MADURAI KAMARAJ UNIVERSITY

(University with Potential for Excellence)

DISTANCE EDUCATION

M.Com. (COMMERCE)

First Year

PAPER - III

BANKING AND INSURANCE

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BANKING AND INSURANCE
SYLLABUS

UNIT 1 : Origin and growth of Commercial Banks - Branch Banking - Unit Banking - Structure and Organisation of Commercial banking - Commercial banks and economic development.

UNIT 2 : Nationalisation of Commercial Banks in India - Objectives, Achievements - Branch Expansion - Deposit mobilisation - Credit disbusements for development.

UNIT 3 : Changing role of commercial Banks - Advances to priority sector - lending to agriculture - credit to small scale industries - Export credit - Assistance to weaker section.

UNIT 4 : New Services of banks - Merchant Banking - Credit Cards - Mutual Fund - Factoring.

UNIT 5 : Problems of Indian Commercial Banks - Poor capital base - Financial problem - Social problem - Organisation problem - Managerial problem - Political problem.

UNIT 6 : Definition and nature of insurance - Evolution of Insurance - functions of insurance - Role and importance of Insurance - Classification of insurance - Insurance Contract.

UNIT 7 : Life insurance - Nature of life insurance contract - Classification of policies - surrender value - policy condition - settlement of claims.

UNIT 8 : Marine insurance - nature of marine insurance contract - Marine insurance policies - Policy conditions - marine losses - payment of claims.

UNIT 9 : Fire insurance - Fire insurance contract - Kinds of Policies - Policy conditions - payment of claims - Re-insurance.

UNIT 10 : Privatisation of insurance - Impact of Privatisation - Life Insurance corporation of India Vs. Private participants - General insurance Corporation of India Vs. Private participants.

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INTRODUCTION

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There has been a remarkable change in the policies and objectives of banks in India Since nationalisation. They have come out of them traditional business of banking and diversified their activities into various other fields of operation Insurance business is not only commercial but it has become professional now. Knowledge of Insurance is as much essential as trading business for the Society keeping the above objectives in mind, most of the Universities all over the country have incorporate a paper in 'Banking and Insurance' in the course curriculum of their Distance Learning Programmes. The Book has Several features. These include the following :

- The subject matter has been divided into convenient units, as required by the course curriculum.
- Written in simple and straight style.
- Gives a lucid explanation of the basic concepts of accounting and finance with plenty of illustrative material.
- The book does not presuppose the basic knowledge of accountancy and finance and hence makes learning of both accounting and finance for managers a painless exercise.
- Incorporates at the end of each unit :
  - Objective type questions with short answers to enable the students to test their understanding;
  - Essay type questions for review, discussion and practice;
  - Practical problems with short answers for practice to develop a sense of confidence amongst the readers.
- Provides unit objectives at the beginning of each unit to tell the students what they will learn after studying the unit.
- Defines key terms at the end of each unit for recapitulation and better grasp over the subject.
- Will prove a refreshing guide for business executives.

We are confident that with all these PLUS features the readers will find the book extremely useful and rewarding for them. Their constructive and helpful suggestions for improvement in the book will, be gratefully acknowledged.

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UNIT 1 ORIGIN AND GROWTH OF COMMERCIAL BANKS

Structure

1.0 INTRODUCTION

Banking in its most simple form is as old as history. As early as 2,000 B.C. Babylonians had developed a system of banks in ancient Greece and Rome the practice of granting credit was widely prevalent. In Rome, the bankers were called Carpentaria, men sari or collybistoe. The banks were called Tuberose Carpentaria. Some of the banks carried business on their own account and others were appointed by the governmenc to receive the taxes.

During the early periods, though banking business was mostly done by private individuals, many countries established public banks either for the purpose of facilitating commerce or to serve the government. The bank of Venice established in 1158 is supposed to be the most ancient bank. Originally, it was not a bank in the modern sense, being simply an office for the transfer of public debt.

History shows the existence of a 'Monte' in Florence in 1336. ; Monte is a standing bank or amount of money found in cities of Italy.

As early as 1349, the business of banking was carried on by the drapers of Barcelona. It was subject to official regulation.

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The drapers were not allowed to commerce their business until they had given sufficient security. During 1401, a public bank was established in Barcelona. It is used to exchange money, receive notes, and discount bills of exchange both for citizens and foreigners. During 1407m the bank of Genoa was established. The bank of Amsterdam was established in 1609 to meet the needs of the merchants of the city. It accepted all kinds of deposits. These deposits could be withdrawn on demand or transferred from the account of one person to another. The bank also adopted a plan by which as depositor received a kind of certificate entitling him withdrawn his deposit within six months.

These written orders in course of time came to be used in the same manner as the modern cheques. Most of the European banks now in existence were formed on the model of Amsterdam.

1.1 UNIT OBJECTIVES

They used to transact their business on similar lines as those of the modern bankers. People used settle their accounts with their creditors by giving a cheque or draft on the bank. If the creditor had also an account at the same bank, the account was settled by an order to make the transfer of such money from one name to another. Payment of money by a draft was known as 'prescribe' and 'describer'. The draft was known as 'attribution'. These bankers also receive the deposits and money. Loan banks were also common in Rome. From these loan banks, the poor citizens received loans without paying interest. They lent money for a period of three to four years on the security of land.

1.2 NEED FOR COMMERCIAL BANKS

Banking in modern times is indispensable for economic progress. It serves community in numerous ways. It comes to the timely rescue in times of need of the businessmen by supplying them funds in sufficient amount to carry on the business operations. The banking system of today supplies the community with the exchange medium by creating credit. The commercial banks receive the surplus funds of the community by way of deposits of funds and passed on the most productive channels. In short, it acts as a fruitful agency through which the borrowers or users of the credit obtain access to the quantity of credit required by then. In recent days, there is severe criticism against the commercial banks that they have so far gone to help more the rich, than the needy poor and the unorganized sector.

1.3 GROWTH OF COMMERCIAL BANKS

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From times immemorial, the banker has been an inseparable pillar of Indian society. He may have been missing, in the good old days, when self sufficiency was the law of the land. The introduction of the division of labour brought in its matter of exchange. Money economy in its turn could not do without the institution of banking for any considerable time.

India was not a stranger to the conception of banking. Loans and usury were well understood in those days, and Rashes occasionally lament, the state of indebtedness with the simplicity to primitive times. Reference is often made to debts contracted at closing. To pay off a debt was called Ram San-m. Illusions are also made to debts contracted without intention of payment. This shows that the giving and taking of credit in one form or other must have existed as early as the Vedic period. Sir Richard Temple justifies to the fact, that banking business was carried on in ancient India. Dr.Pramath Nath Banerjee, in his books public administration in ancient India, quotes from Gautama, Brihaspati and Budhayana, verses regarding the regulation of interest. Reference is also made to the same in Kautilyas Arthashashtra.

In recent years, the history of banking has started to receive attention, thanks to research workers in this field, to give any detailed description of the banking system, which served this country before the advent of the modern economy. However, banking in those days must have meant largely money lending, financing kings and their wars, though certain rudiments of modern banking functions were not unknown to the then bankers.

Bankers in India have always been regarded as very important members of the community in government as well as social circles. The banker's assistance was m, ore or less indispensable in this connection. Even in other financial matters of state, he was frequently consulted. In the unsettled days of civil wars, when insecurity was so pronounced a feature of the times, the banker was almost the only seller in money matters. He was the only reliable agency for the deposit of jewellery, cash and hoarding in other forms; as was the case with goldsmiths in England in 17th century. State official had not much reputation in this respect. The Indian banker, however, was highly esteemed and regarded as worthy specimen of commercial morality. The time honoured adage; *"No salvation except through the preceptor; no credit except through the money lenders"*, is significant in this respect.

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Even in modern times, bills of exchanges are generally for the collection of debts. Although probably strainers to the paper money, the Hindus has been accustomed to use of the Hindi form. Among them the banking business was confined to the issue and discount of bills of exchange, money lending and money changing. Very often, banking business was carried on along with dealing in grains, cloth etc., or with agency business. The transfer of funds from one place to another at a fair distance took place with the help of the hundis. Bankers lent money against personal as well as other securities, such as ornaments, goods and immovable property. The early Indian banker had comparatively a little deposit or discount business, or dealings in other people's money which is the unfailing characteristic of modern banking. He may therefore be called a money-lender rather than a banker.

The times have changed and Indian indigenous banking of the good old days has undergone many alterations, on account of the different forms and functions, and the extreme complexity of modern business. All the same, the old system still retains its importance, though not to the same degree. Although the role of the indigenous banker is fast dwindling each year as he is unable to adjust himself to modern banking conditions, it must be presumed that the private banker is not yet extinct.

Economic growth has been widely accepted by the economists as a major goal of national policy, both in the industrialized countries and developing countries. The concept of economic growth has almost become common place in the economic studies particularly those of undeveloped countries. In fact, economic growth is a complex process which despite the intensive study is still not understood in its true perspective in many cases, the terms "economic growth" are used to evaluate development during a period of time, whereas development as such is a continuous process. Financial institutions readiness to adopt the objectives of development-economic and social and to bring about greater mobility of resources to meet the emerging needs of the economy is a necessary commitment for development. Economic growth as already stated depends upon mobilization of resources-men and material and utilizing the resources in a planned way. Among the financial institutions that have been mobilizing savings in a planned way. Commercial banks have created a nucleus in the process of economic growth. Commercial banks are both the repositories of the community's savings and the purveyors of credit for economic activity. They provide to the saver a convenient venue for investment of surplus funds and to the investor, a source of finance.

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The importance of commercial banks in the process of economic development has been stressed form time to time by the economic thinkers and progressive bankers in the country. Commercial banks play a very important role in an economy; in fact, it is difficult to imagine how an economic system could function efficiently without many of their services. The success of economic development depends essentially on the extent of mobilization of resources and investment and on the operational efficiency and economy discipline displayed by the various segments of the economy.

From the beginning of the banking in India, the Calcutta Agency Houses, and the trading firms undertook banking operations for the benefit of their constituents. That banking is incompatible with any other kind of business, was illustrated by the commercial disaster of 1829-32. Banking needs to be run with great caution, while adventure to a certain extent is necessary for other kinds of business, e.g., industry and commerce. Reckless speculation, and a policy of placing profits before safety, was responsible for the failure of the agency houses which also involved the collapse of their banking department.

The Indian Government did not awake to the great need for bank of Bengal obtained its Charter with a capital of Rest. 50 lakes, one fifth of which was contributed by the government which shared in the privilege of voting and direction. The charter restricted the bank's rate of interest or a maximum of 12 percent. The power of note issue, however, was not given to the bank till 1823. In 1839, the bank was given the power to open branches and to deal in inland exchange. The two other presidency Banks, viz., the Bank of Bombay and the Bank of Madras were established in 1840 and 1843, respectively. The year 1860 marks a newer page in the history of public banks in India, because it was in this year that the principle of limited liability was first applied to the joint stock bank. So far little or no banking legislation existed in India. Many banks had sprung up like mushrooms and failed, mostly due to speculation mismanagement and fraud, on the part of those responsible for their flotation, organization and management.

It was unfortunate for India that the crisis of 1862-66 should have come so soon after the introduction of this important banking legislation. The fall in the gold and silver price almost synchronized with the above disaster, without allowing any time to the Indian indigenous banker to recover from the panic. India, being then on the silver standard, every fall in the value of silver lowered the gold value of the rupees, and added to the burden of the Indian Government which had a find more rupees to meet the Home charges in London.

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Thanks to the Swedish movement, which prompted Indians to start many new institutions, the number of joint-stock banks increased remarkably during their boom of 1906-13. The boom continued till it was overtaken by the crash of 1913-17, the most severe crisis that the Indian joint-stock banks to have so far experienced.

The Presidency Banks were amalgamated into the Imperial Bank of India. Which was brought into existence on the 27th January, 1921, by the Imperial Bank of India Ac of 1920? With the passing of the State Bank of India Act, 1955 the undertaking of the Imperial Bank of India was taken over by the newly constituted State Bank of India. The severe trade depression that started in 1919 and the civil disobedience movement in 1931 retorted to some extent the further growth of banking institution in India till the founding of the Reserve Bank of India. Although suggestions had from time to time been made that India ought to have a central bank, they did not take definite shape until 1926, when the Royal Commission on Indian Currency and Finance recommended that a central Bank should be started in India so as to perfect her credit and currency organization. The Institution of the Bill Market Scheme in January 1952 is a land mark in the monetary history of the country. The classical function of a central bank in a country is to control the currency and credit of that country and to mobilize its reserves, but the constitutional structure and power vary in details according to the prevailing economic conditions the organization of money and capital market, etc., in a country. No doubt due to the acute economic conditions prevailing in India as well as all over the world during the lass few years the functions of a Central Bank have become more important.

The banking business is carried on by the joint stock banking companies, although there existed some private banking institutions, indigenous bankers and banks formed under special acts or Royal charters. Gigantic enterprises in the field of industry and commerce, quite naturally stimulate, public confidence and this, together with the publicity. Public banks have also been responsible for lowering the rates of interest, attracting depositors and encouraging the use of cheque currency. They have equally facilitated the making of payments. The India joint-stock banks form an important constituent of the India Money Market. Banks registered under the Indian Companies Act come under the category.

The structure of financial institutions in India is well developed and broad based. The system has developed in three sectors-State, Private and Co-operative The

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commercial banking system consists of scheduled and non-scheduled banks. The former accounting for an overwhelmingly large proportion of business. Over the last two and a half decades, the Indian banking system has undergone a significant structural reorganization. The chart brings out the structure of the financial system in India.

Chart I: Organizational Structure of Financial Institutions

All Financial Institutions

All - India Financial Institutions	**State Level Institutions**		**Other Institutions**
All India Development Banks	Specialized Financial Institutions	Investment Institutions	Refinance Institutions NABARD (1982)
IDBI (1964)	EXIM Bank (1982)	UTI (1964)	NHB (1980)
SIDBI (1990)	IVCF** (formerly)	LIC (1956)	
IIBI (1997)	RCIC (1988),	GIC & its	
IFCI (1948)	ICICI Venture	Erstwhile four	
	(Formerly TDICI (1988)	Subsidiaries	
	TFCI (1989)	(1972)	SFCs SIDCs ECGC
	IDFC (1997)		DICGC
			(18) (28) (1957) (1962)

* The erstwhile Industrial Reconstruction Bank of India (IRDI), established in 1985 under the IRBI Act, 1984, was renamed as Industrial Investment Bank of India Ltd. (IIBI) with effect from March 27, 1997.

** IVCF – IFCI Venture Capital Funds Ltd

Notes: 1. Figures in brackets under respective institution indicate the year of establishment or incorporation.

2. Figures in the brackets under State Financial Corporations (SRCs) / State Industrial Development Corporations (SIDCs) indicate the number of institutions in that category.

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Chart II : Scheduled banking structure in India

(As on march 31,2002)

Scheduled Banks in India

Scheduled Commercial Banks			Scheduled Co-operative Banks	
Public Sector Banks (27)	Private Sector Bank (30)	Foreign Banks in India (40)	Regional Rural Banks (196) Scheduled Urban Co-operative Banks (52)	Scheduled State Co-operative Banks (16)
Nationalized Banks (19)	State Bank of India & its Associates (8)	Old Private Banks (22)	New Private Banks (8)	

#As included in the second schedule of the reserve bank of India Act 1934.

Note: Figures in brackets indicate number of Banks in each group

1.4 STRUCTURE OF INDIAN BANKING

According to section 42(6) of the rese3vere bank of India act 1934, commercial banks are classified into two categories

I. SCHEDULED BANKS ; and

II. NON SCHEDULED BANKS.

A "SCHEDULED BANKS" ; means a bank include in the second scheduled of the reserve bank of India act 1934. the reserve bank is empowered to include in the second schedule, a bank which carries on the business of banking in India and which satisfies the following conditions.

I. It must have a paid-up capital and reserve of an aggregated value of not less than Rs.5 Lakhs.

II. It must satisfy the reserve bank that its affairs are not being conducted in a manner detrimental to the interest of its depositors, and

III. It must be –

a. A state co-operative bank, or

b. A company has defined in the company's, Act 1956, or

c. Indian scheduled commercial; banks, or

d. Foreign scheduled commercial banks.

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The public sector banks that is the state bank its seven subsidies and 20 nationalized banks have been notified as scheduled banks.

The reserve bank is authorized to exclude the name of the bank from the second schedule if any of the above mentioned conditions are not fulfilled.

Before enforcement of the banking regulation act 1949, there was a little control and regulation over the activities of the banking companies.

As a result there was a mushroom grow of large no of banking companies. They have week and undesirable features, the failure of the Palai CentraL Bank in 1960, proved to be a turning point in the history of Indian banking. As a result the urgency of weeding out of the weaker banks felt more keenly. Reserve bank of India was entrusted with additional powers to prepare schemes of compulsory merge of the banks. 212 banking companies mostly weaker and unsound once, were merged either voluntarily / compulsorily with other banks of their assets and liabilities were taken by other banks during the period 1962 – JUN 1970.

As a result of these reorganization and consolidation, the no of non scheduled banks declined from 481 in 1951 to 14 in June 1970, and that of small scheduled banks with deposits of Rs.10 crores or less from 66224. The total no of banks was significantly reduced from 566 to 86 in June 1970. This reduction in the no of banks was accompanied by the significant increase in the no of banks offices from 4151 in 1951 to 8254 in June 1969. The present structure of commercial banking in India is the outcome of a long process of expansion reorganization and consolidation extending over a period of two decades and especially during sixties of the century.

A significant feature of the structure of the percent, commercial banking is the co-existence of–

I. Private Sector Commercial Bank ; and

II. State or Public Sector Commercial Banks or Nationalised banks.

The growth of public sector in banking took place in three stages, first in 1955 when the Imperial Bank of India was converted into the State Bank of India and subsequently when the state associated banks were made the subsidiary banks of the state bank; second stage was the nationalization of 14 major commercial banks on 19th July 1969.

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The third stage was the nationalization of six more commercial banks on 18th Apr 1980, they are as follows;

I. The Andhra Bank Ltd
II. The Punjab and Sind Bank Ltd
III. New Bank of India Ltd
IV. Vijaya Bank Ltd
V. Corporation Bank Ltd
VI. Oriental Bank of Commerce

These 20 banks constitute the strong public sector in Indian banking.

The idea of state bank of India was mooted primarily to assign a significant role in the field of rural credit. The government established the state bank in 1955. but did not accept the recommendation for the integration of state associated banks with the state bank. Eight medium sized and state associated banks were converted as the subsidiaries of the state bank between October 1959 and May 1960 under the state bank (subsidiary banks) Act 1959.

The ordinance to nationalize the fourteen major banks having deposits of Rs.50 crores or more was issued on 19th July 1969 "To serve better the needs of development of the economy in conformity with national priorities and objects".

Structurally a banking system in India has gained distinctly in strength and coherence after nationalization. The policies and working of the nationalized banks have now been brought into closure harmony and coordination with those of state bank.

The major achievements of the nationalized banks are in the area of branch expansion deposit mobilization and extension to agriculture, small scale industry and other neglected sectors.

1.4.1 Structural changes in the Indian Banking System

A variety of structural and institutional developments have taken place. Indeed, they are far reaching changes in the entire landscape of Indian Banking.

There is a market reduction in the number of operating banks through the elimination of weaker units. It is due to the result either of voluntary or compulsory mergers. This reduction has not resulted in any significant reduction in the availability of

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banking service. Thus, there has been no contraction of banking facilities, though there has been a decline in the number of banks from 566 in 1951 to 89 in June 1969.

In the place of old imbalance, a healthy and balanced growth of broach banking is to be witnessed in the present time. The RBI seems to have made a good and judicious use of the powers vested in it for bringing about mergers and for sanctioning the opening of branches. A far reaching change has taken place in the structure of Indian Commercial banking system after the nationalization of fourteen major Indian Scheduled banks by ordinance in July 1969.

There has been a consistent effort taken by all concerned to evolve an integrated structure of financial institutions. Each such institution aims at specializing in it sown sphere but in close co-ordination with others. The linking of the commercial banks with Industrial Development Bank as well as with Agriculture Refinance Corporation persuaded the banks to enter the sphere of agricultural credit and brought the co-operative banks within the purview of the Banking Regulation Act. It has brought the two systems closer to each other. The building up of agricultural development has been the aim of the Reserve Bank's Policy.

1.5 FUNCTIONS OF COMMERCIAL BANKS

A bank is known by the functions it discharges. A description of the function and service may broadly indicate the nature of a bank and its importance in the economy to the country. The main functions of a bank are the acceptance of deposits and making advances. In addition to the main functions, Section 5 of the Banking Regulation Act, 1949 permits a banking company to engage in any one or more of the following forms of business, namely.

1.a) The borrowing, raising or taking up of money; the lending or advancing of money either upon or without security, the drawing accepting, discounting, buying, selling collecting and dealing in bills of exchange, hundies, promissory notes, coupons, drafts, bill of lading, railway receipts, warrants, debentures, certificates, scripts and other instruments transferable/negotiable or not, the granting and issuing of letters of credit, travelers cheques and circular notes; the buying, selling and dealing in bullion and species, the buying, and selling of foreign exchange including foreign bank and the acquiring, holding, issuing on commission; underwriting dealing in stock, funds, shares, debenture. Debentures, debenture stock, bonds obligations, securities and investments of all kinds; the purchasing

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and selling of bonds, scripts or other forms of securities on behalf of constituents or others, the negotiating of loans and advances, the receiving of all kinds of bonds, scripts or valuable on deposit or safe custody or otherwise providing of safe deposit vaults; the collecting and transmitting of money and securities.

b.Acting as agents for any Government or local authority or any other person or persons; to carry on agency business of any description including the clearing and forwarding of goods giving of receipt and discharge and otherwise acting as an attorney on behalf of customers; but excluding the business of a managing agent of a company.

C) Contracting for public and private loans and negotiating and issuing the same;

d)The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out any issue, public or private, of state, municipal or other loans of shares stock, debentures, debenture stock of any company, corporation or association and the lending of money for the purpose of such issue;

e) Carrying on and transacting every kind of guarantee and indemnity business;

f) Managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of its claims;

g)Acquiring and holding and generally dealing with any property and right title or interest in any such property which may form the security or part of the security for any loans or advances or which may be connected with any such property.

H) Undertaking and executing trusts;

I) Undertaking the administration of estates as executor, trustee.

j) Otherwise; establishing and supporting or aiding in the establishment and support of associations, institutions funds, trust and conveniences, calculated to benefits employees or ex-employees, of the company or dependents or connections of such persons granting pensions and allowances and making payments toward insurance subscribing to or guaranteeing money for charitably benevolent objects or any exhibition or for any public t general or useful object;

k) The acquisition construction, maintenance and alteration of any building works necessary or convenient for the purpose of the company;

l)Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company.

m) Requiring and undertaking the whole or any part of the dealing of any person or company, when business is of a nature enumerated or described in this sub-section.

n) Doing all such other things which are incidental or conducive to promotion or advancement of the business of the company;

o)Any other form of business which the Central Government may, by notification in the official Gazette specify as a form of business in which it is lawful for a banking company to engage;

2. No banking company shall engage in any form of business other than those referred to in sub section (1).

The range of services offered differs from bank to bank. Receiving deposits from the public and provision of credit are the two important functions of bank.

1.5.1. Receiving of Deposits :

This is the most important function of almost all modern banks. The power of a bank to help business community depends upon the amounts it receives by way of deposits. By taking money, on deposit, a bank provides safe keeping for people's money but the money is not set apart in a strong room. It is placed by a debts use from a banker, who ordinarily pays interest so long as the money is retained by him as a deposit. The principal together with interest is returned on its being claimed in accordance with the terms of the contract. Deposits accepted by a bank are of different types.

A) Fixed deposits,

b) Saving deposits,

c) Recurring deposits or cumulative deposits, and

D) Current deposits.

1.5.1.1 Fixed Deposits

The term» fixed deposits "means deposits repayable after the expiry of a certain period. When a customer deposits a fixed amount with the bank for a specified period,

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He is not allowed to withdraw the amount before the expiry of the period. Fixed deposits are accepted for periods ranging from 3 months to 5 years or more. Fixed deposits are also accepted for less than 3 months, if the amount offered for deposit is sufficiently large. The interest rate depends on the period for which deposit is made. It varies from 3% to 10%. Fixed deposit carries a higher rate of interest than the other types of deposits. Fixed deposits have grown in importance and popularity in India during recent years. These deposits constitute more than half of the total bank deposits.

1.5.1.2 Savings Deposits

- Savings deposits are meant for the people of the lower and middle classes who save a part of their currency for future needs and also expect an income from their deposited savings. The banks, therefore, impose certain restrictions on the savings bank accounts and also offer a reasonable rate of interest.

There are certain restrictions on the maximum amounts that can be with drawn. There are also restrictions, regarding the total number of withdrawals that can be done in particular period such as 25 withdrawals with in a quarter or 5 withdrawals in a month. The bank permits the use of the cheques for withdrawals of money from the savings bank account, if the customer agrees to maintain a minimum balance of Rs.1000 in the account. The banks do not accept cheques or other instruments payable to a third party for the purpose of deposits in savings of the people which would otherwise remains idle in the hands of people.

1.5.1.3 Recurring Deposit Of Cumilative Deposit

A variant to the savings Bank account is the recurring deposit or cumulative deposit. The deposit is intended to in calculate the habit of saving on a regular basis by offering a reasonable rate of interest. A deposit opening a recurring deposit account is recurred to deposit an amount chosen by him, generally a multiple of Rs.5or 10or100, in his account every month for a period selected by him. The period of recurring deposit varies from bank to bank. banks open such accounts for periods ranging from one year to 10 years. the rate of interest offered on recurring deposit are generally in accordance with the rates prescribed by the reserve bank for various term deposits. compound interest is payable on recurring deposit and the rate of interest is almost equal to that of the fixed deposit accounts. in case, depositor closes the account before maturity, the

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bank wipe no interest if the deposits were made for less than 3 month interest at 1 ½% is payable for deposits upto 6 months; upto 4% deposits made up 12 month and in other cases2%below the rate payable if it is continued till maturity.while opening the account,the depositor is given apass book which is to be presented to the bank at the time of monthly deposit and repayment of amount.instalments for each month should be paid before the last working day of that month.accumulated amount with interest will be payable after a month of the last instalment.

1.5.1.4 Current Deposits

A current account is a running and active account which may be operated upon. Any number of times during a working day.there is a restriction of the number and the amount of withdrawals from a current account.the banker is under an obligation to repay deposits are generally opened by business houses,public institutions, corporate bodies and other organization whose banking transactions are numerous and frequent. As these deposits are payable on demand, the banker is obliged to keep large cash reserves.that is why banks do not pay any interest on credit balances in current accounts.

1.5.2 Granting of credit to customers:

The bank takes into account the credit requirements of its customers and advances. The funds in varying froms,which are traditionally divided into two broad categories,viz.,

a)cash credits,overdrafts and loans.

b)purchase and discounting of bills,

1.5.2.1 Cash Credit

Cash credit is an important method of lending by banks. Under this system, the banker will specify a limit as to the amount of advance which may be extended to the company. As an when necessary, the customer can withdraw the required amount subject

To the maximum limit from the bank. The customer can deposit in this account any amount of money which he finds surplus with him on any day the customer is required to provide tangible assets as security to cover the amount borrowed from the banker the borrower will be charged interest taking into account the actual amount utilized and the period of such utilization. The banker normally fixes the cash credit limit after taking into account several factors such as the working of the borrowing company's production capacity, sale proceeds, inventory levels, past utilization limit act.

The advances made under cash credit system are repayable on demand.butthere is no specific date of repayment hower,in practice such advances roll over a period of time.

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Over Drafts

When a current account holder is permitted by the banker to draw more than what stands to his credit,such an advance is called an overdraft.overdraft is usually granted to industrial and commercial concerns doing regular business. Overdraft is more suitable for lending of small amounts.under the overdraft system the customer is allowed to overdraw his current account upto the limit agreed by the banker.thecustomer has to pay interst only on the amount over–draw and not on the maximum limit that is allowed,the rate of interest charged on overdraft is lower than that charged on cash credit,the usual security offered for an overdraft will be shares,government securities personal credit etc., whereas the security offered for cash credit will be commodities personal credit ect.,whereas the security offered for cash credid will be commodities like food grains, manufactured good etc.,

Loan

When a bank makes an advance in a sum which is usually repaid along with interest in a lump sum at a time ,it is called a loan.the rate of interest chared on a loan is lower when compared to overdraft.

1.5 2.2 Purchase and discounting of bills:

The purchuse and discounting of bills from the collection of the bills.the bills purchased and discounting by the bank are show as part of loans and advances in the balance sheet of the bank.both in the case of purchase and discounting of bills,the banker credits the customer's account with the amount of the bill after deducting his charges or discount.

As the demand bill are repayable on demand and there is no maturity, the banker is entitled to demand the payment immediately on presentation before the drawer.this practice is know as purchase of the bill .in the case of usance bill maturing after a period of time;the banker retains the amount of bill .the discount includes,besides the expenses incurred in realization, the inerest on the amount of the bill credited to the drawer.

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Besides the two main function mentioned above, a bank performs a variety of other functions. They may be grouped under tow main heads, namely the agency services and general utility services. They are also called the subsidiary services of a commercial bank.

1.5.3 Agency Services

A bank performs a number of functions for and on behalf of its customers. They are called agency services.

1. The bank helps the customers for the remittance of funds from one place to another. The transfer of funds is effected through cheques, drafts and mail transfer.

2. A commercial banker the payments of subscriptions, insurance premium, rent etc., and collection of cheques, bills, salaries, pension, dividend, interest etc., on behalf of the customers. He accepts standing instructions from the customers and arranges for payment and collections on their behalf. He charges a small amount by way of commission for those services.

3. A banker acts as a representative or correspondent for his customer and accepts bills of exchange in return for a commission.

4. A banker buys and sells securities, foreign currencies on behalf of customers.

5. A banker acts as a trustee, executor administrator and attorney. As a trustee, he takes care of the funds of the customers. He helps in the proper management of the trust. As an executor, the bank carries out the desire of the deceased customer in terms of the will left by him. As an attorney, the banker sign transfer forms and documents on behalf of the customers.

1.6 GENERAL UTILITY SERVICES

In addition to the agency services enumerated above, a commercial banker renders a number of other usual services known as general utility services. They include those services in which the banker does not act as the agent of customers.

A very useful function rendered by banker is to facilitate remittance of funds from one place to another. He issues documents such as drafts, letters of credit, travelers cheques etc.

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Banks accept valuables of their customers for sale custody and render a valuable survive to them. Banks are well-equipped with safes and strong rooms and hence are imminently suitable for rendering this service is done in two ways.

A. by accepting the valuables like jewellery, documents title deeds eg., for safe custody; and

B. by hiring out safe deposit vaults (lockers) to the customers.

The bankers collect valuable information relating to the traders and the traders and manufactures in their localities. This information is placed at the disposal of their customers and the trading community. They acts as referees as to the financial status, business reputation and respectability of their customers.

The banks underwrite the issue of shares and securities issued by joint stock companies. The banks help customers to make investment in stock exchange securities.

From the analysis it is clear that a modern bank renders very valuable services to the trading community of the trading community of the nation. Services rendered by Indian commercial banks as specified by the Banking Commission's Report:

1.6.1 Allied Deposit Schemes

1. Current account
2. Savings account
3. Fixed term deposits
4. Monthly interest income deposit schemes
5. Cash certificates
6. Annuity or retirement schemes
7. Farmer's deposit schemes
8. Daily savings schemes
9. Minor's saving schemes
10. Marriage/educational savings plan

1.6.2 Deposits Linked with Special Benefits

1. Insurance linked savings bank account
2. Housing deposits schemes
3. Salary deposit schemes

1.6.3 Service provided to Depositors

1. Collection of chouse, demand drafts, bill of exchange, promissory notes, Hun dies inland and foreign documentary and clean bills.
2. Purchase of local and foreign currency, documentary clean credit, advising of inland and foreign letters of credit established by branches and correspondents.
3. Carrying outstanding instructions of depositors for

a. Payment of insurance premium

b. Payment of subscription

c. Payment of certain taxes, and

d. Gift remittances etc.,

1.6.4 Allied Loan Schemes

1. Call loan
2. Term loan
3. Cash credit
4. Overdraft
5. Letters of credit
6. Personal loans for
   a. Durable commuter goods
   b. Construction of residential house
   c. Electrification, gas connection
7. Loan participation
8. Load to farmers
   a. Short term
   b. Medium term
9. Loans to small scale industry
10. Loans to road transport operators
11. Loans to self-employed persons
12. Loans to technocrats, technologists and entrepreneurs
13. Loans to retail trade
14. Educational loans
    a. Graduate & post graduates in India
    b. Higher studies abroad

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15. Assistance for industrial estates

1.6.5 Ancillary Service

1. Guarantees
   a. Performance Guarantee
   b. Financial Guarantee
2. Safe custody of deeds, securities
3. Purchase and sale of securities
4. Collection of interest on securities, debentures and dividend on shares, collections of pension bills
5. Remittance of funds, banks draft, mail transfer, telegraphic transfers to other parts of the country and to foreign countries
6. Executors and trustees.
   a. Executors and trustees under a will
   b. Trustees under trust deed
   c. Trustees under a deed of settlement
   d. Trustees for LIC policies under married women's property Act.
7. Personal tax assistance
8. investment facilities- under writing, bankers to new issue, guidance on investment, stock exchange assistance
9. Credit transfers
10. Credit cards
11. Travelers cheques
12. Gift Cheques
13. Emergency vouchers
14. Sale of units of unit trust of India, National Savings Certificate etc.,

1.7 BANKING SYSTEM

The development of commercial banking institutions has taken place under different banking systems in different countries. The two principal banking systems are unit banking and branch banking. There are also three other types of banking systems. Viz., group banking, chain banking and correspondent banking.

1.7.1 Unit Banking

When a bank carries on business in a single locality with a single office, the system is called unit banking. Unit banking system involves limited area of operations and small size deposits. Each bank has got a separate legal entity, having its own capital, stock holders and directors. Each bank has got only one office and has no branches elsewhere. In the words of Shapiro and Salomon, "an independent unit bank is a corporation that operates one office and that is not related to other banks through either ownership or control". U.S.A is the home of the unit banking.

1.7.2. Branch Banking

Where a bank carries on banking business in different places with a number of branches, the system is called branch banking. In this case, the bank has a head office in a big city and its branches in different parts of the country. The head office of the bank and its branches are under single ownership and management.

Branch banking is also described as "an individual banking corporation, having one group of directors and one charter that directly owns, runs and operates two or more banking offices". Each local branch office is managed, run and supervised by a manager appointed by the officers of the bank.

In England, branch banking is well developed and well organized.

1.7.3. Group Banking

The group banking system is prevalent in the United States of America. This is also known as the holding company banking system. Under the group banking system, the ownership and operations of two or more commercial banks are controlled directly or indirectly by a holding company. The main feature of the group banking system is the centralized management and control of all units of the group by a holding company not with standing that each bank has got a separate entity.

1.7.4 Chain Banking

The chain banking is prevalent in the USA. The chain banking system is a variant of the group banking system. The main feature of the chain banking system is the control of two or more banks by a single person or group of persons through the ownership of stock or otherwise. It is a system under control by a device other than holding company.

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Check your Progress

1. State whether each of the following statement is 'True or false'

(a) Banks can lend no more than what they can borrow from the public

(b) Unit banking was popular in England

(c) Loan creates no deposits

(d) The primary reserve of a commercial bank is cash

(e) Before independence, bank failures were must common; they retarded growth of banking business

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Chain banking is also defined as "type of multiple office banking through which the operations or policies of a number of independent incorporated banks are controlled by one or more individuals. The control is being exercised through stock ownership or common directors".

1.7.5 Correspondent Banking

The system is very popular in the USA under this system; banks are linked together through deposits of smaller banks with bigger banks. The bigger banks with which the deposits are to make are called Correspondent banks. The Correspondent banks have expert consultant whose services can be utilized by other banks depositing cash with them.

A bank in a small town has its Correspondent bank in the city and the bank in the city has in its turn a Correspondent bank in the small town. This arrangement helps remittances.

1.7.6 Comparison Between Branch Banking and Unit Banking

A Branch bank is generally a big bank and it can carry on banking business on a large scale. But a unit bank is generally a small bank and its scale of operation is limited. Thus a comparison between branch banking and unit banking is essentially a comparison between large scale and small scale operations. The advantages of branch banking are the disadvantages of unit banking and vice versa. Now let us consider the advantages and disadvantages of both branch and unit banking systems separately

1.7.7 The Case for Branch Banking System

Better and efficient management is the sine qua non for the success of the bankin organization. But small sized unit banks cannot afford good management while the branc banking system is able to employee competent, experienced and efficient staff.

Branch banking system is able to mobilize greater financial resources so as t cope up with the increasing requirements of customers. The command over large resourc would also strengthen and liberalise the lending operations of the Brach banking systen

The most important advantage of branch banking system is the diversification of deposit Branch banks are able to mobilise, large amount of deposits due to the following reason

The existence of wide area operations and Facility of the transfer of funds from the areas where deposits are high to the areas where the deposits are poor.

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Branch banking system minimizes favoritism and despotism of small-town personnel, because large loan applications are usually granted only by the head office.

Computer technology and the economy of the scale of the work are available to the advantage of large banks with branches.

Branch banking system makes central banking control much more effective and easier that is possible when the central bank has to deal with innumerable unit banks.

Under branch banking system, it is possible to diversify loan risks geographically and also sector-wise.

Under this system, it is possible to offer cheap and quick remittance facility to the customers

This system offers more safety to the funds of the investing public due to the diversification and loan risks. This aspect enables the banks to win the confidence of the investors and build up their goodwill.

1.7.8 Case against Branch Banking

A fundamental weakness of branch banking is its inherent tendency to promote expansion for its own sake rather than in response to any need for more banking service.

Due to the expansion of branch banking, unit banking system tends to disappear and the community is deprived of the benefits of banking competition.

The control of head-office over loans and investment policy paves the way for redtops in granting credits and penalizes smaller communities which have to wait upon the pressure of the head office.

Branch banking system results in creating the oligopolistic and monopolistic condition in the banking industry.

It is said that the branch managers are not familiar with local conditions. The branch managers simply execute orders coming from the Head Office. As a result, the branch banking system is less sympathetic to the local needs as compared to the unit banking system.

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The branch banking system results in a huge waste of national resources arising from the establishment of branches by every bank at selected large centers. (Chennai, Mount Road is over crowded with many bank branches).

There is always the fear of a big loss to the bank because the failure of one branch may shake the confidence of the public. Thus a run on one branch is likely to affect the entire banking organization.

1.8 UNIT BANKING VS BRANCH BANKING

A bank may confine its operations to a narrow area by having just one or two officers. Or the operations of a bank may cover a very wide area through a network of branches. We call the former by the name of unit banking and the latter by the name of branch banking.

1.8.1 The Unit Banking System of USA

Among several countries of the world, only in the USA one can find unit banking system. For instance, on 1st of January, 1962 in the USA there were 13,432 banks of which 10,948 were unit banks and only 2,484 banks had branches in other places. The following are the reasons for the existence of unit banking system in the USA.

1. Historically, this system is the product of the American political philosophy of individualism.
2. In the beginning stages, the Americans were afraid of bank monopoly. So branch banking did not find favour with, them.
3. The people in the Middle West and Far West were suspicious of the New York Financiers.
4. Several state governments have imposed restrictions on the opening of branches by banks. For instance, in Chicago city, no bank has been allowed to have braches as result, in 1965 there were 34 unit banks in Chicago city without branches.

1.8.2 England - Branch Banking System

In contrast to the unit banks of the USA. In the other countries of the world, banks are very large institution with a network of branches throughout the country. England offers the best example of the branch banking organization. Before 1968 in England about 85 percent of the operations of banks were conducted by five big banks popularly known as the "Big five". The Midland, The West Minister, the Barclays, the Lloyds and the national provincial were the "Big five". In 1968 the national provincial and the west minister decided to amalgamate. They formed what is now called the national west minister bank. Thus, at present in England there are four big banks in control of about 85 percent of the banking operations. They are popularly known as the "Big four".

1.8.3 Advantages of Branch Banking

Sayers compares unit banking with small scale business and branch banking with large scale business. To quote Sayers, "A comparison between unit banking and branch banking is essentially a comparison between small and large scale operations". The main advantages of branch banking system as compared with unit banking system are as follows,

1. Economies of Large Scale Operations

A branch bank can apply the principle of division of labour in it operations. It can appoint experts in each field. It can afford to have experienced and competent officers on its staff paying them suitable remuneration. Such things are not possible I the case of a bank which may have only limited resources.

2. Geographic Distribution of Risks

A branch bank different will invest its funds in different industries in different localities like putting eggs in different baskets instead of in a single basket. So, even if some branches were adversely affected as a result of business depression in some industries the other branches would be making profit. As a result, there may not be any net loss, or losses will be minimum. But in this case of unit bank, in the event of depression in industry to which it may have lent money the bank itself may be ruined. For instance, before 1929 there was a depression in Lancashire area were incurring heavy losses. But their losses were offset by gains in other areas by the other branches of the banks. Hence, there was no general crisis in England at that time. At that tine, in the USA, there was no depression in some sections of agriculture. This led to the failure of about 6,000 local banks in the USA. That is, at that time there was banking crisis in the USA.

3. Economy of Reserves

In case of branch bank, each branch can offered to maintain a low cash reserve. For, in the case of necessity one branch can draw upon the resources of the other branches.

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Thus, branch banking secures economy of reserves. But this is not possible in the case o: a unit bank.

4. Cheaper Remittance Facilities

The branch bank can provide remittance facilities at relatively cheaper rates This is due to the reason that the branch bank has its branches in all the important centers But under unit banking system, remittance facilities cannot be provided at as cheaper rate as possible under branch banking system.

5. Adds to the Profitability of Banking Operations

Under branch banking system, funds lying idle in on branch may be transferrec to the other offices where they are in great demand. This will enable the bank to earn the maximum profit.

6. Reduction of Disparities in Interest Interest Rates

Under branch banking system, funds can be moved easily from one locality tc another locality. Hence branch system will ensure the prevalence of uniform rate of interest throughout the country.

7. Effective Centrai Bank Control

Under branch banking, the numbers of banks are small; but under unit banking . the number run to several thousands. So the central banks control over banks can be more effective under branch banking system than under unit banking.

8. Size of Loan

A branch bank can provide credit for large amounts. But small unit bank cannot grant large credits.

1.8.4. Disadvantages of Branch Banking

However, the branch banking system is not without defects. There is limit to the development of branch banking. Beyond the limit, branch banking is liable to suffer from the following disadvantages.

1. May become unwieldy

If the size of the bank becomes very big, it may become unmanageable. As a result, there may be mismanagement or in competent management. That is, it is very

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difficult to exercise control, supervision and vigilance over too many branches in an effective manner. Moreover, as the branches become more and widely scattered and the business increases in volume as a whole, the cost of co-ordination and centralize control over branches will be high.

2. Bank Failure and its Effect on the Economy

If a unit bank fails it may mean the elimination of one weak unit in the economy. The economy as a whole may not be affected to and great extent. But if a bank having network of branches throughout the country fails, it may produce adverse effects on the economy as a whole.

3. Personal contact in the Unit Banking

If a unit bank is a local bank. It will have direct personal knowledge of the local businessmen. So the unit bank can take quick decisions. But in the cash of branch bank, decision is taken by officers at the head office. The branch manager's arte given little scope for initiative. So branch bank cannot take quick and prompt decisions.

4. Neglect of particular localities

Under branch banking system the banks may neglect particular localities. That is they may neglect rural areas and small towns. Even when they set up their branches in such places, they may make use of deposits mobilized in such places in big financial centers of the country. But the unit banks invest funds in localities where they mobilise deposits.

5. Monopoly in Banking Business

There is a danger of growth of monopolies on banking business under the branch banking system. A single bank operates over a large area through its branch may tend to become a monopoly in course of time. The federal deposit insurance corporation of the USA made a mention of this defect of branch banking in its annual report for the year 1944.

6. Branch Banking System Preferable

However, the advantages of branch banking system far outweigh the disadvantages. Hence branch banking system has found throughout the world with the

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solitary exception of the USA. Even in the USA the correspondent banking system the chain banking system and the group banking system have modified the unit banking system to a very great extent.

1.8.5 Historical Basis of Unit Banking

Single office banks are most popular in the United States. The typical American bank is the unit bank. The unit bank is organized under federal or State Laws.

Unit banking is regarded as typical beca use of two reasons. The first reason is the existence of dual system of government which consists of both federal and state administrative organizations vested with the powers to charter banks. As a result, banks established in one state have not been permitted to operate in other states in a full service sense.

Secondly the prevalent fear of money trust has worked against the legal concentration of banking power in the hands of a few.

As independent unit bank is the financial counterpart of the independent business enterprise. The bank has its origin in the industry and commerce of the local community and in the farming population which it serves.

Unit banking system involves limited area of operation and small size of deposits. Each bank has got a separate legal entity, having it own capital, directors and stockholders. Each bank has got only one office and has no branches elsewhere.

1.8.6 Operations of Unit Banks

Unit bank is operating under state restrictions completely prohibiting the establishment of branches. In spite of that some unit banks have grown to a large size. Unit banks activities are closely integrated with the local economy and social organization from which its stockholder, directors and officers are drawn, as are also its customers, both depositors and borrowers. Thus, it is peculiarly and chiefly close to local activities. As a result, its officers are able to act as the chief dispensers of business advice to the community.

The agriculture and rural regions have the largest proportion of small and independent unit banks, and the urban and industrial sections have smallest. However, unit banks have to solve certain problems arising out of chaining economic conditions. The problems as follows:

Unit banks are losing the best business of the community to adjacent large centers due to the shifts of population and the widening of market areas together with the development of good roads.

The growth and development of large scale business has meant a removal if the head office of many concerns to industrial centers.

Because of the higher operating expenses, lower interest rates and heavy loss on loans and investment, unit banks earning and revenue have been adversely affected. And due to the agricultural depression, these problems aggravated through the inter-war period.

1.8.7 Advantages of Unit Banking

The main advantage of unit banking system is that being highly localized in its operations the individual banks are more responsible to the needs of the localities served by them. Unit banking is free from the diseconomies of large scale operation which are generally with branch banking.

Since the operations of the bank are less scattered, there are less possibilities of fraud and irregularities. Management and supervision do not offer any serious problems.

The unit bank is in a position to take quick decisions. There is no delay or redtops in taking decision.

1.8.8 Disadvantages

Unit banking system is weak in facing the financial crisis. Individual banks, being small, find it difficult to meet the sudden rush of withdrawals of deposits.

Unit banks also find it difficult to employ high-paid, well trained managers because they cannot afford costly management.

Unit banking system is not able to meet all the financial requirements of its customers.

It is not able to provide full and adequate banking facilities to its customers because of their higher costs.

The unit banker may have to follow considerations other than strict economic principles in granting loans to influential persons. He may find it very difficult to refuse financial accommodation to an influential local businessman who may not be so trustworthy.

Branch Banking System Preferable

However the advantage of branch banking system far outweighs the disadvantages. Hence branch banking has found favour throughout the world with the solitary exception of the USA. Even in the USA the correspondent banking system, the chain banking system and the group banking system have modified the unit banking system to a very great extent.

Which is Suited to India?

As between unit banking and branch banking, the branch banking system is suited to India. The reasons are:

1. In the past the number of bank failures was quiet large only among small banks.
2. To weed out the inefficient units, the reserve bank of India adopted the method of compulsory mergers. This has lent a considerable measure of stability to the Indian banking structure.
3. The small banks are quite unsuited to mobilise the savings of rural areas. Small banks cannot function profitably in rural areas.
4. After the nationalization of major banks in our country a tremendous increase in bank branches has taken place in rural areas and in hitherto unbaked centers. Hence only under the system of branch banking, facilities can be provided in every nook and corner of India.

Thus branch banking is more suited to India than unit banking.

1.9 Role of Commercial Banks in Economic Development

1.9.1 Importance of the Banks

Banks occupy an important position in the modern economic world. The banks constitute the life line of a sound economy. As such, they lubricate and cater to all sorts of economic activity. They keep the wheels of commerce and industry revolving. The functions

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of banks in advanced economies are so enormous that we cannot imagine a state without banks. In advanced economies the banks:

1. Help in the mobilization of the savings of people in the form of deposits.
2. Help industry, trade and commerce through the provision of loans and advances for short periods.
3. render important agency services like collection of bills and cheques, serving as agents of their customers at home and abroad, etc.,
4. Render general utility services like keeping valuables in safe custody. Provision of cheap remittance facilities, etc.,

1.9.2. Role of Banks in Backward Economies

Banks play a useful role in underdevelopment countries of the world in bringing about rapid economic development. The under developed countries of the world suffer from poverty. Low rate of domestic savings, low rate capital formation, low industrial development, low standards of living, problem of unemployment and under employment, absence of sufficient banking facilities, etc., these economies strive hard to bring about rapid economic development through the formulation of economic plans converting the economy as a whole. The commercial banks can play as active and dynamic role in such economies in the following ways:-

1.9.3. Mobilization of Saving for Productive purpose

Banks mobilise the idle savings of the people in country in the form of deposits. They channel them for productive investment by making loans and advances.

1.9.4 Spreading of Banking Facilities

By opening a wide network of branches throughout the length and breadth of the country, they spread the banking habits among people. The banking habit consists in getting occasioned to keeping accounts with banks and making use of cheques in the settlement of debts. The establishment of banks in unbaked and under banked areas

Besides encouraging habit of thrift on the part of people helps in reducing regional disparities in economic development. The spread of banking facilities in the country contributes towards enlarging the area of the monetized sector in economy. This is an essential pre-requisite for effective monetary and fiscal controls in the economy.

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1.9.5 Balanced development in the Economy

Banks provide credit facilities to all the three sectors in the economy. Via, primary sector or agriculture, secondary sector or manufacturing industry and tertiary sectors or the service industry. Uniform development of these sectors is essential for the balanced development of the economy. Banks by providing the required credit facilities to these three sectors contribute to the balanced development of the economy.

1.9.6 Exports

Promotion of exports is quite essential for rapid economic development. The earnings from exports will enable the country to get the foreign exchange it needs for importing machines and raw materials. By providing adequate credit facilities to exporters, the commercial banks can assist the process of economic development in the country.

1.9.7 Help to Small Scale Industries

In economically backward countries the objectives of rapid economic development and full employment and full employment of man and materials are sought to be achieved within a short period. Naturally emphasis is placed on small scale industries. The time needed to start small scale industries is short. In technical economic language the gestation period in these industries is relative small. Hence, small scale industries can ensure rapid economic development without being accompanied by steady rise in the price level; moreover the small scale industries employ mostly labour-intensive methods of production. Thus, the employment potential in small scale industries is very great. The commercial banks by providing the requisite finance to small scale industries accelerate the pace of economic development in an under developed country.

1.9.8 Help in the Development plans of the Government

Development planning is now a universal phenomenon. There is no under developed country which does not resort to economic planning? In an under developed country, in the absence of private initiative the government has to set up industries in the public sector. The government needs both short term finance and long term finance to the government by investing their funds in government securities. Again the commercial bank provides short term finance to the government by buying Treasury Bills sold by the government. Thus, banks play a an active role in bringing about rapid economic development by rendering both short term and long term financial assistance to the Government.

1.9.9 Employment Opportunities

There are many talented young people capable of contributing their mite to the productive activity in the economy if they get financial assistance. For instance, there are engineering graduates, medical graduates, etc., who can set up firms of their own if they get financial assistance. Banks by providing financial assistance to professionals and self employed people can help not only in the solution of the problem of unemployment in the country but also in accelerating in the pace economic development.

1.9.10 Transfer of funds from places plenty to places of scarcity

Banks have a wide network of branches throughout the length and breathe of the country. Hence they tap the resources available in the different parts of the country. They transfer the surplus capital of one region to the other region where it can me usefully and efficiently employed. In fact the deposits of the banks represent the reservoir from which the financial need for business and industry are supplied

1.9.11 Influence of interest rate

Banks can influence economic activity by bringing about changes in interest rates. Generally, the decisions of the industries to invest or not to invest are also dependent on the rates of interests on various types of loans prevalent in the market. If the rate of interest is low, investment acetic in the economy receives a boost. Increase investment activity bring about rapid economic development the banks by making more credit available can bring about a decline in interest rates which will encourage investment activity and economic growth in the country.

1.9.12 Capital Formation

Capital information is an essential – requisite for rapid economic development in any country. Among other things capital formation is dependent on domestic savings. The rate of savings of people can be stopped up through the setting up of a network of bank branches throughout the country. Thus, through the mobilization of the savings of the community banks help capital information and economic development.

Thus, banks are quite indispensable for economic progress. They contribute to the growth of the economy. Economic development is impossible without an efficient banking system.

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Check your Progress

2. Indigenous banking system is also known as
   a) Organized
   b) Un Organized
   c) Trading
3. When a number of banks are controlled by a few individuals instead of by a holding company is
   a) Group banking
   b) Mixed banking
   c) Chain banking
4. The Nationalized Banks function as independent units and their credit policy us determined by
   a) GOVT
   b) RBI
   c) Investments Banks
5. The Nationalization of 14 major banks with deposits of Rs50 crores or more
   a) On July1968
   b) On July1969
   c) On July1989.

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Statistics at a Glance

Indicators	June 1969	March 2002
Number of commercial banks	89	297
(a) Scheduled commercial banks of which: Regional Rural banks	73 -	293 196
(b) Non-Scheduled Commercial Banks	16	4
Number of Bank Office in India	8262	68195
(a) Rural	1833	32503
(b) Semi-Urban	3342	14962
(c) Urban	1584	11328
(d) Metropolitan	1503	9402
Population per Office (In thousands)	64	15
Aggregate deposits of Scheduled Commercial Banks in India (Rescore)	4646	1131188
(a) Demand deposits	2104	169103
(b) Time deposits	2542	962085
Credit of scheduled commercial Banks in India (Rest. core)	3599	609053
Investments of Scheduled Commercial Banks in India (Rest. core)	1361	437482
Deposits of Scheduled Commercial Banks per office (Rs.Lakh)	56	1659
Credit of scheduled commercial Banks per office (Rs.Lakh)	44	893
Per capita Deposits of Scheduled Commercial Banks (Rest.)	88	11008
Per capita Credit of Scheduled Commercial Banks (Rest.)	68	5927
Deposits of Scheduled Commercial Banks as percentage to National Income (at current prices)	15.5	
Scheduled Commercial Banks Advances to priority Sectors (Rescore)	504	
Share of Priority Sector Advances in Total Credit of Scheduled Commercial Banks (percent)	14.0	
Credit - Deposit Ratio (Percent)	77.5	53.8
Investments - Deposits Ratio (Percent)	29.3	38.7
Cash - Deposit Ratio (Percent)	8.2	7.1

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1.10. KEY TERMS

- **Banking:** Section5 of the Banking Regulation Act, 1949 defensive banking as the accepting, for the purpose of bending or investment, of deposits of money from the public repayable on demand or otherwise and withdraw able by cheque, draft, and order or otherwise.

- **Brands Banking:** It is a system of Banking where the business is carried by a single office with a network of branches stead throughout the country. England offers the best example of the branch banking system.

- **Unit Banking:** Under this system, the banks operations are confined mostly to a single office the area of operation and the size of the bank in smaller and for more limited is the case under the branch Banking system. U.S.A is the home of the unit Banking System.

- **Banks and Economic Developmentnks :** Banks play an important role in the economic growth of a country. Banking when property organized, aids and facilitates the growth of trade and Industry and hence the National Economy. In the Modern Economy, banks are to be considered not as dealers in money but as the leaders of development.

1.11 SUMMARY

The underlying principle of the business of banking is that the resources mobilized through tee acceptance of deposits must constitute the main stream of funds which are to be utilized for lending or investment purpose.

The banking institutions have eloped rapidly over the last few decades. They have come up in different countries under different organizational structures. He most important and popular systems of banking are unit banking and branch banking. The other systems are group Banking and chain banking, investment banking.

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1.12 ANSWERS TO 'CHECK YOUR PROGRESS'

1 (a) T (b) F (c) F (d) T (e) T

2(b)

3(c)

4(a)

5(b)

1.13 QUESTIONS / EXERCISES :

SECTION - A

1. Define the term banking. Briefly explain the origin of Banks
2. What are the various functions of commercial Bank?

SECTION - B

3. Evaluate the Banking System that prevents in India with its merits and demerits.
4. Distinction between units banking Vs Branch Banking.
5. Explain the role played by the commercial bank sin the Economic development of the country.

1.14 FURTHER READING

1. JONES R.K - STUDIES IN PRACTICAL BANKING

2. SAYERS R.H - MODERN BANKING

3. VASANTH DESAT - INDIAN BANKING

Unit-2 NATIONALISATION OF COMMERCIAL BANKS IN INDIA

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Structure

2.0 INTRODUCTION

Prior to 1949, commercial banks in India were exclusively owned, controlled and managed by private entrepreneurs and shareholder. The process of nationalization of banks began when the Reserve Bank of India was nationalized on 1 January 1949 with the passing of the Reserve Bank (Transfer of Public Ownership) Act, 1948. It was essential to nationalize the RBI as the central bank of the country in order to ensure greater coordination of monetary, economic and fiscal policies in independent India which was to embark itself on the path to planned economic development.

But the first step towards the nationalization of commercial banks was taken with the nationalization of the Imperial Bank of India as the State Bank of India on 1 July 1955. The second step was taken when 7 State-associated banks were nationalized as subsidiaries of the State Bank of India in 1959. These seven associate banks are: the State Bank of Hyderabad, the State Bank of Jaipur and Bikaner, the State Bank of Travancore, the State Bank of Mysore, the State Bank of Patiala, the State Bank of Indore, and the State Bank of Saurashtra.

The third major step was the nationalization of 14 major commercial banks with deposits exceeding Rs.50 crores each on 19 July 1969. They are Allahabad Bank,

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Bank of Baroda, Bank of India, Bank of Maharashtra, Canara Bank, Central Bank of India, Dena Bank, Indian Bank, Indian Overseas Bank, Punjab National Bank, Syndicate Bank, Union Bank of India, United Bank of India, and United Commercial Bank.

The last step was the nationalization of 6 more commercial banks on 15 April 1980. They are: Andhra Bank, Corporation Bank, New Bank of India, Oriental Bank of Commerce, Punjab and Sind Bank, and Vijaya Bank. At the time of nationalization, each one of these had crossed the deposit mark of Rs.200 crores, though at the time of nationalization of 14 banks their individual deposits were below Rs.50 crores.

In June 1996, there were 19 nationalized banks; New Bank of India was merged with Punjab National Bank in 1993.

2.1 UNIT OBJECTIVES:

(1) To mobilize the savings of the people to the largest possible extent and to utilize them for productive purposes in accordance with our plans and priorities.

(2) To ensure the operations of the banking system for a larger social purpose and to subject them to close public regulation;

(3) To meet the legitimate credit needs of private sector industry and trade, big or small.

(4) To meet in an increasing manner the needs of productive sectors of the economy and in particular those of farmers, small scale industrialists and self-employed professional groups;

(5) To actively foster the growth of the new and progressive entrepreneurs and credit fresh opportunities for hitherto neglected and backward areas in different parts of the country;

(6) To curb the use of bank credit for speculative and other unproductive purposes;

(7) To develop adequate professional management and modern managerial techniques and practices in the banking field;

(8) To provide adequate training and reasonable terms of service to bank staff;

(9) To considerably expand the branch network of banks in all parts of the country; and

(10) To reduce regional and sectoral imbalances in banking and through that in economic development.

2.2 JUSTIFICATION FOR NATIONALISATION OF COMMERCIAL BANKS:

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The nationalization of the commercial banks in India was a very controversial issue till the nationalization of 14 major banks in July 1969. A number of arguments were advanced by economists, political leaders, bankers, workers, and the public in support of the nationalization of banks which are enumerated below.

2.2.1. Neglect of Priority Sectors: A major charge against banks in India was the advanced loans to the large scale industries and neglected the priority sectors such as agriculture, small scale industries, etc. The banks advanced 60% of the total bank credit to big industries and 19% to trade in March 1968. On the other hand, the share of agriculture was 2.2%, of small industries 6.9%, and of retail trade less than 2% in the total bank credit. It would be possible to direct bank credit on a large scale through bank nationalization.

2.2.2. Neglect of Plan Priorities: Another charge was that commercial banks neglected plan priorities and diverted credit into less important channels. Bank nationalization would help the Government in directing bank credit in accordance with plan priorities.

2.2.3. High Profits: It was alleged that bank earned huge profits which were disproportionate to the capital invested in the banks. The ratio of profits of scheduled banks before tax to the paid-up capital and reserve increased from 12.2% to 42.5% in 1968. In other words, they earned Rs.42.5 crores annually. On the other hand, their capital base was declining. The ratio of paid-up capital and reserves to deposits fell from 9.7% in 1951 to 2.6% in 1968. This was in contravention of RBI's directive to banks to keep at least 6% of their deposit liabilities in reserve. Whereas the banks earned huge profits and used them for their interests, the shareholders earned almost nothing because they had hardly more than 1% of deposits as share capital. This was one of the arguments advanced by the Government for bank nationalization.

2.2.4. Funds for Plans: By nationalizing the banks, these huge profits of the banks would be available to the Government for financing plans and achieving the plan objectives.

2.2.5. Concentration of Economic Power: It was alleged that the commercial banks had led to the concentration of wealth and economic power in the hands of a few big business houses and industrialists. For instance, the Central Bank of India Ltd. was

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being controlled by the Tatas, the Bank of India Ltd. By the Mafatlals, the Punjab National Bank Ltd. By the Dalmias, the United Commercial Bank Ltd. by the Birlas, etc. These big business houses, in turn, controlled a number of industries, thereby enjoying a virtual monopoly in their business. Moreover, about 90% members of the Boards of Directors of banks consisted of industrialists and big businessmen. A single director of a bank was a common director of many other industrial concerns and with his control over the bank he was able to turn the bank for the benefits of his industrial house. This interlocking of directorship in banks led to unusually high amount of credit to big business houses. Bank nationalization was, therefore, essential to stop the misuse of the resources of the banks for the benefit of directors and their concerns, and to reduce the concentration of economic power and wealth in a few hands.

2.2.6. Socialist Arguments: It was argued that bank nationalization was essential for the attainment of a socialist society in India. Such a step would not only reduce concentration of economic power and wealth but also give the State control over the resources of the banks to be utilized for the masses.

2.2.7. Regional Imbalances: It was alleged that commercial banks were increasing regional imbalances. Banking was concentrated in big cities, urban centres and a few States: The Gadgil Study Group of the National Credit Council (1969) vividly brought out the imbalances in banking in the country. It pointed out that till December 1967, out of 5,64,000 villages in India, not even 1% were served by commercial banks. In 13 districts of the country, there was not a single commercial banks. In 13 districts of the country, there was not a single commercial bank office. More than 600 towns did not have commercial banking facilities. Thee were 63 districts in which per capita credit was less than one rupee. In another 13 districts, credit was not extended even to a single individual, although deposits were mobilized from there. The two metropolitan cities of Bombay and Calcutta accounted for one-third of total deposits was more than 100% in the metropolitan cities which means that deposits mobilized in smaller centres were diverted to these cities for financing the activities of big business. It was argued that bank nationalization would remove these imbalances, ensure even distribution of banking facilities, and spread banking to rural unbanked and underbanked areas.

2.2.8. Ignored RBI Directives: Big banks with strong financial background often ignored the Reserve Bank's directives under the Banking Regulation Act, 1949. This, in turn, adversely affected the RBI's monetary policy. By nationalizing such banks, the RBI would be in an advantageous position to implement its monetary policy more effectively.

2.2.9. Protection to Depositors: It was argued that bank nationalization would remove the fear of bank failures from the mind of public, thereby protecting the interests of depositors. This, in turn, would inculcate banking habits among the people, especially in the rural non-monetised sector of the economy.

2.2.10. Check of Undesirable Activities: The commercial banks often indulged in anti-social and undesirable activities. They advanced credit for such activities which encouraged speculation, profiteering, black marketing, etc. which led to the accumulation of black money in bank accounts. All such activities would be stopped when banks were nationalized.

2.2.11. Encouraged Inflation: It was alleged that commercial banks encouraged inflation by increasing the supply of money without due regard to the directives of the RBI. Banks often used their resources to the discretion of their directors for their own interest and that of their business friends. So they did not follow the guidelines issued by the RBI for credit restriction. This led to inflation. Thus nationalization of banks was considered to be the only remedy.

2.2.12. Increase in Efficiency: It was argued that bank nationalisation would improve the efficiency of banks and the quality of service to the customers because the employees would have a greater sense of security. The efficiency of banks would also increase due to the standardization of banking operations throughout the country.

2.2.13. Better Management: With the nationalization of banks, the Government would be in a position to develop and provide adequate training and modern managerial techniques to the staff. This would lead to greater efficiency of bank operations.

2.2.14. Better Service Conditions: It was hoped that bank nationalization would provide better service conditions for the employees. The would have the satisfaction of being Government employees. This would also improve employer-employee relations and pave the way for a smooth working of the banking system in the country.

2.2.15. Success in Other Countries: The protagonists of bank nationalization argued that in a number of developed the developing countries where commercial banking was

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Check your Progress

1. State whether each of the following statement is 'true or false'

(a) The reserve bank was empowered to appoint a director or an observer on the boards of the commercial banks.

(b) National credit council was set up in February 1969.

(c) New branches were opened to extend banking facilities in remote rural areas.

(d) The most important event affecting banking system in India since independence was nationalization.

(e) The top 14 banks were nationalized in June 1969.

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in the hands of State, it had been highly successful in helping the masses and mobilizing resources for development. For example, 90% of commercial banking was in the public sector in Italy, 80% in France and 70% in Germany. Among the developing countries, Egypt, Burma, Indonesia, and Ceylon had been successfully operating nationalized banks.

2.3 NATIONALIZATION OF BANKS IN FORIGN COUNTRIES

The French government rejected control of deposit banks on the model of the British clause (4) and proceed to nationalize not only the central bank but also four deposit banks.

Perhaps the bitterest controversy on this question of nationalization had raged in Australia. The Labour party in that country had for a long time favored a nationalized banking system and in fact in 1947 an attempt was made to give effect to this policy by the labour government. Public opinion in Australia at that time was opposed to nationalization of banks and the banking issue was undoubtedly responsible for the labour party in the general election.

In recent years, however some countries have nationalized their banking system, but the policy has been promoted by more political upheavals and ideological consideration then the economic reasons. Cases in point are the East European countries and the UAR.

2.4 WORKING OF NATIONALISED BANKS :

Structurally, the commercial banking system in India has gained distinctly in strength and cohesion, after bank nationalization in 1969. The policies of and working of the nationalized banks have now been brought into closer harmony and coordination with those of the State Bank of India and its subsidiaries. A better environment has thus been created for the formulation and implementation of monetary and banking policies. This major achievements of nationalized banks are in the realm of branch expansion and expansion of credit to agriculture, small scale industry and certain other hitherto neglected sectors.

2.4.1 Branch Expansion

Branch expansion gained momentum after the nationalization of major commercial banks and the introduction of the Lead Bank scheme. The following table shows the progress of branch expansion of commercial banks.

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Branch expansion since nationalization of banks

As on	Total no. of Branches	Rural branches	Rural branches as % of the total	Population per bank office
June 1969	8262	1833	22.19	64000
March 2002	68195	32503	47.66	15000

From the Table, it is clear thatafter bank nationalization in July 1969, there was a large increase in the number of branches, but the most spectacular progress was in rural centres, an increases from 1833 to 32503 bank offices.

The nationalized banks were entrusted with the task of opening new branches and taking banking facilities to remote rural areas and provide banking facilities. The task of opening new branches was quite easy, not only because the newly opened branches do not become viable for quite sometime from the point of view of profitability, but also because any vigorous branch expansion programme calls fro a matching number of adequately qualified and suitably trained personnel who should have the additional merit of adaptability in strange and economically backward areas. Despite, these obvious limitations, the nationalized banks have opened more new branches raising the total to 68195 as on 30th June, 2002.

