Bureau's

HIGHER SECONDARY (+2)

# BANKING & INSURANCE

## (For +2 First Year Commerce)

(Approved by the Council of Higher Secondary Education, Odisha)


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# FOREWORD

**The Odisha State Bureau of Textbook Preparation and Production, Bhubaneswar** has made a pioneer attempt to publish text books for +2 Commerce Stream with an excellent team of teachers in different subjects.

The present book **"Banking and Insurance"** is meant for Higher Secondary Commerce students. This book has been written by a team of learned academicians namely Dr. Satyabrata Tripathy, Dr. Ajoy Mohanty, Dr. Banamali Panda and Dr. Sunil Kumar Jena and reviewed by Prof. (Dr.) Girija Prasad Acharya. I would like to record my sincere gratitude to all them for accomplishing this maiden venture in time. The main purpose of developing this text book is to provide a thorough exposure to the students of Commerce in this subject. The book, prepared according to the new syllabus prescribed by the CHSE, Odisha shall cater to the needs of young students.

I believe that the students and teachers of Commerce stream shall welcome and appreciate the book. I would also like to welcome constructive suggestions for further improvement of the book.

Geetika Patnaik

**(Dr. Geetika Patnaik)**
**Director**
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# PREFACE

There has been a manifold increase in the demand for banking services along with an increase in insurance services to cover various commercial and personal risks arising out of increasing complexities of modern life. Over the years, the banking sector has witnessed a substantial transformation in its operations with the emergence of information technology by taking an innovative approach with the objective of creating more value for customers. Similarly, insurance has evolved as a process of safeguarding the interest of people for loss and uncertainty and thus contributes a lot for the general economic growth of the society. Considering the importance of banking and insurance Council of Higher Secondary Education, Odisha has introduced a paper on 'Banking and Insurance' as a part of the prescribed new syllabus for +2 Commerce students. This book has been designed in accordance with the prescribed new syllabus of Council of Higher Secondary Education, Odisha for students of +2 First Year Commerce.

All possible attempts have been made to present the book in a simple, lucid and comprehensive form. Each chapter is followed by many typical multiple choice questions, very short, short and long type questions for the benefit of the students. We are confident that the students will find the book extremely helpful. No originality is claimed in the subject, rather literature from different sources have been referred to and collected. The authors owe to the original thinkers. Despite our best efforts, errors still might have remained undetected. We, therefore, invite constructive suggestions which would be instrumental in further improving our work in the next edition.

We express our deep sense of gratitude to Prof. (Dr.) Girija Prasad Acharya, former Principal, Ravenshaw College (now Ravenshaw University), Cuttack and former Director, Odisha State Bureau of Textbook Preparation and Production, who has taken pains in reviewing the manuscript thoroughly and making necessary modifications. The authors are indeed thankful to the Council of Higher Secondary Education, Odisha for giving an opportunity to prepare the manuscript and the Odisha State Bureau of Textbook Preparation and Production, Bhubaneswar for timely publication of the book. We are also thankful to all persons associated with the publication of this book in its present form.

***Board of Writers***

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# SYLLABUS

## BANKING AND INSURANCE

### +2 1st Year Commerce

### 4th ELECTIVE (PAPER-I)

**Objectives**

- To provide students an understanding of the Concept, functions, typ+es and role of commercial bank with their credit creation policy;
- To help the students in learning functions of commercial bank and methods of credit control;
- To enable students to learn the concept and types of innovative banking;
- To make the students able to know the concept, functions, types and principles of Insurance;
- To help students understand the concept, importance, process of effecting a life insurance policy along with its types;
- To enable the students to learn the concepts of various types of insurance like Marine, Fidelity, Crops, Motor and Credit Insurance

**Course Inputs**

**Unit-I : Commercial Banking**

Meaning and Functions of Commercial Banks, Types of Commercial Banks, Income Statement and Balance Sheet of a Commercial Bank, Credit Creation, Portfolio Management and Nationalisation of Commercial Banks, Role of Commercial Banks in a Developing Economy.

**Unit-II : Central Banking**

Central Bank- Functions, Methods of Credit Control, Quantitative Control, Bank Rate, Open Market Operations, Cash Reserve ratio and Selective control.

Innovative Banking- Merchant banking, Consortium Approach, Credit Card Facilities, On-Line Banking, Telephone Banking, Internet Banking, ATM cum Debit Card, E-Banking and Social Responsibilities of Banks.

**Unit-III : Introduction to Insurance**

Risk - Its classification and how to deal with it, Insurance-Meaning, Definition and Mechanism of Insurance, Functions of Insurance, Basic Concepts, Double Insurance, Re-insurance, Co-insurance, Insurance Market) Insurance Contract, Contingent Contract, Wagering .Contract, Fundamental Principles of Insurance Contract, Insurance Act and Role of IRDA.

**Unit-IV : Life Insurance & Other Insurances**

Life Insurance : Element of protection and investment, Importance of Life Insurance, Procedure of effecting a Life Policy, Premium computation including Mortality table, Various Policy conditions,

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CHAPTER - 1

# DEFINITION, MEANING, TYPES AND FUNCTIONS OF COMMERCIAL BANK

**STRUCTURE**

1.1 Introduction
1.2 Evolution of Commercial Banking– A global view.
1.3 Evolution and Growth of Commercial Banking in India
1.4 Definition, Meaning and Features of Commercial Bank
1.5 Types of Commercial Bank
 1.5.1 On the basis of Inclusion in Schedule
 1.5.2 On the basis of Ownership
 1.5.3 On the basis of place of Registration
1.6 The State Bank Group and Other Nationalised Commercial Banks
1.7 Regional Rural Banks
1.8 Co-operative Banks
1.9 Functions of Commercial Bank
 1.9.1 Primary Functions
 1.9.2 Secondary Functions
**Questions**

## 1.1. INTRODUCTION :

Perhaps very few man made economic institutions worldwide have proved so much powerful as effective instruments of socio-economic transformations or catalysts of socio-economic growth as the banking institutions have. In the spheres of finance, they function as the main arteries and veins chanelising flow of finance from the sources where they are available to the point where they are much needed for optimal productive utilization. They render varieties of

money related services to almost every sections of the society - be they individuals or institutions like business houses, industrial undertakings Governmental bodies or international agencies. So powerful are these institutions that the overall health and strength of the economy of a nation is always linked and correlated with the health and strength of its banking system. The banking institutions, in short, are universally recognised in modern economies, as the most powerful growth catalysts or propellers of economic growth and development. The recent global slowdown in economic growth which created a worldwide shock-wave had its origin in the banking performance and it vochsafes the commanding influence of banking system on the economy of nations.

## 1.2. EVOLUTION OF COMMERCIAL BANKING – GLOBAL VIEW

A systematic glance at the evolution of the banking global scenario depicts five successive stages. In the first stage, it was the merchant banker who first introduced the system of banking by way of facilitating remittances in trading commodities. As these trading activities required remittance of money from one place to another, they issued 'hundies' to remit funds. In our country this role of merchant banking was played by a category of persons known as 'seths'.

The impetus for the second stage of growth of banking came from goldsmiths. The goldsmiths were, as a basic need of their profession, in possession of safe and strong rooms. Their basic duty was to take special precautions against theft of valuables like gold, bullion, money made of gold and silver coins and jewellery of people and merchants. In lieu of this, the goldsmiths received some money and issued receipts which later on acquired the status of bank notes or a cheque which served as a medium of exchange and a means of payment. Further, the gold and silver coins had no mark of the owner. Hence, the goldsmiths started lending out such money to the needy which subsequently proved profitable for them.

The third stage in the growth of banking can be attributed to the money lenders. The goldsmiths who indulged themselves in accepting valuable and money and lending them out found the business to be profitable. Therefore, they started advancing coins on loan by charging interest. This became a regular feature. Regular accounts were maintained and passbooks were also issued. In due course, the goldsmiths started lending money to the government. Thus, the goldsmith-money-lender became a banker who started performing the two most important functions of modern banking i.e., accepting deposits and advancing loans.

The fourth stage of growth in banking sector was demand driven. With population increasing, trade and commerce expanding, the demand for more loans and safe keeping of savings increased. This gave rise to the development of a more developed form of money handling institutions

known as modern banking institutions. The first modern bank called the 'Bank of Venice was established in Venice, Italy in 1157 to finance the monarch in his wars which is recognised as the oldest commercial bank in the world. The bankers of Lombardy were famous in England. But modern banking in true sense only began with the Bank of England established in 1694. Banks in many countries in Europe came into existence on the pattern of the banks in England which led to the spread of modern banking system all over the world. However, the growth of joint stock company based commercial banks started only after the enactment of Banking Act in 1833 in England.

The latest stage of growth and development may be regarded as electronic driven banking stage or e-banking stage which characterised extensive use of modern electronic gadgets.

## 1.3. EVOLUTION AND GROWTH OF COMMERCIAL BANKING IN INDIA

Indigenous banking is an old tradition in India. The evidence of money lending operations can be traced to Vedic times. The Manu Sanghita of Saint Manu contained enough references regarding credit transactions. Similarly, Kautilya's Arthashastra had also enough indications about credit operations. Hundies, the indigenous version of modern 'Bills of Exchange' came to be used in the 12th century which is clearly evidenced from the writings of a few Muslim historians, European travellers and different state records. Thus, the indigenous bankers in different forms used to be the only players that continued till the Britishers entered into the field through English Agency Houses established at Calcutta and Bombay (presently Kolkata and Mumbai). These 'Agency Houses' paved the way for establishing joint stock banks in India. Bank of Hindustan was established in 1770 by the Calcutta based English Agency House which failed in 1782 with the closure of the agency house. Three presidency banks viz, Bank of Calcutta (1806), Bank of Bombay (1840), Bank of Madras (1843) were established in subsequent years with gaps of time. These three banks were, however, merged together to form the Imperial Bank of India in 1921 which was later nationalised in 1955 and named as State Bank of India. However, the first bank which was established with Indian ownership and management was the Oudh Commercial Bank formed in 1881 followed by Ajodhya Bank in 1884, the Punjab National bank in 1894 and Nedungadi Bank in1899. Many other banks like Allahabad Bank (1865), Bank of India (1906) Indian Bank (1907), Bank of Baroda (1909), Central Bank of India (1911) came into existence. However, Indian Banking system experienced a series of crisis and witnessed failure of a number of banks more so in the post world war - I period. Therefore, the Reserve Bank of India was established in 1935 to function as the Apex Central Bank of India to regulate and to

control the banking system in India. With a view to laying a strong foundation for a sound banking system in the country, the Banking Companies Regulations Act was passed in 1949.

The entire banking scenario till 1968, however, was mostly class based and not mass based with little importance given for the growth and development needs of the country. Therefore, to make them mass based and development oriented and more specifically to use them as effective instruments for financing priority sector, twenty of the private owned big commercial banks were nationalised (14 banks in 1969 and 6 banks in 1980). The years 1991 and also the period thereafter, however, proved to be a turning point for commercial banks in India, as a fall out effect of the recommendation of a high level committee headed by Mr. M. Narasimham. This phase is referred as second banking revolution phase. Varieties of new reforms were introduced during this phase, the important ones being permission for establishment of private banks, more operational freedom to banks, varieties of other structural reforms. With the changes made, the banking scene in the country has totally transformed. The banks have not only grown in size but they have also became robust by changing their scope and ambit of functioning and integrating themselves with the global changes.

## 1.4. DEFINITION, MEANING AND FEATURES OF COMMERCIAL BANK :

As has already been explained earlier, banks are classified into different categories principally depending upon their ownership pattern, the clients they mostly serve and the nature of finance they provide. One such broad classification is Industrial Banks and Commercial Banks. Banks which mostly deal with long-term financial needs of the industrial and commercial organisation are categorised as Industrial Banks and banks which generally deal with short term and medium-term credits mostly out of the deposits mobilised by them from individual and institutional customers, are classified as Commercial Banks. Commercial banks have been defined in different ways as explained below :

**Crowthey** defines it as an institution "that collects money from those who have to spare or who are saving it out of their income and lends the money so collected to those who require it." **F. Agger** states that "The term bank is ordinarily applied to an institution which receives deposits of money or of credit and which seeks profit through the extension or sale of its own credit."

**The Banking Regulation Act 1949** which was enacted to regulate banking system in India although does not provide a direct definition of commercial banks but it defines in a very comprehensive way explaining what banking means and what may come under other forms of business of banking.

Under Sec. 5(b) it is provided that "banking means the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise".

Under Sec. 6 it is provided that in addition to the above, other functions as mentioned below (only a few major activities mentioned here as illustrations) would also be regarded as banking business:

- borrowing or raising of money
- carrying on and transacting every kind of guarantee indemnity business
- granting and issuing of letters of credit,, travelers' cheque and circular notes
- providing safe deposit of valuables
- collecting and transmitting money and securities
- managing, selling and realizing any impurity which may come into its possession in satisfaction of its claims
- acquiring, constructing and maintaining any building for its own purposes.
- Acting as agents for any Government, Local authority, or any other Person or persons
- Do all such things which are incidental or conducive to the promotion or advancement of the business of the company etc.

In the light of the above definitions, Commercial Banks can be simply defined as financial institutions routinely engaged in granting short and medium term loans and advances to individuals and institutions out of the resources they mobilise from public in different forms of deposits and also in carrying on all such other activities which are incidental and conducive to the promotion or advancement of the business. They thus perform the role of intermediaries between the depositors and borrowers.

## ESSENTIAL FEATURES OF COMMERCIAL BANKS

The following are the main features of Commercial Banks :

1. They are financial institutions enjoying legal entity being duly registered under the Companies Act if privately owned or incorporated under special Acts of Parliament if they are public owned or public sector banks.
2. They are primarily concerned with accepting deposits and advancing loans to the public.

3. They usually provide a variety of utility based services to the customers.
4. They generally provide short and medium term loans and advances.
5. They mostly cater to the credit needs of trade and industries besides meeting the needs of individual customers.
6. They cover clients across the country through their net work of branches.
7. They play a significant role as most effective instrument of Socio-Economic transformation of the nation.

## 1.5 TYPES OF COMMERCIAL BANKS :

In our country, commercial banks can be classified into different categories depending upon the criterion of classification. On the basis of their inclusion in the Schedules maintained by RBI, they may be classified as Scheduled or Non-scheduled banks. These may be further classified as Indian or Foreign Banks depending on their place of registration, Public sector or Private sector banks on the basis of their ownership pattern and on the basis of nationalisation as Nationalised or Non-Nationalised Banks.

### 1.5.1. On the basis of Inclusion in Schedule

#### (A) Scheduled Banks :

All banks whose names are enlisted or included in the Second Schedule of the Reserve Bank of India Act, 1934 are called as Scheduled Banks. A bank must satisfy the following three conditions in order to be a Scheduled Bank.

i) It must have a paid up capital and reserves of an aggregate value of at least Rs. Five Lakhs

ii) It must satisfy the Reserve Bank of India that its affairs are not conducted in a manner detrimental to the interests of its depositors and

iii) It must be a corporation or a company or a state cooperative bank and not a partnership or a single-owner firm.

Scheduled Banks enjoy certain privileges like free or concessional remittance facilities through the offices of the RBI and its agents and borrowing facilities from the RBI. In return, the Scheduled banks are under obligation to (i) maintain an average daily balance of Cash reserves with the RBI which varies between 3 percent and 15 percent of their total liabilities (ii) submit periodical returns to the RBI under various provisions of the Reserve Bank of India Act. 1934 and the Banking Regulation Act. 1949.

**(B) Non-Scheduled Banks :**

Non-Scheduled banks on the other hand are those which are not included in the Second Schedule of Reserve Bank of India Act, 1934. These banks have to maintain the cash reserve requirements. But they are not required to keep them with the RBI. These banks cannot also borrow from the RBI for normal banking purposes but they may approach the RBI under abnormal circumstances like shortage of funds.

### 1.5.2. On the basis of Ownership

**(A) Public Sector Banks**

The public-sector bank means the banks owned, managed and controlled by Government. They constitute the dominant part of commercial banking system in India. The Government first entered into the field with the nationalisation of the then Imperial Bank of India on 1st July, 1955 and renamed it as State Bank of India. This bank has five other State Banks as its subsidiaries. In July 1969, fourteen other large banks and in 1980 six more banks were nationalised. Of this, one nationalised bank namely New Bank of India was later merged with Punjab National Bank. Thus we are having now a total of 25 such banks in the public sector.

**(B) Private Sector Banks**

Private Sector Banks are the banks which are established, managed and controlled by private parties. For starting such banks by private people, permission from RBI is absolutely necessary and when permitted, they are to operate strictly under the provisions of Act and under the control and guidance of RBI. The private sector banks started their operation after the issuance of licences by the RBI from 1994-95. ICICI Bank, HDFC Bank Ltd. IDBI Bank Ltd. etc. are the glaring examples of private sector banks.

### 1.5.3 On the basis of place of Registration

**(A) Indian Banks**

Banks which are incorporated in India and have their head offices in India are known as National Banks or Indian Banks. Indian banks may also have their branches abroad. The major part of banking business in India is in the hands of the Indian banks.

**(B) Foreign Banks**

Banks which have been incorporated in foreign countries and have their head offices outside India but having operational branches in India are known as Foreign Banks. They occupy a place of importance in the Indian banking industry, especially in the financing of foreign trade and

in the field of merchant banking i.e. underwriting and promotion of new Capital issues. All foreign banks are Scheduled banks. The following are the list of foreign banks.

**Foreign Banks**

- ABN Amro Bank
- ABU Dhabi Commercial Bank
- American Express Banking Corporation
- Antwerp Diamond Bank
- AB Bank
- Bank International Indonesia
- Bank of America
- Bank of Bahrain & Kuwait
- Bank of Ceylon
- Bank of Nova Scotia
- Bank of Tokyo Mitsubishi UFJ
- Barclays Bank
- BNP Paribas
- Calyon Bank
- China Trust Commercial Bank
- DBS Bank
- Deutsche Bank
- Hongkong & Shanghai Banking Corporation

### 1.5.4 On the basis of Nationalisation

**(A) Nationalised Banks**

When Banks owned and managed by the private entities are taken over by the Government under its control and management they are called as Nationalised Banks. As stated earlier, the first privately owned bank namely The Imperial Bank of India was nationalised in 1955 followed by 14 such private banks in 1969, 6 more in 1980 and 1 in 2003.

