policies;
- Know what is double insurance, over and under insurance and reinsurance;
- Understand about various other miscellaneous insurance.

18.1 Introduction

The Fire Insurance Policy is available to cover any movable and immovable property having monetary value. The cover under the policy relates to the loss of or damage to insured property by specified perils. This is the 'material damage' policy, and is known as the standard fire policy. Damage by fire to property in manufacturing premises may result in total or partial stoppage of production leading to loss of profits. Such loss of profits can be covered under loss of profits (fire) insurance policy (also known as a fire consequential loss policy).

18.2 What is Fire Insurance?

Definition

Fire insurance is a contract to indemnity, to the insured for destruction of or damage to property caused by fire. The insurer undertakes to indemnify the insured against loss due fire caused to the property insured against, not in excess of the maximum amount stated in the policy. A contract of fire insurance is essentially a contract of indemnity, and not against accident, but against loss caused by fire. For example, if a person has insured his house of Rs. 1.00 lakh against loss by fire, the insurer is not liable to pay the sum, unless the house is destroyed by fire, but actual loss subject to the maximum limit of Rs. 1.00 lakh.

Section 2(6) of the Fire Insurance Act, defines, "Fire insurance business means the business of affecting, otherwise than in evidently, to some other class of business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire insurance policies."

A fire insurance is a contract under which the insurer in return for a consideration (premium) agrees to indemnify the insured for the financial loss which the latter may suffer due to destruction of or damage to property or goods, caused by fire, during a specified period. The contract specifies the maximum amount, agreed to by the parties at the time of the contract, which the insured can claim in case of loss. This amount is not, however, the measure of the loss. The loss can be ascertained only after the fire has occurred. The insurer is liable to make good the actual amount of loss not exceeding the maximum amount fixed under the policy.

A fire insurance policy cannot be assigned without the permission of the insurer because the insured must have insurable interest in the property at the time of contract as well as at the time of loss. The insurable interest in goods may arise out on account of (i) ownership, (ii) possession, or (iii) contract. A person with a limited interest in a property or goods may insure them to cover not only his own interest but also the interest of others in them. Under fire insurance, the following persons have insurable interest in the subject matter:-

- Owner
- Mortgagee
- Pawnee
- Pawn broker
- Official receiver or assignee in insolvency proceedings
- Warehouse keeper in the goods of customer
- A person in lawful possession e.g. common carrier, commission agent.

The term 'fire' is used in its popular and literal sense and means a fire which has 'broken bounds'. 'Fire' which is used for domestic or manufacturing purposes is not fire as long as it is confined within usual limits. In the fire insurance policy, 'Fire' means the production of light and heat by combustion or burning. Thus, fire, must result from actual ignition and the resulting loss must be proximately caused by such ignition. The phrase 'loss or damage by fire' also includes the loss or damage caused by efforts to extinguish fire.

Activity A:

1. According to you what do you mean by fire insurance?

Characteristics of Fire Insurance

1. **Fire Insurance is a Contract of Indemnity:** The insurer is liable only to the extent of the actual loss suffered. If there is no loss there is no liability even if there is a fire.

2. **Fire Insurance is a Contract of Good Faith:** The policy-holder and the insurer must disclose all the material facts known to them.

3. **Fire Insurance Policy is Usually Made for One Year Only:** The policy can be renewed according to the terms of the policy.

4. **The Contract of Insurance is Embodied in a Policy Called the Fire Policy:** Such policies usually cover specific properties for a specified period.

5. **Insurable Interest:** A fire policy is valid only if the policy-holder has an insurable interest in the property covered. Such interest must exist at the time when the loss occurs. In English cases it has been held that the following persons have insurable interest for the purposes of fire insurance-owner; tenants, including carriers; mortgages and charge-holders.

6. **In Case of Several Policies for the Same Property, Each Insurer is Entitled to Contribution From the Others:** After a loss occurs and payment is made, the insurer is subrogated to the rights and interests of the policy-holder. An insurer can reinsure a part of the risk.

7. **Fire Policies Cover Losses Caused Proximately by Fire:** The term loss by fire is interpreted liberally. Example: A women hid her jewellery under the coal in her fireplace. Later on she forgot about the jewellery and lit the fire. The jewellery was damaged. Held, she could recover under the fire policy.