The average population served per bank office at the time of nationalization was around 65,000. This has declined by April, 1976 to 26,000 and to 18,000 to June '79 and 15,000 by end-March '2002. In some of grossly underbanked States there has been a significant improvement in the population coverage of the commercial banks.

Thus the population per bank office in different states have come down sharply.

2.4.2. Deposit Mobilisation :

Deposits are the life blood of commercial banks. Deposits which are known as "stock-in-trade" are the major sources of operating funds and occupy 90 per cent of their total amount of liabilities. It is therefore, the banking system has a very import[illegible] role in mobilizing deposits (savings) to meet the challenges of economic growth in a developing economy. In order to finance the rapid development of the new priority-sectors without creating credit gaps in other sectors, the banking industry has to make all

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efforts to exploit the saving potential in new areas and among new classes of people, urban as well as rural, and introduce new schemes keeping in view the needs of the markets.

The record of commercial banks in mobilizing deposits in the post-nationalisation period has been quite encouraging. There has been a significant increase in the rate of deposit growth. From June 1969 to end of March 2002, deposits of 14 nationalised banks rose from Rs.4646 crores to Rs.1131188 crores.

The fast rate of growth of deposits of the banks can be of course ascribed to various factors. Important among them is the genuine effort made by nationalized banks in this direction. A sizable portion of the fresh deposits secured by the banks have originated form the new branches opened by them. The new branches are proving to be excellent for mopping up the surplus income of the rural people. Similarly, the concerted effort made by the banks to secure additional deposits at their metropolitan and urban areas, and other centres have been remarkably successful. During the past three years almost all banks have introduced attractive deposit schemes and the public has been showing interest in these new schemes.

2.5 Trend of Advances :

Bank lending is very important to the economy for it makes possible the financing of the agriculture, commercial and industrial activities of the country. Through their lending operations commercial banks have contributed to mass production and consumption, both of which have been responsible for our productive ability and scale of living. In short, bank credit is the base of all economic activity in the country and barameter of economic growth.

In pursuance of the objects of bank nationalization, new guidelines have been issued to commercial banks in the matter of provision of credit. They are:

1. Liberal assistance to the hitherto neglected sectors of the economy after estimating their credit requirement; and

2. To shift emphasis in the matter of lending from the security to the social objective and credit worthiness of the project for which credit is sought.

During the seven years since nationalization of the 14 major banks, their advances have increased at a phenomenal rate. Advances of nationalized banks which stood at Rs.3599 crores in June 1969 rose to Rs.609053 crores in March 2002.

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2.5.1 Credit to Priority Sectors :

The greater share of the increased advance went to the priority sectors are agriculture, small scale industry, transport operators, small business, retail trade, professionals and self-employed. Advances granted by the nationalized banks to the priority sectors, which stood at Rs.504 crores in July, 1969 rose to Rs.182255 crores in March 2002. The share of the priority of the priority sector stands today at 31 percent which was only 14 percent in June,1969.

Check your Progress

2. The reserve bank of india was nationalized in the year
   (a) 1935 (b) 1938
   (c) 1949 (d) 1951
3. In which field of advances is the state bank of India called a pioneering bank
   (a) ssi advances
   (b) agricultural advances
   (c) weaker section advances
   (d) small Business advances
4. This bank has the highest number of branches
   (a) RBI
   (b) Punjab national bank
   (c) state bank
   (d) none of these
5. The motive of a commercial bank is
   (a) safe custody of deposit
   (b) earning profit
   (c) social welfare
   (d) none of these

2.5.1.1. AGRICULTURE:

Prior to nationalization, agriculture which supports about 70% of our population and contributes nearly half of the gross national income had received the barest minimum credit facility. However with the nationalization of banks, the picture has completely changed. Advances to agriculture have increased by more than 800 percent apart from advancing funds for feeds fertilizers, pesticides, tubewells, pumpsets, tractors, land developments, poultry etc. Banks are also financing for setting up of service units in rural areas and for repairing costly equipments, like tractor and combiners. In accordance with the guidelines issued by the R.B.I. many banks have launched the village Adoption Scheme with a view to facilitating intensive agriculture development Nationalised banks advances to agriculture amounted to Rs.63083 crores as at the end of March 2002.

2.5.1.2. SMALL SCALE SECTOR:

During the period between June, 1969 and March 2002, advances granted by the nationalized banks to small scale sector have increased. Total advances granted by the nationalized banks to the small scale industries stood at Rs.49743 crores at the end of March 2002. The share of the Public sector banks in the total outstanding credit to the small scale sector increased to 12.5% in March 2002.

2.5.1.3. DIFFERENTIAL INTEREST RATE SCHEME:

Under the differential interest rate scheme of banks lending has been introduced recently to help farmers and workers belonging to low income brackets. Its operations have shown a marked increase in both the bumber of accounts and the amounts advanced.

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2.6 PROBLEMS OF NATIONALISED BANKS IN RURAL AREAS :

1. Public sectors banks in rural areas are facing competition from the post offices in the respective areas. Over the last 100 years, the post office has become a part and parcel of common man's life in rural areas, the post office is a companion of the people.

2. Banks have proved to be a very costly instrument for purposes of rural development Banks have a culture alien to the life. Extravagance and wastefulness in acquisition and décor of premises is transplantation of an urban habit to the rural scene.

3. A bank clerk getting salary much more than the village teacher or government official at the local level has created social tension by upsetting the stabilised set of monetary values.

4. The urban-oriented managers find it inconvenient to stay in rural areas, especially if they have the problem of educating their children. All the time they are busy in manipulating their transfer. By the time they come to know local people and environment, they are successful in obtaining a transfer.

5. So far as agriculture is concerned cheap credit is required by small and marginal farmers. It is beyond the present framework of commercial banks to cater to this sector in view of high costs and local skills.

2.7 COMMITTEE ON PUBLIC SECTOR BANKS :

In order to study all aspects of the functions of the public sector banks and to make recommendations for improving their efficiency, the Reserve Bank appointed the Raj Committee in 1977 to deal with the following matters.

1. To assess the impact of branch expansion that has taken place since 1969 and to examine whether any change in the tempo and direction of such expansion is called for.

2. To enquire into the present pattern of branch expansion of public sector bank and to suggest future course of action keeping in view the need for rural development and removal of regional imbalances.

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3. To evaluate the performance of public sector banks in the matter of lending to the priority sections and weaker sections of the society and to suggest ways for the orderly and balanced growth of such advances.

4. To advise on improving the efficiency of banks with a view to rendering better and speedy service to the public and

5. To examine the operation of vigilance work in the banks and to make recommendations to bring about improvements.

2.8 KEY TERMS

- **National credit council** : It was set up in February 1968 with the finance minister as the chair man and the governor or the reserve bank as Vice - chairman
- **Branch expansion** : The banks were required to open more branches in rural and semi - urban areas to have a balanced distribution of Bank officers in the countries.
- **Deposit mobilization** : The bank deposits have registered an enormous growth in the field of deposit mobilization due to expansion of branches and innovate schemes of deposits.

2.9 SUMMARY

The nationalization of commercial banks on 19 July, 1969 was a watershed in the history of Indian banking. Together with the state bank of India and its 7 associates which were brought under public ownership in the 1950s. The nationalization of 20 commercial banks there after resulted in bringing about 90% of banking business under the direct control, ownership and management of the public sector.

2.10 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) T (b) F (c) T (d) T (e) F
2. C
3. A
4. C
5. C

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2.11 QUESTIONS / EXERCISES

SECTION - A

(1) What are the causes for ntionalization of banks?

(2) What are the objectives of nationalization of banks in India? How far these objectives have been achieved?

SECTION - B

(3) Discuss the achievements and failures of nationalized banks in India?

2.12 FURTHER READING

(1) Sundaram & Varshiny - Banking theory law and practice

(2) M.L.Jingham - Money, banking international trade and public finance

(3) S.N.Maheswari - Banking theory law and practice.

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Unit-3 CHANGING ROLE OF COMMERCIAL BANKS

Structure

3.0 INTRODUCTION

Banking system is not immune to changes. Far-reaching changes are taking place in the system. But the influence of the system on the economy is believed to be dwindling. It is due to the growth of the country's economy which is accompanied by the growth of specialised financial Institutions. The growth of the public sector, the rise of financial intermediaries like building societies, hire purchase finance companies, specialised financial institutions for financing industries and the changing pattern of corporate financing and other factors have brought a grater emphasis on self financing.

3.1 UNIT OBJECTIVES

There appears to be a broad trend towards a shift of commercial bank's interest in favour of direct term loans. The participation in term loan business had aroused a great interest ever since the II world war, when enjoyed unprecedented liquidity. The use of term loans as a source for capital funds for industry is significant.

The Banking system in Great Britain, Australia and in India has shown remarkable resilience and vitality. As a result, there is an interesting diversification of banking functions. Thus Commercial banking today presents a new picture of innovations in practice.

3.2 PRIORITY SECTOR LENDING

Broadly, the priority sector comprises the following :

1. Agriculture
2. Small scale industries (including setting up of industrial estates)
3. Small road and water transport operators(owning upto 10 vehicles)
4. Small business (Original cost of equipment used for business not to exceed Rs.20lakhs.
5. Retail trade (advances to private retail traders upto Rs.10lakhs)
6. Professional and self-employed persons (borrowing limit not exceeding Rs.10 lakhs of which not more than Rs.2 lakhs for working capital; in the case of qualified medical practitioners setting up practice in rural areas, the limit are Rs.15 lakhs and Rs.3 lakhs respectively and purchase of one motor vehicle within these limits can be included under priority sector)
7. State sponsored organizations for Scheduled Castes/Scheduled Tribes
8. Education (educational loans granted to individuals by banks)
9. Housing [both direct and indirect – loans upto Rs.5 lakhs (direct loans upto Rs.10 lakh in urban/and urban areas respectively]. Metropolitan areas), Loans upto Rs.1 lakh and Rs.2 lakh for repairing of houses in rural/semi-urban
10. Consumption loans (under the consumption credit scheme for weaker sections)
11. Micro-credit provided by banks either directly or through any intermediary; Loans to self help groups (SHGs)/Non Governmental Organisations (NGOs) for onlending to SGHs.
12. Loans to the Software Industry (having credit limit not exceeding Rs.1 crore from the Banking system)

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13. Loans to specified industries in the food and agro-processing sector having investment in plant and machinery up to Rs.5 crore.

14. Investment by banks in venture capital (venture capital funds/companies registered with SEBI)

3.2.1 TARGETS UNDER PRIORITY SECTOR LENDING:-

The targets and sub-targets set under priority sector lending for domestic and foreign banks operating in India are furnished below:-

	Domestic banks (both public sector and private sector banks)	Foreign banks operating in India
Total Priority Sector advances	40 percent on NBC	32 percent of NBC
Total agricultural advances	18 pecent of NBC	No taget
SSI advances	No target	10 percent of NBC
Export credit	Export credit does not form part of priority sector	12 percent of NBC
Advances to weaker sections	10 percent of NBC	No target

(note : NBC denotes net bank credit)

3.3 NET BANK CREDIT

The net bank credit should tally with the figure reported in the fortnightly return submitted under section 42(2) of the Reserve Bank of India Act, 1934. However, outstanding deposits under the FCNR(B) and NRNR Schemes are excluded from net bank credit for computation of priority sector lending target/sub-targets.

'Direct Finance' for Agriculture Purposes denotes the following :-

Direct Agricultural advances denote advances given by banks directly to farmers **for agricultural** purposes. These include short-term loans for raising crops i.e. for crop loans. In addition, advances upto Rs.5 lakhs to farmers against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months, where the farmers were given crop loans for raising the produce, provided the borrowers draw credit from one bank.

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Direct finance also includes medium and long-term loans (Provided directly to farmers for financing production and development needs) such as Purchase of agricultural implements and machinery,Development of irrigation potential, Reclamation and Land Development Schemes. Construction of farm buildings and structures, etc. Other types of direct finance to farmers includes loans to plantations, development of allied activities such as fishery, poultry etc and also establishment of bio-gas plants, purchase of land for agricultural purposes by small and marginal farmers and loans to agri-clinics and agri-business centres.

'Indirect Finance to Agriculture denotes the following :-

Indirect finance denotes the finance provided by banks to farmers indirectly, i.e. through other agencies. Important items included under indirect finance to agriculture are as under.

(i) Credit for financing the distribution of fertilizers, pesticides, seeds, etc.

(ii) Loan upto Rs.25 lakhs granted for financing distribution of inputs for the allied Activities such as, cattle feed, poultry feed, etc.

(iii) Loans to Electricity Boards for reimbursing the expenditure already incurred by them for providing low tension connection for energising the wells.

(iv) Loans to State Electricity Boards for Systems Improvement Scheme under Special Project Agriculture (SI-SPA)

(v) Deposits held by the banks in Rural Infrastructure Development Fund (RIDF) maintained with NABARD.

(vi) Subscription to bonds issued by Rural Electrification Corporation (REC) exclusively for financing pumps-set energisation programme in rural and semi-urban areas and also for financing system Improvement Programme (SI-SPA)

(vii) Subscriptions to bonds issued by NABARD with the objective of financing Agricultural/allied activities.

(viii) Finance extended to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, subject to the following conditions :

(a) The dealer should be located in the rural/semi-urban areas.

(b) He should be dealing exclusively in such items or if dealing in other products, should be maintaining separate and distinct records in respect of such items.

(c) A ceiling of upto Rs.20 lakhs per dealer should be observed.

(ix) Loans to Arthias (commission agents in rural/semi-urban areas) for meeting. Their working capital requirements on account of credit extended to farmers for supply of inputs.

(x) Lending to Non Banking Financial Companies (NBFCs) for on-lending to Agriculture.

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3.4 'SMALL SCALE INDUSTRIES' (SSI)

Small scale industrial units are those engaged in the manufacture, processing or preservation of goods and whose investment in plant and machinery (original cost) does not exceed Rs. 1 crore. These would, inter alia, include units engaged in mining or quarrying, servicing and repairing of machinery. In the case of ancillary units, the investment in plant and machinery (original cost) should also not exceed Rs. 1 crore to be classified under small-scale industry.

The investment limit of Rs. 1 crore for classification as SSI has been enhanced to Rs. 5 crore in respect of certain specified items under hosiery and hand tools by the Government of India.

3.4.1 Definition of 'Tiny Enterprises'

The Status of 'Tiny Enterprises; is given to all small scale units whose investment in plant & machinery is upto Rs.25 lakhs. Irrespective of the location of the unit.

3.4.2 'Small Scale Service & Business Enterprises '(SSSBES) : -

Industry related service and business enterprises with investment upto Rs. 10 lakhs in fixed assets, excluding land and building will be given benefits of small scale sector. For computation of value fixed assets, the original price paid by the original owner will be considered irrespective of the price paid by subsequent owners.

3.4.3 Indirect finance in the Small - Scale industrial sector includes the following important items :

i. Financing of agencies involved in assisting the decentralized sector in the supply of inputs and marketing of outputs of artisans, village and cottage industries.

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ii. Finance extended to Government sponsored Corporation/organization providing funds to the weaker sections in the priority sector.

iii. Advances to handloom co-operatives.

iv. Term finance/loans in the form of lines of credit made available to State Industrial Development Corporation/State Financial Corporations for financing SSIs.

v. Funds provided by banks to SIDBI/SFCs by way of rediscounting of bills.

vi. Subscription to bonds floated by SIDBI, SFCS, SIDCS and NSIC exclusively for financing SSI units.

vii. Subscription to bonds issued by NABARAD with the objective of financing exclusively non-farm sector.

viii. Finaincing of NBFCS or other intermediaries for on-lending to the tiny sector.

ix. Deposits placed with SIDBI by Foreign Banks in fulfilment of shortfall in attaining priority sector targets.

x. Bank finance to HUDCO either as a line of credit or by way of investment in special bonds issued by HUDCO for on-lending to artisans, handloom weavers, etc, under tiny sector may be treated as indirect lending to SSI (Tiny) Sector.

3.5 TYPE OF INVESTMENTS MADE BY BANKS UNDER PRIORITY SECTOR

Investments made by the banks in special bonds issued by the specified institutions could be reckoned as part of priority sector advances, subject to the following conditions.

3.5.1. State Financial Corporation (SFCs) State Industrial Development Corporations (SIDCs)

Subscription to bonds exclusively floated by SFCs & SIDCs for financing SSI units will be eligible for inclusion under priority sector as **indirect finance to SSI.**

3.5.2. Rural Electrification Corporation (REC)

Subscription to special bonds issued by REC exclusively for financing pump-set energisation programme in rural and semi-urban areas and the System Improvement

Programme under its special Projects Agriculture (SI-SPA) will be eligible for inclusion under priority sector lending as indirect finance to agriculture.

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3.5.3. Nabard

Subscription to bonds issued by NABARD with the objective of financing exclusively agriculture/allied activities and the non-farm sector will be eligible for inclusion under the priority sector as indirect finance to agriculture/SSI, as the case may be.

3.5.4. Small industries Development Bank of India (SIDBI)

Subscriptions to bonds exclusively floated by SIDBI for financing of SSI units will be eligible for inclusion under priority sector as indirect finance to SSIs.

3.5.5. The National Small industries Corporation Ltd. (NSIC)

Subscription to bonds issued by NSIC exclusively for financing of SSI units will be eligible for inclusion under priority sector as indirect finance to SSIs.

3.5.6. National Housing Bank (NHB)

Subscription to bonds issued by NHB exclusively for financing of housing, irrespective of the loan size per dwelling unit, will be eligible for inclusion under priority sector advances as direct housing finance.

3.5.7. Housing & Urban Development Corporation (HUDCO)

a. Subscription to bonds issued by HUDCO exclusively for financing of housing, irrespective of the loan size per dewelling unit, will be eligible for inclusion under priority sector advances as indirect housing finance.

b. Investment in special bonds issued by HUDCO for on-lending to artisans, handloom weavers etc. under tiny sector will be classified as indirect lending to SSI (Tiny) sector.

3.5.8. The weaker sections within the priority sector : -

The weaker sections under priority sector include the following:

1. Small and marginal farmers with land holding of 5 acres and less and landless labourers, tenant farmers and share croppers.

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2. Artisans, village and cottage industries where individual credit limits do not exceed Rs. 50,000/-

3. Beneficiaries of Swarnjayanti Gram Swarojgar Yojana (SGSY)

4. Scheduled Castes and Schedules Tribes

5. Beneficiaries of Differential Rate of interest (DRI) scheme

6. Beneficiaries under Swama Jayanti Shahari Rojgar Yojana (SJSRY)

7. Beneficiaries under the Scheme for Liberation and Rehabilitation of Scavangers(SLRS)

8. Self Help Groups (SHGs)

3.6 ACTION TAKEN IN CASE OF NON-ACHIEVEMENT OF PRIORITY SECTOR LENDING TARGET BY A BANK : -

Domestic scheduled commercial banks having shortfall in lending to priority sector / agriculture are allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established in NABARD. Details regarding operationalisation of the RIDF such as the amounts to be deposited by banks, interest rates on deposits, period of deposits etc., are decided every year after announcement in the Union Budget about setting up of RIDF.

i. In the case of foreign banks operating in India which fail to achieve the priority sector lending target or sub-targets, an amount equivalent to the shortfall is required to be deposited with SIDBI for one year at the interest rate of 8 percent per annum.

3.6.1 Time limit for disposal of loan applications

All loan applications upto a credit limit of Rs.25,000/- should be disposed of within a fortnight and those for over Rs.25,000/- within 8 to 9 weeks.

3.6.2 Rate of interest for loans under priority sector

As per the current interest rate policy, in the case of loans upto Rs.2 lakh, the interest rate should not exceed the prime lending rate (PLR) of the bank, while in the case of loans above Rs.2 lakh, banks are free to determine the interest rate.

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3.6.3 Priority sector lending monitors by the reserve bank

Priority sector lending by commercial banks is monitored by Reserve Bank of India through periodical Returns received from them. Performance of banks is also reviewed in the various* for a set up under the Lead Bank Scheme (at State, District and Block levels).

3.6.4. Public sector banks

The outstanding priority sector advances of PSBs increased by 16.8 per cent to Rs. 1,71,185 crore as on the last reporting Friday of March 2002. At this level, priority sector advances formed 43.1 per cent of net bank credit (NBC). While other priority sector advances registered the maximum rise (33 percent), direct and indirect advances to agriculture, taken together, registered an increase of Rs.9,398 crore (17.5 percent). Advances to agriculture constituted 15.7 percent of NBC as on the last reporting Friday of March 2002.

3.6.5. Private sector banks

2.109 Total priority sector advances extended by private sector banks as on the last reporting Friday of March 2002 amounted to Rs.25,709 crore and constituted 40.9 percent of the NBC as compared with Rs.21,550 crore (38.2 percent of NBC) a year ago. The share of other priority sector category was the highest at 14.4 percent of NBC, followed by advances to small-scale industries (13.7 percent of NBC) and agriculture (8.5 percent).

3.6.6. Foreign banks

Foreign banks operating in India have to achieve the target of 32.0 percent of NBC for priority sector with sub-targets of 10.0 percent of NBC for SSI and 12.0 percent of NBC for exports. Lending to priority sector by foreign banks at Rs.13,414 crore constituted 34.2 percent of NBC as on last reporting Friday of March 2002 of which the share of export credit, as percentage to NBC was 17.7 percent.

3.6.7 Differential Rate of Interest (DRI) scheme

The differential rate of interest (DRI) scheme, introduced in 1972, is being implemented by all SCBs throughout the country. Under the scheme, bank finance is

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provided at a concessional rate of interest of 4.0 per cent per annum to the weaker sections for engaging in productive and gainful activities, enabling thereby an improvement in their economic conditions. As per the scheme, banks are required to lend at least 1 per cent of their aggregate advances as at the end of the previous year. Moreover, two-thirds of the total DRI advances must be routed through the bank's rural and semi-urban branches. The annual income ceiling for eligibility is Rs.7,200 per family in urban or semi-urban areas and Rs.6,400 per family in rural areas. The size of land holding must not exceed one acre of irrigated land and 2.5 acres of unirrigated land, with exemptions for SCs/STs. The maximum assistance per beneficiary has been fixed at Rs.6,500 for productive purposes. In addition to this, physically handicapped persons can avail of assistance to the extent of Rs.5,000 (maximum) per beneficiary for acquiring aids, appliances, equipment, provided they are eligible for assistance under the scheme. Similarly, members of SCs/STs fulfilling the income criteria under the scheme can avail of housing loan upto Rs.5,000 per beneficiary over and above the loan amount available under the scheme.

3.6.8. Special Agricultural Credit Plans (SACP)

In order to enable the achievement of the targeted agricultural lending, PSBs were advised to formulate Special Agricultural Credit Plans (SACP) since 1994095, and fix self-set targets for achievement during the year (April-March). Since the introduction of the SACP, there has been substantial increase in the flow of credit to agriculture from Rs.8,255 crore in 1994-95 to Rs.29,332 crore in 2001-02. During the year 2001-02 PSBs had disbursed Rs.29,332 crore upto March 31, 2002, as against the target of Rs.30,883 crore set for the year. The PSBs have set the target of Rs.36,779 crore for the year 2002-03.

3.6.9. Rural credit and credit to small-scale industries

The scope of priority sector lending was expanded during the year to include financing of activities relating to setting up of agri-business centres and purchase for agricultural purposes by small and marginal farmers. Further, the limits for financing of distribution of inputs for allied activities such as cattle feed, poultry feed, etc., under the priority sector was increased to Rs.25 lakh from Rs.15 lakh. In order to help the farmers in marketing their products, credit limits for marketing of crops was increased to Rs.5 lakh from Rs.1 lakh and the repayment period for such credit was enhanced to 12 months

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from 6 months. To avoid double counting, It was decided that sponsor banks of RRBs, while computing their performance under priority sector lending, should exclude funds provided to the RRBs for on-lending to priority sector.

Keeping in view the stipulated two-year time for achievement of priority secotr lending targets/sub-targets (fro lending to agriculture and weaker sections), all domestic SCBs having shortfall in their lending to these sectors as on the last reporting Friday of September 2001 and March 2002 were advised to take appropriate steps to improve credit flows to the priority sector, to achieve the target/sub-targets by March 2003.

3.6.10. Credit to small scale industries

Commercial banks have been advised to dispense with collateral requirements for the SSI sector for loans up to Rs.5 lakh. To further enhance credit flows to SSIs, the limit for dispensation of collateral requirements has been raised to Rs.15 lakh for those units having a good track record and financial position.

3.6.11. Specialised SSI bank branches

The PSBs have been advised to make concerted efforts to operationalise at least one specialized small scale industry (SSI) branch in every district and centre having cluster of SSI units. The convenor of the state-levela bankers committee (SLBC) for each state has to monitor the progress in the operationalisation of such specialized SSI branches. As at end-March 2002, there were 395 specialised SSI bank branches operating in the country. With a view to encourage banks to open more specialized SSI branches, banks have been permitted to categorise their general branches having 60 per cent or more of their advances to SSI sector as specialized SSI branches.

3.6.12. Standing advisory committee for Small Scale Industries (SSIS)

The Standing Advisory Committee was reconstituted to review the flow of institutional credit to the SSI sector. The terms of references broadly are to review credit flow to the sector and problems encountered thereon, suggest procedural and policy improvements in catering to the credit needs of the sector, examine other connected and related issues; and make recommendations related to or incidental to the above items. So far, two meetings of the reconstituted Standing Advisory Committee were held to deliberate on above issues of SSI sector.

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3.6.13. Khadi & Village industries commission

A consortium scheme with the corpus of Rs.1,000 crore has been set up for the banking system to provide finance to the Khadi and Village Industries Boards (KVIBs). As at the end of September 2002, an amount of Rs.365 crore was outstanding out of an amount of Rs.738 crore disbursed by the consortium under the scheme.

Table II. Advances to the Priority Sectors by Public Sector Banks

(As on the last reporting Friday)

Sector	No. of Accounts (in lakh)			Amount Outstanding (Rs.crore)		
	June 1969	March 1999	March 2002@	June 1969	March 1999	March 2002@
1	2	3	4	5	6	7
I. Agriculture	1.7	166	161 (5.4)	162 (14.2)	37,631 (15.8)	63,083
i) Direct	1.6	163	157	40 (1.3)	31,167 (11.7)	44,909 (11.3)
ii) Indirect	0.1	3	4	122 (4.0)	6,464 (2.4)	18,174 (4.6)
II. Small-scale Industries	0.5	24	22	257 (8.5)	42,591 (16.1)	49,743 (12.5)
III. Other priority sector advances	0.4	93	83	22 (0.7)	23,661 (8.9)	53,712 (13.5)
IV. Total priority sector advances #	2.6	284	269	441 (14.6)	1,04,094 (39.2)	1,71,185 (43.1)
V. Net Bank Credit	-	-	-	3,016	2,65,554	3,96,954

@ Date are provisional

\# Inclusive of advances to setting up industrial estates, funds provided to RRBs by sponsor banks, loan to software industries, food and agro processing sector, self-help group and venture capital.

Note : Figures in brackets represent percentages to net bank credit.

Source : RBI, Trend & Progress of Banking in India 2001-02, PP 78,29,22,207.

3.7 CREDIT POLICY

The main function of a commercial bank is to collect deposits and to make loans and advances. The banking companies are also considered to be business enterprises. So, they are to account for profitability. To ensure profit, they must employ their funds profitably. The loans and advances made by the commercial banks play an important role in their gross earnings and net profits. In order to promote the economic development of the country, the banks will have to play a responsible role in investing their funds. According to Sayers, the Commercial banks are not only purveyors of money but also manufacturers of money. They manufacture bank money through the process of credit creation. The banks can create more than and more credit with the desire of increasing their earnings. But, they cannot do so. Because, the credit creation capacity of Commercial banks is primarily based upon their deposit holding. Moreover, they will have to adhere to the principles of the monetary policy laid down by the monetary authority of the respective country. The Reserve Bank of India, being the central monetary authority, in consulation with the Central Government frames the monetary policy of the country. Moreover the RBI –the apex bank has enormous powers to direct, supervise and control the Commercial banks regarding their credit creation capacity. Also the RBI prescribes the terms and conditions under which the banks are to employ their funds.

From the customers point of view the banks will have to ensure safety, liquidity and profitability. It is a known fact that the success of the banking industry mainly depends upon the public confidence. Unless the banks make safe, liquid and profitable investments they cannot satisfy their customers as prudent bankers. Suppose, if a bank concentrates in profit and makes unsafe long term advances, it cannot ensure liquidity. So also if it makes safe and secured short term advances, profit will come down. Hence, it will have to take a wise decision before employing its funds, i.e., the money deposited by the public with a lot of ambitions.

3.7.1 Loan Function and Bank Income :

The most important objective of commercial banks is to maximize profitability. So in acquiring assets, the bankers will be influenced by the consideration of profit. The bank acquires assets mainly out of the deposits of the public. The deposits from the public constitute the biggest proportion of the bank's working funds. These funds are liabilities of the banks and returnable to their owners. They are also assets to the bank

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Check your Progress

1. State whether each of the following statement is 'true or false'

(a) The public sector banks are the banks owned by the Govt.

(b) Funds required for the conduct of industry and trade is known as Development Finance.

(c) Off-shore Banking borrows and lends - funds abroad

(d) A State Financial Corporation is allowed to subscribe directly to the shares or stocks of any company

(e) In credit authorisation scheme, scheduled commercial banks are required to obtain permission from RBI before sanctioning any fresh credit.

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since they fetch some revenue to the bank. The soundness of a bank will be clearly seen from the distribution of the bank funds on different types of assets. A good banker is one who follows a wise investment policy.

The basic function of credit by banks is to enable individuals and business enterprises to purchase goods and services. Demand for credit by businessman arises because of the time consuming nature of the productive and distributive processes. consumers need credit to procure goods in advance for which they pay in future. This time gap between production, distribution and consumption provides good chance the wide use of credit and with the development of the economy and its complexities have given birth to the growth of a number of financial institutions. Credit demands are accommodated by savings, but the demand for credit for productive purposes outstrips savings, and so the need for additional funds from financial institutions. Hence, the commercial banking system is a residual supplier of credit.

The commercial banks are doing the most important function of lending of funds with or without security. If we look into the balance sheet of a commercial bank, it clearly reveals that about 85 percent of its revenue arises from interest and discount i.e., earnings derived from advances including bills purchased and discounted and interest on investments. The strength of the banking system mainly depends upon the soundness of the advance. The fact is that advances inspire confidence in the minds of depositors and prospective customers of the banking industry.

The commercial banks are also the primary suppliers of credit in their savings deposits that are made available to borrowers just as funds are made available by other financial institutions. Banking companies provide credit facilities by crediting the account of the customers by accepting promise to pay from borrowers. These deposits created by the lending process result in an increase in the volume of money supply, and the economy is provided with more money. The capacity of the commercial banks to create money is playing a significant role in the economic development of the country. Easily available money will ensure economic progress.

The accumulated savings alone could not have increased our productive facilities and operations without the elastic bank credit system. A changing and developing economy wants not only abundant money supply but also one that is elastic which can be adjusted to the seasonal demands of business. Thus we find that, every loan made by the banker, comes back to the banking stream some how or other in the form of deposits. And every deposit that is received by the banker gets multiplied and takes the shape of more loans and advances which becomes a continuous process. On the other hand, if the borrower repays the loan, bank loans are reduced. With the result, the money supply gets reduced and the economic activity affected. Thus the economic activity of any country is governed, regulated and controlled by the lending operation of banks.

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The most important function of loans is to make it possible the financing of agricultural, industrial and commercial activities of the economy. Bank loans are called the indirect agents of production. Loans are available for producing commodities not only to meet the current requirements but also to feed the future requirements of the economy. Through consumer loans, they create constant demand for consumer goods such as houses, furniture, equipments, and all other essential and luxurious items.

The profitability of a bank always depends on the able manner and the areas in which its funds are employed to yield the maximum income. A successful industrial or business concern is one which has most profitably employed its resources. The banks resources position is slightly different i.e., in the case of typical industries they raise additional capital, float debentures, borrow from banks, make credit purchase etc., whereas the bank mainly depends upon the mobilization of deposits, the demand on its resources from trade, business and industrial sectors, both short term and long term, and the borrowing facilities available to it from the existing money market and from the central bank. Banks very rarely use the weapons of floatation of additional capital of debentures in order to strengthen their position.

The banks cannot simply keep the funds with them without proper utilization. Because, interest has to be paid on the deposits mobilized. Unless they earn, they cannot pay interest. It is, therefore necessary for the banks to lend or invest their funds at rates of interest higher than the rates offered or paid by them to their depositors.

When a bank lends loan to industrialist, the industrialist utilizes the funds for productive purpose. He may install a machine, but raw materials or hire an employee. The agriculturist or the employee either spends it on some purchase or deposits the money back to the banker. When the money is deposited back into the bank, it results in be lent out and so on. Deposits become the basis fro loans or investments which again come back to the bank as fresh deposits become the basis for new loans. Therefore,

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commercial banks are able to multiply loans and advances and thus multiply deposits. A small volume of cash is the basis for multiplication of deposits through magnification of loans and advances. It is in this sense that loans are the major source of deposits. Thus creation of credit is defined as the expansion of bank deposits through the process of more.

3.7.2. Lending Policy

"A Good bank is one which follows a wise and sound lending policy". The policy should bring in maximum profit for the share-holders and depositors and should provide maximum security to the depositors and customers. The banks do not usually lend hard cash. Most of the borrowings of the customers consist of the rights to draw cheques. They may be in the form of loans and advances, over-drafs, cash credits, or discounting bills of exchange. Etc., a bank does not lend its own money. Lord Overstone said "It is my own brain and other people's money". Ricardo also said, "A man becomes a banker only when he begins to lend other people's money". So the banks have no alternative left but to lend other people's money which they have received in the form of deposits. But, these are to be returned to the depositors on demand and in case, they fail to do so, they are to liquidate, and have to stop their business ultimately.

The funds of the banks are employed in the following six items.

(i) Cash (ii) Balances with other bank (iii) Money at call and at short notice

(iv) investments (v) Advance and (vi) the residual item "Other Assets".

The "Cash" is the most liquid form of assets and represents cash in hand and with the other banks and Reserve Bank of India. Its amount has varied from year to year. "Money at call and short notice" represents largely the amount lent to the money market and bill and stock brokers for short periods. "Investments" show the bank's investments in (i) securities of the central and state governments, (ii) semi-government securities such as port trusts, municipal bonds an debentures (iii) securities of public limited companies (iv) the amount used in buying gold. The item "advances" consists of two (i) of loans and advances and (ii) of bills discounted and purchased. Other assets contain all residual asset. For example, bullion, adjustment account of interest, commission, stationery, stamps, suspense, share in subsidiaries and balances with banks outside India in special accounts under trade agreements.

The banks can get maximum income by the proper development of its resources and it is necessary particularly in the present context when, till recently, there was a ceiling on the lending rates imposed by the RBI, and as the wage bills are going on mounting. The deposits rates are already sufficiently high although they do not compare favorably with many other areas of employment of funds yielding higher profits. The present rapid branch expansion into the rural and unbanked areas also contributes much to the increase in expenses of the banks. In order to maximize its profits a bank must effectively utilize its resources in the best possible manner despite the many inhibiting factors that come in the way of investment in areas of portfolios where the yield is heavy and the statutory restrictions preventing all its resources from being lent to borrowers without maintaining the prescribed liquidity of credit – deposit ratio. Great care has to be exercised in the choice of sectors or projects depending upon the priority under the social control objectives. Equally important is the estimate of funds required to finance these vis-à-vis the projected deposit growth.

Under the present RBI directives, banks are required to maintain 5% of total Demand and Time Liabilities in cash resources with the RBI and 33% in cash, investments and treasury bills Commercial banks mostly invest in Union Government, State Government securities and other approved securities. A small portion is also held in debentures and preference shares of companies. Apart from this banks also keep a small amount with Joint stock banks.

Thus the amount available for lending is restricted to 62% of demand and time liabilities and other resources minus other assets comprising stationery, furniture and fixtures, premises, etc.

3.7.3. Principles of Sound Lending

3.7.3.1. Safety :

"Safety" should be the first principle of banker, so far as his advances are concerned, because the very existence of the bank depends on the safety of its out standings, which should never be sacrificed to the profit earning capacity of its advances. By safety, it is meant that the borrower is in a position to repay the loan along with interest, according to the terms of the loan depending upon the borrower's capacity to repay and his willingness to pay. The banker should, therefore, take utmost care in ensuring

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that the enterprise or business for which a loan is sought is a sound one and the borrower is capable of carrying in out successfully. He should be a person of integrity, good character and reputation. The banks must make the people to believe that a bank will never advance any loans unless, it is fully secured. Such is no doubt the ideal conception of banking, but as a result of competition from other banks, every bank has sometimes to grant loans to its customers against their personal security. However, to maintain a banking concern in sound condition, it is very essential that the safety of its advances to customers should be its first principle. Due care must be taken to see that the funds lent out are not subject to any risk of being lost.

3.7.3.2. Liquidity

The banker while making advances must see that the money lent will not be locked up for a very long time, because banks are essentially the intermediaries for short-term funds as their deposits are largely repayable on demand. The banker must ensure that the borrower is able to repay the loan on demand or within a short period. It is the function of commercial banks to make loans which are more or less of a permanent nature. This is one important aspect which distinguishes banking from insurance finance. "The art of banking consists in knowing the difference between a mortgage and a bill of exchange". A mortgage is a kind or more less permanent investment and not ordinarily a banking security. The discounting of a good commercial bill of exchange on the other hand, is a very sound banking transaction. This depends on the nature of assets pledged to the banker. To say, goods and commodities are easily marketable while lands and buildings can be liquidated after a time gap. So liquidity is regarded as important as the safety of the funds.

3.7.3.3. Profitability

Without exception, commercial banks are profit-making institutions. They must employ their funds so as to maximize their income out of which to pay interest to the depositors, salaries to the staff to meet various other establishment expenses, distribute dividend to the share-holders and to spend something on developmental activities the interest rate charged by banks mainly depends upon the bank rate and the directives issued by the RBI fixing ceilings on interest rates on certain categories of advances. The sound principle of lending is not to sacrifice safety or liquidity for the sake of higher profitability.

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3.7.3.4. Purpose of the loan

The purpose for which the loan is required and the resources where from he is expected to repay have also an important bearing not only on its liquidity, but its desirability too. Banks do not grant loans for each and every purpose. They grant only to productive purpose and not for speculative and unproductive purposes.

3.7.3.5. The Principles of Diversification of Risks

This is a good principle of sound lending an efficient banker always tries to select the borrower very carefully and takes securities of tangible assets to safeguard his interests. Tangible assets are valuable assets. An industry or trade may face depressionary condition and the prices of goods and commodities may sharply fall. Even natural calamities like floods and earthquakes, policitical disturbances and the like causes may affect the business. To safeguard their interest against such unforeseen contingencies, the banks follow the principle of diversification of risks based on the famous maxim "do not keep all the eggs in one basket". It means that the banks should not lend to a few business enterprises only. On the other hand, the loans and advances should be spread over a reasonably wide area, distributed amongst a good number of customers belonging to different trades and industries. The banks thus diversify the risks involved in making loans and advances.

3.7.4. Loan portfolio

The manner in which these two apparently conflicting principles of liquidity and profitability are happily reconciled to the maximum benefit, calls for sound judgement and business acuman on the part of a banker, which come only after considerable experience. Experienced and successful bankers strike a golden mean by so arranging their various assets (advances, investments, etc) in different proportions of liquidity and profitability, that they do not find much difficulty in meeting their various commitments even during periods of crisis.

The loan portfolio is being widely classified in a variety of ways, according to security, maturity, method of repayment origin and purpose.

3.7.4.1. Cash Credit

Cash credit is given in cash to the business. It is an operative account against a credit limit granted by the bank. It is a drawing account operated in the same way as a

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current account on which an overdraft is sanctioned. This is considered as secured advance as it is ordinarily allowed against pledge, or hypothecation of goods, against book-debts or personal security. In India cash credit is the most popular mode of advance.

3.7.4.2. Over Drafts

It is a fluctuating account. Overdraft facility is allowed in current accounts only, within a limit and enables the customers to draw more than his credit balance, but not above the limit fixed for him. The security for this may be personal, shares, debentures, government papers etc. in certain cases life insurance policies and Fixed Deposit receipts are also accepted. This account is also operated in the same way as a current account with cheque book facility. The customer is charged interest on the daily balance only.

3.7.4.3. Demand Loans

A loan where no maturity period is prescribed and which is payable on demand is called Demand Loan. The specialty of this is that the entire amount of loan is paid to the debtor at one time either in cash or by transfer to his current account. Interest is collected at quarterly rates and where repayments are stipulated In installments , the interest is collected on quarterly rates on the reduced balance. The security can either be personal or in the form of shares, debentures, government papers, immovable property, fixed deposit receipts, life insurance policies, good etc. Maintenance of a loan account is chapter when compared to overdrafts and cash credit accounts.

3.7.4.4. Term Loans

It is defined as being a loan that has a final maturity period longer than one year, but less than ten years, depending upon the borrower's future earning capacity or cash flow. The most important feature of it is that it must meet the borrowers needs and help them to grow on a sound financial basis, and at the same time satisfy the lending bank's requirements for earnings, liquidity and safety. Term loans have assumed greater importance in the advance port folio of the banking system in the country next to cash credits. In the cash of long term loans, two or more banks agree to advance jointly to the borrowers in a certain agreed proportion, against a common security. Such loans are called participation loans or consortium finance. In 1970, participation certificates – a new credit investments – by which it sells, to a third party a loan it has already made to one of its customers. Participation certificate is a deed of transfer, legally transferring the title of customer's hypothecated current and movable assets.

3.7.4.5. Bills Purchased

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Clean or documentary bills are purchased by banks. The purchasing bank holds the bill only as security for the advance. The bills are sight bills and payable on presentation.

3.7.4.6. Bill Discounted

Usance bills maturing within a short period or on sight, are discounted. There are debited to bills discount account and credited to the customers account, less the discount. In this type of advance, banks mainly rely upon the credit worthiness, standing and means of the endorsers and the drawer. It is said that a good banker would prefer to invest in bills and avoid lending on real estate, because in the later case there are numerous complications which are not there in discounting the bills or promissory notes.

3.7.4.7. Packing Credit

It is essentially a short term advance to an exporter for assisting him to buy process, back and ship the goods. It does not normally exceed ninety days and is to be liquidated by negotiation. It is granted either by way of pledge or hypothecation of goods or against an export trust receipt.

3.7.4.8. Import Finance

Import financing includes finance for import settlement, finance or taking delivery of imported goods and import usance.

3.7.4.9. Consumer Credit

This is given only for limited amounts to customers for meeting their personal expenditures including purchase of household properties, luxurious items, repairing of houses, meeting of medical and educational expenses etc. under our Prime Minister's 20 point economic programme, the scope of consumer credit has been extended to cover marriages, funerals and associated religious ceremonies etc. The amount is given in lumpsum which is repayable in instalments within a short period.

3.7.4. 10. Clean Advance

It is generally grants for a short duration after considering the capacity of the borrower. As no security is offered, only such parties are considered eligible who would

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be in a position to adjust the accounts within a short period. This is sometimes provided on guarantee basis also.

Thus the banking industry is spreading its resources on various ways for ensuring safety, Liquidity, and Profitability. Mostly the banks make only secured advances, in order to reduce their risk of loss in the event of filure of the borrower to pay the loan at maturity. Unsecured loans do not give any protection to the bank. Credit of the type is based upon the integrity of the borrower. His legal promise to pay serves as the security.

Besides, bank loans can be classified as short, medium and long term loans according to the maturity of the loan contract. Further advance by use of purpose may be grouped as agricultural, industrial, trade, consumer credit, housing and numerous other forms.

There have been several changes in bank lending over the years in total amount, composition of the loan portfolio, security, maturity and attitude towards lending.

In a developing economy, when a dynamic role is being played by the banks, the loan portfolio will take new dimensions and let the banking industry cover and dominate all the fields of our economy.

3.8 CREDIT ADMINISTRATION

Industrial Administration is the art of determining objectives policies and procedures. Any individual, association or body corporate functioning in a dynamic economy should have a desirable objective. Towards the attainment of the predetermined objectives, one must lay down a suitable policy, executable under the present circumstances. Banking industry is an organized sector, which must contribute much in the lines of deposit mobilization and employment of resources in the most effective manner. Much is expected by an individual, the community and the economy at large form the Banking industry. We know that the banks, besides, performing their obligatory functions, involve themselves in each and every avenues of human and business activities. Towards social responsibility, the Bank Management should plan their activities accordingly so that they can serve everyone magnificently. The economic development of any country depends upon the sincere rendered and the dynamic role played by the Commercial banks. Finance which is primarily needed for any economic activity is scarce and shy on its availability and utility. It is the banking industry that mobilizes the savings of one and all and allocates properly subject to certain considerations on various means of employment of funds.

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3.8.1. Sources of credit information for credit administration

Usually banks do not exchange information with one another regarding credit facilities sanctioned by them to their constituents. In the absence of such credit information regarding the aggregate amount of credit obtained by a constituent from banks, it may be possible for him to obtain financial accommodation from a number of banks to an extent not warranted by his means or repaying capacity. To enable the banks to ensure that the grant of credit to individual parties was not excessive or beyond the safety limits, it was considered desirable to provide a machinery to pool the information relating to the total banking commitments of their constitutions. The Reserve bank has been given wide powers to direct any banking company. The RBI Act was suitably amended in 1962. This power also applies to the State Bank of India (Sec.27(2)). The RBI is also given power to publish any information obtained under the act if it considers it in the public interest to do. This information may be published in such a consolidated form as the RBI thinks fit.

The RBI is very much concerned with the administration of credit so that the finance available may be made use of by all the sectors. For proper utilization of credit, there must be some restrictions to the level of bank advances. The following are some of the factors of restrictions on the level of bank advances.

3.8.1.1. The size and maturity of Deposits

The major source of bank funds is the deposits made by the customers. Hence, the size of the deposits and maturity limit the advances. Bankers should keep the loans and advances always at a lower level and the advances should be repayable, at a short notice.

3.8.1.2. Credit control by RBI

The capacity of the banks to lend money largely consists of many questions in order to collect information. Even the pass book of the customer or a personal interview with a customer will enable the banker to get a clear picture of his position. Though the commercial Banks are free enough to create credit, they will have to adhere to the directions made by the RBI then and there, because the RBI is the ultimate controller of credit.

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3.8.1.3. Bazaar Reports

Banks also get information from the stock exchange brokers, traders and businessmen directly. The feelings of these people and a balanced opinion may be collected from these bazaar reports.

3.8.1.4. Exchange or credit information amongst banks

Banks use to exchange credit information among themselves. This will help for free and frank exchange of credit information amongst banks. In 1974, a new section was introduced in the RBI Act, to provide statutory protection to banks to exchange the credit information.

3.8.1.5. Balance sheet and Profit and Loss account

An analysis of the Balance Sheet and Profit and Loss account of the borrower over the previous few years will also reveal the borrower's financial condition.

In foreign countries, there are a number of specialized agencies collecting the credit report of a large number of businessmen. In India, there are no such agencies and in the absences of such a system crdit information about the prospective borrower has to be collected by the banks themselves through various sources. For the purpose of assessing the credit worthiness of a borrower, a banker has to, collect information relating to the character, capacity and financial standing of the borrower from a number of sources. Every bank maintains a credit investigation Department at the head office and main offices in larger cities to collect information. At other centres, the credit investigation function is performed by branch Managers.

3.8.2. The following are the important sources of credit information.

3.8.2.1. Loan Application Form

The application form is comprehensive enough containing a detailed questionnaire pertaining to the name of the concern, place of business, name of bankers with existing facilities, year of establishment, details of assets and liabilities, amount of advance required, period of advance applied, type of securities offered, sources of repayment, purpose of

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the advance etc., As all the needed information are to be incorporated in the said application, the banker at the time of scrutinizing the forms can get a clear picture about the borrower.

3.8.2.2. Market Report

Market Report of the party from the bazaar or from persons in the same line of business. Diverse options may be available which require to be carefully weighed.

3.8.2.3. Accounts

The account of the party in the bank or with other banks will help the bank to know The financial position, the turnover, the nature of transactions, the type and means of parties with whom the borrower is having connections.

3.8.24. Financial statement

These explain particulars regarding Income tax, Sales Tax and Wealth Tax. The income tax assessment orders will help bankers to have an idea about the net income of the party, whereas the sales tax assessment will give as idea as to the turnover of the party. The Wealth tax assessment orders may not be there in all cases, but wherever available, they will give a clue as to the extent of assets of the parties.

3.8.2.5. Legal documents

Reports about actions and decrees in the government gazette, Registration, Revenue and/or Municipal records, search in the office of the Registrat of Joint Stock companies and/or Sub-Registrar's office, etc., will also give some information needed to gather credit reports of borrowers.

3.8.2.6. Credit information bureau

The RBI in exercise of its powers under Sec. 450(1) of its Act., 1934 calls for statements from all the banks of the limits and particulars of advances sanctioned to various parties. These are statements relating to the last Friday of March, June, September and December and have to be forwarded by the branches of banks direct to the Chief Officer, Department of Banking operations, credit Information Division. This division is in a position to advise the principal officers of the banks about the number of banks that a party is dealing with and the total limits sanctioned by the said banks in respect of parties whose particulars are reported under the aforesaid section.

A study group of bankers has recommended the establishment of a central agency to be called the "Credit Information Trustee", for organized collection, collation, storage and exchange of credit information amongst banks. The study group which was appointed to interview exchange of credit information amongst banks, has submitted its report to the RBI. The group has observed that credit reports should highlight.

Management practices adopted by the subjects of inquiry and their behavioural pattern with their buyers, sellers and with the bank, instead of concentrating entirely on the worth of assets and financial strength. Aspects of ability, business acumen, business integrity and willingness to honour commitments have been given their due place in the scope of credit reports recommended by the study group. The group further favours the adoption by all banks of unified and common approach in collection credit information from market sources. It has suggested the use of a standardized check-list for the purpose.

Despite the various sources mentioned there is nothing like a Personal Interview with the borrower, by which a lot of information could be gathered by the banker before he takes a decision to lend or not. It may be formal with prior engagement or through a common friend. The essential purpose of the interview is to make a first hand knowledge of the borrower.

3.9 CREDIT ANALYSIS

A banker should not make any direct or indirect commitments and give any indication as to his recommendations. He should not accept what the borrower says as gospel truth. He should rather try to analyse and judge for himself the correctness or otherwise of the statements made by him. Sometimes, customers are inclined totally to exaggerate the size of their business, means, capacity, connections and the profitability of their proposals.

After gathering credit information through any one of the aforesaid sources, the banker should if necessary obtain further reports on the party from different sources. He should carefully assess the information and from a balances opinion regarding the acceptability or otherwise of the proposal. A good banker cannot lose his patience. He has to be human and full of understanding in dealing with the customers point of view although occasionally he may come across difficult types of customers. The banks also maintain a record of confidential reports on their important customers, particularly borrowers. These credit reports should be independently verified by the Managers and the sources from which such reports are obtained. The reports should be revised from time to time, at least once in a year.

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Each and every loan proposal should be a bankable proposition. Proposal for short term advances such as for working capital, seasonal needs, payment of tax, bridge over needs are preferred. On the other hand, proposal for long term loans are not attractive to banks. So also it is for financing an entirely new scheme or venture banks will consider them with great caution. The banker should justify the amount of loan needed by the borrower. The amount should be need-based. It is quite necessary that factors like tax, overheads, wages, legal expenses, stamp duties, agent's fees etc. should taken into account.

The banker should ensure that in the case of any type advance, there is a definite source from which prompt repayment is assured. There are certain points which may not have a direct bearing on the loan proposal, but will influence the banker's decision to consider the proposal favourably. Hence before disposing any proposal, the banker should examine from all possible angles and justify himself. With such a proper credit pattern, the banks can make credit available to all the sectors of the economy with special emphasis on the neglected and weaker sections. As per the recommendations made by the Thakkar Committee, the unemployment problem in the country may tend to have a solution, when the banks finance the job oriented proposals.

Credit planning which was introduced in the wake of bank nationalization aims at redirecting the flow of bank credit in favour of priority sectors and according to the overall national policies. Credit planning is a conscious effort on the part of banks to allocate their loan able funds among the various sectors. The Reserve Bank has till recently, initiated banks in credit planning at a micro level. The RBI has already set up a credit planning cell to direct Banks to prepare on an annual basis covering the traditional stock and busy with the individual banks or with top Management. Credit discipline is also another important factor for credit planning. The idea of production oriented credit assumes that for every manufacturing activity, there is a minimum credit need which must be satisfied and that every increase in production is expected to lead to a corresponding increase in the need for credit. Credit planning by banks alone will not bring credit discipline. The total credit creation from various sources in the economy will have to be matched with the increase in production and the total availability of funds to a unit will have to be kept under observation to ensure alignment with production trends. Only then credit planning would become successful. To make it more effective, the role of nonfinancial agencies has to be reduced. Thus credit planning, credit discipline and credit management are three important tools of future lending operation.

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3.10 BANK LOANS AND ADVANCES

In the modern economy, development of trade and commerce occupies a commanding position. To facilitate the growth of business activity and thereby to help and achieve economic growth, the supply of finance is essential. The Shakesperian saying "Neither be a lender nor a borrower" may benefit the individual and not the nation, as a whole. The whole business world will be at a stand-till if the flow of finance is checked. The modern business field is so large that its capital or financial requirements cannot be met by a single individual or by a group. That is to say, the group of investors who constitute the business sector is as big as the group of savers who constitute the capital market.

3.10.1. Types of bank loans and advances

A business unit needs finance for two purposes: 1) to start a new unit or to expand the old one, and 2) to run the present unit or for current operations. The type of finance required for the first purpose is called the fixed capital finance and for the second, the working capital finance. The term finance is granted for acquisition of fixed assets, establishment of new industrial undertakings, expansion in plant capacity, renovation or modernization of existing units and for other developmental activities. The term finance is different form the working capital finance in that the former is for medium term or long term, while the latter is for short period and it is repaid from the sale or liquidation of current assets against which such finance is usually given.

3.10.2. Term finance

Term finance is given for a 'term' because it cannot e repaid like the repayment of working capital finance from out of the sale of current assets over a short period. The term finance is in the nature of long term borrowing and hence as the resources of the commercial banks are mostly of a short term nature, it will not be desirable for them to look up their funds on term advances. That is why, there is a standing directive by the Reserve Bank of India that banks should not invest more than 5 percent of their deposits in term loans to industries.

Commercial banks can get refinance from the industrial Development Bank of India for industrial advances. In respect of agricultural advances for term loans refinance is available from the Agricultural Refinance and Development Corporation. Commercial banks grant term loans also in consortium with other financial institutions.

3.10.3. Working capital finance

Working capital is required mainly for financing inventory. Any stock in trade is called inventory. For holding the inventory, whenever the business concerns find their own funds inadequate, they resort to borrowing. In modern economy, banks assume a predominant role in inventory financing.

Banks extend finance against inventory either in the form of pledge or hypothecation. In the case of pledge, goods are in the custody of the banks and in hypothecation the stocks will be in the custody of the borrowers.

However, inventory financing by the banks should be need based. If it is granted just to enable the borrower to hoard the stocks to make them scarce in the market, it will be violating the policy of social objectives by the banks.

In the discussion of working capital financing, the following concepts come into the picture.

A) Clean Advance

A clean advance is extended if the borrower, is of first rate. It may be in the form of an overdraft or demand loan.

B) Margin

Banks do not advance the full value of the inventory to the borrower. They fix a margin ranging from 10 percent to 50 percent depending mainly on the durability and salability aspects of the stock. In respect of the selective credit control commodities like food grains, indigenous cotton and kapas, margin is fixed by the Reserve Bank of India.

C) Double Finance

The concept of double credit has an important position in the discussion of industrial financing. Many of the financial indisciplines in the past were due to double

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financing. The meaning of the concept is very simple. When inventory is obtained on credit basis from the market and if credit is obtained on the same stock either on pledge or hypothecation from the bank it means double financing. However, thanks to the studies made by the Dehejia Committee in 1968 and by the Tandon Committee in 1974, now things have changed. The guidelines of these committees in their reports will enable bank to appraise the credit proposals perfectly. The banks follow certain important techniques in valuing the inventories of the industries and assessing their credit requirements by eliminating double financing.

3.10. 4. The findings of the dehejia committee

This committee, as a study Group, was appointed by the National Credit Council in 1961 with Mr. T.V. Dehejia, State Bank of India as its chairman. The object was to study the extent to which credit needs of industry and trade are likely to be inflated and how such trends could be checked. The Study Group had found that the ratio of bank borrowings to inventories had steadily gone up in all industries since 1962-63 from 46. to 93.2 percent. The Study Group had also found that several industries had obtained credit much higher than the rise in their production. In short, it was shown that there was a big credit inflation in industrial financing. Further the committee made out on its report that a greater part of the funds borrowed for working capital on short term basis were diverted to acquire fixed or other "non-current assets". The Group was of the opinion that unless measures are taken to check the tendency for division of bank credit for acquiring long term assets, it may assume wider dimension in the next few years.

3.10.5. Tandon study group : Banks are bridging working capital gap

The Reserve Bank set up a Study Group to frame guidelines for follow up in July 1974. It was under the chairmanship of P.L. Tandon. The terms of reference to the group were :

(a) to suggest guidelines for the commercial banks to ensure the end use of funds and keeping a watch on the safety of the advances.

(b) to suggest the type of operational data and other information that may be obtained by the banks periodically from the such borrowers and by the Reserve Bank from the lending banks.

(c) to make recommendations for obtaining periodical forecast from borrowers of a) business production plans and b) credit needs

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(d) to make suggestions for prescribing inventory norms for different industries both in the private and public sectors and indicating the broad criteria for deviating from these norms.

(e) to suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings.

(f) to make recommendations regarding the sources for financing minimum working capital requirements.

(g) to make recommendations as to whether the existing pattern of financing working capital requirements by cash credit, overdraft system etc, requires to be modified and if so, suggest suitable modifications, and

(h) to make recommendations on any other related matter.

The Study Group was appointed after the nationalisation of major commercial banks in July 1969. Hence, it assumed more importance after the nationalisation. There was an imperative need for the banking system to have a new approach as a credit agency, based on security only to assist the weaker sectors of the society and to lend to the public sector also. The study group submitted its report to Reserve Bank in August 1975. The Reserve Bank considered some of the main recommendations of the Group and advised banks accordingly.

3.10.6. Norms for inventories and receivables

The Reserve Bank has accepted the norms suggested by Tandon Study Group in respect of a total of 15 major industries and these should be applied in respect of both the existing and new borrowers with immediate effect. In the case of all existing borrowers if their levels of inventories and receivables are excessive on the basis of the suggested norms, the matter should be discussed with them and a programme for a phased reduction therein worked out. In case the excessive levels continue without justification, the Bank may consider charging a higher rate of interest on the portion of the borrowings considered as excessive. In this situation the bank should not abruptly stop the operation of the account which may upset the borrower's account. But it may consider charging interest only after a reasonable period of about two months. To keep a watch in this regard, bank may call for additional information. The control should, however, be exercised with due flexibility and understanding of the circumstances which may warrant deviation from the norms for temporary periods.

3.10.7. Coverage

Initially, the norms were to cover all industrial borrowers including small scale industries with aggregate limits from the banking system in excess of Rs. 10 lakhs. Small borrowers (i.e., industrial borrowers with aggregate limits of Rs. 10 lakhs or less) should be covered progressively as early as possible. In case of industries for which norms have not been specified by the Tandon Study Group, the purpose and spirit of norms should be kept, in mind while extending credit facilities.

3.10.8. Approach

The Study Group has identified working capital gap, viz., the borrower's requirements of funds to carry current assets (based on normals) then those financed out of his other current liabilities. The gap could be bridged partly from his owned funds and permissible limits of bank borrowings could be worked out in three ways. In the I method, borrower will have to contribute a minimum of 25 percent of the working capital from long term funds. (i.e. own funds and term borrowing) This will give a minimum current ratio ot 1:1., In the II Method the borrower will have to provide a minimum of 25 percent of total current assets from long term funds and this will give a current ratio of at least 1:3. In the III method, a borrower's contribution from long – term funds will be to the extent of the entire core, current assets and a minimum of 25 percent of the balance current assets, thus strengthening the current ratio further.

A beginning may be made with I Method placing all borrowers in this method within a period of about 1 year and the ideal III Method may be reached in stages. The literal approach under the I Method has been suggested as a first step, particularly to facilitate financial structure of new companies setting up project in backward areas and also for flexibility in restricting of existing companies with a week financial base. However, the aim should be to move forward and the borrower should not slip back from a higher to a lower category.

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The Reserve Bank directed the banks to initiate immediate action to place all borrowers having credit limit in excess of Rs. 10 lakhs from the banking system on the I Method suggested by the Group i.e., financing a maximum of 75 percent of the working capital gap. It should be completed within a period of about one year, say by the end of September 1976. At the same time the banks should ensure that the borrowers already in the II Method do not slip back to the position, under I Method. However, in the case of borrowers already in the II Method (i.e., where more than 5 percent of current assets are financed by borrower's owned funds and term borrowing) bank may view a case if there is a possibility of their increasing their dependence on bank's finance. For existing borrowers, any excess over the finance to which they would be eligible under the new formula will be identified and covered into a term loan which may be amortised gradually, the period of amortization depending upon the borrower's cash generating capacity, his ability to raise additional equity and other relevant factors.

3.10.9. MODEL OF CREDIT

The Reserve Bank directed the banks to bifurcate the cash credit accommodation into two components viz, a) loan and b) demand cash credit. The former comprises the minimum level of borrowing which the borrower expects to use throughout the year; the latter is to take care of the fluctuating requirements. Both are being reviewed annually. Within the overall availability, bill limits may also be allowed. Such bifurcation of credit limits should be done in all cases at the time they are required to conform to the criteria specified in the 1 method.

3.10.10. INFORMATION SYSTEM

One of the suggestions of the Study Group said that the borrower should furnish to the banker an operating statement and fund flow statement for the whole of the next year, as also projected balance sheet as at the end of the next year along with the application for advance or renewal for fixation of the overall credit limit.

The Reserve Bank recommended that the proposed information system may be introduced, to start with in respect of borrowers with limits aggregating Rs.1 crore and above from banking system and the process should be completed within six months.

The borrowers who are already having the information system should be asked to commence submitting quarterly data straightaway and other borrowers should be

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asked to buildup the requisite information system what we call the Selective Credit Control. This is the most effective way so that they also start submitting the data within the aforesaid period of six months.

It was urged that the implementation of new system should be effected with a considerable degree of understanding and flexibility so at the switch over is smooth.

It is believed that the new system release the excess funds locked up with the existing borrowers. These funds could be realized not only to facilitate further growth of the economy; but also orderly growth of bank credit.

3.10.11. The control of R.B.I. on bank loans and advances

Since finance plays a vital role in the development of the economic activity, the Reserve Bank controls and regulates the business activity through its monetary policy. Monetary policy is of two types a cheap money policy. The supply of money is regulated according to conditions prevailing in the country.

The Reserve Bank controls the commercial banks in the matter of financing industry and trade by altering the credit margin on credit ratio by manipulating the bank rate and through the system of variable cash reserve. The Reserve bank follows a discriminatory monetary policy by resorting to a system of what we call the selective credit control. This is the most effective system that ever could the bank follow in controlling the evil practices of speculation by business people. The manipulation of credit margin and, the fixation of credit all these fall under this system.

The authoritative powers of the RBI exercised over the bank advances and loans may be vividly seen.

3.10.11.1 Directives by the RBI on credit limits

In 1970, the RBI issued a directive to all commercial banks to regulate their advances against shares. According to this directive, every commercial bank which grants or renews an advance limit of over Rs.50,000 against the security of shares to a borrower stipulate that the shares shall be transferred to its name and that it shall have exclusive voting rights in respect thereof in any manner whatsoever and get the shares transferred to its name.

With a view to meeting, on a priority basis, the financial requirements of industry to manufacture and supply goods necessary for defence purpose in the context of war situation the **RBI advised banks** on December 11, 1971, to grant on merits, defence **packing cum supply' credit** limits against confirmed defence orders or acceptance of tenders.

In the view of the continuous increase in prices of sugar and gur, the RBI issued an amending directive to all schedule commercial banks on December 27, 1971, tightening the control on advances against these commodities. Thus the minimum margin was raised from 50 percent on advantages against these commodities.

3.10.11.2 The credit authorisation scheme

The Reserve Bank introduced this scheme in November 1965. Under this scheme, schedule commercial banks are required to obtain the prior authorization of the Reserve Bank before sanctioning any fresh credit limit exceeding Rs.25 lakhs to an individual.

3.10.12 Consortium advances

In the present context of monetary policy and the credit queeze imposed on the commercial banks in the country, the resource position has become very tight for each and every bank. Large advances can be extended only –by two more banks jointly. This type of financing is known as consortium advance.

3.11 APPRAISAL OF PROPOSALS FOR BANKS LOANS AND ADVANCES

Before sanctioning a loan, the bank takes much care in appraising the loan proposal of the applicant. This is to eliminate double financing and to evaluate the credit worthiness of the borrower. Thus appraisal of the loans and advances is an integrated path in the study of bank financing. Appraisal is easy in respect of an existing unit as there are details about the performance; but it is very difficult in the case of new projects. The bank has to assess the proposal on the basis of the future performance of the unit.

The commercial banks observe the norms and other guidelines which are suggested by the Dehejia and Tandon Committiees in appraising the loan proposals.

In commercial the proposals the Bank has to be provided which the following information.

3.11.1. Information required for appraisal

a) Description of the business unit with full name, address, history, nature of business and capital structure.

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Check your Progress

2. Funds needed and supplied for the conduct of agriculture and allied Activity

a) Development Finance
b) Government Finance
c) Agricultural Finance

3. The aggregate bank credit of public sector advances

a) 40% b) 50% c) 60%

4. The Narasimham committee on the Banking Sector reforms submitted its report to the Government

a) In April 1968
b) In April 1988
c) In April 1998

5. NABARD's Resources are contributed by

a) equally by RBI and the Govt. if India
b) only by RBI
c) By Commercial Bank

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b) The names of principal shareholders, directors and officers with their industrial and business background.

c) The annual for the past three years of the company

d) Shares through finances by the IDBI, IFC, ICICI, LIC and UTI.

e) In the case of company affiliated to a group, details regarding its relationship to the group about its registration under the monopolies and Restrictive Trade Practices Act.

f) The present production facilities of the company.

g) The annual account of the past or four years and up-to-date performance accounts.

h) The company's tax status under Income=Tax Act.

Banker will always will examine this overflow (tax payments etc.,) aspects by preparing the funds flows statement. The funds statement for 3 to 4 years will show how the variation in liabilities (funds) are reflected in investment with variation in the assets over years. The flow of funds can be identified in variation in assets by rise for all.

3.11.2. Working capital assessment - Tandon panel system

The Tandon Committee has suggested three alternative methods to find out the working capital gap i.e., the borrower requirement of finance to carry current assets based on the suggested money fixed by it and lays down the maximum permissible level of borrowing in each situation.

The following is an example of a borrower's financial position projected at the end of the next year (in lakhs of rupees)

CURRENT LIABILITIES		CURRENT ASSETS	
Creditors for purchase	100	Raw materials	200
Other current liabilities	50	Stock in process	20
Finished goods	90	Receivables	50
Bank borrowing	220	Other current assets	10
Total	**370**	**Total**	**370**

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METHOD - I

ADD:	Current assets as per the norms	360
	Other current assets	10
	Total current assets	370
LESS:	Current liabilities other than the bank borrowings	150
	Working capital gab	220
	25% of the gab to be brought from long term sources	55
LESS:	maximum bank borrowings permissible	165

In the first method as above the borrower will have to contribute a minimum of 25 percent of the working capital gab from owned funds.