**(B) Non-Nationalised Banks**

Banks which are established, controlled and managed by private parties or entities but are controlled and regulated by the RBI are called Non-Nationalised or Private Sector Banks.

## 1.6. THE STATE BANK GROUP AND OTHER NATIONALISED COMMERCIAL BANKS :

This group comprises of State Bank of India and its five subsidiaries. In 1955 the Government of India nationalised the then Imperial Bank of India to form SBI under SBI Act of 1955. Most of the shares of the bank are held by RBI and Central Government. Later on in 1959, the State Bank of India (Subsidiary Bank) Act was passed enabling SBI, to take over 8 princely state associated banks, as its subsidiaries. After the merger of two associated banks (State Bank of Jaipur and State Bank of Bikaner into State Bank of Bikaner and Jaipur) the number reduced from eight to seven. Again, during the later part of last decade, two more associate banks namely State Bank of Indore and State Bank of Saurashtra were merged with SBI further reducing the number of associates to five. The name of five associate banks are :

1. State Bank of Bikaner and Jaipur
2. State Bank of Hyderabad
3. State Bank of Mysore
4. State Bank of Patiala
5. State Bank of Travancore

The other nationalised banks consist of a total number of 20 banks. The Government of India passed Banking Companies Amendment Act (Acquisition and transfer of undertaking) and nationalised fourteen major commercial banks in July 1969. Subsequently, in 1980 the Government nationalised another six bank having deposits more than Rs. 200 crores than making the total to twenty. But, in 1990 New Bank of India was merged with Punjab National Bank. Hence, the total number was reduced to nineteen. Again inclusion of IDBI Bank in the nationalisation list during 2003 increased the total number to twenty. The followings are the nationalised commercial banks in India :

**A) Nationalisation of Banks in 1969**

1. Central Bank of India
2. Bank of India
3. Punjab National Bank
4. Bank of Baroda
5. UCO Bank

6. Canara Bank
7. United Bank of India
8. Dena Bank
9. Syndicate Bank
10. Union Bank of India
11. Allahabad Bank
12. Indian Overseas Bank
13. Indian Bank
14. Bank of Maharashtra

**B) Nationalisation of Banks in 1980**

1. Andhra Bank
2. Corporation Bank
3. Oriental Bank of Commerce
4. Punjab & Sind Bank
5. Vijaya Bank
6. New Bank of India*

(* This bank was merged with Punjab National Bank in 1990)

**C) Nationalisation of Banks in 2003**

1. IDBI Bank

## 1.7 REGIONAL RURAL BANKS :

The Regional Rural Banks (RRBs) the newest form of banks, came into existence in the middle of 1970s (sponsored by individual nationalised commercial banks) with the enactment of Regional Rural Banks Act, 1976. The basic objective of government was to develop rural economy by providing credit and deposit facilities for agriculture and other productive activities of all kinds in rural areas. The emphasis is on providing such facilities to small and marginal farmers, agricultural labourers, rural artisans and other small entrepreneurs in rural areas. In our state, Odisha Gramya Bank and Utkal Gramya Bank serve this purpose. Odisha Gramya Bank is operating in east and northern part of the state consisting 13 districts and Utkal Gramya Bank in 17 balance districts. There is a proposal to merge both the RRBs and to operate under one name and administrative control all over the State.

**Other special features of these banks are :**

i) Their area of operation is limited to a specified region, comprising one or more districts in any state; (ii) their lending rates cannot be higher than the prevailing lending rates of cooperative credit societies in any particular state; (iii) the paid-up capital of each rural bank is Rs. 25 lakhs, 50 percent of which has been contributed by the Central Government, 15 percent by State Government and 3.5 percent by sponsoring public sector commercial banks which are also responsible for actual setting up of the RRBs.

These banks are helped by higher-level agencies. The sponsoring banks lend them funds and advise and train their senior staff. The NABARD (National Bank for Agriculture and Rural Development) gives them short-term and medium-term loans. The RBI has kept CRR (Cash Reserve Requirements) for them at 3% and SLR (Statutory Liquidity Requirement) at 2.5% of their total net liabilities, whereas for other commercial banks, the required minimum ratios have been varied over time.

## 1.8. COOPERATIVE BANKS :

Cooperative banks are so-called because they are organised under the provisions of the Cooperative Credit Societies Act of the states. The major beneficiary of the Cooperative Banking is the agricultural sector in particular and the rural sector in general.

The cooperative credit institutions operating in the country are mainly of two kinds : agricultural (dominant) and non-agricultural. There are two separate cooperative agencies for the provision of agricultural credit: one for short and medium-term credit, and the other for long-term credit. The former has three tier and federal structure. At the apex is the State Co-operative Banks (SCBs), at the intermediate (district) level are the Central Cooperative Banks (CCBs) and at the village level are Primary Agricultural Credit Societies (PACSs).Long-term agriculture credit is provided by the Land Development Banks (LDBs). It has a two tier structure with State Land Development Bank (SLDB) as the apex bank at state level and Primary Land Development Banks (PLDBs) operating at village levels. The funds of the NABARD meant for the agriculture sector actually pass through SCBs and SLDBs. Originally based in rural sector, the cooperative credit movement has now spread to urban areas also and there are many urban cooperative banks coming under SCBs.

## 1.9. FUNCTIONS OF COMMERCIAL BANK

Banks were originally established to discharge the basic function of accepting deposits for the purpose of giving loans. But in course of time they have assumed greater responsibilities and

the functions performed by them have multiplied. The functions of a bank may be broadly divided into two categories as **Primary functions** and **Secondary functions**.

### 1.9.1 Primary Functions :

Acceptance of deposits in various forms, granting of loans and advances for variety of purposes and investment of funds in securities constitute the primary functions of a commercial bank. However in modern economies, creation of credit and transactions in foreign exchange are also treated as primary functions of such banks. The various primary functions of a commercial banks viz. (A) Acceptance of Deposits, (B) Granting of Loans and Advances and (C) Investment of funds are discussed as under :

### (A) Acceptance of Deposits

It is important to note that commercial banks mostly generate resources for lending purposes through the collection of deposits from public. Hence to mobilise the maximum possible deposits, the banks provide wide scope for various types of deposits to suit the needs and expectations of various types of customers. One of the primary functions of all commercial banks is to accept deposits of money from the public. The deposits accepted by such banks may be broadly classified into (a) Demand Deposits (b) Time Deposits.

**(a) Demand Deposits :** Such deposits are withdrawable on demand and thus no prior notice for withdrawal is needed. Deposits in savings accounts or saving deposits and deposits in current accounts or current deposits come under this category as discussed below :

i) Savings Bank Deposit : This deposit can be opened with a very small amount. Money in the savings account can be withdrawn at will but there are certain limitations on the total number of withdrawals per week. The rate of interest on this deposit is higher than current deposit but less than fixed deposit. By mobilising small amounts from large number of individuals through savings bank deposits, banks are able to gather huge amount of funds. Such types of deposits are more popular with the people belonging to lower and middle income groups who wish to save a part of their unspent income to meet their future needs and also intend to earn an income from their savings.

ii) Current Account Deposits : It is also known as Demand Deposit as the deposited amount is payable on demand. Such accounts suit the requirements of business houses, public institutions and authorities as they require numerous transactions on every working day. There are no limitations on the amount to be deposited and on times of withdrawals. It can be operated upon any number of times during a working day. The bank, however, opens this account only

after satisfying itself about the credit worthiness of the customer. Normally no interest is paid on current deposit, but overdraft facilities are provided.

**(b) Time Deposits :** Such deposits are only withdrawable on the expiry of the period pre-fixed at the time of deposits although there is also provision for withdrawal earlier with loss of interest. Fixed deposits, recurring deposits are included in such category which are discussed below :

**i) Fixed Deposits :** A fixed deposit, also known as Term Deposit, is one where a customer keeps a specific amount with the bank for a fixed period. Fixed deposit holder gets interest on the deposit for that period. In case the depositor withdraws before the completion of the stipulated period, he loses interest earned on that deposit. The rate of interest on the fixed deposits is the highest compared to other forms of deposits.

**ii) Recurring Deposits or Cumulative Deposits :** In this type of deposit, the depositor is required to deposit regularly a fixed amount generally a multiple of Rs. 5 or Rs. 10 once in every month for a specified number of years. The depositor gets the principal amount along with interest after the expiry of that specified period. The rate of interest offered on these deposits is generally the same as that offered on fixed deposits.

**(B) Granting of Loans and Advances**

This constitutes another most important function of commercial banks and a major portion of the banks' funds is used for giving loans and advances. The interest earned on such loans and advances constitute the major source of earning and profits for banks.

**Classification of Loans and Advances**

The loans and advances are classified on period basis as Short-term, Medium-term and Long-term loans. On the basis of securities, they are classified as Secured loans which means loans backed or supported by property or personal guarantee as security and Unsecured loans with no need for any security. Purpose-wise they are classified as trading / business loans, industrial loans, agricultural loans, consumption loans, loans and advances for priority sectors or export and import loans.

**Form of Loans and Advances**

Banks grant loans and advances in the following forms :

• **Overdraft :** It means over drawing or drawing more money than one has in his account with the bank. It is thus an arrangement by which the borrower is allowed to withdraw more

money than what he/she has deposited. It is a short-term facility extended by the bank to some of its trusted business customers who are having current account only. Interest is charged by the bank on the exact amount of overdraft and for the period the amount actually overdrawn. The bank may demand some collateral security or allow overdrafts on the personal security of the borrowers.

• **Cash Credit :** It means permission to draw cash upto a certain limit fixed by bank known as cash credit limit and it is fixed on an annual basis. Such facility is granted against the security of goods or personal security of one or more persons other than the principal borrower. Cash Credit limit is fixed on the basis of volume of sales, amount of transactions with the bank, stock of inventory etc. Once the amount of cash credit is sanctioned, payment is not made in the form of cash rather the amount is credited to the customer's account. The peculiarity of this loan is that the bank can withdraw the facility or reduce the sanctioned limit whenever it likes. Interest is charged only on the amount made use of by the customer under this arrangement. In India, this is the main method of lending and it accounts for more than 70 percent of total bank credit.

• **Direct Loans :** It means giving of loans directly to the borrowers for a definite purpose and for a pre-determined period. Such loans are granted against security of movable properties or on personal securities. Borrower has to pay interest on the entire amount of loan sanctioned from the date of taking the loan till the time of repayment. Such loans may be granted in the form of short-term, medium-term or long-term loans.

• **Discounting of Bills :** It is yet another way of providing loan under which bills before maturity are kept by the bank and the amount mentioned in the bill is paid deducting a certain amount known as discount. If trade bills are allowed by banks for discounting, they are called bills discounted.

**(C) Investment of funds :**

Banks also employ a significant portion of their funds in different types of securities which generate huge returns for the banks. In fact, over the years the investments in total assets of the commercial banks has grown remarkably. In the balance sheets, banks' investment in securities are shown under the following six heads :-

i) Government securities

ii) Other approved Securities

iii) Shares

iv) Debentures and Bonds

v) Subsidiaries and Joint ventures

vi) Others (Certificate of Deposits, Mutual Funds etc.)

### 1.9.2 Secondary Functions

For the convenience of customers, banks perform a lot of non-banking functions called secondary functions These functions are - Agency services, Public utility services and E-Banking services.

#### (A) Agency Services :

Various functions performed by a banker as an agent on behalf of the customers, whenever duly authorised, are called agency services. The agency services include collection of cheques / drafts, payments, sale and purchase of securities, trustee executor and attorney, and correspondence on behalf of the customers.

**i) Collections :** Commercial banks when requested take up collection of cheques, bills, dividends, promissory notes, subscriptions, rents on behalf of their customers as agents. The bank charge 'services charges' for providing these services to the customers.

**ii) Payments :** Banks also accept the responsibility to pay insurance premium, rents, taxes electricity bills periodically on behalf of their customers for which they charge commission.

**iii) Sale and purchase of securities :** Customers sometimes approach the bankers for sale and purchase of their securities. For these services the banks charge commission.

**iv) Trustee, executor and attorney :** Banks act as trustees, executors and attorney on behalf of their customers. As a trustee, the banker takes care of funds of the customers, helps in proper management of trust. As executor it carries out the desires of the deceased customer in terms of the will left by him. As an attorney, the banker signs transfer form deeds and documents on behalf of the customer.

**v) Correspondence :** Banks serve as correspondent agents or representatives of their customers and in that capacity they may write letters, serve notices, reminders etc. on their behalf.

**vi) Executing Standing Instructions :** Sometimes, customer may direct his banker to make specific amount of payments to certain persons or institutions in a regular time interval like payment of insurance premium, loan installment, house rent etc. The written order is called standing instruction. The bank being the agent of its customer executes the standing instructions.

**vii) Acting as Tax Consultant :** Commercial bank when requested acts as tax consultant to its client. The prepares general sales tax return, income tax return, etc. and also files the same with tax authorities.

**viii) Portfolio Management or Merchant Banking Services :** They can asct as issue managers, lead managers and under writer of issues.

**ix) Special Purpose Vehicle (SPV) services** are also provided for scrutinisation of assets under Securitization & Reconstruction of Financial Assets and Enforcement of Security Interest Act.

**(B) Public or General Utility Services**

Commercial banks render various services useful to the customer. These services include issuing letters of credit, providing draft facilities, underwriting, giving guarantee for deferred payments, providing locker facilities, references, business and statistical information and facilitating foreign exchange dealings.

**i) Letters of Credit :** Banks issue Letters of credit to their Customers. These are useful to traders to buy goods from foreign countries on credit as through letters they certify the credit worthiness of their customers.

**ii) Draft Facilities :** Banks issue drafts to customers and enable them to transfer funds from place to place.

**iii) Underwriting :** Banks underwrite share capital and debenture capital, raised by Government and Joint stock companies, thereby provide them relief from the tension of raising funds .

**iv) Guarantee for Deferred Payments :** Importers may not be in a position to pay for their imports immediately. Exporters in such cases may allow them to pay in future but only if the payment is guaranteed. In such cases banks may give guarantee for deferred payments to the exporters.

**v) Locker Facility :** Banks provide locker facility to customers to keep their valuables like securities, jewellery and documents.

**vi) Referee :** Banks serve as referee for unifying the financial standing and business reputation and honesty and responsibility of their customers.

**vii) Business and statistical information :** Banks collect and classify information regarding different aspect and issues of trade, commerce and industry and provide the same to their

customers. Some banks also publish bulletins, journals etc. other form of information for use by the customers as well as the general public.

**viii) Consultalcy services & payment of pensions :** When requested, banks also provide consultancy services and undertake the responsibilities of disbursing pensions.

**(C) E-Banking Services**

Indian banking industry, today is in the midst of an IT revolution. A combination of regulatory and competitive reasons has led to increasing importance of total banking automation in the Indian banking industry. Information Technology has basically been used under two different avenues in banking. One is Communication and Connectivity and other is Business Process Reengineering. Information technology enables sophisticated product development, better market infrastructure, implementation of reliable techniques for control of risks and helps the financial intermediaries to reach geographically distant and diversified markets.

The bank which used the right technology to supply timely information will see productivity increase and thereby gain a competitive edge. To compete in an economy which is opening up, it is imperative for the Indian banks to observe the latest technology and modify it to suit their environment. Banks need greatly enhanced use of technology to the customer friendly, efficient and competitive services. They also need technology for providing newer products and newer forms of services in an increasingly dynamic and globalise environment. Information technology offers a chance for banks to build new systems that address a wide range of customer needs including many that may not be imaginable today.

Following are the innovative e-banking services offered by different banks in the recent past :

**i) Electronic Payment Services - E Cheques**

Nowadays we are hearing about e-governance, email, e-commerce, e-tail, etc. In the same manner, a new technology is being developed in US for introduction of e-cheque, which will eventually replace the conventional paper cheque. India, as harbinger to the introduction of e-cheque, the Negotiable Instruments Act has already been amended to include, Truncated cheque and E-cheque instruments.

**ii) Real Time Gross Settlement (RTGS)**

Real Time Gross Settlement system, introduced in India since March 2004, is a system through which electronics instructions can be given by banks to transfer funds from their account to the account of another bank. The RTGS system is maintained and operated by the RBI and provides a means of efficient and faster funds transfer among banks facilitating their financial

operations. As the name suggests, funds transfer between banks takes place on a 'Real Time' basis. Therefore, money can reach the beneficiary instantaneously and the beneficiary's bank has the responsibility to credit the beneficiary's account within two hours.

**iii) Electronic Funds Transfer (EFT)**

Electronic Funds Transfer (EFT) is a system whereby anyone who wants to make payment to another person / company etc. can approach his bank and make cash payment or give instructions / authorization to transfer funds directly from his own account to the bank account of the receiver / beneficiary. Complete details such as the receiver's name, bank account number, account type (savings or current account), bank name, city, name of the branch etc. should be furnished to the bank at the time of requesting for such transfers so that the amount reaches the beneficiaries account correctly and faster. RBI is the service provider of EFT.

**iv) Electronic Clearing Service (ECS)**

Electronic clearing services is a retain payment system that can be used to make bulk payments / receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller amount. This facility is meant for companies and government departments to make / receive large volumes of payments rather than for funds transfer by individuals.

**v) Automatic Teller Machine (ATM)**

Automatic Teller Machine is the most popular device in India, which enables the customers to withdraw their money 24 hours a day 7 days a week. It is a device that allows customer who has an ATM card to perform routine banking transactions without interacting with a human teller. In addition to cash withdrawal, ATMs can be used for payment of utility bills, funds transfer between accounts, deposit of cheques and cash into account, balance enquiry etc.

**vi) Point of Sale Terminal**

Point of Sale Terminal is a computer terminal that is linked online to the computerised customer information files in a bank and magnetically encoded plastic transaction card that identifies the customer to the computer. During a transaction, the customer's account is debited and the retailer's account is credited by the computer for the amount of purchase.