8. **Nothing Can Be Recovered Under a Fire Policy:** if the fire is caused by a *deliberate act* of policy-holder. In such cases the policy-holder is liable to criminal prosecution.

9. **Fire Policies Generally Contain a Condition:** that the insurer will not be liable if the fire is caused by riot, civil disturbances, war and explosions. In the absence of any specific expectation the insurer is liable for all losses caused by fire, whatever may be the causes of the fire.

10. **Assignment:** According to English law a policy of fire insurance can be assigned only with the consent of the insurer. In India such consent is not necessary and the policy can be assigned as a chose-in-action under the Transfer of Property Act. The insurer is bound when notice is given to him. But the assignee cannot be recovering damages unless he has an insurable interest in the property at the time when the loss occurs. A stranger cannot sue on a fire policy.

11. **Payment of Claims:** Fire policies generally contain a clause providing that upon the occurrence of fire the insurer shall be immediately notified so that the insurer can take steps to salvage the remainder of the property and can also determine the extent of the loss. Insurance companies keep experts on their staff of value the loss. If in a policy there is an international over valuation of the property by the policy-holder, the policy may be avoided on the ground of fraud.

Meaning of Fire

The term fire in a Fire Insurance Policy is interpreted in the literal and popular sense. There is fire when something burns. In English cases it has been held that there is no fire unless there is ignition. Stanley v. Western Insurance Co. Fire produces heat and light but either o them alone is not fire. Lighting is not fire. But if lighting ignites something, the damage may be covered by a fire-policy. The same is the case with electricity. Therefore, fire which is used for ordinary domestic purposes or even for manufacturing is not fire. 'Fire' in fire insurance must have the following two features:

1. Production of Light and Heat

According to Justice Boyles "Fire means the production of light and heat by combustion and unless there is actual ignition, there is no fire within the meaning of the term in ordinary policy."

Loss Caused by Fire: Heating unaccompanied by ignition is not fire. 'Loss or damage' occasioned by fire means loss or damage either by ignition of the articles consumed, or by ignition of that part of the premises, where the article is. In one case there is loss, in the other case, a damage occasioned by fire. Thus, it can be stated that no claim is possible without flame. The losses by the following instances or losses subsidiary to fire are as follows:

1. Damage which occurs as a result of smoke or of putting out the fire would be covered by the fire risks.

2. Any loss resulting from apparently necessary and bonafide efforts to put out a fire, whether it be by

spoiling goods by water, or throwing articles of furniture out of the window, are covered by the fire risks.

3. Even by damages to a neighboring house by explosion done for the purpose of arresting fire, would be covered by the fire risks.
4. Every loss directly, or if not directly at least consequently resulting from the fire is within the policy.
5. Loss by theft during a fire is covered as a fire risk.
6. Even loss by fire caused by the insured's negligence is covered by the policy.
7. Any loss occurred while putting out the fire.

2. Fire by Accident

In the case of fire insurance, the occurrence of fire is accidental, and then only it is covered by the policy. In case the fire is the deliberate act of the insured, the insurer is not liable to compensate. The fire which is used for ordinary domestic purposes, or even for manufacturing, is not fire, as long as it is confined within the usual or proper limits. Thus, fire by accident means the production of light and heat by combustion and with actual ignition and heating unaccompanied by ignition is not fire.

Activity B:

1. What do you mean by fire? Explain various characteristics of fire insurance.

18.3 Significance of Fire Insurance

Fire insurance provides the security for home, stock, furniture, business buildings, etc,. Fire insurance provides the cost of replacement of properties and assets, which gets damaged due to the fire accident.

Fire insurance provides the benefits for the home owner in these ways

1. It provides the cost of damage for the building
2. It provides the replacement cost, if any furniture is destroyed due to the fire accident, like plywood furniture, carpets, clothes.
3. It provides replacement or repair cost for the electronic items, which is damaged due to fire, like television, computer, air coolers.

Fire insurance provides benefits to the business in the following ways

1. It covers the cost of stock damaged due to the fire
2. It provides the death benefits to employee, in case of death occurred due to the fire accident.
3. It provides the replacement or repair cost for the machines, if they get damaged due to fire accident.
4. It provides the medical expenses for the employees, if they get injured due to the fire accident.