In the second method the bank finance admissible may be shown as under:

METHOD – II

Total current assets	**370**
Less: 25 percent from long terms sources	92
	278
Less: current liabilities other than bank borrowing	150
	128
Working capital gab	128
maximum bank borrowing permissible.	

In the second method, the borrower will have to provide a minimum of 25% of the current assets from long-term funds.

In the third method the permissible bank finance can be shown as under:

METHOD - III

Total current assets	370
Less: core current assets to be financed from long term sources	95
This figure is assumed one	275
Real current assets	
Less: 25 percent from long term sources	69
	206
Less: current liabilities other than bank borrowing	160
working capital gab	56
Maximum bank borrowing permissible	56

3.11.3. Commercial bank and terms loans in india

3.11.3.1. Term Loans

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A term loans is a business loan with a maturity of more than one year. Ordinarily, term loans are retried by systematic repayments, (often called amortization payment) over the life of the loan, although there are exceptions to the rule. Security, generally in the form of chattel mortgage on equipment, is often employed; but the larger, and financially viable companies are able to borrow on an unsecured basis. The primary lenders of term credit are commercial banks, insurance companies, financial corporations, etc.

3.11.3.2. Characteristics of term loan

There are four important characteristics of term loans viz., a) Maturity b) Collateral c) Options and d) Repayment provisions.

Maturity

For commercial banks, the term loans run for years; while for insurance companies, it runs for 5 years. This different reflect the fact that liabilities of commercial banks are shorter than those of insurance companies. Banks and insurance companies are occasionally co-operative in their lending. For example, if a firm (usually a larger one) seeks fifteen-years term loan, banks make the loan for the first five years and an insurance companies for the last ten years.

Collateral :

Collateral security refers to additional security. For term loans over and above the personal securities such as stocks, bonds, machinery and equipments. Normally commercial banks require security of above 60% of the volume and 90% of the number of term loans.

Options :

In recent years, institutional investors have increasingly taken compensation in addition to fixed interest payments on directly negotiated loans. The most popular form of additional compensation is an option to buy Equity Shares, "the option being in the form of detachable warrants permitting the purchase of the shares at stated price over a designated period.

Repayment provisions :

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Most of the loans are repayable in equal installments. Only a small percentage of the loans have and balloon segment of unamortized balance, at the end. It is possible to repay term loans ahead of schedule, but a repayment penalty equal to 3 to 8 percent of the outstanding balance is usually assessed in such cases.

3.11.3.3. Needs

Term lending and financing of industries are twins. They always move together. In the modern era, every industry does require two types of capital for financing their assets. They are i) block capital and ii)working capital. Block capital is required by the exiting as well as new industries. New industries require block capital to make a start, and the old industries for expansion and replacement. It is utilized to finance fixed assets such as machinery buildings, land and other permanent equipments.

But working capital is needed to finance current or floating assets such as purchase of raw materials, conversion of raw materials into finished goods, and the provision of funds for daily needs. The working capital is obtained partly on long term and partly on short term basis. The production between block and working capital in every industry depends upon its nature of production process. The more the round about the process of production the greater is the proportion between block and working capital.

Thus from the above analysis, it is obvious that every industry gets finance for long-term and short-term. And the longer period aspect in case of lending to industries to go in for fixed is referred to as "term" and the lending aspect based thereon is called, "Term – lending".

3.11.3.4. Appraisal of term loan proposals

The habit and practice of making an appraisal of tem loan application was not so significant during the initial stages. But with a view to reduce the risks involve in term lending, the commercial banks now a days assess the more or less equivalent to investment decision. It requires dynamic approach, involving a projection of future trends of sales, production, returns and inflow of funds and estimates of casts and to a certain extent the managerial capabilities.

Appraisal of term loans depends to a large extent on estimate of forecasts. Its purpose is not to set down a categorical statement of the long range prospects of an industrial unit, but only to provide a broad outline to the financial institutions.

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In practice, banks do not have fixed or set principles and approach for appraising tem loans. Numerous and diverse elements enter into the process of appraisal. The weightage given to the several factors in the scrutiny varies from one case to another. The important factors among these are:

a) The type of organization:

b) The activity of the borrowing unit:

c) The nature of its product:

d) The market share and potentiality:

e) The size:

f) The nature and the trend of the economy and industry:

g) The capability of its management:

h) The soundless of its financial position:

i) The amount of the loan:

j) The term of the loan:

k) The repayment schedule: and

l) The government regulations:

The above factors are readily available in case of projects for the expansion or reconstruction of the existing units whereas in the case of new projects, assessment is difficult due to the absence of data on past performance. Hence, the degree of risk involved more in the case of new projects than in the case of the existing one.

Generally, two important criteria are adopted by the financial institutions before extending term loans. They are:

a) Commercial profitability of a project and

b) The importance of the development aspects to resources of the economy.

But banks are usually inclined to adopt commercial profitability than that of development criterion, because sometimes commercial profitability is more real than apparent. The commercial profitability of a project also depends upon the extent of state support and the manner in which it is made available in the form of import control, protective duties, subsidies, tax, rebates and other concessions provided the state. Hence, banks have to take note of these aspects in their appraisal. An appraisal of a loan application should take into consideration the current developments in the economic policy of the

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Government. In addition to that, import control, general price traffic protection etc., affecting the establishment as well as the day to day functioning of an industrial unit.

3.11.4. Security against term loan

The important basis for lending is the consideration of security. They constitute necessary adjunct to financial appraisal.

Generally loan proposal are examined by the lending institutions from the point of view of nature an extent. Of security offered. In under development countries like India, security considerations are most important because on the non availability of information On character, honesty, and credit worthiness of the borrowers. So every prudent term lending institution secures its loans by collateral securities and sometimes even by guarantees. Now a days term lending institutions do not depend upon the integrity of the borrower's past and present earnings for the repayment of loans. Hence, almost 90% of the loans are secured by collateral securities.

Types of securities

The term lending institutions are generally granting loans by accepting the following ypes of security viz.,

Though the above stated securities are accepted by the term lending institution or granting loans, to ensure prompt repayment of term loans, they do prefer to sanction oans only on the personal guarantees of the directors.

There are certain procedures followed in sanctioning term loans. The intended orrower has to make an application stating the amount required to the lending institutions and agree to the loan agreement.

The objects of enforcing the conditions of loan agreement are as follows:

i) To ensure prompt repayment of loans.
ii) To induce the borrower to give the primary importance for discharging the term.
iii) To ensure the maintenance of soundness of the financial position of concern.
iv) To restrict a concern not to borrow additional loans of long term basis with the approval of the lending institution.
v) To maintain sound dept equity ratio of a concern.

vi) To restrict a concern not to declare excessive rate of dividends.

vii) To insist a concern to maintain minimum working capital.

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3.11.4.1. Technical feasibility

The first and foremost appraisal of term loan is examination of technical feasibility. It involves a careful and through study and assessment of the goods and services the project. It includes land, raw materials, building, supplies, water, etc., The lend institution should assure itself that these requirements are available. If these requirement are imported from abroad, the lending institution should study the market condition abroad and their Government policies to a certain extent the political stability and general economic order.

The examination of the type of technology to be used for the project is another peculiar feature of technical feasibility. For this purpose, it is inevitable on the part of the institution to employ technical-personnel, so that exiting as well as new type of technical process used can easily be reviewed. Usually, the examine to technical feasibility draws the attention of the lending institution to the following aspects.

a) The feasibility of the technical process selected and its suitability to Indian conditions.

b) Location of the project, particularly in relation to the sources and availability resources.

c) specifications of plant and equipment.

d) Arrangement for securing the technical known how and training of personnel and labour

e) Plant layout

f) Facilities for the disposal of effluents and also of by products

g) The construction schedule and

h) The quality of the Research and development department

3.11.4.2. Economic feasibility

The examination of economic feasibility of a project requires the assessment of the following factors viz.,

a) The earning capacity of a project

b) Market condition and

c) The projection of demand

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a) The earning capacity of a project depends on the volume of turnover. And the volume of turnover is determined as to the extent of absorption of the output at given prices. In other words, the examination of this aspects takes into account two vital factors, viz., i) the total output of the product and ii) the existing demand for it with a view to ascertains of unsatisfied demand are i) the price level and ii) the existing of controls.

b) The assessment of market conditions draw the attention of the lending institution towards the examination of the supply side of the product. It involves the collection of the following data:

i) Production capacity

ii) Age of plant and machinery

iii) Profitability

iv) Technical competence and

v) Scope of expansion, etc.,

c) Projection of demand is another important task involved in examination of Economic feasibility. The demand for a product is affected by a variety of factors and may be difficult to take into account all these. If information concerning the demand for a product in the past is available, forecasting of demand over a period of years can be made on the basis of assumption concerning future trend of all prices and incomes particularly in the case of consumer goods industry. The forecasting of demand for intermediate goods and capital goods is more complicated because the demand for such goods is affected by changes in incomes and prices only indirectly. Estimation of demand can never be wholly reliable. They can at best be considered as approximation.

3.11.4.3. Financial Feasibility and Term Loans:

The assessment of financial feasibility of a project requires the following data:

a) Cost of the project

b) Cost of production and profitability

c) Cash flow estimates during currently of the loan and

d) Proforma Balance Sheet

e) Cost of the project

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Term lending institutions would like to obtain data relating to cast of the project with a view to ascertain whether the project is a sound financial proposition or it would require modifications. And the data relating to cast of project usually includes the examination of the following items:

i) Assets such as buildings, plant and machinery, etc.,
ii) Technical known – how,
iii) Preliminary expenses,
iv) Interest and loan,
v) Architect's fees,
vi) Intangibles
vii) Networking capital requirement and
viii) Allowance for unforeseen costs;

The total of the above represents the total cost of the project. In addition to this the borrowing unit should also finish as to how this cost of the project is determined to be financed which is described as "means of financing". The usual source of finance are as follows:

i) Share capital
ii) Issue of debentures
iii) Borrowing
iv) Deposits from public
v) Reserves and surplus
vi) deferred payments; etc.,

3.11.5. Cost of production and profitability

In obtaining the statement relating to cast of production, care should be taken by the lending institution that no important element of cost is omitted. It should also assure itself that data regarding each component of the total production is clearly obtained.

The next duty is the examination of profitability. It depends on two important factors. Viz., i) sales and ii) total cost of production. When we deduct total cost of production from the sales, we get operating profit. And from that, if tax and other indirect expenses are deducted the net profit is arrived at.

.11.6. Cash flow estimates

Cash flow estimates of the project are absolutely essential with a view to determine when the project will need money for different purpose, and what are the different sources

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or such funds. This will ensure sound financial planning and reasonable assurance the availability of cash to meet the requirements of the project from time to time. Repayment of installments of loans is also arranged according to the cash accrual shown in the cash flow statement. And for each year cash flow estimate can be shown in the following manner:

	Rs.
Sources of funds	
1) Net profit after (deprecation and development reserve)	
2) Share capital increase	....
3) Increase in long-term borrowings	....
4) Increase in short-term borrowings	....
5) Depreciation rebate reserve	....
6) Development rebate reserve	....
7) Others (specify)	....
	....
Total	Rs.
	....
Application of funds	
1) Fixed assets and capital expenditure	....
2) Current assets (such as book debts, closing stock, bills receivable etc.,)	....
	....
3) Repayment of long-term borrowings (including deferred payments)	....
	....
4) Repayment of short-term borrowings	....
5) Interest	....
6) Other assets	....
7) Taxation	....
8) Other expenses	....
	....
Total	Rs.
	....
Opening balance of cash	....
Surplus / deficit between sources and applications of funds	....
	....
closing balance of cash	....
Rs.	....

$$\text{Dept services coverage ratio} = \frac{\text{interest on long-term loans}}{\text{Net profit before interest / tax}}$$

3.11.7. Proforma of balance sheet

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The assessment of financial feasibility for the existing concern under this has three important steps viz.,

a) The examination of final accounts and balance sheets of the past few years.

b) The preparation of estimate of the cash flow statements for the new next few years depending upon the period for which the term loan facility is utilized for.

c) The working out of the estimated balance sheet for similar period.

For the new project, all the required figures come from the cash flow estimation. And the preparation for the proforma balance sheet usually reflect the projected financial position of a concern. The following is the Pro-Forma Balance – Sheet Estimates.

	Construction I Year II Year	Operation I Year II Year
LIABILITIES		
Capital	………	………
Reserves and surplus	………	………
Long term debt	………	………
Total	………	………
ASSETS		
Gross fixed assets	………	………
Less : Depreciation	………	………
Current Assets	………	………
Intangible assets	………	………
Total	………	………

$$\text{Debt equity ratio} = \frac{\text{Debt / Total Assets}}{\text{Equity / Total Assets}}$$

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

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3.11.8. Managerial competence and term loans

The appraisal of the repaying prospects of the borrower is another important task of the lending institution. It involves the assessment of the managerial competence of the borrowing unit. The confidence of the lending institution in repayment capacity of the borrower will be strong only when the following managerial factors are well established:

a) Managerial ability
b) Technical competence
c) Integrity and dynamism of the management
d) Managerial co-ordination management
e) Resourcefulness of the management

Hence, it is evident to say that a loan application gets priority and favourable Consideration only when the management of the borrowing unit is sound. That is why the appraisal of the managerial competence is the tough stone of term credit analysis.

3.11.9. Difficulties encountered by the commercial banks in term lending

Formerly banks mainly depended much on the financial capability and vitality of their customer for lending; but after the nationalization of the banks, they attach more importance to the anticipated income generation than the financial soundness of firms. As there was stress in these points, slowly commercial banks are leaving the practice of rolling over (temporarily loans are renewed and converted into medium term loans at the maturity). In these process of conversion from the rolling over to term lending the difficulties encountered are:

1) Insufficient technical staff to process and assess the feasibility of good projects. This difficulty is being overcome by recruiting technical staff of other banks.

2) Especially, when the volume of the loan is huge and heavy banks fear to lend their heads there. This can be solved by the arrangement of participative lending. (More banks participate in one loan so that the risk is spread over)

3) Though the Industrial Refinance Corporation and Agriculture Refinance Corporation help in refinancing the term loans, these commercial banks do not get that much protection as the refinance corporation. So the banks must be treated on pair with the finance corporation in protecting their interests.

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4) The establishment of Federal Deposit Insurance Corporation in the USA lend to increased participation by banks in term loan facilities. Like hat the existing protection of the DIC should be extended further.

3.12 DIVERSIFICATIONS FUNCTIONS

Banks do participate in medium and long term financing. This is a significant change in function of banking system. The participation of the banks in the stocks of industrial finance Corporation of India and State Finance Corporation etc., are pointers in this direction. Similar is the case in England i.e., The British Bank's participation in the I.C.C.I. and F.C.I. This is how banks participate in industries, of course, indirectly through financial intermediaries.

3.12.1. Term loan in great britian

In Great Britain, the term loan is not quiet to commercial banks. In fact, it is gaining popularity. The Radcliff Committee has also recommended that the banks should be ready to grant term loan facilities to industrial concerns. There are two circumstances in which the over draft may seem to be cheaper than the term loans. They are; (i) the interest rate on fixed term loan is likely to work out higher than average rate on an overdraft extended over the same period of time and (ii) interest on the overdraft is payable on outstanding daily debit balance and not on the industrial advance. But many customers prefer term loans. It means they are prepared to pay a higher cost for the sake for an arrangement, which would relieve them of the fear of the recall in the event of contingencies like the imposition of credit squeeze.

British Banks are providing term loans for small businessmen for requirements of fixed capital not expecting $10,000. Their maturity period varies form three to five years in the case of plant and equipment and ten years or more for business purpose, The later is repayable in equal half year installments and bearing interest at the rate of 3% over bank rate with a minimum of 6%.

Another significant line of extension of their activity in this connection has been the provision of advances against export credit guarantees. The demand for medium term bank credit for the actual machinery and installations a new phenomenon not experienced before the war.

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British banks want to make it clear that they are not very anxious to develop this ine of business. They want to use only a significant portion of their deposits in that lirection. They also believe that the potential amount of business of this type is not likely to be great for them. The rate of interest on term loans is higher than that on the orthodox loans. Hence, many customers do not prefer it.

3.12.2. Hire - Purchase finance by british banks

The entry of British banks into the realm of hire-purchase finance in the second half of 1958 was on outstanding event. Merchant Banks in England never hesitated to take part in hire purchase finance. But the London cleaning banks did not forward to do this till the first half of 1958. The lifting of the credit squeeze in 1958 and the official call for the stabilization of hire –purchase in the context of an expanding economy made nine out of eleven British clearing banks into the field of hire-purchase finance.

The credit squeeze required the banks to limit overdraft facilities to the finance house. Also, the capital issue control had already denied them access to capital market. In these circumstances the hire purchase finance house began to attract deposits from the public at higher interest rates.

The directives of monetary authorities had forced the banks to decline accommodation to various potential borrowers. They were driven to the hire-purchase finance companies. In these circumstances, hire purchase business had become highly profitable.

As early as 1958, certain banks had been contemplating an active interest in hire purchase either directly or by the acquisition of an existing hire purchase company. Hence, when free conditions were created by the credit squeeze, banks readily moved into this lucrative field. It was to the mutual advantage of both broadly speaking; this extension of interest from orthodox banking into the field of hire purchase has been welcomed by the British Bankers.

3.12.3. Hire - purchase finance and banking business

There may be direct participation of the banks in hire purchase finance as in U.S.A. instead of a mere subscription to the equity capital of hire purchase finance company in U.K. Direct participation may take up only through a wholly-owned subsidiary or though the setting up of a special department with its own expertise.

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Although hire-purchase business and banking business resemble each other, the two are not one and the same. In some respects, credit extended for hire-purchase facilities does not differ from other forms of banks credit. In the absence of direct participation the relation between the bank and the hire purchase company does not materially differ from that existing between other banks, which grant over draft facilities to hire purchase finance. The banker takes into consideration primarily the character and standing of the customer and secondarily the collateral security. However, the hire purchase financier looks into the security first, second and perhaps for all time. The majority of British bankers have regarded hire purchase finance and banking business to be different in many ways and have preferred to keep them separate. As the banks do not have either the experience or specializations in hire purchase finance, it may be specialized institutions or departments of commercial banks staffed by specialized trained personnel. The arrangement under which a hire purchase finance company could operate as a subsidiary of the bank under its own established and proved management has made a greater appeal to them.

3.12.4. Benefits in hire purchase financing

The hire purchase companies in which the banks have taken an interest are likely to be less dependent upon borrowing from the public than other concerns of the kind. This could lead to a general function of interest rates.

Even when the parent bank does not provide accommodation to subsidiary company, hire purchase Company, its very existence will enable the later to rise money from the public at lower interest rates and thus offer better terms to its customers. Also, hire purchase companies associated with banks are likely to attract business form those who will remain uncommitted.

The alliance between the banks and hire purchase business has been welcomed by monetary authorities. Hire purchase business has become an indirect function to banks. The governor of Bank of England was of the opinion that the alliance between banks and hire purchase should be in the public interest approved of the collaboration through specialized companies rather than through direct management of two different types of lending.

3.12.5. Hire - purchase finance and banks in india

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Hire –purchase finance business is the result of another functional development in the Indian banking system. A small number of Indian banks have financed hire purchase and installment purchasing of durable consumer goods, chiefly motorcars, as well as producers equipment. The usual form of agreement executed by the purchasers is endorsed in favor of the lending bank. A margin on the face value of demand no the executed by the buyer is usually maintained but in some cases a collateral security has to be furnished by the sellers. Many banks do not come forward to undertake this line of business as they hardly and idle founds for the purpose. Another reason for it is the degree of risk attached to this line of business. The Reserve Bank of India could not approve extension of this business in unsecured loans.

Hire purchase agreement forms were taken in bunches as collateral securities form the financing agencies and loans were advanced by commercial banks in lump sum by way of refinancing. The banks had full recourse to these agen ies, which are in regular business with them. Thus, they were fully recovered against a possible losses. The banks did not collect the installments. It was the business of th seller c the goods. Automobiles were the most important articles, which figured in the lines of hire purchase finance.

3.12.6. SBI and Hire - Purchase Finance

State Bank of India was authorized to grant consumer credit while the Indian Overseas Bank introduced the personal Loans Scheme. An amendment to section 33 (1) of the State Bank of India Act has empowered the bank to provide credit facilities to undertakings engaged in the financing of the hire purchase transactions. In pursuance of the provisions of the amended Act, a scheme has been prepared under which the bank finances undertakings engaged in selling commercial vehicles on hire purchase to transport operators. The bank does not consider the hypothecation of debts and assets relating to a hire purchase business as tangible or enforceable security. It prefers to obtain wherever possible the security of the stock debts and assets of another business. Advances will be made on the basis of the original security of the debts of assets of undertaking engaged in hire purchase transaction provided the obligations are further guaranteed by a reputed insurance company or by other acceptable parties considered un doubtable good for the amount. Advances against any agreement will have maturity of eighteen to twenty four months, when installment turns to be in arrears, no advances would be allowed to continue. The SBI unlike to British and Australian banks does not zcome forward to provide equity capital to hire purchase insurance companies.

3.13 PERSONAL LOANS

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The discovery of personal loans is another significant development in the field of British Banking. There are far reaching social changes in Great Britain since the out break of Second World War. There has been a redistribution of income in favour of the working class. A couple of decades ago bank accounts would not have been useful to the working class. But today a great many of them are enjoying incomes and a living standard hence, they do have bank accounts, which are only useful to them but also profitable to the banks themselves. Nowadays people need not be deprived of their enjoyment of durable consumer goods until they are able to accumulate sufficient money. They can enjoy them while earning to pay for them.

As soon as the credit squeeze relaxed and freedom was restored banks began to meet increasing demand for consumer goods. They took two significant steps, the first was alliance with hire purchase companies through participation in their equity capital and the second was the personal loan business. The later has been on outstanding feature of the American banking scene.

The personal loans scheme of the Midland Bank was inaugurated in September 1958. It marked a major development in British Banking. The object was to provide customers with financial assistant in meeting exception non recurring items of expenditure, purchase of cars, house hold appliance and professional equipment and under take decoration etc., Loans should be granted in minimum amounts of a 50 rising by multiples often to a maximum of 500 for a maximum period of two year repayable in monthly installment. The interest was fixed at 5%, which was subject to alteration from time to time. It was to be tide to the amount of the loan and paid as part of monthly installment. In fixing the rate of interest, a new formula was followed in fixing it. The traditional formula of a lending rate equal to the bank rate plus a margin was abandoned. The amount of the loan would be related to the customer's income and the bank's existing knowledge of the consumer. The facility was made available only to consumers having current or deposit account.

3.13.1. Features of loan

The personal loan shame should be distinguished from the provision of hire purchase finance. The banks do not lay any claim to the goods bought with the money advanced either during the life of the borrower or after his death. An important feature of the personal loan is the cancellation of the debt on the debt on the borrower, life cover Bering usually provided for dept. certificates for tax relief may be issued for the interest paid on the loan which cannot be done before the purchase transaction. And finally, the interest rate is more attractive to the borrower.

These new trends have been characterized as revolutionary departure from orthodox banking practice and have been said to change the face of British Banking. In real terms, the trends do not represent revolution in British Banking traditions. They are merely a revolutionary development called of by the need for adoption to the changing circumstances.

3.13.2. Price and Income Board (P.I.B.)

The newer forms of specialized financing are undertaken by 'back door' subsidiaries comprising hire purchase financing companies and that special in export financing and term lending to industry. But the Prunes and incomes Board has strongly argued in favor of wider diversification British Banking functions by merging the entire spectrum of financial services under one root for the lines for the big commercial banks in USA and Canada instead of conducting them through back door subsidiaries. The P.I.B.'s concept of the role of commercial banking, is radically different form the traditional concept. A merger of the British bank's new activities "should obviate some duplication of premise and should also facilitate some reduction in unit costs". The P.I.B. was the view that they (hire purchase finance companies and other non banks types of financial institutions) should be required to maintain specified liquid assets ratios on the same away as ordinary banks in relation to their deposit liabilities and maximum capital borrowing ratios. This is a new concept, which imports common treatments to all types of financial in stoutness, banks and non-bank.

3.13.3. Personal Loans in India

The Indian Overseas Bank is the pioneer in the matter of introducing personal loans scheme. It aims to provide credit to people hitherto outside the fold of organized banking business. Under the scheme, applications for such loans would have to satisfy the test of having a stable income with reasonable prospect of its continuance during the term of the loan. Employees of state and Central government, statutory corporation, industrial, financial and commercial enterprises, owners of urban properties with stable rental income would be eligible.

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Loans would be granted for the purchase for the durable consumer goods such as motorcars, sewing machines, electric fans, house-hold appliances, radios, scooters, etc., as well as for the purchase of professional equipment like agricultural equipment, X-ray and other equipments, electric motor etc., The object of the personal Loan Department Would be to provide direct credit to consumers rather than finance loans to dealers and hire purchase agencies. Such direct loans to consumers would not only enable them to enjoy the advantage of a relatively cheaper interest rate but would also benefit the bank and in that it will increase indirectly the number of its existing and potential consumers. The loan amount may vary between Rs.150 and Rs.5000 and it may go up to Rs.10,000 in exceptional cases. The loans would be repayable in installment varying between six months and thirty months. Guarantors for these loans are not normally required. Failure to repay the installments of the loan would attract a penal rate of interest according to the period for which the installment has been overdue while a loan repaid in full before maturity would be granted a reb

The borrower should contract a reliable dealer. He should deposit a small portion of the cost by way of initial payment with the bank. Then, the bank will pay the dealer in full and the ownership of article will pass on to the purchaser. The bank would receive the installment from him.

3.14 STRUCTURAL CHANGES IN THE BANKING SYSTEM

Dr.Bimal Jalan, Governor, RBI, while summarizing the structural changes in the Indian banking system remarked:

"Financing systems worldwide are undergoing structural transformation. Technological innovation, deregulation of financial services at the national level, external financial liberalization, and organizational changes in the corporate world are some of the global factors driving the transformation. Banking and financing in emerging economies is also caught up in this change. In these economies, in addition to global developments, Country-specific factors are motivating the structural shifts. Consequently, two separate directions of reform are evident. There is an expansion of the financial system due to vacation of policy interventions in entry, exit and operations, the application of new

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advances in information technology and in general, a greater emphasis on competition and market–based outcomes. Almost contemporaneously, there is a strong drive towards consolidation in a quest for exploiting core competitiveness and for developing "niche" strategies.

In India, the primary force for transformation was structural reforms launched in the aftermath of the balance of payments crises of 1990-91. It was recognize that a vibrant, resilient and competitive financial sector is vital for sustaining the reform process in the real sectors of the economy. Significantly, financial sector reforms in India were preemptive and proactive rather than the result of banking crises, as has been the experience of several emerging economies. Secondly, the momentum of change in the financial system has been the motivation for upgrading the technological infrastructure in Indian banking and finance rather than the other way round. In that sense, the Indian financial system has been a late entrant in the expressway created by the information and communication technology has been reforms-driven rather than a driver of the transformation. Finally, a large measure of the impetus for change has come from reforms in the regularity and supervisory regime and the aspiration to apply international best practices to the country specific situation.

The role of public sector bank has come under close scrutiny in the recent period. It is necessary to recognize that these banks have played a critical role in the developed of the Indian economy in the period 1969-90, particularly in the spread of banking and mobilization of savings and their allocation by the plan priorities. For all economy in the early and intermediate stages of development, credit markets face a persistence excess demand, reflecting the existing resource constraints. Moreover, market processes can well exclude the genuine credit needs of the weaker sections of society, which do not have the competitive strength to bid for funds in the market for bank credit. Public ownership in India banking was intended to address both concerns i.e., the rationing of in the face of excess demand not cleared by the market, and the channeling of bank credit flow to the economically disadvantaged sections of society. Over the period 1970-90, a massive expansion of bank branches occurred, and credit allocations ensured some equity in the distribution of bank credit.

At the same time, however, there was erosion in the financial health of public sector banks and deterioration in the quality of customer service. Within the ambit of financial sector reforms therefore, the focus since the early 1990s has been on the viability,

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efficiency and competitiveness of banks and financial institution. Liberalization and deregulation has to go hand in hand with a greater emphasis on consolidation, productivity, asset quality and profitability. There is also an urgent need for government to divest substantial shareholding to the public, so that these banks can respond effectively to changing market conditions. Under the present circumstances, improvement in the cost structure of the banks and work culture are important priorities.

In order to enable the public sector banks to deal with the new capital requirements, as per international guidelines, recapitalisation was initiated in 1993, aggregation Rs.20,446 crore by the end of the 1990s. The Verma Committee's recommendation and recapitalisation of 'weak' public sector banks be accompanied by conditionality relating to managerial and operational aspects of the banks' functioning was endorsed in the union Budget, 2000-01, a sum of Rs.1, 300 crore was provided to one of the weak nationalized banks. Two of the weak banks have already turned around and are reporting profits and a capital adequacy ratio of 9 percent. The last on is also going through a turnaround. Recapitalisation is associated with a monitorable reform program and operational restructuring to ensure that flow problems in a bank's performance are dealt [illegible].

Mergers have re[illegible]ected effort to reap economies of scale and scope through joint production of financial services and non-stop delivery wherever synergies in service supply can be exploited to lower costs of production. In general, these mergers have come about as a result of government efforts to restructure inefficient national financial systems. Market driven consolidation is a relatively new phenomenon in these countries. A critical issue in almost all emerging economies is a reassessment of the ownership of the state in the financial system and a redefinition of the role of state-owned banks and financial institutions. The changing structure of the banking and financial systems in emerging economies has implications for systemic stability and the supervisory regime.

A major structural change in our financial system is the infusion of competition. The enable conditions for a more competitive environment initially took the form of shifts in the policy regime. Statutory preemptions were progressively lowered, interest rates were deregulated and restrictions on entry and exits were eased. Financial markets were developed to enable financial intermediaries to deal in assets and liabilities of varying maturities and risk profiles. Activity restrictions were eased and banks can now undertake

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various types of activities reserved earlier for development financial institutions. Likewise, the term-lending financial institutions have been allowed to undertake working capital financing. Elements of this growing convergence have determined the pace and sequencing of the approach to universal banking in the recent years.

Within the banking systems, there is heightened competition with the introduction of new generated private sector banks. In January 2001, revised guidelines were issued for entry of new banks in the private sectors. Despite the preponderant share of domestic banks in banking activity in India, foreign banks have been a source of competition, at least potentially; given their use of sophisticated technology, risk monitoring analysis and exposure, management. In recent years, the policy thrust has been to level the playing field for domestic and foreign banks. For example, foreign banks that were earlier allowed to operate only branches but not subsidiaries are now free to choose to set up. either branches or subsidiaries common banking regulations including lending norms. Appropriate legislative changes are also under consideration of the government. Foreign direct investment up to 49 percent has been allowed in private sector banks and up to 20 percent in nationalized banks. Guidelines have been issued for the entry of banks in to insurance business either as joint venture participants or to take up strategic investment for providing infrastructure and services supports without any contingent liability.

3.15 KEY TERMS

- **Direct Agricultural Advance** : It denotes advances given by Banks directly to farmers for agricultural purposes. These include short-term loans for raising crops.

- **Small Scale Industries** : Small Scale industrial units are those engaged in the manufacture, processing or preservation of goods and whose investment in plant and machinery does not exceed Rs. 1 crore.

- **Credit Administration** : It is the art of determining objectives, policies and procedures In order to attain the predetermined objectives, one must lay down a suitable policy, executable under the present circumstances. Banking industry is an organised

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sector, which must contribute much in the lines of deposit mobilisation and employment of resources in the most effective manner.

- ❖ Technical Feasibility : The first and foremost appraised of term loan is examination of technical feasibility. It involves a careful and thorough study and assessment of goods and services for the project.

- ❖ Economic Feasibility : The examination of economic feasibility of a project requires the assessment of (a) the earning capacity of a project, (b) market condition and (c) the projection of old.

3.16 SUMMARY

According to the instructions of the RBI, Commercial banks are permitted to provide long-term advances to industries upto 5% of their total deposit liabilities commercial banks also underwrite the shares and debentures of Joint Stock companies and financial institutions. Now a days with a view to accelerate term lending to industries by the commercial banks, refinancing facilities are provided to banks in respect of their industrial advances by the Industrial Development Bank of India and the Reserve Bank of India.

3.17 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) T (b) F (c) T (d) F (e) T
2. (c)
3. (a)
4. (c)
5. (a)

3.18 QUESTIONS / EXERCISES

SECTION - A

(1) Discuss about the Direct and Indirect finance to Agriculture.

(2) Explain the changes that are taking place in Commercial Banking System.

SECTION - B

(3) What are the principles of Sound lending policy?

(4) Write a note on

(a) Economic Feasibility

(b) Technical Feasibility

(c) Financial Feasibility

3.19 FURTHER READING

1. Roger Leroy - Modern Money and Banking
2. Vasanth Desat - Indian Banking
3. Jones – R.K - Studies in Practical Banking

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Unit - 4 NEW SERVICES OF BANKS

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Structure

4.0 INTRODUCTIONS

Merchant banks are issue houses rendering such services to industrial projects or corporate units as flotation of new companies, preparation, planning and execution of new projects, consultancy and advice in technical financial managerial and organizational fields. A number of other functions such as restructuring, revolution of assets, merges, take-overs, acquisition etc, are also undertaken by them.

A major function of merchant banking is the issue management. The issue can be public issue through prospectus, offer for sale or private placements etc.

In the case of management debentures, apart from the above the managers to the is ue have to do the following things:

A) To finalize the terms of the issues which will make the debenture issue attractive and

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B) To assist in the finalization of the relative security or mortgage documents and obtaining approval thereto from the company's solicitors and trustees.

Funding and pattern of financing is available from the merchant banks. They work in close liaison with the client his technical consultants and the funding institutions prepare and submit complete financial details and arrange for various sources of finance. Assistance in legal documentation for the finance arranged is also provided.

4.1 UNIT OBJECTIVES

- Growing industrialization and increase of technologically advanced industries.
- Need for encouragement of small and medium industrialist who requires specialist services.
- Growing complexity in rules and procedures of the government.
- Need to develop backward areas and states which require different criteria.
- Exploring the possibility of joint ventures abroad and foreign market.
- Promoting the role of new issues market in mobilizing savings from the public

4.2 MAIN FUNCTIONS OF MERCHANT BANKING

4.2.1 **Corporate Counseling :** Merchant bankers provide involve in such activities that are undertaken to ensure efficient running of a corporate enterprise at its maximum potential through effective management of finance.

4.2.2 **Project Counseling :** Merchant Bankers provide advisery assistance on the viability of the project and procedural steps for its implementation.

4.2.3 **Pre-Investment Studies :** Merchant Bankers conduct pre-investment relating to activities connected with a detailed feasibility exploration to evaluate alternative avenues of capital investment in terms of growth and profit prospectus.

4.2.4 **Capital Re-Structuring :** Merchant Bankers involve in activities to assist Project to restructure the capital base, diversify operations and implement schemes for amalgamations, and mergers etc.

4.2.5 **Credit Syndication :** Merchant bankers undertake activities connected with credit procurement and project financing, aimed at raising Indian and foreign currency, loans from banks and financial institutions.

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4.2.6 Issue Management and Underwriting : Merchant Bankers are engaged in activities that are connected with the management of the public issues of corporate securities, i.e., equity shares, preference shares, debentures or bonds and are aimed at mobilization of money from the capital market.

4.2.7 Port – folio Management : Merchant Bankers help in taking decisions relating to the investment of the cash resources of a corporate enterprise in marketable securities by deciding the quantum, timing and type of security to be bought.

4.2.8 Working Capital Finance : Merchant Bankers undertake the finance activities for meeting the day-to-day expenses of the enterprises.

4.2.9 Accepting Credit and Bills Discounting : Merchant Bankers undertakes the activities relating to the acceptance and discounting of bills of exchange

4.2.10 Merger, Amalgamation and Take overs : This is a specialised service provided by the Merchant Banker who makes arrangement for negotiating acquisitions and mergers by offering expert valuation regarding the quantum and the nature of consideration and other related matters.

4.2.11 Venture Capital Financing : Merchant Bankers undertake the services relating to equity financing for funding high risk and high reward projects.

4.2.12 Lease Financing : Merchant Bankers provide financial facilities to companies that undertake leasing.

4.2.13 Foreign Currency Financing : Merchant Bankers provide fund to foreign trade transactions.

4.2.14 Fixed Deposit Banking : Merchant Bankers provide services to the companies for computing the amount to be raised by the company in the form of deposits.

4.2.15 Mutual Funds : Merchant Bankers are engaged in the mobilization of savings of innumerable investors for the purpose of channeling them into productive invest ment of a wide variety of corporate and other securities.

4.3 ROLE OF MERCHANT BANKS

To promote the new issue market there is need for qualitative improvement in the offer of new issues both in terms of time taken and the cost of flotation. At present the

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time taken for organizing a new issue is between 12 to18 months and the cost of raising new capital varies from 3% to 8% and sometimes even 20%. This can be brought down relatively by specialized merchant banking institutions by catering to the requirements of both large and small industrial units. Cost of flotation for new companies is high. Merchant banks can help in savings in the cost of new companies.

The main work of merchant banks relates to underwriting of new issues and rising of new capitals for the corporate sectors. The merchant banks should have an organization large enough to deal with a number of applications at a time. The issue house which acts as a merchant banker normally pays visits to the company's plant, warehouses and other physical assets and if a company, is making its first issue, it might issue independent reports from charted accountants, industrial consultants, technical experts etc.

A merchant bank has to suggest an approximate time of issue and of the terms. Once these terms are settled, the shared certificates, prospectus and other documents are drafted by merchant bank with the assistance of lawers, accountants and others. They have to satisfy the companies act and other requirements of law.

The merchant bank has to make an application to the appropriate stock exchange ation and satisfy the stock exchange authorities with respect to the terms of issue spectus. Listing requirements are to be observed and familiarity with the stock ge rules and bye-laws as well as the provision of the securities contracts (regulations) uld be essential. They may have to advise on the desirability or otherwise (listing) stock exchange as well as help the company go through the process of getting hares listed Advertisements containing all the information legally required to be n the prospectus must be published in all the leading newspapers. The prospectus hould contain the number of shares, amount, time, proposed date of opening and g, a summary of the company's business history, balance sheet etc. Once the issue le, their merchant bank relates to the allotment of shares in consolation with the exchange authorities.

Merchant banks should have an overall view of the type of the shareholders and pective clientele who are attracted by the type of company and industry. They have lvise the company on the type of security to be offered and nature of issue and type lacement, terms, etc. On the basis of its likely clientele for its shares. They nave to keep a hold on the pulse of the market and the investment climate so as to judge rightly and advise the company accordingly.

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The merchant banker should be familiar with the administrative procedure rules and regulations governing the issue of industrial license, import license etc.

Thus, the main function of merchant banks would appear to be sharing risks with the company, particularly for unquoted companies, either in terms of equity or some other basis and then the development of the company. A merchant bank helps the company in reducing the costs of floatation and financing the project.

The merchant banks have come to occupy an important place on the financial scene of India. Most of the banks and some of the specialized banking firms have entered this field in more recent years. The future growth of the capital market depends, to a large extant, on the financial services rendered by the merchant banks and the quality of their services.

4.4 LICENSING OF MERCHANT BANKS

Since the settings up of the SEBI in 1988, it has been given the responsibility for promoting a healthy growth of the new issue market. The SEBI has issued guidelines asking the merchant banks to be licensed by them and to have minimum capital requirements. The SEBI has laid down the authorized activities of merchant bankers as follows.

1) Issue management
2) Corporate advises
3) Underwriting
4) Portfolio management services
5) Managers, consultants or advisers.

SEBI guidelines for merchant bankers:-

1. Authorization

Any person or body proposing to engage in the business of merchant banking would need authorization by the securities and exchange board of India in their prescribed format. This will apply to those presently engaged in merchant banking activity, including as managers, consultants or advisers to issues.

Authorized activities

(1) issue management, which will inter-alia consist of preparation of prospectus and other information relating to the issues, determining, financing, structure, tie-up of financiers and final allotment and/or refund of subscription.

(2) Corporate advisor services relating to the issue

(3) Underwriting

(4) Portfolio management services

(5) Management, consultants or advisers in the issue.

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uthorization criteria:

Al merchant banks are expected to perform with high standards of integrity and ess in all their dealings. A code of conduct for merchant bankers will be prescribed EBI. Within this context, SEBI authorization criteria would take into account mainly llowing:

Professional competence

Personal, their adequacy and quality and other infrastructure.

Capital adequacy.

Past track record, experience, general reputation and fairness in al their transactions.

erms of authorization

1) All merchant bankers, including the existing ones, must obtain the authorization from SEBI within 3 months from the issue of these guidelines.

2) All merchant bankers must have a minimum net worth of rs.1 crore.

3) The authorization will be for an initial period for 3 years.

4) SEBI may collect from merchant bankers an initial authorization fee, an annual fee and renewal fee.

5) Merchant bankers would be responsible for ensuring timely refunds and allotment of securities of the investors.

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(6) The involvement of merchant bankers is an issue should continue at least till the completion of essential follow up steps, which must include the listing and dispatch of certificates and refunds.

(7) The merchant banker shall make available to SEBI such information, documents, returns and reports as may be prescribed and called for.

(8) SEBI shall prepare and prescribe a code of conduct for merchant bankers which they should adhere to.

4.5 UNDERWRITING

The idea of underwriting originated on account of uncertainties prevailing in the capital market as a result of which the success of the issue become unpredictable. If the issue remains undersubscribed the directors cannot proceed to allot the shares, and have to return money to the applicants if the subscription is below a minimum amount fixed under the companies Act. Consequently, the issue and hence the project will fail.

Underwriting entails on agreement whereby a person/organization agrees to take a specified number of shares or debentures or a specified amount of stock offered to the public in the event of the public not subscribing to it, in consideration of a commission called the underwriting commission. If the issue is fully subscribed by the public, there is no liability attaching to the underwrites; If not they have to come forth to meet the shortfall to the extent of the under-subscription.

The Underwriters in India may broadly be classified into the following two types.

(i) Institutional Underwriters

(ii) Non-institutional Underwriters

Institutional underwriting in our country has been development oriented; It stands as a major support to those projects which often fail to catch the eye of investing public. Those projects rank high from the point of view of national importance e.g. Steel, fertilizer and generally receive higher priority by such underwriters. Thus institutional underwriting may be broadly recognized, in the context of development credit, as playing a decisive role in directing the economic resources of the country, towards desired activities.

The public financial institutions namely IDBI, IFCI, ICICI, LIC and UTI, underwrite a portion of the issued capital. Usually, the underwriting is done in addition to granting term finance by way of loans on debentures. These institutions are usually approached when one or more of the following situations prevail.

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(i) The issue is so large that broker – underwriting may not be able to cover the entire issue.

(ii) The gestation period is long enough to act as disincentive.

(iii) The project is weak, in as much as it is being located in ac backward area.

(iv) The project is in the priority sector which may not be able to provide an attractive return on investment.

(v) The project is promoted by technicians

(vi) The project is new to the market.

The quantum of underwriting assistance varies form institution to institution according to the commitments of each of them to a particular industry.

However, institutional underwriting suffers from the following two drawbacks:

1) The institutional handling involves procedural delays which sometimes dampen the imitative of the corporate managers or promoters.

2) The other disadvantage is that the institutions prefer to wait and watch the result to fulfil their obligation only where they are called upon to meet the deficit caused by Under subscription.

4.6 CREDIT CARDS

At present, there are various types of cards in usage in the market.

They are:

1. Debit card
2. Charge card
3. Credit card

4.6.1. Debit Card

A debit card is like carrying a savings account while on the move. It is in short a mobile savings account. Whenever a card holder makes purchases, the amount paid for purchases is deducted from the savings account. There are two types of debit cards.

1. Personal identification based card (PIN)

2. Signature based card. The signature based cards are widely in use.

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4.6.2. Charge Card

It is like the credit card but without the maximum credit facility and installment facility. As there is no limit to amount spent, the card holder has to pay the entire amount on the due date. No part payment is allowed.

4.6.3. Credit Card

A credit card is also called as plastic money. It is an instrument which enables the holder to buy goods or services on credit up to a certain limit at monthly rates of interest from those business enterprises which are enrolled as members of the credit card system.

Instant credit facility is obtained for a specific period at a fixed monthly interest rate. In short, a credit card holder gets instant money besides various fringe benefits. Three parties are involved in a credit card. They are:

1.Issuing bank

2.Card holder

3.Member business concerns.

The credit limit is fixed by the back after assessing the three Cs.-Character, capacity and credit worthiness.

4.6.4. Working of the Credit Card System

Anyone who wants to have a credit card must get the application form from the card issuing bank, fill it up and submit it to the bank. Actually these works are attended to by a representative of the bank. A salaried person should enclose his salary certificate or pay slip along with the application form. A self employed persons should enclose the latest copy of income tax return and also a Xerox copy of bank transactions for the past 6 months. If the back is satisfied with the details given in the application, it will provide the credit card to the applicant.

4.6.5. Persons not eligible for credit card

Illiterate persons, minors and those whose dealing s with the bank are not satisfactory and whose integrity is doubtful are not eligible for credit card.

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Contents of the Credit Card

The credit card contains:

1.The name of the card holders

2.Card holder's account number

3.card holder's specimen signature

4.Photo copy of card holder.

Whenever the card holder makes purchases, he hands over the credit card to the shop and the business man inserts the card in the electronic machine which shows the sufficiency of balance in the credit card. The sales voucher is prepared and fed to the machine and the bank transfers the amount to the account of the business man. A monthly bill is sent to the card holder by the bank every month. The card holder may pay the amount in full or in installments. Generally, 5 percent of the outstanding amount is the minimum amount payable. If the full amount is paid on or before the due date, no intrest is charge. If the amount is paid in installments, interest will be charged on the outstanding balance. The rate of interest charged varies form bank to bank.

Penal rate of interest will be charged if the minimum amount is not paid within the due date.

4.6.6. Functions of Credit Card

1. It serves as a convenient method of making payments for good and services bought.
2. It serves as a means to get cash at any time
3. It amounts to revolving credit.
4. It is the risk less way of carrying cash.

.6.7. TYPES OF CREDIT CARDS

There are three major types of credit cards with differing features and privileges.

1. Gold card
2. Silver card
3. Classic or executive card.

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The charges vary from card to card. The names are for the sake of differentiation between the cards as the range of services rendered by the issuing bank differs from card to card.

4.6.8. Factors to be Borne in Mind

A credit card is like a loaded gun. It is necessary to take certain precautions while using credit cards.

4.6.8.1. Annual Gross Income

Credit cards are issued on the basis of annual income and the credit worthiness of the applicant.

A salaried person should enclose his salary certificate or pay slip along with the application form. A self employed person should enclose the latest copy of income tax return and also a Xerox copy of bank transactions for the past 6 months. The annual income requirement varies from bank to bank. If the bank is satisfied with the details given in the application, it will provide the credit card to the applicant.

4.6.8.2. Entrance Fee

Once the application is approved, the applicant has to pay the entrance fee or joining fee which varies from bank to bank. Some banks have now waived the entrance fee on account of severe competition between banks.

4.6.8.3. Annual Fee

The annual fee is to be paid in advance. Generally it is included in the first bill. It varies from bank to bank depending up on the type of credit card. Due to the cut throat competition between banks, some banks have waived the membership fee for one year.

4.6.8.4. Monthly interest rate

Interest is charged every month on the withdrawn amount and the purchases carried forward beyond the permitted free credit period. The rate of interest varies form bank to back and it is between 2.5 and 3%. If the amount is repaid in instalemtns, an annual simple interest rate of 30 to 36 percent is charge. The credit card holder must not that credit card debt is very costly and try to settle it as quickly as possible.

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4.6.8.5. Cash Advance

A card holder can withdraw cash from the ATM upto a certain percentage of the total credit limit. (generally 40 per cent). Once cash is withdrawn from the ATM, it is treaded as transaction and charged fee. Interest is charged from the very first day of the transaction (no interest free credit period)

4.6.8.6. Interest Fee Credit Periods

Interest free credit period is generally 50 days in most of the banks. During this period no interest is charge for purchases made through the credit card. In order to avail this facility, the card holder must have settled the total amount due as shown in the previous statement.

4.6.8.7. Add on Card fee

It is only a supplementary card which the card holder gets for his close family members by paying additional fee. But the total credit limit remains the same. In other words the total credit limit is shard between the main card and the add on card. A comprehensive bill covering both the main card and the add on card is sent every month to the main card holder.

4.6.8.8. Automated Teller Machine (ATM)

The ATM has revolutinised the withdrawal of cash at any time, day or night and some customers call it as ANY TIME MONERY. The credit card holders enjoy this facility.

4.6.8.9. Lost Card Facility

When the credit card is stolen or lost, the card holder should inform the bank immediately, The bank will at once inactivate the card so that any fraudulent use can be prevented. banks issue now photo credit cards. The card holder has to pay replacement fee to get a new card.

..8.10. Insurance Facilities

The banks which issue credit cards offer a wide range of insurance covers to the policy holders. They include: personal accident insurance, insurance for add on credit card holder, baggage cover purchase protection etc.,

4.6.8.11. Credit shield

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If the credit card holder dies, the onus of payment falls on dependents of the card holder. But if there is credit shield, the amount due on the card is waived upto a certain percentage. But not all the banks extend this credit shield.

Reward points

This is an incentive system to encourage the card holder to use the card frequently. For insurance the card holder gets one point for every purchase worth one hundred rupees and the points are allowed to be accumulated and they may be used as permitted by the cared issuing bank.

4.6.8.12. Other Services

The card holders get a lot of other facilities and benefits by using credit cards, such as travel discounts, privileges at selected hotels and restaurants, purchase of petrol at petrol bunks, reservation of railway tickets with the use of credit cards etc.,

4.6.9. SANCTIONINGAUTHORITY FOR APPROVAL OF ISSUANCE OF CREDIT CARD

The sectioning powers have been delegated to respective Branch Heads and above upto a limit of Rs.2.00 lacs. Branches should continue to route their applications through their Regional Office. The Regional Head after sanctioning the limit should send the applications to Credit Card Cell, the Head Office for issuance of Card.

The credit card applications will have to be processed by the concerned branches after ascertaining eligibility criteria and also after ascertaining the antecedents of the applicant, i.e. whether he/she owns house, whether he/she is known in the locality, etc. and sanction the limits. it should be ensured by the Branch Heal that a Xerox copy of the applications forwarded to Central Head Office are kept with the branch.

The credit card will be issued within a week's time of the receipt of such approved applications from branches and the cards issued will be sent by Credit Card Cell, Central Office to the respective branches for delivery of credit cards to the concemed cardholders.

The recoveries of the bills of the credit card should be made form the cardholders individuals/personal account. However, when the cardholder maintains a joint account, the necessary authority letter/consent of the account holders should also be held for debiting the charge to the account. If the card holder is also a director/partner of a company or firm and desires that the charges be debited to the account of the companies/ 'firms' the necessary Board Resolution/authorization of the other partners of the firm should be held on record for such debit of the charges to the companies/ 'firms' accounts.

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4.6.10. LOSS OF CREDIT CARD AN DISSUE OF DUPLICATE CREDIT CARD:

If the credit card is lost/stolen, the cardholder should notify the branch/Credit Card Cell immediately either by telephone / telex/fax/telegram and also confirm the same by registered letter. If the information is passed on orally, it should be confirmed in writing within 7 days. The cardholder should also file a police complaint regarding the loss. A copy of the complaint should also be sent tot eh credit card cell, immediately. A nominal fee of Rs.100/- will be charged in their bill for both hot listing as well as for issue of duplicate card. The cardholder will also state in his letter the circumstances under which the card was lost and will undertake all reasonable steps to assist the Bank to recover the missing card/s.

The lost card information will be conveyed to Bank immediately by credit card cell, and will be confirmed in writing, so that the Head officer will take necessary steps to include details of the card in the 'Warning Bulletin' issued to all Member Estabilisments branches, with a request to stop honoring such cards.

In case of a fraudulent use of the lost/stolen/misplaced card reported to the bank, the card holders liability will be restricted Rs.1000/- only from the date of reporting to the Head Office. Any misuse before the date and time of information received by the Bank will be at the risk and responsibility of the card holder. if the card holder has not confirmed the loss/theft in writing the loss arising out of fraudulent use shall be the cardholder's liability.

In case the cardholder recovers the lost/stolen/misplaced card, he shall not make further use of it and it shall be surrendered to the issuer alongwith a report giving details of recovery.

The warning Bulletin will be issued by the Head Office at regular fortnightly interval.

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The bank reserves the absolute discretion to issue a 'Duplicate Card'.

4.6.11. Black - Listing / Hot-Listing of credit cards

A. The credit card will be blacklisted:

1. If there are continuous over-drawings.

2. On account of misusing the card, without providing funds in the account.

3. If any adverse reports are received about the card holder.

These types of cards will be blacklisted to avoid to avoid further misuse and to arrest the liability.

B. Cards reported lost or misplaced shall be hot listed. A fee of Rs.100/- shall be charged, which incuse charges for replacement of the card.

4.6.12. Cash withdrawals by the carholders

The cardholder is eligible for cash withdrawals in any of the Bank's branches, subject to the following:

1. The cash withdrawal limit shall be as discussed ablve.

2. Only one transaction in a month shall be permitted.

3. Cash withdrawals shall be permitted only on credit cards that are valid.

4. Amount paid shall be clearly indicated in the cash withdrawal pass book and shall be signed by an official.

5. The card shall not figure in the list of card/missing card/black listed/hotlisted card/withdrawn/cancelled card and therefore the branch shall verify the latest Warning Bulletin issued by the Head Office.

6. In case of add-on cards, cash withdrawal can be made as per the limits specified in the cash withdrawal passbook.

7. No cash withdrawal shall be permitted for corporate cards.

The branches before allowing any cash withdrawals must carefully peruse the cash withdrawal pass book to ascertain the cash withdrawal limit stated therein.

4.6.13. RENEWAL OF CREDIT CARDS:

1.The credit card will be valid for two years. However, the annual fee will be charged every year at the commencement of the year as per the date of issue of credit card. The credit cards will be renewed at the absolute discretion of the sanctioning authority after satisfying that the concerned cardholder is not a defaulter, previous card was utilized satisfactorily and the outstanding dues in the card account have been cleared.

2.The branches should inform well in time (2 months prior to the expiry of the card) about the advisability of renewing any particulars credit card due to persistent overdrawing, change in financial position or dealings to the Head Office. There is no need to obtain fresh application for renewal as the renewal is automatic unless there are any adverse features observed and reported by the branches. The moment the branches inform about non-renewal of the card, the Head Office will be informed accordingly.

If the branch desires that the card should not be renewed, they must contact the cardholder and request him/her to surrender the card. If he/she refuses to surrender, a letter should be issued to the cardholder stating that his/her card is invalidate and is placed under hot listing / blacklisting in the Warning Bulleting. The letter should be sent under Regd. A/D. A copy of this letter should also be sent to Credit Card Cell, Head Office, requesting themk to blacklist the card and to delete if from the list in the system to avoid future renewals.

When the cardholder surrenders the card, it should be destroyed at the branch level. A certificate to this effect should be sent to the Head Office.

Brach should get the card blacklisted when they observe features and also retrieve the card immediately. Information of such black listed cards will be sent to the Head Office for inclusion in Warning Bulleting and branches should take a note of the same for their future reference. Branch should furnish full particulars like Name, Address, Occupation, Card No. Validity date etc., of the card which they intend to Blacklist.

The branch shall not allow cash withdrawal to a cardholder whose card number is enlisted in the Warning Bulletin.

4.6.14. CANCELLATION OF CREDIT CARDS:

Branch should recommend cancelled of credit card to the Head Office on the following grounds:

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Check your Progress

1. State whether the following statement is "True or False".

a) Lease is a contract between a lesser and a lessee for using the asset.

b) Credit card is valid for 5 years.

c) Factoring means instant cash.

d) Kothari group in collaboration with the pioneer group of US was the first private sector mutual fund.

e) Merchant Banks are not required to obtain license.

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1. There is gross mis-utilisation of the credit of the credit without the cardholder providing funds on regular basis.

2. On account of death of the credit card holder

3. Insolvency of the credit cardholder

4. Any reason which might result in a loss to the Bank

Brach should recommend for cancellation of credit cards with full details to the Head Office. In the cases enumerated above, the branch should attempt to retrieve the card.

4.7 OVERDUE : PROCEDURE FOR RECOVERY

Overdrafts on account of credit card bills are not generally permitted. Branch should persuade the clients to clear the overdues with in a reasonable period for which they should charge @ 2.5% p.m. or part there of.

When requests for early adjustment of overdues/overdrafts go unheeded/ overdrafts are continued, necessary steps should be initiated immediately to safeguard the interest of the Bank. Branches should not allow overdues beyond 45 days from the date of the billing andtimely recovery steps are to be taken. While primary responsibility of recovery rests with branches, the Regional Officer/Zonal Office should exercise strict vigil over the overdues by guiding the branches about the timely action to be initiated for recovery.

The branches must exercise due care and diligence before sanctioning a new card. Good customers who satisfy the eligibility criteria and are well known to the branch and whose dealings are highly satisfactory only should be sanctioned. This is to ensure that undesirable persons are not issued the card. If the applicant is maintaining any other account, details thereof must also be furnished in the application form.

4.7.1. REPORTING SYSTEM OF OVERDUES:

All branches should submit the statement of overdues in respect of credit Cards every month by 5th of succeeding month to their controlling office i.e. Regional Office/ Nodal Regional Office, as the case may be and, in turn, such controlling Office/s will consolidate the information and shall submit the branch-wise statement for the entire region on monthly basis by 10th of succeeding month to Retail Banking Dept., Central Office.

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4.8 MUTUAL FUNDS

In recent years mutual funds have experienced external rapid growth. Their numbers have increased and their shares have become common items in the holdings of thousands small investors. Probably the greatest capital market participation on the part of the average investor has occurred in the ownership of mutual shares. Because of their importance as investment vechiles it is necessary to know what is mutual fund's growth, advantages and role in Indian capital market.

A mutual fund is a special type of investment institution which acts as an investment channel. It collects or pools the savings of the community and invests funds in a fairly large and diversified portfolio investments. It employs professionally qualified and well experienced investment consultants and managers who take the pooled money and invest the money in shares of variety of companies long-term bonds and in short term debt instruments issued by business enterprises or government. Their main aim is to maximize returns on investments. Institutions that collectively manage funds obtained from investors have commonly come to be known as mutual funds. Thus "Mutual fund is a non depository, non banking financial intermediary".

"Mutual fund is a corporation which accepts money from savers and uses the same to buy stocks, long term bonds, short term debt instruments issued by business and government units. "Mutual funds are corporations which pool funds and reduce risk by diversification".

These investment institutions are known as unit trust or investment trust in UK and mutual fund in the U.S.A In India it is safe to define mutual fund as trusts because except the mutual promoted by Unit Trust of India. (U.T.I) all have been organized and set up under Indian Trusts-Basically the functions are same. They accept money from investor and diversify the portfolio (Portfolio means holding of securities by an individual or institution. A portfolio may contain bonds and shares of various types of different enterprises). Every thing is done according to objectives incorporated in Trust deed.

4.8.1. History of Mutual Funds

Mutual funds originated in mid 19th century in Europe. In Belgium (1882) the societal general De Belgium strated a mutual fund with the modern concept of risk sharing. In 1868 the foreign Colonical Government Trust founded in London was the real pioneer of mutual fund.

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The mutual fund concept soon found its way to United Kingdom and then to united States of America, In 1924 the first mutual fund, Massachusetts Investors Trust, was launched in Boston. The period 1925-27 witnessed a substantial expansion in the movement. This enormous was a part of a general development in the field of finance resulting from an abundance of investment money and speculative spirit of the period.

By 1930's large number of close ended mutual funds were formed in U.S.A Subsequently hundreds of mutual funds, both open and close ended were developed and started in other parts of Europe, the Far East and Latin America. Mutual funds emerged as the most important investment vechicles for household investment in U.S.A.

In India mutual funds date back to February 1st 1964, when the Unit Trust was set up under the Unit Trust of India Act 1963 as a financial institution with the aim to mobilize the savings or small investor. To day mutual funds occupy a pivotal position in the Indial capital market.

4.8.2. Mutual Funds in India

In India mutual funds date bake to 1964 when U.T.I. was set-up. For nearly two decades U.T.I. had its monoply in the capital market. Later on government allowed the commercial banks and insurance corporation to operate mutual funds. State Bank of India and Canara Bank have launched their mutual funds appointed their bank subsidiaries as managers and followed by LIC, India Bank, Bank of India GIC and Punjab National Bank.

As part of liberalization policy the government allows the private sector to operate mutual funds in collaboration with foreign mutual funds. One of the key developments in this regard was opening up of mutual funds in the private sector in early 1992. Though quite a few industrial groups and financial majors showed keen interest in setting up mutual funds, it took nearly two years for the private mutual funds, to be lunched. At present many known groups of industry have set up mutual funds. Some of the important mutual funds are dealt in detail subsequently.

4.8.3. Unit Trust of India

The unit trust has been organized broadly on the line of unit trust in the United Kingdom. Unit Trust is essentially a financial intermediary which pulls the financial resource from numerous subscribers, particularly the small investors and invests, in a wide range of securities.

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UTI has since inception introduced 12 open, ended schemes and 46 closed ended schemes including 2 off shore schemes. Unit scheme – 64, the first and major open ended scheme has a two tier (sales/repurchase) meachanism. If offers divided on an annual basis. Other open ended schemes include (a) Children's Gift. Growth Fund (CGGF which expects a minimum divided of 14% (b) Capital Gains Scheme (CGS) linked to capitqal gains tax exemption provision, (c) CRTS scheme catering exclusively to charitable and Religious Trusts and Registered societies (d) Unit Linked Insurance plan offering life cover and accident insurance benefit besides tax exemption benefit.

The trust also offers close ended regular and deferred schemes . Some of these schemes provide option of re-investment of dividend. Other close ended schemes are equity oriented growth unit scheme Master share and Master share plus. The last two as well as the master gain offer listing and trading facilities on the stock exchange.

Unit Trust of India has launched two off shore funds also viz., India Growth fund Inc in association with Merril Lynch Capital, Market and Nomural International. The India Fund was launched to enable the investor in the United States of America, Canada the United Kingdom and Japan to participate in Indian Capital market. The shares of India Growth Fund are listed on the New York Stock Exchange.

4.8.4. State Bank of India Mutual Fund

The SBI mutual fund is backed by State bank's excellent track record of growth and profitability as well as its experience in investment in India and abroad. SBI Mutual fund – Magnum was announced in the Prime Minister's Budget speech in 1987 and opened on 30th Nov 1987 as close and mutual fund worth Rs.100 crores. It main terms were income oriented carrying minimum assured yield of 12% per annum. SBI Capital Markets Ltd. a wholly owned subsidiary of SBI has been managing the magnum. The State Bank of India is offering growth schemes like Magnum Multiplier, Maganum Express and Magaum Multiplier plus. Apart from the income schemes and income growth schemes, tax planning and off shore schemes are offered by SBI.

4.8.5. More Mutual Funds

Besides the issues of mutual funds from Unit Trust of India, and State Bank of India, Canara Bank, Punjab National Bank, Bank of Indan Bank and General Insurance Corporation of (GIC) and life Insurance corporation of India have established Mutual funds.

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4.8.6. Private Sector Mutual Funds

Kothari group in collaboration with the pioneer of US was the first private sector mutual fund. This was followed by number of funds. ICICI premier, 20th century and credit capital. Taurns and Morgan Stanley's growth fund, Credit capital asset management which has launched the Taurns star has international finance corporation of Washington, European commission of Brussels Lazard Freres and of Newyork and the Asian Development Bank of Manila for its partners.

However, Morgan Stanley which managers funds worth 44.2 billion chose to go alone. Apple mutual fund started without the collaboration of foreign asset management company. It was sponsored by Apple industries Ltd and Apple Asset management company. Some of the growth schemes of private sector funds are given in the following Table.

Growth scheme profile – private sector funds

Fund Manager Kothart pioneer MF	**Launch date**	**Redemption**	**Corpus Rs.Cr.**
prima(open Ended)	Nov.1993	Open-ended	154
Blue chip	Non.1993	Jn-1997	30
Morgan Stanley Mf			
Growth fund MSGF	Jan.1994	Jan.2009	982
ICIC Mutual Fund			
ICIC Premier	Dec.1993	March-1999	159
ICIC Power	Aug.1994	Oct.2001	-
20th Century Mutual			
Centurion quantum	Dec,1993	Jan,1999	-
Taurus Mutual fund			
Taurus the Starshare	Jan,1994	Jan.1999	210
Taurus the Newshare	Aug1994	April-1997	-
Apple Mutual Fund			
Apple Midas			
Gold share	April-1994	Jul-1999	

4.9. FUNCTIONAL CLASSIFICATION OF MUTUAL FUNDS

NOTES

Any mutual fund could be either of the following two kinds:

Open end fund

Close end fund

4.9.1. Open end fund

The holders of the shares in this fund can resell them to the issuing mutual fund at any time. They receive in turn the net assets value of the shares at the time of resale. Such mutual fund companies place their funds in the secondary securities market. They do not participate in new issue market as do pension funds or life insurance companies. Thus they influence market price of corporate securities. Open and investment companies can sell an unlimited number of shares and thus keep going larger. These companies sell new shares at net asset values plus a loading or management fee.

Open end schemes are of

1. Regular Income schemes
2. Cumulative Growth Schemes and
3. Recurring investment scheme

4.9.1.1. Regular Income Scheme

This provides fairly steady current income with marginal capital appreciation. Example: unit scheme 1964 of U.T.I. Cancigo and Can gift schemes of Canra Bank Mutual fund. Under cancigo shceme an investor has to invest in a minimum of 5 cancigos (fce value Rs.1000 and thereafter in multiples of 1000 for minimum period of 365 days after which the fund will buy back the cancigo when offered by the investor. The canglit scheme appears primarily for the institutional investors. The face value as well as the issue price Rs.1,00,000. The canglit has to be held for a period of 365 days.

4.9.1.2. Cumulative growth schemes

While the regular income scheme provide steady capital accumulation, the reinvestment plan which is different version of unit scheme 1964 is such a scheme where dividends earned on units will be automatically invested in additional units and called the Accumulated Dividend units at a special offer price in July. Thus the original investment grows at a compound rate.

4.9.1.3. Recurring investment scheme

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These schemes are meant for investors who would like to have a certain sum over a period of time by regular savings for which tax incentives are available, Unit linked insurance plan is a prominent example of such scheme. The unit holder is required to contribute a fixed amount either on half yearly or yearly basis. The provisional contribution, of course, depends on the target amount and savings and plan period. The contribution made under this plan brings a tax rebate under Section 88 of Income. Tax Act. In addition, dividends received on units and the investment accumulated to credit of the unit holder are exempt form income tax and wealth tax respectively.

4.9.2. Close ended scheme

A close ended scheme has a fixed amount of subscription and it can not sell more shares after its initial offering. its growth in terms of number of shares is limited. Its share are issued like any other companies new issues, listed an quoted at stock exhange. Closed end schemes fall into four broad classes.

1. Regular Income Schemes
2. Deferred Income Schemes
3. Cumulative Growth Schemes
4. Multi-option schemes

4.9.2.1. Regular Income Schemes

These schemes provide a steady regular income which is payable monthly or annually. Some of the important regular income schemes are:

Scheme Mutual Fund

Can stock, Can Bank Mutual Fund

Magnum Regular Income SBI Mutual Fund Scheme 1987

Ind Jyothi Ind Bank Mutual Fund

Dhanashree 1999 LIC Mutual Fund

The minimum dividend is 15% or so and it is indicated every year. A higher divided may he declared depending upon the performances. Unitsor shares can be encashed after one year at the price stipulated from time to time.

NOTES

4.9.2.2. Deferred Income Scheme

A variation of the regular income shceme, the deferred income schemes are designed for investors who prefer to forego dividends for the first two to the years in return for higher dividends in the subsequent years. Ex: Deferred Income Unit Schemes (DIUS) 1990 of unit Trust of India.