**vii) Tele Banking**

Tele Banking is a concept of providing 24 hours entire non-cash related banking services to the customers on telephone. Under this system Automatic Voice Recorder is used in the bank

computers for simpler queries and transactions. The caller generally a customer of the bank will be able to call the bank anytime and inquire balances or transaction history, and to transfer funds between accounts. In this system computer, at the bank end is connected to a telephone linked with modem. The voice processing facility provided in the software identifies the caller, by key word and provides him services with suitable reply whenever necessary.

**viii) Online Banking**

It is a system of banking which facilitates a customer to monitor the performance of portfolio, movement of savings and current accounts, view market dynamics, do scenario analysis, run queries and execute transactions on a real time basis. All these facilities can be available anytime, anywhere in houses, offices and while a person is on move even with an internet connection to PCs and laptops.

**ix) Mobile Banking**

The services provided under online banking system are also available under a system called 'Mobile Banking' in mobile telephones. The biggest limitation of online banking is the requirement of a PC/laptop or access to a computer terminal is addressed through this service. The explosive growth of mobile users in India is the main reason that Mobile Banking scores over Online Banking which enables customers 'Anytime Anywhere Banking'.

**x) Electronic Data Interchange (EDI)**

Electronic Data Interchange is the electronic exchange of business documents like purchase order, invoices, shipping notices, receiving advices etc. in a standard, computer processed, universally accepted format between trading partners. Both EDI and e-mail involve the transmission of electronics messages between computer systems but the content of an e-mail message is not intended to be processed in any way by the receiving system, whereas EDI messages are intended for and are therefore structured for automated processing. EDI can also be used to transmit financial information and payments in electronic form thus brings significant benefits to the organisations.

❍

## QUESTIONS

No. 1. Form the given alternatives choose and write serially the correct answer:

i) The first stage of evolution of banking is :

a) Merchant Banker b) Goldsmith,

c) Goldsmith accepting valuables d) None of these

ii) The name of the State Bank of India prior to its nationalisation was :

a) Bank of Bombay b) Bank of Hindustan

c) Bank of Madras, d) Imperial Bank

iii) The Reserve Bank of India was established in the year :

a) 1921 b) 1934 c) 1935 d) 1955

iv) The most ancient bank in the world is :

a) Bank of Venice b) Bank of England

c) Bank of Bombay d) Bank of Calcutta

v) ABN Amro Bank is a

a) Public Sector Bank b) Private Sector Bank

c) Foreign Bank d) None of the above

vi) Fixed deposit is otherwise known as :

a) Term Deposit b) Demand Deposit

c) Savings Deposit d) Current Deposit

vii) The main source of funds for a bank is :

a) Acceptance of deposit from public b) Borrowings from public

c) Borrowings from other banks d) Borrowings from Govt.

viii) RTGS stands for :

a) Real Time Goods Settlement b) Real Time Gross Settlement

c) Real Trade Goods Settlement d) Real Time Goods Security

ix) The bank which is not an associate of SBI is :

a) State Bank of Mysore b) State Bank of Patiala

c) State Bank of Hyderabad d) State Bank of Bengaluru

(x) HDFC Bank Ltd. is a :

a) Nationalised Bank b) Public Sector Bank

c) Private Sector Bank d) None of these

(xi) Which of the followings is a regional rural bank of Odisha :

a) Bhubaneswar Gramya Bank b) Utkal Gramya Bank

c) Jagannath Gramya Bank d) None of these

(xii) ATM stands for :

a) Automatic Teller Machine b) Automatic Tailoring Machine

c) Autocratic Tailor Machine d) None of these

2. Fill in the blanks with appropriate words :

a) The English Agency Houses established__________banks in India.

b) Imperial Bank of India was formed in the year_________.

c) The first commercial bank with Indian ownership was_________formed in 1881.

d) In the year________the Reserve Bank of India was formed.

e) IDBI Bank was nationalised in the year_________.

f) Generally commercial banks provide _________ and _________ term loans to its customers.

g) All schedule banks are included in_________schedule of the RBI Act.

h) BNB Paribas is an example of__________bank.

i) In1959 SBI has taken over _______ numbers of princely state associated banks.

j) Union Cabinet in June, 2016 has approved to merge all________banks of SBI and Bharatiya Mahila Bank with SBI.

k) Odisha Gramya Bank and_________are the regional rural banks in the State of Odisha.

I) Acceptance of deposits comes under________functions of commercial banks.

3. Correct the underlined words in the following sentences :

a) Bank of Calcutta, Bank of Bombay and Bank of Madras were merged to form <u>Reserve Bank of India.</u>

b) Punjab National Bank was formed in the year 1955.

c) The name of Central Bank in India is State Bank of India.

d) In the year 1969 the Banking Companies Regulation Act was passed

e) Prior to 1969 the focus of commercial banks was mostly mass based.

f) Commercial Banks are primarily concerned with accepting deposits and advancing of gold coins.

g) On the basis of place of registration banks were classified as public sector and private sector banks.

h) The bank incorporated in India but operating abroad through its branches is called as foreign bank.

i) The State Bank of Indore was merged with State Bank of Patiala in 2008.

j) During 1980, 10 leading commercial banks were nationalised by the Govt. of India.

k) Current Account deposits normally carry a high rate of interest.

l) Overdraft facility given by a commercial bank to its customers having Savings A/c.

4. Answer the following questions in not more than **two** sentences each :

a) Define a 'Bank'.

b) What do you mean by general utility functions of a bank?

c) What is cash credit?

d) Which banks are the associates of State Bank of India?

e) Name those banks merged to form Imperial Bank of India?

f) Name any three commercial banks operating in India.

g) What is meant by Indian Bank?

h) Mention in which area of our State Utkal Gramya Bank is operating.

i) What do you mean by 'Bank Overdraft'?

j) State the meaning of 'Underwriting'.

k) What is the meaning of term 'hundi' ?

l) Write any two features of commercial bank.

m) State what is 'time deposit'.

n) Name any three types of loans and advances given by the banks.

o) What is meant by 'mobile banking' ?

p) Write what is 'online banking'.

5. Answer the following questions in not more than **six** sentences each :

a) State the agency functions of a bank.

b) What was the role of goldsmith in the evolution of banks?

c) Explain the meaning of savings bank deposit. .

d) What is letter of credit ?

e) Name the banks which were nationalised in 1980.

f) Write any six names of foreign banks operating in India.

g) Write a note on cash-credit system of lending money.

h) Distinguish between scheduled and non-scheduled bank.

i) Discuss the meaning of Electronic Data Interchange (EDI).

j) Explain what is Electronic Funds Transfer (EFT).

k) Make a distinction between time deposits and demand deposits.

l) Write a note on co-operative bank.

m) State the basis on which the commercial banks are classified in our country.

n) Explain the importance of e-banking services.

**LONG TYPE QUESTIONS**

1. Discuss the different stages of evolution of banking in India.

2. Explain the meaning and features of a commercial bank.

3. Describe in brief the primary functions of a commercial bank.
4. Briefly discuss various secondary functions of a commercial bank.
5. Classify commercial banks on the basis of different criteria.
6. What e-banking ? Briefly discuss various services offered by the commercial banks under e-banking.
7. Write short notes on :
   (a) State Bank of India and its associates
   (b) Regional Rural Banks
   (c) Foreign Bank

## ANSWERS

1. (i) a (ii) d (iii) c (iv) a (v) c (vi) a (vii) a (viii) b (ix) d (x) c (xi) b (xii) a
2. (a) Joint Stock (b) 1921 (c) Oudh Bank (d) 1935 (e) 2003 (f) Short, Medium (g) Second (h) Foreign (i) 8, (j) Associate (k) Utkal Gramya Bank (l) Primary.
3. (a) SBI (b) 1894 (c) RBI (d) 1949 (e) Class based (f) Loans (g) Ownership (h) Indian Banks (i) State Bank of India (j) 6 (k) No (l) Current Account.

CHAPTER - 2

# INCOME STATEMENT AND BALANCE SHEET OF COMMERCIAL BANK

**STRUCTURE**

2.1 Introduction
2.2 Income Statement or Profit and Loss Account of Commercial Bank
2.3 Balance Sheet of Commercial Bank
**Questions**

## 2.1. INTRODUCTION

As per Sec. 29 of the Banking Act 1949 every Banking Company incorporated in India is required to prepare the Balance Sheet and Profit & Loss Account in respect of all business transacted by it and through its branches in India as on the last working day of the Accounting year (which was earlier calender year, now it is 1st April to 31st March) in the Form A for Balance Sheet and in the Form B, for Profit & Loss Account as prescribed in the Third Schedule of the Act. The amalgamated Balance Sheet and Profit & Loss Account are required to be signed by the CMD and atleast 3 Diectors where there are more than 3 Directors or where there are not more than 3 Directors, by all the Directors. In case of Banking Company incorporated outside India, by the principal officer of the company in India.

Commercial Banks are required to prepare the Profit and Loss Account and Balance Sheet at the end of one year to know the profitability and the financial position of the bank.

## 2.2. INCOME STATEMENT OR PROFIT AND LOSS ACCOUNT OF A COMMERCIAL BANK

Every year as stated above commercial banks are required to prepare its Income Statement or Profit and Loss Account only in the prescribed format known as **Form B of Schedule III** attached to the Banking Regulation Act 1949. The Form B has been revised w.e.f. 1st April 1991 and since then the Profit and Loss Account of a bank for the year ending March 31, 1992, and onwards has to be prepared in the prescribed new format as given below :

**Form 'B'**

**Third Schedule**

**Form of Profit and Loss Account**

**Profit and Loss Account (for the year ended 31st March, ......)**

| | Schedule Number | Year ended (Rs.) |
|---|---|---|
| I. INCOME | | |
| Interest earned | 13 | ...... |
| Other Income | 14 | ...... |
| Total | | ...... |
| II. EXPENDITURE : | | |
| Interest expended | 15 | ...... |
| Operating expenses | 16 | ...... |
| Provisions and contingencies | | ...... |
| Total | | ...... |
| III. PROFIT / Loss | | ...... |
| Net Profit / (Loss) for the year | | ...... |
| TOTAL | | ____ |
| IV. APPROPRIATIONS : | | |
| Transfer to statutory reserves | | ...... |
| Transfer to other reserves | | ...... |
| Transfer to Govt. / Proposed dividend | | ...... |
| Balance carried over to balance sheet | | ...... |
| TOTAL | | ___ |

**Schedules to be annexed with Profit and Loss Account**

This Act also requires banks to prepare and attach explanatory notes in respect of every items of income and expenditure in the form of **Schedules**. Therefore a Schedule can be defined as a short explanatory note mentioning the different items to be included under different heads. The revised format of Profit and Loss Account therefore has two Schedules (13 and 14) in respect of incomes and two Schedules (15 and 16) in respect of expenditures as given below :

**SCHEDULE 13: INTERST EARNED**

| | Rs. |
|---|---|
| i. Interest / Discount on advances / Bills | …. |
| ii. Income on investments | …. |
| iii. Interest on balances with RBI and other inter-bank funds | …. |
| iv. Other | … |
| TOTAL | ____ |

**SCHEDULE 14: OTHER INCOME**

| | Rs. |
|---|---|
| i. Commission, exchange and brokerage | …. |
| ii. Profit on sale of investments | …. |
| Loss : Loss on sale of investments | …. |
| iii. Profit on revaluation of investments | |
| Loss : Loss on revaluation of investments | |
| iv. Profit on sale of land / building and other assets | …. |
| Loss : Loss on sale of land, Bldg. and other assets | …. |
| v. Profit on exchange transactions | …. |
| Loss : Loss on exchange transactions | …. |
| vi. Income earned by way of dividends etc. from subsidiaries / | … |
| Companies and /or joint ventures abroad / in India | … |
| vii. Misc Income | … |
| TOTAL | ___ |

**Note : Under Items II to V loss figures may be shown in brackets.**

### SCHEDULE 15 : INTEREST EXPENDED

| | Rs. |
|---|---|
| I. Interest on deposits | …. |
| II. Interest on RBI / Inter-Bank borrowings | …. |
| III. Others | …. |
| TOTAL | ___ |

### SCHEDULE 16 : OPERATING EXPENSES

| | Rs. |
|---|---|
| i. Payments to and provisions for employees | …. |
| ii. Rent, taxes and lighting | …. |
| iii. Printing and stationery | ….. |
| iv. Advertisement and publicity | …. |
| v. Depreciation on Bank's property | …. |
| vi. Directors' fees, allowances and expenses | …. |
| vii. Auditors' fees and expenses (including branch auditors) | …. |
| ix. Law charges | …. |
| x. Insurance | …. |
| xi. Other expenditure | …. |
| TOTAL | ___ |

Note :

Corresponding figures for the immediately preceding financial year should be shown in separate columns.

## 2.3. BALANCE SHEET OF A COMMERCIAL BANK

In order to know about the financial position of a business establishment, it becomes imperative to analyse its Balance Sheet. The financial status of a bank, which is also a business establishment, is revealed from its Balance Sheet. Balance sheet of a bank depicts complete details about its assets and liabilities. It indicates the sources from which the bank collects its funds and the manner in which it deploys them. Therefore, the balance sheet is viewed as a true index of the activities, managerial prudence and solvency of the bank. The total of the liabilities matches exactly with the total of assets. As a matter of principle, the bank prepares its balance sheet at the end of each financial year and publishes it for the information of the public. It is therefore a statement of assets and liabilities of an enterprise prepared on a particular date.

The Balance Sheet of a bank has to be prepared in the prescribed format known as Form A of Schedule III, attached to the Banking Regulation Act. 1949. The Form of Balance Sheet has been revised w.e.f. April 1. 1991 and a bank has to prepare its Balance Sheet in the prescribed new form for the year ending 31st March 1992, and onwards as given below : As in the case with Profit and Loss Accounts, for Balance Sheets also, there is a provision for attachment of Schedules in respect of each item of assets and liabilities. A Balance Sheet therefore has **five** Schedules (from 1 to 5) in respect of liabilities and **seven** Schedules (from 6 to 12) in respect of assets as given below :

**Form 'A'**
**Third Schedule :**
**Form of Balance Sheet**
**Balance Sheet as on 31st March............**

| Particulars | Schedule | Current Year | Previous Year |
|---|---|---|---|
| **CAPITAL AND LIABILITIES :** | | | |
| Capital | 1 | .... | .... |
| Reserves and surplus | 2 | .... | .... |
| Deposits | 3 | .... | .... |
| Borrowings | 4 | .... | .... |
| Other liabilities and provisions | 5 | .... | .... |
| | Total | ___ | |
| **ASSETS :** | | | |
| Cash in hand and balance with RBI | 6 | .... | .... |
| Balance with banks and money at call and short notice | 7 | .... | .... |
| Investments | 8 | .... | .... |
| Advances | 9 | .... | .... |
| Fixed assets | 10 | .... | .... |
| Other assets | 11 | .... | .... |
| | TOTAL | ___ | |
| Contingent liabilities : | 12 | | |
| Bills for collection | | .... | .... |

**The following schedules are required to be furnished with the Balance Sheet :**

As in the case with Profit and Loss Accounts, for Balance Sheets also, there is a provision for attachment of Schedules in respect of each item of assets and liabilities. A Balance Sheet therefore has five Schedules (from 1 to 5) in respect of liabilities and seven Schedules (from 6 to 12) in respect of assets as given below :

**SCHEDULE 1 : CAPITAL**

| | Rs. |
|---|---|
| I. FOR NATIONALISED BANKS : | ___ |
| Capital (Fully owned by Central Government) | ….. |
| II. FOR BANKS INCORPORATED OUTSIDE INDIA : | |
| I) Capital (the amount brought in by banks by way of start-up capital as Prescribed by RBI should be shown under this head) | …. |
| | Rs. |
| a) Amount of deposit kept with RBI under Section 11(2) of the Banking….. Regulation Act. 1949. | Total ____ |
| | ….. |
| | ____ |
| III For Other Banks | |
| Authorised Capital (….. Shares of Rs. …. Each) | …….. |
| Issued capital (…. Shares of Rs. .. each) | ……. |
| Subscribed capital (.. shares of Rs. … each) | ……. |
| Called up capital (…. Shares of Rs. … each) | …… |
| Less : calls unpaid | |
| Add : Forfeited shares | ….. |

**Schedule 2 : Reserves and Surplus**

| | Rs. |
|---|---|
| I. Statutory reserves : | ….. |
| Opening balance | …. |
| Additions during the year | ….. |
| Deductions during the years | ____ |

II. Capital reserves :

| | |
|---|---|
| Opening balance | ….. |
| Additions during the year | _____ |
| Deductions during the year | …… |

III. Share premium :

| | |
|---|---|
| Opening balance | …… |
| Additions during the year | …… |
| Deductions during the years | ______ |

IV. Revenue and other reserves :

| | |
|---|---|
| Opening balance | …… |
| Additions during the year | ….. |
| Deductions during the year | …… |
| V. Balance in profit and loss A/c : | _____…… |
| Total (I,II,III, IV and V) | _____ |

**Schedule 3 : Deposits**

| | | Rs. |
|---|---|---|
| A. I Demand deposits : | | |
| | (i) From banks | …… |
| | (ii) From others | …. |
| II Savings bank deposits | | |
| | (i) From banks | …… |
| | (ii) From others | …... |
| | | _______ |
| | Total (I, and II) | |
| B. | (i) Deposits of branches in India | …..…. |
| | (ii) Deposits of branches outside India | …..… |
| | TOTAL _________ | |

## Schedule 4 : Borrowings

| | Rs. |
|---|---|
| I. Borrowings in India | …. |
| (i) Reserve Bank of India | …. |
| (ii) Other banks | …. |
| (iii) Other institutions and agencies | ___… |
| II. Borrowings outside India | …. |
| Total (I and II) | …. |
| Secured borrowing in / and //above | Rs.…. |

## Schedule 5 : Other Liabilities and Provisions

| | Rs. |
|---|---|
| I. Bills payable | …. |
| II. Inter-office adjustments (net) | …. |
| III Interest accrued | …. |
| IV Others (Including provisions) | …. |
| Total | ___ |

## Schedule 6 : Cash and Balances with RBI

| | Rs. |
|---|---|
| I. Cash in hand (including foreign currency notes | …. |
| II. Balance with RBI in : | |
| (i) Current A/c | … |
| (ii) Other A/c | … |
| Total (I & II) | …. |