Fire accidents are very much unexpected but are heavily destructive. Hence, having a fire insurance is very much essential.

The industry, trade and commercial articles have been developing and diversifying at faster rate in India. Along with the growth of industrial and commercial articles the infrastructural fields like transport, communication, finance, advertising, stock marketing, etc., have also been developing continuously so as to cope with the pace of economic development. The importance of foreign trade also has been very much for a developing country like India. All these developments in various fields brought in much risks and uncertainties in business activities. Insurance is the only field that provides security, against business risks. The role of fire insurance has been increasing day by day as a means against destruction or damage of business property caused by fire. The significance of fire insurance can be discussed under the following points:

- As a source for minimizing losses
- Decreases in probabilities of fire losses
- Increase in production of fire proof materials
- Decrease in social loss of fire
- Asset valuation
- Loss preventing efforts and advice by the insurer
- Helpful in business progress
- Beneficial for new industries
- Credit facility
- Distribution of risks

Activity C:

1. Discuss the significance of getting fire insurance policy.

18.4 Scope of Fire Insurance

The scope of fire insurance is much wider. This can be understood from Section 2 of Indian Insurance Act, 1938. According to this provision, the scope of fire insurance involves the following types of risks:

a. The Risks Directly Involved By Fire.

b. The Risks Indirectly Involved.

For the convenience of study, the scope of fire insurance can be classified on the following basis:

I. Ordinary Scope,

II. Special Scope, and

III. Comprehensive Scope

I. Ordinary Scope

Before May, 2000 three types of fire insurance policies (A, B and C) were issued in India. Therefore, the scope of fire insurance policies is classified on this criteria. After May, 2000, only single type of fire insurance policy is issued in India by fire insurance companies, which is known as "Standard and Special Peril Policy." The policy covers the following types of perils:

1. Loss caused by fire
2. Lightening
3. Explosion/ implosion
4. Aircraft damage
5. Riot strike, malicious and terrorism
6. Storm, cyclone, typhoon, tempest, hurricane, tornado, flood and inundation

7. Impact damage
8. Subsidence and landslide including rock slide
9. Bursting or overflowing of water tanks, apparatus and pipes
10. Missile testing operations
11. Leakage from automatic sprinkler installations
12. Bush fire

II. Special Scope

Certain special kind of risks are also included in the fire policy. By paying extra premium, the insured can include such special risks as given below within the scope of fire insurance policy:

1. The fees paid to the architect, surveyor or consultant engineer, if such fees exceed more than 3 percent of the claim money.
2. The expenses incurred in connection with removal of wastages from the construction site, if that amount exceeds more than 1 percent of the claim money.
3. Loss to the goods kept in the cold storage due to fluctuations in electricity/ power but within the causes stated in the policy.
4. Loss arising out of earthquake, fire or combustion.
5. Forest fire.
6. Loss due to falling the goods from fork lifts, or from own vehicle of the insured, etc.
7. Loss due to spontaneous combustion.

III. Comprehensive Scope

Almost all the insurable risks are included in the comprehensive scope of fire insurance. It includes not only the ordinary and direct risks, but also the consequential losses. This way the following risks are included within the comprehensive scope:

1. Risks of standard policies.
2. Special risks which can be insured by paying extra rate of premium.
3. Excluded perils in the standard policy.
4. Consequential losses or risks arising consequent to fire.

Activity D:

1. Throw some light on the scope of fire insurance policy.

18.5 Types of Policies

1. Average Policies: It is a policy containing average clause. If refers that if a person insures his property for an amount lesser than its value, the insurer is not bound to indemnify for the total loss of the property, even if the claim is not more than the sum insured by the policy. This way, the insurer shall be liable to pay in proportion to the actual loss, in which proportion the policy amount and the real value of subject matter exists.

Features of Average Policies

1) This policy contains 'Average Clause'.
2) The sum insured under this policy shall be lesser than the market value of the property insured.
3) The insurer shall be liable to compensate the loss in proportion of the policy amount with the market value of the subject matter when the even took place.
4) The insured is benefited where the market value of the insured property declines.