4.9.2.3. Cumulative growth scheme

The aim of this scheme is to provide for capital growth rather than periodic dividends. Dividends are ploughed back to ensure steady capital accumulation. Typically these schemes seek to double the capital in five years or quadruple the capital in ten years.

The important cumulative growth scheme launched are can double by can – bak Mutual Fund. Dhanaviridhi by LIC fund, Double plus by BOI mutual fund.

In the case of double it aims to cumulate the capital fund at least twice the amount of face value. Each can double held at the end of five years has the facility of being listed in the stock exchanged after the expiry one year from the date of allotment. Their would improve t4he liquidity.

4.9.2.4. Multi - option schemes

Mlti option schemes provide investors a choice between the regular income plan and cumulative growth plan.

Dhana Viridhi – LIC Mutual Fund

GIC Rise – GIC Mutual Fund

Dhanasahayog – LIC Mutual Fund

4.9.3. Tax Saving Schemes

Tax saving schemes are basically growth schemes which also offer tax reb under income Tax act. currently rebate is covered under section 88 f the income Act 1961, which entitles an investor to 20% rebate in income tax for investments may under such schemes up to a maximum investment of Rs.12000-per annum ULIP (Unit linked insurance plan)

Portfolio classification of mutual funds. Different mutual funds are designed to meet the objective of different type of savers.

NOTES

1.Bond Funds: They provide fixed return for those who desire safety of money and the funds are is invested in bonds.

2. Stock Funds: Here assets held are entirely of common stocks of various industrial corporations. These may be further classified as "growth funds" which assume high risk to obtain high return.

Income fund: It is established to maximize the current income of the investors. There are two aspects of income fund namely low investment risk generating constant income and high investment risk generating maximum income.

Money Market fund: These funds are used in short time liquied asset like certificate of deposit or commercial papers. The emphyasis is on liquidity with a low a rate of return. This is also known as liquid asset fund.

Balanced Fund: Some mutual funds are called balanced fund where assets are a dicious mixture of industrial stocks and bonds.

Special fund: These funds invest only in special type of investment. As specified them such funds carry more risk, lack of diversification approach. Investment may be gold, silver or in any other specified form.

Index Linked funds: These funds invest only on those shares which are included the market indices. Whenever, the market index goes up, the value of such index and also goes up, Conversely when the market index comes down, the value, of the linked funds also goes down.

4.9.4. Average Fund

Funds are used in order to increase the size of the value of the portfolio. Funds are in speculative and risk investment. Decline in the price of share and increase in price of shares will be utilized to gain more profit.

4.9.5. PURPOSE FUNDS:

Income and growth are two objectives of this fund. Income shares and growth shares are offered. Money is pooled and used and income earned from the portfolio

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goes to the income share holders. The investors who hold capital shares receive no income but they reveive capital gains received from the sale of investment of total portfolio.

4.9.6. Estate Funds

Here the fund is invested in real estate ventures.

4.9.7. Funds of Funds

When Mutual funds invest in other mutual fund it is called funds of funds. Geographical classification: Mutual funds can be classified from the angle of territorial jurisdiction of operation.

4.9.8. Domestic Mutual funds :

Thos funds scheme operate within the political territorial limit of a country for the residents or non residents.

Off Shore Mutual funds: OMF's are cross border funds meant to attract foreign savings for investment of India.

4.9.9. Advantages of Mutual fund

1. Mutual funds are managed by full time professional money manager. This is a major advantage for small investors who lack sufficient knowledge and experience. Also mutual funds are convenient investment media for investors who do not have the temperament or time to watch over and manage a well diversified portfolio.

2. Mutual funds enable the investor to get the full benefits of diversification which a small investor may not able to get with a small some of money. A UTI master share enable the investor to get the benefit of a diversified portfolio spread over more than 136 companies belonging to 17 different industry sectors. The investor takes one year or six months to diversify the investment. But mutual fund gives the benefit of instant diversification.

3. By virtune of their large asset base, shareholders of mutual funds enjoy greater liquidity than most company shares. Open end funds are generally more liquid them close end funds.

4. Revolving type of investment. Automatic re-investment of dividends and capital gains provides relief to the members of mutual fund.

5. Investment care–Care of securities is available through mutual fund to the investors reliving them of various rules and regulations.

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4.9.10. DISAVANTAGES:

There are basically two disadvantages of investing investing in mutual funds.

1. Professional money managers, the kinds that manage mutual funds tend to be conservative, risk averse and unimaginative. As a result, sometimes they do not take bold, timely decisions which are quite often required for earning really high profits. Also, since they are usually under pressure to produce short term results they are less inclined to take a long term view and thus miss out in the really big long term gains.
2. Mutual funds give the advantage of diversification but deny the advantage of concentration. In certain special situations in the stock markets, an investment strategy based on concentration can give superior results than based on diversification.

Mutual funds returns: Holders of mutual fund get return in the following term.

Dividends: The dividend income of the mutual fund company's investments in shares, both equity and preference, are passed on to holders.

Capital gains: Mutual fund holders or owners also get benefits of capital gains which are realized and distributed to them in cash or in kind. These are subject to tax in the same way as gains or losses of directly held securities.

3. Increase or decrease in net assets value: The increase or decrease in net assets value are the results of realized gains and losses on portfolio holding. They are not taxed until realized.

Calculation of Net Asset Value:

Mutual fund sell their shares to public and redeem them at current net asset value (NAV) of shares which is computed as follows:

$$\text{NAV} = \frac{\text{Total market value of mutual fund holdings} - \text{liabilities}}{\text{No of funds outstanding shares}}$$

4.10. OPERATION OF MUTUAL FUND

Mutual funds are authorized for business by the Securities Exchange Board of India (SEBI). The 1993 regulation of SEBI envisages of three-tier-structure for the mutual funds comprising the Board of Trustees, the Asset management company (AMC) and the custodian. The functions of all three are well defined to establish not only independence of operation form the sponsoring organization and an arm's length relationship between the board of trustees and the AMC. This provides in-built checks and balance on the actions of all three constituents.

NOTES

The function of Board of Trustees is to elect, manage and disburse what is due to unit holders. The custodian is to take physical delivery of the securities required from the funds. The AMC function is resource mobilization and fund management.

The AMC manages the funds through various schemes. It employs a large number of professionals for investment and research for investor and agent servicing. The AMC also come out with new schemes periodically. It plays a key role in the running of a mutual fund and it operates under the supervision and guidance of trustees AMC supplies all information demanded by the trustee on regular basis.

This type of structure becomes all the more necessary since investors in mutual funds are not shareholders and do not have a voice of their own in the management of the mutual funds. Regulation and superintendence by SEBI is therefore, essential to ensure that investor interests are not already affected.

4.10.1. Sale and purchase of Mutual funds

Mutual fund shares may be easily purchased or sold directly through the management, company sales office/agents or through stock brokers who are dealing in such shares as commission agents. A loading fee is usually charged (in the case of open-end mutual fund) for sales expenses. The fees islinked to the Net asset value of shares in order to arrive at the purchase price. This loading fee goes to the sales representatives. The fee may range from 4% to 10% of the total purchase. These funds are calls load mutual funds.

Non-load mutual funds will have higher management fee to offset the absence of loan fee. A small fee is charge on the redemption of non-load mutual fund shares when redemption occurs within 6 months of purchase date. A high load charge on purchases ...rages investors to put their money in mutual fund shares.

4.10.2. Management of Funds

A mutual fund invests the money received from the investors in shares, debt instruments and money market instrument depending up on the objective of the respective

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scheme. Regular expenses like custodian fee, coast of dividend warrants, registration fee and the asset management fee, are borne by the respective schemes every year. Balance of everything is given back to the investor in full.

4.10.3. Management Fees

A mutual fund gets an annual fee for managing the investor funds. The fee fixed by the Securities Exchange Board of India (SEBI) is a maximum of only 1% for funds managed in excess of Rs.100 crores.

4.10.4. Liquidity and listing of Mutual fund

Listing of the close ended schemes units on a recognized stock exchanges mandatory. A mutual fund may in addition to listing the unit. A mutual fund may in addition to listing the unit., also repurchase the units back to the fund a the repurchase price determined by the mutual fund. The repurchase price is always linked to the Net asset value and a small discount is made to cover the transaction cost. Repurchase and reissue prices are relevant for open ended schemes. Open ended schemes are not listed on the stock exchange. Investors can buy or sell their units only form and to the funds at the re-issue and repurchase price.

4.10.5. Regulation of Mutual funds in India

In India mutual funds were administered by the directives issued by RBI or ministry of finance, central government from time to till the birth of SEBI. In pursuance to the recommendations of the Dave committee, the Central Government announced opening up of the mutual fund industry for private sector and released guide lines on 14.2.1992 vesting regulatory powers in Securities and exchanges board of India. All mutual funds excepting UTI are governed under said guidelines by SEBI Act 1992.

At present, the following regulatory structure is in vogue to regulate mutual fund industry.

1.UTI Act 1963 (in respect of UTI only)

2 Guidelines from the government, RBI UTI's own guidelines and SEBI

3.The Indian Trust Act.

4.Companies Act 1956

5.SEBI (Mutual Funds) Regu!ations 1993

4.10.0. A REVIEW OF THE MUTUAL FUNS IN INDIA:

Mutual funds are to collect huge sums of money for investments purpose. The best examples are Master Gain 1992 with the corpus of Rs.4712 crores and Morgan Stanley of Rs.98 crores.

But Indian Funds managers have been criticized for the mismanagements of money. In Nov 1993, 23 out of 25 listed schemes of public sector mutual funds are being quoted at prics of heavy discounts on their net asset values-many of them even below par UTI Master gain quoted at Rs.840 nearly 32% below NAV. In the same manner in August 1994, Morgan Stanley was quoted below the par value.

The disclosure practices followed by mutual funds are not only inadequate but lso accounting norms for working out NAV vary widely. SEBI's regulations do not rovide disclosure norms are very stringent. SEBI guidelines for mutual funds are contained 50 pages as against nearly 500 pages in U.S. and at most twice that length in U.K.

investment objectives are not made available to investors except in highly :neralized terms. The investor has an inherent right to know how, where and under hat circumstances his funds have been deployed.

Penalties are also very severe abroad. Slightest error in NAV even up to three :cimal point is an enough to make the fund refund the loss with retrospective effect to ose investors who took decision on the stated NAV. In India also it is obligatory on the nd to recalculate NAV if there is an error. But necessary legislature backup is inadequate take steps against the erring mutual fund.

In spite of these limitations with the entry of private sector mutual fund industry, ıancial analyst say market will see new innovative schemes replace the existing ones, gher returns to the investor and a positive change in investor service.

1 GUIDELINES FOR HEALTHY FUNCTIONING OF MUTUAL FUNDS:

The Union Government has recently allowed the private sector to set up mutual ds. The mutual funds have become a major vehicle for mobilization of savings particularly n the small as well as household sectors for investments in the stock market. In view ıeir growing importance in the decision to allow mutual funds to be set up in the joint

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Check your Progress

2. If the underwriter undertakes the responsibility for only a part of the issue is called
   a) Partial undertaking
   b) Firm undertaking
   c) Syndicate undertaking
3. Credit limit for credit holder is fixed after assessing
   a) Purchasing power
   b) Consumer behaviour
   c) Credit worthiness
4. All branches should submit the statement of overdues regarding credit cards by
   a) 2nd of every month
   b) 5th of every month
   c) 7th of every month
5. Acquisition Financing is known as
   a) Buyout financing
   b) Development financing
   c) Early Stage financing

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and private sectors it has become necessary to evolve a comprehensive guideline for all round development and regulation of mutual funds and for ensuring investor protectic

4.11.1. Following are the guide lines

1) Mutual Fund shall be authorized for business by the SECURITIES AND
2) Mutual Funds shall be sponsored by the registered companies with a sound track record, general reputation and fairness in all their business transactions.
3) Mutual funds shall be established in the form of Trusts under the Indial Trust Act. The sponsoring institution will be free to work out the details regarding the constitution of the Trust.
4) The Trust shall then be authorized to float one or several different schemes.
5) Mutual funds will be allowed to invest only in transferable securitie either in the money market, or in the capital market including any privately placed debentures or scrutinized debt.
6) Mutual funds should not be allowed to give term loans for the same purpose.
7) No individual scheme of the mutual fund should invest more than 5 percent of its corpus in any one company's share .
8) No mutual fund under all its scheme should own more than 5 percent of any company's paid up capital carrying voting rights.
9) No mutual fund under all its schemes taken together should invest more than 10 percent of its funds in the shares or debentures or other securities of a single company.
10) No mutual fund under all its schemes taken together should invest more that 15 percent of its funds shares and debentures of any specific industry.
11) No mutual funds\ under all its schemes taken together should invest more that 15 percent of its funds in the shares and debentures of any specific industry.
12) No scheme should invest in or tend to another scheme under the same AMC.
13) Mutual funds must take delivery of scrips purchased and give delivery in the case of scrips sold and in no case shall engage in short selling or carry forward

transactions. The scrips purchased should be transferred to the fund's name and scheme also.

14)All mutual funds must distribute a minimum of 90 percent of their profits in any given year.

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4.11.2. Mutual funds

Policy Developments relating to Mutual Funds:

The SEBI tightened the disclosure norms for the mutual funds to help investors take more informed decisions. SEBI laid down detailed investment and disclosure norms for employees of asset management companies (AMCs) and Trustee companies in order to avoid any actual or potential conflict of interest. To promote venture capital activity, SEBI allowed the mutual fund to invest in the listed or unlisted securities or units of venture capital funds within the overall ceiling for such investment. Detailed guidelines or disclosure and reporting requirements were issued to mutual funds for investment in foreign securities. With a view to improve the professional standards, SEBI decided to make it mandatory for all mutual funds to appoint agents/distributors who have obtained Association of Mutual funds of India (AMFI) certification.

Resource Mobilisation by Mutual Funds:

During 2001-02 resource mobilization (net) by all mutual funds together declined by 27.9 per cent of Rs.8,024 crore form Rs.11,135 crore in the previous year. While resource mobilization by the public sector mutual funds (other than UTI) declined to Rs.1,330 crore from Rs.1,521 crore, that by the private sector mutual funds at Rs.13,977 crore increased by 50.4 percent from Rs.9,292 crore during the same period. The composition of portfolio of mutual funds moved away from equity funds in favour of debt funds. Resource mobilization by UTI declined sharply registering an outflow of Rs.7,284 crore during 2001-02 as compared with an inflow of Rs.322 crore during the previous year.

Restructuring of UTI:

The Cabinet Committee on Economic Affairs (CCEA) granted its approval to a UTI reform package in its meeting on August 31, 2002. The major highlights of the reform package are:

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The Government would honour the redemption guarantee, as approved by Cabinet Committee of Economics Reforms on December 27, 2001, for US-64 unit holders. The liability in this account was estimated to be about Rs.6,000 crore, which could vary depending on market conditions. In respect of the assured return schemes, wherever interest can be reset at a lower level. The shortfall in these schemes was estimated to be about Rs.8,561 crore. The Government would also consider certain tax concession son USW-64 with a view to providing an incentive to unit holders to remain invested with the scheme.

UTI would be divided into two parts:

Table IV Resource Mobilization by Mutual Funds

(Rs. Crore)

Mutual Funds	1998-99	1999-2000P	2000-01P	2001-02P
1	2	3	4	5
I. Bank – sponsored (1 to 6)	-88.3	335.9	247.8	717.6
1. SBI Mutual Fund-71.8	659.0	257.5	457.0	
2. Canbank Mutual	-16.5	-361.0	-5.4	143.2
3. Indian Bank Mutual Fund	…	…	…	…
4.BOI Mutual Fund …	…	…	…	
5. PNB Mutual Fund	…	39.6	2.1	56.7
6. BOB Mutual Fund	…	-1.7	-0.4	60.7
II. Fls-sponsored(1to3)	546.8	295.5	1,272.8	612.8
1.GIC Mutual Fund-12.1	-268.2	-43.5	58.2	
2. LIC Mutual Fund 348.4	284.5	566.0	732.5	
3. IDBI Mutual Fund	210.5	279.2	750.3	-177.9
III Unit Trust of India	170.0	4,548.0	322.0	-7,284.0
	(1,300.0)	(5,762.0)	(1,201.0)	(-6,119.0)
IV. Private Sector Mutual Fund	2,066.9	16,937.4	9,292.1	13,977.1
ToTAL(I+II++IV)	2,695.4	22,116.8	11,134.7	8,023.5

P Provisional

… Nil or negligible

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Notes:

1. For UTI, the figures are gross value (with premium) of net sales and for other mutual funds, net sales under all schemes.
2. Figures in brackers in case of UTI pertain to net sales at face value.
3. Date exclude amounts mobilization by off-shore funds and through roll-over schemes.

Source: UTI and respective mutual funds.

a) UTI-I and (b) UTI-II

a) old protected UIT-I comprising of US-64 for which assured repurchase prices have been announced and assured return schemes, and

b) New UTI (UTI-II) comprising of all net asset value based schemes.

Government will meet its obligations annually to cover any deficit in UTI-I

UIT-I will be managed by a Government appointed administrator and a team of advisers nominated by Government.

UTI-II will for the time being be managed by professional Chairman and Board of Trustees and will be disinvested.

UTI Act would be repealed through issued of an Ordinance an both UTI-I and UTI-II will be structure as per the SEBI Regulations.

The operational aspect including, but not limited to distribution of assets and liabilities between UTI-I and UTI-II etc., would be worked out by Government.

On September 3, 2002 the Government announced the following decisions.

a) In view of the commitment of the Government of India of to meet all shortfalls in UIT-I, UTI-II it will not indulge in asset selling to meet redemption pressure and all sale and purchase of stocks will take place in UTI-II based upon the market perception of its fund managers or the management.

a) Fresh units of US-64 in its present form will not be issued by UTI-I. Certain initiatives undertaken by the UTI in the recent past in the areas of investor service and efficient fund management are the following.

making US-64 NAV-based effective January 1, 2002 disclosure of portfolio for all schemes includingUS-64 on a monthly basis.

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daily announcement of NAVs.

introduction of special repurchase facility with monthly increasing price support for investments upto 3,000 units per investor from August 1, 2001 and upto 5,000 units per inventor from January 1, 2002.

price support of Rs.10 per unit from may 31, 2003 for holdings in excess of 5,000 units per investor.

issue of detailed investment manual an comprehensive delegation of powers;

setting up of Risk Management department.

setting up of Asset Reconstruction Fund for focused effort for recovery of NPAs; performance-linked incentivisation for officers;

commissioning of central processing centre and central data centre and centralization of all back office functions and implementation of integrated front office automation system.

Table V: Resource Mobilization by Mutual Funds

Year	Public Sector Mutual Funds					Private Sector Mutual Funds	Grand Total (6+7)
	Sponsored by						
	Banks	Fls	Total	Unit	Total		
1	2	3	4	5	6	7	8
1995-96	113.3 (4)	234.8 (3)	348.1 (7)	6,314.0 (1)	5,965.9 (8)	133.0 (11)	-5,832.9 (19)
1996-97	5.9 (3)	136.9 (2)	142.8 (5)	-3,043.0 (1)	-2,90000 (6)	863.6 (17)	-2,036.6 (23)
1997-98	236.9 (2)	203.4 (3)	440.3 (5)	2,875.0 (1)	3,315.3 (6)	748.6 (15)	4,063.9 (21)
1998-99	-88.3 (2)	546.8 (3)	458.5 (5)	170.0 (1)	628.5 (6)	2,066.9 (16)	2,695.47 (22)
1999-2000P	335.9 (6)	295.5 (3)	631.4 (9)	4,548.0 (1)	5,179.4 (10)	16,937.4 (27)	22,116.8 (37)
2000-2001P	247.8 (6)	1,272.8 (3)	1,520.0 (9)	322.0 (1)	1,842.6 (10)	9,292.1 (27)	11,134.7 (37)
2001-2002p	717.6 (6)	612.8 (3)	1,330.4 (9)	-7,284.0 (1)	-5,953.7 (10)	13,977.1 (27)	8,023.5 (37)

P : ovisional

Exclude re-investment sales.

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Notes:

1.For UTI, the figures are gross value (with premium) of net sales under all domestic schemes and for other mutual funds, figures represent net sales under all ongoing schemes.

2.Date exclude amount mobilization by off-shore funds and through roll-over schemes.

3.Date within parentheses relate to the number of mutual funds which mobilized resources during the year. The actual number of funds in operation could be greater than the number indicated in parentheses.

Source: UIT and respective Mutual Funds.

Source: RBI, Trend & Progress of Banking in India 2001-2002, PP-119-122-224

4.12 FACTORING SERVICES

FACTORING – MEANING

Factors are financial intermediaries who come in between the supplier and the customer. They perform a lot of financial services. The Factors buy trade debts or lend money on the security of book debts. The purchase of book debts and the collection of book debts are the most important functions of factors. The supplier assigns the book debts to the factor and it is the factor who undertakes to collect them on the maturity date. The factors pay about 70 percent of the book debts to the supplier in advance and the balance on the maturity.

4.12.1. Nature of Services

The following are the services rendered by Factor.

4.12.1.1. Management of Book Debits

The factor manages the trade debts of the supplier.

1. maintains the sales ledger,
2. issues invoices and
3. collects amounts when they fail due.

Thus the supplier is relieved of the burden of running a credit and collection department.

4.12.1.2. Protection against bad & doubtful debts

The Factor assumes responsibility for credit collection and thus greatly reduces the risks associate with bad and doubtful debts. The Factoring companies maintain their intelligence wings which assess the creditworthiness of traders.

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4.12.1.3. Short term advances

The Factor provides short term advances for a major portion of the value of book debts and the balance amount on maturity. This practice enables the supplier to increase and turnover and reduces the need for maintenance of a large working capital.

4.12.2. FETURES OF FACTORING ARRANGEMENT

4.12.2.1. SELECTION OF BOOK DEBS

The factor selects the book debts of a supplier which are to be bought by him continuously on the basis of customer's age, amount of credit, period, of credit etc., After purchasing all the debts, the factor works out the credit decisions for the supplier, Generally, the factor and the supplier decide the crdit ceilings for each customer, collection period and factoring charges.

4.12.2.2. Collection of Debts

The Factor assumes responsibility for collection of debts. Whenever, sales are made, the supplier informs the customer regarding the factoring arrangement and requests him to make the payment directly to the factor.

4.12.2.3. Recorse on Bad Debts

The factoring arrangement may be with recourse to bad debts or without recourse to bad debts. If it is with recourse to bad depts., the factor has a right to demand for payment from the supplier, if the customer fails to pay on the due date.

4.12.2.4. Payment by factor

The factor will advance 70 to 80 percent of the outstanding book debts and the balance will be paid on maturity.

4.12.2.5. Factor reserve

A certain percentage of the debts is reserved as factoring reserves to serve as a security for the advances granted by the factor. This will offer protection to the factor in case some customer returns goods to the supplier.

4.13 TYPES OF FACTORING

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There are various types of factoring such as the following :

1. Full factoring
2. Recourse factoring
3. Maturity factoring
4. Advance factoring
5. Undisclosed factoring
6. Invoice discounting
7. Bank finance factoring
8. Supplier's guarantee factoring
9. International factoring

There are briefly discussed below.

4.13.1. Ful Factoring

Full factoring is also referred to as standard or old line factoring . In addition to the provision of finance against debats, the factor assumes responsibility for sales ledger maintenance, collection of book debts and also assumes risks against bad debts.

4.13.2. Recourse Factoring

Under recourse factoring, the factor all servic4s except credit risk. In case bad debts arise the factor recovers them from the client.

4.13.3. Marity Factoring

Maturity factoring is also reared to as collection factoring. The factor renders all services including the administration of client's ledger and collection of book debts but the amount is paid bu him after the collection or on the date of maturity. In other words, the factor does not give advance amount against book debts.

4.13.4. Advance Factoring

Under this method the factored amount is paid even before the amount is collected from the client. As such it amounts to repayment. The payment is restricted to about 80 percent of the book debt.

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4.13.5. Undisclosed Factoring

Under this method the customers are not informed of the factoring arrangement with the client and the factor provides finance against the debts. The amount is collected by the cokent himself without involvement of factors.

4.13.6. Invoice Factoring

Under this method, the factor finances against the invoices without assuming any other responsibility. The invoices are bought by the factor at a discount. The client thus overcomes liquidity problems.

4.13.7. Bank Finance Factoring

Under this method, the bank provides finances for that portion which is kept as reserve by the factor . It may be up to 30 per cent.

4.13.8. Supplier's Guarantee Factoring

When goods are sold through intermediaries, the factor guarantees against the invoices.

4.13.9. International Factoring

Export sales come under this method. The factor completes legal another procedural formalities relating to exports.

4.14. RESERVE BANK OF INDIA'S GUIDELINES ON FACTORING

1. Banks should not finance companies engaged in factoring. But the banks may set up separate subsidiaries for factoring with the approval of RBI.
2. Banks should not finance companies engaged in factoring.
3. Investment in a factoring company's shares should not exceed 10 percent of paid up capital and reserves of the bank.
4. If subsdiaries or joint ventures are to be set up, RBI's prior clearance is a must.
5. banks which set up subsidiaries or joint ventures must furnish information to the RBI.

4.14.1 ADVANTAGES OF FACTORING

1.Factoring improvers liquidity

As the Factor provides advance to the supplier, it improves the liquidity of the supplier.

2.Higher returns

As the Factor provides advance against book debts, the supplier can use the money to acquire more stocks and thus increase his business by simple rotation of funds.

3.Increased operating leverage

As the funds provided by the factor are available for working capital needs, (without worrying for working capital needs) more investments can be made in fixed assets.

4.Cash discount can be availed

With the easy flow of funds from factor, the client will be able to settle his payments and avail cash discounts.

5.Trade discounts

As the customer directly pays to the factor, the supplier nee not pay any trade discount to the customer.

1. No need to bother about the sales ledger
   a. The supplier need not bother about the sales ledger as it is maintained by the factor. As the factor undertakes to collect debts and collect credit information, the supplier is enabled to concentrate on sales and his business.

4.15 KEY TERMS

- Mutual Fund : It is a special type of investment institution which acts as an investment channel. It collects or pools the savings of the community and invests funds in a fairly large and diversified portfolio of investments.

- Factoring : Factors are financial intermediaries. They buy trade debts or lend money on the security of book debts.

- Underwriting : It is an agreement where by a personal organisation agrees to take a specified number of shares or debentures or a specified amount of stock offered to public in the event of the public not subscribing to it.

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4.16 SUMMARY

Of late India has become increasingly active in the international money markets and this trend likely to continue. For import of goods and services from overseas, the arrangement, of various kinds of export credits from different countries is also required.

In respect of many joint enterprises and overseas ventures in the Middle-East, South-East Asia and Africa etc., advice on the financial structuring of these projects, as well as assistances in syndication of the finance itself, is now increasingly available through the Indian Merchant Banks.

4.17 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) T (b) F (c) T (d) T (e) F
2. (a)
3. (c)
4. (b)
5. (a)

4.18 QUESTIONS / EXERCISES

SECTION - A

1) Define Merchant Bank. What are the main functions of Merchant Bank?

2) A Credit Card is like a loaded Gun. Do you agree?

3) What is meant by Factory Service? Explain the different kinds and point out the advantages of factoring.

SECTION - B

4) List out the advantages and disadvantages of Mutual Fund.

5) Write a note on
   a) Underwriting
   b) Overdue

4.19 FURTHER READING

1. Dr.N.Premavathy - Banking Theory Law and Practice.

2. M L. JHINGAN - Money, Banking, International Trade and Public Finance.

3. S.N.Maheswari - Banking Theory Law and Practice.

Unit - 5 PROBLEMS OF INDIAN COMMERCIAL BANKS

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Structure

5.0 INTRODUCTION

The Manager must be efficient in all enterprises and more so in Commercial Banks. The banks must be managed prudently, safely profitably, if we want to have a strong growing and adaptable banking system capable of meeting the demands of society.

The very nature of commercial banking, with its great reliance on public confidence and its influence on the nation's economic life, makes it mandatory that the management and organizational structure of commercial banks be of high quality and efficiency. In the past the small size and limited services of many banks, and in some cases the shortage of

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executive talent have contributed to lack of scientific organization and departmentalization. The growth of commercial banking, its changing structure, the rising cost of operations and competition from other financial institutions have caused many banks to improve their resources and reduce their cost of operation.

5.1. UNIT OBJECTIVES

- ❖ To improve the resources and reduce the cost of operation
- ❖ To envisage safety, liquidity and profitability for the successful operation of the Banking Companies.
- ❖ To take care of the Society.

5.2. MANAGEMENT GROUP

Irrespective of the size of a bank, its area of operation, its market or products (services) its organization must consist of 4 management groups as under.

1) General Management
2) Planning Management
3) Functional Management
4) Operation Management

5.2.1. General Management:

Conflicts of interest will exist in any organization because of diversities of its various components and the organization must present a balance of these interests. For example, the Marketing Department may wish to launch a new product like rural lending, the Development Department may have a growth plan, the Personnel Development may wish to slow down new innovations so as to lighten the burden and wish to inhibit growth because of lack of trained personnel, and so on. Finding a balance in such a situation is not easy and no one but the general management can determine priorities and drive the organization as a coherent whole towards its goals.

In a small bank with a limited range of services and narrow market, the chief executive may be able to discharge this function of co-ordination and control. Whereas, in a large bank, intricate problems may arise and the burden imposed may be too great for one man to cope with, unless, he is supported by an advisory group.

5.2.2. Planning Management:

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In banking, planning of resources is very important because their availability is rather inelastic to market changes. For example, premises once used for the bank systems, when merchandised clerical staff and high grade management cannot be swiftly changed, increased or reduced.

Planning cannot be left to develop naturally in functional or operational departments. It needs a constant drive from a special team backed by the general management. The planning process cannot be carried out at a low management level for two important reasons. A broad outlook, an overall view and total feeling of the whole organization would be available only at the top. Secondly, unless the general management commits itself to the plans, they are less likely to be accepted by the operational managers. Moreover, it will be necessary to bring together the plans of all concerned like marketing, development resources etc. to draw up a final plan. In this way, the whole organization can be guided towards the attainment of its objective like growth, profit, service etc., while there may be a Planning Department to correlate the plans and draw-up an over all plan, the whole organizational structure will have to be involved in analyzing forecasting and setting of targets.

5.2.3. Functional Management:

A small bank may not require separate departments to deal with marketing, personal or automation. With the increase of bank's resources and its activities, the need for functional management arises. Again, in a highly controlled economy as in India, the way in which the banking business interacts so closely with economy of the nation has led (through government policies) to the authority of the individual operational managers being subjugated to centralized authority in matters like credit policies, interest rates, etc., Consequently, these have also become matters of functional management.

With the increase in functional management, the powers and freedom of action of operational managers have less control over the resources which tend to get centrally controlled. For example a branch manager of large bank has little. 'Say in the rent charges of his branch or the salary of his personnel. A major part of the cost of his resources is pre-determined by other people and he has to approach these people for additional resources when required. Centralized functional management has certain

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advantages such as it ensures high professional standards, the best use of available resources and the like. But, diseconomies of scale may also arise in overburdening the organization with excessive head office administration, inflexibility and intensitivity to local conditions.

5.2.4. Operational Management

With the emphasis on extending banking to unbanked areas the spread of banks has assumed large geographic dimensions that geographic divisions have become most common in large banks. As such, divisionalisation has become inevitable and with it, a degree of certain decentralisation of the functional management structure also has become essential. However, such decentralization needs to be balanced by an appropriate measure of centralization by which the general management retains the function of overall decision-making and planning and co-ordinates and controls the operational management by setting appropriate goals, policies and standards and evaluating performance periodically against these.

Now-a-days, banks are extending their services to the rural people and weaker section of society. Hence, the role of banking institutions is changing which brings about palpable change in the role of operational management. The requirement of functional expertise is progressively increasing with the increase in the number of specialized services such as small scale business, agriculture, cottage craft etc. The operational management which does business cannot succeed unless it is highly flexible to demand and competition. Thus, local conditions have an important bearing on determining the quantum of power that can or should be delegated.

5.3 BOARD OF DIRECTORS

Like any other company, a bank under the Companies Act 1956, is a legal entity and being impersonal by nature can act effectively only through the authority of other persons acting as it agents.

The persons or the group of persons who direct, conduct and manage the company's affairs, frame the general policy of the company appoint the personnel and superintendent their work and advise the shareholders regarding the business and profits, are known as directors. The directors of a company are collectively known as the 'BOARD OF DIRECTORS' or the 'BOARD'.

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The management of a bank vests in the Board of Directors which is responsible for the efficient handling of the business, including lending operations. To carry on the affairs of a bank, the Board is entrusted with all powers which the banking company may possess.

The Directors are elected by the shareholders on the basis of their shareholding, influence and experience. The Board delegates the necessary powers and authority to the Chief Executive Officer who may be known as Managing Director or General Manager. Prior to the introduction of Social Control Act, the office of the Chairman of the Board and that of the Chief Executive Officers were held by different persons. There has been a radical change in the concept of bank management since the passing of the Banking Laws (Amendment) Act, 1968. It has been decided that commercial banks should function as development agencies and the lending capacity of the banks should be utilized for the benefit of society and its neglected constituents instead of the so called 'Credit – worthy' business and industry groups. Section 10 A(2) the Banking Regulation Act provides that "Not less than 51% of the total number of members of the Board of Directors of a banking company shall consist of persons who shall have special knowledge and experience in one or more of the following matters. (i) accountability (ii)agriculture and rural economy. (iii) banking (iv) co-operation (v) economic (vi) finance (vii) law (viii) small-scale industry and (ix) any other matter, the special knowledge of, and practical experience in, which would, in the opinion of the Reserve Bank of India, be useful to the banking company". Out of the above, not less than 2 shall be persons who will have special knowledge or experience in respect of agricultural and rural economy, co-operation or small-scale industry.

Where the composition of the Board does not fulfill the requirements of the Act, the Reserve Bank of India has been authorized to direct any bank to reconstitute its Board and replace any person from the office of the director by another suitable person. It has also been provided in the Act that Chairman of the Board of a bank shall be in the whole time employment of the bank. It was though necessary that the Chairman and the Chief Executive of the bank should be one and the same person.

5.4 THE NATIONALISED BANKS

In the case of private banks, the share capital is held by share-holders. In the case of State Bank of India, a considerable portion of the share capital is held by

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the Reserve Bank of India. With regard to the Nationalised Banks, the entire share capital is held by the Central Government. Therefore, the structure of nationalized banks is different from that of private banks and even from the State Bank of India, or its subsidiaries in regard to ownership.

Due to the absence of a general body of share holders and in view of the fact that these banks should subserve public interest, it was felt that the Board of nationalized bank should consist of persons nominated by the Central Government in consultation with RBI.

According to the Banking Companies (Acquisition and Transfer of Undertakings) Act 1970, the general superintendence, direction and management of the business affairs of a nationalized bank have been vested in a Board of Directors which shall be entitled to exercise all such powers and do such acts and things as the bank is authorized to do and exercise. It was also provided that the Board of each nationalized bank shall include.

a) representatives of (i) the workers and (ii) depositors of respective bank and

b) such other person as may represent the interest of the following categories, (viz.,) farmers, workers and artisans.

In consultation with the RBI, the Government of India made the scheme known as Nationalised bank (Management and Miscellaneous provisions) Scheme 1970.Under the scheme, the Government of India shall constitute the Board of a nationalized bank consisting of:

i) not more than 2 whole time directors of whom one shall be the Managing Director

ii) 1 director from among the workmen of the respective bank;

iii) 1 director from among those employees of the banks who are not workmen;

iv) 1 director who is competent to represent the interest of the depositors;

v) 3 directors who in the opinion of the Government of India, are competent, to represent, respectively, the interests of farmers, workers and artians;

vi) not more than 5 directors, to be appointed by the Government of India from among persons having special knowledge or practical experience in respect of one or more matters which are likely to be useful for the working of a bank;

vii) 1 director who is an official of the RBI; and

viii) 1 director who is an official of the Government of India.

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Under the said Scheme, every director member of a local board, adviser as also every worker of a bank whose business has been taken over by the Government will have to sign a form of declaration of fidelity and secrecy.

The directors who are appointed from among the different categories other than those nominated by the RBI and Government of India will hold office for a period of 3 years and shall be eligible for re-appointment. The Managing Director of a nationalized bank shall be the Chief Executive Officer of the bank and the same person may be appointed to hold at the same time both the offices of the Chairman and Managing Director. He shall be whole time employee of the bank and shall hold office for a term not exceeding 5 years at a time.

Under the new set up, the Chairman and Managing Director, has a dual function on the one hand, he frames the policies along with other members of the Board and on the other, he is directly responsible for the implementation of the policies. He has to work under the guidance of the Board and yet, he enjoys considerable authority. He can exercise such authority for the smooth running of the bank but has to place before the Board periodically the details of all important developments for their approval.

Foreign Banks:

Each foreign bank operating in India has an Advisory Board following more or less the same pattern as that prescribed in respect of the Board of Directors of Indian banks in the Banking Law (Amendment) Act 1968.

5.5 COMMITTEES UNDER NATIONALISED BANKS

Under the Nationalised Banks (Management and Miscellaneous Provisions) Scheme 1970, there shall be

1. A Managing Committee;
2. Advisory Committee; and
3. Regional Consultative Committee for the nationalized banks.

5.5.1. Management Committee:

The Management Committee shall consist of the Chairman/Managing Director the directors appointed to represent the RBI and the Government of India and not more than 4 other directors nominated by the Government of India.

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5.5.2. Advisory Committee:

The Advisory Committee may be constituted by the Board of Directors to render advice to the Board on such matters as may be referred to them.

5.5.3. Regional Consultattive Committee:

The Regional Consultative Committeeshall consist of the following members:

i) not more than 3 persons tobe nominated by the Government of India; and

ii) 2 representatives from the state of the Union Territories in the region and representatives from the banks.

It shall review the banking developments within the region and may take necessary recommendations for consideration of the Government of India.

Formation and Management of other Committees:

In addition to the Board of Directors, the scheme also provided for theformation of a Management Committee for each nationalized bank. It shall consist of the Chairman, the Maaging Directors representing the RBI orIDBI and the Central Government and nt more than 4 directors, nominated by the Government of India after consultation with RBI. These 4 directors will hold office for a period not exceeding 1 year. The committee will exercise such powers as may be delegated to it by the Board with the approval of the Government of India. Such approval will be given after consultation with the RBI. The quorum for the meetings is 4 directors meeting should be held twice a month. The minutes of the meetings shall be placed before the Board immediately after the meeting of the Committee. Provision was also made to constitute such other committees, or partly of directors and partly of other persons as deemed fit to renderadviceto the Board on such matters as may be generally or specially referred to them and shall perform such duties as the board may entrust to them.

5.5.4. Formation of Regional Consultative Committees:

The formation of Regional Consultative Committees was intended to review banking developments witin the region and to make such recommendations as it may deem appropriate for the consideration of the Government of India and the RBI for this purpose the country was divided into 5 regions and a provision was made to form one Regional Consultative Committee for each region.

The meetings of the committees would be presided over by the Union Minister of Finance or by such Minister or Deputy Minister in the Union Ministry of Finance as may be nominated by the Minister of Finance.

The Committeeshall consist of the following members:

a) not more than 3 persons to be nominated by the Government of India.

b) 2 representatives from each of the States and 1 from each of the Union Territories included in the respective regions to be nominated by the respective government; and

c) I representative each to be nominated by such of the designated by the RBI.

Formation of full- fledged board of directors and regulation over them:

Under the Nationalized Banks (Management and Miscellaneous Provisions) Scheme 1970, the Government of India announced that the Chairman and Managing Director were to be given to one person in each board.

The Chairman and Managing Director was also required to work as the Chief Executive Officer of each bank. The tenure of non-official directors except for the directors representing the interests of workmen employees (Where the term was 3 years in all banks except one where it was 6months only for want of a new panel).

The size of each board was 9 in the case of Allahabad Bank, Bank of Baroda, Bank of India, Syndicate Bank and United Commercial Bank and 10 in the case of remaining other nationalized Banks Each of these boards includes 1 whole–time director as Chairman and Managing Director, one director each to represent the –RBI.

Government of India,

Workmen – Employees,

Office – Employees,

Depositors of Banks and

- Artisans. One director was appointed on each board, except on the boards of Central Bank of India. Punjab National Bank to represent interest of farmers. The remaining directors on each board were appointed on the basis of their having special knowledge of practical experience of the matters likely to be useful for the working of these bodies. Retired persons, professors, social workers, economists, top executives of business concerns, journalists, lawyers etc have been appointed under this class. No director was appointed on any board to represent the interest of the workers. However, these boards were announced with an idea, to include more directors in future. In all, there were 141 directors on all these as each of the four appointed by the Government of India had directorship in 2 banks. These board were on the pattern of policy boards where part time members representing many interests and having varied knowledge and experience were appointed.

5.6 DECISION MAKING

It is less costly to have a few experts in the head office for functions such as loans, operations, and promotion than to have such experts in every branch. Since most decisions are made centrally, there is little difficulty in controlling the decision – makers.

There is a natural tendency toward centralization of processing when the decisions are made in the head office. This is advantageous if the economies of centralization are obtained. But it may result in slower action in the branches, since this involves time – consuming preparation and review of reports and ensuring discussions or correspondence. Many services cannot be rendered since have a time factor or a person to person relationship that will not permit reference to head – office for decision or action.

Apart from slower service, lack of opportunity for the customer to plead his case face to face with the decision- maker is disturbing and frustrating. Coupled with this is the decision – maker's task for personal knowledge and of some degree, interest in the customer and his problems. Unless, the decision – makers participate actively in local affairs, it is difficult for bank to demonstrate its good citizenship.

When the authority to make most decisions in the branch only the services be rendered more conveniently and promptly, but here is like hood of great personal interest on the part of the staff member when he is dealing with some one whom he sees in the bank occasionally and who may even be an acquaintance or a neighbour with expertness and authority; the branch personal can render almost any service without reference to administrative specialists.

A high degree of decentralized decision – making may result in undesirable differences in the interpretation and implementation of institutional policies. Not only

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most policies be communicated, but there must be adequate means of detecting non – complanice or misinterpretation.

Geographic Divisionalisation or Regionalisation is a necessary outcome of growth. But regionalisations, the bulk of decision – making is placed up on the regional head quarters so as to obtain flexibility and speed in an expanding, demanding and competitive market, where the banks are trying to sell multiple services, it should be viewed as a process of delegation and decentralization and should be carried out when the situation demands. If carried out, the regional managers should be granted powers so that they can provide the flexibility demanded by the local conditions and they can make quick decisions.

Regional organizations may present certain dilemmas of organizational relationships. One situation is under which the head of the region reports to the general management and the function specialists in his region report to him and have staff relationship with their respective head office functionaries. On the other hand these specialists report to their respective head office functionaries on a line basis and they will be under the board supervision of their regional heads only. But the specialists may view it as having two bosses to serve and the regional head may feel that he has no responsibilities in special areas.

5.7 ORGANISATIONAL PROBLEMS

An organization is integrated by well defined objectives and clarly outlined plans, understood and accepted by all who have to implement them. This is the frame work. the motive power in the hierarchyof goals along with commensurate authority is delegated through out the organization within the parameters of the overall plan system of communication and joint consultation at all levels. If organizational relationships are kept in one's head, rather than on paper, employees work in uncertainty, hence the need for organization charts and manuals. These organization charts graphically represent authority, responsibilities and accountability. Though chars are static depicting what existed when they were made, yet they can be kept up to date and in any case they are a convenient reference point. Two charts are provided here. One shows the organization structure of Commercial Bank Branch while the others shows the pattern of organization and management of one of the biggest Nationalized Commercial Banks in India.

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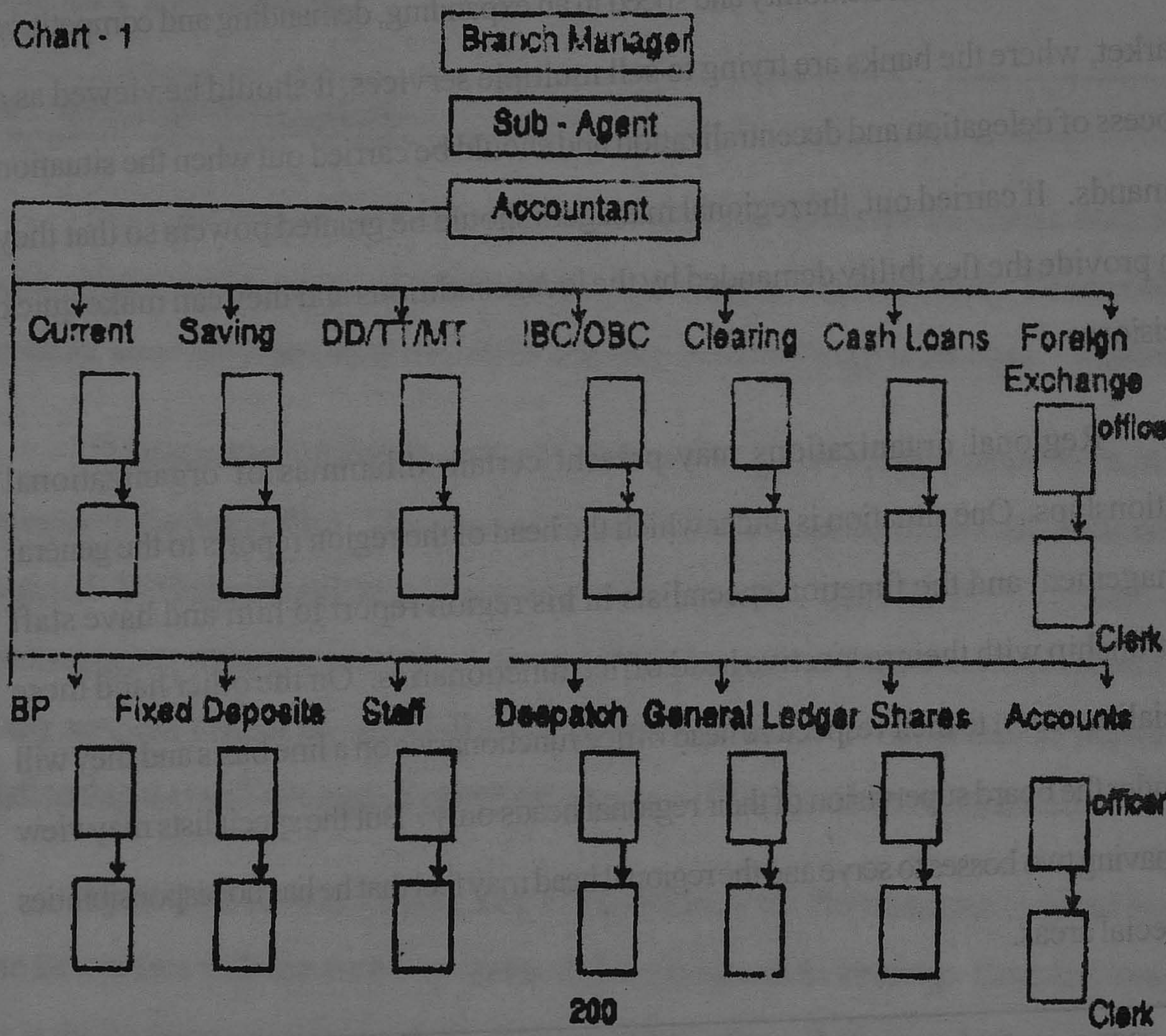
ORGANISATIONAL STRUCTURE OF THE COMMERCIAL BANK BRANCHES

Chart - 1



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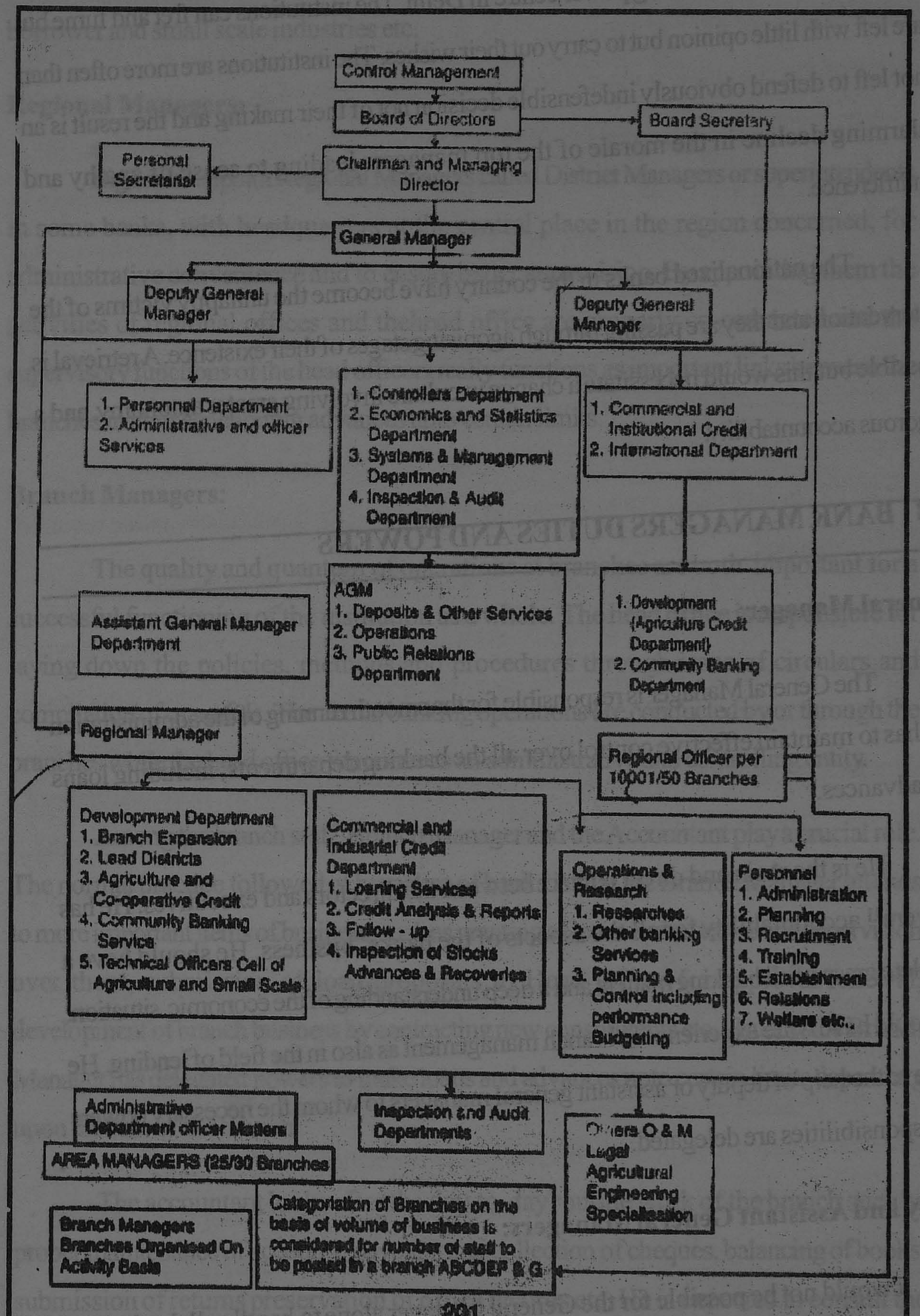
PATTERN OF ORGANISATION & MANAGEMENT OF ONE OF THE BIGGEST NATIONALISED COMMECIAL BANKS



Management Weakened:

The independent functioning of the nationalized banks gets affected from three principal quarters. Of course, the first is the bureaucracy which has its own conception of what is meant by control of the public sector. This control of bureaucracy produces voluminous paper-work mostly not relevant to the fulfillment of the objectives of the

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institution but does threaten its viability. The second is the Minister and the group of politicians, for whom party interests are more important than the sanctity of the decision. Most of the damage that has been caused to the nationalized banks has come from this quarter. The third is a strong power centre in Delhi. The institutions can fret and fume but are left with little opinion but to carry out their wishes. The institutions are more often than not left to defend obviously indefensible decision not of their making and the result is an alarming decline in the morale of the top managers leading to sense of apathy and indifference.

The nationalized banks in the country have become the unhappy victims of the intervention and they are passing through agonising stages of their existence. A retrieval is possible but this would necessitate a change in culture involving greater autonomy, and a rigorous accountability.

5.8 BANK MANAGERS DUTIES AND POWERS

General Manager:

The General Manager is responsible for the smooth running of the administration and has to maintain effective control over all the banking departments, including loans and advances.

He is the main and direct contact between the directors and executives. He has an overall accountability for all the aspects of the banks' business. He should have a complete grasp of all banking matters and a deep understanding of the economic situation. He should have wide experience in branch management as also in the field of lending. He will have the help of deputy or assistant general managers to whom the necessary powers and responsibilities are delegated.

Deputy and Assistant General Managers:

It would not be possible for the General Manager alone to handle all the duties and responsibilities entrusted to him. In all his activities, the general manager is assisted by a team of Deputy and Assistant General Managers. Some of the duties and responsibilities of the General Manager are usually delegated to each of the Assistant and Deputy General. Each one of them is placed in charge of administration, investments and property and yetanother of inspection and the kind of loans and advances including foreign exchange and so on. The Deputy General Manager and Assistant General Managers may also look after the supervision of branches in particular areas or regions and specialized department of the head office, say industrial financial firm finance, foreign exchange, branch expansion, staff training schemes for deposit mobilization, special needs of borrower and small scale industries etc.

Regional Managers:

Big banks appoint Regional Managers called District Managers or superintendents in some banks, with headquarters at the central place in the region concerned, for administrative convenience and to ensure better supervision. By appointing them the activities of regional offices and thehead office are properly co-ordinated and the supervisory functions of the head officers really functions as important links between the branches in their sanctioning advances upto certain limits.

Branch Managers:

The quality and quantum of operations at branches are both important for a successful functioning of the institution as a whole. The head office is responsible for laying down the policies, methods and procedures through issue of circulars and compilation of manufals. The actual banking operations are conducted by or through the branches while the head office functions as an administrative and controlling entity.

Among the branch staff, Branch Manager and the Accountant play a crucial role. The normal practice followed at branches of banks is that the Branch Manager attends to more important items of business, such as granting of loans and advance and supervision over them, submission of loan proposals to Head Office for approval/renewal, development of branch business by contracting new constitutents etc. Usually, the Branch Manager has delegated powers to make loans and advances upto certain limits depending upon the size of the branch.

The accountant looks after the day-to-day routine work of the branch such as proper maintenance of accounts, payment and collection of cheques, balancing of books, submission of returns preservation of office records etc. He is expected to consult the branch Manager on all important matters under his charge.

5.9 COMPETITION BETWEEN BANKS

Prime view appears to be that of unhealthy competition amongst the commercial banks which sometimes proves advantageous to a client, particularly a borrowing

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constituent to bargain with the banks where by the basic discipline which is an essential aspect to be admintained by the borrower client becomes difficult to be maintained. In days of better liquidity, there is a stiff competition for getting borrowal client from one bank to another, even at the cost of reduction in the rate of interest. From the point of view of the company, it maybe beneficial to them. But taking the view point of the Government, it is a loss to the government, because afterall income of the Nationalised Banks as well as State Bank and its subsidiaries goes to the government and therefore, in view of interchange from one bank to another results in the reduction of the government income.

Often, some of the clients have multiple banking arrangements. Hence, it is not possible for each of the bank financing one or more of its units, to have a closer watch on the end-use of funds. Many a times the account holders dictate terms about the security, margin etc. In such cases, banks are unable so adhere to the financial discipline required to be maintained.

Different practices amongst banks for charging interest, commission, service charges etc. as well as remittances are prevailing. There is over expansion of branches in certain areas. There might be more than 10 branches of different banks in the same area having a radius of half-a-mile, while there are innumerable unbanked centres in rural and undeveloped areas. The top management of banks, instead of competing for deposits, should insist on extending better service to the public, timely submission of statements, good house-keeping and maintaining good recovery of advances. The should also concentrate on reconciling inter-branch accounts, making them upto date, there buy preventing trauds.

All the above factors have been hovering in the government's mind and are from time to time reflected in its policies. In order to have some final solution, the Government earlier appointed the Banking Commission and recently a commission has been appointed under the relationship of Shri Manubal Shah. While no crystal clear ideas have been emanating even from these authoritative commissions, there have been alternatives suggested as under:

1) State Bank of India to remain as a separate entity and all its subsidiaryBanks to be merged into one or two Nationalised Commercial Banks.
2) Small Banks amongst the nationalized sector to be merged along with bigger and stronger banks and four or five big banks to work as Nationalised Banks.

3) In order to give priority for the development of each and every region, it is also suggested as an alternative to have Regional Banks and to divide all banks into five or six banks viz., Eastern Zone; Western Zone; Northern Zone; Southern Zone; Central Zone; etc. In case there is heavy pressure on one Region, it could be allotted two Regional Banks.

4) It is also suggested as an alternative to have state-wise Banks, so that, the needs of the development of that State could be easily met and widely looked after by that prime bank in association with other banks.

5) It has further been suggested that the existing banking structureshould be maintained and separate entities should be allowed to be continued. However, the practices amongst banks about processing of advance proposals, collection and mobilization of deposits, formulation and implementation of variusschemes under priority and neglected sectors should be streamlined and brought on the same line for the banking sector as a whole.

It may be mentioned that before any of the above alternatives could be implemented, it is absolutely necessary that the present cadre at the official and other levels in the banking industry should be rationalized, so that, it will be easier to transfer personnel from one Bank/Zone ie., wherever they can be found more useful.

Amongst all these alternatives, at present, it appears that after rationalizing all the procedures as well as wage/salary structure, it will be better to maintain the independent status/entity of all the banks and they mauy be asked to gear to their machinery with proper management set up and managerial responsibilities. An Advisory Committee at the central level may be established to enable the bank to move in the desired direction as necessitated by the government plans and programmes.

5.10 RBI'S CONTROL OVER BRANCH EXPANSION :

Rapid economic development presupposes rapid expansion of commercial banking. Between July 1969 and March 2002 the number of bank offices in the country increased from about 8,320 to 66,186. Branch expansion during the last five years has corrected somewhat lopsided growth of bank offices in the pre-nationalisation period. While the progress made by branch expansion programme in recent years is notable, the area not covered by banks is pretty large. Barring about 15,000 village which are said to

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Cheque your Progress:

1. State whether the following statement is 'True or false'

a. Planning of resources is very important since their availability is rather inelastic to market changes.

b. The directions are elected by the Manager.

c. The Regional consultative committee consists of the persons nominated by the Govt. of India.

d. The Chairman and Managing Director was required to work as the Chief Executive Officer of each bank.

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have been taken care of, there are 5,40,000 villages without banking facilities. There are about 400 towns in India which have absolutely no banking facilities. The commercial banks were of course, anxious to branch out into the un banked areas in a vigorous way. But they were faced with certain serious problems of organization locating premises, training the staff, providing them with houses and overcoming the natural reluctance of officers and clerks to settle down in semi-urban and rural areas. There is also the question of economic viability of new offices, especially in rural areas. Rapid branch banking of rural and semi-urban areas is one of the objectives of bank nationalization.

Branch expansion gained momentum after the nationalization of major commercial banks

Table 1 shows the progress of branch expansion of commercial banks. From the table, it is clear that after bank notionalisation in July 1969, the number of branches increased from 1,860 to 66,186 in June 2002. With the progress of branch expansion programme, the national average of population per bank office which was 64,000 at the end of June 1969 had declined progressively to 15,000 at the end of March 2002. It may be mentioned that the coverage of villages by the banking system is even wider than the number of bank offices in rural centres. About 83 percent of villages have population below 1,000 each as such cannot individually offer sufficient banking potential for a full fledged ranch. A rural office frequently serves other villages within a radius of 10 miles. Some banks have started mobile offices and satellite offices.

While formulating a new comprehensive Branch Expansion policy in 1978, the Reserve Bank of India kept in mind two points.

1) The added emphasis given to rural development, dispersal of industries and development of small scale industries in the Sith-Plan and

2) The recommendations of James Raj Committee, the Dantwala Committee and the Kamath Working Group.

The commercial banks have followed a policy of systematic branch expansion designed to achieve a progressive reduction in regional imbalances. In this connection, special emphasis has been laid on the expansion of banking facilities in the rural and semi rural areas of deficit districts in the country.

The massive branch banking, significant though it is, shows the magnitude of the problem before the nationalized banks.

5.11 VICTIMS OF INTERVENTION

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The stead erosion in the independence and autonomy of financial institutions began way back in 1974 but gathered considerable momentum during the last five years. Only in (1983) the Government of India sought to take away from the Reserve of India powers in respect of branch licensing through an amendment of the statue. The Government withdrew only when the Reserve Bank Governor threatened to resign on the issue. The issue by itself might not have been all that important but it nevertheless indicated the direction in which the mind of the government was working.

TABLE 1

Bank Grou and Population Group-wise Distribution of Commercial Bank Branches in India

Bank Group	No. of Banks #	Number of Branches As on June 30,2002@ Rural	Semi urban	Urban	Metro politan	Total
1	2	3	4	5	6	7
1 State Bank of India	1	4,102 (45.8)	2,440 (27.2)	1,421 (15.9)	1,000 (11.2)	8,963 (100.0)
2. Associate Banks of SBI	7	1,408 (31.5)	1,552 (34.7)	819 (18.3)	692 (15.5)	4,471 (100.0)
3. Nationalised Banks	19	13,765 (42.1)	6,911 (21.1)	6,497 (19.9)	5,511 (16.9)	32,684 (100.0)
4. Indian Private Sector Banks	31	1,138 (21.2)	1,761 (32.8)	1,322 (24.6)	1,155 (21.5)	5,376 (100.0)
5. Foreign Banks in India	41	- -	2 (1.0)	20 (9.9)	180 (89.1)	202 (100.0)
6. Regional Rural Banks	196	12,060 (83.3)	2,037 (14.1)	359 (2.5)	17 (0.1)	14,473 (100.0)
7. Non-Secheduled comm. Banks (Local Area Banks)	4	3 (17.6)	7 (41.2)	7 (41.2)	- -	17 (100.0)
Total	299 (49.1)	32,476 (22.2)	14,710 (15.8)	10,445 (12.9)	8,555 (100.0)	66,186

As on June 30, 2002

@ Population group - wise classification of branches is based on 1991 Census

Notes : 1. Figures in bracket indicate percentage to total in each group

2. Bank branches exclude administrative offices.

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5.12 FINANCIAL PROBLEMS OF COMMERCIAL BANKS

Every business institution has problems of varied nature though the dimensions of the problem may vary from one institution to another. The problems faced by the commercial banks in regard to management and organization and social and political problems were pointed out in the earlier lessons. The banks face some financial problems also. They are:

1.Profitability:

2.Capital adequacy & Capital restructuring

3.Non performing assets (NPA)

These are discussed below. Banks of late have implemented voluntary retirement schemss (VRS) for their employees and this has resulted in reducing their operating expenses and in increasing their profitablilty.

5.12.1. Profitability:

"An important indicator of the strength of any system is its profitability level. The financial sector reform process brought in its wake measures like tightening of prudential norms, which affected the profitability of banks in the initial years. However, banks ahad responded well to the reform process. This has been possible due to careful sequencing of introduction of various prudential norms by the Regular as also proper planning by the banks in adopting these norms.

Except for the year ended March 31, 2001, when public sectorsbanks introduced Voluntary Retirement Scheme (VRS), resulting in huge charge to their profit and loss account and affecting their profitability, the operating and net profit of all bank groups for the last three years ended March 31, 2000 to 2002, had shown remarkable improvement.

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Bank Group	Operating profit (Rs. crore)*			Net Proft (Rs. crore)		
	2000	2001	2002	2000	2001	2002
Public sector banks	13,042 (1.46)	13,801 (1.34)	21,672 (1.88)	5,116 (0.57)	4,316 (0.42)	8,301 (0.72)
Private sector banks	2,576 (1.95)	2,843 (1.74)	4,628 (1.73)	1,160 (0.88)	1,141 (0.70)	1,778 (0.66)
Foreign banks	2,687 (3.24)	5,739 (3.05)	8,719 (3.13)	967 (1.17)	2,221 (0.93)	3,449 (1.33)
Total	18,305 (1.66)	22,383 (1.53)	3,5019 (1.94)	8,243 (0.66)	7,678 (0.49)	13,528 (0.75)

*** Figures given in parenthesis are operating profit and net profit as a percentage to total assets**

As compared to March 2000, the operating and net profit of banks had almost doubled by March, 2002.

However, there are still some factors/constraints, which affect profitability levels in banks. One of them is NPAs, particularly in the public sector banks and old private sector banks. Other factors are the large number of un remunerative branches, low staff productivity and archaic methods of operation. With increasing competition, margins will come under further pressure and therefore banks have to build long-term strategies for increasing their profitability levels by:

rationalization of branch network

rationalization of manpower deployment

use of latest technology in banking for further reduction in cost of operations and well concerted efforts to minimize the NPAs to the lowest possible level. "9

9 Address by Shri.G.P. Muniappan, Deputy Governor, Reserve Bank of India at the NIBM Annual Day Celebrations January 6, 2003.

impact of Voluntary Retirement Scheme for PSBs

"With a view to optimize utilization of human resources, 26 out of the 27 PSBs introduced voluntary retirement schemes (VRS) in 2000-01. As on March 31, 2002

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implementation of the scheme involved a total cost of Rs.12,3000 crore for PSBs and resulted in nearly 12 per cent reduction in staff strength. The RBI permitted PSBs to amortise VRS related expenditure over a period of five years. The guidelines for such amortization were set out in consultation with competent professional bodies. During 2000-01 and 2001-02, PSBs charged Rs.3,007 crore and Rs.2,346 crore, respectively, on their profit and loss account on account of VRS and on March 31, 2002 the balance of deferred revenue expenditure related to VRS was Rs.6,947 crore.

The staff costs, as proportion of total costs declined during 2001-02, inspite of the appointment for VRS. The business per employee and profitability (as measured by return on assets) for PSBs has increased during 2001-02.

With the lowering of wage costs, the ratio of wagebill to total assets of SCBS declined from 1.8 per cent in 2000-01 to 1.4 per cent in 2001-02. The decline was visible within both the sub categories of PSBs. The ratio for old private sector banks and foreign banks, however, witnessed marginal upward movements in tandem with the increase in their wage expenses".1

5.12.2. Capital Adequacy:

"Ability of a bank to absorb unexpected shocks and losses, is solely dependant upon its capital base. Basle Capital Accord of 1988 played a positive role in strengthening the soundness and stability of banks and enhanced the competitive equality among international banks. While on the one hand ongoing refinement in the capital adequacy norms had increased the capital requirements in our banks, there was increased pressure on the bottom lines of banks in view of the demand for setting aside profits for meeting the increased provisioning requirements. However, as indicated in the Table below, the system as a whole has managed to maintain capital adequacy ratio of more than 11% over the last few years. However, there are still a few banks in the system, which operate with a capital adequacy below the stipulated level.

Year	98-99	99-00	2000-01	2001-02
Nationalised Banks	10.63	10.11	10.2	10.91
SBI Group	12.34	11.57	12.7	13.26
Public Sector Banks	11.25	10.66	11.15	11.76
Old Private Sector Banks	12.07	12.35	11.93	12.52
New Private Sector Banks	11.76	13.44	11.51	11.69
Foreign Banks	10.78	11.93	12.57	12.97
All Banks	11.27	11.1	11.39	11.29

The introduction of 90 days delinquency norm for recognition of loan impairment effective from March 31,2004, reduction in the transition period for migration of a substandard asset in to doubtful category from 18 months a present to 12 months effective from March 31,2005, making adequate provision to cover country risk, etc. Would put increased pressure on the capital adequacy and bottom lines of banks.

Indian banking industry is playing a significant role in the financial intermediation process and as the pace of economic development is accelerated, the ratio of the bank credit to GDP is likely to be doubled from the existing ratio of about 25% to 50% within next 5 years which implies that the bank credit would increase two fold. Added to this, the big thrust being accorded to infrastructure sectorrequires substantial support from the banking system in the form of long-term loans. Hence, banks would be required to increasingly explore avenues to raise capital from the market.