## Schedule 7 : Balance with Banks & Money at Call and Short Notice

| | | Rs. |
|---|---|---|
| I In India | | |
| (i) Balance with banks : | | |
| (a) In Current A/c | | ….. |
| (b) In Other deposit A/c | | …….. |
| (ii) Money at call and short notice | | |
| (a) With banks | …. | |
| (b) With other institutions | …….. | |
| | Total (i) and (ii) | ____ |
| II. Outside India | | |
| (i) In Current A/c | …. | |
| (ii) In Current A/c | …. | |
| (iii) Money at call and short notice | …. | |
| Total (i), (ii) and (iii) | …. | |
| Grand Total (I and II) | …. | |

## SCHEDULE 8 : INVESTMENTS

| | Rs. |
|---|---|
| i. Investment in India in | |
| (i) Govt. securities | …. |
| (ii) Other approved securities | …. |
| (iii) Shares | … |
| (iv) Debentures and bonds | … |
| (v) Subsidiaries and /or joint ventures | … |
| (vi) Others (to be specified | … |
| Total : | ___ |

| | | |
|---|---|---|
| II. Investments outside India in | | |
| (i) Govt. Securities (including local authorities | …. | |
| (ii) Subsidiaries and / or joint ventures abroad | … | |
| (iii) Other investment (to be specified) | … | |
| Total | ___ | |
| Grand Total (I and II) | ….. | |

**Schedule 9 : Advances**

| | | Rs. |
|---|---|---|
| A. (i) Bills discounted and purchased | | … |
| (ii) Cash credits, overdrafts and loans payable on demand | | … |
| (iii) Term loans | | … |
| | Total | ___ |
| B. (i) Secured by tangible assets | | …. |
| (ii) Covered by Bank / Govt. guarantees | | …. |
| (iii) Unsecured | | …. |
| | Total | …. |
| C. I Advances in India : | | |
| (i) Priority sectors | | …. |
| (ii) Public sectors | | …. |
| (iii) Banks | | ….. |
| (iv) Others | | ….. |
| | Total | …. |
| II. Advances outside India : | | |
| (i) Due from banks | | …. |
| (ii) Due from others : | | |
| (a) Bills purchased and discounted | | …… |
| (b) Syndicated loans | | ….. |
| c) Others | ….. | …. |
| | Total : | …. |
| Grand Total (CI and CII) | | …. |

## Schedule 10 : Fixed Assets

| | Rs. | |
|---|---|---|
| I. Premises : | | |
| At cost as on 31st March of the preceding years | …. | |
| Additions during the year | …. | |
| Deductions during the year | ….. | |
| Depreciation to date | …. | |
| II. Other fixed assets (incl. furniture and fixture ): | | |
| At cost as on 31st March of the preceding year | …. | |
| Additions during the year | ….. | |
| Deductions during the year | …. | |
| Depreciation to date | …. | |
| Total (I and II) | …. | …. |

## Schedule 11 : Other Assets

| | Rs. |
|---|---|
| Inter-office adjustment (net) | ….. |
| Interest accrued | …... |
| Tax paid in advance / tax deducted at source | …. |
| Stationery and stamps | …. |
| Non-banking assets acquired in satisfactions of claims | ….. |
| Others* | …. |
| Total | …. |

*In case there is any unadjusted balance of loss (i.e. when the loss exceeds the aggregate of capital, reserves and surplus), the same may be shown under this item under appropriate footnote .

**Schedule 12: Contingent Liabilities**

| | Rs. |
|---|---|
| I Claims against the bank not acknowledged as debts. | ….. |
| II Liability for party paid investments | ….. |
| III Liability on account of outstanding forward exchange contracts | …. |
| IV Guarantees given on behalf of constituents : | |
| (i) In India | …. |
| (ii) Outside India | …. |
| V. Acceptances, endorsements and other obligations | ….. |
| VI. Other items for which the bank is contingently liable | …. |
| Total | …. |

**Importance of Balance sheet**

The true picture of bank's activities get reflected in its balance sheet. The balance sheet provides basic information about the sources of bank's funds and the avenues of their investment. The study of the balance sheet indicates as to whether the bank is able to maintain a healthy ratio between its assets and liabilities. The balance sheet not only throws light on the liquidity and solvency position of the bank, but it also indicates the extent to which the bank is able to protect the interests of its share holders, debtors and creditors. A year-wise comparison of a bank's balance sheet reveals the true picture of the growth or decay. A comparison of the balance sheets of different banks in given year indicates the real status of a particular bank in the banking system of the country. A bank's ability to inspire the confidence of the public can also be gauged from the increase and decrease in its deposits which get reflected in the balance sheet.

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## QUESTIONS

1. Choose the correct answer from the given alternative answers against each bit :

i) Income statement of a bank is prepared to know :

a) Amount of loans b) Financial position

c) Profitability d) Amount of borrowings

ii) Balance Sheet of a bank shows the :

a) Financial position b) Total expenditures

c) Gross profit d) Total income

iii) The Profit and Loss Account of commercial banks are prepared in :

a) Form A b) Form B c) Form C d) Form D

iv) The Balance Sheet of commercial banks are prepared in :

a) Form A b) Form B c) Form C d) Form D

v) The format for preparing final account of a bank has been revised w.e.f. :

a) 1st April 1935 b) 1st April 1949

c) 1st April 1971 d) 1st April 1991

vi) The number of Schedules shown in Profit and Loss Account of banks are :

a) Four b) Six c) Seven d) Ten

vii) The number of Schedules shown in Balance Sheet of banks are :

a) Seven b) Ten c) Twelve d) Fifteen

viii) Provisions and Contingencies are coming under the head :

a) Incomes b) Expenditures

c) Appropriations d) None of these

ix) Profit on sale of investment of a bank is treated as :

a) Other income b) Interest earned

c) Income on investments d) None of these

(x) In a bank Balance Sheet number of Schedules allotted for capital and liabilities are:

a) Four b) Five c) Seven d) Ten

(xi) Customers' savings deposit amount is shown in bank Balance Sheet as :

a) Asset b) Liability c) Capital d) None of these

xii) The deposits by customers in a bank repayable after a specified period is known as :

a) Demand deposit b) Current deposit

c) Term deposit d) None of these

2. Fill in the blanks with appropriate words.

a) Final account of a bank is prepared on_______of every year.

b) Profit and loss account of commercial bank are to be prepared in_____of schedule III attached to Banking Regulation Act., 1949.

c) Profit on sale of investment comes under schedule ____ as other income of commercial banks.

d) The main source of_______ of a commercial bank is interest and dividend from investment.

e) Schedule 16 of profit and loss account shows _____of a commercial Bank.

f) The financial position is revealed from the_____of a bank.

g) The liabilities of a bank consists of______schedules.

h) The schedule I of the balance sheet shows the_____of a bank.

i) Savings bank deposits comes under______in a balance sheets of bank.

j) Bills payable is treated as_______of commercial banks.

k) ______liabilities are not shown under the head capital and liabilities of a bank balance sheet.

l) 'Money at call and short notice' is an item of ______ in the balance sheet of a bank.

3. Correct the underlined protions in the following sentences :

a) Final account of a commercial bank consists of <u>trial balance</u> and balance sheet.

b) The explanatory notes attached to profit and loss account and balance sheet is known as <u>working notes</u>.

c) Profit and loss account of commercial banks contain <u>12 numbers</u> of schedules.

d) Schedule <u>15</u> of profit and loss account shows interest earned.

e) Expenses on printing and stationary comes under <u>interest expended</u> in a profit and loss account.

f) The assets and liabilities of a commercial bank are shown in income statement.

g) Balance sheets of commercial banks are prepared in form B of schedule III attached to the Banking Regulation Act, 1949.

h) The assets of a bank shown through twelve number of schedules,

i) The reserves and surplus are coming under assets of a Bank,

j) Borrowing from RBI and other institutions by a commercial bank are shown as assets in balance sheet.

k) Bills discounted and purchased is coming under liabilities of a bank.

l) Schedule -10 of a bank's balance sheet shows loans and advances,

m) Tax paid in advance comes under fixed assets of a bank balance sheet.

No.4 Answer the following questions in not more than **two** sentences each.

a) What is final account of a bank ?

b) Why Profit and Loss Account of banks are prepared ?

c) What is the objective of preparing Balance Sheet of a bank ?

d) What is a Schedule ?

e) Name the items coming under the head 'Interest Earned'.

f) What is meant by appropriation of profit ?

g) Write any three items of 'Operating Expenses' in an Income Statement.

h) What items are included under the head 'Provisions and Contingencies' ?

i) How investment in Govt. Securities are treated in a Balance Sheet ?

j) Define the term 'Held to Maturity' in respect of investment in securities.

k) Why Investment Fluctuation Reserve is created by the banks ?

l) Explain the term 'Cash Credit' system of a bank.

m) What is meant by 'Bills for Collection' ?

n) Name any three types deposits accepted by the banks.

No.5. Answer the following questions in not more than **six** sentences each :

a) Write a note on Profit and Loss Account of a bank.

b) Make a list of items included under the head 'Other Income'.

c) Show the treatment of 'Auditors' Fees and Expenses while preparing Profit and Loss Account of a bank. .

d) Write a note on Investment Fluctuation Reserve.

e) How 'contingent liabilities' are treated in Balance Sheet ?

f) Why preparation of Balance Sheet is important for a bank ?

g) Discuss the meaning of 'Bills Payable'..

h) Distinguish between Profit and Loss Account and Balance Sheet.

i) What are the items included under the head 'Investment in India' as an asset in Balance Sheet ?

j) Explain 'Cash Credit' system of advances given by a commercial bank.

k) Make a distinction between securities 'Held to Maturity' and securities 'Held for Trading'.

l) How the item 'Premises' treated in a bank's Balance Sheet ?

m) Name the items coming under the head 'Contingent Liabilities' of a commercial bank.

**Long Type Questions**

1. Discuss various expenditure items in a Profit and Loss Account of a Commercial bank.
2. What is a Schedule ? Explain Schedule 13 and 14 of a commercial bank's Income Statement.
3. What do you mean by Balance Sheet of a commercial bank ? Draw a proforma of Balance Sheet as per Banking Regulation Act.
4. Briefly discuss various items of 'Advances' (Schedule-9) in a Balance Sheet of commercial bank.
5. What is a Profit and Loss Account of commercial bank ? Distinguish its Profit and Loss Account from Balance Sheet.

## ANSWERS

No.1. (i) c (ii) a (iii) b (iv) a (v) d (vi) a (vii) c (viii) b (ix) a (x) b (xi) d (xii) c

No.2. (a) 31st March (b) Form B (c) 14 (d) Income (e) Operating expenses (f) Balance Sheet (g) Five (h) Capital (I) Liabilities (j) A liability (k) Contingent (l) Asset

No.3. (a) Profit & Loss Account (b) Schedule (c) 04 (d) 13 (e) Operating expenses (f) Balance Sheet (g) Form A (h) Six (i) Capital and Liabilities (j) Liabilities (k) Assets (l) 9 (m) Current.

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CHAPTER - 3

# CREDIT CREATION AND ROLE OF COMMERCIAL BANKS IN A DEVELOPING ECONOMY

**STRUCTURE**

3.1 Introduction
3.2 Credit Creation
 3.2.1 Mechanism of Credit Creation
 3.2.2 Limitations of Credit Creation
3.3 Portfolio Management of Commercial Banks
3.4 Nationalisation of Commercial Banks
3.5 Role of Commercial Banks in a Developing Economy
**Questions**

## 3.1 INTRODUCTION

Banks play an important role in the development of a country. Commercial Banks as well as the Central Bank or the banking system as a whole constitute an important and integral part of the financial system that helps in mobilising the idle resources of a country in the right direction for its overall development. Banks also render many essential services to the society. Development process in agricultural sector, rural and cottage industries in different remote areas of our country started after nationalisation of commercial banks in 1969 and 1980. Alongwith the developmental and welfare activities, commercial banks managed their portfolio for getting returns. In the light of the above, the credit creation, portfolio management, nationalisation and role of commercial banks are discussed below.

## 3.2 CREDIT CREATION :

Creation of credit refers to the power of banks to multiply loans and advances through creating deposits. In the words of Newlyn, credit creation refers to the "the power of commercial banks to expand secondary deposits either through the purpose of making loans or through investment in securities". It is a unique function of commercial banks by which it can manufacture credit.

At the time when a bank accepts cash from customer and opens an account in his/her name, that deposit in the bank is called the primary deposit. Huge amount of money is deposited by a large number of customers with a bank. Every depositor does not demand to withdraw his/her deposit money at one time nor all the depositors collectively demand the bank at one time for withdrawal of their full deposit money. For that reason, banks do not keep cent per cent reserve of deposit money but are able to meet the demand of their customers with a very small reserve amount, because some may withdraw, while others may also deposit at the same time. Therefore, the banker is always left with some of the deposits without being demanded by depositors which they use for granting loans and earn profits thereon. The banker, however, is required to keep a certain percentage of the deposit as reserve to meet the demands of the depositors. This percentage of reserve is called cash reserve ratio.

The primary deposit left after meeting requirement of cash reserve ratio are available with the bank for being used for giving loans and advances to needy parties. The amount of the loan sanctioned is not directly paid in cash to the borrower but is credited to his account. So the amount sanctioned as credit is immediately shown as a new deposit by the bank. Thus every bank credit creates an equivalent amount of bank deposit and each borrower becomes a depositor for the bank. Such deposits are called secondary or derivative deposits. Again, keeping certain percentage of these derivative deposits as cash reserve, banks grant further credit. This facility or process of granting credit results in creation of credit. According to Prof. Sayers, 'Every loan creates a deposit".

Creation of credit is the power of banks to multiply loans and advances by creating deposits. The banks can multiply a given amount of cash or primary deposit to many times of credit or derivative deposits. The ratio of total derivative deposits to the total primary deposits of a bank is called credit multiplier. A commercial bank operating as a single unit is able to create very little amount of credit, but the entire banking system is able to create credit several times larger than the original deposit money. Therefore, Prof. Sayers remarks, "banks are not merely purveyors but also in an important sense, manufacturers of money."

**3.2.1 Mechanism of Credit Creation**

Every banker generally prefers to have a minimum amount of idle cash. The banker wants to increase the circulation of money which does not mean that the banker increases the total amount of currency notes or coins. When a loan is sanctioned to a customer, the customer is not

paid the amount in cash but the amount is credited to the customer's account. In this way the customer or borrower acquires a claim against the bank, just like the way a certain sum of money deposited by the customer with the banker creates a claim against the bank. When the customer issues cheques in favour of other people, they deposit the cheques into the banks for collection, and their deposit increase.

The process of multiple credit creation may be explained through an example. Suppose Mr. A has deposited Rs. 20,000 in a bank. This amount of deposit is known as primary deposit. Out of this deposit, bank maintains a minimum percentage of reserve as fixed by RBI as Cash Reserve Ratio (CRR) and the balance can be advanced as loan to the parties who are in need of funds. The balance sheet of the bank would in that case appear as :

| **Liabilities** | | **Assets** | |
|---|---|---|---|
| Deposits | Rs. 20,000 | Cash in hand | Rs. 20,000 |

If the banker maintains a cash reserve of 10 percent of the deposits which amounts to Rs. 2,000 and lend out the balance of Rs. 18,000 to Mr. B, the bank will open an account in his name and credit the amount. Now the bank has a total deposit of Rs. 38,000, though the actual cash deposit is Rs. 20,000. The extra Rs. 18,000 is known as bank money and only in pen and paper. At this stage the balance sheet would appear as–

| **Liabilities** | **Rs.** | **Assets** | **Rs.** |
|---|---|---|---|
| Deposits - | 20,000 | Cash in hand | 20,000 |
| Deposits (credit balance of Mr. B) | 18,000 | Loans - | 18,000 |
| | 38,000 | | 38,000 |

Now, the bank can advance a loan maximum upto Rs. 16,200 after deducting a further cash reserve of 10 per cent (i.e. Rs. 18.000 – Rs. 1,800). If the said amount is advanced to Mr. C, the bank opens an account in his name and credits the amount to his account. After this transaction the total deposit amount of the bank increased to Rs. 54,200 (i.e., Rs. 20,000 of A's initial deposit + Rs. 18,000 of B's derivative deposit + Rs. 16,200 of C's derivative deposit) and the loan amount to Rs. 34,200 (i.e., Rs. 18,000 to B + Rs. 16,200 to C). Then the balance sheet would appear as–

| Liabilities | Rs. | Assets | | Rs. |
|---|---|---|---|---|
| Deposits - | 20,000 | Cash in hand | | 20,000 |
| Deposits (Credit balance of Mr. B) | 18,000 | Loans | Mr. B – | 18,000 |
| (Credit balance of Mr. C)———> | 16,200 | | Mr. C – | 16,200 |
| | **54,200** | | | **54,200** |

In this process the banker can go on increasing the creation of additional money. But this has a limit. The banker can increase the supply of deposit money to a limited extent and continue this process till the total cash reserve is equal to the initial Primary deposit i.e., Rs. 20,000. The entire process of credit creation is presented through the following table.

**Credit Creation by the Bank**

| Stages | Deposit Rs. | CRR@10% Rs. | Credit Created Rs. |
|---|---|---|---|
| 1st – Mr. A | 20,000 (Initial Deposit) | 2,000 | 18,000 (Initial Excess) |
| 2nd –Loan to Mr. B | 18,000 | 1,800 | 16,200 |
| 3rd –Loan to Mr. C | 16,200 | 1,620 | 14,580 |
| 4th | ..... | ....... | ....... |
| 5th | ..... | ....... | ....... |
| ....... | ..... | ....... | ....... |
| ....... | ..... | ....... | ....... |
| ....... | ..... | ....... | ....... |
| ....... | ..... | ....... | ....... |
| **Total** | **2,00,000** | **20,000** | **1,80,000** |

Here, the initial excess reserve is Rs. 18,000 and the total credit created is Rs. 1,80,000. It is 10(ten) times of Rs. 18,000. So in this case the credit multiplier is ten. It is obtained by the formula–

$$\text{Credit Multiplier} = \frac{1}{\text{Cash Reserve Ratio}} = \frac{1}{10\%} = 10$$

Credit Multiplier and CRR are inversely and proportionately related. So, by decreasing CRR, higher credit can be created and vice-versa. To create more credit RBI decreases CRR and to control credit it increases CRR.