2. Valued Policies: In case of valued policy, the property is valued by expert valuers at the time of affecting the policy and the insurer agrees to pay the insured sum on occurrence of fire irrespective of the loss. This amount can be either less or more than the actual loss. Here in this case the contract is not an indemnity. The valued policy is also known as 'insured policy'.

Features of Valued Policies

1) Valuation of the risk is made at the time of affecting policy.
2) The amount of claim has nothing to do with actual loss.
3) The insured is benefited when the market value of the property declines, but suffers loss when the market value appreciates.
4) It becomes easier to evaluate the loss at the time of fire.
5) Such policy is issued on very rare cases where the valuation becomes difficult at the time of fire.

3. Specific Policies: It is a policy under which the property is insured for a fixed or a specified sum without taking into account the actual value of the property. The sum assured shall be usually less than the actual value of the insured property. The insurer's liability under this policy arises only when the loss reaches to the extent of certain specified sum. However, the insurer shall not be liable for indemnity more than the policy money.

Features

1) This policy is insured for a specific fixed sum.
2) In case of loss by fire, the insurer is liable to the extent of this specific sum.
3) The policy sum is usually less than the actual value of the property.

4. Replacement Policies: This is a policy in which a clause is inserted in the policy under which the insured can recover not the value of the buildings or the plant as depreciated, but the cost of replacement of the property destroyed by new property of the same kind or the insurer may reinstate the property instead of paying in cash. In both the cases we have the example of "New lamps for old."

Features

1) The market value of the insured property is not calculated for indemnity, only the value of the replacement value is ascertained.
2) In the case of repairing also, no change in the size or quality of the insured property is made.
3) Since it involved moral hazards, this policy is issued only to reputed companies.

5. Floating Policies: Floating policies can be issued for stocks to take care of frequent changes in sum insured at various locations. For example, some of the goods of other trader are kept in one godown, and few kept in another godown, some are kept in the railway godown or some at the sea port open. This way, for the goods kept at different places, a floating fire insurance policy can be obtained by such a trader to cover the risk of goods lying at different places under one policy.

6. Declaration Policies: To take care of frequent fluctuations in stocks this policy is issued. At the time of affecting the policy, it is estimated that how much of the goods are to be covered by risk during the tenure of policy. On the basis of this estimate insurance is affected on maximum value of goods. The insurer shall be liable upto this limit only. The minimum sum insured under this policy shall be Rs. 1 crore.

At the beginning, the insurer charges three-fourth of the premium fixed on the basis of maximum value of stocks. Thereafter, the insured declares after certain time interval the value of his actual stock. In the case of loss by fire, indemnity is calculated on the basis of value of the goods declared by the insured, in the above manner.

Activity E:

1. Write short notes on:

   a. Floating Policies
   b. Average Policies
   c. Specific Policies
   d. Replacement

18.6 Conditions on Fire Insurance Policies

I. General Exclusions

This policy does not cover:

1) 5 percent of each and every claim resulting from the operation of Act of God Perils covered under the policy.
2) Damage caused by war, invasion, act of foreign enemy hostilities, civil war, rebellion, revolution, insurrection or military or usurped power.
3) Loss, destruction of damage directly or indirectly caused to the property insured:
   a) Ionizing radiations or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel;
   b) The radioactive toxic, explosives or other hazardous properties of any explosive nuclear assembly or nuclear component thereof.
4) Loss, destruction or damage caused to the insured property by pollution or contamination.
5) Property which at the time of happening of loss, destruction or damage is insured by or would, but for the existence of this policy, be insured by any Marine Policy or policies except in respect of any excess beyond the amount which would have been payable under the Marine policy had this insurance not been affected.
6) Loss, destruction or damage to the stocks in cold storage premises caused by change of temperature.
7) Loss or damage to any electrical and electronic machine, apparatus, fixture or fitting arising from or occasioned by over running, excessive pressure, short circuiting, arcing, self heating or leakage of electricity, from whatever cause.
8) Consequential loss of any kind other than smoke and water damage following an operation of insured peril covered under the policy.

II. General Conditions

1) **Policy Voidable:** This policy shall be voidable in the event of misrepresentation, mis description or non disclosure of material facts.