Banks have, in recent years, placed greater reliance on subordinated debt to meet the increased capital requirements. However, scope for raising capital through subordinated debtis also limited in view of the prudential limit that subordinated debt cannot exceed 50% of Tier I Capital.

Added to this, there is a constraint for public sector banks to raise capital from the market. The Committee on Banking Sector Reforms (Chairman. Shri.M.Narasimham) has high-lighted the fact that recapitalisation of public sector banks is costly and in the long run, is not a sustainable option. The committee has therefore, suggested that no further recapitalization of banks be undertaken from the Government budget and public sector banks should be encouraged to go to the market. Sixteen public sector banks have accessed the capital market so far, reducing the share of Government holding in these banks. The head room available to raise further capital by these banks is limited. In this context, there is an imperative need to expedite the proposed amendment to the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/80, enabling the nationalised banks to bring down the Government shareholding from 51 % to 33%.

The New Capital Accord (Basel II) has already generated wide debate among the various sections of the banking industry. This shows that the Indian banking systems is gearing itself to study, analyse and adopt the New Accord. RBI has been actively involved in the international discussions and is bargaining for national discretion to promote recognition of a feasible approach which could be adopted by less complex banks without imposing significant costs.

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It was emphasised in the Monetary and Credit Policy of April 2002 that banks should constitute an expert internal team to study the methodology of the new Basel Committee proposals and its likely impact and the difficulties that Would be experienced in implementing the proposals on account of their complexity and costs.

A Quantitative Impact Study (QIS) has been conducted by the Reserve Bank of India in seven banks and the impact of assessment is being evaluated. In the meanwhile, the banks have to refine their existing systems with a view to ensuring smooth transition to the New Accord."[4]

"Strengthening of the financial sector and improving the functioning of financial markets can be described as the core principles of financial sector reforms in India. The central plank is a set of prudential norms that are aimed at imparting strength to banks and financial institutions, and inducing greater accountability and market discipline. These norms include not only capital adequacy, asset classification and provisioning but also accounting standards, exposure and disclosure norms and guidelines for investment, risk management and asset-liability management.

By the end of March 2002, 25 out of 27 public sector banks had risk weighted capital adequacy ratios above the prescribed minimum of 9 percent with 23 in excess of 10 percent. Strategies are being worked out to turn around the two weak public sector banks including recapitalisation. Capital adequacy has improved significantly in other segments too. i.e., financial institutions in the regulatory domain of the Reserve Bank (except for IFCI), non-bank financial companies (NBFCs) and other segments of the banking industry except for co-operative banks. Banks have been making equity offerings and issuances of subordinated debt for inclusion under tier-ll capital under transparent and non-discretionary guidelines. A cumulative amount of capital of Rs.867 crore has been returned by public sector banks to the Government.

Capital adequacy in banks and financial institutions has become a matter of considerable international attention, particularly after the Asian crisis. The draft of a new Capital Accord, proposed for implementation in 2005, envisages increased risk sensitivity of capital ratios, refinement of measures of credit risk including a greater role for external credit rating, flexibility and national discretion rather than a one-size fits all approach. The Reserve Bank's position has been that the new Accord should focus primarily on complex and internationally active banks while national choices of methodologies for assigning risk weights on capital ratios be accommodated within its framework. India is also engaging in collaborative studies to-assess the potential impact of the new Accord.

Banks are being prepared for tightening of the norms for asset classification with convergence to international standards by March 2005. The 90 day norm for recognition of loan impairment will come into operation from 2004-05 and this is now applicable for all segments of the financial system. Phased provisioning and charging of interest on monthly rests are seen as immediate steps in the preparation.

Exposure norms in respect of single/group borrowers have been set up to limit the credit risk in banks' portfolios and are linked to capital. Additional disclousures have been prescribed in notes to accounts of balance sheets. Asset liability management systems are being constantly refined with tolerance levels prescribed on all time hands for liquidity/interest rate sensitivity mismatches. There has been considerable progress in the implementation of risk management systems although there is a need for substantial upgradation of management information systems, preparation of contingency plans and stress testing. Internal systems need to be developed further for quantifying and monitoring operational risk"5.

Capital Adequacy – CRAR

As at end-March 2002, 25 out of the 27 PSBs had capital to risk-weighted assets ratio (CRAR) above the prescribed minimum levels. Out of this, as many as 23 banks had capital adequacy levels in excess of 10 percent. Only two nationalised banks could not satisfy the capital adequacy standard. For PSBs as a whole, the CRAR at end-March 2002 stood at 11.8 percent, which was substantially higher than 11.2 percent as at end-March 2001.

During 2000-01 of the 23 old private banks, two banks had negative CRAR, while one could not achieve the stipulated CRAR. As compared to that position, during 2001 -02, out of the 22 old private banks, only one bank had a negative CRAR, while all others satisfied the prescribed CRAR. Among 8 new private sector banks, 7 banks had achieved the stipulated CRAR during 2001-02.

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Cheque your Progress:

2. It maintains databse on credit information of the borrowers.

a) Credit information Bureau
b) Profitability
c) Capital adequacy

3. When there is any default or offences by the securitization or reconstruction company every company or office would be fined per day upto

a) Rs.10,000
b) Rs.15,000
c) Rs.5,000

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Out of the 40 foreign banks operating in India at end-March 2002, only one bank had negative CRAR, while the CRAR of the remaining banks were in excess of the stipulated minimum level.

Table II. Distribution of Scheduled Commercial Banks by CRAR

Banks Group	Capital to Risk - weighted Assets Ratio (CRAR)							
	2000-01				2001-02			
	Below 4 per cent	Between 4-9 per cent	Between 9-10 per cent	Above 10per cent	Below 4 per cent	Between 4-9 per cent	Between 9-10 per 10 per cent	
1	2	3	4	5	6	7	8	9
State Bank Group		-	-	8	-	-	-	8
Nationalised Banks	IV	1	2	15	1	1	2	15
Did Private Sector Banks	2*	1	4	16	1*	-	2	19
ieyi Private Sector Banks	-	-	1	7	-	1	1	6
Foreign Banks	-	-	4	38	r	-	2	37
Total	3	2	11	84	3	2	7	85

* Negative

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Table 11.23 : Details of Public Equities by Public Sector Banks : 1993 - 2002 (end-March)

(Amount in Rs. crore)

Name of the Bank / Sale of Issue	Equity Capital before public issue	Size of the Public		Total	Equity after public issue	Post - issue Gol	hare holding others
		Equity	Premium				
1	2	3	4	5	6	7	8
State Bank of India	200.00	274.00	1,938.1	2,212.17	474.00	314.34(66.3)	159.67(43.7)
December, 1993		(Rs.90 per share)					
State Bank of India (GDR) October, 1996	474.00	52.28	1,218.12	1,270.40	526.28	314.34(59.7)	211.94(40.3)
		(Rs.233 per share)					
State Bank of Bikaner & Jaipur November, 1997	36.40	13.60	59.84	73.44	50.00	37.50 (75.0)	12.50(5.0)
		(Rs.440 per share)					
Oriental bank of Commerce October, 1994	128.00	60.00	300.00	360.00	192.54	128.00(66.5)	64.54(33.5)
		(Rs.50 per share)					
Jena Bank	146.82	60.00	120.01	180.01	206.80	146.80(7.10)	60.00(29.0)
December, 1996		(Rs.20 per share)					
Jankol Baroda	196.00	100.00	750.00	850.00	296.00	196.00(66.2)	1000.00(33.8)
December, 1996		(Rs.75 per share)					
bank of India	489.00	150.00	525.00	675.00	639.00	489.00(77.0)	150.00(23.0)
February, 1997		(Rs.35 per share)				(69.3)*	(30.7)*
Corporation Bank	82.00	38.00	266.00	304.00	120.00	82.00(68.3)	38.00(31.7)
October, 1997		(Rs.70 per share)				(57.2)*	(42.8)*
State Bank of Travancore January, 1998	35.00	15.00	75.00	90.00	50.00	37.50(75.0)	12.50(25.0)
		(Rs.500 per share)					
Syndicate Bank	346.97	125.00	At par	125.00	471.97	346.97(73.5)	125.00(26.5)
October, 1999		(Rs.10 per share)					
Vijaya Bank	259.24	100.00	At par	100.00	359.24	259.24 (72.2	100.00 (27.8)
December 2000		Rs.10 per share				(70.0)*	(30.0)*
Andhra Bank	347.95	150.00	At par	150.00	460.00	299.98 (66.6)	150.03(33.4)
February, 2001		Rs.10 per share)					
Indian Overseas Bank February, 2001	333.60	111.50	At par	111.50	444.80	333.60(75.0)	111.20(25.0)
		Rs. 10 per share)					

-* Indicates shareholding post return of capital to Government. GoI - Government of

** Subsequent upon allotment of equity shares on preferential basis to 'Others'.

Note : Figures in brackets in Columns 7 and 8 indicate shareholding.

RBI, Trend & progress of Banking in India, 2001-2002, p.69

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Asset rehabilitation involves swapping impaired assets for cash or bonds. These will be at market prices. Even so, these swaps will improve capital adequacy, liquidity and the ability to make loans and can reduce funding costs. Risk-weighted capital ratios improve because of the swap, generally, replaces risky loans with low-risk investments, such as Government bonds or cash.

Loss sharing arrangements can assume various forms. They might be proportioned or the bank could take the first hit upto a certain amount, with the Government covering subsequent lossess according to a sliding scale. Loss sharing could also be for a limited period. The loans to be covered under loss sharing could be based on an (aggregate) assessment of the distribution of expected loan losses under different economic scenarios by sector. For example, commercial real-estate loans may have more favourable loss-sharing arrangements than home loans.

Equity purchases by Government, sub-ordinate debt or bonds (negotiable or non-negotiable) will also immediately increase net worth, improve capital ratios, liquidity and potential profitability. If asset values and corporate earnings are temporarily low, but expected to recover as the economy strengthens, support through capital injections is often a preferred choice. Where Governments provide support through purchase of preferred stock, they might forgo dividends for some time to boost banks' income. Sub-ordinated debt convertiable into equity if not repurchased by the bank within a specified time can be used to protect the Government form banks' inability to service the debt (by allowing Government to intervene). Such contingent can also be a powerful incentive for owners and management to rehabilitate the bank as quickly and effectively as they can.

Granting Government loans or placing deposits will also improve bank liquidity and prove an opportunity for the bank to buy impaired assets. This does not immediately increase capital, however, nor does it improve capital ratios, because assets and liabilities increase by the same amount.

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Table Capital Restructuring in the Banking Sector

Institution	Assistance Budget,	Provision made in the Central Government
Nationalised Banks	Rs. 21,746 crore provided as recapitalisation support to nationalised banks upto end - March 2002	The Central Government Budget 2002-03 has made a provision of Rs.770 crore.
Regional Rural Banks	Rs.2,188 crore have been infused by the share holders (Goverment of India, State Governments and sponsor banks) as additional capital support to 187 RRBs through several phases of recapitalisation upto January 2000.	No recapitalisation exercise was undertaken during 2000-01 and 2001-02. Further the Government has not made any budgetary allocation in this regard for the year 2002-03
Co-operative Banks		Rs.1000 Crore proposed in the Central Government Budget 2002-03. The provision is for grants through NABARD for providing incentives to staes and co-operative institutions to adopt reform measures for strengthening co-operative

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5.12.3. Non Performing Assets

As pointed out by Dr. Rakesh Mohan, Deputy governor, RBI," an area of concern relates to the absolute level of non-performing assets (NPAs), more so with the publicsector banks. Several steps have been taken towards NPA management, includingcompromise settlements, debt recovery tribunals and resort to court process, but thelack of necessary legislative empowerment in terms of foreclousure hampered recovery.Although loans were largely collateralised, timely execution of collateral remained a difficult problem in the absence

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of enabling legislation. The large difference between |banks' gross and net NPAs reflected both obligatory provisions against NPAs and thelimited write-offs of NPAs by the public sector banks. Write-offs were deterred by thepublic sector banks' modest profits and capital position and the risk of investigation, particularly in the case of large write-offs. Hence, NPAs tended to be carried on thebooks and provisions against them gradually built up.

5.12.4. The level of Non-Performing Assets

As on March 31, 2002, the gross NPAs of scheduled commercial banks stood at Rs. 71,000 crore, of which the NPAs of public sector banks constituted Rs. 57,000 crore. The absolute amount of NPAs continues to be a major drag on the performance of banks.. The large volume of NPAs reflects both an overhang of past dues and on-going problem of fresh accretion, considering the international norm of 90 days for recognition of loan impairment, there may be a temporary increase in crystallization of NPAs in the banking sector. There is therefore the urgent need to bring about improvements in credit administration and management of credit risk. In this context, the Credit Information Bureau (CIB) should help in improving credit decisions by providing institutional mechanism for sharing of credit information on borrowers and potential borrowers among banks and financial institutions. The Reserve Bank of India (RBI) modified the guidelines for compromise settlements of NPAs of the small sector to provide a simplified, non-discretionary and non-discriminatory mechanism. Banks should work out processes for settlement procedures and expendite quick recovery of NPAs.1

5.12.5. NPA Management

"The issue of NPA management continues to be the biggest challenge before the banking sector. One of the major constraints of the competitive efficiency of banks is the tendency to accumulate poor quality of assets. Nothing is more true indicator of the quality of assets than the incidence and quantum of NPAs in relation to the total portfolio.The level of gross NPAs of all groups of banks for the last three years from the Table below, is on the rise, though the rate of growth has decelerated.

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Bank Group	Gross NPAs* Rs. in crores		
	2000	2001	2002
Public Sector banks	53,033	54,773	56,507
	(14.0)	(12.4)	(11-1)
Private sector banks	4,761	6,039	11,672
Foreign banks	(8.2)	(8.4)	(9-7)
	2,614	3,071	2,726
	(7.0)	(6.8)	(5-4)
Total	60,408	63,883	70,905
	(12.7)	**(11.4)**	(10.4)

*Figures given in parenthesis are gross NPAs as percentage of gross advances

Though the banks have taken steps to reduce the level of NPAs, it is still high by international standards. RBI / Government of India have taken several steps to arrest the NPA levels. The steps taken have been preventive, remedial and legal in nature.

For instance, the Corporate Debt Restructuring (CDR) mechanism has been introduced which is aimed at restructuring the debt of viable corporate entities outside the purview of B1FR, DRT, etc. Further, efforts are being made to make CDR mechanism more efficient. However, some banks have not joined the CDR mechanism and those who have joined have not referred many cases to CDR Cell.

Another major step in this direction has been the introduction of One Time Settlement Schemes (OTS). The success of the OTS has been modest. Under both the OTS schemes, i.e. upto Rs. 5 crore and upto Rs. 25,000 banks could recover only around Rs. 3000 crores

While the steps taken by RBI / Government of India will go a long way in reducing the level of NPAs, banks' Boards, on their part should also formulate clear cut guidelines for monitoring NPA level, refine their own appraisal- systems and strengthen the loan review mechanism to prevent incidence of fresh NPAs."2

"A major drag on financial sector reforms in India is the slow progress in the management of non-performing assets (NPA). Although net NPAs have undergone

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a steady decline since 1992 - 93, they are still high by the international standard of about 2 per cent. The cumulative provisions against loan losses at 43 per cent of gross NPAs is also extremely low by international standards. From the regulator's perspective, NPA management involves four steps i.e., assessment, provisioning, recovery and prevention. A menu approach is adopted in India which involves intensification of recovery with ongoing tightening of norms for assessment and provisioing.

Settlement advisory committees were introduced in 1999 to provide a simplified non-discretionary and non-discriminatory mechanism to deal with the stock or 'overhang' of NPAs especially in the small sector. The effectiveness of debt recovery tribunals was enhanced through the amendment of relevant legislation in 2000. In the recent period, there has been a substantial increase in the number of cases disposed of by these tribunals. In 2001, a corporate debt restructuring mechanism as prevalent in the UK and South East Asian countries was finalised for restructuring debts of viable corporate entities, Lok Adalats have proved to be an effective institution for settlement of similar dues. The Union Budget for 2002-03 announced the setting up of a pilot Asset Reconstruction Company with the participation of banks, financial institutions and multilateral agencies. The new Credit Information Bureau will provide an institutional mechanism for sharing of information on borrowers.

The constitution of an Asset Reconstruction Company (ARC) is another channel to remove NPAs from the balance sheets of banks through the processes of securitisation of assets.

A recent landmark development which should have a long term favourable impact in reducing the level of NPAs is the passage of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act. It lays out the conditions to be satisfied for the establishment of securitisation or reconstruction companies, the terms for acquisition of financial assets by these companies, enforcement of security interest, dispute settlement procedures, prudential norms, offences and penalties. The Act empowers banks and financial institutions with appropriate legal authority to speed up the recovery of the stock of impaired assets through a one-time cleaning of balance sheets. This is expected to improve their financial health and functioning considerably.

Efforts have been simultaneously undertaken to broaden and deepen the various segments of the financial market spectrum. The call money market is emerging as a pure inter-bank market and activity is rising in the repo market for non-banks. The development of money market segments has gone hand in hand with rationalisation of standing liquidity facilities at the Reserve Bank. In the gilt market, there is greater transparency, new instruments have been introduced, and there is a progressive widening of the investor base. With the operationalisation of the Negotiated Dealing System, price and trade information is available on a near real time basis. The Clearning Corporation of India has also launched net foreign exchange clearing in India on a guaranteed settlement basis. These developments bring us closer to our goal of transforming our financial system into a resilient and competitive structure with market participants operating in different segments of the financial markets catering to varying classes of financial assets and liabilities.

Table II. Bank Group-wise Movements in Non-performing Assets - 2001-02

tern / /	Scheduled commercial Banks	Public Sector Banks (27)	Old Private Banks (22)	New Private Banks (8)	Foreign Banks (40)
1	2	3	4	5	6
3ross NPAs					
\son 31st March, 2001	63,581.41	54,671.58	4,262.42	1,616.51	3,030.90
<\ddition during the year	24,824.32	15,668.25	1,718.72	6,312.52	1,124.83
deduction during the year	17,502.10	13,833.24	1,131.43	1,107.47	1,429.96
^son 31st March 2002	70,903.63 #	56,506.59	4,849.71	6,821.56 #	2,725.77
slet NPAs				-	
!\son 31st March 2001	32,402.68	27,976.55	2,716.30	929.08	780.75
\s on 31st March 2002	35,545.71	27,957.64	3,005.00	3,663.03	920.04
iflemo :					
3ross Advances	6,80,958.41	5,09,368.39	44,057.25	76,901.44	50,631.33
slet Advances	6,45,858.78	4,80,680.56	42,285.70	74,187.10	48,705.42
^atio :					
3ross NPAs/Gross aDVANCES	10.41	11.09	11.01	8.87	c oo
\let NPAs/Net Advances	5.50	5.82	7.11	4.94	1.89

The gross NPAs for end-March 2002 include an amount of Rs.4,512 crore on account of merger.

Notes : 1. Data is based on audited balance sheet figures of 97 scheduled commercial banks.

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Cheque your Progress:

4. The National goal is
   a. Political pattern
   b. Socialistic pattern
   c. Management pattern.
5. RBI appointed a committee to examine the question of differented interest rates under the chairmanship of
   a. Dr.R.K. Hazari,
   b. Finance Minister Mr.Y.B. Chavan
   c. Deputy Governor of RBI Dr. Rahesh Mohan

2. Figures in brackets indicate the number of banks in each group. **Source :** Respective bank balance sheet.

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5.12.6 Non - Performing Assets & Profitability

The quality and performance of advances have direct bearing on the profitability and viability of banks. Despite the credit appraisal and disbursement mechanism, the problem often tends to manifest itself\, an accretion to the stock of non-performing assets (NPAs). Although the net NPAs of the commercial banks in India have witnessed a decline over the past several years, they are still high as compared to developed country standards of around 2 per cent. Prompt remedial actions are, therefore warranted in this regard.

In market-driven systems, the seeds of credit excesses are often sown in an upswing when boom conditions prevail. Once financial excesses are unwound, however, there can be a tendency for loans to go bad, at the expense of the lender and the health of the financial system. In order to counter the benefits of faster credit growth in a boom against the costs of volatile economic cycles once the movements reverse, it is important that banks are not only equipped with balanced prudential norms, but also have forward-looking or dynamic provisioning so as to build-up a protective cushion in good times that can be drawn down in exigencies. The cumulative provisions against loan losses of PSBs in India amounted to 42.5 per cent of their gross NPAs for the year ended March 31, 2002. This is low compared to the international standards, where provisions against impaired assets are often as high as 140 per cent. There is, therefore, need for banks to improve their provisioning practices; full provisioning towards already impaired assets needs to be a priority corporate goai.

The approach to NPA management by the banks has to be multi-pronged, necessitating varied strategies suited to different stages of the passage of credit facility. Close monitoring of the account, particularly the larger ones, is of prime importance. Emerging weakness in profitability and liquidity of corporates, recessionary trends, recovery of instalments/interest with time lag, etc. should alert and caution the banks. The loan review mechanism is to be adopted as a tool to bring about improvements in credit administration. Banks should also adopt their own risk-rating systems to assess the risk of lending. Sanctions above certain limits should be through a Committee, which can assume the status of an ‘Approval Grid’. Exchange of credit information among banks would be of immense help to avoid possible NPAs. The banking system ought to be so geared that a defaulter at one place is recognised as a defaulter by the system. The system will have to provide a mechanism to ensure that the unscrupulous borrowers are unable to play one bank against the other.

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It is in this context that the facility of Credit Information Bureau (CIB) becomes relevant. A CIB provides an institutional mechanism for sharing of credit information on borrowers and potential borrowers among banks and FIs. It acts as a facilitator for credit dispensation and helps mitigate the credit risk involved in lending. Based on cross-country experiences, initiatives have been taken in India to establish a credit information bureau.

5.13. CREDIT INFORMATION BUREAU INTERNATIONAL EXPERIENCE

Banks and lending institutions have a traditional resistance, because of the confidential nature of banker-customer relationship, to share credit information on the client, not only with each other, but also across sectors. Specialised institutions, known as Credit Information Bureaus (CIBs) have, therefore, been set up to function as a respository of credit information both current and historical data on existing and potential borrowers. These institutions maintain database on credit information ofi trie borrower which can be accessed by the lending institutions..

CIBs have been established not only in countries with developed financial systems like USA, UK, Australia, New Zealand, France, Germany and Belgium, but also in countries with relatively less developed financial markets such as Sri Lanka, Mexico, Bangladesh and the Philippines. The Bureaus established in these countries collect information on both individual borrowers (retail segment) and the corporate sector. In general, separate Bureaus have been established by several countries (e.g. USA, UK, New Zealand, Sri Lanka, Philippines) for collecting information on retail/individual borrowers and corporate customers.

Country experiences show that there is no uniformity in the ownership and operational aspects of CIBs in various countries. For example, in USA, UK, Australia and New Zealand, credit bureaus are privately owned. The two large bureaus collecting information in the retail segment in USA are Equifax and Trans Union which maintain databases at the national level. The Dun and Bradstreet in USA is the leading CIB

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maintaining database on the corporate sector. Experian is the leading credit referencing agency in UK, alongwith a number of smaller bureaus formed through private initiatives. In New Zealand, there are no public CIBs, but several companies like Baycorp which provide credit reports on individuals and corporates. In Australia, while Credit Reference Ltd., provides information on small and medium-sized businesses, Dun and Bradstreet (Australia) provides commercial credit information on large corporates.

In several European countries such as France, Belgium and Germany, credit information services or credit registers have been set up as divisions of the Central Banks. Illustratively, in France, the Credit Bureau Division of the Banque de France, collects information at monthly intervals from banks on their lending to corporate customers above a certain threshold. In Belgium, on the other hand, credit information offices, set up as divisions of the central bank capture defaults on instalment contracts, consumer credit, mortgage agreements, leasing and corporate borrowings. Banks and financial services institutions in Germany are required to notify the details of those borrowers whose indebtedness exceeds DM 3 million during the three calendar months preceding the reporting date.

Among Asian economies, the CIB in Sri Lanka was formed by an Act of Parliament at the initiative of the Central Bank. In Bangladesh, the CIB was formed as a department of the Central Bank and collects from commercial banks, on a monthly basis, information on corporate borrowers availing credit above Taka Ten lakh. It also furnishes, on demand, to any commercial bank a CIB report. The CIB in Philippines provides information on both corporates and individuals.

In the Indian context, the Central Government is examining a draft legislation covering, inter alia, responsibilities of CIB, rights and obligations of the member/reporting credit institutions and safeguarding of privacy rights that may arise in the process of information sharing by CIBs. Pending the enactment of CIB Regulation Bill, a Working Group was constituted in December 2001 (Chairman; Shri S.R. Iyer) to examine the possibility of the CIB performing the role of collecting and disseminating information on suit-filed accounts and the list of defaulters, presently being reported to RBI by banks and notified financial institutions. The Working Group submitted its Report in January 2002 and the recommendations which satisfy the existing legal framework are being implemented by the RBI.

Based on the recommendations of the above Working Group, banks and FIs have been directed under Section 35A of the Banking Regulation Act, 1949 that they should submit the list of suit-filed accounts of Rs.1 crore and above as on March 31,2002 and quarterly updates thereof till December 2002 and suit-filed accounts of wilful defaulters of Rs.25 lakh and above as at end-March, June, September and December 2002 to the RBI as well as to CIBll for a period of one year till March 31, 2003. Thereafter, the aforesaid information should be submitted to CIBIL only and not to the RBI.

Banks and notified FIs would, however, continue to submit the data relating to non suit-filed accounts of Rs.1 crore and above, classified as doubtful and loss, as on March 31 and September 30 and also quarterly list of wilful defaulters (Rs.25 lakh and above) where suits have not been filed only to RBI as hitherto. Thus, the statement on non suit-filed accounts need not be sent by banks/FIs to CIBIL.

From a policy perspective, it becomes imperative that a reduction in NPAs would require both a "stock" (a one-time cleansing of balance sheet) and a "flow" (preventing substantial accretion) solution. Several measures have been taken to address the 'flow' problem (viz., Lok Adalats, settlement advisory committees), whereas the issue of stock of NPAs has not been adequately addressed. Towards this end, the Central Government Budget for 2002-03 announced the setting up of a pilot Asset Reconstruction Company

(ARC) with the participation of private and public sector banks, FIs and multilateral agencies. Accordingly, the Ordinance to regulate securitisation and reconstruction of financial assets and enforcement of security interest was promulgated on June 21,2002 (subsquently re-promulgate#tfn August 22,2002).

5.14 THE SECURITISATION AND RECONSTRUCTION OF FINANCIAL ASSETS AND ENFORCEMENT OF SECURITY INTEREST ORDINANCE, 2002

5.14.1. Registration

According to the above Ordinance, a securitisation or reconstruction company, with owned funds of not less than Rs.2 crore or not exceeding 15 per cent of total financial assets acquired or to be acquired as specified by the RBI, can commence or carry on business after obtaining a certificate of registration (CoR). Existing securitisation or reconstruction companies would have to apply for registration to the RBI, within ix months from the commencement of the Ordinance.

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For grant of CoR to a company, the conditions to be satisfied include: (a) not incurred loss in any of the three preceding financial years, (b) made adequate arrangements for realisation of financial assets for securitisation or asset reconstruction, (c) pays periodical returns, and (d) complies with the prudential norms of the RBI. In addition, the Directors of the company should have adequate professional expertise and not have been convicted of any moral turpitude offence. Not more than half the Board members should be associated in any manner with the sponsor, and should not otherwise hold any controlling interest in such securitisation or reconstruction company.

5.14.2. Operations / Functions

The acquisition of financial assets by the securitisation/reconstruction company would be through the issuance of debentures/bonds or agreements with banks/FIs. The notice of acquisition may be sent by banks/FIs to the concerned obligor.who, in turn, is to make payment to the concerned securitisation or reconstruction company. In case no notice of acquisition is given, then money/properties received subsequently by banks/ FIs would be held in trust on behalf of the securitisation or reconstruction company. Other functions of such company would include acting as agent for banks/FIs to recover their dues from borrowers, acting as manager and receiver if appointed by court or tribunal. The disputes will be settled by conciliation or arbitration as provided in the Arbitration and Conciliation Act, 1996.

5.14.3 Prudential Norms

The RBI, in public interest and to regulate the financial system of the country to its advantage would, determine policy and give directions to such companies on income recognition, accounting standards, provisions for bad and doubtful debt, capital adequacy and deployment of funds.

5.14.4. Enforcement of Security interest

The Ordinance empowers secured creditors to enforce any security interest created in its favour without any intervention of court or tribunal. The secured creditor may require the borrower to discharge his liabilities within 60 days from the date of notice, failing which the secured creditor is entitled to take possession or management of the secured assets including the right to transfer by way of lease, assignment or sale or appoint any person to manage the secured asset. The borrowers are allowed to seek protection by filing an appeal in the Debt Recovery Tribunal (DRTs) along with a deposit of 75 per cent of the amount claimed with the DRT in order to prevent misuse of appeal provisions.

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5.14.5 Offences and Penalties

There are strict provisions of penalties for offences or default by the securitisation or reconstruction company. In case of default in registration of transactions, modification of security interest or in reporting satisfaction of security interest, every company or officer would be fined upto Rs.5,000/- per day. In case of non-compliance with directions by the RBI, the company could be fined upto Rs.5 lakh and in case of continuing offence, an additional fine of Rs.10,000 per day may be imposed.

The provisions of this Ordinance will override other laws. The application of other laws such as the Company's Act 1956. Securities Contract (Regulation) Act, 1956 and Securities and Exchange Board of India Act, 1993 however, are/not barred.

The RBI has constituted two Working Groups for stipulating suitable norms for registration, prescribing prudential norms, recommending proper and transparent accounting and disclosure standards and framing appropriate guidelines for the conduct of the asset reconstruction/securitisation.

Reference :

Government of India (2002), The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Ordinance, New Delhi.

5.15 SOCIO - ECONOMIC AND POLITICAL PROBLEMS OF BANKS IN INDIA

Banking is conducive to economic development. Banks offer a wide variety of financial and non-financial services, besides giving credit to individuals, corporate bodies and governments. They have been conscious of their social responsibilities. Through their branch expansion policy they are widening the scope of employment. They are also serving the community in a big way by their education and housing policies.

The National goal is Socialistic pattern of Society. Towards the attainment of this goal regional imbalances should be avoided and equitable distribution of opportunities assured. Our government, industrialists, economists, and even politicians are striving very hard and Banking cannot be an exception in this regard. Banks realising their social responsibility will have to contribute much towards reaching our plan targets. The Planning Commission considering the need for accelerating economic prosperity, lays down five year plans and annual plans stressing importance for various faculties. The entire economy is to focus its attention towards such areas. The Governmental plans, industrial plans and individual plans are to be implemented effectively only with the support of the Banking industry. Hence the banking companies at the time of deciding their credit policies will have to give due importance for the feelings and policies of the economy.

Of course, the banking companies are business enterprises and they are to envisage safety, liquidity and profitability for their successful operation. But there are certain justifications in the banking companies sacrificing their time, energy and money. Because, in a developing economy the banking companies are functioning under certain pressures. Being the organ of the Society, and when the Society expects much from the Banking industry, it should contribute something for the benefit of the Society. While framing its lending policy, it should consider the needs of the society and try to accommodate them reasonably. Strictly speaking the banks cannot make unsecured advances and should not entertain unnecessary risks. But from the society's point of view, the banks are to deviate slightly from their strict lending principles and enable the society with financial accommodation. Sometimes, the banks are to incur loss which may even weaken the financial position of banking. But it should be accepted towards Social Welfare. Unless the Banks themselves entertain the Society, there will be no other system to take care of the Society, and hence the Society will get dejected and this will ultimately result in the collapse of the Society. If the Society itself is not conducive, how can the banking industry, an organ of the Society, survive, function and succeed. So it is the responsibility of the banks to involve themselves in the Social pressure and try to foster Social Welfare.

From the monetary mechanism point of view also banks are under certain pressures. The RBI, the central monetary authority of the country, in consultation with the Central Government lays down the monetary policy which is subject to changes as and when the situation warrants. In accordance with this changing monetary policy, the banks will have to design their lending policies, Moreover, the RBI being the banker to the banks will make directions to the Commercial banks from time to time. This is also to be considered by banks.

Hence the lending policies of banks are influenced either directly or indirectly by the Reserve Bank. Unless the Commercial banks abide by the directions of the RBI, their future expansion will come to a standstill.

Finally, the banks are under the pressure of the Government also. Government with the responsibility of setting up of welfare economy. Will have to concentrate in several developmental and welfare activities. Besides, the Government while designing the planned economic growth may have to stress more importance on the development of certain areas. Here the Banking companies are expected to consider the government policies and the areas stressed. They are to give due importance to these areas at the time of diesigning and implementing their lending policies. Certain areas may seem to be unsafe and unprofitable. However, the banks are to concentrate in these areas also for the benefit of the society. The Prime Minister's Twenty point Economic Programme is the best example in this regard and the banking companies are to do a lot towards the proper implementation of such social Welfare programmes which are sincerely needed for helping the poor people and enabling the society to prosper.

Sincerely speaking the pressure on banking is purely voluntary. What is expected of the Banking operation is that they are to realise, what an individual, Society and the Government except from banking and concentrate in this regard.

Some of the practical aspects of banking under the Socio-Economic pressure are given below.

Prior to bank nationalisation in 1969, bank lending was done more to persons in whom bank directors or executives were interested. Once the advance was granted on demand basis, it continued unclaimed for years together irrespective of production. Persons behind the loan was more important than the objectives and the end use of the loan. Now Banks are forced to change their attitude towards lending and lending policies. The practice of the banker waiting for the borrower to come and approach him has been totally reversed. Banks have established merchant banking divisions and other special cells to serve the industrial agricultural and other small borrower's credit needs. Even the small loan is willingly granted. Competition and Government direction has done wonders in bank lending. Banking has moved from the concept of wholesale to retail banking. Now the banks provide nearly one-half of their loans to the priority and preferred sectors. Moreover, in a planned society banking system harnesses the infrastructure, built to perform their tasks effectively and in accordance with the needs of Socio-economic goals of the Country. Besides, the Reserve Bank has been persuading the Commercial Banks to link the supply of credit to the levels of production of the borrowing firms with a view to arrest the credit inflation in the country. The growing menace of unemployment of the educated

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unemployed is table concentrated by the banks, to utilise the talents of the educated unemployed. Nationalised banks have been reorganizing their methods of working. Latest in the services is the opening of the entrepreneurial clinics or advisory service as part of their organisational reforms.

The entire nation is watching the progress of nationalised banks. The nationalisation must be looked upon as an instrument to change attitudes and create necessary atmosphere for full utilisation of the bank's facilities for productive purposes. It is the duty of the bank not only to spot out the entrepreneur but also,help him in every way to create productive wealth.

A scheme known as Credit Authorisation Scheme was introduced in November 1965. The banking system grew in strength and stability, but it was deficient in terms of geographical and functional coverage and was not properly equipped to assist the attainment of the basic economic and social objectives, namely rapid economic growth, diffusion of economic power and channeling of credit in accordance with the priorities of the plans. It was felt that the priority sectors like agriculture, small industries and exports and weaker sections of the community like small artisans and transport operators were neglected. In 1968, the Scheme of Social Control was introduced with the main objectives of achieving a wider spread of bank credit directing a large volume of credit to flow to priority sectors and making machinery, so that the decisions of monetary and credit policy laid down by the RBI would be effectively implemented. The National Credit Council was set up in 1968 with a view to establish a forum for discussing and assessing credit priorities on an all India basis.

With a view to ensure the banks were adequately motivated towards a speedy achievement of the social purposes such as meeting the legitimate requirement of the weaker sections of the society, 14 banks were nationalised in July, 1969 and six banks were nationalised in November, 1980.

5.16 DIFFERENTIAL INTERES T RATE SYSTEM IN INDIA :

The then Finance Minister Mr.Y.B. Chavan at the meeting with Chairman and custodians of the Public Sectors on July 22,1970, suggested that lower interest rates should be charged to carefully selected low income groups who deserve financial asistance for productive purpose. Responding to this suggestion, the RBI appointed a Committee under the Chairmanship of Dr.R.K. Hazari to examine the question of differential interest rates. The Committee was expected.

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1. to review the scope and the extent to which differential interest rates are already being charged by banks to borrowers in each sector.

2. to suggest ideas for finding out the borrowers who could be granted the benefit of a lower interest rate within each sector:

3. to point out the range of the difference that could be allowed in each sector; and

4. to examine the possibilities of additional concessions that could be granted. The Committee submitted its report on May, 21,1971. The Scheme of Differential Interest Rates[1] was announced as a Policy in the parliament on 25th March, 1972, which applies to public sector banks only.

Banking is the powerful instrument of service to the Community and interest rate mechanism should sub serve the objective of Social justice in the distribution of credit, with this view, some borrowers who cannot get any credit facilities from banks; have to be encouraged to borrow at low rates.

The confessional rates of interest will be available to the borrowers belonging to

1. Scheduled Tribes, Scheduled Castes and others engaged on a very modest scale in Agriculture.

2. People who are engaged in the collection and elementary processing in forest areas and supply them to farmers and traders.

3. Those who are engaged on a small scale basis in cottage and rural industries in vocations in urban areas.

4. Students going abroad for higher education, who do not get any scholarship or grant.

5. Physically handicapped persons doing profitable ventures from whom some durable equipments and continuous supply of raw material is useful.

6. 'Orphans and Women's' homes where marketable goods are made and for whom no adequate and dependable sources of finance is available.

The selection of borrowers have to be done after the following considerations that they

a) have really no tangible security or guarantee;

b) cannot produce a security or guarantee;

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c) are prepared to work hard;

d) are to be helped to raise their economic level*, in the productive ventures with assistance from banks so that the productive venture will become viable within three years.

e) do not incur liability to two sources of finance at the same time.

f) do not engage any workers.

Further, the borrower's family income should not exceed Rs.2000/- per annum from all sources in an urban or semi-urban area and Rs.1200/- per annum in a rural area. He does not own any land or the size of his holding does not exceed one acre of land if irrigated and 2.5 acres if non-irrigated. Depending upon the situation, the loan may be sanctioned for working capital or for acquiring fixed assets, and the period of loan is to be decided in each case. Term loans shall not exceed five years which may be extended to seven years in eligible cases. Tangible security is no bar; but a margin of 15% to 20% can be allowed for assets purchased with the loan should be hypothecated to the banks.

Credit facilities will be covered under the existing Credit Guarantee Schemes and the guarantee fee shall be borne by the bank. In case the assets are insured, it also should be at the cost of the bank.

If needed, banks should offer managerial and other guidance besides granting advances to the following classes of borrowers :

1. Small Farmers
   Crop input loans
   Term loans
2. Small Retail Traders

a) For traders on obtaining
   general
   hypothecation

b) For traders handling fertiliser
   distribution key loans
   General Hypothecation

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3. Transport Operators:
   (including Taxis, Rickshaws etc)
   For acquiring single vehicle (on hypothecafion)
   For Rickshaw, Cart, Boat, Scooter For other vehicles
4. Professional and Self-employed
5. Small Scale Industries
   (Only for loans up to Rs. Two lakhs)
6. Loans for working capital

Key loans

Hypothecation

Term Loans

These differential rates are subject to alteration as and when situation watt ants and no distinction should be in the interest rate as between secured and unsecured loans.

It is believed that disparities in income and wealth will be reduced and talent and enterprise that is wasted will be encouraged, by making financial facilities available to the needy sectors of the economy. Effectiveness of the policy depends upon the tact, zeal and the experience of the branch managers who have to put the scheme in actual practice. Sincere attempts make by the administrators will definitely fetch benefits and it will give way for economic prosperity.

5.16.1. Implementation of differential rate of interest (DRI) Scheme

The differential rate of interest (DRI) scheme, introduced in 1972, is being implemented by Sall SCBs throughout the country. Under the scheme, bank finance is provided at a confessional rate of interest of 4.0 per cent per annum to the weaker sections for engaging in productive and gainful activities, enabling thereby an improvement in their economic conditions. As per the scheme, banks are required to lend at least 1 per cero their aggregate advances as at the end of the previous year. Moreover, two-thirds of the total DRI advances must be routed through the bank's rural and semi-urban branches\ The annual income ceiling for eligibility is Rs.7,200 per family in urban or semi-unbar Weas and Rs.6,400 per family in rural areas. The size of land holding must not exceed\)ne acre of irrigated land and 2.5 acres of unrelated land, with exemptions for SCs/Sik The maximum assistance per beneficiary has been fixed at

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Rs.6,500 for productive pur Wses. In addition to this, physically handicapped persons can avail of assistance to the extent of Rs.5,000 (maximum) per beneficiary for acquiring aids, appliances, equipment, provided they are eligible for assistance under the scheme. Similarly, members of SCs/STs refilling the income criteria under the scheme can avail of housing loan upto Rs.5,000 per be\efficacy over and above the loan amount available under the scheme.

5.16.2. Competition between banks

Unhealthy competition amongst the commercial banks sometimes proves advantageous to a client, particularly a borrowing constituent to bargain with the banks. But the basic discipline which is an essential aspect to be maintained by the borrower client becomes difficult to be maintained. In days of better liquidity, there is a competition for getting borrowal client from one bank to another, even at the cost to reduction in the rate of interest. From the point of view of the company it may be beneficial to them. But taking the view point of the Government, it is a loss to the government, because after all income of the Nationalised Banks as well as State Bank and its subsidiaries goes to the government and therefore, in view of interchange from one bank to another results in the reduction of the government income.

Often, some of the clients have multiple banking arrangements. Hence, it is not possible for each of the bank financing one or more of its units, to have a closer watch on the end-use of funds. Many a times the account holders dictate terms about the security, margin etc. In such cases, banks are unable to adhere to the financial discipline required to be maintained.

Different practices amongst banks for charging interest commission, service charges etc, as well as remittances are prevailing, There is over expansion of branches in certain areas. There might be more than 10 branches of different banks in the same area having a radius of half-a-mile, while there are innumerable unbaked centers in rural and undeveloped areas. The top management of banks, instead of competing for deposits, should insist on extending better service to the public, timely submission of statements, good house-keeping and maintaining good recovery of advances. They should also concentrate on reconciling inter-branch accounts, making them up-to-date, thereby preventing trauds.

5.17. BANKS LIQUIDATIONS AND AMALGAMATION

5.17.1. Liquidation Of Banks

There were 78 banks under liquidation as on June 30,2002. The matter regarding early completion of liquidation proceedings is being pursued with Official/Court Liquidators.

5.17.2. Merger/Amalgamation Of Banks

The RBI accorded approval for merger of ICICI Ltd., with ICICI Bank Ltd., on April 26,2002 subject to inter alia the following conditions: (a) ICICI Bank Ltd., would have to maintain SLR/CRR as prescribed on the net demand and time liabilities of the bank on the post merger liabilities even though the liabilities of ICICI Ltd., as existing prior to merger did not attract the reserve requirements : (b) since the assets and liabilities of ICIC1 Ltd., would be taken over by ICICI Bank Ltd., after the merger, the bank would have to comply with all prudential requirements, guidelines and other instructions concerning capita! adequacy, asset classification, income recognition and provisioning requirements as applicable to banks afterthe merger. RBI had, however, given a transition period for compliance with certain prudential norms to avoid any hardship in the interim; (c) ICICI Bank Ltd., would have to deploy an additional 10.0 per cent, over and above the requirement of 40.0 per cent, on the residual portion of its advances after the merger till such time as the aggregate priority sector advances reach a level of 40.0 per cent of the total net bank credit of the bank.

5.18 E-BANKING

On the technology front, there is the issue of e-banking or,the use of electronic delivery channels for banking products and services through automated teller machines (ATM), internet banking and tele-banking. E-banking leads to greater competition among banks, both domestic and foreign, as well as competition from the non-banking segment. Competition results in lowering of transactions cost, enables penetration into new markets and expansion of geographical reach. It also compels banks to offer a broad range of deposit, credit and investment products through diverse distribution channels.

In India, e-banking, however, has not been able to make significant inroads as an independent mode of banking due to psychological, technological and socio-economic factors. There are the additional hurdles relating to infrastructural and legal constraints. This channel of distribution, though promising, is unlikely to threaten traditional distribution channels in the immediate future.

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Areas where innovations in IT and telecommunications have made significant transformation in banking services relate to new product development, speed of transaction processing and reduction in transaction costs. The major issue about new IT is its impact on the processing of information, which lies at the very core of banking business. Inspite of its advantages, reliance on such technology often exacerbates traditional risks; operational risk (since it requires changes in procedures), reputational risk (if the bank fails to deliver secure, accurate and timely services) and legal risk (uncertainty about which legislation applies to e-banking transactions), besides the emergence of other risks (business and credit risks). Another source of concern related to e-banking is the emergence of the 'digital divide[1] in the access to banking services. Since e-banking and other IT-led innovations in the financial sector are knowledge intensive, it often tends to favour more educated participants, that too at the cost of ignoring the relatively less privileged sections.

5.19 KEY TERMS

- Regional consultative committees: This committee was intended to review banking developments within the region and to make such recommendations as it may deem appropriate for the consideration of the Govt. of India and the RBI.
- Come principles of financial sectors: Strengthening of the financial sector and improving the functioning of financial markets can be described as the cone principles of financial sector reforms in India.
- Credit information Bureau: CIB has been set up to function as a repository of credit information both current and historical data on existing and otential borrowers.

5.20 SUMMARY

The structure of an organization should be deliberately and consciously created, having due regard to a variety of considerations. The starting point would be to determine what he objectives of banks are, in as much as its organization must be designed to accomplish them. The next step would be to determine what primary work would have to be performed to achieve its objectives and then group and arrange this work in balanced packages. In the final stage, the proper span of supervision for each management position needs to be demarcated.

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5.21 ANSWERS TO 'CHECK YOUR PROGRESS'

1. a) T b) F c) F d) T e) F
2. a)
3. c)
4. b)
5. a)

5.22 QUESTIONS / EXERCISES

SECTION - A

1. Explain the four management Groups of organization
2. What are the different kinds of committees under Nationalized Banks?
3. Briefly discuss the organizational problems of commercial Banks.
4. What are the Duties and powers of Bank managers?

SECTION - B

5. What are the financial problem faced by commercial banks?
6. In detail, discuss about the Socio-Economic and political problems of Banks in Erdia.
7. Write a rote on
   (a) Securitization and Reconstruction of Financial Assets.
   (b) Enforcement of security interest.
   (c) NPA management
   (d) E- Banking.

5.23 FURTHER READING

1. S.N. Maheswari - Banking Theory Law and Practice.
2. Dr. N. PREMAVATHY - Banking Theory Law and Practice/
3. M.L. JHINGAN - Money, Banking , international Trade and public finance.
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Unit - 6 MEANING AND FUNCTIONS OF INSURANCE

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Structure

6.0 INTRODUCTION

The modern age of industrialization has rendered man and his property most vulnerable to different types of risks and uncertainties of life. The uncertainties may relate to the life of a man such as death, unemployment, sickness or to his properties such as risks arising from accident, fire, earth quake, floods, perils at sea and so on. Insurance is the result of man's search for security. The effective solution of reducing the burden of these risks and uncertainties has been devised by shifting these risks to agencies or persons such function of shifting these risks is known as insurance.

Insurance is a Co -operative method for spreading over the loss caused by a particular risk, over a number of persons, who agree to share the loss. However, insurance can reduce the financial burden arising from a risk, but cannot eliminate the risk.

Different authors have defined insurance. Megee, D.H. , defines insurance as a plan by which large number of people associate themselves and transfer, to the shoulders of all, risks attached to individuals".

Hansell, D.S., defines insurance as "a social device providing financial compensation for the effects of misfortune, the payments being made from the accumulated contribution of all parties participating in the scheme".

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Patterson, E.W., defines insurance as "a contract by which one party, for a compensation called the premium assures particular risks of the other party and promises to pay him or his nominee a certain or ascertainable sum of money on a specified contingency".

6.1 UNIT OBJECTIVES

- ❖ Provides Safety and Security
- ❖ Prevention of loss.
- ❖ Provides Capital
- ❖ Helps Economic Progress.
- ❖ Encourages Savings.

6.2 NATURE OF INSURANCE

The following are the main features of insurance which are observed in cases of life, fire marine and general insurance.

6.2.1. Sharing of risk:

Insurance is a device for sharing of risk which may fall on an individual or his family on the happening of some unforeseen event, such as sudden death of earning member in the case of life insurance, perils at sea in marine insurance, fire in fire insurance and theft in case of general insurance.

6.2.2. Co-operative Device:

Large number of persons agree to share the financial loss arising due to a particular risk, such agreement is effected voluntarily. There is no compulsion of anybody to purchase the insurance policy. Hence, insurance is a co-operative device.

6.2.3. Valuation of Risk:

Before insurance contract is entered into, the valuation of the particular risk is made. On the basis of the value of the risk involved, the premium or consideration is fixed.

6.2.4.Happening of Event:

In case of life insurance, payment is made, generally on the death of the person insured or after the expiry of the fixed period, whichever occurs earlier. In case of other

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types of insurances, the happening of the event may or may not occur within the stipulated period. For example, in case of fire insurance, payment will be made only if fire accident occurs within the period of insurance. So, if the contingency occurs, payment is made, otherwise no amount is paid to the policy holder.

6.2.5. Amount of Payment:

In general insurance, the amount of payment depends upon the value of loss occurred due the particular risk insured. The happening of event and amount of loss are required to be proved by the policy holder. In life insurance, the purpose is not to make good the financial loss. The insurer promises to pay a fixed amount on the happening of an event. The main facts is that the policy must be valid and in force at the time of the happening of the event.

6.2.6. Large number of Insured persons:

To make the insurance cheaper, it is essential to insure large number of persons or property. Hence, only if many people from cities and villages take insurance, the cost of insurance per person will be cheap.

6.2.7. Insurance is not Gambling:

Death may occur to any person, at any time. It cannot be predicted in advance. Likewise damage to property may occur at any time. By taking out insurance policy, uncertainty is converted into certainty, because the insurer promises to pay a definite sum at damage to property or death of an individual.

In fact, if a person does not get his property or life insured, he is gambling with his life or property.

6.2.8. Insurance is not charity:

Charity is given without consideration. In insurance, payment is assured only against the consideration called the premium. Hence, insurance is not charity, it is a business, in which security and safety is assured against payment called premium.

6.3. EVOLUTION OF INSURANCE

It is very difficult to find out the origin of insurance. The earliest traces of insurance are found in the form of marine trade looms or carrier's contracts. Marine insurance

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the oldest form of insurance. When sailors were bold enough to venture in to the unchartered seas, they faced not only the fury of nature, but also were exposed to the risk of booting of their ships and merchandise by the notorious pirares on open seas. Travelers on road also faced similar risk of highway robbery of caravans. The system of credit and the law of internet were well developed in those days. If the ship was lost: the loan and interest were forfeited. The marine traders were ingenious in devising ways of spreading of risk. The marine policies of the present from were sold in the beginning of fourteenth century. Then, the insurance practice spread throughout Spain, Portugal, France, Holland and England. The Lloyd's of England gave a fillip to the development of marine insurance.

After marine insurance, fire insurance development occurred. It has been originated in Germany in the beginning of sixteenth century. The fire insurance got momentum in England after the great fire in 1666 when the losses by fire were very heavy. When England established colonies though out the world, the fire insurance business also was developed thorough out the globe.

Life insurance business was first established in England in the sixteenth century. The first registered life office in England was the Hand in Hand society established in 1696. Life insurance business did not make much headway in the United States during the Eighteenth Century because of serious functuations in death rate, but subsequently, it was established.

Miscellaneous insurance covering different types of insurances such as accident insurance, fidelity insurance, liability insurance burglary insurance were established as a consequence of the industrial revolution which took place in the nineteenth century. With the technological revolution and social changes sweeping across the world, new dimensions are added to the general insurance business, and new types of insurance businesses are progressing at a faste rate.

6.4 FUNCTIONS OF INSURANCE

6.4.1. Primary Functions:

6.4.1.1. Certainty of Compensation of Loss:

Insurance provides certainty of payment at uncertainty of loss. The insurer charges premium for providing certainty. Life is full of risks. Life without risks and uncertainties is unthinkable. Man has always encountered risks of various types since the inception of civilization. Minor risks can be ignored, but the major risks cannot be ignored and their avoidance is desirably. One of the ways or techniques of meeting the risks is through loss prevention and insurance. Insurance removes all uncertainties and the assured is given certainty of payment of loss.

6.4.1.2. Provision for Protection

The insurance cannot check the happening of risk in future, because it is not possible to find out whether the risk will occur or not, even if it occurs, when will it occur and how much loss will have to be burns. Moreover, insurance can surely provide for losses at the happening of the risk. Hence, insurance provides protection against the probable chances of loss.

6.4.1.3. Risk sharing

Insurance is a co-o creative method of spreading over the loss suffered by one or more, caused by a particular risk, over a number of persons, who agree to share the loss. Since risk cannot be avoided and eliminated, its effect can be reduced by risk sharing. When the risk is assumed deliberately, provision is made against losses by creating founder by building up reserve fund. This approach might be suitable to big concern but not suitable to small concerns and persons of moderate means. For them, the suitable method is risk sharing.

6.4.2. Secondary Functions

6.4.2.1. Prevention of loss

Prevention is always better than cure. Prevention of loss is the best solution to the problem of risk. It is the most effective and cheapest method to avoid unfortunate consequences. By constructing a building with fire resistence materials, of serving safety instruction, installing automatic sparkler and the like, fire can be prevented. Similarly, better roads, better lighting and effective traffic regulations help to minimize automobile accidents. By providing improved medical facilities, life span can be prolonged. However, such preventive measures cannot always be effective. When prevention fails, other methods must be adopted. Insurance joins hands with those institutions which are actively engaged in preventing the losses of the society. Since the insurer assures the insured to make

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good the loss suffered in general insurance and a fixed sum on the happening of an event in life insurance, prevention of loss is made possible to a greater extent.

6.4.2.2. Mobilisation of Funds

For planned development of a country, there is great need for mobilisation of funds. The accumulated funds of insurance companies are invested in providing proper infrastructure and development of industries. Insurance companies help the development of trade, commerce and industries of a country through different schemes of investments.

6.4..2.3. Tool for social welfare:

Insurance companies help in improving the social environment, which is complex due to many economic, social and political problems. Security of life and property given by insurance bring peace of mind to the insured. The investment made by insurance companies in schemes such as electricity development, housing loans, water supply, agriculture and agro based industries help to promote social welfare schemes.

6.4.2.4. .Provision of financial cover:

The needs of socially and economically backward classes, especially in rural areas were not taken care of Insurance, by reaching out to them, provide adequate financial cover against death at reasonable cost. When more and more persons learn about the importance of insurance and join hands in taking insurance policies, the cost becomes cheaper.

6.4.2.5. Mobilisation of savings:

Normal mentality of an Indian is to save a part of his earnings; before spending the rest. But, due to exposure to western culture, introduction of credit card schemes, ATM facilities and the like, there is a great change in the attitude of an India: and the concept of savings in almost forgotten. Insurance companies, especially life insurance companies help to mobilize the savings of masses, by creating an awareness in the minds of masses about the importance of savings.

6.4.2.6. Effective Service:

The insurance companies motivate their employees to discharge their services to the best of their ability and provide efficient service with curtesy and hones'. All and employees work with full sense of participation, pride and job satisfaction through discharge of their duties with dedication.

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6.5 IMPORTANCE OF INSURANCE

Insurance, as a co-operative method of spreading over the loss suffered by one or more caused by a particular risk, has become indispensable in the modern social life. It has become a part of life. Insurance cannot be avoided or ignored by any section of the society. Its importance to individual, society and industry cannot be under estimated.

6.5.1. Importance of Individual:

6.5.1.1. Provision of Security:

Death may occur to any individual at any time. It cannot be predicted in advance. Death of the head of the family, who may be the sole earning member of the family, will usher in unimaginable miseries to the family. In such cases, life insurance helps to reduce the financial loss to a greater extent. Life insurance provides security against untimely death and old age sufferings. In the same way, property and goods are exposed to various risks such as fire, flood, earth quake etc. General insurance provides the necessary security against such risks and resultant losses.

6.5.1.2. Encouragement of savings:

Saving for a rainy day is an integral part of the life of every Indian. But due to exposure to western culture, introduction of credit card schemes, ATM facilities and the like, there is a grant change in the attitude of an Indian and the concept of the savings is almost forgotten. In case of life insurance, the principles of insurance and savings is combined. The insured is to pay premium regularly to keep the policy alive. It becomes, in a way, a compulsory saving. The insured is able to get the policy amount together with bonus on the expiry of the stated period. If the insured dies before the expiry of the policy, his nominees get the assured amount. Hence, the insured is motivated to pay premium regularly. Thus, insurance encourage savings.

6.5.1.3. Lucrative Investment:

Different types of life insurance policies not only encourage savings of individuals, but also help in converting them into profitable investments. Policies, when they nature,

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entitle the insured to receive not only the policy amount, but also additional income, called bonus. Such investment in life policies are safer and better avenues of investment. Deferred ammunities help the companies. Insurance policies enjoy tax benefits also.

6.5.1.4. Provides Motivation:

According to Maslaw's theory of hierarchy, safety and security needs are basic needs in the life of an individual. Once there needs are satisfied, the individuals are able to perform their functions comfortably. Since, life insurance assures that the financial loss of untimely death is taken case of, an individual can work with peace of mind. Likewise general insurance policies assure that risks to properties are taken care of such reassurances will help the individuais to work to the best of their abilities, without worries. When motivated people perform their functions with zeal and zest, the productivity of the country also improves.

6.5.1.5. Takes care of personal needs:

Different types of policies are issued to take care of different needs of individuals. Policies may be taken for augmenting funds for different needs, such as for education of children, marriage needs of daughters, old age needs such as provision for medical expenses, ammunities to supplement reduction in earnings due to retirement, inability to work and so on. Hence, insurance policies are planned in such a way to satisfy every conceivable need of an individual. Money back policies are available which provide a fixed percentage of sum assured at regular intervals to take care of monetary needs, during the period of policy. Hence, a judicious selection of various types of insurance policies will help on individual to meet his commitments without much difficulty. Moreover, the insured can obtain loan on policies from insurance companies to tide over temporary difficulties.

6.5.2. Importance to business:

6.5.2.1. Provision of Security:

Huge amount is invested in stock and other assets of businesses. Investment in assets is essential for successful running of the business. But these assets are exposed to different types of risks like fire accident, burglary, floods, lighting and a host of others. Insurance helps to make good any loss suffered. It provides safety and security. The businessman, by knowing that his assets are protected against various risks by insurance, can concentrate his efforts towards improving his business.

6.5.2.2. Welfare of employees:

Labour is an important factor of production. Only if employees are satisfied and motivated, their productivity will increase, which will tend to increase in production. When industry and business performs well, the national economy will prosper. In order to take care of the welfare of employees, such as provision for pension, accident and sickness benefit, provision against untimely death, group insurance schemes are available. The premium for such schemes are paid by employer. When employees are assured of such benefits, they will work to their best of abilities and as a result industries will prosper. Industrial disputes will decrease.

6.5.2.3. Improvment of Business:

By taking policies covering risks against properties and assets, the businessman is relieved of such botheration. He can devote him time and attention towards improving his busine... Likewise, by taking group insurance policies, welfare of employees is also taken care of. Their unstinted co-oper...ion is available to businessman since the working environment is pleasant and safe, the businessman can reach even unimaginable levels of heights in business only those who dare can reach new heights. Since the businessman is free from worries, he can do better work, with the aim of maximizing profit and create a place for himself in the business world.

6.5.3. Importance to Society:

6.5.3.1. Formation of capital:

Since a number of people take insurance policies fo. a variety of reasons, crores and crores of rupees are collected as insurance premia by insurance companies. The money so collected is invested in various fields such as agriculture, industry, housing and so on. These investments help capital formation of the country. The help capital formation of the country. The salutary effect is that such capital formation is made by way of internal generation of funds, without depending upon foreign investment. Adequate capital will accelerate production cycle and ill lead to economic growth of the nation.

6..5.3.2. Protection of the wealth of the society:

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Group insurance schemes satisfy various needs of employees and motivate them to work to the best of their activities. Labour, one of the most important factors of production is protected against risks arising from accidents, untimely death, sickness etc. Other general insurance policies provide protection to buildings, machinery, stock, live stock, crop etc. against risks. Thus, insurance helps to provide protection to the wealth of the society. Even if some losses of occur due to risks like fire, flood etc. insurance helps to repair, rebuild and replenish them. Such protection helps stabilization and expansion of business and industry. Prosperity and happiness can be witnessed everywhere with the help of insurance.

6.6 KINDS OF RISKS

There are different types of risks. A study of them will help to understand their nature, whether insurance policies can be taken against them and how to manage them effectively.

6.6.1. Pure Risks:

Pure risks involve the prospect of loss or no loss. if the risk becomes a reality, it will result in a loss. If the risk does not take place, there will not be any loss. But the absence of risk will not result in a gain. For example, if a building catches fire, it will result in a loss of property. If no fire accident takes place, there will not be any loss to the building. There will not be any gain also.

6.6.2. Speculative Risk:

Speculative risks involve the prospect of loss or gain. Such risks take place in speculative transactions. For example, if a share is purchased at a particular price, the speculator expects its to go up. If, on the contrary, the price comes down, there is a loss. When the price goes up us he expects, he stands to gain.

6.6.3. Dynamic Risks:

These kind of risks arise from changes in economic conditions, such as changes in fashions, habits, customs of consumers, changes in technology, changes in income level and price level, changes in Government policies, rules and regulations etc. These risks change swiftly, less predictable and effect a large number of individuals.

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6.6.4. Static Risks:

Static risks are caused by reasons other than those which arise from changes in economic conditions: Such risks occur due to perils of nature such as fire accident, perils at sea, lighting, floods, earth quake etc. They involve destruction of or damage to assets. Static risks occur with a degree of regularity with time and to some extent expected.

6.6.5. Insurable Risks:

The risks which can be shifted and insured against losses are known as insurable risks. These risks are capable of being measured in terms of money. Examples of these risks are pure risks which involve the prospect of loss or no loss. These risks can be insured.

6.6.6. Non insurable Risks:

Certain types of risks cannot be insured and they are known as non insurable risks. Risks arising out of changes in the market conditions such as price fluctuations or where the danger of risk is very high and certain, cannot be insured. Moreover, most of these risks are not capable of being estimated.

6.7. RISK MANAGEMENT

Risk management can be defined as the identification, analysis and control of those risks which can threaten the assets or the earning capacity of an enterprise. It is a scientific approach to the problem of dealing with pure risks faced by individuals and businesses. It deals with insurable and uninsurable risks and the choice of the appropriate techniques for dealing with them. Risk management can be classified into three categories, namely, risk identification, risk evaluation and risk control.

6.7.1. Risk Identification

The job of identifying a risk can be successfully done by a risk manager, who is a specialist in dealing with risk. He must always the operations of the organization and discover the risks to be dealt with. For this purpose, he must use various tools such as check lists, questionnaires, relating to risk analysis, analysis of financial statements, insurance policy etc. In addition to these tools, he should have the diligence and imagination to discover the various risks of the organization. He should have a wide reaching information system, which could provide information about all aspects of the organization.

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6.7.2. Risk Analysis

After identifying the risk, the risk manager must take steps to measure the potential impact of the organization. He must gather all relevant information about the risk and make a through analysis of them. Past experience will guide him to device suitable remeddical actions. He must assess the level of severity of the risk concerned and its periodicity. A through study of the past history, percent nature and future expectations of the risk will help him to assess it property and devising ways of dealing with it.

6.7.3. Risk Assessment

The risk manager must assess the frequency of the risk, its monetary cost and human cost in terms of physical and mental strain. He must analyse the potential size of the loss and its probability to occur. Based on the quantum of severity in dealing with the risk, he could classify the risks as critical, important and unimportant. Critical risks include all possible losses that may result in bankruptcy of the organization. These risks may paralyse the organization and lead to its closure. Important risks will not lead to the bankruptcy of the organization, but create a constraint on the firm to borrow for continuing its operations. Unimportant risks could easily he managed. It will not create undue financial strain.

6.7.4. Risk Retention or Self Insurance:

After identifying the risk, it is essential to consider how to bear with the effects, when the worst happens out of the risk. In case of events of risk with high frequency and low severity, it is wise to retain the risk, rather than to seek protection. A separate fund may be established, out of which the losses may be paid, when the cost of meeting the loss may be lesser than that of paying insurance premium. Moreover risk retention gives more awareness of the risk and the need to be vigilant to prevent it.

6.7.5. Risk Transfer:

The financial loss of the risk may be transferred to other parties through insurances. Insurance is a risk transfer mechanism, by which one can exchange its uncertainty to certainty. For example, the hazardous nature of a property to fire accident is an uncertainty. When a fire insurance policy is taken, such uncertainty is converted into a certainty of getting the claim, in case the property is damaged in a fire accident, critical risks should be insured without lapse to bring effective protection. In planning the quantum of insurance to be taken, the insured may seek the assistance from outside agencies like insurances agent, broker etc.

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6.7.6. Risk, Peril and Hazard:

Risk:

Risk means uncertainty concerning loss and not the loss itself or the cause of loss or the chance of loss. If for example, the chance of loss by fire to a particular type of house is 1 in 1000, a single person who owns a single house cannot predit the loss. Either his house will burn or will not burn. He is faced with complete uncertainty, even though the chance of loss is low. The uncertainty is called risk.

Peril:

When risk is known as uncertainty of loss, peril is known as the source of loss. It is an event that causes a personal or property loss. People are subject to loss or damage from many perils, such as, fire, explosion, premature death, flood etc. These are perils in the sense that they give rise to risks, but these are not risks in themselves.

Hazard:

Hazard may be defined as a condition that may create, decrease or increase the chance of loss from a given peril. For example, oily rags near the thatched cottage or petrol pumps, which are likely to increase the risk of loss due to fire. There are two types of hazards, namely, physical and moral hazards. Physical hazards occur accidentally by nature, over which, generally, human beings have no or little control. Moral hazards are man made, as these are dependent upon human nature or behaviour. The losses are created intentionally, such as, knowingly setting fire to the house of his energy.

As a matter of fact, moral hazards in life insurance are lesser. Nobody would like to put an end to his life, merely for the sake of some financial gain to his dependent. When a man knows positively that he is likely to live for a very short period of time and thus upto for a policy, such case can easily be detected through medical escammation The greatest danger of moral hazard arises in loss caused through fire accident. The insured may deliberately put the property on fire and gain by a loss caused to the insurance company. Hence, the insurance companies must be on their guard, while making an assessment of the loss.

6.8. INSURANCE CONTRACT

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Insurance may be defined as a contract between two parties, whereby one party called insurer undertakes, in consideration of a fixed amount called premium, to pay the other party called insured, a fixed a sum of money on the happening of an event. Insurance contracts are based on certain fundamental principles. These principles are common to all types of life, fire, marine and miscellaneous insurance contracts, with the exception of the principle of indemnity, which is not applicable in case of life insurance contract, since it is a contingent contract.

Principles of Insurance Contracts :

6.8.1. Agreement:

An agreement includes offer and acceptance. Acceptance requires an offer. An offer may be precededed by an invitation to offer. In insurance, the convassing of agents or even the publication of prospectus is an invitation to offer. The offer may be given to the insurance company in the form of filling up a proposal form. When the insurance company accepts the offer, it becomes an agreement. Hence, the important fact is that the acceptance is essential. When the insurance company accepts the offer, it issues an insurance policy to the insured.

6.8.2. Legal consideration:

When the insurance company promises to pay a fixed sum on the happening of an event, I must have some return for such a promise. The return is called legal consideration. The return may be in the form of money called premium. It need not be in the form of money only, but may assume any other valuable form, such as, benefit, profit, right, interest etc. Hence, without a legal consideration, normally in the form of premium, the contract of insurance cannot be entered into.