### 3.2.2 Limitations of Credit Creation

The individual banks or the banking system as a whole can create credit. But a number of problems crop up in credit creation in practice. Such problems may be viewed as limitations of credit creation.

- The ability of the credit creation of a bank depends upon the amount of cash. The bank can create more credit, if it has larger amount of cash.
- The cash reserve ratio affects the credit creation. The lower is the ratio, the greater is the ability to create credit.
- The bank cannot create enough credit because of leakages like excess reserves and currency drains.
- The number of reliable borrowers to avail the entire credit created by banking system may not be available.
- Credit policy of the Reserve Bank greatly influence and affect the cash reserve ratio
- All the people in the country may not have the banking habits to the desired extent.
- The public may not deposit their saved money in banks and prefer to invest in mutual funds, shares, debentures etc.
- Changing Business conditions like inflation, depression affect the credit creation process.
- Required securities may not be available with the borrowers to offer to the banks as security.
- All the banks may not have the same nature and extent of programme of credit sanction and disbursement.

## 3.3 PORTFOLIO MANAGEMENT OF COMMERCIAL BANKS :

Any body who earns or receives every month more money then he needs to spend, is left with some surplus of money which becomes his savings. He does not like to keep it idle rather he would like to use his savings in a way to earn a little income from it. So when he uses his surplus money for earning income on it, it becomes his investment. Investment therefore, implies the

employment of funds with the objective of realising additional income or growth in value of investment at a future date. The interest for using savings or surplus funds gets more and more intensified when the volume or quantum of funds goes on increasing. But the question that will increasingly bother him is where to invest as there are many alternatives available for him like keeping the funds in bank, purchasing shares or debentures, investing in real estates, in mutual funds or giving others as loans. While selecting any one or a combination of some such alternatives, he would obviously desire that his investments would remain safe, when desired can be converted into cash and would give him expected return. Therefore he will not like to put all his funds in one avenue nor all money on equally long term basis. Depending upon his own assessment of his immediate needs of cash, money for which he can wait longer, the expected return that he expects from alternative avenues of investment, risks involved in each alternative etc. he will prepare a list of alternatives in order of preference and distribute or allocate his funds among the preferred avenues of investment. The list he prepares can be called his portfolio of investment and when he closely monitors the flow pattern of return, changes the mixing of patterns of investment from time to time, he can be said to be involved in his portfolio management.

Just the way a person deals with investible funds for maximising returns, the commercial banks also follow the same practice and process while dealing with their funds. But the basic difference between individual level cases and banking institutions is the huge volume of surplus resources available with them. Further, the bulk of the resources they posses do not belong to them and they always stand committed to return others money as per demand at different points of time. Besides keeping in view the basic consideration of safety, liquidity and profitability factors while selecting the avenues for investment, they are also to keep in mind the legal obligation in respect of their choice of investments. So with all these considerations they go on preparing for a given period of time, a list of avenues of investments in which and in what proportion they would invest their investible funds. This represents their portfolio of investment.

### 3.3.1 Portfolio Management of Commercial Banks

A portfolio, in the context of Commercial banks can, therefore, be defined as a combination of different kinds of securities such as Government and Corporate bonds, equity shares, preference shares, mutual funds, cash and so on depending on the bank’s income, budget and convenient time frame. Similarly, Portfolio Management can also be defined as the art of selecting appropriate securities and adopting the right investment policies that should ensure maximum return with minimum of risk. Portfolio management therefore means managing investments in the form of

bonds, shares, mutual funds, cash etc. in such a way that maximum profit is earned within the stipulated time frame with minimum of risk. It involves constant monitoring, evaluating and revising the portfolio under the expert guidance of portfolio managers in order to attain investor's goal. According to Sharpe and Alexander, ''Investment Management, also known as Portfolio Management is the process by which money is managed''. From the above definition it appears that Investment Management is the same as Portfolio Management. But investment management is practically different from portfolio management because, it includes investment in portfolio (i.e. in securities) along with investment in real estate, contribution to provident fund, payment towards life policy etc. Hence, investment management is a broader activity of which portfolio management is a part.

### 3.3.2 Basic Principles of Portfolio Management.

Portfolio Management is always integrated within the following three basic principles.

(a) Principle of liquidity : This principle suggests that the investments are made in such a way that the bank has sufficient amount of liquid assets–assets that can be turned into cash with case and certainty.

(b) Principle of Safety : This principle suggests that the portfolio would be selected in such a way that there is minimum of risk involved and all eggs are not put in one basket.

(c) Principle of profitability : This principle suggests that the portfolio is selected in such a way that the return on investments is maximised.

Each of these principles being competitive in nature, the portfolio manages is required to walk on a tight rope because favouring one principle or another would mean gain on one front and loss on the other front. Hence a careful balancing is always called for while applying these principles.

### 3.3.3 Objectives of Portfolio Management

The followings have been suggested as the basic objectives of portfolio management.

- Appropriate Liquidity
- Security of principal investment
- Maximum Capital growth
- Proper diversification of portfolio

- Conducive for tax status
- Consistency of returns

### 3.3.4 Evolving practices in India

In India, Portfolio Management is still in the growth stage. Though Unit Trust of India, India's first ever mutual fund, was established in 1964, the real growth of managed portfolio (i.e., the mutual fund) started only from 1986 onwards, when the Public Sector banks got into the act of establishing mutual funds. Mutual funds were established by the State Bank of India, Bank of India, Punjab National Bank, Canara Bank and Indian Bank among the nationalised banks, GIC Mutual Fund by the General Insurance Corporation and LIC Mutual Fund by the Life Insurance Corporation of India. With the entry of private sector mutual funds from the year 1993, the scenario has been changed. In Indian context, shortage of trained portfolio manages and investment managers to provide Portfolio Management Services (PMS) hinders the process of growth. However, it is a healthy sign that professional educational programmes started in the recent past to train Professional Financial Analysist, Portfolio Advisors and Managers to take up the responsibilities of providing Professional Portfolio Management Services to individual clients.

Portfolio management as already explained means the choice of assets and their appropriate composition or mix to optimise their returns. Being commercial entities, their prime objective is to make profits. The capacity of commercial banks to earn profit, depends upon their investment policy which in turn depend on the manner in which they manage their investment portfolio. To do so, the banks must place their funds on earning assets, mainly loans, advances and investments. Ordinarily, cash in hand, money at call and short notice and investments appear on the asset side of a bank's balance sheet. Furthermore, investment comprises loans, advances, discounting of bills and investments in government and other approved securities. The last-mentioned item is an important aspect of bank's portfolio choice, thanks to the statutory requirement. A bank can invest in government securities like Treasury bills, National Savings Certificates etc. or in other approved securities as per Banking Regulation Act of 1949. A large part of the investment in the above (Govt. and other approved securities) is statutorily held by banks under Statutory Liquidity Ratio (SLR) requirement. This unique feature of Indian banking system implies that a commercial bank is required by law to hold a prescribed minimum proportion of its daily total demand and time liabilities in the form of designated liquid assets. Started in 1949, its main rationale has been to allocate a growing share of banking sector's aggregate resources to government and specified public sector agencies. In other

words, during the early years of planning, the government wanted to ensure smooth flow of credit for its development projects and programmes through statutory provision. The commercial banks were also seen willing to hold excess securities than SLR needs because they could borrow from RBI against these securities. During pre-nationalisation phase (1950-1969), the banks maintained SLR reserves of around 25%.

However, the period following nationalisation of banks (first in 1969 and then in 1980), the nature of banking changed from being purely commercial to social. In other words, in Social Banking, the financial institutions are supposed to promote and further national and social objectives irrespective of the commercial outcomes.

• Two main tasks were set before the public sector banks in India viz. (a) mobilisation of deposits through massive programme of branch expansion especially in unbanked rural and semi-urban areas; (b) diversification of bank credit to ensure flow of financial assistance to the neglected sectors and sections of the economy, otherwise known as priority sector lending by banks.

• Branch expansion mandate for the banks gave primacy to social banking through promotion, mobilization, availability of institutional credit and remittance facilities in rural and remote regions even while their profitability was invariably low.

• After nationalization, the sectoral allocation of bank credit has undergone a qualitative change. In the pre-nationalisation phase of banking in India (1950-1969), the share of industry in total bank credit increased to nearly 70% while that of trade and agriculture declined. Even within industry, credit was heavily concentrated with the corporate sector (at 80%) while small scale industries were utterly neglected.

• After nationalisation, 'Priority sector lending' became the cornerstone of credit and portfolio management of banks. They were expected to lend 40 % of their outstanding credit to priority sectors like agriculture, small industries, exports, transport operators, self-employed persons, retail trade, small business and education. Apart from total targets, the banks were set sub-targets within a sector and the banks tried to fulfill these social obligations diligently regardless of their profitability.

• The SLR requirement also increased from 25% in late 1960s to 40% by 1990 which meant it was an important instrument for financing economic development through govt. and public sector agencies.

Thus, it can be said that with so much resources statutorily going to priority and Govt. sector, the commercial banks could hardly resort to an optimal asset mix with a view to maximising profits. Though consistent with social banking objectives, this path was never sustainable without government support. The lack of profitability, growing percentage of non-performing assets and inefficient operations was apprehended to eventually defeat the purpose of commercial banking. Therefore, varieties of banking and financial sector reforms were introduced since mid 1990s which resulted in kind of reverse process towards healthy commercial banking with sound portfolio mix, profitability, efficiency, provisioning for bad assets as basic tenets.

Commercial banks in an economy are supposed to discharge their social obligations in terms of meeting credit needs of sections/sectors of the economy. Also being growth oriented, they have to meet the objective of profitability for which they rely upon various channels of investment. In case of Indian banks, substantial quantitative and qualitative changes have taken place in their investment portfolio over the period of time. Indian banks used to rely heavily upon central government securities whereas they are reducing their share in public sector undertakings and gradually diverting towards more market-friendly assets especially in the stock market.

### 3.4 NATIONALISATION OF COMMERCIAL BANKS

Nationalisation means a process that a Government adopts for taking over the ownership and control of any privately owned organisations or entity that it considers essential in the best interest of the public and nation. This is done following due legal process like passing of an Act and settlement of all legal claims of the owners whose organisations or entities are taken over. Nationalisation, therefore, implises acquiring of ownership of private entities by Government through due legal process.

As per the discussion above, nationalisation of commercial banks obviously implies taking over the privately owned commercial banks by the Government through due legal process in the best interest of the nation. Commercial banking in India had a long history of functioning with lots of freedom barring some controls by the RBI under private ownership till India attained independence. After independence, they were subjected to direct control & regulation with the enactment of the Banking Regulation Act of 1949. By then there were more than 500 commercial banks already functioning but all were under private ownership. Since commercial banks were very effective instruments for socio-economic transformation of the nation and more importantly for carrying forward the developmental programmes of the Govt, the need was felt to persuade the commercial banks to be more responsive to the socio-economic needs of the nation. But

despite all efforts, they were found more interested in pursuing their own commercial interest at the cost of the overall interest of the nation. Hence for the reasons stated below, pressure slowly mounted up for nationalisation of the leading privately owned banks.

### 3.4.1 Reasons or grounds for nationalisation :

The reasons which prompted the Government to go for nationalisation of 14 privately owned banks in 1969 and again 6 of such banks in 1980 were :

1) **Interest of the nation ignored :** The privately owned banks were used as powerful instruments by their owners primarily to promote and protect their own financial interest paying little regard to the interest of the nation.

2) **Class based banking :** They adopted class based lending practices confining their lending operation within big business and industrial houses not bothering much for the credit needs of the masses.

3) **Concentered in big cities :** The privately owned banks had banking operation mostly in metro and big cities.

4) **Rural India totally ignored :** Vast majority of people living in rural areas had no access to banking services as these banks considered operation in rural areas highly expensive and unprofitable.

5) **Total negligence of credit needs of important sectors :** Important sectors like agriculture, cottage and small industries, small traders, handloom and handicraft sectors who badly needed credit, no attention was paid to them.

6. **Unhealthy practices :** Being privately owned and very much profit minded, many of the banks were adopting many kinds of unhealthy practices in handling finance that was detrimental for the interest of the nations.

Further during First and Second Five Year Plans emphasis was given on the rapid growth of agricultural sector and small scale industries for employment generation and development of backward areas. To assess the requirement of rural credit in the changing scenario, Govt. of India had formed a committee named, All India Rural Credit Survey Committee, which after examining the issue of credit availability at the rural areas, had recommended the creation of a State partnered/sponsored bank to ensure the flow of credit to rural sector opening branches in rural areas. Accepting this recommendation, the State Bank of India Act, 1955 was passed and the then Imperial Bank of India was nationalised and renamed as State Bank of India. Later in

1959, the State Bank of India (Subsidiary Bank) Act was passed enabling SBI, to take over 8 princely state associated banks, as the subsidiaries. These were the first moves for nationalisation of Commercial Banks in India.

Hence for the reasons stated above pressure slowly mounted up for nationalisation of the leading privately owned banks. The Government of India, therefore on 19th July, 1969, nationalised, 14 major Indian commercial banks, by an ordinance, having deposits of Rs.50 crores and above followed by 6 more banks in April 1980, each having deposits of Rs. 200 crores or above. The objectives and reasons accompanying Bank Nationalisation Act, 1969 were stated as under– "an institution such as banking system which touches and should touch the lives of millions, has to be inspired by a larger social purpose and has to subserve national priorities and objectives such as rapid growth in agriculture, SSI and exports, raising of employment levels, encouragement of new entrepreneurs and the development of backward areas. For this purpose, it is necessary for the Government to take direct responsibility for extension and diversification of banking services, and for the working of substantial part of the banking system".

The banks nationalised in 1969, 1980 and 2003 were as below :

**(A) Banks Nationalised in 1969**

1. Central Bank of India
2. Bank of India
3. Punjab National Bank
4. Bank of Baroda
5. UCO Bank
6. Canara Bank
7. United Bank of India
8. Dena Bank
9. Syndicate Bank
10. Union Bank of India
11. Allahabad Bank

12. Indian Overseas Bank

13. Indian Bank

14. Bank of Maharashtra

**(B) BANKS NATIONALISED IN 1980**

15. Andhra Bank

16. Corporation Bank

17. Oriental Bank of Commerce

18. Punjab and Sindh Bank

19. Vijaya Bank

20. New Bank of India (This bank was merged with PNB in 1990)

**(C) BANK NATIONALISED IN 2003**

20. IDBI Bank

### 3.4.2 Benefits of Nationalisation

As a result of bank nationalisation, the nation has been benefitted in the following ways :

1. **Effective Instruments of Socio-economic change :** Commercial banks have become very powerful instruments of socio-economic transformation.

2. **Massive expansion of branches :** The banking services have been extended almost all areas of the nation with the massive expansion of bank branches.

3. **Greater financial inclusion :** With banking service made available everywhere, more and more people are making use of banking services. So class banking has turned into mass banking.

4. **Greater care of priority sectors :** Certain important sectors like agriculture, cottage industries and small traders, artisans, transport operators etc. have been declared as priority sectors and are given more importance and preference in getting credit.

5. **Creation of more jobs :** With massive branch expansion after nationalisation huge employment opportunities have been created giving jobs to lots of people.

6. **Better banking services :** There has been substantial improvement in the banking services provided to the customers. Many types of technology based services through e-banking services are now made available.

7. **Expansion of credit :** With more of financial inclusion and massive expansion of banking services, there has been a spectacular increase in the volume of credit being flown to different sectors.

## 3.5 ROLE OF COMMERCIAL BANKS IN A DEVELOPING ECONOMY

Besides performing the usual commercial banking functions, banks in developing countries play an effective role in their economic development. The majority of people in such countries are poor, unemployed and engaged in traditional agriculture.

There is acute shortage of capital because national income is low and so is the savings rate. People lack education, training, initiative and enterprise. Means of transport are also undeveloped. Industry is confined to a few urban centres and is not well-spread out. The commercial banks help in overcoming these obstacles and promoting economic development. The role of a commercial bank in a developing country like India is discussed as under.

### i) Mobilising Savings for Capital Formation :

The commercial banks help in mobilising savings through network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilise idle savings of the few rich. By mobilising savings, the banks channelise them into productive investments. Thus they help in the capital formation of a developing country.

### ii) Financing Industry :

The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry. In India they provide short-term loans. In Latin American countries like Guatemala, they advance medium-term loans for one to three years. But in Korea, the commercial banks also advance long-term loans to industry.

In India, the commercial banks undertake short-term and medium-term financing of small scale industries, and also provide hire- purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is undeveloped in such countries.

**iii) Financing Trade :**

The commercial banks help in financing both internal and external trade. The banks provide loans to retailers and wholesalers to stock goods in which they deal. They also help in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts, etc. Moreover, they finance both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

**iv) Financing Agriculture and Allied Activities:**

The commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernisation and mechanisation of their farms, for providing irrigation facilities, for developing land, etc.

They also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming, pisciculture and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people.

**v) Financing Consumer Activities:**

People in underdeveloped countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities and by creating complementary demand for industries.

**vi) Financing Employment Generating Activities:**

The commercial banks finance employment generating activities in developing countries. They provide loans for the education of young person's studying in engineering, medical and other vocational institutes of higher learning. They advance loans to young entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in India. Thus the banks not only help inhuman capital formation but also in increasing entrepreneurial activities in developing countries.

**vii) Help in Monetary Policy:**

The commercial banks help the economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy.

Thus the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.