2) **Alteration:** This policy shall be avoided with respect to any of the property insured in regard to which there be any alteration after the commencement of the insurance:

   a) By removal; or

   b) Whereby risk or damage is increased; or

   c) Whereby the interest of the insured ceases except by will or operation of law unless admitted by the insurer in writing.

3) **Fall or Displacement:** On expiry of seven days from the date of fall or displacement of any building or part thereof or of any structure of which such building forms part, the insurance under this policy in respect of such building shall cease unless agreed to by the insurer.

4) **Warranties:** Every warranty to which this policy or any item thereof is or may be made subject shall, from the time the warranty attaches, apply and continue to be in force during the whole currency of this policy. Noncompliance with any such warranty in so far as it increases the risk of damage shall be a bar to any claim in respect of such damage provided that whenever this policy is renewed a claim in respect of damage occurring during the renewal period shall not be barred by reason of a warranty not having been complied with at any time before the commencement of such period.

5) **Reasonable Precautions:** The insured shall take all reasonable precautions to prevent damage.

6) **Cancellation:** This insurance may be terminated at any time at the request of the insured, in which case the company will retain the customary short period rates for the time the policy has been in force. This insurance may also at any time be terminated at the option of the company, on 30 days notice to that effect being given to the insured, in which case the company shall be liable to repay on demand a proportion of the premium for the unexpired term from the date of the cancellation.

III. Claims Conditions

Action by the Insured

a) In the event of damage the insured shall

   i) Notify the insurer immediately;
   ii) Notify the Police Authority immediately if it becomes evident that such damage has been caused by malicious persons;
   iii) Carry out and permit to be taken any action which may be reasonably practicable to prevent further damage;
   iv) Not abandon any property to the insurer whether taken possession by the insurer or not;

b) No claim under this policy shall be payable unless the terms of this condition have been complied with.

   1) Condition of Average (Under Insurance): The sum insured declared under the policy or each item thereof should separately be subject to average.

   2) Fraud: If a claim is fraudulent in any respect or if fraudulent means are used by the insured or by any one acting on his behalf to obtain any benefit under this policy or if any damage is caused by the willful act or with the connivance of the insured all benefits under this policy shall be forfeited.

3) Reinstatement: If any property is to be reinstated or replaced by the insurer the insured shall at his own expenses provide all such plans, documents, books and information as may reasonably be required. The insurer shall not be bound to reinstate exactly but only as circumstances permit and in a reasonably sufficient manner and shall not in any case be bound to expend in respect of any one of the items insured more than its sum insured.

4) Insurer's Right Following a Claim: On the happening of damage in respect of which a claim is made, the insurer and any person authorized by the insurer may without thereby incurring any liability or diminishing any of the insurer's right under this policy:

i) Shall have the opportunity of inspecting the loss or damage;

ii) Take possession of such property insured; and

iii) Deal with such property for all reasonable purposes.

5) Reinstatement of Sum Insured after a Loss: Upon the settlement of any loss under this policy, pro rata premium for the amount of such loss shall be payable by the insured to the company for the unexpired period from the date of suchloss.

6) Contribution: If at the time of any damage there is any other insurance affected by or on behalf of the insured covering any of the property lost destroyed or damaged, the liability of the insurer here under shall be limited to its ratable proportion of such damage.

7) Subrogation: Any claimant under this policy shall be at the request and expense of the insurer take and permit to be taken all necessary steps for enforcing rights against any other party in the name of the insured before or after any payment is made by the insurer.

8) Arbitration: if any dispute or difference shall arise as to the quantum to be paid under the policy such difference shall independently of all other questions be referred to the decision of a sole arbitrator to be appointed in writing by the parties to or if they cannot agree upon a single arbitrator within 30 days of any party invoking arbitration, the same shall be referred to a panel of three arbitrators.

18.7 Various Kinds of Insurance

Double Insurance

Situation in which the same risk is insured by two overlapping but independent insurance policies is known as Double insurance. It is lawful to obtain double insurance, and the insured can make claim to both insurers in the event of a loss because both are liable under their respective polices. The insured, however, cannot profit (recover more than the loss suffered) from this arrangement because the insurers are law bound only to share the actual loss in the same proportion they share the total premium. Also called dual insurance.