6.8.3. Competent to make contract:

The parties to the contract must be competent. A person is competent to enter into a contract when e has attained the age of majority according to law, he is of sound mind and is not disqualified from entering into contract by any law. Hence, a minor cannot enter into a contract, except when it is contract for necessities of life. Likewise, a person of sound mind alone can enter into a contract. Even a person of unsound mind can enter into a contract, if it can be proved that, at the time of entering into contract, he possessed a sound mind. In the same way, a person must not have been disqualified by any law, when he enters into a contract. Examples of such disqualified persons are undischarged insolvent, alien enemy etc.

6.8.4. Free Consent:

When a person enters into a contract, he must enter on his own free will. He should not be compelled to enter into a contract. Such absence of free consent may be due to coercion, undue influence, fraud or misrepresentation. Coercion refers to any act of threatening a person physically or psychologically. Undue influence refers to exercising the power over a person, which arises due to the special relationship existing between the parties, such as, doctor and patient, teacher and student, guardian and wat etc. Frand refers to cheating. Misrepresentation refers to representing a false fact or not representing a true fact. In case of fraud, the contract is void. In all other cases the contract is voidable at the option of the aggrieved pary. Hence, free consent is essential for entering into a contract.

6.8.5. Certainty:

An agreement must not be vague, loose and uncertain. The terms and conditions must be clearly understood by both the parties to the contract. If the proposer turns out to be illiterate, the insurer must analyse or make the terms and conditions clear to him. Otherwise, there will be no mental accord. The insurance company issues a printed policy document which contains all the terms and conditions of insurance contract.

6.8.6. Possibility of Performance

The agreement must be capable of being performed. A promise to do an impossible thing cannot be enforced. The insure must be able to pay the money, on the happening of the event and the insured is also expected to make regular payment of the premium. Otherwise, it would define the meaning of the insurance plan.

6.8.7. Writing and Registration

The law requires certain formalities of writing and registration, in some special cases. An oral contract is also a valid contract, but for insurance, the agreement must be in writing. They must be property signed, stamped and registered. In insurance, the

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formalities are fulfilled as the proposer makes his proposal through a printed from duly signed by him and also the insurer issues the original policy document, property signed and stamped to the insurer.

6.8.8. Lawful object:

In order to make a valid contract, the object of the agreement must be lawful. An object that is not forbidden by law, not immoral, not opposed to public policy and which does not defeat the provisions of any law is lawful. Hence, when a contract of insurance is entered into, all these factors must be thoroughly considered. Apart from all these principles which are to be adhered to while entering into a contract, the following principles are essential for a contract of insurance.

6.8.9. Utmost Good Faith:

Insurance contracts are based upon mutual trust and confidence between the insured and the insurer. Hence, insurance contracts are said to be contracts of Urerrimaefider, namely, of the utmost good faith. It means that each party to a proposed contract is legally obliged to reveal to the other party, all information which would influence the other's decision to enter into the contract, whether such information is requested or not. Hence, the legal principle of cavet Emptor, namely, let the buyer beware, is not applicable in a contract of insurance. Under the principle of careat emptor, the buyer must be careful and the seller is under no obligation to supply information. But, in an insurance contract, the buyer, namely, the insured and the seller, namely, the insurance company, must disclose all material facts. That is the reason why an insurance contract is called a contract of whereinal fider, namely, contract of absolute good faith. A material fact is one which has a direct hearing on the degree of risk in relation to the subject of insurance. In life insurance examples of material facts are age, health, income etc. In case of fire and marine insurance, they are the quantity, quality, ownership of the property.

Cheque your Progress:

1. State whether the following statement is 'True or false'

a. Agreement means offer and acceptance.

b. The person must be compelled do enter into a contract.

c. Proximate cause is an important principle of insurance.

d. Pure risk means the prospect of loss or gain.

e. The agreement must not be lawful, if the contract is a valid contract.

6.9. INSURABLE INTEREST

The insured must have an actual interest, called the insurable interest, in the subject matter of the insurance. It means that the insured stands in such relation to the subject matter of insurance that the suffers loss by its destruction or damage and is benefited by its safety or existence. For example, a man who insures his car against accident, has insurable interest in it, because he uses it for official and non official visits

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and is thus benefited by its existence. If on the other hand, the car is damaged or totally lost, it would cause him financial loss. The owner will have to incur huge expenses on its repairs, if it is damaged or has to replace it, if it is totally lost and will have to pay for hire of alternative modes of transport. Hence, in every contract of insurance, possession of an insurable interest in the subject matter of insurance is essential.

Insurable interest, to be valid, must satisfy the following three conditions.

1. There must be a physical object, life, limb or property, which is subject to risk and the risk can operate on the subject and cause damage or destruction.

2. There must be a potential liability and thus must be caused by the happening of an event which is insured.

3. The insured must be in a legally recognized relationship with the subject matter of the insurance, whereby, he benefits from continued safety and suffers from damage or destruction to it.

In property insurance, anyone who owns a house, furniture, goods or an antomobile has an insurable interest in it. Agents who act on behalf of their principals, administrators, excentors and trustees, mortgagees and failees also have insurable interest in the properties entrusted to them in such capacities.

In life insurance, insurable interest exists between the parties given below, on the basis of special relationship existing between them.

6.9.1. Husband and Wife

Stemming from the ancient concept that marriage is a contract which is force till death do us apart, man and wife are one person. Hence, a husband and wife have a mutual, unlimited insurable interest in each other.

6.9.2. Relatives

For others, the right to insure does not arise automatically from family relationship. A father or his or her son, unless some direct financial loss is likely to arise from his death. In the same way, if the relationship between brother and sister, grand parents and grand children meet the pecuniary test of insurable interest, their lives can be insured.

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6.9.3. Creditors and Debtors:

A creditor has a right to insure the life of his debtor to the extent of his debts, because he stands to loose if the debtor dies without paying the debt.

6.9.4. Partners:

The partners of a partnership firm have an insurable interest in the lives of their copartners, as the death could cause financial loss to the remaining partners.

6.9.5. Employers and Employees:

An employer has a right to insure the life of his key employee, director or highly trained personnel during the course of his employment.

6.9.6. Surety and Principal Debtor:

A surety has an insurable interest in the life of the principal debtor to the extent of his debts.

The next important factor to be considered is the time when the insurable interest must exist, whether it must exist at the time of entering into contract or at the time of happening of event or both. In case of life insurance, insurable interest must be present in the person at the time when the policy is taken. It may or may not be existent at the time of the death of the insured. In the case of fire insurance, the insured must have insurable interest in the things insured against fire, both at the time when the policy is taken and also at the time when the loss is incurred. In case of marine insurance, the insured must have insurable interest in the insured object only at the time of loss.

6.9.10. Indemnity:

The principle of indemnity is the regulating principle of insurance and is applicable in all contracts of insurance, except life, personnel accident and sickness insurance. Under the insurance contract, the insurer undertakes to indemnify the insured against loss suffered by the later. If the insured suffers a loss, the insured shall be indemnified only to the extent of loss, in terms of money, but not for anything more than that. This is in conformity with the basic concept of insurance, whereby an insurer is required to compensate the unfortunate few for the loss they sustain, but does not allow to earn profit from the misfortune.

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In this is not prohibited, then persons would be induced to take insurance with the purpose of making profit out of such contracts by willfully bringing about loss. The insured will be tempted to destroy their goods or property intentionally in order to reap a profit. Many insured may resort to such anti social act.

Since the amount of indemnity does not exceed the amount of loss, over insurance is discouraged. For example, a person insures his house for Rs.2,00,000. In the course of fire, the house is completely destroyed and its value is found to be Rs1,50,000. In such a case, the owner is indemnified to the extent of Rs.1,50,000 only. The insured by over insuring his property, will be paying higher premium rates without getting corresponding returns.

Likewise, indemnity principle also operates against under insurance. For example, a person insures his house for Rs.1,50,000, though it value is Rs.2,00,000. Then, in case of total loss of the house, he can claim only Rs.1,50,000 and not Rs.2,00,000, as he is supposed to be his own insurer to the extent of Rs.50,000. In under insurance, he may save little on the premium, but fails to obtain full indemnity.

There are four ways by which the insurer may indemnify the insured in respect of losses suffered by him, through the risks insured against. Cash is the first method. Payment of compensation in the form of cash is the most popular and suitable methods of settling claims. The second method is Replacement method. Sometimes, the insurers prefer to replace the article itself rather than to make cash payments. The third method is repairing the damaged articles. Repair to the satisfaction of the insured also constitutes an indemnity and is common in motor car, motor cycle etc. Reinstatement is the fourth method, under which, restoration of the property to their original condition is undertaken. It is normally resorted to in fire insurance, where the rebuilding of premises to their formal condition is undertaken. The choice as to the method in which the indemnity will be provided is normally given to the insurer. In genuine cases, the insurer tries to comply with the requirements of the insured.

6.9.11. Mitigation of Loss

This principles places a duty on the insured to make every effort and to take all steps, to mitigate or minimise the loss, in the event of some mishap to the insured property. This principle is included in order to check the insured not to become careless or inactive.

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He is not excepted to be a silent spectator and must do everying in his power to minimise the loss and to save whatever is left. The insured must act to save the property and minimise the loss, as a rational uninsured person would do in similar circumstances. If the insured fails to do so, the insurance company can avoid the payment of loss sttributable to the insurer's negligence. Although the insured is expected to do his best for his insurer, he is not bound to do it at the risk of his life. If the insured has taken all the available precautions and made reasonable efforts to save the property and to make the loss less severe, the insurer will be liable for the entire loss, resulting from the peril insured against. The insured will be absolved from his liability.

6.9.12. Attachment of Risk:

The contract of insurance can be enforced only if the risk is attached.If for any reason, the risk does not run or could not run, the consideration for which the premium was given fails and the insurer must return the premium. For example, A without knowing that his ship has already arrived at the port of destination safely, takes a marine insurance policy or x, without knowing that his house has been already burnt, effects a fire insurance policy, the insurance company must return the premium collected, since the concerned parties were under the misapprehension of the subject matter of insurance. The premium must be returned even where the risk could not run due to the fault, will or pleasure of the insured.

6.9.13. Proximate Cause:

Cause Proxima or proximate cause is an important principle of insurance. According to this principle, the cause of the loss must be a direct and insured one in order to claim compensation. Doctrine of proximate cause runs as "causa proxima non remote spectator' which means that proximate or nearest cause and not the remote cause is to be taken notice of at the time of determining the liability of the insurers. Proximate does not necessarily mean nearest in time. The time that lapses between cause and result may be long or short, but this will not affect the issue, so long as the relationship of cause and effect can be established. It is not the latest, but the direct, dominant, operative and efficient cause that shall be taken into account. In a policy where loss due to rates is not an insured peril, but rats have been found to have been responsible for making a whole in the bottom of the ship resulting in the entry of water and loss to the goods, claim of the insured for compensation of the loss has been held to be a valid one.

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In such a case, it was held that the rate were a remote cause and sea was a proximate cause and because insured perils include sea perils, the insurer would be liable for the loss.

The loss may occur as a result of a single cause, in which case, it can be verified easily. If that cause is insured, then the insurer shall be liable under the policy. Examples of such single cause are destruction of a house property by fire, damage to a building due to earthquake, damage due to collision of ships etc. If there is a loss caused by a clain of events of causes, the difficulty arises to trace out the real or direct cause of the loss. Normally, the insurer looks into the last cause for fixing the compensation, though the result would not have happened without the other causes. In certain disputable cases, these are referred to the courts for final decision.

In practice, the basis for tracing out the real cause of loss is to find out which of the two occurred first, the expected peril or the insured peril. In case an expected peril occurs first and then the insured peril and that causes loss, the insurer is not liable for such loss. But, when the reverse is case, namely ,the insured peril occurs first, followed by expected peril, the insurer is liable for such loss. For example, suppose a fire breaks pit in a theatre hall and destroys the furniture in the hall. During the course of fire, an explosion takes place and as a result the screen gets burnt. Suppose a fire insurance policy excluding explosion has been taken. Since the proximate cause is the fire which occurred first, namely the insured peril, loss due to fire shall be recovered from the insurance company. Further, the cost of the screen bunt due to explosion, which occurred after the insured peril shall also be recovered.

6.9.14. Subrogation

The principle of subrogation refers to the right of the insurer to stand in the place of insured, after settlement of a claim, in so far as the insured' s right of recovery from an alternative source 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 subrogation may be excercised by the insurer before payment of loss. For example the owner of a motor car, having a comprehensive insurance cover, has got two alternative in case of an accident with another car. He can claim the damages from the insurance company, as well as, from the negligent driver. If the insured decides to collect compensation from the insurance company, then, his insurance company, is in due

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course, subrogated to his rights against the third party. The company can recover the money from the negligent driver, which has already been paid under the policy. Hence, the insured is not paid twice for the same damage. Principle of subrogation has many essential features.

6.9.14.1. Corollary to the principle of Indemnity

According to the principle of indemnity, the insured must be fully indemnified. If the insured recovers the full extend of loss from the insurer and then he gets compensation from third parties in respect of the same loss, the insured will be more than fully indemnified and the whole doctrine of indemnity would be done away with. He is not to make a profit of his loss and it is this rule that gives rise to the doctrine of subrogation. The right of subrogation is a necessary corollary of the principle of indemnity and is essential for its preservation.

6.9.14.2. Suborgation is the substitution:

The insurer, according to this principle, becomes entitled to all the rights of insured in the subject matter, after payment, because he has paid the actual loss of the property. He is substituted in the place of another so that he succeeds to the rights of the other in relation to the claim, its rights, remedies or securities.

6.9.14.3. Subrogation only upto the amount of payment:

The insurer is subrogated to all the rights claims, remedies and securities of the damaged insured property after indemnification, but he is entitled to get these benefits only upto the extent of his payment to the insured.

4.Subrogation may be applied before payment:

If the assured gets certain compensation from the third party before being fully indemnified by the insurer, the insurer need pay only the balance of the loss.

6.9.15. Personal Insurance:

The doctrine of subrogation does not apply to personal insurance, because the doctrine of indemnity is not applicable to such insurance. The insurer has no right of action against third party in respect of damages. For example, if as insured dies due to the negligence of a third party, his dependent has the right to recover the amount of the loss from the third party, along with the policy amount. No amount of the policy would be subrogated by the insurer.

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6.9.16. Contribution:

The principle of contribution is that where there are two or more insurers on one risk, one insurer can call upon other insurers similarly liable to the same insured, to share the cost of an indemnity payment. In other words, contribution is the right of an insurer who has paid under a policy, to call upon other insurers equally or otherwise liable for the same loss to contribute to the payment. This doctrine ensures equitable distribution of losses between different insurers. It should, however, be remembered that the law does not prevent a policy holder covering the same risk with various insurers from recovering the whole of his loss from one single insurance company, if the sum assured with him is adequate. The claim paying insurance company, will have a legal right of obtaining contribution to the loss from other insurers in proportion of the amount they have insured. Usually, at the time of making claims, insurers enquire whether any other insurance exists covering the loss. Where other insurances do exist and each policy is subject to a valid claim, contribution will apply and the loss is shared by the insurers proportionately.

The application of principle of contribution can be made according to independent liability method or rateable method. According to independent liability method, the amount payable by each insurer is calenlated independently, totally ignoring the fact that insurance has also been effected by other insurers. If the amounts calculated are more than the loss, then the contribution of every insurer is reduced proportionately, so that an indemnity is provided.

Under the rateable method, the insurers pay proportionately, according to their insurance cover. For example A insures a building against fire with two insurance companies. Company x covers for Rs.10,000 and company y covers for Rs.20,000. If the actual loss to A happens to be Rs.12,000. x is liable to compensate the loss for Rs.4,000 and y is to compensate for Rs.8,000. They share the loss in the ratio of 10,000:20,000. If the whole amount of loss is paid by y, it can recover Rs.4,000 from company x. The contribution clause is usually inserted in the policy.

6.9.17. Assignment of Interest:

Assignment of interest is a method by which any living person who is entitled to transferable interest in a property conveys it to another living person. Thus, the legal right or interest is transferred to a third person. The policy so transferred is called assigned, the person who transfers the policy is called assignor and the person to whom the policy is so assigned is called assignee. On a valid assignment, the assignee becomes entitled to all the benefits under the policy and can use the insurer upon the contract in his own name. In an English case, it was held that insurance policies are marketable commodities, which can be validly assigned with or without consideration, to a person who has insurable interest in the life insured. Hence life insurance policies are treated by law as reversionary interests of actionable claims, which the insured may assign, sell or mortgage, change, settle or deal with in any way he likes.

Any person having title to the policy of life insurance or authority to transfer the policy may assign the policy. Such assignment may be made absolute or conditional. An absolute assignment is one in which all rights, titles and interests which the assignor has in the policy passes immediately and absolutely to the assignee and will not revert to the former in any event. The assignee can, therefore deal with the policy in any way he likes without the consent of the assignor. In conditional assignment, the policy will revert to the assured in the event of his surviving the date of maturity or on the death of the assignee. So, the assignment is not absolute. It may become inoperative subsequently, though the assignee obtains an immediate vested interest in the policy.

The essential conditions of assignment are:

1. The person executing an assignment must have absolute right or interest in respect of the policy.
2. The assignor must be a major to make valid contract.
3. The assignee must not be subject to any legal disqualification.
4. The assignment must be either for valuable consideration or on consideration of natural love and affection between persons standing in near relation to ether other or when the assignment is by way of voluntary gift.
5. The transfer must not be opposed to any law in force in the country.
6. The assignment must be in writing and must specifically set forth the fact of transfer of policy.
7. The assignor must affix his signature in the presence of at least one witness.

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Check your Progress

2. Socurce of loss is

(a) Risk, (b) Peril,
(c) Hazard.

3. Risk management includes

(a) Risk analysis,
(b) Suborgation
(c) indemnity.

4. Ary living person who transfers interest in a property to another living person

(a) Contribution,
(b) Warrantier
(c) Assignment of interest

5. The loss due to dishonesty, disappearance etc

a) Guarantee insurance
b) Personal insurance
c) Property insurance

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6.9.18. Warranties:

In an insurance contract, warranty means that the assured undertakes that some particular thing shall or shall not be done or that some stipulation shall be fulfilled. Any breach of insurance warranties goes to the very root of the contract and gives the aggrieved party the right to avoid the contract. Whereas, in other contracts, for breach of warranties, the buyer cannot return the goods and demand refund of the money. In case of a contract of insurance, there is a main difference between condition and warrantly. If a warranty is broken, the contract comes to an end and becomes void, but when a condition is broken, the contract cannot be terminated, but a claim can be lodged for compensation for breach of condition.

Warranties are two types, namely, express warranties and implied warranties. Express warranty is one which is expressed in the policy document, either specifically or by reference. Examples of express warranties are that the ship will sail on a specified date, the ship is neutral and will remain so during the entire voyage etc. Implied warranties are those which do not appear in the policy document, but are understood without being put into words. They are understood to have been included in the policy by law, general practice, long established customs, usage or general agreement. Examples of implied warranties are sea worthiness of ship, legality of venture, non-deviation and so on.

6.10 KEY TERMS

- **Indemnity :** On the happening of an event insured against the insured will be placed by the insurer in the same pecuniary position that he occupied immediately before the event.
- **Suborgation:** The right of the insurer to stand in the place of insured, after settlement of a claim, in so far as the insured's right of recovery from an alternative source is involved.
- **Warranties:** The assured undertakes that some particular thing shall or shall not be done or that some stipulation shall be fulfilled.

6.11 SUMMARY

Every risk involves the loss of one or other kind. the function of insurance is to spread the loss over a large number of persons who are agreed to co-operate each other at the time of loss. The risk cannot be averted but loss occurring due to a certain risk can be distributed amongst the agreed persons.

6.12 ANSWERS TO "CHECK YOUR PROGRESS"

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1. a) T b) F c) T d) F e) F
2. b)
3. a)
4. c)
5. a)

6.13 QUESTIONS / EXERCISES

SECTION - A

1.Define insurance and explain its features.

2.Explain the various principles of insurance contracts

3.What are the various functions of insurance

SECTION - B

4.Describe in detail the importance of insurance

5.What are the different types of risks?

6.Explain insurable interest in a contract of insurance.

6.14 FURTHER READING

1. M.N.MISHRA – Insurance Principles and practice
2. P.K.Gupta – Insurance and Risk Management

Unit - 7 LIFE INSURANCE

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Structure

7.0 INTRODUCTION

Life Insurance is a contract for payment of a sum of money to the person assured or to the person entitled to receive the same, on the happening of the event insured against. Usually thecontract provides for the payment of an amount on the data of maturity or at specified dates out periodic intervals or at unfortunate death, if it occurs earlier. Among other things, the contract also provides for the payment of premium periodically to the insurance corporation by the assured. Life Insurance is concerned with two hazards that stand across the life path every person, namely, that of dying prematurely leaving a dependent family to fend for itself and that of hiving to old age without visible means to support. By and large, life insurance is civilization partial solution to the problems caused by death.

7.1 UNIT OBJECTIVES

- ❖ Provides elements of protection
- ❖ Best form of savings
- ❖ Provides long term investment
- ❖ Civilisation partial solution to the problems caused by death

7.2 FACTORS AFFECTING RISK

Since the life insurance companies are entering into contracts of paying a fixed amount on the happening of an event, they want to know, first of all, the extent of risk to which they are exposed. The first purpose of selection of risk is to find our whether the proposal should be accepted or not. The second objective of the selection of risk is to find out the rate of premium to be charged from the assured. The premium depends upon the quantum of risk. Higher the risk, more will be the amount of premium. Since the degree of risk is not the same for all persons, different premia should be charged for different people. Hence for practical purpose, the risks are classified and permia are fixed accordingly. There may be persons who are not insurable and for such persons, the proposal should not be accepted. If the proposal is accepted, it results not only as a loss to the insurer, but the honest insured would be required to pay more premium to meet the total loss of the insurer.

7.2.1. Age

Age of the applicant is an important factor to be considered. With advancement of age, risk factor also increases. Hence when a person takes our an insurance policy at a comparatively young age, say 25 years of age, the risk is less, policy for a longer duration may be taken and the amount of premium will also re less. The reverse is true in case of persons of advanced age. Mortality increases with advancement of age. Hence, age proof is very essential and unless age is proved, payment of claim is not made. Now a days, age should be admitted at the time of proposal, to avoid dispute later. If a misstatement is discovered with discovered with regard to age, when the claim is made, the amount of the claim is adjustable in accordance with the rectification of age.

As proof of age, certificates such as, municipal certificate from Baptison of from Family bible, if it contains age or date of birth, school or college record and service record Register are accepted. Age proof is essential at the proposal itself, if the policy is term insurance, non medical policies and immediate amity or for a child.

7.2.2. Physique

Physique refers to the build of the applicant and it includes height , weight and chest expansion. The relationship between height, weight, girth and expansion of chest are the basic determinants of mortality expectation. Overweight or underweight for a

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specific age is not a healthy sign. Hence, insurance companies have fixed standards for height and weight for specific ages for males and female separately. If the applicant height and weight does not fall within the standards, the proposal may not be accepted or may be accepted at extra premium .

Apart from height and weight , insurance companies are very particular about the conditions of applicant' sight, hearing, heart etc. Medical practioners can assess the longevity or mortaltings of person due to impairment of vital organs of the body. The questions on the proposal form are so designed elicit information's about the health conditions of the proposers.

7.2.3. Personal History

The personal history of the applicant will help to assess the risk factor involved in insuring his life. The personal history is revealed by his past health records, halits and insurance policies already taken. If an applicant was refused insurance earlier, it is not advisable to insure his life at present. In the same way, if the applicant was already insured for a large amount, his request for additional insurance must be scrutimised carefully. It is essential to know his past habits, whether the had the habit of taking drugs or consuming alcohol, because even if he was cured, the chances of his becoming an addict, cannot be ruled out.

His past health record should also be thoroughly investigated, like, whether he was suffering from any serious, disease, whether he undervent any surgery. These information's are expected to the furnished by the applicant himself. The medical examination may reveal these information's. On the basis of these information, a decision is to be taken, whether to accept his proposal or not.

7.2.4. Family History:

History of the family members are also requird to decide about the proposal of the applicant informations about Health, age, occupations and if fdecelared the age at which death occurred, of parnts, brothers, sisters and children of the applicant must be obtained. Such informations will help to know whether any hereditary defects are there in the family of the applicant. An adverse family history will adversely affect the chances of longevity of the applicant.

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7.2.5. Occupation:

Occupation is an important factor to be considered in assessing the risk factor. The atmosphere at the work place, which is called as occupational hazard, may advesly affect the physical and mental health of an employee. For example, exposure to inhaling obnoxious gases in a chemical factory, inhaling dust from a cement or taxtiles factory may affect the lungs of an employee. If the nature of work is hazardons or accident prone, the morale of the worken wil also be affected. Hence the nature of work and the occupational hazard involved in the work must be considered before deciding about the insurance proposal.

7.2.6. Economic Status:

The earnings of the applicants must be thoroughly scrutinized, because it must justify the amount of insurance applied for. If a person of modest income applies for an insurance policy of very hung sum assured, naturally, it mist create suspision in the minds of the insurers. Educational, financial and professional consciousness make the applicant insurance minded. The changes of death is also lower in high strata of the society, because of better medical care, better way of life and the like. Higher the economic status, lesser will be the risk factor from the insurer's point of view.

7.3 PROCEDURE FOR EFFECTING LIFE INSURANCE

7.3.1. Filling up the proposal:

In general, the proposal form is filled by agent. This form should be filled in carefully, without omitting any detail and must be signed to the proposer. It is designed in such a way to gather informations about the name of the insured person, address, policy amount, date of birth, mode of premium occupation and the like.

7.3.2. Medical Examination:

The proposer has to undergo a medical check up by one of the doctor appointed by the insurance company. The doctor is to report about the general health of the proposer. Male lives, not more than forty years nearer the birthday are accepted for non medical general schemes. But minors are not issed policies under this scheme Illitrate males, earning income, for getting the benefits of the non medical schemes must be below forty years. Non medical special schemes are also available to males who are interate, not

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more than forty five years nearer the birthday and are employed in Government and quasi government offices, state corporation, Government industrial undertakings and reputed commercial firms, who keep accurate leave records.

7.3.3. Agents Report:

The agent helps the proposer by explaining the technical terms. He advises him regarding the type of policy suitable for a particular person, He, further, inform the propose about the rate of premium chargeable, keeping in view the period of insurance type of policy, mode of payment and the sum assured. The agent, then prepares a report in which he states the anme, income, occupation, period of acquaintance with the proposer etc. He is supposed to give correct information about the proposer. On the basis of this report and the medical report, the insurer makes and assessment of the risk.

7.3.4. Assessemnt of Risk for acceptance:

The insurer makes an assessment of the risk on the basis of the information in the proposal form and report of the doctor and the agent. If necessary, the insurance company may verify the informations through an independent investigation agency without the knowledge of the applicant. Information's regarding the applicant can also be obtained through his friends and relatives, attending physicians and neighbor and business associates. If the life to the insured is found insurable, then, the insurance company accepts it an sends an acceptance letter along with a premium notice, stating the amount of the premium and the due dates. As soon as the first premium is paid, the insurance contract becomes complete and the life risk is said to have commenced.

7.3.5. Proof of Age:

The proposer is required to submit the proof of his age. It may be a copy of certified extract of Municipal or local body's record, Certified of laptism, certified extract from school or college records certified extract from service register of Government and Qnasi Government servants or passport issued by passport authority of India. When the insurer is fully satisfied as to its validity, an age admitted certificate is issued by the insurer. For policies with monthly premium, payments are asked for the insured receives a cash race.

7.3.6.Issue of policy:

The insurer sends the original policy document after it is being signed and stamped. The policy contains all details, terms and conditions of the life insurance contract. It is an evidence of the contract between the insurer and the insured. The policy holder should preserve the policy carefully till the contracted amount under it is settled, as it is required to be submitted to the corporation at the time of claim. The loss of the policy document, if its occurs, should be immediately intimated to the office of the insurer, where it is serviced. The office will them qnote requirements for a duplicate policy or a copy of the policy, whichever is required by the policy holder. It may, however, be noted that the loss of the policy document does not extinguish the right of the policy holder in the policy.

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The risk under the corporation's policy commences on the date of receipt of the first premium is full or the date of acceptance, whichever is later.

7.4 LIFE INSURANCE CONTRACT

Life insurance contract may be defined as the contract, whereby the insurer in consideration of a premium undertakes to pay a certain sum of money either on the death of the insured or on the expiry of a fixed period. Since it comes under Indian contract Act, it must have certain essentials of a general contract.

7.4.1. Offer and acceptance:

The offer and acceptance of life insurance is of a typical nature. The agent canvassting to offer, because, the public are invited to make proposal for insurance. Submission of proposal along with the primuimis an offer and the dispatch of acceptance letter is the acceptance. The risk will commence as soon as the acceptance letter is dispatched by the insurer. When proposal is niot accompanied with the first premium, it would be an invitation to offer by the prospect and the letter of the insurer asking the proposer to pay the first premium is an offer and the payment of first premium by the prospect is acceptance.

7.4.2. Competency of the parties:

Every person is competent to enter into contract if he has attained the age of majority according to the law, he is a person of sound mind and he is not disqualified from entering into contract by any law. The insurer will be competent to contract, if he possesses a valid licence to carry on insurance business and is working within the Articles of Association and Memorandum of Association in case of a company, or the deeds of Partnership in case of a partnership firm.

The insured should not be a minor. If a life insurance policy is issued to a minor, the insurer cannot repudiate it, but the minor can repudiate it during his minority. On attaining majority, he has to exercise the option, within a reasonable time, of whether he would continue the carry on the policy or not.

Persons of sound mind alone can enter into a contract. A person is said to be of sound mind for the purpose of making a contract if at the time when he makes it, he is capable of understanding it and of forming a rational, judgment as to its effect upon his interest. A person who is usually of unsound mind, but occasionally of sound mind may make a contract, when he is of sound mind. A contract with an alien enemy is also void.

7.4.3. Free consent of the parties:

Both the parties must be of the same mind at the time of contract. The contract is not made through coercion, undue influence, fraud, misrepresentation or mistake. In life insurance, both parties must know the exact nature of the risk to be underwritten. If the consent is not free, the contract is voidable at the option of the party, whose consent was not freely given.

7.4.4. Lawful consideration:

The presence lawful consideration is essential for a contract. The consideration need not be in the fort of money only. It may be interest right, dividend etc. It should be anything valuable or to which value may be assigned. In life insurance, the consideration for payment of fixed sum of money at maturity or death, whichever occurs earlier is the premium.

7.4.5. Legal objective:

The contract would be legal, only if the object is legal. The object of a legal life insurance-contract is to protect oneself or one's family against financial losses at the death of the insured. The contract, may be, to provide for financial emergencies that may occur in old age. The objective will be legal, only when there is insurable interest. Without insurable interest, the object of the contract would not be legal. It would be wager contract.

7.4.6. Insurable Interest:

The insured must have an insurable interest in the life to be insured. Insurable interest arises out of the pecuminary relationship that exists between the person who

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takes the insurance policy and the life to be insured, so that the former stands to loose by the death of the latter and stands to gain by his survival. The expected loss must be financial. Insurable interest may be classified into insurable interest in own life and insurable interest in other's life. A person always has an insurable interest in own life. Such interest need not be proved. Moreover, the insurable interest in own life is unlimited and so no limit can be placed to the amount of insurance that one may take on life. However, in practice, insurance companies issue policies of value that seems suitable and within the paying capacity of the policy holder.

Life insurance can be effected on the life of others also, provided the person who takes insurance on the life of others must have an insurable interest in their lives. When insurance is effected by husband on his wife or by wife on her husband, proof of insurable interest is not required. In all other cases of taking insurance on the lives of third parties, proof is required. The wife will suffer financially, if the husband is dead and will continue to gain is he survives. In the same way, the husband is benefited at the survival of his wife and suffers if death of his wife occurs. According to ancient concept, marriage is a contract which is in force till death do us apart, man and wife is one person. Hence, a husband and wife have a mutual, unlimited insurable interest in each other.

In all other cases of insurance effected on the lives of third parties, proof of insurable interest is necessary. A father or mother has no right to insure the life of his or her son, unless some direct financial loss is likely to arise from his death. In the same way, if the relationship between brother and sister, grandparents and grand children meet the pecuniary test of insurable interest, their lives can be insured.

A creditor has a right to insure the life of his debtor to the extent or his debts, because he stands to loose if the debtor dies without paying the debt. Likewise, the partners of a partnership firm have an insurable interest in the lives of their co-partners, as the death could cause financial loss to the remaining partners. An employer has a right to insure the life of his key employee, director or a highly trained personnel during the course of his employment. A surety has an insurable interest in the life of his principal debtor to the extent of his debts.

7.4.7. Utmost Good Faith:

According to the principle of utmost good faith, both the parties, the insured and the insurer, must be of the same mind at the time of contract, because only then the risk

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may correctly be ascertained. They must make full and ttrue disclosure of the facts material to the risk. In life insurance, material facts are age, income, occupation, health, habits, residence family history and plan of insurance. It is not only the insured, but also the insurer, who is responsible to disclose all the material facts which will influence the decision of the insured, whether to take an insurance policy or not. There should be full disclosure of all material facts. Full and true disclosure means that there should be no consealment, misrepresentation, half disclosure and fraud of the subject matter of the insurance contract.

In the absence of utmost good faith, the insurance contract is voidable at the option of the person who suffered loss due to non disclosure. The intentional non disclosure results in frand and it makes the contract void a initial. the uninternational non disclosure is voidable at the option of the party not at default. Once the voidable contract has been validated by the party not at fault, the contract cannot be avoided by him later on. For example, if the insure has continued to accept the premium when certain non disclosure, say, misstatement of age has been disclosed, the insurer cannot invalidate the contract and cannot refuse to pay the amount of claim.

The following are certain facts which need not be required to be disclosed. Circumstances which diminish the risk, facts which are known or reasonably expected to be known to the insurer in his ordinary course of business, facts which the insurer should inter from the information's given, facts which are waived by the insurer, facts which are superfluous to disclose by reason of a condition or warranty and facts which are public knowledge.

7.4.8. Warranties

Warranties are those representations, which are included in the contract and which form part of the contract, either expressly or impliedly. Every information given by the proposer to the insure during negotiations is a representation. The representations may be material or immaterial. If the proposers' representations are false or untime, the contract maybe voidable at the option of the insurer. Warranties are of two types namely, informative and promissory. Informative warranties are those material facts, which the proposer is expected to disclose to the best of his knowledge and belief. Promissory warranties are those statements of his expectations or intentions of that proposer, such as, that his promise not to take up any hazardous occupation. If thee is a breach of warranty, the insurer may render the contract void or he may choose to ignore the breach In case fraud, the contract becomes void.

7.4.9. Proximate Cause:

Causa proxima or Promimate or Proximate cause mean that the cause of the loss must be direct the insured one, in order the make a valid clain. However, this principle is not much of practical importance in connection with life insurance, because the insurer is bound to pay the amount, whatever may be the reason for death. It may be nature or unnatural. But, in certain circumstances, this principle is observed inlife insurance. Where a policy is issued specifically excluding war and aviation risks, the proximate cause of death assumes importance, if the insured was in the field or is engaged operation of war, only premium paid or surrender value whichever is higher is payable. The value of the policy will not be paid. In case suicide occurs unthin oneyear of the policy or there was an intention to commit suicide, the policy amount is paid at the time of accidental death or injury. Under such circumstances, the proximate cause of death assumes importance.

7.4.10. Assignment:

The life insurance policy can be assigned for a legal consideration or out of love and affection. The assignment, to be effective, must be endorsed on the policy itself or by executing a separate deed to that effect. Proper notice must be given to the insurer, who will acknowledge the assignment. Once the assignment is complete, it become irrevocable. The assignor cannot cancel the assignment, because the title to the policy passes on to the assignee. The life policies can be assigned, whether the assignee has an insurable interest or not.

7.4.11. Normination

The life insurance policy holder can nominate any person to receive the policy amount in the event of his death, either at the time of effecting the policy or at any subsequent time, before the maturity of the policy. Unlike assignment, nomination may be cancelled before unaturity. However, notice of cancellation must be given to the insurer, because the insurer will not be liable for any bonafide payment to a nominee registered in the records. If the nominee dies before the policy matures or the insured expires, the policy amount will he paid to the policy holder or his legal representatives as the case may be.

7.5 MEASUREMENT OF RISK

The risks are measured for fixation of premium to be charged by the insurer. The two methods of calculating premium are value of service and cost of service. Value of service finds out the rate of premium according to the use cf insrance to the policy holder.

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Since the use of insurance to individual differs, the premium rate will also vary. It is difficult the fix different premium rate to each and every policy holder. Moreover, if higher premium is to be charged, it will not attract business. Hence, the value of service principle is impractical to use.

Hence, cost of a service principle can be used to fix premium. The cost normally includes all expenses of the business plus small profit margin. The most important cost to the insurer is the cost of claim. The claims may arise at the death of the life assured or at the maturity of the policy. In annuity contracts, the payments shall continue upto death. Hence, payment of claim, in most cases of life insurance, depends upon death. The main problem before the insurer is to decide when the death will take place. The forecasting of death can be done on the experience of past records and on the experience of medical science. The medical science is useful to modify the knowledge based on past experience which is treated as a basis for germinating future mortality.

Another cost to the insurer is the cost of administration. It includes all expenses of management and other amount for provisions of contingency. The cost of administration may again be classified into fixed cost and recurring cost. The premium charged to meet the amount of claim is called net premium. The inclusion of fixed as well as recurring cost along with cost of claim is called gross premium.

7.5.1. Mortality Table:

A mortality table shows the probable proportion out of the persons living at each age who are expected to die in a year. This proportion is referred to as the rate of mortality for the age, or the probability of death. In preparation of mortality table, persons of a generation, namely, persons of a single age are selected an they are observed upto death. The mortality and survival rates for the generation who are selected at a particular age are considered each and every year. Each year's number living is the previous year's number living minus previous year's number dying and therefore, a persons of on dying year after year, the number of living goes on shrinking till it is reduced to zero and mortality table ends there.

For construction of mortality table, the number of living at the beginning of each age and the number of deaths during the age are required. The mortality table should be constructed to represent the past experience as accurately as possible. The source of getting these data are population statistics. The insurer can get number of living at each age from the censers records and the number of deaths from the municipal and other death records. Such information will help the insurers to prepare the mortality table correctly and easily.

Mortality tables are constructed by determining attained age of large number of selected persons. For example 24 years and 6 months to 25 years and 5 months and 29 days will be treated as the age of 2 years. This is called attained age or nearer age. The selected persons of attained age will be constantly watched and the number of deaths will be recorded during a year. On the basis of such data collected, mortality table will be prepared. A model is given below.

Mortality Table

Age	No.of Persons Living	No.of persons Dead	Death Rate	Survival Rate
25	1,00,000	200	0.002	0.998
26	99,800	299	0.003	0.997
27	99,500	398	0.004	0.966

With increase in age, risk will increase and consequently death rate will also increase. The mortality table compiled from past experience of lives will help to fix claims. A model is give below.

Mortality Table

Age	Expected No. of Deaths for 1 lakh lives of a given age
25	128
30	134
35	178
40	280
45	465

For example, 1,00,000 persons are insured in a year, at Rs.1,000 each. All of them are aged 40. As per the table, it is expected that 280 persons will die at the age of 40. The insurer has to pay 280 death claims for this year. The total claims payable will be Rs.2,80,000. As 1,00,000 persons are insured, the contribution from each would be 2,80,000/1,00,000=Rs.2.80. This is the risk payable by each person. Interest income is not considered for the sake to simplification.

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Check your Progress

1. State whether the following statement is true or false

a. Nomination may be cancelled before maturity.

b. Payment of Claim defends upon death.

c. Under Natural Premium plan, accummulation of reserves must be required

d. Liquidity means convertibility into Cash

e. In the Case of Annuity Premium, the payment of Instalment starts at the middle of the Contract

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7.5.2. Interest Factor:

The second factor after death rate is the interest factor for calculation of premium to be charged, because the premium is obtained in advance and the claim is paid subsequently. The insurer can earn certain rate of interest. The benefit of such interest should be passed on to the policy holder. Insurers are generally conservative in assuming such rate of return since the premium is determined in advance, the present value should be calculated, so that, this value at an assured compound rate of interest must be adequate to pay the amount of claim. the present value is calculated by the formula:-

$P=S/(1+i)^n$, where "P" stands or the present value, "S" for given sum, "i" stands for assumed rate of interest and "n" for number of years.

7.6 COMPUTATION OF PREMIUM

The premium is of two types, net premium and gross premium. The net premium is based on the mortality and interest rates, the gross premium depends upon the mortality rate, assumed interest rate, expenses and bonus. Hence gross premium is the premium which the policy holders are required to pay. They do not know the net premium. Hence, the gross premium is known as office premium. It includes net premium and an addition fixed to cover cost of claim, expenses of business and bonus. This addition is called loading.

Net single premium is that premium which is received by the insurer in a lump sum and is exactly adequate along with the return earned, to pay the amount of claim, wherever it arises, whether at death, maturity or even at surrender. The formula used for calculating net single premium for one year in term insurance present value of claims = No. of Deaths x Amt. of Claim x Present Value of Re.1

For example, if the assured is Rs.1,000 the rate of return is 3% the net single premium for a five year term policy can be calculated as per the following table.

Year	Age	No.of Persons	No.of Deaths Claims	Amt. of Value @ per death	Present Value of 3% for Re.1 $(1/1+0.03)^n$	Present Claim [4x5x6]
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1	40	96,463	273	1,000	0.971	2,65,083
2	41	96,190	302	1,000	0.943	2,84,786
3	42	95,888	336	1,000	0.915	3,07,440
4	43	95,552	375	1,000	0.888	3,33,000
5	44	95,177	418	1,000	0.863	3,60,734
				Total		15,51,043

Present value of all claim is Rs.15,51,043 Total number of policies for 1 year is 96,463 Therefore, premium per policy is 15,51,043/96,463 = Rs.16.18

In case of adornment policies, payment is based on death and survival, Hence, net premium is to be calculated on death and survival rate. Premium for survival rate is to be calculated as follows:

Premium=Probability for survival x Policy amount x Present value @ 3% for Re.1

It we continue with the above example and if probability of survival is 0.981, premium 0.981x1,000x0.863 = Rs.846.60. Hence the net singly premium for both death and survival rate is Rs.16.18+Rs.862.78 likewise, premium is calculated for different type of policies differently moreover, gross premium is arrived at by adding loads to the net single premium.

7.7. RESERVE

In insurance companies, the term reserve represents a liability, which is to be settled by the insurer. In commercial organizations, reserve represents accumulation of profit. The reserve is that fund, which, together with future premiums and interest will be sufficient to pay the future claims. It may also mean that reserve is the difference between net premiums collected and claims settled. The premium receipts are more than the payments in the beginning and less after a point, because of heavy mortairty claims will be the increase sources of Reserve.

7.7.1. Premium

The main source of reserve is the premium since different insurance plans involve collection of premium differently, accumulation of reserve will vary.

a) Assessment Premium Plan:

Under this plan, the members is the premium of a group would contribute to a fund, which could be used in rendering assistance at the time of death to the deceased's dependents. The payment is made by contribution only at the time of death. Hence, there is no need to accumulate amount for payment of the claim.

b) Natural Premium Plan

Under this plan, the rate of premium will increase as the insured groups older. It is based on the risk. Since risk increases as time passes, the premium charged from the policy holder also increases. Hence, it is called yearly renevalue premium plan. The reserve is not accumulated, because premium increases as cost of insurance increases.

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c) Level Premium Plan

Under, this plan, premium to be paid are levelled, so that, same premium is paid every year. The premiums paid in the early years are more than the actual cost determined by the mortality rate with the result that the excess payment of premiums in the earlier years are accumulated as reserve which makes up any deficiency out of lower premium in later years.

7.7.2. Interest

The second source of reserve is interest because the accumulated fund is not remaining idle, but is invested.. Hence, the interest of the investment made out of the accumulated fund is the second source.

7.7.3. Nature of Policy

Nature and duration of policy is an important criterion for building up reserve. If the policy is for a longer duration, the increase of mortality risk in later years may actually reduce the accumulated reserve. Likewise policies under natural premium plan, do not require accumulated of reserves.

The reserve can be calculated by applying either prospection method or by retrospective method. Reserve calculated by either of these methods will give the same result, provided the mortality rates and interest rates remain the same. Under prospective method, reserve is the difference between the present value of further claims and the present value of future premiums. At the beginning of the contract, the present value of future calims is equal to the present value of future premiums. But, as soon as, one premium is paid, the present value of future premium. The difference will go on increasing as years pass. The difference between the two must be held by the insurer. This difference is reserve and the insurer must told the amount equal to the difference to pay the amount of claim.

Under retrospective method, the reserve is calculated by reference to past experience. The reserve represents the net premiums collected by the insurer plus interest at an assumed rate less the death claim settled. The method of calculation of reserve is given below:

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For example, there are 100 policy holders who took insurance policy for Rs.10,000 for a term of 10 years. They are paying Rs.1,000 as net premium. Assuring the rate of interest at 10% the reserve will be calculated as follows:

I Year	Rs.
Net Premium of 100 persons at Rs.1,000 each	**1,00,000**
Add: Interest at 10%	10,000
	1,10,000
Less: Claims Settled	Nil
II Year	
Net Premium (100x100)	1,00,000
Add: I Year terminal reserve	1,10,000
	2,10,000
Add: Interest at 10%	21,000
Less: Claims Seltled	2,31,000
(for ex. 10 deaths @ Rs.10,000)	1,00,000
Terminal Reserve	1,31,000

The process of calculating reserve continues till the tenth year. In the third year premium will be paid by only 90 policy holders because ten policy holders passed away in the second year.

7.8 INVESTMENT OF FUNDS

Insurers receive premium from policy holders. The funds are invested to earn a reasonable rate of interest. Such investment will not only increase the total income of the insurers, but also help to invest funds for the economi development of the nation. The main sources of funds are premiums collected, interest earned and saving in expenses.

7.8.1. Principles of Investment

7.8.1.1. Safety

Safety and security of investment is more important than earning maximum profit. Speculative investments, through offered attractive income, are not dependable. Most of the funds collected in life insurance is inrested in Government securities. Safety includes safety of principal and safety of interest.

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7.8.1.2. Profitability

The insurer must earn at least the assumed rate of interest. Safer investment earn lesser income. Insurers must plan an effective investment programme, in which safety of principal is assured along with reasonable rate of return. Major portion of investment must be made in safe securities and a small portion may be invested in profitable securities. In also be created to meet any possible losses on account of fluctuations in return.

7.8.1.3. Liquidity

Liquidity refer to convertibility into cash. Investment must be such that they can be easily and quickly converted into cash in times of need. A rough estimate can be made of the payment of claims, surrender values, policy loans and regular expenses. Investments are so make that the maturities will occur at intervals adjusted to meet the needs of maturity obligations. If large amount of cahs is kept, it is not possible to earn interest and hence, only the minimum required funds need be kept in the form of cash.

7.8.1.4. Diversification

Diversification of investments is absolutely essential for reducing risk. If entire funds are invested in a singly industry or area, there will be a high degree of risk. The principle of do not put all eggs in the same basket is very relevant incase of investments. The diversification may be in different industries firms, and even geographical areas.

7.8.1.5. Social objectives:

Investments should be made in social institutions such as municipal boards, hospitals, brousing societies, health centres and schools because they will help in reducing mortality which will tend to reduce premium rates. The life insurance business will increase consequently. Such investments help to increase the economic development of a country.

7.8.2. Types of Investments

7.8.2.1. Government securities

Government securities are considered to be the safest securities, in the sense that there are no substantial fluctuations in their values. The returns on these securities though not higher, are steady. Investment in Government securities will arrangement the funds of the Government, which will be used for nation buildings activities.

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7.8.2.2. Industrial securities

Investmnt in shares and debenture of business and industrial units are also better sources of investments. Debentures are better source than shares, because they are secured. Moreover, interest is paid, whether the company is earning profit or not. Debentures are also redeemed after the epiry of the stipulated period. Of shares preference shares are better. If there is profit, preference divided is paid first at the fixed rate. In case of cumulative preference shares, arrears of dividends are also payable. On winding up of the company repayment of preference share capital is first made, before anything is paid to equity shareholders. Hence, equity shares are not desirable source of investment.

7.8.2.3. Mortages

Loans are granted on the mortgage of properties such as buildings and land Though such loans are given for an amount lesser than the value of the property, they are expensive to initiate and to service. The marketality of such properties is also not easy. It is a time consuming process. Mortgages as a form of investment requires skill and experience in their management.

7.8.2.4. Real Estate

The purchase land and buildings is known as investment in real estate. There are huge fluctuation the prices of real estate. Moreover, the real estate does not guarantee or constant and higher income apart from the lesser marketability. It requires specialized knowledge also. Hence, investment in real estate is not suitable.

7.8.2.5. Policy Loans

Policy loans are given to the policy holders against the surrender value of the policy. The amount of loan and interest will not be more than the surrender value. The loan, if not paid, can be taken over from the amount of surrender value. The liquidity factor is also not bright. The rate of expenses in handling such loans are very high. However, this is an important investment, because it improves business and customer relationship and provides facilities to the policy holders.

7.9 CLASSIFICATION OF POLICIES UNDER LIFE INSURANCE

Different types of policies are issued to policy holders to satisfy their special needs. The basic elements covered by these policies are protection and investment. Life insurance provides against premature death and a fixed sum at the maturity of the policy. Let us study the various types of policies offered.

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7.9.1. Whole life policies

Whole life policies are issued for life. It means that the policy amount will be paid at the life assured. The life assured, cannot get the policy amount during his life time. Only his dependents will get the advantage of this policy. The whole life policies can be effected either by payment of single premium, continuous premium or limited premium. The single premium payment is not very common. In continuous premium payment, premium is to be paid upto the life of the policyholder. This method is not favoured by the policyholders, because only the dependents of the life assured get the benefit, though the policy holder makes payment till death.

The limited premium payment is the most popular form of whole life policies, because it is convenient to the policy holder to arrange the payment of premium during his income earning period. If the policy holder survives the premium paying period, the policy continues in full force, though no further premium is required to be paid. If death occurs within the premium paying period, his dependents will receive the policy amount and no further premium is required to be paid.

7.9.2. Convertiable whole Life Policy

This is a whole life policy, which gives its holder an option to get it converted at the end of five years into an endowment policy. If this option is exercised, the policy becomes an endowment policy. If it is not exercised, the policy continues to be a whole life policy. The policy is designed to meet the needs of the young man, who is on the threshold of his carrer and has prospect for increase in income after a short period. If the policy is converted into endowment, the premium is suitably increased. However, no difference in premiums for the previous five years and interest thereon will be charged. The policy would be entited to bonus at the rate applicable to endowment assurance.

7.9.3. Straight term or Temporary Insurance

This particular insurance is called a two year temporary assurance policy. The sum assured will be payable only in the event of the life assureds death occurring within two year from commencement of policy. A single premium is required to be paid at the beginning. The policy is not entitled to any surrender value and no loan can be granted on the security of the policy. This policy is beneficial to the dependents who are required to pay estate duty and to those persons who age given charity or donation of fixed property.

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7.9.4. Renewabel Term policies

These policies are renevable at the expiry of term for an additional period, without medical examination, but the premium rate will be altered, according to the age attained at the time of renewal. This policy is beneficial to those whose health are deteriorating and will be uninsurable at an advances age. With the help of this policy, they continue to enjoy the insurance benefit without going through fresh medical examination. However, the premium rate will be increasing according to the attained age. Payment is made only in the event of death.

7.9.5. Convertible Term Policy

Under this policy, option to convert it into whole life or endowment policy is available. The life assured has an option to convert this term policy (issued for a limited term) into either a limited payment life policy or an endowment assurance policy, without having to undergo fresh medical examination at any time during the speicifked term, except during the last two years. If the option of conversion is exercised, a new policy under the limited payment life plan or endowment assureance plan will be issued as the case may, subject to the rates of premium and terms and conditions prevailing on the date of conversion. This plan is of much use to those who are initially unable to pay the larger premium required for a whole life or endowment policy. The premium rate of considerably lower.

7.9.6. Pure Endowment Policy

The sum assured is payable on the life assureds surviving the endowment term. In the event of his death within the term, premiums paid may be returned. The pure endowment policy is the opposite of term policy, because the insured is paid if he survives in pure endowment whereas if he dies in term policy Pure endowment policy is for the benefit of the policy holder and term policy is or the benefit of others. This is beneficial to those, who, for reasons of health, would be unacceptable for life insurance on standard premium. It is a sort of compulsory saving for old age.

7.9.7. Ordinary Endowment Policy

This policy provides an ideal combination of both the family protection and investment. It is taken out for a specified term of years, the sum assured being payable either or the

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life assureds death during the period or on his survival to the end of the period. Premiums are payable throughout the term of the policy or to a limited period or till the death of the life assured, if it occurs first. Ordinary endowment policy is the combination of term insurance and of pure endowment. Other advantages of this policy is to meet the specific needs of the policy holder such as to meet marriage expenses education expenses or other requirements of the policy.

7.9.8. Joint Life Endowment Policy

This policy covers more than one life under a single policy. Under this policy, the sum assured is payable on the expiry of the term or on the death of one of the assure lives during the endowment period. Premiums are payable throughout the endowment period or till the prior death of any one of the lives assured. The premium is calculated with certain modification according to the age of all insured lives. Paid up and surrender value are payable on the policy. The Policy is suitable to partners of a firm, because, on the death of a partner the business can be continued by the remaining partners with the policy amount. Policy can be taken on the lives of husband and wife.

7.9.9. Fixed Term (Marriage) Endorement Policy

Under this policy, the sum assured is payable at the end of the stipulated period, but the premium ceases if death of the policyholder occurs earlier. In such an event the policy will remain fully paid until the maturity date, but the beneficiary may discount the policy before maturity. This policy is designed to meet the needs of a family man who wants to make available a certain sum for marriage of a female dependant.

7.9.10. Double Endorment Policy

Under this policy, if the assured dies during the endorment period, the basis sum assured is payable and if he survives to the end of the terms, double of the sum assured is paid. Premiums are payable throughout the endorment term or till the prior death of the life assured. This policy is beneficial to those who are confident of living long, hut would like to have some cover in the event of early death. the investment elements is higher than the protection element in this plan.

7.9.11. Money back policy with profits

The money back policy is useful to those who, resides desiring to provide for their old age and family, feel the need for lump sum benefits at perrodical intervals. For

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a policy with a term of 12 years, 1/5th of the sum assured becomes payable on the life assureds surviving 4 years, a further 1/5th of the sum assured becomes payable on his surviving of year and balance 3/5th of the sum assured becomes payable on his surviving to the end of the term of 12 years.

For a policy with a term of 15 years, 1/4th of the sum assured becomes payable on the life assureds surviving 5 years, a further 1/4th sum assured becomes payable on his surviving 10 years and the balance ½ of the sum assured becomes payable on his surviving to the end of the term of 15 years.

For a policy with a term of 20 years, 1/5 the of the sum assured becomes payable on the life assureds surviving 5, 10 and 15 years and the balance 2/5the of the sum assured becomes payable on his surviving to the end of the term of 20 years.

However, in the event of death at any time within the selected term, the full sum assured is payable without any deduction or adjustment for the amount that may have been paid earlier by way of survivance benefit. The bonus addition to the policy will be reckoned on the full sum assured and are payable at the end of the selected term at years or at the life assureds death, if it occurs earlier.

7.9.12. Children's deferred Endowment Assurance Policy

A parent or guardian or a near relative of a child may take this policy, under which the proposer pays the premium during the first few years and by the life assured there after. The low premium rate under this plan is a great attraction. A parent can help his children by taking a policy at a rate which is considerable lower them what they would be called upon to pay when they attain majority another advantage of this policy is that the habit o thrift is developed among young children. The cash thrift is developed among young children. The cash value, if the policy is discontinued before or at majority, can be available for meeting specific expenses of education and marriage. The policy is taken on the life of the child and not on the partent. The parent is merely a proposer and is contracting on behalf of the child. The risk does no commence immediately on the issue of the policy, but only on completion of 1 or 21 years of the child, namely when the child attains majority.

In the event of the assureds death before the deferred date, namely, the date of commencement of risk, the policy shall stand cancelled and all premiums will be repaid.

It is obligatory on the life assured to adopt the policy in writing at any time after attained majority, but before the deferred date. On such adoption, the policy will be deemed be a contract between the insurer and the life assured. Policies under this scheme will not he issued for deferment period of less than 4 years.

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7.9.13. Children Anticipated policy with profits:

This policy can be taken by the parent or legal gnaradian or any near relative on the life of child on whose life, risk will commence at the age of 18 years or 21 years as required by the proponent. The policy will automatically vest in the child at the end of the deferment period, namely, on the date of commencement of risk on the child's life. Half of the premiums paid during this period will be paid to him in lump sum. Risk will commence on the deferred date and full sum assured will be payable or survival of the life assured to the date of maturity or on his death, if occurred earlier. The policy will attach bonus from the deferred date at the endowment assurance rate. Policies under this scheme will not be issued for deferment period of less than 4 years.

7.9.14. Jeevan Sakthi:

Jeevan Sakthi is the new joint life plan with a difference. The plan is designed to give total protection to the working couple. The basic sum assured together with vested bonuses are payable in the event of survival to maturity of either or both of the couple. In the event of the first death of any one of the lives assured, the survivor gets the basic sum assured. Again, basic sum assured with nonuses is payable to the nominee in the event of premature death of the second life partner. The premiums under this policy ceases on the first death and the surviving partner need not pay any more premium. Inspite of such non payment of premium after the first death,the policy will continue to participate, sum assured and the nonuses will accure till the final settlement.

7.10 ANNUITES

An annuity is a periodical level payment made in exchange of the purchase money for the remainder of the life time of a person or for a specified period. The recipient is called annuitant since at the time of death, the insurer does not sinffer loss, medical examination is not necessary. However, age proof is essential at the time of the proposal. The payment of annuity generally continues upto the life. So, the premium rate is determined according to longevity.

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7.10.1. Kinds of Annuities:

7.10.1.1. Immediate Annuity:

The immediate annuity comes into effect immediately after the end of the first income period. For example, if the annuity is to be paid annually, then the first instalment will be paid on the expiry of one year. The annuity can be paid either annually, half lyearly, quarterly or monthly. The purchase money is caollected in single instalment. Evidence of age is always asked for at the time of entry.

7.10.1.2. Annuity Due:

Under this annuity, the payment of installment starts from the time of the contract. The first payment is made as soon as the contract is finalized. The premium is generally paid in single installment, but may be paid in installments also. The difference between the annuity due and immediate annuity is that the payment for each period is paid in its beginning under the annuity due contract, while at the end of the period in immediate annuity contract.

7.10.1.3. Deferred annuity:

Under this annuity, the payment of annuities starts after a deferment period or at single premium or in instalments. The payment of premium continues until the stated date for commencement of the instalments or until prior death of the annuitant. At the death, the premiums may be returned without interest. The deferred annuity can be surrendered for cash at the end of or before the determent period. No surrender value is payable after the deferment period. This type of annuity is useful to those who desire to provide a regular income for thermselve and their dependents after the expiry of a specified period.

7.10.1.4. Life Annuity

This annuity offers regular income to the annuitant throughout his life time. No payment is made after his death. So, if the arrvitant dies recerving all the amounts of the purchase price, he at loss. But, if he survives for a longer period than expected, he is benefited by this annuity.

7.10.1.5. Guaranted minimum Annuity

Annuity payment is guaranteed by the insurer upto specified or period. If the annuity dies before the specified period, annuity will continue upto the unexpired period. This annuity is two types, namely, Immediate annuity with guaranteed payment and Deferrd annuity with guaranteed payment.

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(a)Immediate annuity with guaranteed payment

Under this annuity, payment is made for a predetermined period, at times, even after death of the annuitant. If the legal representative of the annuitant do not wish to continue receving payment, the difference between the purchase money and annuity instalments already paid are returned as a lump sum payment will be made upto the period whether annuitant is alive or dead within this period end if the annuitant survivers after the period, he is paid the annuity upto this survival.

(b) Deferred annuity with guaranteed payments

During the deferment period, there is no difference between this annuity and ordinary deferred annuity. After deferment period, the payment will continue for a fixed period and upto life thereafter. This policy also guarantees refund of cash value of the balance of annuity where the insure promises to pay a lump sum to the beneficiary in the event of death of annuitant, calculated as the difference between the total of annuities received and the purchase price.

(c) Retirement Annuity Policy

This annuity is useful to employees at the time of retirement. During the life of the annuity, no sum other than the annuity is to be paid. The annuity must commence between the ages of 58 and 68. The annuity payable shall not be capable of surrender, commutation or assignment. The annuity will normally be payable for the life of the annuitant, but it may be payable for a fixed period irrespective of the death of the annuitant.

7.10.2. Difference between annuities and Life Insurance Policies.

The annuity is a protection for living long, where as the life insurance is a protection against premature death.

The premium in annuity contract is calculated on the basis of logerity of the annuitant, whereas the premium in life insurance is based or mortality of the life assured.

The annuity is taken for one's own benefit, whereas, life insurance is taken generally for the benefit of others.

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In annuity contract, the payment is made normally upto death, whereas in life insurance, the payment is made on death.

The annuity contract generally liquidates the accummurated funds, whereas, the life insurance contract provides gradnal accumulation of funds.

7.11 CONDITIONS OF POLICY

7.11.1. Conditions Relating to Commencement of Risk

7.11.1.1 Commencement of risk

The risk will commence when the first premium is offered and accepted by the insurer. If premium was paid along with proposal form, the date of letter of acceptance will be the date of commencement of risk. After acceptance of risk, the insurance policy containing terms and conditions of the insurance is issued.

7.11.1.2. Proof of Age

The proof of age must be produced at the time of proposal, because the rate of premium depends upon the age of the life assured, the insure does not with hold the issued of the policy for want of proof of age, but does not admit any claim unless the age is proved to the satisfaction of the insurer. However, if it is subsequently found that the age at entry was mentioned lower then the correct age, the assured sum is reduced to such amount as would have been purchased at the true age. If the actual age comes out to be lower than the stated age, the difference is either refunded or adjusted towards future premium or policy amount.

7.11.2. Conditions of Premiums

7.11.2.1. Payment of premiums

The premium rate if calculated annually, but for the convenience of the assured, it can be paid half hearly, quarterly or monthly. When premiums are not annual but fractional and if death takes place before all the premiums have fallen due for the current policy year, the insurer deducts the unpaid instatments of the premiums from the assured sum at the time of settlement of claim.

7.11.2.2. Days of Grace

Policy holders are required to pay the premiums to the insurers on or before the due dates. But, for convenience of the policy holder, certain additional periods called

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days of grace are allowed to pay the premiums. If the insured pays premium within the days of grace, the policy would not lapse. Due calendar month not less than 30 days of grace is allowed for payment of yearly, half yearly, quarterly premiums and fifteen days for payment of monthly premiums. The days of grace are to be counted excluding the date of the premium. When the days of grace expire on a Sunday or a holiday, the premium must be paid on the following working day.

7.11.2.3. Premium Notice

In order to remind the policy holder to pay premium promptly, notice of premiums falling die will be regularly sent to him except in case of policies for which the mode of payment of premium is monthly.

7.11.3. Conditions relating to continuation of policies

7.11.3.1. Indisputabel clause

In order to protect the interest of the assured, indisputable clause is added which provides that the policy will not be disputed on grounds of unintentional misstatement misrepresentation or non disclosure of a material fact after two years of the issue of the policy. However on ground of fraud or for non payment of premium, the policy can be disputed at any time during the currency of the policy.

7.11.3.2. Alteration of policies

The insurer permits certain alterations in the terms and conditions of the policy at the request of the policy holder. The insurer has the right to turn down such request without assigning any reason. Alteration may relate to change of class of policy, term of the policy, reduction or increase in the sum assured, change in the mode of premium payment, splitting up of a policy into two or more policies and so on. The insurer generally does not permit alterations which increase the amount of risk to the insurer.

7.11.3.3. Non Inclusion

Standard premium rates are not sufficient to cover the risks of war mortality. So war clause is not included in policies, If such clauses are to be included, it will be specifically mentioned that if death occurs due to war, the liability of the insurer is limited to the premium paid or surrender value, whichever is higher. The total sum assured not be paid.

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In the same way, the insurer does not insure persons engaged in hazardous occupations. If their lives are to be insured, they have to pay extra premium.

7.11.3.4. Loss of Policy

The policy document is an evidence of the contracts between the insurer and the insured. The policy holder should preserve the policy carefully till contracted amount under it is settled. If the policy is lost or destroyed, the insured must inform the insurer. On the satisfactory evidence of loss or destructions the insurer will issue a duplicate policy, after advertising the fact and will charge the assured the fee for insuring the duplicate policy.

7.11.3.5. Loans

The insurer grants loan on the security of the surrender value of the policy. Loans are not granted on certain types of policies where surrender values are not accumulated as in the case of money back polices. Loans are granted on unencumbered policies upto 90 per cent of their surrender value.

7.11.3.6. Nomination

The policy holder when effecting the policy or at anytime before the policy matures for payment, nominate a person or persons, to whom the sum assured shall be paid in the event of his death. If the policy matures by expiry of time, the policy amount is payable to the insured himself and not to the nomiee. When such nomination is made for the first time, the insurer will register it, even if no notice is given, provided the nomination is in order. But for cancellation and changes, the insurer insists on a notice of nomination.

7.11.3.7. Assignment

The policy holder can make an assignment or transfer of his policy only by an endorsement on the policy itself or by a separate instrument, signed by both the assignor and the assignee and attested by at least one witness. The assignment may be made with or without consideration. The insurer must be given a notice of such assignment. The insurer must be given anotice of such assignment. The insurer has to record the fact of the assignment and has to give a written acknowledgement of receipt of such notice. As a result of assignment, all the right and liabilities under the policy will be transferred to the assignee. In case of absolute assignement, all rights, title and interest of the assignor will pass to the assignee without reversion to the former or his representatives in any event. In case of conditional assignment, the right may revert back to the assignor depending upon the condition stated.

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7.11.3.8. Double Accident Benefit

This double accident benefit provides for payment of double the usm assured on death by accident. The main condition is that death must have occurred mainly die to accident. The benefit is available to certain limited proposals.

7.11.3.9. Disability Benefit

Under disability benefit, if the life assured is disabled by accident from earning his livelihood, he will be exempted form paying premium on his poloicy, falling due after the date of disablement. The example of permanent disablement are loss of sight of both eyes, or amputation of both hands at or above wrists or amputation of both feet and hands. The extended disability benefit provides for waiver of premium and also for payment of an amount equal to the sum assured on permanent total disability as a result of an accident. This benefit is available by paying extra premium of a nominal amount.

7.11.4. Lapse conditions

7.11.4.1. Lapse of policies

The insurer shall remain liable for the payment of the claim so far the assured continues to pay the premiums. When they fall due. If the policyholder fails to pay any of the due premiums within the days of grace, the insurer's liability ordinarily ceases under the policy and the contract comes to an end. Thus the policy is lapsed and all the benefits related to the policy are terminated. The insurer, however, provides certain alternative to help the insured at the time of lapsation.

7.11.4.2. Revival of Lapsed policies

If a policy lapses by non-payment of premium within the days of grace, it may be revived to the full policy amount at any time during the life time of the life assured but within a period of five years from the due date of the first unpaid premium and before the date of maturity. The revival is possible with in six months from the due date of the first unpaid premium without evidence of health on payment of the premiums in arrears with interest at the rate of 7 ½ percent per annum compounded half yearly. The revival after the first six months from the due date of the first unpaid premium but before five years from the due date of the first unpaid premium will be effective only on satisfactory production of evidence of health and habits of the life assured and no adverse change in personal or Family History or occupation.