❍

## QUESTIONS

1. Choose the correct answer from the given alternative answers against each bit :

i) Increases in the cash reserve ratio by the Central bank result in :

a) Leakage of credit b) Expansion of credit

c) Contraction of credit d) disappearance of credit.

ii) The main objective of portfolio management is :

a) Maintaining liquidity b) Ensuring safety

c) Increasing profitability d) All of the above

iii) The ability of commercial banks to multiply loans and advances by expanding secondary deposits referred as :

a) Credit creation b) Credit contraction

c) Credit leakage d) Credit linkage

iv) Keeping certain percentage of their deposits to meet the demand of customers by the Banks is termed as :

a) Cash reserve ratio b) Cash reverse ratio

c) Credit reserve rate d) None of these

v) The credit multiplier of a bank refers to the ratio of total derivatives to the :

a) Total secondary deposits b) Total primary deposits

c) Total public borrowings d) None of the above

vi) In a bank Balance Sheet 'money at call and short notice is treated as :

a) Borrowings b) Contingent liability

c) Bills payable d) Asset

vii) SLR stands for :

a) Short-term liquidity ratio b) Statutory liquidity rate

c) Statutory liquidity ratio d) None of these

viii) The number of banks nationalised on 19th July, 1969 are :

a) Seven b) Fourteen c) Seventeen d) Twenty

ix) In 1990 the New Bank of India was merged with :

a) State Bank of India b) United Bank of India

c) Union Bank of India d) None of these

(x) After nationalisation of commercial banks the nature of banking changed from purely commercial to :

a) Autocratic banking b) Artificial banking

c) Social banking d) Democratic banking

No.2. Fill in the blanks with appropriate words.

a) Deposit received from a customer at the time of opening an account is called _________ deposit.

b) Secondary deposit is otherwise known as__________of a bank.

c) Credit policy of _________ greatly affects the cash reserve ratio.

d) Maximization of _________ is the prime objective of a commercial bank.

e) During pre-nationalization, the SLR reserves of banks was about _______ of their total investments.

f) After 1969 the nature of Indian banking changed from purely_______to social banking.

g) Commercial banks were expected to lend about 40% of their total credit as _________sector lending after nationalisation.

h) In 2003 ________ bank was included in the nationalization list of commercial banks.

i) A nationalized bank named __________ was merged with Punjab National Bank in 1990.

j) State Bank of India Act was passed in the year__________.

k) The Banking Law (Amendment) Act was passed in the year__________to bring social control over banks.

l) The commercial banks having deposits of Rupees ____________ or above were nationalized in 1980.

No. 3. Correct the underlined portions of the following sentences if necessary.

a) Credit creation refers to the power of commercial banks to expand primary deposits.

b) A certain percentage of deposit money kept as reserve by the banks to meet the demands is termed as Bank Rate Ratio.

c) Higher is the cash reserve ratio greater is the ability of banks to create credit.

d) Choice of assets and their appropriate composition by commercial banks is known as asset choice management.

e) A prescribed portion of banks' investment in Govt. securities is made to fulfil the requirements of security loan ratio.

f) Credit policy of SBI greatly influence and affect the CRR.

g) During pre-nationalisation phase a lion share of the total bank credit was given to small scale industries.

h) In 1969 the Govt. of India has nationalised 20 major Indian commercial banks by an ordinance,

i) State Bank of India had taken over 8 regional rural banks as its subsidiaries in 1959.

j) Commercial banks mobilised the idle savings of people in developing country for encouraging spendip habits.

No.4. Answer the following questions in not more than **two** sentences each.

a) Explain the term 'credit creation' ?

b) What is meant by cash reserve ratio ?

c) How increase in cash reserve ratio affects credit creation ?

d) Define portfolio management.

e) Name the priority sectors to which commercial banks lend their credit.

f) Explain the meaning of secondary deposit.

g) State any two reasons for nationalisation of commercial banks.

h) Name any four banks nationlised in the year 1969.

No.5 Answer the following questions in not more than **six** sentences each :

a) What are the objectives of nationalisation of commercial bank ?

b) Name the banks nationalised in 1980.

c) Discuss how commercial banks helps in financing industry.

d) 'Commercial banks facilitate employment generating activities' - explain.

e) State how commercial banks help in capital formation by mobilising savings.

**Long Type Questions**

1. What is credit creation ? Briefly discuss its mechanism.
2. Discuss the benefits of nationalisation of commercial banks.
3. Explain the role of commercial banks in a developing economy.
4. What is portfolio management ? Give a picture of portfolio before and after nationalisation.

**ANSWER**

No.1. (i) c (ii) d (iii) a (iv) a (v) b (vi) d (vii) c (viii) b (ix) d (x) c

No.2 (a) Primary deposit (b) Derivative deposit (c) Reserve Bank of India (d) Profit (e) 25% (f) Commercial (g) Priority (h) IDBI (i) New Bank of India (j) 1955 (k) 1968 (l) 200 crores

No.3 (a) Secondary (b) Cash Reserve (c) Lower (d) Port folio (e) Statutory Liquidity (f) RBI (g) Large Scale (h) 14 (i) Princely State (j) Saving.

CHAPTER – 4

# CENTRAL BANKING

**STRUCTURE**

4.1 Central Bank
4.2 Functions of the Central Bank
 4.2.1 Traditional Functions
 4.2.2 Developmental Functions
4.3 Methods of Credit Control
 4.3.1 Quantitative methods of Credit Control
 4.3.2 Qualitative methods of Credit Control or Selective Credit Control
 **Questions**

## 4.1 CENTRAL BANK

Almost in every country there exists one financial institution which works as the apex bank, acting as the leader of the money market. In other words, a central bank is the supreme monetary institution and is at the top of the monetary and banking structure of a country. It is the leader of the money market and controls, regulates and supervises the activities of commercial banks and other financial institutions. It is the central monetary authority which manages the currency and credit policy of the country and functions as a banker to the Government as well as to all the commercial banks.

Some of the important definitions of central bank are given below :

**De Kock** defines central bank as "a bank which constitutes the apex of the monetary and banking structure of the country."

According to **Vera Smith,** "the primary definition of central bank is a banking system in which a single bank has either a complete or residuary monopoly of note issue."

According to the **Bank of International settlements,** a central bank is defined as "the bank in any country to which has been entrusted the duty of regulating the volume of currency and credit is that country."

In the words of **Kent,** a central bank is an "institution charged with the responsibility of managing the expansion and contraction of the volume of money in the interest of general public welfare."

**Oxford Advanced Learner's Dictionary** defines central bank as "A national bank that provides financial and banking services for its country's government and commercial banking system, as well as implementing the government's monetary policy and issuing currency."

From a general review of all the definitions given above, it appears that each definition highlights only certain features of a central bank. But none gives a comprehensive idea of a central bank incorporating all its essential features. Hence, taking a synthesized view of the different features highlighted, a central bank can be more comprehensively defined as the apex banking institution statutorily established by a country entrusted with the duty and responsibility of regulating and controlling the country's entire banking system as well as the volume of currency and credit in the best interest of general public welfare, together with functioning as the banker to all commercial banks as well as Government.

**Essential features of central bank**

The definition given above highlights the following essential features of a central bank :

a. It is the apex bank of a country.

b. It is statutorily established.

c. It regulates and control the entire banking system of a country.

d. It is empowered to control and regulate the volume of currency and credit.

e. It acts as the banker to all commercial banks as well as of the Government.

f. It plays a significant role for the overall economic development and growth of the country.

Bank of England is the central bank of the United Kingdom. It was the world's first effective central bank that was established in 1694 and is known as the mother of all Central

Banks. The central banking system in the United States is known as the Federal Reserve System. In India, Reserve Bank of India is the central bank. It is the apex institution of country's monetary and financial system. It plays a leading role in organising, supervising and regulating the monetary and financial system. Reserve Bank of India was established on April 1, 1935 under the Reserve Bank of India Act, 1934. It was nationalised on January 1, 1949. The executive head of the Bank is called Governor who is assisted by deputy governors and other officers. Its head office is at Mumbai.

## 4.2 FUNCTIONS OF THE CENTRAL BANK

In the monetary and banking set up of a country, central bank occupies central position. It works as an institution whose main objective is to control and regulate money supply keeping in view the welfare of the people. Central bank is an institution that fulfills the credit needs of banks and other financial institutions. It works as banker to the banks and the government and works for the economic interest of the country. The central bank does not deal with the general public directly. It performs its functions with the help of commercial banks. The central bank is accountable for protecting the financial stability and economic development of a country.

The functions of the central bank are broadly divided into two parts, i.e., traditional functions and developmental functions.

### 4.2.1 Traditional Functions

The traditional functions of the central bank include the following :

#### (i) Monopoly of Note-Issue

Monopoly of note-issue is the primary and the most important function of a central bank. Central bank in every country has been given the sole right of issuing currency notes in order to secure control over volume of currency and credit. These currency notes are circulated throughout the country as legal tender money. Legal tender means currency that may be lawfully tendered in all types of payments. Bank currency notes and coins are usually defined as legal tender. But personal cheques, debit cards and credit cards are not usually considered as legal tender. Central Bank has to keep a reserve in the form of gold and foreign securities against the notes issued by it as per statutory rules. It may be noted here that the monopoly of central bank to issue the currency notes may be partial in some countries. For

example, in India one-rupee notes are issued by the Ministry of Finance, Government of India and all other notes are issued by the Reserve Bank of India.

Bank notes in India are currently being issued in the denominations of L10, L20, L50, L100, L500 and L1,000/-. These notes are called bank notes as they are issued by the Reserve Bank of India. The printing of notes in the denominations of L2 and L5 has been discontinued as these denominations have been coinised. However, such bank notes issued earlier can still be found in circulation and these bank notes continue to be legal tender. Rupee-one note was also not being printed due to coinisation. However, the Central Government has recently reintroduced this note. Rupee-one notes issued in the past also continue to be legal tender.

The main advantages of giving the monopoly right of note-issue to the central bank are as follows :

a. It brings uniformity in the monetary system of note-issue and note circulation.

b. The central bank can exercise better control over the money supply in the country. It increases public confidence in the monetary system of the country.

c. Monetary management of the paper currency becomes easier. Being the apex bank of the country, the central bank has full information about the monetary requirements of the economy and thus, can change the quantity of currency accordingly.

d. It enables the central bank to exercise control over the creation of credit by the commercial banks.

e. Monopoly right of note-issue to the central bank avoids the political interference in the matter of note-issue.

f. The government is able to earn profits from printing notes whose cost is very low as compared to their face value.

**(ii) Banker, Agent and Advisor to the Government**

Central bank acts as a banker to the Government both Central and State Governments. It carries out all banking business of the Government. Government keeps cash balances in the current account with the central bank. Central bank accepts receipts and makes payment on behalf of Government. It also gives loans and advances to Government for temporary periods as and when required. As the banker to the Government, the central bank performs the same

functions for the Government as a commercial bank performs for its customers. It maintains the accounts of the Central as well as State Governments. It receives deposits from Government, makes short-term advances to the Government, collects cheques and drafts deposited in the government account, provides foreign exchange resources to the Government for repaying external debt or purchasing foreign goods.

As the agent to the Government, the central bank collects taxes and other payments on behalf of the Government. It raises loans from the public and manages public debt. It also represents Government in the international financial institutions and conferences.

As a financial advisor, the central bank gives advice to the Government on economic, monetary, financial and fiscal matters such as deficit financing, devaluation of currency, trade policy, foreign exchange policy, etc.

**(iii) Banker's Bank**

There should be some agency to regulate and supervise proper functioning of commercial banks in a country. This duty is discharged by central bank. Central bank acts as banker's bank is three capacities : (a) as custodian of cash reserves of commercial banks, (b) as lender of last resort and (c) as clearing agent. In this way, the central bank acts as a friend, philosopher and guide to the commercial banks. Central bank is the custodian of cash resources of commercial banks. Banks are required to keep a certain percentage of their deposits with the central bank and in this way, the central bank becomes the ultimate holder of the cash reserves of commercial banks. Such cash resources can be utilised by the commercial banks in times of emergency. The centralisation of cash reserves in the central bank has the following advantages :

a. Centralised cash reserves inspire public confidence in the banking system of the country.

b. Centralised reserves can be used in most effective manner during the periods of seasonal strains and financial emergencies.

c. Centralised reserves enable the central bank to provide financial help to the commercial banks which are in temporary difficulties.

d. Centralised reserves enable the central bank to influence the creation of credit by increasing or decreasing the cash reserves.

e. The cash reserve with the central bank can be used to promote national welfare.

**(iv) Lender of the last resort**

When commercial banks exhaust all resources to supplement their funds at times of liquidity crisis, they approach central bank as a last resort. Central bank guarantees solvency and provides financial help to the commercial banks as lender of the last resort by rediscounting their eligible securities and bills of exchange and by providing loans against their securities. The main advantages of central bank's role as lender of the last resort are:

a. It increases the elasticity and liquidity of the whole credit structure of the economy.

b. It enables the commercial banks to carry on their activities even with their limited cash reserves.

c. It provides financial help to the commercial banks in times of emergency.

d. It helps the central bank to exercise its control over banking system of the country.

**(v) Clearing Agent**

As the custodian of the cash reserves of the commercial banks, the central bank acts as the clearing house for these banks. Since the banks have their accounts with the central bank, the central bank can easily settle the claims of the various banks against each other with least use of cash. The clearing house function of the central bank has the following advantages :

a. It economises the use of cash by banks while settling their claims and counter-claims.

b. It reduces the withdrawals of cash and these enable the banks to create credit on large scale.

c. It keeps the central bank fully informed about the liquidity position of the commercial banks.

**(vi) Controller of credit and money supply**

Central bank controls credit and money supply through its monetary policy. Monetary policy deals with two matters namely, currency and credit. Central bank has monopoly of issuing currency notes (except one-rupee notes, one rupees coins and small coins issued by the Central Government in India) and thus can control the volume of currency. The basic objective of credit control function of central bank is to ensure price stability along with full employment. It controls credit and money supply by adopting different measures of credit

control, such as Bank Rate, Open Market Operation, Cash Reserve Ratio (CRR), and Selective Credit Control as explained below :

**Bank rate** is the rate fixed by the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. The central bank controls credit by making variations in the bank rate. If the need of the economy is to expand credit, the central bank lowers the bank rate, enabling the commercial banks to borrow more and advance loans to customers at a lower rate. On the contrary, when credit is to be contracted in the economy, the central bank raises the bank rate discouraging the banks to borrow.

**Open market operation** refers to buying and selling of eligible securities by the central bank in the money market and capital market. The buying and selling of securities by the central bank results in increase or decrease in the cash resources of the commercial banks. This in turn, affects the credit creation of the banks.

**Cash Reserve Ratio(CRR)** is also another method to exercise control over credit. The central bank has the power to vary the percentage of deposits that must be kept as reserve with it by commercial banks within certain limits. When the central bank wants to reduce credit, it will increase cash reserve ratio to be kept by the banks. This reduces the capacity of the banks to lend and thus credit creation is controlled. On the other hand, when the central bank wants to increase the flow of credit, it reduces the cash reserve ratio. As a result of this, the banks have more cash resources leading to credit expansion.

**Selective credit control** methods are another type of tool to control certain type of credit. They directly affect the demand for bank credit as also the capacity of the banks to lend. They can be used more effectively without any change in the prevailing rates of interest. Some of the methods of selective credit control are : changing the margin requirement of loan, rationing of credit, publicity, moral persuasion, etc.

**(vii) Custodian of National Reserve**

It is the central bank which serves as the custodian of the country's resources of gold and foreign exchange. It is its duty to take appropriate measures to safeguard these resources. All foreign currency received by the citizens have to be deposited with the central bank and if the citizens want to make payment in foreign currency, they have to apply to the central bank for such purpose.

**(viii) Maintenance of Exchange Rate**

It is the duty of the central bank to see that the external value of currency is maintained. A stable exchange rate is necessary to maintain and promote a country's foreign trade thereby paving the inflow of more of foreign investments into the country. Promotion of foreign trade and inflow of foreign investment is very much essential for accelerating the pace of economic growth of a country.

### 4.2.2 Developmental Functions

Besides the traditional functions, the central bank also discharges the following developmental functions for promotion of banking system and economic development of a country, particularly in a developing country :

**(i) Developing Specialised Financial Institutions**

The Central bank plays a key role facilitating the establishment of institutions that serve credit requirements of the agriculture sector and other rural businesses. These are called specialised financial institutions as they serve the specific sectors of the economy. For example, in India Industrial Development Bank of India (IDBI) and National Bank for Agriculture and Rural Development (NABARD) are the specialised financial institutions.

**(ii) Influencing Money Market and Capital Market**

Central bank helps in controlling the financial market, i.e., capital market and money market. Capital market deals in long-term credit whereas money market deals in short-term credit. The central bank maintains the country's economic growth by controlling the activities of these markets.

**(iii) Collecting and disseminating Statistical Data**

Central Bank keeps on regularly collecting and analysing data relating to banking, currency, foreign exchange position, etc. of a country. The data are very much helpful for policy makers, economists and researchers. For instance, in India Reserve Bank of India publishes a magazine known as Reserve Bank of India Bulletin, whose data are useful for formulating different policies for making decisions about economic development of the country.

## 4.3 METHODS OF CREDIT CONTROL

As discussed earlier, one of the basic functions of the central bank is to control credit. A central bank controls credit with a view to achieve the following objectives :

a. To maintain stability of internal prices

b. To eliminate fluctuations in production and employment

c. To achieve stability in foreign exchange rate

d. To safeguard country's gold and foreign exchange reserves

e. To accelerate economic growth of the country

The central bank uses different methods to control credit. These methods can be broadly classified into two broad categories :

Quantitative methods of credit control and

Qualitative methods of credit control or Selective Credit Control.

### 4.3.1 Quantitative Methods of Credit Control

The quantitative methods of credit control are general and traditional in nature. They aim at the regulation of the quantity of credit. The objective of quantitative control methods is to regulate the volume of bank advances, i.e., to encourage the banks for giving more advances or less advances. Quantitative control of credit may be exercised through the use of any one or all of the following methods :–

(i) Bank Rate policy,

(ii) Open Market Operation, and

(iii) Variation of Cash Reserve Ratio.