Double insurance denotes insurance of same subject matter with two different companies or with the same company under two different policies. Double insurance is possible in case of indemnity contract like fire, marine and property insurance. Double insurance policy is adopted where the financial position of the insurer is doubtful. The following are some of the broad features of double insurance:

- Insurance on the subject matter is effected with two or more insurance companies.
- A person may get two or more policies and can claim the amount of all these policies.

- In case of life insurance, more than one policy can be effected and the amount of all these policies can be claimed on all these policies at the time of death.
- The insured cannot recover more than the actual loss.

Underinsurance

Refers to insuring assets for less than their real value. While this will bring down your premiums, you are only insuring your vehicle for a percentage of its value. This means that you will only ever be paid out that percentage – on every claim.

For example, if your car is worth R100,000 and you cover it for R80,000 you are only insuring your car for 80% of its value. If you claim accidental damages to the amount of R5,000 (although covered in the R80,000), you will only be paid out R4,000 or 80% of the R5,000 (R5,000 x R80,000 ÷ R100,000 = R4,000). While the difference may not be a lot of money on a claim R5,000, if the car is stolen, you'll be responsible for the R20,000 difference if you want to replace the vehicle. It makes sense then to insure for replacement value instead of saving every month.

Over-insurance

To prevent the above from happening and earn yourself a couple of extra thousand rand in the event of your car being stolen, you over-insure. This will cost you more each month, but you rationalise that it's worth it.

For example, if your car is worth R100,000, you cover it for R120,000 hoping to receive an extra R20,000 when claiming. But you don't. Your insurer will only ever pay out the maximum market value of the car and never more. This means you've insuring an extra R20,000 of imagined value which doesn't even help to cover your excess when claiming. It's a waste of money.??

Reinsurance

Reinsurance is insurance that is purchased by an insurance company (*insurer* also sometimes called a "cedant" or "cedent") from another insurance company (*reinsurer*) as a means of risk management. The *reinsurer* and the *insurer* enter into a **reinsurance agreement** which details the conditions upon which the *reinsurer* would pay the *insurer's* losses (in terms of *excess of loss* or *proportional to loss*). The *reinsurer* is paid a **reinsurance premium** by the *insurer*, and the *insurer* issues insurance policies to its own policyholders. The main reason for insurers to buy reinsurance is to transfer risk from the *insurer* to the *reinsurer*, but reinsurance has various other functions as explained below.

For example, assume an *insurer* sells one thousand policies, each with a $1 million policy limit. Theoretically, the *insurer* could lose $1 million on each policy – totalling up to $1 billion. It may be better to pass some risk to a reinsurance company (*reinsurer*) as this will reduce the *insurer*'s exposure to risk.

There are two basic methods of reinsurance:

1. **Facultative Reinsurance:** In facultative reinsurance, the ceding company cedes and the reinsurer assumes all or part of the risk assumed by a particular specified insurance policy. Facultative reinsurance is negotiated separately for each insurance contract that is reinsured. Facultative reinsurance normally is purchased by ceding companies for individual risks not covered by their reinsurance treaties, for amounts in excess of the monetary limits of their reinsurance treaties and for unusual risks. Underwriting expenses and, in particular, personnel costs, are higher relative to premiums written on facultative business because each risk is individually underwritten and administered. The ability to separately evaluate each risk reinsured, however, increases the probability that the underwriter can price the contract to more accurately reflect the risks involved.

2. **Treaty Reinsurance:** It is a method of reinsurance in which the *insurer* and the *reinsurer* formulate and execute a **reinsurance contract**. The *reinsurer* then covers all the insurance policies coming within the scope of that contract. The reinsurance contract may oblige the reinsurer to accept reinsurance of all contracts within the scope (known as "obligatory" reinsurance), or it may require the insurer to give the reinsurer the option to reinsure each such contract (known as "facultative-obligatory" or "fac oblig" reinsurance).

There are two basic methods of treaty reinsurance:

- Quota Share Treaty Reinsurance, and
- Excess of Loss Treaty Reinsurance.