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7.11.4.3. Surrender value

When the assured is unable to revive his policy, he can surrender his policy and can get cash surrender value. With this payment, the contract comes to an end and the assured will get the cash value without any liability to pay further premiums. In India, the corporation has guaranteed surrender value if the premiums have been paid for atleast two years or to the extent of one-tenth of the total number of premiums stipulated for in the policy provided such one-tenth exceeds one full years premium. The minimum surrender value allowable under this policy is equal to 30 percent of the total amount of the, within mentioned, premium paid excluding the premiums for the first year and all extra premium. The percentage increases along with the increase in duration of premium payment because the amount of the surrender on any policy depends on its reserve value. Thus, on such policies which do not have any reserve, no surrender value is allowed.

7.11.4.4. Extended Term Insurance

If a premium remains unpaid at the end of the days of grace and the policy has been in force for at least three years, the insurance will continue as paid up for the full sum assured up to a period called term.

The term depends upon the amount of premium paid. During this period, if the life assured dies payment will made up to the full amount. But, if the assured survives the period, no payment is made. Actually, the amount of premium paid before the lapsation is utilized as a single premium or purchasing term insurance and the duration of the term insurance upon the amount of premium paid for meeting as single premium.

7.11.4.5. Automatic premium Loan

The assured may use the option of automatic premium loan before the maturity of the policy. In this case if the assured is unable to pay the premiums the insurer will not allow the policy to lapse but will automatically pay the premiums out of the net surrender

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alue. The assured can repay the unpaid premiums with interest at any time while the policy is so kept in force without furnishing evidence of insurability. If the whole of surrender value is exhausted by advances on account of payment of premium, the policy will lapse and can be revived only after payment of all the premiums unpaid and interest thereon.

7.11.5. Claims conditions

7.11.5.1. Settlement of claims

The policy amount becomes payable either on the assureds death during the term of insurance or on his surviving till the end of the term i.e., on maturity. In case of death claims proof of death, proof of title and age proof are essential. In case of maturity proof of title and age proof are required. The age proof is required only when the age was not admitted before the claims. In atutrity claim, the policy holder is generally advised well before the actual date of maturity in order that the necessary papers may be completed. The proof of death may be certificate from the doctor who attender the deceased in his last illness, or certificate of Registration of the Death by the official Registrar of Deaths, or certificate from employer identifying the deceased or if the deceased was not in service a certificate of identity from a responsible person acquainted with the deceased. In case of assignment and nomination, or assurede having the policy right, no proof of title is required. In other cases, proof of title is essential, the probate of will or succession certificate or Administration Generals certificate may be used as a proof of title.

7.11.5.2. Settlement Options

The claim amount may be paid in cash or in installment. The installment payment may be of different types; payment of interest annually for a particular period or up to survived and the sum assured at a time may be paid. Annuity may be purchased for life or for a particular period and life thereafter.

7.12 SURRENDER VALUE

When the insured wished to surrender his policy or fails to pay his premium, reserve is no longer accumulated and the insured, generally, is given a surrender value. The surrender value will not be equal to the accumulated reserve because certain epenses

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or losses are involved in payment of surrender values. now, the definition of surrender value can be as that amount of premium paid which is returned to the policy holder at the time of surrendering the policy. Normally no surrender value is paid if the policy lapses within two or three years of its issue because huge expenditure are involved during the inception of the policy. It has been realized that the insures may return the excess of receipts over expenditure only after two years of the policy. In India, the policy can be surrendered for cash after the premiums have been paid for at least two years or to the extent of one-tenth of the total number, stipulated for in the policy, provided such one-tenth exceeds on full years premium.

7.12.1. Bases of calculating surrender values:

There are two bases of calculating surrender values: 1. Accumulation Approach 2. Saving Approach.

1. Accumulation Approach

Under this approach, surrender value is the accumulation of overcharge sin the net premium, which upon the surrender of the policy is no longer required to pay the amount of claims, therefore, theoretically he should pay all the accumulated reserve but if it is allowed, the insurer will be left very small amount for meeting other obligations because a huge expenses are involved at the time of surrender.

The accumulation approach is very scientific because it allows surrender values to all types of policies, whereas in practice surrender values on the terms policies and pure endowment policies are not allowed because there the question of payment may be losing when claims would not arise on the policies.

The accumulation approach regards reserve for policy as the basis of distribution of surrender values. The reserve is calculated in this case on gross premium. So the expenses are also dedicated form the premiums received. Thus, the reserve would be equal to all the premiums paid and interest earned thereon minus shares of death claims and of over all expenses of the insurer. The surrender value can be the largest amount which the insurer can pay without going into loss. The full amount of reserve to a particular policies cannot be given as a surrender value because there are certain expenses and loss because of surrendering the policies. Thus,

Surrender value = Full Reserve – Surrender charges

Check your Progress

2. The Insurer grants loan on the security of the
   a) Surety
   b) Surrender value of the Policy
   c) Jewellery
3. Under life Insurance contract, the proposal is required to submit
   a) Age proof
   b) Professi
   c) Edudcational Qualification
4. Both the parties must be of the same mind at the time of contract - implier
   a) offer
   b) Legeal procedures
   c) Free consent
5. Accumulation of funds means
   a) Reserves
   b) Asset
   c) Loans

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7.12.2. Surrender charges

The surrender charges are those expenses and losses which occurred on account of a surrender or lapsation of policy. The surrender charges are discussed below:-

i. Initial Expenses

In the beginning of the contract, certain expenses are involved for processing the proposals, payment of commission to agents and medical officer, correspondence and issuing of policy. The initial expenses are so high that the first years premium is unable to meet all the expenses. These expenses, actually are recouped after years continuation of the policy. Moreover, the initial expenses involved are equally distributed throughout the premium paying period. If policy is lapsed or surrendered before maturity, a part of the initial expenses are left unpaid. So, it is a justified matter to charged the unpaid initial expenses from the reserve of the policy which is surrendered if it is not done, it would be a great injustice to remaining policy, holders who are willing to continue the policy. The surrender values are lesser in the beginning and higher at later stage because initial expenses to be recouped in the beginning are more than at later age.

7.12.3. Adverse Financial Selection

During the period of business depression, the surrendering of policies weaken the financial standing of the insurer because at that time most of the policy holder will rush for surrender values and the insurers funds will be reduced to minimum. In such cases the policy-holders should not be allowed to receive surrender values more than the realized values of the invested funds. The insurer has to liquidate some assets at depressed prices. The demand of surrender values necessitates some liquid assets with the insurer, which means the insurer is unable to earn sufficient amount on the liquid assets.

7.12.4. Adverse Mortality Selection

It is well-known fact that the persons in extremely poor health are not likely to surrender their policies. They will beg, borrow or steal to maintain the protection. Those who do surrender are expecting longer lives than those who do not surrender. Consequently at every surrender, the average or actual mortality tends to increase more than the assumed mortality. Thus, the increases mortality should be adjusted while surrender value is permitted.

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7.12.5. Contribution to contingency Reserve

While calculating gross premium a small amount for contribution to contingency reserve is charge from the policy holders to meet the sudden and accidental rise in claims due to wars and epidemics. If the policy is surrendered in the beginning, the contribution is left unrealized.

Contribution to profits

The policy is expected to contribute a fund towards the profit. If the policy surrendered, the expectation is lost. So this contribution should also be treated as surrender charges while permitting surrender of policy.

7.12.6. Cost of surrender

The insurer will incur a certain amount of expenses in processing the surrender of policies. Sometimes, the cost of surrender is, like other expenses, spread over the premium paying period. In early surrender the cost is left unrealized and a deduction form the reserve is permitted.

These expenses and losses are estimated by the actuary. He tries to allow maximum surrender values keeping all the above factors.

7.12.7. Saving Approach:

An insurer is responsible for payment of claims whenever of claims whenever it may arise but if a policy is surrendered the insurer is relieved of its obligation for payment of the assured sum. He is in a position to save something due to non-payment of claims. Thus, where the insurer is relieved of the responsibility of payment of claims he is in a position to return some amounts to be insured. But where he may not be required to pay the claims, he is not relieved of the responsibility and no surrender value can be given to the policyholders.

The saving approach is more scientific because it reveals the reason of payment of surrender value. Thus it forbids payment of surrender values on term and pure endowment policies and agrees to pay the surrender amount on whole life and endowment policies.

Under this method, the surrender value is paid in lieu of the claim amount. Here it is to be understood that the amount of saving in non-payment of claim can be calculated

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only after considering various transactions from the inception of the policy up to its surrender and from the date of surrender up to the maturity or deaths. had, instead of surrendering the policy, the insurance continued, the insurer would have received the level premiums on the policy and have earned interest on invested amounts and would have occupied certain expenses. Thus, at the surrender of the policy, the insurer does not get certain income and has not to occur future expenses in relation to the policy. The incomes or expenses will continue up to the policy life. Therefore, the life expectancy is to be known while determining the saving in expenses or loss of income. So, at the time of surrender of the policy, it is expected that the policy would have continued up to the maturity or till end of mortality table. The surrender value on a policy can be calculated as below:-

Surrender value = (Sum assured +Accumulated value of future expense+ Future revesionally bonus, if participating policy)- (Accumulated value of all future premiums +expenses incurred in processing the surrender value)

On the basis of above formula, at the time of maturity or death, the surrender value is calculated, but it does not mean that the surrender value is paid only at that time. A provisional sum, called minimum surrender allowance, is paid at the time of surrender and then at the time of maturity or death the surrender value is adjusted. The adjusted amount will be the full surrender value minus the accumulated value of the minimum surrender allowance.

7.13. KEY TERMS

- **Nomination** : Policy holder can nominate any person to receive the policy amount in the event of his death.
- **Mortality Table** : It shows the probable proportion out of the persons living at each age who are expected to die in a year.
- **Annuity** : An annuity is a periodical levels payment made in exchange of the purchase money for the remainder of the life time of a person or for a specified period.

Life insurance can be considered as the best form of savings, because it guarantees full protection against risk of death of saver. In the event of death, full amount of insurance is paid, while in other savings schemes, only the amount saved is paid. It encourage leng term savings. Loans can also be taken on the security of the policy. To benefit are also offered. A suitable insurance plan can be taken out it meet specific needs, that are likely to arise in future such as children's education, marriage or even periodical need for cash over a period of time.

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7.15 ANSWERS 'TO CHECK YOUR PROGRESS"

1. (a) T (b) T (c)F (d) T (e) F
2. b
3. a
4. c
5. a

7.16 QUESTIONS / EXERCISES

SECTION -A

1. What are the different kinds of annuities under life Insurance.

2. How surrender value is calculated under a policy?

3. How risks are measured in life Insurance.

SECTION - B

4. List out the various factors that affect risk in life Insurance

5. What are the procedures followed for effecting a life insurance Policy?

6. Describe the essential features of life insurance contract.

7.17 FURTHER READING

1. M.N.MISHRA - Insurance Principles and Practice

2. Dr. P.K. GUPTA - Insurance and Risk Management

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Unit - 8 MARINE INSURANCE

Structure

8.0 INTRODUCTION

The Marine Insurance act 1963, defines marine insurance in the following words: "a contract of marine insurance is an agreement whereby the insurer undertakes to indemnify assured, in the manner and to the extent thereby agreed, against marine losses, that is to say, losses incident to marine adventure".

A marine insurance policy may cover a ship in course of building or the launch of a ship or any adventure analogous to a marine adventure. For the purpose of the Marine Insurance Act, insurable property means any ship goods or other movables are which exposed to marine perils. Marine adventure includes any adventure where (i) any insurable property is exposed to marine perils (ii) the earnings are acquisition of any freight, passage money, commission, profit or any pecuniary benefit, or the security for any advances, loans or disbursements is endangered by the exposure of insurable property to marine perils (iii) any liability to a third party that may be incurred by the owner or other person interested in or responsible for insurable property by reason of maritime perils.

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8.1 UNIT OBJECTIVES

- Provides protection for goods transported over water
- Protects the ship power for damage caused by the ship to perils, docs etc.,
- Ocean Marine Insurance is essential to internal trade.

8.2 ELEMENTS OF MARINE INSURANCE CONTRACT

The main elements of principles of Marine Insurance Contract are

(i) Elements of General Contract

(ii) Insurable Interest

(iii) Utmost good faith

(iv) Doctrine of Indemnity

(v) Subrogation

(vi) Warranties

(vii) Proximate Cause and

(viii) Assignment and nomination of policy and return of premium

8.2.1. Elements of General Contract:

In a general must exist. There must be a proposal, its acceptance, lawful consideration and issue of policy having various other conditions written on the back of policy. Proposal form is needed in all insurance contracts. Every Marine Insurance company has its own proposal form.

Acceptance. The Original ship is given to the insured that sings it and thus the proposal is accepted. The under writer can refuse to sign the policy thus no legal claim can arise and non-acceptance of a contract is illegal. Illegal contracts are void.

Consideration. In marine insurance contract the premium is determined on the assessment on the proposal and is paid at the time of contract. The amount of premium is popularly as consideration.

Issue of policy. Having effected the insurance the broker now sent his client a cover note advising the term and conditions on which the insurance contracts is established. The policy is prepared, stamped and signed by authorized person it will form the lawful bond of a valid contract.

8.2.2. Insurable Interest:

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An insured person will have insurable interest in the subject matter where he stands in any legal or equitable relation to the subject matter in such a way that he may benefit by the safety or due to arrival of insurable property or may be prejudiced by its less or by damage thereto or by the detention thereof or may in an liability in respect thereof. Since the ownership and other interest of the subject matter often change from hand to hand, the requirement of the insurable interest to be present only at the time of loss makes a marine insurance policy freely assignable.

Exceptions. There are two exceptions of the rule in marine insurance

(a) Lost or not lost, A person can also purchase policy in the subject matter in which it was known whether the matters were lost or not lost. In such cases the assured and the underwriter are ignorant about the safety or otherwise of the goods and complete reliance was placed on the principle of good faith. The policy is terminated if any one of the two parties was aware of the fact loss. In this case therefore, the insurable interest may not be present at the time of contract because the subject matter would have been lost.

(b) Policy proof of Interest (P.P.I.Policy). The subject matter can be insured in the usual manner by P.P.I. (i.e.) Interested proof policies. It means that in the event of claim underwrite may dispense with all proofs of insurable interest. In this case if the underwriter does not pay the claims. It cannot be enforced in any court of law because P.P.I.Policies are equally void and unenforceable. But the underwrites are generally adhering on the terms and pay the amount of the claim.

The insurable interest in marine insurance can be of the following forms:

1. According to Ownership. The owners are of different types according to the subject matter (a) in case of ships (b) in case of cargo (c) in case of freight.

2. Insurable Interest in Re-assurance. The underwriter under a contract or marine insurance has an insurable interest in his risk and may be re-insuring in respect of it.

3. Insureable Interest in other cases. In this case all these underwrites are included who have insurable interest in the salary and own liabilities. The lender of money on bottomry or resondentia has insurable interest in respect of loan.

8.2.3. The principal or utmost Good Faith.

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The Doctrine of caveat Emptos (let the buyer beware) applies to commercial contracts. But insurance contracts are based upon the principle of uberimae fides (utmost good faith). When this is not observed by either of parties the contract can be avoided by other party.

The good faith clause applies to both parties of the marine insurance contract. The duty of disclosure of material facts rests highly on the insured because he is aware of the material common in other branched of insurance are not used in marine insurance. Ships and cargoes proposed for insurance may be thousand of miles away and surveys on under writer's behalf are usually impracticable.

The assured must disclose all material information, which may influence the decision of the contract. The doctrine of good faith may not be adhered to.

Exception. (1) Facts of common knowledge (2) facts, which are known or should be known to the insurer (3) facts, which are not required by the insurers. (4) Facts, which the insurer ought reasonably to have inferred from the details given to him (5) facts of public knowledge.

8.2.4. Doctrine of Indemnity.

The contract of marine insurance in of indemnity. In no cases the insured is allowed to make a profit out of a claim in the absence of the principle of Indemnity it was possible to make a profit. The insure agrees to Indemnity the assured only in the manner and only to the extent agreed upon. Marine insurance fails to provide complete Indemnity due to large and varied nature of the marine voyage. The basis of Indemnity is always a cash basis as the underwriter cannot replace the lost ship and cargoes and the basis of indemnification is the value of the subject matter. The valve may be either the insured or insurable value. While fixing insured value the cost of transportation and anticipated profits are added to original value so that in case of loss the insured can recover not only value of goods but also a certain percentage of profit. This value is known as agreed value. Doctrine of indemnity applies where the value of the subject matter is determined at the time of loss where the market price is paid this doctrine has been precisely applied.

Exceptions: The following two exceptions are found in Marine Insurance, which is as. (i) Profit allowed and (ii) Insured value price of the loss should be indemnified and the profit should be permitted, but in marine insurance a certain profit marine is also allowed.

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(ii) Insured value. The doctrine of Indemnity is based on the Insurable value whereas the marine insurance is mostly based on insured value. The purpose of the valuation is to be predetermined the worth of the property insured.

8.2.5. Subrogation:

The aim of subrogation is that the insured should get more than the actual loss or damage. After payment of the loss, the insured gets the right to receive compensation or any sum from the third party from whom the assured is legally liable to get the amount of compensation. The main characteristics of subrogation are as follows: -

1. The insurer subrogates all the remedies, rights and liabilities of the insured after payment of the compensation.

2. The insurer has right to pay the amount of loss after reducing the sum received by the insured from the third parts. But in marine insurance the right of subrogation arises only after payment has been made, and it is not customary as in fire and accident insurance, to alter this by mears of a claim, at the same time the right of subrogation must be distinguished from abandonment. If property is abandoned to a marine insurer, he is entitled whatever remains to the property irrespective of value of subrogation.

3 After indemnification, the insurer gets all the rights of the insured on the third parties, but insurer cannot file suit in his own name. Therefore, the insured must assist the insurer for receiving money from the filling suit against the third party; the insurer can receive the amount of compensation from the insured.

8.2.6. Warranties:

Warranties means "Guarantee" for quality of goods, in case of defects in the goods the seller will remedied by the seller but contract of sale still stand. The buyer cannot return the goods and demand the refund of money. But in Marine Insurance Contract, the term warranty has different meaning than sale of goods. Here any breach of Insurance Warranties goes to the root of the contract and gives the aggrieved party the right to avoid the contract.

Warranties are of two types,

(i) Express Warranties and

(ii) Implied Warranties

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(i) Implied Warranties are those Warranties which are not mentioned in the policy but are totally understood by the parties to the contract and are as fully binding as expressing warranties.

In maritime insurance implied warranties are very important. There are,

(i) Seaworthiness of ship

(ii) Legality of venture

(ii) Non-duration

All these warranties must be literally complied with as otherwise the underwriter may avoid all liabilities as from the date of breach.

Exception (i) where owing to a change of circumstances the warranty is not longer applicable (ii) where compliance would be unlawful owing to the enactment of subsequent law.

8.2.7. Proximate Cause

According to marine Insurance Act, Subject to the provisions of the act and unless the policy otherwise provides the insurer is liable for any loss proximately caused by a peril insured against, but subject to as aforesaid he is not liable for any loss which is not proximately caused by a peril insured against.

1. The insured is not liable for any loss attribute to the willful misconduct of the assured, but, unless the policy otherwise provides, he is liable for any loss proximately caused by a peril insured against.

2. The insured will not be liable for any loss caused by delay unless otherwise provided.

3. The insurer is not liable for ordinary wear and tear, Ordinary leakage and breakage. Inherent voice or nature of the subject matter insured, or for any loss proximately caused by rats or vermin, or for any injury to machinery not proximately caused by maritime perils.

8.2.8. Assignment and nomination of policy and return of premium:

A marine policy is assignable unless it contains terms expressly prohibiting assignment. It may be assignment either before or after loss. A marine policy may be assigned by endorsement thereon or on other customary manner.

Ordinarily, the premium once paid cannot be refunded. However in the following cases the premium paid are returnable.

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Equity implies a condition that the insurer shall not receive the price of running a risk he runs. Thus, there the contract does not come into effect or it is held to be void ab initio.

Where the insured is guilty of fraud in obtaining a policy, he will fail in his claim to the sum assured. He cannot ask for a return of the premiums because he will have to allege his own fraud to succeed in his claim and no court will assist such person.

As in the case of every type of insurance a contract of marine is embodied in a policy and must specify the following:

(a) The name of the assured or of some persons who affects the insurance on his behalf. (b) The subject matter insured and the risk insured against. (c) The voyage, or period of time, or both, as the case may be. (d) The sum insured (e) the name of the insurer (f) the rate of amount of premium (g) the risk insured against etc. The contract is concluded when the insurer accepts the proposal and it is not essential for the company to issue policy for this purpose. The contract comes into force from the time of ship or covering note or other customary memorandum is issued, even is such instrument is unstamped. Insurance company may take some time to issue the policy.

8.3. PROCEDURE TO MARINE INSURANCE CONTRACT

Marine insurance may be affected either, with the Lloyd's Underwriter or with Marine Insurance Companies and the policy goes by the name Lloyd's policy or the company policy as the case may be:(a) Company policy. A company policy is that policy which is issued by a joint stock company. Ordinarily, an insurance company is a joint stock company, which carries on business of marine insurance. In India, there is only the marine insurance (under the direct control of General Insurance Corporation of India) and as such, only company policies can be taken out here. (b) Lloyd's policy. In the U.K the Lloyd's Association, each doing as important fraction of the total business, does by the marine insurance companies as well as the business. The Lloyd's is an association of under writers who carry on business of marine insurance in their individual capacities. The London Lloyd's which is the model on which such associations have

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been formed in other countries of the world, is recognized internationally and operate throughout the world. Since the procedure of effecting a company policy and Lloyd's policy varies.

The procedure of taking out a company policy is much simplified and straightforward and the intervention of an insurance broker is not always necessary, through his service may be utilized by those who are not well acquired with the procedure. The procedure involves the following steps:

(1) Selection of the company (2) Selection of Agent or Broker

(3) Marine Declaration Form (4) Assessment of Risk

(5) Payment of premium (6) Issue of cover note

(7) Issue of Policy

8.3.1. Selection of the company:

First of all, the person seeking marine insurance has to select the insurance company. He writes them to quote their lowest rates for the risk. These companies have their scheduled rates of premium chargeable and the merchant can insure direct on payment to requisite amount of premium or indirect through the agent or broker. There are a large number of insurance companies, which are working as subsidiaries of General Insurance Corporation of India. Its four subsidiaries are:(i) National Insurance Company Ltd., Calcutta (ii) New India Assurance Co.Ltd.,Bombay (iii) Oriental Fire and General Insurance Co.,New Delhi(iv) United India Fire and General Insurance Co.Ltd., Madras. These subsidiaries have their head office in Calcutta, Bombay, New Delhi and Madras and a large number of companies are working under them. Some of the important marine insurance companies (which are working under the above mentioned subsidiaries) are: Hanouer Insurance Company, Zurich Insurance Company, Western Assurance Company, Jubille Insurance Company, Atlas Assurance Company Ltd., Eagle star Insurance Company, Hercules Insurance Company, etc.,

8.3.2. Selection of Agent or Broker:

A person who seeks a policy may not necessarily have the proper channel for taking a policy and as such, is liable to undergo disappointment at some stage or the other. In order to avoid this, he may contract an agent to settle the affairs or a broker who possesses a specialized knowledge about the affaire and goings in the insurance

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world. The agent has special approach where an ordinary person has none. He knows the correct procedure and will not only help in the proceedings but will periodically offer sound advice on certain things and steps which to him should be avoided.

8.3.3. Marine Declaration Form

The proposal insured or his agent will fill up a Marine Declaration Form or Requisition Form. This form requires the propose to give all the details about the risk such as name of the insured, the number of cases, the item, the port of destination, the value of the goods (which is 10% higher than the actual value), the name of the carrying vessel, the place where the claim, if any, is payable , in case of any damage, marks on the goods to be skipped etc. This information may either be sent on the phone or may be sent in writing, which is handed over the company either direct or through the agent. The agent will see that the declaration requisition form is in order and will pass on to the insurance company. It is to be noted that the amount for which the insurance is affected is the cost of the goods together with shipping expenses plus 10 or 15 percent added thereto for anticipated profits. It is not customary in marine insurance to fill up the proposal form but the marine declaration form serves the purpose of proposal form.

8.3.4. Assessment of the Risk:

Having received the Marine Declaration form, the company's officials will assess the risk to be insured. The risk insured must be found to exist in the condition as is mentioned in the declaration form. The company's official then, after making an assessment of the actual risk involved, will fix the rate and the premium to be paid by the insured, along with the stamp fee. These calculations are made on the backside of the declaration form filled up the insured.

8.3.5. Payment of premium:

After the acceptance of the declaration form, and the assessment of the risk the premium is to be paid and receipt obtained. The premium may be paid either in cash or through cheque or through any other agreed mode of payment.

3.6. Issue of Cover Note:

After the acceptance of the risk, the company will issue a cover note, subject to the conditions of the company's printed policy and the relevant institute clause,

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if any to the extent of the amount mentioned. The cover note contains details about the name of the company, the name of the insured, amount insured, name of the vessel, port of the destination, port of departure, rate of premium, etc., This cover note covers the property pending the preparation of the final policy. However, the cover note becomes null and void if policy is not obtained prior to or within 24hours of the issue of transport carries receipt.

8.3.7. Issue of Policy:

Then the company will make a final policy on a proper form with full details and stamps and will hand over to the insured.

Effecting Marine Insurance at the Lloyd's. In the U.K. in addition marine insurance companies, a sizeable business is done by the Lloyd's Association of under writers who carry on business of marine insurance in their individual capacities. The London's Lloyd's which is the model on which such associations have been formed in other countries of the world, is in the London Royal Exchange. It originated form a coffee house run by Edward Lloyd's in Tavern Street in 1689 where persons interested in shipping mallere used to meet for gathering shipping information. At that time, though the Electric Telegraphic was not known, yet to satisfy these customers Lloyd's established means of obtaining news about shipping by Semaphore Telegraphs from the various also by means of correspondence from the various parts of the world. The meager activities, rather whims, of that far-sighted proprietor of the coffee-canteen gradually grew up in various directions concerning shipping and are directly responsible for the establishment of a world-wide organization which is one of its kinds today. There is practically no port in the world today where one does not come across with at least one agent of the "Lloyd's". these agents scattered in every part of the global, collect every information about shipping matters and forward the same to the central organization where it is recorded and published daily in the Lloyd's list.

The history of Lloyd's was one of continual expansion, and in 1928 Lloyd's moved to its own buildings in Leaden hall street, London in 1957, a new building was opened in Lime Street with marine underwriters housed on the ground floor and non-marine underwriters in the gallery. Membership to this world-famous institution in only limited. In order that a person may become a member, he has to satisfy the committee of the Lloyd's that he has ample fund to undertake insurance business. He is further required

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to deposit with the committee a large amount of money, as a guarantee that all engagements entered into by him shall be fulfilled. Although marine insurance business is the most usual and predominating in the Lloyd's in the Lloyd's institution.

It is to be remembered that only broker and underwriters are members of the Lloyd's. in Lloyd's policy therefore, the risk is undertaken by individual insurers, known as "underwriters" thought the medium of expert brokers. The brokers are remunerated for their services not by the merchants on whose behalf they act, but by the underwriters at the Lloyd's. The remuneration is paid to them in the shape of a reduction to the extent of 5 percent of the premium the insured pays. Each risk is underwritten in parts by a number of underwriters, which is different from an insurance company which insurers the whole amount. Each underwriter writers his name on a slip and also the amount for which he makes himself responsible. That is why he is known as an underwriter. In case of any default on the part of the underwriter, the association will pay it out of the security, which it had taken from the underwriter at the time of enlisting his membership.

Each underwriter at the Lloyd's is a sole trader although they operate in syndicates. The corporation itself has no liability for the default for its members. However, a member must deposit a substantial sum of money before he is accepted, and premiums received by underwriters are placed in a trust fund. Claims are paid out of this fund. Annual audit of the accounts of the corporation of Lloyd's is compulsory.

8.4. PROCEDURE OF TAKING OUT A LLOYD'S POLICY

8.4.1. Approaching the Broker:

The main desirous of effecting marine insurance must approach a broker and given him full information regarding the property to be insured and the amount for which insurance is required. The services of brokers are indispensable as the assured is prohibited to enter the Lloyd's office. The broker, on being approached, will give a quotation for premium payable for the risk. If the rate if satisfactory, he is advised by the propose to place the insurance

8.4.2. Preparation of the Slip:

The broker on receiving the instructions prepares a brief memorandum on the risk to be covered, which is known as a slip. The slip contains full information regarding the subject matters to be insured, their amount, the name of the vessel, the voyage or the duration of time, or both, as the case may be, the nature of risk to be insured, the post of loading and discharge and any other condition. In actual practice, the amount insured is the actual price of cargo plus 10 percent. This additional amount of 10 percent is loaded with a view to covering the insured, in the event of any loss for the amount of freight, insurance and other incidental charges in connection with the shipment.

8.4.3. Submitting the slip to underwriters:

After the slip has been prepared, the broker goes to a particular market at Lloyd's interested in this type of risk and offers the slip to one of the underwrites with whom he usually deals. The underwriter signs his name on the slip and states the amount underwritten by him. He initials on rate of premium he will charge for that risk. The broker will then go to other underwrites with the remaining portion of the risk and the process is repeated till the full amount is covered and the total amount of premium payable is ascertained. If the broker is enabled to get the full amount of risk underwritten at the Lloyd's, he may offer the balance to some marine insurance company. After the slips has been signed, the underwrites will ask the broker to supply definite instructions regarding the details which he has supplied in the original slip. These details are required to enable the underwrite to issue a final policy. The instructions are to be given on a form called "Closing slip".

8.4.4. Preparation of a Debit Note:

When the full amount has been underwritten and the premium payable ascertained, the broker would forward to the insured a debit note stating the particulars of insurance, premium and the stamp duty payable.

8.4.5. Preparation of the policy:

The next step is preparation of the policy from the slip by the broker. Afterwards, he takes it to the Lloyd's Signature Bureau to be signed by the various underwriters who initialed the slip with their individual amounts and is subsequently stamped.

8.4.6. Payment of premium:

The brokers will handover the policy to the insured on payment of the premium. The broker gets commission from the underwriters in the form of a reduction on the premium charged. The gross amount of the premium is subject to a reduction of 5 percent

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Check your Progress

1. State whether each of the following statement if 'True or False'

(a) Cargo Insurance may be written under a single risk policy

(b) Marine policy may not be assigned

(c) The premium can be ascertained only by numerical rating system.

(d) Marine losses are the result of the various perils.

for brokerage. An additional amount of 10 percent is also deducted by way of commission. The broker gets the 5 percent and the 10 percent discount goes to the insured who pay 10 percent less(10 percent of 95 percent). Upon receipt of the premium, the broker forwards the policy to the insured.

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There are various kinds of marine insurance policies, which are known by different names. Though a general stand form is used for all marine policies which have much in common, yet the variety of risk to be covered and the differing needs of the insured for different types of marine adventures have led to the evolution of a variety of marine insurance policies.

8.5. DIFFERENT CLASSESOF POLICIES

8.5.1. Time policy:

When the contract is for insuring a subject matter for a definite period of time irrespective of the number of voyages made, the policy is called a "time policy". A time policy has nothing to do with the voyage of the ship. The ship may pursue any course it like, the policy would cover all the risk from the perils of the sea for a stated period of time, say, "from noon 1st January, 1976 to noon, 1st January 1977". **In India, a time** policy cannot for a period exceeding 12 month [sec, 27(2)]. **However a time policy may** contain a "continuation clause" **providing that if at the end of the period, the ship is yet at sea, the policy will continue for a reasonable time thereafter till the ship arrives "continuation clause" a fresh policy duly stamped covering the period is question must be taken before the assure can claim any loss under the policy. This kind of policy is generally suitable for** hull insurance, though it may be taken out also for movables and other goods when **small** quantities are involved. The ship-owners find it much convenient to insure their **ships up** to a stated amount for a specified period of time instead of getting them **insured from** voyage to voyage.

8.5.2. Voyage policy:

When the contract is to insure the subject –matter at and from, or from one place to another or others, The policy is called a "Voyage Policy" Thus a voyage policy is one by which the subject- matter is insured on a specified voyage from the port of departure to the port of destination, the limits of the risk being defined by the places. It is to be noted that the policy may cover the risk being defined by the place. It is to be noted that

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the policy may cover the risk "from a post" of "at and from a post". If the policy is "from a port", the risk starts when the ship saits from a particular port. But, if the policy is "at and from a port", it protect the subject-matter insured both while the ship is at the port of departure and also from the time of the sailing of the ship on her voyage till it reaches the port of destination. This policy is more suitable for cargo insurance as cargoes are in danger of destruction from maritime perils during the period of transportation. Since this policy covers the risk in transit, it is not suitable for hull insurance, as the ships generally do not operate over a particular route only. Mixed policy. A mixed policy combines the characteristics of a time policy and a voyage policy. It insures the subject matter from and to certain places between specified periods. In other words, it is a policy, which covers the risk during a particulars voyage for a specified period. Such a policy contains a contract for both voyage and time. Such policies are governed by the combined application if the rules relating to both time and voyage policies. These policies are also known as "time and voyage policies" and are issued for ships and steamers operating over particular routes or sailing between certain fixed ports.

8.5.3. Valued policy:

This is a policy in which is inserted the agreed value of the thing insured. In other words, it is a policy which species or expressly declares the agreed value of the subject-matter insured. In case of goods, the insured value is found out by adding to the cost or invoice price of the goods: (i) Freight and shipping charges, insurance, etc. and (ii) A fixed percentage say, 10 percent or 15 percent of margin to cover for anticipated profits and others incidental charges. In the absences of fraud of misrepresentation, the declared value of the policy is the measure of indemnity. In case of total loss of the goods, the insurance company is required to pay the declared amount to the insured. However, in case of partial losses the liability of the insurance company is determined on the basis of the assessment made by the officials of the partial damaged goods.

It should be remembered that the insured value is not necessarily the actual value of the cargoes, which may be even less than he invoice price of the goods.

8.5.4. Unvalued policy:

An unvalued or open policy is the one in which the value of the subject matter of insurance is not stated, but is left to be ascertained and proved later on when the loss occurs. In other words, unvalued policy leave the value of the loss to be subsequently

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decided subject to the limit of the sum insured, in case of loss. The value so left undecided is called "Insurable value" and forms the basis of the measure of indemnity, when the loss occurs. The insurable value is ascertained as follows: (1) As regards the ship, the value includes her output, provisions and stores, money advanced for wages and disbursement to make the ship fit for the voyage plus the charges of insurance on the whole. In the case of steamships, it is also includes the machinery, boilder, coals and engine stores (2) As to the freight, the value is the gross freight at the risk of the assured, including the changes of insurance. (3) As regards the goods and merchandise, the value is the prime cost of the property insured, plus the expenses of and incidental to shipping and the charges of the insurance. It is to be remembered that the unvalued policies do not include any margin of anticipated profits. In the case of a total loss, the insurable value is that which can be relies from the company; and in the case of partial losses, it is which will be the basis of assessment, subject to the limit to the sum insured. Such policies are not frequently met with these days and not very common obviously because under this method this loss is ascertained at a later date which gives rise to various complications, difficulties and botherations.

8.5.5. Floating policy:

This is marine policy describing the insurance in general terms without stating the name of the ship. It thus mentions the amount for while the insurance is taken out, and leaves the name of the ship or ships and other particulars to be defined by subsequent declarations. The subsequent declaration may be made by endorsement on the policy or in other customary manner. Unless the policy otherwise provides, the declaration must be made in the order of dispatch or shipment. In other words, a floating policy may be taken for a round amount. Whenever some cargo is shipped, the insured makes a declaration about the value of the shipment and the total value of the policy is reduced by that amount. With each declaration, the amount of insurance policy goes on decreasing. Such declarations are made from to time till the total value is "fully declared" or "run off". The underwriter then informs the shipper so that he may take out another floating policy in order to cover such risks. The practice of taking out floating policies has come into common use of the difficult in taking out a marine policy everything the regular insurer ships the goods. The floating policy proves to be of much use as only the amount for which the policy is taken out is mentioned with a provision that the benefit of such a policy is to attach to the ship or cargo "Hereafter to be mentioned". Thus, this policy has

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the double advantage of avoiding the necessary of taking a policy each time the shipment is made and if a lower later of premium.

Floating policies have made the present day gigantic commercial transactions possible and are particularly convenient for merchants who are interested in a series of regular shipments of goods of cargo – owners are automatically insured against marine perils immediately after their shipment, whether known to the insured or not. However, it is necessary that the declarations should be duly made after each shipment within a reasonable time. The premium is calculated according to the amount at risk as determined from the declarations made.

8.5.6. Blanket Policy:

A blanket policy covers several different properties or exposure under one form is taken for certain amount but the premium is paid on the whole of it in the commencement of contract and is re – adjusted at the end of the term of policy. Term of the policy in accordance with the actual amounts at risk as shown by the accounts and records of the insurance companies.

8.5.7. Named Policy:

Named policy specifies the specific vessel by which the shipment is made. This policy differs from the floating policy only in respect of the declaration of the name of the ship. In a floating policy, the name of the ship is not specified at the time of taking out the policy but is declared afterwards when the shipment is made. But in named policy the name of the vessel, by which the shipment is made, is mentioned with the specified interest. Thus, policies which specify the name of the vessel before hard are known as "Named Policies".

8.5.8. Single vessel and Fleet Policy:

When the own of the vessel or ship insurer his individual vessels separately it is called "Single Vessel Policy". But when an individual or a corporation insures whole fleet of lines or steamers under one policy it is called "Fleet Policy". Fleet literally means "number of ships, aircraft, buses, etc. Moving or working under one command or ownership". Fleet insurance policies have become popular with the advent of steamships and the development of large companies, which, in turns has resulted in the concentration of ownership of a number of steamers in the hands of individual and companies. The

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"Fleet Policies" are beneficial to the owners in –as – much – as these insure the older and less desirable vessels at an overage rate along with the perfect and new vessels. Moreover, these policies save the duplication of efforts in effecting different policies on different ships and much avoid wastage of time. The ships may be specifically designated or province may be made for automatic coverage of all ships owned by the insured, on a reporting basis. To be eligible for such coverage all vessels must be owned by a single insured generally, the insurance companies do not insure a vessel to her full declared value obviously because it might tempt the dishonest and unscrupulous owners to effect heavy insurances upon the ships and directly o indirectly may cause heave loss to the insurer. This is especially true when the ships are old. Obsolete and unseaworthy. Thus, the owners are to share some part of the risk upon their own shoulders.

8.5.9 Block Policy:

Block Policy is a special type of marine insurance policy, which covers all the property of the insured against most perils, including transportation. The interest is covered from the time of collection, through the land journey, and then to the port of shipment and finally reaching the port of destination. In other words, block policy covers both on and off the insured's premises, including incidental inland risks. For instance, if the goods are dispatched either, by truck or rail transport and then on steamers for further transmission to a warehouse or ships to the point of destination, then in such a case, the single policy will cover all the risks from the point of origin to the point of consumption, till the goods are delivered abroad at the point of destination. The black policy may also cover property of other held by the insured on consignment sold but not delivered, for repairs, of otherwise held, like jeweler's block policy, camera and musical instrument dealer's block policy, equipment dealer's policy etc. Such a policy is popular in connection with the insurance of gold in South Africa, where the interest is covered from the time of collection of gold in mines, through the refineries, and then to the post of shipment and finally reaching the port of destination.

8.5.10. Currency Policy:

A currency policy is one, which is issued, in foreign currency. In other words, a currency policy specified the sum insured and the value of the goods in foreign currencies. Such as Pound Sterling, Dollars, Yen, Mark, Bats, Tika etc. Currency policy ensures a fixed amount to the insured in the event of any violent fluctuations in the values of different currencies, like devaluation of the local currency or appreciation of foreign currency. In a way, currency policy removes the uncertainly regarding the actual amount of claim, in case the loss occurs. Thus, by issuing currency policies in any currency the underwriters undertake to compensate the insured in the same currency, as desired by him in the event of any loss, irrespective of any rise or fall in the value of the currencies. In such policies the premium is collected in the currency, which is mentioned in the policy.

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8.5.11. Wagering Policy:

A wager Policy is one, which does not have any evidence that the insured has any insurable interest in the subject matters of insurance or in which the underwriter dispenses with any proof of interest. Such policies are clearly indicated by such words as "Policy poof of interest" (PPI) or "Interest or No Interest" or other expression of the same types, in order to make a clear distinction and to make he point clear. Since these policies do not have any insurable interest, these are void and nothing but the gambling contract. Hence they are known as "Wager Policies" and cannot be enforced in a court of law. If the underwriter refuses to meet his liability he cannot be sued. Indian contract Act, 1872 specifically lays down that all wagering agreements with certain exceptions are void. However it does not mean that wagering policies are not at all issued. In fact insurance companies are willing to issue policies without insurable interest and pay the claims whenever they arise. Though no legal action can be taken against an underwriter if he refuses to pay the loss on such a policy. Yet to maintain his honor, business prestige and goodwill he variably pays the amount of loss or damage. Indeed, such policy is regarded of an obligation, not of law but of honor, between the parties. In view of this, such policies are also known as "Honor Policies". Such policies provide a commercial convenience is cases where there existed some interest, which is difficult, perhaps incapable of actual proof. As stated earlier, the PPI policy which is a striking example of honor or wager policies includes a clause stating that is the event of claim the underwriters will dispense with proof of insurable interest and the policy itself will be a sufficient proof of interest. Usually, PPI policies are issued to protect such persons who have insurable interest but it is difficult to substantiate it. The law draws no distinction between ordinary policies where the assured definitely has no insurable interest, and policies, which merely dispense with proof of insurable interest. Deeming both kinds of wagering contracts and therefore equally void law. Such policies are not issued in India, but are issued only by the Lloyd's organization.

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8.5.12. Interest Policy:

All policies, which can be legally enforced, are called "Interest Policies". In contradiction to the wagering policies interest policies have insurable interest and are not void but are legally enforceable contracts.

8.5.13. Composite Policy:

A policy underwritten by more than one underwriter is known as "composite policy". But the liability of each underwriter is distinct and separate i.e., each underwriter is responsible for only that specified portion of the risk, which has been underwritten by him.

8.5.14. Port Risk Policy:

A port policy is that policy which covers the ship when it is anchored in a port. Thus, all losses or damages to the subject matter of insurance after the arrival of the ship on the port are covered during a certain period.

8.5.15. Construction Builder's and Risk Policy:

Such policies are issued for the builders of the ships and are issued for a period exceeding one year. It covers risk of vessels during period of construction.

8.6. CONDITIONS OF POLICY

marine policy is issued subject to certain in order to meet this special requirements and speeds of the insured, suitable conditions are incorporated in the policy. These conditions take the form of the clauses which are interested in the body of policy.

8.6.1. Name of Insured:

In marine policy the operating words are followed by a blank space which is used for the name of insured or his agent. If the name is not inserted in policy he document will not constitute a marine policy.

8.6.2. Assignment clause

This clause makes a provisions for the assignment of the policy so that a person who later acquires insurable in the subject matter of insurance may avail of the protection

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given by the policy. Thus, the policy can be assigned. All policies can be so assigned, in favor of other persons to whom the interest or ownership in the subject matter may be transferred at a later late.

8.6.3. Lost or not Lost:

Where the subject matter is inured "lost or not Lost" and the loss has occurred before the contract is concluded, the risk attaches unless, at such time the assured was aware of the loss, and the insurer was not the wording of the policy run as follow. It is hereby agreed and declared that the said insurance shall be and is an insurance.

Thus lost or not clause is a portion of ocean marine insurance policy providing for coverage even if loss has occurred before the insurance was placed.

8.6.4. At and from clause

This clause describes the point of time from which the risk commences and is generally applied to hull and freight insurance. When the slip is insured "At and from" a particular place, and the sea is at that place in good safety when the contract is concluded, the risk also commences. However, if the ship is not present at that place when the contract is concluded, the risk attaches as soon as the ship arrives there in good safety, and unless the policy otherwise provides, it is immaterial that the ship is covered by another policy for a specified time after arrival. The risk terminates on the discharge and safe landing of goods. The goods must be landed in a customary manner and within a reasonable time after at the port of discharge.

8.6.5. Warehouse to Warehouse clause:

This clause is used in marine cargo insurance which provides coverage from the originating warehouse to the termination warehouse. In actual practice, he places from where the goods are dispatched and where they should reach or not the seaports but the far off interior towns or hinterlands. The institute "Warehouse to Warehouse" clause speaks about the effect of covering the goods from the warehouse at the place named in the policy to consiguee's warehouse at destination. This clause says the risk of land and craft transport and transshipment are all covered from the moment transit commences from the interior place by a single marine insurance policy. The risk continues to be covered till the goods arrive at the consigneer's or other warehouse at the destination named in the policy.

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8.6.6. Change of voyage:

The voyage to be performed by a ship must be described in the policy. The ship must follow course mentioned in the policy. When the course is not specified, it must follow the usual and customary course. Where the place of departure is specified I the policy, and the ship, instead of sailing from that place, sails from any other place the risk does not attach. After the commencement of the risk, the destination of the ship is voluntarily changed from destination given in the policy, there is said to be change in voyage. Where there is a change of voyage, the insurance company is discharged from liability as from the time of change. It is immaterial that the ship may not in fact have left the course of voyage given in the policy when the loss occurs. It is therefore important that (i) The voyage should be accurately described (ii) The voyage should be properly performed and (iii) There should be the literal fulfillment of this condition.

8.6.7. Delay:

The vessel must sail from the agreed port within a reasonable time, the voyage should be completed within a responsible time. Otherwise the underwriters will not be responsible. Sometimes the ship is unusual delayed the risk may increase on account of ice condition or hurricane with the variations in the seasons. Not only the port of discharge be proceeded to without delay but the venture should also be completed within a reasonable time. when the goods are insured for inland risks they should be forwarded to he warehouse or stores promptly.

8.6.8. Deviation:

In marine Insurance Deviation occurs when a vessel departs from the course of the voyage described in the policy. When a ship without any lawful excuse deviate from the voyage given in the policy, the insurer is discharged from liabilities as from the time of deviation and it would not make any difference even if the ship regains her route before any loss occurs.

8.6.9. Touch and stay:

The touch and stay clause in marine policy authorizes the ship to touch and stay at the various ports wherever necessary for taking coal or unloading cargo or some other purpose. The clause accords liberty to the vessel to call upon such mention is made, the report must be in the ordinary course of the voyage and they must be ports usually called as the particular trade in which the vessel is engaged.

8.6.10. Name of the vessel:

In this clause the mane of the vessel by which the voyage is to be made is inserted in the policy after "at and from" clause, along with the mane of the masters. Usually the name of vessel is given in the policy. This is important because in the case of cargo, the vessel cannot be changed subsequently unless the consent of the underwriter has been obtained. Thus, once the name of a particular vessel is mentioned, it can only be changed with the prior approval of the insurance company.

8.6.11. Name of the Master:

Usually the name of the master is not filled, though it is n important item to be mentioned in the olden times when the safety of the ship or the cargo depended to a large extent on the skill experience and common sense of the mate. Once the name of master is filled it cannot be changed except when the master originally named is prevented from taking command by reason of some unavoidable such as sickness, accident etc.

8.6.12. Valuation clause:

It specifies the subject matter insured in the policy, the description of the goods, insured is made as accurately as possible. The valuation clause lays down the value of the subject matter insured, and is to be met with in valued policy only. Where the value of the subject matter is agreed upon between the insured and the insurer and is written in the policy.

8.6.13. Waiver clause

This clause supplements the "sure and labour" and declares that not act of insurer or insured in recovering, saving or preserving a subject matter of insurance shall be considered as a waiver or acceptance or abandonment. Both insured and insurer can take step to minimize a loss. This clause is added for the benefit of both the assured and the underwriter and assures that either party to the contract may take such steps, or incur such expenses as are contemplated under the sure and labour clause, to reduce a loss, in the event of a casualty.

8.6.14. Premium clause:

This clause is known consideration, it contains as acknowledgement on the part of the underwriter of having received the premium which is the source of formal binding of a insurance contract.

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8.7. LOSSES IN MARINE INSURANCE

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Losses in marine insurance business are result of the various perils. Marine insurance policy does not necessarily cover all the risks. An insurer is liable to indemnity an insured in respect of only losses which result from perils insured against. When the loss occurred is beyond the insured peril, the insured himself shall have to bear.

8.7.1. Actual Total Loss:

If refers to the complete destruction of the property insured. When an insured property is completely destroyed or damaged beyond repairs, if termed as actual total loss. If a ship sinks down or get burnt completely it will be an example of actual total loss of a ship. When the subject matter is lost to the owner by any decree of the court, sinking after collision of a vessel which is missing are instances of actual loss of ship, cargo and freight.

The amount payable by the insurers is calculated in the ratio which the value of the subject matter bears to that of the assured sum.

8.7.2. Particular Average on slip:

Sometimes due to storm and high waves the ship or its machine suffer partial damage and the cost of repair born by the owner can be claimed from the insure. A responsible amount is payable by the insurer towards the cost of repairs. In setting the claims of particular average on ship, the reasonable actual cost for repairs forms the basis of the claim but not the insured value of the ship.

When the ship is insured against several accidents and damages the insurer is liable to pay successive losses, even though the total amount of successive losses exceed the amount of the policy. For instance a ship is damaged and is repaired, thereafter it is lost totally. In such case the insurer is liable to pay for both the total loss and particular average loss.

8.7.3. Particular Average on freight:

Freight cannot be recovered or earned in case of loss of cargo. It is because freight is the amount payable either for the hire of a vessel or for the conveyance of cargo from one port to another. In order to claim for particular average on freight there must be partial loss of the subject matter.

8.7.4. General Average Loss:

The general average loss will be there where the loss is caused by an extraordinary sacrifice or expenditure voluntarily made or incurred in time of peril for the purpose of preserving the property under pilled in common adventure.

8.8. ELEMENTS OF GENERAL AVERAGE LOSS

The loss must be extraordinary in nature. The expenditure must not be related to the performance of routine work.

1. The whole adventure must be imperiled. The peril should be something more than the ordinary peril of the sea. It should be imminent and real.
2. The general average act must be voluntary and intentional accidental loss or damage is excluded.
3. The loss expenses or sacrifice must be incurred or made reasonably and prudently. The master of the ship is the proper person to decide the reasonableness of a particular circumstance.
4. The sacrifice, loss or expenditure should be made for the preservation for the whole adventure. It should be made for the common safety.
5. If the sacrifice proved abortive, it will be allowed as the total loss, Therefore to call it generally it must be successful at least in part.
6. In absence of contrary provision, the insurer is not liable for any general average loss or contribution where the loss was not incurred for the purpose of avoiding or in connection with the avoidance of a peril insured against.
7. The loss must be the direct result of a general average act. Indirect losses such as demurrage and market losses are not allowed as general average.
8. General average must not be due to some default on the part of the person, whose interest has been sacrifice.

The object of the principle of general average is two fold. Firstly, to give justice to all concerned and secondly, to enable the master of the ship, in the event of dire peril to the whole adventure to take such measures as are calculated to be in the best interests of the

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Check your Progress

2. The subject matter insured for a definite period of time is

(a) Valued policy
(b) Floating policy
(c) Time policy

3. Conditions of policy are

(a) Name of Insured
(b) Cargo
(c) Notice of claim

4. The Receipt for goods delivered to a ship for carriage is

(a) Survey report
(b) Bill of landing
(c) Voucher

5. The policy which can be legally enforced is called

(a) Currency policy
(b) Port Risk policy
(c) Interest policy

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safety of the adventure without discriminating between sacrifice of ship or of the goods on board. Examples of general average act are the jettision of the goods to lighten the standard ship to make it float, the pulling of waters or the ship or goods to prevent the spreading of fire etc.

8.9. TYPES OF GENERAL AVERAGE LOSS

The general average losses are divided into two classes.

8.9.1. General Average scarifies:

The general average scarifies are made for common safety i.e.jettision or throwing away of the cargo to lighten the ship or using the cargo as fuel etc.

8.9.2. General Average Expenditure:

The general average act involves expenditure. In this case, extra expenditure is involved for common safety. Here, additional charges incurred at the port the ship is repaired. Expenses may be involved for hightenning and reloading of the cargo.

8.9.3. General Average contribution:

The parties interested rateably contribute the general average loss. In contribution of general avearage loss, the contributory interest, amount to be made good and contributory values are considered.

8.9.3.1. Contributing interest:

The interest saved by the general average act are liable to contribute rateably to make good the sacrifices or expenses. There are certain articles which are not required to contribute toward general average loss. Postal articles, parcel, crew's effects and the personal effects of passengers not shipped under a bill of lading. There are three main contributing interest, namely, ship, cargo and freight. When a general average loss occurred among different interests, it is of vital importance that the interest which has been sacrificed must also rateably contribute to the loss, otherwise it would be in a better position than the interest saved by general average act.

8.9.3.2. Amount to be made good:

The amount to be made good in general average differs from adventure to adventure.

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(a) Ship:

The amount to be made good in general average in respect of a ship is measured by reasonable cost of repairs less the actual deduction, new for old. The cost of repairs are taken into account as they have been actually either at port of refugee or at a destination.

(b) Cargo:

The amount of general average, in case of goods, is their net value which is calculated, taking into account the value of goods sacrificed at their safe arrival and from this, the expenses such as freight unpaid, duty and landing charges, which would have been incurred had the goods arrived safely are deducted. Thus, he net value of goods is arrived.

(c) Freight:

Where the freight is to be paid at the destination in respect of cargo which is used for general average act, the ship owner will loss it and it would be made have earned, had the goods not been sacrificed loss the charges which he would have incurred to earn such freight during the remainder of the voyage, but which he has not incurred as a result of sacrifice.

(d) Expenses:

All the extraordinary expenses properly incurred by the ship owner in time of peril for the common safety of all the interest are also made under the general average contribution.

8.9.3.3. Contributory values:

The contributory values are of three types.

(a) Ship

The ship owner will contribute on the ships value as saved by the sacrifice. The value is the amount for which the ship owner, as a reasonable man, would be willing to sell her on arrival, at her destination.

(b) Cargo:

The cargo owner will contribute on the market value of goods served at the place where the voyage ends. To arrive at this value the expenses incidental to the safe arrival of the cargo are deducted from the selling price of the cargo.

(c) Freight:

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If the freight has been paid in advance, it would have been included in the value of separate interest. The goods arrived safely at destination will have to contribute on the basis of et value of fright saved, if the freight was not paid in advance.

8.10. SETTLEMENT OF CLAIMS

Before admitting a claim relevant evidence in connection with the policy is required. In marine insurance the policy is generally issued on mutual understanding and good Faith of both the policies. But at the time of claim the insurer should satisfy himself on he information furnished by the insured. Value of the subject matter, nature of the subject matter, warranties, insurable interest etc. are some of the matters to be considered at the time when the claims arrive.

8.10.1. Notice of claim. A prompt notice of claim by the insured is required. It should contain all relevant particulars. Besides for constructive losses a notice of abandonment is also to be served on the insurer.

8.10.2. The Insurance policy. The insurance policy taken to cover the risk has to be submitted along with the notice and other documents.

8.10.3. Invoice or Bill. In case or cargo, an invoice or a bill is attached along with the policy, so that the value of the goods can be known

8.10.4. Bill of Landing. A copy of the bill of landing is submitted which acts as a receipt for goods delivered to a ship for carriage. It is issued and signed by the ship owner or his agent or the captain of the ship.

8.10.5. Survey report. If possible a survey report should be obtained by the agent and it is to be submitted to the insurer in support to the claim stated.

8.10.6. Assesment of the loss. After receiving the above documents from the insured, the experts make an assessment of the loss from the above documents. For valued policies, there won't be much dispute and discrepancy in the calculation or losses. But in case of invalued policies, there arises a difficulty in ascertaining the correct amount of loss.

8.10.7. Payment of loss. After a detailed assessment of loss and satisfaction, the insurer makes payment for the indemnification under the policy.

8.10.8. Later of subrogation. This letter empowers the insurer to get possession of the residue of the subject matter of insurance or start legal proceedings against their party of the recovery of any amount receivable. But before a claim is paid, it is essential to prove the following:

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1. That he insured had insurable interest in the subject matter.
2. That the loss was due to proximate cause of the peril insured against.
3. That the ship was seaworthy after commencement of the voyage.
4. That there was no deviation or change of voyage.
5. That the voyage was in every respect a legal one.
6. That the loss was caused by the willful misconduct of default of the insured himself.

8.10.9. Documents in Different types of Claims:

(a) Total loss. Insurance policy; Billing of landing; copy of the invoice protest, letter of subrogation; notice of abandonment.

(b) Partial loss. Surveyor's report; Bill of sale; letter of subrogation, cost of protection, besides the policy, the invoice, the bill of landing, the copy of masters protest or an extract from log book of the ship.

8.11. KEY TERMS

- Hull Insurance: Insurance of vessel and its equipment are included under Hull Insurance.
- P.P.L. policies: In the event of claim underwriters may dispense with all proof of Insurance Interest.
- Man-of-war: This is he vessel which is authorized by nations for the purpose of defense or attack in the event of hostilities.

8.12. SUMMARY

Marine Insurance business means ice business of effecting extracts of Insurance upon vessels of any description, including cargoes, freights and other interest which may be legally insured in or in relation to such vessels, cargoes and freight, goods, wars, merchandise and property of whatever description insured for any transmit by land or

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water or both, and whether or not including warehouse risk or similar risk in addition or as incidental to such transit and includes any other risks customarily included among the risks insured against in marine insurance policies.

8.13 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) T (b) F (c) F (d) T (e) T
2. c
3. a
4. b
5. c

8.14 QUESTIONS / EXERCISES

SECTION - A

1.What are the various principles of Insurance contract?

2.Explain the various kinds of Marine Insurance Policies.

3.Discuss the various procedures to effect Marine Insurance contract?

SECTION - B

4.What are the procedures of adjusting Marine Insurance losses?

5.Discuss the condition of policy under Marine Insurance:-

6.How settlement of claim is effected under Marine Insurance?

8.15 FURTHER READING

1. M.N.MISHRA – Insurance Principles and Practice.

2.Dr.P.K.Gupta – Insurance and Risk Management.

Unit - 9 FIRE INSURANCE

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Structure

9.0 INTRODUCTION

The word "fire" literally means a "condition of burning" and is used in its popular sense to mean a friendly fire which is used for domestic or manufacturing purposes and is confined within the proper limits. But, in insurance, by fire is meant only "hostile" fire in a place where it is not intended to be, as against friendly fire which has broken bounds. The word fire in fire insurance must be given its plain and ordinary meaning and not any technical or restricted meaning. Fire in this sense means that (a) there must be actual fire or ignition and (b) it must be accidental or fortuitous in origin so far as the insured is concerned. Thus, to form a valid claim under the policy there must be actual ignition which was accidental.

9.1. UNIT OBJECTIVES

- ❖ To compensate for the loss consequent upon destruction by fire
- ❖ To prevent the fire waste to some extend
- ❖ To provide protection by indemnifying the financially loss

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9.2. NATURE OF FIRE INSURANCE

9.2.1. There must be actual fire or ignition:

Fire means the production of light and heat by combustion and unless there is actual ignition here is no fire within the meaning of the term in an ordinary policy. In this sense, heating not accompanied by ignition is not fire. Loss occasioned by fire means loss by ignition on of the articles consumed or by ignition of that part of the premises storing them. In fact, we call a thing as fire when there is a flame ending in burning.

9.2.2. 432Actual fire must be accidental:

Secondly, the fire must be accidental or fortuitous in its origin so far as the insured in concerned. Unless the fire owes its origin to an accident, it is not a fire within the meaning and intention of the policy. Thus, a fire lit in an ordinary stove or gas, burier or in the furnace of a boiler where a process requiring the application of heat is carried on is not an accidental fire. The cause of fire is immaterial unless it was the deliberate act of the insured. In such cases the insured cannot recover any loss caused by his own willful misconduct. However if fire is intentionally lit for the purpose of cooking which accidentally goes beyond control, then it will also come within the definition of fire. Even loss by fire caused by negligence of insured, his servant or strangers is covered.

9.3. PROCEDURE TO EFFECT OF FIRE INSURANCE

9.3.1. Nature of the Company

First of all, the person who wants to effect fire insurance should selected the company or a broker with whom insurance is to be effected. The selection of the company is an important consideration as it ensures guidance and counseling in loss prevention and early settlement of claims at the time of loss. Broadly, there are two types of fire insurance organizations offering fire insurance policies: (a) Tariff offices comprise those different types of fire risks underwritten by them and to remove competition in among the fire insurance companies. Thus, the tariff offices charge a fixed and agreed scale of premium. (b) Non-tariff offices are insurance companies which function independently without joining any tariff insurance companies. Generally, they offer lower rates of premium in order outside the ring of tariff offices, who generally enjoy a greatr a better reputation. At present, fire insurance business is being transacted only by the

General Insurance Corporation of India (GIC) and its fou subsidiary companies: (1) National Insurance Company Ltd., Kolkata (2)New India Assurnace Co. Ltd., Mumbai (3) Oriental Fire and General Insurance Co. Ltd., New Delhi and (4) United India Fire and Genral Insurance Co. Ltd., Chennai. Under these subsidiaries, 88 other companies are engaged in the fire insurance business. Some of them are: Sun Insurance Office Ltd., phoenix Assurance company Ltd., Eagle State Insurance Co .Ltd., Atlas Assurances Company, Zurich Insurance Co., Jubilee Insurance Co., Queensland Insurance Co. Ltd., Sterling General Insurance Company Ltd, Orissa Co-operative Insurance Society Ltd., etc. These companies can either be directly approached or through a broker.

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9.3.2. Proposal Form:

When the office form which a policy is to be purchase is decided upon the next step is to fill in a proposal form which furnishes the basis of the contract. Maximum possible care should be taken in filling it up. The proposal form contains details like the name and address of the proposer, his business situation and construction of building, occupation of building, amount assured and other terms of the contract. In filling up the proposal form no material should be concealed and none should be wrongly stated. Each question of the form should be answered in language admitting of only one interpretation. Generally the insurance companies, through their agents, approach the public for purchasing the policy in some of the cases the insured can also go to the insurer directly for taking the policy. The insured must observe utmost good faith in disclosing the information. Besides, the insured must have insurable interest in the property propsed to be insured. The proposer can take different types of policies. While indicating the value of the property or the goods, the insured should give the market value because the company takes into account the current market value of the subject-matter at the time of settling the claim. A little margin may be added to such value for likely appreciation in its market value. On the basis of the information contained in the proposal form, the insurance company finds out the actual risk to which the property is exposed and the amount of premium.

9.3.3. Evidence of Respectability:

Before accepting the risk, the insurance company ascertains that the proposer is a respectable person, and is taking the policy in utost good faith. This precaution id obviously because the fire insurance involves a high degree of moral hazard which arises

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from the nature and behaviour of human beings connected with the subject matter of the insurance. By purchasing a policy for setting fire to the property, the insured might get a large sum of temptation to "incendiarism". If the proposer in a well known figure, then the risk is assumed without any enquiry but in the case of new proposers or strangers or doubtful integrity, the company may ask the proposer to furnish some reasonable evidence of his respectability honest and integrity.

9.3.4. Survey of the property:

The next step in fire insurance is a survey of the property proposed to be insured through qualified experts known as surveyors. These surveyors are deputed to inspect the property carefully and to estimate the degree of risk involved. It is on the basis of their report that the accepts or rejects the proposal and quotes the rates of premiums. If the risk is small, the insurance company does not insist on the survey. Generally speaking the insurance companies give their consent for insuring private house, small shops and other small trade buildings etc. even on the basis of proposal forms. On the other hand, if the sum assured is very high or the risk involved is enormous, the experts of the insurance company visit the site or property in order to get first hand information. Surveyors make a thorough study of the situation and give a report to the insurance company. The survey also suggests to the insured regarding certain steps which may reduce the chances of firs.

9.3.5. Acceptance of the proposal Forms:

On the basis of the proposal form and the surveyor's report, the risk is considered by the company. If the company is satisfied with the report of the surveyor it accepts the proposal and intimate the proposer accordingly.

9.3.6. Commencement of risk:

The usual practice of giving the acceptance by the insurer to the insured is to demand the payment of premium. The risk will commence only when the premium has been paid. Unless the contract provides otherwise. For this purpose, a premium note is issued by the company. It is only after the payment of the premium that the contract becomes complete.

9.3.7. Cover Note:

The insurance company may accept the risk unconditionally or subject to certain conditions and may give a provisional protection to the assured through a document, known as cover note, because the preparation of a fire insurance policy takes some time. The cover note is in the nature of interim policy and covers the risk immediately on the receipt of the first premium. The cover note is effective till the fire policy is received.

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9.3.8. Fire Insurance Policy:

The insurance company prepares the fire insurance contract or the policy and sends it to the insured. The policy is the final acceptance of the company and simultaneously it cancels the provisional acceptance given before. All the terms and conditions covering the contract are incorporated in the policy. It contains the insured's name and his mailing address, inception and expiration of the policy, amount of insurances, mode. I payment and total premium for policy, perils insured against, description and location of property covered and other details and policy conditions. The final clause of the policy provides for its renewal and limits the liability of the insurer on any term in respect of which the insured shall have paid and the insurer shall have accepted the premium in renewal of the policy.

9.3.9. Terms of Policy:

The term of fire insurance policy depends upon the requirements of the insured. Usually, the fire policies are issued for one year and are known as annual policies. Short term policies are also issued by the insurance companies for a period shorter than one year as also long term policies for a period exceeding one year. The premium for short term policy is relatively higher than annual policies on account of heavier ratio of expenses.

9.4. ELEMENTS OF FIRE INSURANCE CONTRACT

All the features of general contract are also applicable to the fire insurance contract.

9.4.1. Proposal:

The proposal for fire insurance can be made either verbally or in writing. The proposer gives the necessary description of the property to the insured. In practice, the printed form is used for the purpose. The description of the subject matter of insurance is the basis for the contract for the contract for assessing the risk.

9.4.2. Acceptance:

On receipt of the proposal form, the insurer ill assess the risk. Sometimes, when the contents and the subject matters are not of very high amount, the insurer may accept

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on the basis of proposal forms only. When the subject matters is of large magnitude and where the hazards involved is of a variable or unknown nature, the insurer may send his surveyor to survey the property. On the basis of the surveyor's report, the insurer will consider the proposal.

9.4.3. Commencement of risk

The risk commences as soon as the contract is completed, provided there is no specific time for the purpose. As soon as the proposal is accepted, risk will commence, irrespective of the fact that whether the policy was issued or not and the premium was paid or not. Where risks are unknown and tremendous, the payment of premium will be the basis of the competition of contract. The insurer issues a duly stamped policy which will bear all the terms and conditions of the contract. It is a statutory and formal document of insurance contract.

9.4.4. Utmost Good Faith

Fire insurance contract imposes certain extra responsibilities on the contracting policies. The insured must disclose every material fact regarding the subject matter. Should be maintained throughout the term of the policy and also at the time of loss if any. The material facts must be full and fair regarding contribution, occupation of property, refusal of insurance by other insurers, if any condition of the property etc.,

9.4.5. Indemnity:

Fire insurance contracts are strictly indemnity contracts. The insurer must indemnity only the actual loss of property insured under the policy. The aim of insurance scheme is not to cause profit to any policy-holder. The insured cannot claim any thing in excess of the amount is not the measure of indemnity. It only sets up the upper limit to which the loss can be indemnified.

9.4.6. Insurable Interest:

An insured cannot have a valid insurance contract unless he possesses and insurable interest in the property. With the existence or safety of the property, the insured stands to benefit financially. To insure a property without having an insurable interest is a mere gambling and is against public policy. Without insurable interest, a moral risk would be created because a person would be encouraged to bring about the same event covered by the policy. The insurable interest must exist both a the time of proposal and also at the time of loss of the property insured against fire.

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9.4.7. Causa Proxima :

Causa Proxima means direct or nearest cause, but not distant or remote cause. The insurer is liable only for those losses which are directly and reasonably follow from the event insured against. To claim the loss, the fire must be proximate or direct cause of loss. If the fire is remote cause of loss, the insurer is not liable for the damage to the insured property and not for all the consequences that spring from such loss.