#### (i) Bank Rate Policy

It is also known as Discount Rate Policy. The bank rate is the rate fixed by the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. The central bank controls credit by making variations in the bank rate. The bank rate is raised in times of inflation, i.e., situation of rising prices and is lowered in times of deflation, i.e., situation of declining prices. A rise in the bank rate is usually proceeded by the following events :

1. Over supply of money and rising price level

2. Adverse rate of exchange

3. Mounting demand for money caused by expanding trade

4. Unfavourable balance of trade

In times of rising prices and unfavourable balance of payments, the central bank raises the bank rate. Because of this, credit becomes dear and borrowing from banks becomes costly. The speculators are discouraged to buy and stock goods. They start selling their stock of goods and imports decline. Foreign investors are encouraged to keep their money within the country to earn increased rate of interest. The unfavourable balance of payments gradually disappears. Prices of consumer commodities fall due to less spending and unloading of stocks. But in times of falling prices, the central bank lowers the bank rate. This will lead to increased volume of trade, investment, production and employment and ultimately leads to rise in price level.

**Limitations of Bank Rate Policy**

The effectiveness of bank rate policy is limited by the following factors :

a. Market rate of interest does not change with bank rate. The rate of interest in money market may not change according to the changes in bank rate. The bank rate policy presupposes that interest rates in money market change in the direction of change in the bank rate. If this condition is not satisfied, bank rate policy will be ineffective to control credit.

b. The prices and costs may not also change as a result of changes in the rate of interest. In such a situation, bank rate policy cannot be a success. The success of bank rate policy requires elasticity not only in interest rates but also in prices and costs.

c. The bank rate cannot be the sole regulator of the economic system. The effectiveness of changes in interest rates depends upon the elasticity of demand for capital goods.

d. The effect of rise in the bank rate in controlling credit for industrial and commercial purpose is limited. If the businessmen take the view that prices will continue to rise, a slight rise in interest rate will not discourage them to expand their activities with borrowed money. So long as prices have a tendency to rise and so long as there is business optimism, businessmen would be willing to pay higher interest rates.

e. During the situation of falling prices, a fall in the interest rate can hardly stimulate economic activities. Because the businessmen may not be prepared to increase their activities if they fear about the future.

f. The change in the methods of financing by the businessmen reduces the importance of bank rate policy. The businessmen may utilise their own resources such as ploughing back of profits rather than depending on borrowings from the banks.

g. When the bank rate is increased, the money from the foreign countries may flow into the country making credit control difficult.

h. The bank rate policy does not discriminate the activities into productive and unproductive activities. This will adversely affect the productive activities with increased rate of interest.

**(ii) Open Market Operations**

Open market operations refer to buying and selling of securities, bills and bonds of government as well as private financial institutions by the central bank. But in its narrow sense, it simply means dealing only in government securities and bonds. The buying and selling of securities by the central bank results in an increase or decrease in the cash resources of the commercial banks. This in turn affects the credit creation of the commercial banks.

If the central bank wants to reduce the volume of credit created by the banks, it sells securities in the market. When the banks and the public purchase these securities, they have to make payments to the central bank. This results in the movement of cash from commercial banks and public to central bank. Hence, the capacity of the banks to expand credit will be contracted. In times of rising prices, the central bank sells the securities in the open market. On the other hand, when the central bank wants to expand the volume of credit, it starts buying the securities from the open market. The central bank has to make payments to the commercial banks and the public for such purchases. This results in the movement of cash from the central bank to commercial banks and public and cash resources in their hands will increase. Thus, the banks are in a position to expand credit. This is followed during deflationary situations, i.e., situations of falling prices.

**Limitations of Open Market Operations**

The following are the limitations of open market operations of credit control :

a. The existence of a large and well organised security market is necessary for open market operations. Without a well developed security market, the central bank will not be able to sell and buy securities on a large scale and influencing the reserves of the commercial banks. Further, the central bank must have enough saleable securities with it.

b. The success of open market operations requires the maintenance of a stable cash reserve ratio by the commercial banks. It implies that when the central bank sells or buys securities, the reserves of the commercial banks decrease or increase accordingly to maintain the fixed ratio. But the banks do not stick to the legal minimum reserve ratio and keep a higher ratio than this. This makes the open market operations less effective in controlling the volume of credit.

c. One of the necessary conditions for the success of open market operations is a penal bank rate. If there is no penal bank rate fixed by the central bank, the commercial banks can increase their borrowings from it when the demand for credit is strong. In this situation, the sale of securities by the central bank to restrict credit expansion will be unsuccessful. But if there is a penal rate of discount, which is a rate higher than the market rates of interest, the banks will be reluctant to approach the central bank for additional financial help.

d. Open market operations are successful only when the people also act the way the central bank expects them. When the central bank sells securities, it expects the business community and financial institutions to restrict the use of credit. If they simultaneously start dishoarding money, the act of selling securities by the central bank will not be a success in restricting credit. Similarly, the purchase of securities by the central bank will not be effective if people start hoarding money.

e. Pessimistic or optimistic attitude of the business community also limits the operation of open market policy. When the central bank purchases securities and increases the supply of bank money, businessmen may be unwilling to take loans during a depression because of the prevailing pessimistic attitude among them. On the other hand, if businessmen are optimistic during a boom, the sale of securities by the central bank to reduce the supply of bank money cannot discourage them for getting loans from the banks.

**(iii) Variation Of Cash Reserve Ratio**

Every commercial bank is required by law to maintain a minimum percentage of its deposits with the central bank. This is known as cash reserve ratio. The minimum amount of reserve with the central bank may be either a percentage of its time and demand deposits separately or of total deposits. Time deposits are deposited in bank for fixed period of time (usually 1 year to 5 years), whereas there is no fixed time period involved in case of demand deposits. Fixed or term deposit is an example of time deposits whereas deposits in savings

account and current account are examples of demand deposits. Whatever the amount of money remains with the commercial banks over and above the minimum reserves is known as excess reserves. It is on the basis of these excess reserves that the commercial banks are able to create credit. The larger the size of the excess reserves, the greater is the power of a bank to create credit and vice versa.

When the central bank raises the cash reserve ratio of the commercial banks, it means that the latter are required to keep more money with the former. As a result of this, the excess reserves with the commercial banks are reduced and they can lend less than before. On the other hand, if the central bank wants to expand the volume of credit it lowers the cash reserve ratio so as to increase the credit creation power of the commercial banks. Thus, by variation of cash reserve ratio, the central bank influences their power of credit creation and thereby control credit in the economy.

**Limitations of Cash Reserve Ratio**

Some of the limitations of the cash reserve ratio are given below :

a. This method may not be successful and effective if the commercial banks have excess cash reserves with them.

b. The success of this method depends on the customer's willingness to borrow from banks. If they are not willing to borrow, the credit cannot be expanded even though the commercial banks have adequate cash reserves with them.

c. It is discriminatory and affects banks differently. A rise in the cash reserve ratio will not affect those banks which have large excess reserve. On the other hand, it will hit hard the banks with little or no excess reserves. This policy is discriminatory in the sense that non-banking financial intermediaries like co-operative societies, insurance companies, etc., are not affected by variation in cash reserve ratio though they compete with the commercial banks for lending purposes.

d. This method is inflexible because the minimum reserve ratio fixed by the central bank is applicable to banks in all regions of the country. More credit may be needed in one region where there is monetary stringency and it may be superflous in the other regions. Raising the reserve ratio for all banks is not justified in the former region though it is appropriate for the latter regions.

e. The success of this method of credit control depends on the business climate in the economy. If the businessmen are pessimistic about the future as under a situation of depression, even a sizable lowering of the reserve will not encourage them to ask for loans. Similarly, if they are optimistic about future expectations, a considerable rise in the cash reserve ratio will not prevent them for asking loans from commercial banks.

### 4.3.2 Qualitative Methods of Credit Control or Selective Credit Control

The qualitative credit control is also called as selective credit control. The quantitative method of credit control exercises control over the volume of credit in total. It does not discriminate credit flow into productive and unproductive purposes. But the selective credit control method provides for such discrimination. Under this method, the credit is made available for the productive and priority sectors and restricted to others. Because of this, the method is called selective credit control. This is very much helpful to the developing and underdeveloped economies. This means, the selective credit control method controls certain types of credit and not all. This method can be used more effectively without any changes in the prevailing rates of interest.

**Objectives of Selective Credit Control**

The following are the main objectives of selective credit control :

a. To distinguish between essential and non-essential uses of bank credit

b. To ensure adequate credit to the desired sectors and reducing the flow of credit to less essential economic activities

c. To control the consumer credit used for durable consumer goods

d. To control a particular sector of the economy without affecting the economy as a whole

e. To correct the unfavourable balance of payments of the country

f. To control the inflationary pressure in a particular and important sector of the economy

**Methods or forms of Qualitative Credit Control**

The central bank uses the following qualitative credit control or selective credit control methods to exercise control over credit in the economy :

**(i) Fixation of margin requirements**

The central bank prescribes the margin which banks and other lenders must maintain for the loans granted against commodities, stocks and shares. To restrict speculative dealings in

stock exchanges, the central bank prescribes the margin requirements for securities dealt with. Whenever the central bank prescribes higher margin, the borrower can obtain less amount of credit on his securities and vice versa. For example, if the central bank prescrites a 10% margin on the value of a security worth L 10,000, then the commercial bank can lend only L 9,000 to the holder of the security and keep L 1,000 with it . When the central bank raises the margin to 20%, then the banks can lend only L 8,000 to the borrower and keep L 2,000 with it. The central bank raises the margin to contract credit and lowers the margin to expand credit. The main objective of fixing the margin requirements is to divert investible funds from speculative to productive lines.

**(ii) Rationing of Credit**

The central bank may control the credit created by the commercial banks through the rationing of credit. Under this method, the central bank fixes a maximum limit for loans that a bank can provide to a particular sector or for all purposes. This can be a achieved through the following two methods :

(a) Variable portfolio ceiling, and

(b) Variable capital assets ratio

**(a) Variable portfolio Ceiling**

Under this method, the central bank fixes a ceiling on the aggregate portfolios of banks above which loan should not be sanctioned. It may also fix a ceiling for specific categories of credit. The central bank may also fix the maximum limit for the loans that the banks can borrow from the central bank.

**(b) Variable Capital Assets Ratio**

Under this method, the central bank can fix a ratio which the capital of the bank must bear to the volume of its total assets. The central bank can change such ratio from time to time for regulating the credit keeping in view the economic exigencies.

**(iii) Regulation Of Consumer Credit**

This is another method of selective credit control with the objective of regulating the demand for consumer durable goods in the interest of economic stability. The central bank regulates the use of bank credit by consumers in order to buy durable consumer goods on instalments and hire-purchase basis. It fixes the 'down payments' and the period over which the instalments are to be spread over to regulate the consumer credit. In developed countries,

a large portion of national income is spent on consumer durable goods such as motor cars, air conditioners, costly furniture, etc. It is essential to regulate the consumer expenditure on such durable goods to control credit. Reducing the down payments and increasing the maximum period of repayments by the central bank, the demand for credit for particular durable consumer goods is increased. On the other hand, the central bank raises the amount of down payments and reduces the maximum period of repayment to decrease the demand for credit to buy consumer durable goods.

**(iv) Control through Directives**

The central bank issues directives to the commercial banks to control credit created by them. The directives may be in the form of written orders, warnings, appeals, etc. Through such directives the central bank aims to achieve the following objectives :

a. To control lending policies of the banks

b. To prevent the flow of credit to non-essential lines.

c. To divert the credit for productive and essential purposes

d. To fix maximum credit for certain purposes

**(v) Moral Suation**

Under this method, the central bank uses its moral influence on the commercial banks. It includes the advice, suggestion request and persuation to the commercial banks to co-operate with the central bank.

**(vi) Publicity**

The Central Bank may also use this method of publicity to control the credit creation of commercial banks. Under this method, the central bank gives wide publicity of its credit policy through its bulletins. By this, the central bank educates the general public regarding monetary policy and its implication. Through such publicity the banks are guided and change their lending policies.

**(vii) Direct Action**

This method is the most effective weapon of the central bank to control credit creation. The central bank uses this method to enforce both quantitative and selection credit controls. It is used as supplement to other methods of credit control. Under this method of direct action, the central bank can take action against the commercial banks which violate its instructions.

**Limitations of Selective Credit Control Methods**

Though the selective credit control methods are regarded as superior to quantitative methods of credit control, yet these methods are not free from limitations. The limitations are discussed below :

*a. Limited coverage :* Selective credit control methods have a limited coverage. They are only applicable to the commercial banks but not to non-banking financial institutions. But in the case of the regulation of consumer credit which is applicable both to banking and non-banking institutions, it becomes cumbersome to administer this method.

*b. Difficult to distinguish between essential and non-essential sectors :* It may be difficult for the central bank to distinguish between essential and non-essential sectors and between speculative and productive investment for the purpose of enforcing selective credit control. The same reasoning applies to the commercial banks for the purpose of advancing loans unless they are specifically laid down by the central bank.

*c. Discriminatory :* Selective credit controls unnecessarily restrict the freedom of borrowers and lenders. They also discriminate between different types of borrowers and banks. Small borrowers and small banks are hit harder by selective credit controls than the big borrowers and large banks.

*d. Malallocation of resources :* Selective credit controls lead to malallocation of resources when they are applied to selected sectors, areas and industries while leaving others to operate freely. They place undue restrictions on the freedom of the former and affect their productions.

*e. Require large number of staff :* The commercial banks may advance loans for purposes other than specified by the central bank for the purpose of earning large profits. This is particularly so if the central bank does not have a large number of employees to check minutely the accounts of the commercial banks. Hence selective credit control methods are liable to be ineffective in case of unscrupulous banks.

It should not be concluded that the selective credit control methods are superior to quantitative control methods. Rather they are meant to supplement the latter methods. In fact, a perfect co-ordination and combination of selective and quantitative control methods would be more effective and beneficial for the economy than the use of any one of them.

❍

## QUESTIONS

1. From the alternatives given below, write the correct answer along with its serial number against each bit :

(i) The year Reserve Bank of India established was :

(a) 1945 (b) 1947

(c) 1935 (d) 1953

(ii) One of the functions of central bank is :

(a) Accepting deposits (b) Monopoly of note-issue

(c) Advancing loans to the customers (d) Discounting the bills of exchange of customers

(iii) The bank that functions as the lender of the last resort is :

(a) Commercial bank (b) Regional Rural Bank

(c) Industrial bank (d) Central bank

(iv) The bank that enjoys monopoly power of note -issue is

(a) NABARD (b) Commercial bank

(c) Regional Rural Bank (d) Central bank

(v) The bank considered as the mother of all central banks is :

(a) Bank of England (b) Federal Reserve Bank

(c) Reserve Bank of India (d) Risks bank of Sweden

(vi) The authority whose signature appears in 100-rupee note in India is :

(a) Finance Minister (b) Governor of Reserve Bank of India

(c) Finance secretary (d) Deputy Governor of RBI

(vii) One of the tools used by the Reserve Bank of India to control credit and monetary situation of the markets is :

(a) NEET (b) RTGS

(c) ECS (d) CRR

(viii) One of the functions not performed by the Central bank is :

(a) Bankers' Bank (b) Banker to Government

(c) Lender of the last resort (d) Banker to the public

(ix) Head office of RBI is situated at :

(a) Chennai (b) Mumbai

(c) Kolkata (d) New Delhi

(x) The cash Reserve Ratio is to be maintained by commercial banks in the form of :

(a) Cash in hand at branches (b) Balance with other banks

(c) Balance in a special account with RBI (d) Funds in the currency chest

(xi) One rupee note and all coins are issued by :

(a) RBI (b) Central Government

(c) Finance minister (d) Central and State Governments jointly

(xii) One rupee note in India is signed by :

(a) Governor of RBI (b) Governor of concerned State Governments

(c) Finance secretary, Ministry of Finance (d) Finance Minister, Govt. of India

(xiii) In periods of depression when the Central Bank desires to encourage the banking system to create more credit, it :

(a) Permits the bank rate to be decided by market forces (b) Raises the bank rate

(c) Does not change the bank rate (d) Reduces the bank rate

(xiv) Of the following instruments of credit control adopted by the central bank, the one which does not fall within quantitative methods of credit control is :

(a) Bank rate (b) Open Market Operations

(c) Variation of Cash Reserve Ratio (d) Fixation of margin requirements

(xv) Foreign Exchange Reserves of India are kept in the custody of :

(a) Industrial Bank for Reconstruction and Development (b) State Bank of India

(c) Reserve Bank of India (d) Government Treasury

(xvi) Of currency notes of the following denominations those not printed in India are :

(a) R10 (b) R100

(c) R1,000 (d) R2,500

(xvii) The full form of 'CRR' as used in banking sector is :

(a) Crucial Reserve Rate (b) Compulsory Reserve Rate

(c) Credit and Reserve Ratio (d) Cash Reserve Ratio

(xviii) Of the following, the bank which is called as the Banker's Bank in India is :

(a) SBI (b) Central Bank of India

(c) RBI (d) NABARD

(xix) The Central Bank in the United States is :

(a) Bank of America (b) The Federal Reserve

(c) The U.S Treasury (d) The Bank of United States

(xx) One monopoly that the modern central banks have is :

(a) Regulating other banks (b) Advancing loans to banks

(c) Issuing Govt securities (d) Issuing currency notes

(xxi) Whenever the central bank does some open market operation transaction, actually it wishes to regulate :

(a) Inflation only (b) Credit Creation capacity of commercial banks

(c) Borrowing power of commercial banks (d) Flow of Foreign Direct Investment

(xxii) The RBI was nationalised in the year :

(a) 1947 (b) 1948

(c) 1949 (d) 1950

(xxiii) Increasing Cash Reserve Ratio by the central bank leads to:

(a) Decrease the deposit with the commercial banks

(b) Increase the deposit with commercial bank

(c) Increase the lendable reserves with commercial banks

(d) Decrease the lendable reserves with commercial banks

(xxiv) Of the following, the one which is not a function of the RBI is :

(a) To assume the responsibility of note-issue

(b) To hold cash reserves of the commercial banks and make available financial accommodation to them

(c) To assume the responsibility of all banking operations of the Govt.

(d) To assume the responsibility of statistical analysis of data related to macro economy of India

(xxv) When the central bank conducts a sale of securities, the cash reserves of the commercial banks shall :

(a) increase (b) decrease

(c) remain constant (d) neither increase nor decrease

(xxvi) The most correct illustration showing the implication of "Lender of the last Resort" is :

(a) If a person or firm which is eligible to get a loan does not get it from any commercial bank, may approach to RBI for loan.