Three principles of reinsurance are as follows:

- **Principle of Utmost Good Faith:** Reinsurers maintain utmost faith in underwriters of their company. These underwriters in turn maintain utmost good faith in the underwriters of the primary insurance company.
- **Principle of Indemnity**: The principles of indemnity of the insured risk apply automatically on reinsurance. A reinsurer automatically follows the legal and technical future of the Reinsured in writing and underwriting a risk. Indemnity limit in reinsurance can be more than the sums insured in there are additional legal expenses against the insurer that are incurred while contesting a claim. If the reinsurer's indemnity limit is in foreign currency transactions, it is affected by foreign currency exchange rate fluctuations.
- **No Reinsurance Without Retention:** The insurer must retain a part of the Risk before reinsuring. Though there cannot be reinsurance of the complete risk, there can be complete retention of a risk Those risks that are within the retention capacity of an insurer must be retained completely.

Activity F:

1. Differentiate between double and reinsurance.

18.8 Other Miscellaneous Insurance

All insurances which do not fall under the categories of life insurance, fire insurance and marine insurance are covered under the category of accident insurance. Several of these insurances have no relation with an accident, and hence this branch of insurance is now more appropriately referred to as miscellaneous insurance.

Miscellaneous insurance covers several classes of insurance, important classes listed below being:

- Motor Insurance
- Burglary Insurance
- Engineering Insurance
- Cattle Insurance
- Crop Insurance
- Aviation Insurance
- Personal Accident Insurance

The method of computing premium amount in respect of miscellaneous insurance policies has been a subject of much discussion, as no single method has been found to apply to all policies because of a variety of risks underwritten.

Motor Insurance

Motor insurance is one of the widely known classes of miscellaneous insurance. This class of insurance has two major aspects. One is the loss of or damage to the motor vehicle, to third parties for the bodily injuries sustained by them or for damage to their property. The insurance of the loss of or damage to the motor vehicles is not compulsory, and it is for the individual vehicle owner to decide whether or not to insure the same.

Burglary Insurance

This insurance is useful to manufacturers and traders in respect of their trading stocks, furniture, fixtures, etc. and to households in respect of general household goods and personal effects. This business is not tariffed. However, in those cases where combined fire and burglary insurance policies are issued, fire insurance tariff rates have to be followed for granting cover for the fire portion of the risk.

Engineering Insurance

Engineering Insurance comprises the following broad types namely boiler explosion insurance, machinery breakdown insurance, erection insurance, marine-cum-erection insurance, contractor's all risks insurance.

Cattle Insurance

This insurance provides cover against death of animals within the geographical area specified in the policy arising from any disease or accident contracted or occurring after the commencement of the insurer's liability under the policy.

Crop Insurance

The General Insurance Corporation of India had introduced crop insurance schemes in certain states on the basis that the states concerned shall participate in these schemes as co-insurers sharing claims as well as premium to the extent of at least 25 percent, and that the concerned states shall provide all necessary technical and administrative assistance.

The cover under crop insurance is against unavoidable loss of production due to or arising as a result of one or more of the following causes:

- Climatic reasons such as drought, flood, frost and cyclone
- Pest infestation
- Plant diseases and
- Riot and strikes
- Was and kindred risks are excluded.

Aviation Insurance

Besides the classes of miscellaneous insurance described above, aviation insurance is also an important class. However, in view of the large premium and the technicalities involved, the business of this class is generally handled separately and not as a part of miscellaneous insurance department. In India, bulk of this business is handled from the office of the General Insurance Corporation of India, and the offices of the subsidiary companies handle a very small portion of this business.

Personal Accident Insurance

This class of insurance provides monetary compensation for death or disablement arising out of accidents, and for disablement arising out of sickness. Death arising out of sickness is not covered under this class.

The insurance policies are not contracts of strict indemnity, but this does not mean that the insured under these policies can make profit out of a loss.

18.9 Self Assessment Questions

1. What do you mean by Fire insurance? Describe its nature and scope.
2. Explain the meaning of 'fire' in fire insurance. Distinguish between fire insurance and life insurance.
3. Describe the conditions attached with the fire insurance policies.
4. Differentiate between over and under insurance.
5. Describe various miscellaneous insurance policies.
6. Write short notes on:
   a) Average policies
   b) Adjustable policies
   c) Floating policies
   d) Valued policies

18.10 Books for Further Readings

- Mathew M. J. (2009) 'Risk Management and Insurance'; R B S A Publisher 2009, Jaipur.
- ICFAI University, Management of financial institutions, 2004