9.4.8. Warranties :

The contents of proposal form are expressly incorporated in the policy, which form warranty. Warranty is that 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. Warranties that are mentioned in the policy are called express warranties and those warranties which are not mentioned in the policy are called implied warranties. Warranties must be complied with literally and the effect of a breach of warranty is to render void the relevant item of the policy, even if no increase in risk is involved.

9.4.9. Subrogation :

It is the right of an insurer after paying a loss to be insured, to acquire all rights related to such loss possessed by the insured against third parties to the extent loss. This principle is a corollary to the principle of indemnity. The insured can realize only the actual value of the loss or damage to the property according to the principle of indemnity and it follows that if the damaged property has any value left or the assured can recover the lost property, these must pass on to the insurer.

9.5. KINDS OF POLICIES

9.5.1. Valued Policy

The value of the property to insured is determined at the inception of the policy. In this case, the insurer pays to total admitted value irrespective of the then market value of the properties. The measure of indemnity is, in consequence, not value at the time of fire, but a value agreed at the inception of the policy. The insurer pays the

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insured a fixed sun following the destruction of the insured property. The amount fixed may be greater or less than the actual market value of the property destroyed by fire at the time of loss. In this policy, the measure of indemnity is based on the value of properties rather than on the market values of the property destroyed. This policy is used for insuring specialty pictures, sculptures, works of art, jewellery, rare things, articles of everyday use. Since the value of damage of these articles cannot be easily determined at the time of loss, the valued policies are commonly used.

9.5.2. Valuable Policy:

Valuable policy is that policy where claim amount is to be determined at the market price of the damaged property. The amount of loss is not determined at the time and place of loss. This policy is truly representing the doctrine of indemnity.

9.5.3. Specific Policy:

Where a specific sum is insured upon a specified property in case of a specified period, the whole of the actual is payable provided it does not exceed the insured amount. Here the value of property insured has no relevance in arriving at the measure of indemnity in a specified policy and the insured sum sets a limit up to which the loss can be made good.

9.5.4. Floating policy:

The floating policy is the policy taken to cover one or more kinds of goods at one time under one sum assured for one premium and in relation to the same owner. This policy is useful to cover fluctuating stocks in different localities. Since the properties are spread over various localities and in different forms, the physical and moral hazards are also varying and thereafter, it makes difficult to determine premium rates. In India, the premium rate is approximately the same in such case except the case of most hazardous risk. Such policies are specially taken by big manufacturers or traders whose such cases, it is very difficult for the owner of such goods to take specified policy for each good because the quantities of the goods deposited in each will fluctuate from day to day, place to place, according to sales or consumption be consequent removal and replacement. The average rate of premium is ascertained by taking into account the total premium payable had the property been insured by specific policies. The floating policy contains the average and marine clauses.

9.5.5. Average Policy:

Policy containing average clause is called an Average policy. The amount of indemnity is determined with reference to the value of the property insured. If the policy holder has taken policy for lesser amount than the actual value of the property, the insured will be deemed to be his own insurer for the amount of under-insurance. The insurer will pay only such proportion of the actual loss as his insurance amount bears to the actual value of the property at the time of loss.

The average clause is operative only in case of an under-insurance. This clause is ineffective when the property is insured for the full value as in that case the insured is protected to the extent of his total loss.

9.5.6. Excess Policy:

Sometimes, the stock of a business man may fluctuate form time to time and he may be unable to take one policy or specific policy. If he takes for a higher amount, he has to pay a higher premium. On the other hand, if he takes insurance for lower amount, he will have to bear the proportionate amount of loss. The insured in this case can purchase two polities, one First Loss Policy and second excess policy. The First Loss Policy will cover that stock below which the stock never goes. The minimum level of stock can be found out form the past experience and for the other portion of stock which exceeds the minimum limit. He can purchase another policy called excess policy. the actual value of the excess stock is declared every month. The amount of premium is calculated on the average monthly excess amount. Since the changes of payment on the excess amount are very remote, the rate of premium is also very nominal. Thus, the insured will pay very nominal premium as compared to the premium payable on the total amount had the policy been specific one. The average clause also applies to this policy.

9.5.7. Comprehensive policy:

This policy undertakes full protection not only against the risk of fire but combining within the risk against burglar, riot, civil commotion, theft, damage from pest, lightering. The policy is also termed as "all in Policies". There may be many exclusions and limitations. This policy is beneficial to the insured and the insurer. The insurer can get higher premium and the assured is protected against losses due to several specified perils.

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9.5.8. Consequential Loss Policy:

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The fire insurance is originally purchase to indemnity the material loss only. The intangible interest was not indemnified. This provided a check on the insured to exercise a greater care with respect to the property. However, the settlement of a loss covering material, damage only was not sufficient. The consequential loss was also to be provided. Thus, the consequential loss policy includes the loss of tangible and intangible properties.

9.6. CONDITIONS OF POLICY

9.6.1. Implied Conditions:

9.6.1.1. Existence of property:

The subject-matter of insurance should exist when the policy is effected.

9.6.1.2. Insured property:

When the fire occurs the property damaged should be the property insured for obtaining claim on the property.

9.6.1.3. Insurable interest:

The insured must have insurable interest from the time of the commencement of risk up to the completion of the contract.

9.6.1.4. Good Faith:

The insured must observe good faith towards the insurer. He must disclose all the material facts truly and fully, and should try to prevent the fire and extinguish the fire. if it occurred, with reasonable care.

9.6.1.5. Identity:

The subject-matter of insurance should be described in the policy as to identity i clearly and so define the risk which insurers have undertaken.

9.6.2. Express Conditions:

The policy shall be avoidable in the event of misdescription. Misrepresentatio or non-disclosure of any material facts. If there is any material misdescription of any o the property insured, the insurer shall not be liable upon this policy so far as it relates to property affected by any such misdescription, misrepresentation or omission. This condition is a reiteration of the implied condition of utmost good faith. Therefore, if the assured fails to disclose all material facts or be guilty or be guilty of misrepresentation or misdescription in any way, the policy shall be voidable at the insurer's option. Under common law, a breach of utmost good faith goes to the root of the whole contract. By virtue of this condition, insurer will limit the avoidance of the contract to that part only of the property affected if risk is devisable into distinct parts. If the misrepresentation. Under good faith, relates to a part of the policy only, it will render the whole contract voidable, for a breach of good faith cuts at the root of the whole contract. According to the condition of misdescription, any misrepresentation, misdescription or omission must be material. Usually all the questions asked in the proposal forms are material. Therefore they should be answered correctly and fully. The insurer should be protected in the manner described in this condition should it be subsequently discovered that the insurance has been obtained through an inaccurate statement on the part of the insured.

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9.6.3. Alterantion:

The insurance contract may e avoided if there is any alternation after the commencement of this insurance. The alteration may be of the following types:

(a) Removal

The removal of the insured property without the consent of the insurer makes the contract voidable. If without the consent of the insurer, the property is removed from one place to another, the insurer will no longer be responsible for any loss arising in relation to the property removed.

(b) Increase in risk:

The alteration may take place where the risk of the insured property has increased. The insurer can avoid the policy in respect of the item altered. However, if the insurer is agreed to continue the contract by charging extra-premium on the increased risk, after getting information of alteration, he can do so. If the assured has not informed the insurer the insurer can waive the contract. The insurer usually accommodates the insured either by waiving his right or by charging extra premium depending on the circumstances.

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(C) Change of interest:

Without the consent of the insurer the interest of the insured property cannot be changed. If the interest has been changed, the insurer will cease his responsibility. The assignment, or transfer of property, interest thereon and policy will be only when it has been made after the express consent of the insurer. Except the case of change to hazardous or more risky assignment, the insurer generally accepts the proposal of assignment. Without the consent of the insurer, the assignment or transfer will be invalid.

The insurer can accept the assignment or transfer and the interest of the vendor and of the purchaser may remain intact. Now-a-days by inserting optional memorandum the property ca be transferred under good faith and the interests of both the parties are protected.

Exception:

The change in interest is cease able in the case where the property changes on account of will or operation of law. The insurer in this case will be liable though the consent has not been obtained.

9.6.4. Exclusions

The risks which are excluded from the fire policies are called exceptions or exclusions. The exclusions are explained below:

(i) Destruction or damage by explosion except as stated on the face of the policy

(ii) Goods held in trust or on commission, money, securities, stamps, documents, manuscripts, business books, patterns, models, moulds, plans, designs, explosives unless specially insured by the policy.

(iii) Destruction of or damage to property which at the time of the happening of such destruction or damage is insured by many Marine Policy.

The above exceptions can be covered or modified by payment of extra premium. The meaning of certain works should be clarified. Damage by explosion is not covered but damage by fire consequent on explosion is covered. Goods held in trust can be

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insured by the trustee provided he has an insurable interest in them. The trustee must have some legal liability or reputation at stake for the loss of the goods to created and insurable interest for which he can insure. Money, securities, documents and business books are practically uninsurable under an ordinary policy for the very nature of them except that money can be covered up to a certain small amount under a comprehensive policy. Documents and business books can be insured for the cost of their reinstatement. Some classes of goods when in stock are liable to spontaneous fermentation or heat on account of the internal temperature engendered by compression. There are many heating processes regularly used in trade and in many business. Such cases are underwritten only on payment of additional premium. Stamps, manuscripts, plants, designs are highly perishable articles, and it is very difficult to assess their values. However, they can be covered by payment of a special rate, Earthquake, riot, civil commotion, foreign enemt, etc., can be covered by payment of a special rate of premium and under special conditions. The burden of proof that the fire occurred due to excepted perils lies on the insurer.

9.6.5. Fraud

Fraud always invalidates a contract. The fraud would forfeit all the benefits under the policy. It contemplates three eventualities-presentation of a fraudulent claim, use of fraudulent means and acts of willful destruction like arson etc., Fraudulent does not necessarily include improper or excessive claim. Fraud cannot necessarily be in case of price. However, it may be in respect of quantities. Excepted property if included under insured properties would amount fraud. False valuation of insured properties comes under fraud. Incendiaries or arson committed by the insured or by any one else with his connivance will be fraud and will avoid the policy.

9.6.6. Claim

The notice of loss is to be given forth with after its occurrence though details can be given thereafter. The expenses of claim will be borne by the insured. The insured has to disclose other intendances in respect of the property for the purpose of determining the contribution that may be payable by other insurer. The insured must give immediate written notice of any destruction or damage and should be followed with a written notice within 15 days of the claim. The time may be extended by the insurer where there is a reasonable case for it. The insure must furnish all reasonable proof and information required together with a statutory declarations as to the truth of the claim or any matter connected therewith.

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9.6.7. Reinstatement Clause

The insurer has the option to discharge his liability by reinstating or replacing the damaged property. The case payment of actual loss is not made under this clause.

The insurer shall not be bound to reinstate exactly or completely, but only as circumstance permit and in reasonably sufficient manner and in no case shall the insurer be bound to expend more in reinstatement that it would have cost to reinstate such property, as it was at the time of the occurrence of such loss or damage, nor more than the sum insured by the insurer thereon.

9.6.8. Insurer's Rights After A Fire

On the happening of any loss or damage to any of the property insured by this policy, the company may.

(a) enter and take and keep possession of the building or premises where the loss or damage has happened.

(b) take possession of or require to be delivered to it any property of the insured in the building or on the premises at the time of the loss or damage.

(c) keep possession of any such property and examine, sort, arrange, remove or otherwise deal with the same.

(d) sell any such property or dispose of the same for account of whom it may concern.

The powers conferred by this condition shall be exercisable by the company at any time until notice in writing is given by the insured that he makes no claim under the policy or if any claims is made until such claim is finally determined or withdrawn.

9.6.9. Loss Procedure

It is the responsibility of the insured to inform about the loss as soon as the loss occurs. The insurer will send a claim form to the insured. In this form a detailed information about the loss, the place and the circumstances under which it occurred and the description of the property insured are given. The insurer will examine the claim form and if find it reasonable, claim is paid at once. It the loss is serious and disputable the insurer may appoint an assessor called adjuster. The assessor or the adjuster will examine the cause of fire, the amount loss and amount of salvage. If the insurer is satisfied and the insured is agreed, the amount of claim is paid. In case of dispute, the arbitrators and umpire may settle the dispute.

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96.10. Constribution and Average

The contribution clause clarifies that if there is more than one insurance, all the insurers will indemnity according to their proportion to the total insurance. So the liabilities to the insurers are limited to their ratable proportions of the loss. One alternative is also available that the insured can recover the whole of the loss from any one insurer leaving him to collect the proper contributions from the other insurers. The contribution clause simplifies claim settlement. The rate able proportion of each insurer is arrived at by dividing the sum insured his policy by the total insured sum of all policies on the risk.

The following conditions must be fulfilled for this clauses:

(i)The subject matter of insurance must be common to the policies.

(ii)The peril which is insured against must be common to al of them

(iii)The same insured must be interested in al the policies.

(iv)All the policies must be in force at the time of the loss.

9.7. SETTLEMENT OF CLAIM

The insurer should be informed about the loss as soon as the loss occurs. On receiving notice, the insurer appoints an assessor to examine the facts of the case and to determine the amount of liability. The assessor is an expert person having the ability and experience in handling claims. The assessor is empowered to act and make necessary arrangement on behalf of the insurer. he goes to the site of fire and personally examines the damaged property and collects all available information. The assessor gets the idea of the nature and extent of the damage, the origin and cause of fire. usually the assessor asks from the insured about the loss to avoid future dispute between the insured and the insurer. The insured is suggested to separate the salage or undamaged part to reduce the possibilities of further damage and to evaluate the amount of loss correctly.

Steps are taken to check that

(i)the policy is in force on the date of occurrence of the loss or damage

(ii)the loss or damage is by a peril insured by the policy (iii)the property affected by the loss is the same as insured under the policy

(iv)notice of loss is received without undue delay

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After the initial check up, a number is allotted to the claim entered in the claims register. A separate docket is opened for filling the claim papers and a copy of policy. The face of the docket provides for printed columns for incorporating claim number, policy number, date of loss, estimated amount of loss, date of survey, name of the surveyor, etc.,

A claim form is issued to the policy holder. The claim form requires the following information:

(i) Full description of circumstances of the loss such as date of loss time, the place of fire.

(ii) Cause of fire

(iii) Particulars of the property affected by the loss such as description, value at the time of fire, value of salvage and the claim amount.

(iv) Statement of other insurances on the property, name of the insurer, the policy number and the sum insured.

(v) Sound value of all the property

The claim is recorded in the docket of claim. Where facultative reinsurance is involved, an advice of the loss is sent to the insurance.

The survey report of the assessor contains the following information:

(i) Cause of loss: It is necessary to know whether the fire was caused by an excepted peril or was caused by the negligence of a third party or there was any evidence of fraud. So, the cause of fire is clearly obtained. Often the exact cause and origin of fire cannot be accurately established. In such cases the available evidence will have to be carefully examined to support a plausible cause.

(ii) The amount recommended for payment which is determined on the basis current market value and under-insurance.

(iii)Detail and value of salvage. The method to dispose it of.

(iv)Details of expenses involved in extinguishing fire and salvage corps charges.

(v)The position in respect of compliance with the warranties

(vi)Apportionment of the loss and expenses among the insurers where there are more than one insurer.

(vii)The assessor can judge whether the fire has been started at more than one place and whether it is a case of arson. He will inquire whether there is a breach of warranty or negotiated on the part of the insured.

(viii)The exact amount of loss payable by the insurer. The presence of the average clause in the policy will determine the amount of loss payable.

On receipt of the claim form duly completed and the survey report, the claim is processed and, if it is in order, a discharge voucher is to be signed by the insured. The amount of loss payable by the insurer is usually settled by agreement between the insurer and the insured otherwise the matter has to be referred to arbitration. Market value of the damaged property is usually taken into account while calculating the amount of loss. Sometimes, the cost of replacement is considered for the purpose. But it, is prevalent only in advanced countries because the insurers have well-equipped staff of replacement.

Before the cheque in settlement of the claims is released, the payment is recorded in the claims register and the claim docket. It is essential that the salvage recoveries should be correctly recorded in the claims register. The payment is recorded in the relative policy file and the sum insured is reduced by the amount of the claim. The sum assured can be reinstated on payment of proportionate premium from the date of reinstatement of the sum insured to the date of expiry of the policy. When the amount of loss is estimated to be small and the cost of investigation is disproportionally high the survey is dispensed with and claim is processed and settled on the basis of the completed claim form. When the insurance is on co-insurance basis, the surveyor is appointed by the leading office. Each co-insurer is sent a preliminary advice of the claim followed by a copy of the final survey report which indicates the apportionment of the loss among the con-insurers. Generally the leading office settles the entire loss and recovers the proportionate shares of the loss and expenses form the co-insures.

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9.8 REINSURANCE

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Reinsurance is an arrangement whereby an original insurer who has insured a risk insures a part of that risk against with an other insurer, that is to say, reinsures a part of the risk in order to diminish his own liability. The difference between the retention and the total amount of acceptance is reinsured. The limiting or retention and effecting of reinsurance brings about a wider distribution of the risks and secures to the insured the full advantages of the law of average.

9.8.1. Limits

It is usual to fix a limit up to which the insurer is prepared to loss on risks in a specified class. The limit depends upon the following circumstances:

1. The financial status and premium income of the insurer. A new insurer with small premium income cannot afford to sustain a loss which might be borne with ease by established insurer with ample reserve.

2. The experienced in a particular class of risk:

    (i) The degree of the fire hazared present

    (ii) The extend of the damage likely to be sustained

    (iii) The fire extinguishing facilities available

3. The limit will vary according to the nature and size of the concerns proposing for insurance.

4. Location and other factors affecting the risk are also taken into account while calculating the amount of limit.

9.8.2. Retention:

After deciding the limit retention can be easily fixed. Retention is the amount of maximum liability which the insurer can assume on a particular risk. The retention is determined according to the class to which it belongs and to its merits and demerits. The retention is also decided upon the total amount of insurance in force, the average size of the policies and the amount of surplus fund available with it. It also depends upon the size of company, age of issue, the type of policy and the class of risk.

9.8.3. Reinsurance:

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Reinsurance is the transfer of insurance business from one insurer to another. The insurer transferring the business is called the principal or ceding or original office and the office to which the business is transferred is called for reinsure or guaranteeing office. It is also a contract of indemnity. The original company must disclose all the material facts to the reinsure. At the time of loss the reinsure indemnifies the loss up to the amount of reinsurance. The reinsurance amounts obtained by deducting retention amount from the original policy amount.

9.8.4. Advantages of Reinsurance:

1. The original insurer can accept the risk to the extent of his limit. In absence of reinsurance, a person desiring a large amount of insurance will have to take a number of policies from several insurers. This reinsurance contract makes it possible to purchase only one policy form an insurer.

2. Reinsurance makes it possible to accept each risk for the very amount desired by the proposes and to transfer the excess above the retention limit to another insurer.

3. The reinsurance gives the benefit of the greater stability resulting from a widespread of business. By accepting many risks and scaling down, by reinsurance, all those that are larger than the normal carrying capacity of the insurer justifies, certainty in business is substituted for uncertainty through tech better application of the law of average.

4. The reinsurance makes stability in underwriting and consistency in underwriting results over a period.

5. It provides a safeguard against serious effects of conflagration

6. The reinsurance has the effect of stabilizing income and losses over a period of years.

9.8.5. Methods of Reinsurance

9.8.5.1. Shopping or 'street' Reinsurance:

Under this method, there is no standing agreement regarding re-insuring of risk of one company by the other. Each policy is treated on an individual basis. The reinsurer is sought only when the need of reinsurance on a policy arises. The reinsurer scrutinizes each case on its merits and may accept the risk on any terms and conditions or may decline it. Since the ceding company is not certain abut the availability of reinsurance and a term, it will exercise a greater care in selecting the risk.

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9.8.5.2. Facultative Reinsurance:

The essential features of this method is that each individual risk is submitted by the ceding office to the reinsure who can accept or decline whatever sum they consider appropriate subject to the amount of heir acceptance being approved by the ceding office. The reinsurer is offered the particulars of original contract. The reinsurer will see the plan and report on the risk offered for reinsurance. The reinsurance may quality the acceptance subject to palm and report. The ceding office may retain certain amount on the insurance. The agreement doesn't make it bending upon there-insuring company to provide reinsurance on a particular risk. The ceding office is under no obligation to submit all its business to the insurer.

This method differs from the Shopping in the sense that the two companies are agreed in advance as to the form in which risks, premium, terms and other details are to be submitted. Thus, many expenses connected with shopping are reduced, Under this method also, the ceding office may have to wait before accepting the original risk till it is accepted for insurance. When the under writing rules of the two companies are similar and the plan of insurance seems to be fairly to be fairly satisfactory, it can be assumed with reasonable safety that the required reinsurance will be available.

The ceding office knowing that the risk may also be declined for reinsurance will be more careful in accepting the original risk and may avoid the higher risk. It may receive valuable advice form the re-insurer.

9.8.5.3. Automatic or Treaty Reinsurance:

Under this method, there is an agreement between the ceding office and reinsured office that the amount of insurance on a policy above the retention of the ceding office shall be submitted by it for reinsurance and the same shall be accepted by the reinsuring company. As soon as the original contract is completed the excess above retention amount becomes automatically reinsured under the agreement. The ceding office need not even inform the reinsuring office immediately that a risk has been accepted by it. The terms and conditions of the reinsurance contract are the same as of the original insurance contact. The maximum reinsurance amount acceptable to the reinsurer bears a definite relationship with the retention limit of a ceding company.

9.9 RATE FIXATION IN FIRE INSURANCE

The actual process of rating consists of three steps:

1.classification 2.Discrimination and 3.Fixing rates of schedule rating.

9.9.1. Classification:

Properties are divided into three main classes (a) ordinary (b) hazardous (c) doubly hazardous. Different premium rates are fixed for each class. The risks are classified into various classes according to factors affecting fire risks.

Fundamental Factors Affecting Fire Insurance Rates

9.9.1.1. Constructions or structure:

Properties made of cement, concrete bricks etc. have lesser fire risk than those made of wood and mud. The structure is further analyzed into-area of the structure, nature of walls, height, floors, door etc. All these are taken into account in estimating the fire risk.

The structures may thus be classified as:

(a) Fire proof (pucca) (b) Without fire proof (ordinary) (c) Kutcha etc.

In life insurance the calculation of premium is scientific because the physical hazard being satisfactory estimated. But in the insurance, because of moral hazard, the calculation is not so scientific as that of the insurance.

Occupancy: There exists hundreds of possible hazards of occupancy which reflect the uses to which the property is devoted of the several buildings having the same structure one may be used as a super market, retails store, a musical instrument store, a factory, or as a dwelling house. On the basis of occupancy and nature of risk involved different rate are charge. More than 75 percent of all fires originate from the occupancy in comparison to the building structure.

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Exposure: The degree of risk of each building is influenced by its surroundings. If a number of factories and workshops are situated around dwelling houses the hazard involved is far greater.

Protection: Protection may be of two kinds –public and private. public or Municipal protection is of great importance. Private protection consists of device installed by the owner such as fire extinguishers, sprinklers system and buckets, fire alarmed.

Place: The geographical area where the property is located is of great importance. Losses compared with the amount of insurance with the amount of insurance very form state to state.

Time: Five years is generally taken as a minimum period upon which rates are based. Good and bad years must be averaged out for rate making purposes over a sufficiently long period of time to enable the companies to accumulate, during the years of light losses; funds necessary to absorb the stock of heavy losses at other times.

9.9.2. Discrimination

The differentiation of the rates for individual risks in a particular class is known as discrimination. Each additional feature of risks is charged extra premium. The better type of risks are encouraged and attracted by the insurer. Lesser premium is charged where fire extinguishing appliances are present. The tariff system is based on the law of average and graded schedule is formulated where different rates are ascertained for the different types of risks.

9.9.3. Schedule Rating: It is a plan by which hazards with respect to any particular risk are measured. A standard or average premium is determined as a base for calculating the premium. The average premium rate for a class risk is determined taking into account the total loss and the sums assured during the period of years. The average fire rate is calculated as follows: L/Vx100

Here L stands for losses and V represents the value of insured amounts.

9.9.4. Principles of Rate Fixation:

The fire insurance rates care determined by three ways. (a) personal judgment (b) Tabulated experience (c) By schedule.

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9.9.4.1. Personal Judgment Rating:

This method was the first to be used. The rates so made indicated the opinion or judgment of the rate makers. The judgment is the result of the experience and observations of many years since the personal judgments differ greatly different rates may be determined of the same risk. The shortcomings of this system became more and more apparent with the increasing complexities of modern properties.

9.9.4.2. Experience Rating:

This method is not based essentially upon judgment. The combined judgment of a large number of individuals is taken into account. It is based on the experience of several years and of several persons. It reflects a reasonably accurate treatment of the various elements to measure the fire hazard.

9.9.4.3. Schedule Rating:

Under this method the fire hazard is separated into various elements and each element is assigned a particular value. Pioschedule descries a property as standard. For each standard risk a standard premium is charged. To this basic rate or standard premium, a certain stipulated charges are made for defects in construction and arrangement and certain deductions are made for unusually good features as compared with the standard.

9.9.5. Advantages of the schedule Rating System:

(i) It provides more equitable treatment of all insured. The premium rates come approximately the same.

(ii) It reduces friction between the company and the insured because the insured is able to understand how this rate is made.

(iii) It tends to reduce the fire waste because it encourages proper construction of buildings.

(iv) It secures more through inspection and rating

9.9.6. Difference between Life and Fire Insurance:

9.9.6.1. Form: The insurance contract may be divided into two forms (a) Life insurance contract of indemnity. Life insurance contract is a contact of certainty but the fire insurance contract is a contract of indemnity.

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9.9.6.2. Occuring of Event: The event, the death in life insurance is certain but the only uncertainty is the time when the death will occur. In indemnity insurance the event may not take place at all or may take place in part. Therefore, in life insurance ordinarily every place will become a claim sooner or later but it is not certain in indemnity insurance.

9.9.6.3. Subject Matter: The subject matter in Life insurance in life itself. The changes of death would increase along with the advance in age whatever precautionary measures may be taken for improvement of health, whereas the property and other insurance can be repaired and replaced and may remain usually in good condition.

9.9.6.4. Varaiance in premium: In life insurance premium is not much variable whereas in other insurance premium is variable in numerous forms.

9.9.6.5. Classification of Risk: The classification of risks is generally more simple on life insurance than in other types of insurance contract. In fire insurance contract it would be standard and uninsurable but in other insurance it may be several.

9.9.6.6. Period of insurance: Generally the life insurance is taken for longer period. Whereas the other forms of insurance are taken for not more than once or two years.

9.9..6.7. Protection and Investment: The life insurance contract provides protection against loss of early death and investment to meet the old age requirements. Other forms of insurance do not provide investment because the premium paid, is not returnable if the contingencies i.e., hazards do not occur within the period. Other forms of insurance provides only protection against loss or damage of the property against the insured perils.

9.9.6.8. Premium Payment: The mode of premium payment in life insurance is generally level premium whereas in other forms of insurances it is single premium.

9.9.6.9. Insurable Interest: Insurable interest must be at the time of proposal in life insurance but in property insurance it must be present at the time of loss.

9.10. DIFFERENCES BETWEEN FIRE AND MARINE INSURANCE

Although the two classes of insurance are basically contracts of indemnity and are insured for a short period, say one year or for a specific voyage, the following comparison should be noted.

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Under a fire insurance policy, only the actual loss based on the market value of the property at the time it was destroyed by fire or the amount insured whichever is less, is indemnified. Under a marine insurance policy, the insured is also allowed a margin of expected profits, say, up to 1- to 15 percent of the insured amount.

Under fire insurance, insurable interest must exist at the time of taking out the policy as well as the time of loss. Under marine insurne, insurable interest must exist only at the time of loss and need not exist when the insurance is effected.

A fire policy cannot be transferred without the permission of the insurance company whereas a marine policy can be freely transferred from one party to another.

9.11. KEY TERMS

- Ex-Gratia payment: when the insurer pays certain portion of the claim before final settlement. It is called ex-grate payment.
- Discrimination: The differentiation of the rates for individual risks in a particular class is known as discrimination.
- Subrogation: It means the right of one person to stroy in the place of another and to avail himself of the later's rights and remedies.

9.12. SUMMARY

Fire insurance has not a long history. The real establishment of fire insurance came only after great fire of London in 1066. This fire lasted for four days and rights burning over 436 acres of ground and destroying over 13,000 buildings was the most disastrous fire in history and forcibly awakened the repose to the necessity for a from of protection against such calamites. The main cause of take development was slow progress of trade and commencer after a certain period, when the business and commence ran height, fire insurance received a need fill up. The decision of law court also brought the principles of fire insurance to a standard form.

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9.13. ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) T (b) F (c) T (d) F (e) T
2. c
3. a
4. b
5. c

9.14. QUESTIONS / EXERCISES

SECTION - A

1. What do you understand by the fire insurance and explain the nature of fire insurance
2. Discuss the various kinds of fire insurance policy
3. What are the procedures followed to take out a fire policy?
4. Briefly discuss the various finds of fire insurance policy

SECTION - B

5. What is re-insurance? Explain the advantages and methods of re-insurance.
6. How a claim is settled in fire insurance policy?
7. Distinguish between fire and marine insurance
8. How rate is fixed in fire insurance policy?

9.15. FURTHER READING

1.M.N. MISHRA – Insurance Principles and practice

2.Dr.P.K. GOPTA-Insurance and Risk Management

Unit - 10 PRIVATISATION OF INSURANCE

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Structure

0.0 INTRODUCTION

The proposal to open up the insurance sector and allowing foreign equity have aroused wide spread interest and a number of domestic and foreign players are preparing to enter this area. This move has predictable met with resistance from trade unions on the grounds that this would raise cost of insurance services and that the cream of the business on the urban sector would be taken over by the foreign corporate form the public sector companies affecting their profitability.

10.1. UNIT OBJECTIVES

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- ❖ To increase investment in the country
- ❖ To increase employment opportunities
- ❖ To provide long term funds for long gestation projects and massive infrastructure development.

10.2. MOTOR INSURANCE

Motor insurance got recently a great momentum. In the older times, persons, who were injured or killed through the negligence of the motorist, could not get financial redress either to them or their legal heirs because no scheme of insurance was present at that time. To mitigate the financial hardship caused to the persons, the Motor Vehicles Act. 1939, as amended form time to time, has made it compulsory for the motorists to insurer against the risk of the liability to third parties.

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

Vehicles for the purpose of insurance are classified as below:

(i) Private car (not used for carrying passengers for hire or reward)

(ii) Commercial vehicles such as goods carrying Vehicles, passenger vehicles, tractors and others.

(iii) Motor cycles, scooters and auto cycles.

KINDS OF POLICIES

10.2.1. Act policies:

This policy is designed to meet the requirement of Motor Vehicles Act, 1939,which provides for compulsory insurance in regard to liabilities arising out of use of motor vehicles in a public place. This kind of policy is limited to bodily injury or death of the third parties. Section 95 (2) of the motor vehicles act lays down that a policy of insurance shall cover any liability incurred in respect of any one accident up to the following limits.

(i) Goods Vehicle Rs.50,000/- in all including the liabilities if arising under the W.C. Act, 1923, in respect of death of or bodily injury to employees (other than the

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driver) not exceeding six in number being carried in the Vehicle. **This means that** liabilities if any towards driver and employees (above six) being carried in he Vehicle under W.C. Act in addition to Rs.50,000/-

(ii) Passenger Vehicles: Vehicles in which passengers are carried

(a)For heir or reward

(b)By reason of or in pursuance of contract of employment

(i) in respect of persons other than passengers carried for hire or reward – Rs.50,000/- in all

(ii) .in respect of passengers – Rs.50,000/- in all where the vehicle is registered to carry not more than 30 passenger.

Rs.785,000/- in all where the vehicle is registered to carry not less than 30 but not more than 60 passengers.

Rs.1,00,000/- in all where the vehicles are registered to carry more than 60 passengers and

Subject to the limit aforesaid Rs.10,000 for each individual passenger where the vehicle is a motor car (used to carry into more than 6 passengers excluding the driver) and Rs.5000/- for each individual passenger in any other case.

(iii) Other Vehicles: The amount of liability except as provided otherwise.

The act besides the cover as required under the Motor Vehicles Act provides for indemnification of the claimants costs and expenses which the insured shall become legally liable to pay as also costs and expenses incurred with the written consent of the insurer. The policy may extend to indemnify any driver who is driving the Motor Vehicles on the insurances order or with his permission provided, he is not entitled to indemnity under any other policy.

10.2.2. Third Party Policy:

This policy cover the liabilities of the third parties who suffered loss in connection with the damage of property and person injury or death. Thus, this policy indemnities the insured against his legal liability in resooct of damage to property of third parties over and Rs.2000. The limit of liability is as follows:

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(a) Private Car – Unlimited

(b) Commercial Vehicle

(i) Goods or passenger carrying vehicles Rs.20,000

(ii) other miscellaneous or special type of vehicles Rs.50,000 Motor cycle unlimited

The Policy may be extended to include:

(a) fire

(b) theft risks

(c) legal liabilities to persons employed in connection with the operation and / or maintenance and / or loading and / or unloading of motor vehicles.

The private car policy extends to indemnify the insured (individual only) against legal liabilities incurred by him subject to limitations of indemnity whilst personally driving a private motor car. Private car policy covers legal liability of the insured to passengers (not for hire or reward) in the car although under the passengers (not for hire or reward) in the car although under the Motor Vehicles Act, it is not required to be covered. Liabilities arising while the motor car is being used in private places is covered. The policy covers bodily injury or death, property damage and medical expenses. Due to the amendment to the Motor Vehicles Act, 194, liability on third party claims has gone up as No fault liability compensation has been enhanced and structured compensating has been introduced.

10.2.3. Comprehensive Policy:

The comprehensive policy covers the following risks such as damage to car parts or body, removal charges for repairs, their party liabilities, cost and expenses incurred with risk, repair charges and medical expenses.

At the payment of extra premiums, the following risks are also insured.

(i)Death or injury to family members who are above 16 years and below 65 years

(ii)Riots, strikes, thefts, larceny etc.

10.2.4. Loss or Rugs

Jalf Rahat Yojna (Pre-litigation settlements) has been introduced to help claimants to get payment of compensations without approaching courts. Structured compensation formula has been used for quick settlements of claims.

10.3. BURGLARY INSURANCE

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For the business house Burglary Insurance is as essential as Fire insurance. It enables them to recoup the losses suffered by them consequent on burglary or house braking. The burglary department has devised other types of policies also beside burglary policy in order to give wider covers.

Types of Polices:

The main types of policies are:

(i)Business Premises Policy

(ii)Private Dwelling Policy

(iii) Jewellery and other valuable policy

(iv)All risk policy and

(v)Money in Transit policy

As normally understood burglary is theft of property form the premises following upon entry of the premises by violent and forcible means. It may also be a theft by a person in the premises who subsequently breaks out by violent and forcible means.

Theft is different from burglary. It is taking away any movable property dishonestly out of the possession of any person without the consent of that person. House barding may also be distinguished form burglary and theft. A person is said to commit house breaking who commits house trespass if he effects his entrance into the house for the purpose of committing an offence.

Business premises are generally covered against burglary and house braking only. Mere theft without the use of force and violence is not covered, robbery and decoity being aggravated forms of theft. Burglary and house barding fall within the scope of the insurance. Under policies issued for private dwellings the contents are covered against burglary, house breaking and theft risks. Similarly jewellery and valuables are also insured in the same manner.

10.3.1. Money in Transit:

Policies as a matter of rule cover robbery, holdup and decoity in addition to burglary, house breaking and theft.

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10.3.1.1. Business Premises Insurance Policies:

Business premises Policies cover stock in trade, goods in trust or on commission fixtures and fittings, tools of trade such as typewriters, calculators and other similar property and cash and currency notes in locked safe against the risk of burglary and house braking . A first loss policy insures the property up to a specified amount only which is calculated to the maximum likely loss on any one occasion. This types of policy is taken where a total loss is a physical impossibility. First loss policies are usually is taken for bulk commodities. The amount insured is always specified as a certain percentage of the full value say 10% or 12.5% of the full values.

10.3.1.2. Jewellery and valuables policy:

Policies in this form of insurance cover risks in respected to jewellery, plate, watches, personal moments and other valuables. Loss or damage by any accident or misfortune including fire theft, robbery from the person, defective settings of fastening and accidental damage are thus covered. The policies does not, however, cover, loss or damage.

(i) Occasioned by or in consequence of war, invasion, act of foreign enemy, hostilities, civil war, rioting, rebellion, revolution, insurrection, military or usurped power, riot, civil commotion, earth quake or other convulsion of nature.

(ii) Caused by or arising from any process of repairing, restoring or renovating any property insured.

(iii) Due to moth, wildew, wear or other deterioration or inherent defect in any property insured. The insured is applicable in all places within the geographical limits provided for in the policy.

10.3.1.3. Insurance of Money in Transit:

This is a modified version of Burglary insurance covering money or securities in transit between the insured's premises and bank or post or other specified place or between the insured's premises and branch premises. The cover is granted only to commercial and industrial establishments. The coverage of money in transit policy is as below:

(a) Wages in Transit form back to insured's premises.

(b) Cash in transit from insured's premises to post office for purchase of postal orders. Money orders and postage or Revenue Stamps.

(c) Postal orders money orders and postage or revenue stamps in transit form post office to insured premise.

(d) Wages in transit form the insurer's (main) premises to insured branch premises.

(e) Cash other than wages in transit form bank to insured's premises, from insured's premises to bank and between insured's premises and the insured's branch premises.

(f) Cheques, bills of exchange, money orders and postal orders in transit form the insured's premises to bank.

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In a money in transit policy, two sums are very important

(a) Limit of the insurer's liability for any one loss and

(b) Estimated amount in transit for any one loss and

The normal policy does not cover loss to the insured arising through the acts of the dishonesty by the employees entrusted with the carrying of the money. The policy is extended at additional premium to cover any loss to the insured or the property insured by any act of fraud or dishonesty committed by the employees or employees carrying the property.

10.4. MEDICLAIM

The policy covers reimbursement of hospitalization / domiciliary hospitalization expenses for illness / disease or injury sustained by the insured person within India only.

Person between the age of 5 years to 75 years can be covered without reduction in benefit however children between the age of 3 years can be covered provided one or both parents are covered concurrently.

One can take sum insured ranging form Rs.15,000/- to Rs.3,00,000/- in multiple of Rs.5000 which is inclusive of domiciliary hospitalization. Other terms / conditions / exclusions are almost like old policy.

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Minimum hospitalization of 24 hrs. is mist except treatment like diabetes, chemotherapy, radio therapy, eye surgery, dental surgery, lithotripsy (kidney stone removal) tonsillectomy and DNC.

Claim within first 30 days are excluded except injury arising out of accident.

Pre-existing disease are exclusion part of the policy. Whether or not the insured person had knowledge with the symptoms relating to the sickness.

Disease excluded during the first year of the policy are the same as per old.

Family discount of 10% may be allowed comprising insured any one or more to the following:

(a)Spouse

(b)Dependent children i.e. legitimate or legally adopted children

(c)Dependent parent .

Aids is now clearly defined and same way exclusion regarding eye and ear modified.

10.4.1. Cost of health check-up:

The cost so reimbursable shall not exceed 1% of the average sum insured during the block of 4 claim free underwriting years.

The group Mediclaim policy will be available to any group /association/institution / corporate body provided it has a central administration point. Each insured should cover all eligible members (insured person) under one group policy only. In other words, different categories of eligible members shall not be allowed to be covered under different group policies. It is not permissible to issue any unnamed policy.

Minimum number of person :50

Age limit, basic premium, benefits and exclusions are same as per individual Mediclaim policy .

10.5. PERSONAL ACCIDENT INSURANCE

Personal accident insurance is one of the popular classes of accident insurance and as a supplement to life insurance, it provides and ideal protection against death or disability. Though the majority of the policies still issued are to individuals, it has

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found ... our with employers who offer personal accident insurance benefits as a part of the service benefits to their employees.

personal accident policy provides for specific benefits of insured person suffering injury, resulting in death or disablement arising solely and directly from an accident caused by violent external and visible means. The bodily injury with in 12 calendar months from occurrence there of shall solely and directly cause or result in-

1. Death
2. Loss by physical separation at or above the wrist or ankle of-
   - (i) both hands or feet or one hand and one foot (known as loss of limbs)
   - (ii) Complete and irrecoverable loss of sight in both eyes.
   - (iii) loss of one limb and complete and irrecoverable loss of sight in one eye.

     In these above cases capital sum insured is given .
   - (iv) loss of one limb or complete and recoverable loss of sight of one eye – in this regard 50% of capital sum insured .
3. Temporary total disablement – in this respect 33% of capital sum insured, maximum Rs.500 per week.

10.6 ELECTRONIC EQUIPMENT POLICY

The policy covers sudden and unforeseen material damages to electronic equipment due to any cause.

Fire and allied perils, explosion, machinery break down, short circuit and other electrical causes such as voltage fluctuations, theft, burglary, smoke , soot, corrosive gases, water damage ,humidity, faulty operation, gross negligence, lack of skill, natural calamities , malicious damage, falling object and entry of foreign bodies ,etc, sub to certain exclusions such as Electronic data processing machine, Tele communication equipment, transmitting and receiving installations, radio, TV cinema – sound reproduction and studio equipment, material testing and research equipment, electro medical installations, signal and transmitting units, office calculators, duplicating machines and reproduction machines and control and supervisory units are covered.

10.7 HOUSE HOLDERS INSURANCE

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The householder's insurance policy is designed to cater to the requirement of the householders by combining under a single policy a number of contingencies which are other wise covered separately. The policy covers are building of class 'A' construction, burglar,; house breaking , larceny or theft; all risks; plate glass; break down of domestic appliances; T.V. set; pedal cycles; baggage insurance , personal accident and public liability. The policy does not cover inter – alia loss or damage by war, civil war and the like , depreciation , wear and tear, consequential loss etc. The damage to building against fire, lightning explosion of gas in domestic appliances, bursting and over flowing of water tanks, apparatus or pipes, air crafts of articles dropped there from, riot and strike earthquake, malicious act, flood, inundation, storm, cyclone , subsidence , and landslide damage and impact damage are covered by this policy.

10.8 SHOP KEEPERS INSURANCE

The shop keeper's insurance policy includes fire and allied perils, burglary and house breaking, money insurance, pedal cycle, plate glass neon and glow sign, baggage insurance, personal accident, fidelity guarantee, public, liability and workmen's compensation liability. The premium rate per thousand varies from the minimum of P.S. 0.50 for public liability to Rs.20.00 per thousand for pedal cycle. The premium rate varies content wise.

10.9 CROP INSURANCE

The countrywide comprehensive crop insurance scheme introduced by the Government of India commenced from Kharif 1985-86. The GIC has been entrusted with the task of administering the scheme on behalf of the Government . The insuranc charges and claims in respect of crops insured in any state is shared between the centra crop insurance Fund and Crop Insurance Fund set up by the state Government concerne in the ratio of 2:1. GIC maintains close and constant liaison with state Government ,RBI NABARD, State cooperative Banks, commercial Banks, Regional Rural Banks, and others agencies involved for smooth implementation of the scheme.

10.10 CATTLE INSURANCE

This is a market agreement w.e.f. 1.10.97 amongst the subsidiaries o GIC of India in respect of cattle insurance Business.

The agreement shall be observed by the Constituent companies with regard to the rates, terms and conditions prescribed by this agreement by this agreement to underwrite the business of cattle insurance with India, The word Cattle for the purpose of the agreement refers to:

Milch cow and buffaloes: calves / heifers, stud bulls, bullocks and castrated male buffaloes, whether : indigenous, exotic or cross breed.

Exotic animal means an animal, whose both parents are of foreign breed. This includes animals born in India as well as those born abroad.

Cross-breed animal mean an animal, one of whose parents is of foreign breed.

The market value of cattle varies from breed to breed form area to area and form time to time. The examining veterinarians recommendations shall be considered as the proper guide for acceptance of insurance as well as for settlement of claims.

Sum insured will not exceed 100% of market value.

10.11 TYPES OF INSURANCE ORGANIZATIONS

The insurance organization developed indifferent forms with the advancement of insurance practices. Some of the forms are given below.

10.11.1. Individual Insurer :

An individual like other business can perform the business of insurer provided he has sufficient resources and talent of insurnce business. The individual organization has been rare in the field of insurance.

10.11.2. Partnership:

A partnership firm can also carry on the insurance business for the sake of profit. Since it is not an entity distinct form the persons composing it, the person liability of partners in respect of the partnership debts is unlimited. In case of huge loss the partners have to pay from their own personal funds and it will not be profitable to them to start insurance business.

In the early period before the advent of joint stick companies may insurance undertakings were partnership or unincorporated companies. They were constituted by

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Check You. Progress

1. State whether the following statement is True False

(a) Private Dwelling policy is one of the Burglary Insurance

(b) Hose holder insurance caters to the requirements of the electronic equipment

(c) Crop insurance scheme introduced by Govt. of India

(d) Frane had nationalized large insurance companies

(e) The IRDA Act passed in the parliament

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deed of partnerships which regulated the business. Before formation of joint stock companies, the crown had empowered to grant an application letters patent to such unincorporated companies to operate the business with limited liabilities. Sometimes the policy holders were permitted to share the management of the concern.

These forms of insurance has been completely disappeared with the ad ent of joint stock companies.

Joint stock companies:

The joint stock companies are those which are organized by the share holders who subscribe the necessary capital to start the business are formed for earning profits for the stock holders who are the real owners of the companies. The management of all companies is entrusted to a Board of Directors who are elected by the share-holders from among themselves. The company can operate insurance business and the policy holders have nothing to do with the management of the concern. But in life insurance, it is the practice to share certain portion of profit among the certain policyholders. The participating policy holders are getting the bonus. Before nationalization, according to insurance Act 1938, the policy holders had a right to elect their representatives to the Board of Directors to the event of one fourth of the total number of directors of the company. The provision enabled the policy holders to have an effective voice in the management of the company. Most of the insurance businesses were done on joint stock basis before nationalization. They were operating within the memorandum of association and articles of associating framed by them. They used to distribute only 5 per cent of the divisible profit to the share holders and more than 95 percent of the divisible was distributed amongst the policy holders.

10.11.3. Mutual companies:

The mutual companies were co-operative associations formed for the purpose of effecting insurance on the property of its members. The policyholders were themselves the shareholders of the companies. Each member was insurer as well as insured. They had power to participate in management and in profit to the full-extent. Whenever the i ome was more than the expenses and claims, it was accumulated in the form of saving and was entitled in reducing the rate of premium. Since the insured were insurers also, they always tried to reduce the management expenses and to keep the business at sound level.

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The theoretical base of the mutual companies is issuing of participating policies i.e. the policy holders had full power in management and profit, whereas the joint stock companies, strictly were to issue non-participating policies. But, in practice, the joint stock companies were also issuing participating policies. It made them mixed companies i.e. were the features of joint stock companies and of mutual companies were present.

Co-Operative Insurance Organization:

Cooperative insurance organizations are those concerns which are incorporated and registered under India co-operative societies Act. The concerns are also called "Co-Operative Insurance societies". These societies like mutual companies are not profit organization. The aim is to provide insurance protection to its members at the lowest reasonable net cost. The India insurance Act, 1938, has provided special have been ceased.

10.11.4. State Insurance:

The Government of a nation, sometimes, owns the insurance and runs the business for the benefit of the public. The state insurance is defined as that insurance which is under public sector but more specifically it can be stated that when governments have taken over the insurance business particularly life insurance. France had nationalized larger insurance companies in 1946. In Brazil, Japan and Mexio, the insurance are largely nationalized. Previously, the state undertook only those insurance which were regarded to be very vital for the public interest or where private companies were not able or willing to enter the filed of insurance. Social security, unemployment, Crop insurance, war risk insurance, export credit insurance, aero plane insurance generally under state insurance.

10.12. HISTORY OF LIFE INSURANCE

Life insurance in its existing form came to India form the united Kingdom with the establishment of a British firm, Oriental Life Insurance Company in Calcutta in 1818 followed by Bombay life Assurance Company in 1823, the Madras Equitable Life insurance society in 1329 and oriental Government Security Life Assurance Company in 1874 prior to 1871 Indian lives were treated as sub-standard and charge and extra premium of 15 percent to 20 percent. Bombay Mutual Life Assurance Society, an Indian insurer which came into existence in 1871, was the first to cover Indian lives at normal rates. The Indian Life Assurance Companies Act, 1912 was the first statutory measure to regulate life insurance business. Later in 1928 the Indian insurance Companies Act was enacted, inter alia to enable the Government to collect statistical information about both life and non-life insurance business transacted in India by Indian and foreign insurers, including the provident insurance societies. In 1938, with a view to protecting the interest of insuring public, earlier legislation was consolidated and amended by the insurance act, 1938 with comprehensive provisions for detailed and effective control over the activities of insurers. In order to administer the aforesaid legislation, an insurance wing was established and attached first with the Ministry of commerce and later with the Ministry of Finance. This insurance wing was administratively responsible for deciding policy matters pertaining to insurance. The actuarial and operational matters relating to insurance industry were looked after by an attached office at Shimla headed first by the Actuary to the Government of India, then by the Superintendent of Insurance and finally by the controller of insurance . The Act was amended in 1950, making far-reaching changes, such as requirement of equity capital for companies carrying on life insurance business, ceilings on share holdings in such companies, stricter controls on investments of life insurance companies, submission of periodical returns relating to investments and such other information to the controller as he may call for, appointment of administrators for mismanaged companies, ceilings on expenses of management and agency commission, incorporation of the insurance Association of Indian and formation of councils and committees thereof.

By 1956, 154 Indian insurers, 16 non-Indian insurers and 75 provident societies were carrying on life insurnce business in India. Life insurance business was confined mainly to cities and better off segments of the society.

On 19th January 1956 the management of life insurance business of 245 Indian and foreign insurers and provident societies, then operating in India, was taken over by the central Government and then nationalized on 1st September, 1956. LIC was formed in September, 1956 by an Act of parliament viz. LIC act, 1956, with capital contribution of Rs.5 crores form the Government of India.

10.13 HISTORY OF GENERAL INSURANCE

General insurance would appear to have enveloped with the industrial revolution in the west and consequent growth of seafaring trade and commerce in the

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seventeenth century. It came to India from U.K. To begin with, British and other foreign insurance companies transacted this business through their agencies in India. The first general insurnce company viz. Triton Insurance Company Ltd. was established in Calcutta in 1850, whose shares were held mainly by6 the British. The first insurance company to be set-up Indians for transaction all classes f general insurance business was Indian Mercantile Insurance Company Ltd. in Bombay in 1907. The British and other foreign insurers had a good share of insurance business, about 40 percent, at the time of independence. This share declined thereafter progressively.

In 1957, the General Insurance Council, a wing of the Insurance Association of India, framed a copy of conduct for ensuring fair conduct and sound business practices in the general insurnce industry. An administrative set-up headed by the Controller of insurance was set-up in 1957 at Delhi with branch offices at Bombay, Calcutta and Madras for administering the code of conduct. Further in order to increase retention of general insurance business in India, the insurers started a reinsurance company, via, India reinsurance Corporation Ltd in 1956 to which they all voluntarily ceded 10 percent of their gross direct business. In 1961, by an amendment to the insurance Act, this voluntary arrangement was formalized by notifying the Indian Guarantee and General Insurance Company Ltd. a Government company, along with the Indian Reinsurance corporation as "Indian Reinsures". The cession to each of them was about 10 percent. Besides, the insurers also had a pooling arrangement in terms of which a percentage of their fire and marine hull insurance business was ceded to the Fire insurance pool and the Marine Hull insurnce pool and the Marine Hull insurance pool respectively. Such business was retrocede among the same insurers thereby spreading a portion of the risk under every olicy among the members of the pool. In 1968, the insurance act was act was amended again to provide for members of social control over insurers transacting general insurnce business. The amendments provided inter alia, for regulation of investment of assets, setting up of the Tariff Advisory Committee (TAC) under the chair man ship of the Controller of Insurance, Minimum solvency margin, licensing of surveyors and payment of premium before commencement of risk. The insurance Act also gave. Powers to the controller of insurance to carry out inspection, investigation and search and seizure of books. These amendments to the Act came into force on 1st June, 1969. Before however they could be effectively implemented, management of non-life insurers was taken over by the central Government in 1971 as a preclude to nationalization. General

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insurnce business was nationalized with effect from 1st February 1973 by the General Insurance Business (Nationalisation) Act. 1972.

Prior to 1973, general insurance was by and large city-oriented, catering mainly to the needs of organized trade and industry. One hundred and seven insurers including branches of foreign companies operating within the country were amalgamated and grouped into four companies viz. the national insurance company ltd., and the United Indian insurance company Ltd., with head offices at Calcutta, Bombay, New Delhi and Madras respectively, GIC was incorporated as a company in November 1972 and it commenced business on 1st January 1973.

The Capital of GIC was subscribed by the Government of India, and that of the four companies by GIC. All the five entities are Government companies registered under the companies act.

10.14. PRIVATISATION OF INSURANCE SECTOR

One of the most important reasons behind the decision to open up the insurance sector is perhaps the realization that the existing players would be hard put to support. the quantum jump over current levee is on account of opening up of the economy. Globalization demands a hi-tech, dynamic insurance sector. Insulation of the domestic companies form competition has resulted in less transparency in the working of these companies, which have hardly shown

Insurance is a Rs.400 billion business in India, and together with banking services adds about 7 percent of Indai's GDP. The total number of life insurance policies in the country is estimated at about 10 percent of the total population involving an annual premium of about Rs.20.000 crores. India has the highest number of life insurance policies in force in the world, and the total investible funds with the LIC are almost 8 percent of GDP. However more than three-fourths of Indai's insurable population is without life insurance cover. The scope for expansion covering new lines and selling more policies to existing policy holder's is therefore immense. It has been estimated that out of the vast number that has joined the productive class. LIC covers around 1.2 million while the rest wait for suitable insurance polices.

Similarly, in the sector, the insurance coverage is negligible. The health insurance market in India has tremendous potential to grow to about Rs.10,000 crores from the present level of rs.120 crores. As one Insurance company chief Executive has so aptly put it "insurnce has not yet been sold in the country but has only been bought"

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Private funding of health care is now gaining increased acceptance as a concept This radically increases the total market for health insurance. For example, most credit cards offer personal accident insurance of Rs.1 lakh According to conservative estimates, the number of credit cards would exceed six million by 2001. This will call for massive insurance cover.

India ranks 32nd in volume of General insurance business in the world with the per capita expenditure on insurance of US $2.2 whereas, in South Korea it is US $303. This disparity highlights the potential available for spread of general insurance business in India. However the annual growth in average insurance premium in India is 8.2 percent compared to the global average of 3 to 4 percent. Gross premia recorded by GIC showed a nearly four fold increase over a 10 years period beginning 1988-89.

India ranks 23rd in the world in terms of total insurnce business (premiums). The spread and reach of insurance remains destine nationalization, skewed and urban oriented. India has an insurance density of only 7.6 and ranks eighty-second in this respect in the world. Insurance penetration (premiums as share of gross domestic product) in India is a measly 1.95 and ranks 51st in the world. India is very much behind in ranking even among the Asian countries.

However, total premiums collected per annum in India were only 1.4 percent of GDP in 1996-97 compared to 2.3 percent in Singapore (in 1995). 3.3 percent in Japan and 98 percent in South Korea. Since 1987, when South Korean and Taiwanece insurance business was liberalized the South Korean market has grown three times faster than GDP and it Taiwan the growth has been four times that of GDP.

In the general insurance sector comprising mainly of three lines of business viz., motor vehicles, marine and cargo and fire the claims experience of GIC has risen from 43.8 percent in 1973 to 75.8 percent in 1996-97 due to increasing court awards. Reinsurance forms a substantial part of the general insurance sector. Subsidiaries of GIC are required to insurer 20 percent of their business with the GIC. So far however, reinsurance business form industry outward and inward operations are not significant reflecting perhaps their cautions approach in such matters. Services for general insurance from the institutional sector are also expected to show substantial increases Increased economic activity as a result of globalization and recent emphasis on rapid infrastructure development would involve creation of new assets thereby creating demand for additional insurance cover. It is estimated that the demand for additional insurance cover could go up to a few billion dollars annually. GIC has the potential of emerging as one of the major reinsures in the Asian market.

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Entry of the private sector and creation of competitive structure would be necessary to meet such a massive demand. International investors are likely to be unwilling to commit resource unless convinced that their investment (reasi assets) will be completely protected through efficient insurance services.

It is therefore clear that the opening up of the insurance sector would help increased fund flow into long gestation period projects s the insurance sector has access to long term funds. This would be of special significance in the context of the direct need for massive funds for financing infrastructure. The opening up of the insurance sector of bound to increase investment in the country, increase employment opportunities also provide much needed long term funds for long gestation projects and massive infrastructures development.

Once the insurance sector is opened up to competition, the public sector giants in the insurance business. The life insurance Corporation (LIC) and the General insurnce corporation (GIC) have to be made capable of competing with the new global buyers. then, therefore, have the opportunity of setting their house in order though reduction of unwanted manpower, provision of international standards of service and efficient and speedy settlement of claims so that they continue to enjoy the patronage of their customers. The insurance employees union has expressed its opposition to any private entry and has adopted an agitation approach. Both LIC and GIC have demanded that they should be made the sole re-insurer for al domestic businesses to check the flow of insurance funds out of the country. GIC has also demanded reduction of the governments shared holdings to 50 percent, besides a restructuring of the organization before the market is opened up. It appears that such opposition to private entry is misplaced.

The apprehensions that there would be massive retrenchment and job losses due to modernization and that private firms would skin the urban cream market and ignore the rural areas are totally misplaced, since there is vast potential for life and other forms of insurance. As a matter of fact insurance liberalization in south korea and Philippines exploited and that every company has a proper mix of urban and rural coverage. Apparently the unions fear that private entry would demolish the government monopoly this sector. This, in turn would force managements to take measures to improve the qualify of services performance of employees in erstwhile government companies would be evaluated against stricter norms., forcing them to work better. In order that the public sector insurance companies remain competitive, Government may have to seriously consider breaking up of these companies in to smaller entities (may be on regional basis) so that they are not held to ransom by powerful trade unions.

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10.15 THE IRDA ACT

This act passed in the parliament aims at liberalizing the insurance industry in India. It includes a provision empowering the insurance Regulatory Authority with sole licensing powers. After continued impasse over the provisions of the Bill, the parliamentary standing committee on Finance finally cleared it with certain modifications. These modifications pertain to the level of foreign equity to be allowed for private sector participation – Whereas the government had earlier opted or a 26 percent stake for foreign insurers with an additional 14 percent for foreign investors (NRIs and OCBs) the standing committee had recommended a total of 26 percent stake for foreign holdings. Government has accepted these recommendations. The New Act will force promoters who hold more that 26 percent to divest the excess share capital in phases within a period of 10 years. Companies planning to enter the insurance business would be allowed to do so only in one area of business. life, general or re-insurance. The government has also set the requirement of a minimum share capital of Rs. 100 crores for companies wishing to enter insurance business. The Banking Act is proposed to be amended to permit corporate bodies and banks to be appointed as life insurance agents.

Check Your Progress

2. The share holders of the companies are policy holders in

(a) Mutual companies
(b) Partnership
(c) Joint Stock Companies

3. Shop Keepers insurance Includes

(a) Burglays breaking
(b) electronic equipments
(c) Bullocks

4. Cattle insurance covers

(a) Crops
(b) Crafts
(c) Death of animals

5. Motor Insurance Covers

(a) Jewellery
(b) Scooters
(c) Money in Transit

Some of the areas in IRDA Act which have been widely discussed by the industry and consumers pertain t the proposed 26 percent of cap of foreign equity. The chairman of Insurance Regulatory Development Authority (IRDA) Mr. N. Rangachari has stated that no financial re-engineering would be allowed to circumvent the 26 percent cap on foreign equity proposed for Indian insurance companies. Another area of insurance sector in India will need to bring in at least Rs.100 crores as initial capital. It appears that in actual practice, such companies would need to bring in much more than 100 crores as initial capital on account of stringent solvency margins. With a starting capital of Rs.100

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crores a life insurance company would be in a position to underwrite business up to only Rs.3000 crores. This may turn out to be an unprofitable proposition. Solvency margins being more strict in the case of non-life insurance companies there would be need for companies in this sector to invest many times more than the stipulated minimum of Rs.100 crores.

The IRDA has been set up almost six years after the submission of the insurance reforms (Malhotra) committee report. The IRDA Act incorporates the proposition of the insurance regulatory Authority Bill, 1998 and the amendments suggested by the standing committee on Finance, as well as other recommendations / suggestions from various quarters. Provisions have been incorporated to give a statutory character to the interim insurance regulatory Authority and the three schedules contains amendments to the insurance Act, 1938, amendments to the Life insurance Corporation Act, 1956 and the General Insurance Business (Nationalization) Act, 1972.

The proposed Authority will be a body corporate, consisting of a chairperson and a maximum of nine members, of whom not more that five shall serve full-time. The duties, powers and functions of the Authority, inter alia are outlines in the Act. These include protection of the interest of policy-holders in matters concerning assigning of policies, nominatin, insurance interest, settlement of insurance claims, surrender value of policy and other terms and conditions of contracts of insurance specifying requisite qualifications and the code of conduct and practical training for insurance intermediaries and agents. These powers and functions are expected to enable the Authority to perform the role of an effective watch dog and regulator for the insurance sector in India. To enable the Authority to function in a truly independent manner and discharge its assigned responsibilities effectively it is vested with statutory status.

The amendments to the Insurance Act, 1938 empower the insurance regulatory and Development Authority (IRDA) to effectively regulate, promote and ensure the orderly growth of the insurance industry. The amendments, among others provide for the substitution of the word "Controller" by the word "Authority" and substituting the term central Government by Authority in certain sections of the insurance Act, 1938.k The other amendments relate to empowering the authority in respect of registration of insurers percentage of equity capital to foreign company investment provisions, regulation of licens to intermediaries or insurance intermediaries and to make regulations.

10.16 FUTURE OF INSURANCE

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Insurance in India, over the past 25 years, has been a rather placid sector. Long the sole fiefdom of the two monopolies the Life Insurance Corporation of India (LIC) and the General Insurance corporation of India (GIC) only the past couple of years have seen the entry of private sector players and some excitements.

There are 12 new companies in the $ 10.5 billion life insurnce sector. They are Allianz Bajaj Life insurance, AMP Sanmar Assurance, Aviva Life Insurance Birla sun life insurance, HDFC standard Life Insurnce, ICICI Prudential Life Insurance ING Vysya Life Insurance Max New York Life Insurance, Metlife India Insurance, OM Kotak Mahindra Life Insurance, SBI Life insurance, and Tata AIG Life insurance. They are now into their second year of operations. By November 2002, they had garnered 8.66 percent of the all India premium and sold 3 percent of the total life products available in the market. ICICI prudential is the biggest. The big boy LIC is going strong, however, is still accounts for more than 90 percent of the life business.

In the smaller $ 2.5 billion general insurance there are eight new players. They are Bajaj Allianz General Insurance, Cholamandalam General Insurance HDFC, chubb General Insurance, ICICI Lombard General Insruance, IFFCO Tokio General Insruance, Reliance General Insurance, Royal Sundaram Alliance Insurance and Tata AIG General Insurance. More may join soon. According to a Ficci-Mckinsey report, by 2007, these private-sector companies will capture a 40-50 percent market share. The growth projection is 15 percent a year over the next five years.

Fuelled by competition, increased awareness will bring the customer on to centrestage. The customer will be the single most important factor and will drive change in the life insurance business. The customer in India is increasingly becoming aware and is actively managing his/her financial affaire. Today, while boundaries between various financial products are getting blurred, people are increasingly looking not just at products but at integrated financial solutions that can offer them stability of returns along with total proection. The key to success therefore would be in providing insurance solutions, not insurance products.

In an increasingly competitive scenario the key differentiator will be the customer experience that each insurance player can offer in terms of quality of advice, product choice, policy servicing and settlement of claims. Service would focus on enhancing the customer experience and maximizing customer convenience.

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10.17 KEY TERMS

- Personal Accident Insurance: It provides an ideal protection against death and disability
- Medi claim: It covers reimbursement of hospitalization / disease or injury sustained by the insured reason within India only
- House holders Insurance: It is designed to cater to the requirements of the house holders by combining under a single policy.

10.18 SUMMARY

The move to open up the insurance sector could be perceived as a significant step towards deregulating the metropolises industry. As the banking sector and the capital market sector are already on the path of reforms, it becomes imperative for the Government to risk the insurance sector too on this record.

10.19 ANSWERS TO 'CHECK YOUR PROGRESS'

1. (a) T (b) F (c)T (d)F (e)T
2. a
3. a
4. c
5. a

10.20 QUESTIONS / EXERCISES

SECTION - A

1. What is Burglary Insurance? Explain the type of Burglary policy.
2. Briefly discuss the various types insurance organization
3. Trace out the history of life Insurance in India

SECTION - B

4. Explain the impact of Privatization of Insurance contract
5. Write a note on: (a) Motor Insurance (b) Mediclaim (c)Crop Insurance (d) Cattle Insurnce (e) Shop-keepers insurance

10.21 FURTHER READING

1.MN. NISHRA – Insurnce Principles and Practice

2.Dr. P.K. GUPTA – Insurance and Risk Management

M.Com Degree Examiniation

Model Question

Time : Three hours

Maximum 100 marks

(4 x 10 = 40 MARKS)

SECTION A

ANSWER ANY FOUR OF THE FOLLOWING QUESTIONS.

ANSWER TO EACH QUESTIONS NOT TO EXCEED TWO PAGES.

1. What do you mean by Unit Banking? List out the advantages and disadvantages of Unit Banking

2. Define Insurance and Explain its features.

3. What are the causes of nationalisation of Banks

4. What are the vaerious procedurers to effect Marine Insurance Contract.

5. Discuss about the direct and Indirect finance to Agriculture

6. Write a note on

   a. Motor Insurance   b) Mediclaim   c) Group Insurance

7. Explain the various principles of Insurance contract

8. Distinction between fire Insrance and Marine Insurance

SECTION B

(3 x 20 = 60 MARKS)

ANSWER ANY THREE OF THE FOLLOWING QUESTION.

ANSWER TO EACH QUESTIONS NOT TO EXCEED FOUR PAGES.

9. What are the various functions of Commercial Banks.

10. What are the different types of risks.

11. Discuss the various finds of fire Insurance Policy

12. What are the different kinds of annuities under life Insurance

13. In detail, discuss about the Socio-Economic and Political Problems of Banks in India.

14. Explain the impact of privatization of Insurance contract

M.Com Degree Examiniation

Model Question

Time : Three hours

Maximum 100 marks

(4 x 10 = 40 MARKS)

SECTION A

ANSWER ANY FOUR OF THE FOLLOWING QUESTIONS.

ANSWER TO EACH QUESTIONS NOT TO EXCEED TWO PAGES.

1. What is meant by branch banking?
2. What is meant by unit banking?
3. What were the circumstances which forced the Government to nationalise 14 banks in 1969?
4. What is meant by priority sector?
5. Explain the need for merchant banking.
6. What is meant by surrender value in the case of life policies?
7. Explain the kinds of the insurance policies.
8. Account for the need for privatisation of insurance.

SECTION B

(3 x 20 = 60 MARKS)

ANSWER ANY THREE OF THE FOLLOWING QUESTION.

ANSWER TO EACH QUESTIONS NOT TO EXCEED FOUR PAGES.

9. Trace the origin and growth of commercial banks.
10. Explain the merits and demerits of unit banking and branch banking. Which system is suitable to India?
11. Explain the role of mutual funds in the mobilisation of savings.
12. Explain the role and importance of insurance. Point out the features of the insurance contract.
13. Critically examine the working of Life Insurance Corporation of India.
14. Explain the working of General Insurance Corporation of India.