(b) If the State Govts. are in crisis and need money for short-term, they can approach RBI for the purpose.

(c) If a commercial bank is in crisis, it may place its reasonable demand for accommodation to RBI.

(d) Whenever the Govt. declares a debt relief, the RBI will have to bear it.

(xxvii) RBI takes certain steps to curb the menance of inflation. In this context, among the following that one does not help RBI in controlling the inflation in the country is :

(a) An increase in the Bank Rate

(b) An increase in the Cash Reserve Ratio requirements

(c) A purchase of securities in the open market

(d) A sale of securities in the open market

No. 2. Express the following in **one** word / term :

(i) The apex bank of a country.

(ii) The bank regarded as the 'Central Bank' of India.

(iii) The year of establishment of the Reserve bank of India.

(iv) The year of Nationalisation of Reserve Bank of India.

(v) The rate fixed by the central bank at which it rediscounts first class bills of exchange and Govt. securities held by commercial banks.

(vi) The authority issuing one-rupee coins in India.

(vii) The authority signing one-rupee note in India.

(viii) The Bank known as the banker to the Government.

(ix) One quantitative method of credit control.

(x) One of the selective method of credit control.

Q3. Answer the following questions in **one** sentence each :

(i) What do you mean by 'Central Bank' ?

(ii) Name the Central Bank of India.

(iii) Write one function of central bank

(iv) When was Reserve Bank of India nationalised ?

(v) State one advantage of giving monopoly right of note-issue to the central bank.

(vi) What do you mean by 'Lender of the last resort' ?

(vii) What is bank rate ?

(viii) What is Cash Reserve Ratio ?

(ix) What do you mean by 'Open Market Operation' ?

(x) State one objective of 'Selective Credit Control'.

(xi) What is 'Rationing of Credit' ?

(xii) Write the meaning of 'Moral suation' as a method of selective credit control.

(xiii) Who issues one-rupee note in India ?

(xiv) Write one quantitative method of credit control.

(xv) State one qualitative method of credit control.

Q.4. Correct the underlined portion of the following sentences:

(i) The signature of RBI Governor appears on one-rupee note in India.

(ii) State Bank of India is the apex bank in India.

(iii) RBI was established in the year 1949.

(iv) Central Govt. enjoy the monopoly power of note- issue.

(v) Head office of RBI is situated in New Delhi.

(vi) NABARD is known as the Banker's Bank.

(vii) Rationing of credit is a method of quantitative credit control.

(viii) Bank rate policy is a method of selective credit control.

(ix) Monopoly of note-issue is a function of commercial banks.

(x) In the periods of inflation, the central bank desires to encourage the commercial banks to create more credit.

5. Fill up the blanks :

(i) Reserve Bank of India is the ______ bank of India.

(ii) The signature of ______ appears on one hundred rupee note in India.

(iii) The signature of ______ appears on one rupee note in India.

(iv) ______ issues one-rupee coins in India.

(v) In periods of ______, RBI encourages commercial banks to create more credit.

(vi) ______ is the lender of last resort in India.

(vii) Increasing Cash Reserve Ratio by Central bank leads to ______ in lendable resources with commercial banks.

(viii) Central bank exercise ______ control through CRR.

(ix) When central bank wants to reduce credit, it will ______ CRR.

(x) In times of ______ and unfavourable balance of trade, the central bank raises the bank rate.

(xi) ______ refer to buying and selling of securities, bills and bonds of Government as well as private financial institutions by the central bank.

(xii) When central bank wants to ______ the volume of credit, it starts buying the securities from the open market.

(xiii) Commercial banks are required to maintain a minimum percentage of their deposits with the central bank. This is known as ______.

(xiv) If the central bank wants to expand the volume of credit, it ______ the cash reserve ratio.

(xv) Moral suation is one of the ______ credit control methods.

(xvi) Bank Rate policy is one of the ______ credit control methods.

(xvii) ______ Bank of India is the banker to the Government in India.

(xviii) ______ is the rate fixed by the central bank at which it rediscounts first class bills of exchange and Govt. securities held by the commercial banks.

(xix) ______ is the custodian of country's resources of gold and foreign exchange.

(xx) A ______ in the bank rate is usually preceded by over supply of money and rising price level.

6. Answer the following questions within **two** sentences each :

(i) What is a central bank ?

(ii) State two functions of central bank.

(iii) What do you mean by 'monopoly of note-issue' ?

(iv) Write two advantages of giving the monopoly right of note-issue to the central bank.

(v) State two advantages of centralisation of cash reserves in the central bank .

(vi) What do you mean by 'Lender of the last resort' ?

(vii) Write any two advantages of clearing house function of the central bank ?

(viii) What is bank rate ?

(ix) What do you mean by "open market operations" ?

(x) Write the meaning of "Cash Reserve Ratio" ?

(xi) What is selective credit control ?

(xii) Write any two objectives of credit control.

(xiii) State any two limitations of Bank Rate Policy.

(xiv) Write two limitations of open market operations.

(xv) State two limitations of Cash Reserve Ratio.

(xvi) What is rationing of credit ?

(xvii) Write two objectives of selective credit control.

(xviii) State two limitations of selective credit control methods.

(xix) What do you mean by "moral suation" ?

(xx) What do you mean by "Regulation of Consumer Credit" method of credit control ?

7. Answer the following questions within **six** sentences each :

(i) Describe the "Monopoly of note-issue" function of central bank?

(ii) What are the advantages of giving monopoly right of note-issue to the central bank ?

(iii) Discuss the function of central bank as 'Banker, Agent and Adviser to the government'.

(iv) What are the advantages of centralisation of cash reserves in the central bank ?

(v) Write the advantages of central bank's role as 'lender of the last resort'.

(vi) Discuss the role of central bank as clearing agent.

(vii) Write the developmental functions of central bank.

(viii) What are the objectives of credit control?

(ix) What are the situations which compel the central bank to raise the bank rate ?

(x) Discuss any three limitations of bank rate policy.

(xi) What do you mean by 'open market operation' ?

(xii) State any three limitations of open market operations.

(xiii) What do you mean by 'Cash Reserve Ratio' ?

(xiv) State any three limitations of 'Cash Reserve Ratio'.

(xv) What is 'Selective Credit Control' ?

(xvi) Write any three objectives of selective credit control method.

(xvii) What is fixation of margin requirement ?

(xviii) What do you mean by rationing of credit ?

(xix) Discuss the "Regulation of consumer Credit" as a method of Selective Credit Control.

(xx) State any three limitations of selective credit control method.

**Long Type Questions :**

8. What do you mean by 'Central Bank' ? Describe briefly the functions of the central bank.

9. Explain the concept of 'Monopoly of note issue' as a function of central bank.

10 (a) 'Central bank acts as a banker, agent and adviser to the Government'. Discuss.

(b) Describe 'Lender of the last resort' as a function of central bank.

11. How does the central bank act as a controller of credit and money supply ? Explain.

12. (a) Write in detail the developmental functions of Central Bank.

(b) The central bank acts as the custodian of national reserve of gold and foreign exchange, besides maintaining the exchange rate. Discuss.

13. What are the objectives of credit control ? Discuss the 'Bank Rate Policy' as a method of credit control.

14. What do you mean by "open market operations" ? Describe the limitations of open market operation
15. How does the central bank exercise control over credit in the economy by using the 'Cash Reserve Ratio' ? Discuss the limitations of Cash Reserve Ratio method of credit control.
16. What do you mean by 'Selective credit control' ? Discuss the objectives of Selective Credit Control methods.
17. What is 'Selective credit control' ? Describe the limitations of selective credit control methods.
18. Describe the different Selective Credit Control Methods to exercise control over credit in the economy.

## ANSWERS

No.1 (i) c, (ii) b, (iii) d, (iv) d, (v) a, (vi) b, (vii) d, (viii) d, (ix) b, (x) c, (xi) b, (xii) c, (xiii) d, (xiv) d, (xv) c, (xvi) d, (xvii) d, (xviii) c, (xix) b, (xx) d, (xxi) b, (xxii) c, (xxiii) d, (xxiv) d, (xxv) b, (xxvi) c, (xxvii) c.

No.2 (i) Central Bank, (ii) RBI, (iii) 1935, (iv) 1949, (v) Bank Rate, (vi) Central Govt., (vii) Finance Secretary, (viii) Central bank, (ix) Bank rate policy/ Open market operation/ Variation of CRR, (x) Rationing of Credit/ Moral suation/ etc.

No.4 (i) Finance Secretary, (ii) RBI, (iii) 1935, (iv) RBI, (v) Mumbai, (vi) RBI, (vii) Selective, (viii) quantitative, (ix) central bank, (x) depression.

No.5 (i) central, (ii) Governor of RBI, (iii) Secretary of Finance, (iv) Central Government, (v) Depression, (vi) RBI, (vii) Decrease, (viii) credit, (ix) Increase, (x) rising prices, (xi) open market Operations, (xii) expand, (xiii) Cash Reserve Ratio, (xiv) Decreases, (xv) Selective, (xvi) quantitative, (xvii) Reserve, (xviii) Bank Rate, (xix) Central Bank, (xx) rise.

CHAPTER - 5

# INNOVATIVE BANKING

**Structure**

5.1. Innovative Banking
5.2. Merchant Banking
5.3. Consortium Approach of Financing
5.4. Credit card
5.5. ATM-cum-Debit card
5.6. E-Banking
5.7. Online Banking / Internet Banking Services
5.8. Telephone and Mobile Banking Services
5.9. Transfer of funds through RTGS and NEFT facilities
5.10. Social Responsibilities of Banks
**Questions**

## 5.1. INNOVATIVE BANKING

The term 'Innovation' means to make something new or to enter into an unexplored area or field. Innovation helps an organisation to gain an edge over others and to grow and prosper faster . Banks are no exception to this. Banks no longer restrict themselves only to traditional banking activities such as, accepting deposits and advancing loans, but they explore with innovative spirit and creative mind new areas, new products and services to provide better and wider varieties of services to their costumers without diluting their role as a significant player in contributing for the development of the country. This is called innovative banking. In other words, innovative banking refers to a type and trend of banking where always the thrust is given on exploring new products and services and methods of operations to become customer-friendly and at the same time developing good banking relationships with all the stakeholders.

The innovations in the field of banking is mainly linked with rapid advancements in the field of information technology. In fact, information technology is one of the prime movers and facilitators for the substantial transformation of the modus operandi of banking industry in terms of its transaction processing as well as other internal systems and processes. Banks use latest technology to provide better quality of services to their customers at greater speed. Best possible customer service and optimal customer satisfaction have become the prime objectives as well as responsibilities of the modern banks.

Banking sector has witnessed some major innovations in the area of financial operations over the past few decades which have resulted in tremendous improvements in banking services and operations. Some of the innovations in banking sector are:

a. *Merchant banking,*

b. *Consortium approach of financing,*

c. *Credit card,*

d. *ATM-cum-Debit card,*

e. *E- Banking,*

f. *Online and internet banking services,*

g. *Telephone and Mobile banking services,*

h. *Transfer of funds through RTGS and NEFT facilities, etc.*

These new innovative banking practices are briefly discussed below :

## 5.2. MERCHANT BANKING

Merchant banking means banking along with or combining with different non-banking nature of services in the nature of assisting, advising and counselling industrial and business houses in their promotional, fund raising and other related activities. Such other services may include securities management, portfolio management, underwriting and insurance, financial advice, project counselling, etc. In other words, merchant banking is a combination of banking with business and security related consultancy services. It provides consultancy to its clients on different issues. It provides advice, guidance and service for a consideration of a fee. It helps the businessman to start a new business, to collect or raise finance, to expand and modernise the existing business, to revive sick business units. It also helps in restructuring a business and to help companies to register, buy and sell shares at the stock exchange. In short, merchant banking provides a wide range of services starting from commencement of business

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

Merchant banking is different from commercial banking. A commercial bank basically accepts deposits and advances loans whereas a merchant bank provides financial and consultancy services for a fee. Commercial banks can undertake some of the merchant banking activities like issue management, but merchant banks cannot undertake commercial banking activities. The functions of merchant banking may not widely vary from investment banking. A merchant banker mainly deals with issue management, post issue services, corporate advisory services, etc., whereas the investment banker undertakes trading in securities, investment advices and bought out deals which are not the main activities of merchant banker.

Large brokers, commercial banks, mutual funds, venture capital companies and investment banks offer merchant banking services. In India merchant banking services are provided by commercial banks, financial institutions and private consultancy firms. Merchant banking services were first started by foreign banks, namely Grindlay Bank in India in 1967, followed by Citi Bank in 1970. In the mid-Eighties, the Banking Regulation Act was amended permitting commercial banks to offer a wide range of financial services. State Bank of India is the first bank in India to set up a separate division for merchant banking services in 1972. Later ICICI set up its merchant banking division, followed by Bank of India, Bank of Baroda, Canara Bank, Punjab National Bank and UCO bank. In India every organisation providing merchant banking services should register with SEBI (Securities Exchange Board of India).

### 5.2.1 Functions of Merchant Banking

The Important functions of merchant banking are as follows :

**1. Raising Finance for Clients**

Merchant banking helps its clients for raising finance through issue of shares, debentures, bank loans, etc. It helps its clients to raise finance not only from domestic market but also from international markets as well. The finance so raised is utilised for starting a new business or project or for modernisation or expansion of the business.

**2. Managing Public Issue of Companies**

Merchant banks help in advising and managing public issue of shares or debentures made by its corporate clients. They provide the following services :

(i) They advise on the timing of the public issue.

(ii) They advise on the size and price of the issue.

(iii) They act as the manager to the issue and help in accepting applications and making allotment of securities.

(iv) They help in appointing underwriters and brokers to the issue.

(v) They also help in the process of listing of the securities in the stock exchange.

**3. Broker in Stock Exchange**

Merchant banks act as the brokers in the stock exchange. They buy and sell securities on behalf of their clients. They also advise their clients about which shares to buy, when to buy and how much to buy and when to sell.

**4. Promotional activities**

Merchant banks advise their clients about conceiving an idea, location of the project, preparing the project report, conducting feasibility studies, preparing a plan for financing the project, finding out sources of finance, advising about concessions and incentives from the Government, and obtaining Government approval.

**5. Advice on Expansion and Modernisation**

Merchant banks provide advice for expansion and modernisation of business units of their clients. They also provide expert advice on mergers and amalgamation, acquisitions and take overs, diversification of the business, foreign collaborations and joint ventures, technological up-gradations, etc.

**6. Facilitate obtaining Government consent/ clearance for Industrial Projects**

An entrepreneur has to obtain permission from Government for starting an industrial project. Similarly a corporate body requires permission for expansion or modernisation activities. Many formalities have to be completed for getting such permission from the Government. Merchant banks come forward to extend all possible helps to obtain such permission for their clients.

**7. Disseminating information to Small Companies and Entrepreneurs**

Merchant banks extend their services to small companies and entrepreneurs, particularly in respect of disseminating information on different business opportunities available, Government policy, incentives and concessions available for small entrepreneurs and to take advantage of these opportunities.

**8. Services to Public Sector Units**

Merchant banks offer many services to public sector undertakings. They help in raising long-term finance, marketing of securities, foreign collaborations, etc.

**9. Portfolio Management**

Merchant banks also manage the portfolios (investments) of their clients. They offer expert guidance to their clients for taking investment decisions. This makes investments safe, liquid and profitable for the clients.

**10. Corporate Restructuring**

Corporate restructuring refers to mergers or acquisitions of existing corporate units, sale of exting units or disinvestment. This requires proper guidance for negotiation, preparation of documents and completion of legal formalities. Merchant banks provide all these services to their clients.

**11. Money Market Operations**

Merchant banks deal with and underwrite short-term money market instruments such as, Government Bonds, commercial paper issued by large corporate firms, treasury bills issued by the Government or Reserve Bank of India, etc.

**12. Leasing Services**

Lease is a contract between the lessor and lessee whereby the lessor allows the use of his specific asset such as equipment by the lessee for a certain period. The lessor charges a fee from the lessee called royalty or rental. Merchant banks also help in this type of leasing services such as advice on negotiation for lease, making a contract between the lessor and lessee, etc.

**13. Management of Interest and dividend**

Merchant banks extend their hands in helping the clients in the management of interest on debentures or loans and dividend on shares. They advise about the timing of such interest and dividend, i.e., interim or yearly and rate of dividend.

**14. Revival of Sick Industrial Units**

Merchant banks help to revive the sick industrial unit for their clients. They negotiate with different agencies like banks, term lending institutions and BIFR (Board for Industrial and Financial Reconstruction). It also prepares plans and executes the revival package.

### 15. Other Specialised Services

In addition to the above basic activities of the merchant banks, they also provide advisory services on issues like tax matters, recruitment of executives and cost and management audit, etc.

### 5.2.2 Advantages of Merchant Banking

The following are the main advantages of merchant banking :

1. Merchant banks perform many functions that cannot be carried out by the business enterprises of their own.
2. Merchant banks have access to traders, financial institutions and markets that companies or proprietors of business houses cannot possibly reach.
3. Merchant banks can get the best possible deals for clients by using their skills and contacts.

### 5.2.3 Disadvantages of Merchant Banking

1. Availing the services provided by the merchant banks is very expensive as a result of which the small business enterprises cannot get the services of merchant banking like large corporate houses and wealthy businessmen.
2. Sometimes some of the deals carried out by the merchant banks may result in a failure since the merchant banks do not give guarantee for success in all deals.

## 5.3. CONSORTIUM APPROACH OF FINANCING

Where all the credit needs of a borrower are met by a single bank and where all the financing needs are within the policy framework of the financing bank, it is called sole banking finance. But when financing a large project is not feasible for any individual bank from its own resources, a consortium comprising of two or more banks may be formed. This is known as consortium approach of financing. Consortium is a Latin word which means 'partnership, association or society'. A consortium is a group made up of two or more individuals, companies, organisations or governments or any combination of these entities that work together with the object of participating in a common activity or pooling their resources for achieving a common goal. Under consortium approach of financing, several banks or financial institutions provide finance to a single borrower with common appraisal, common documentation, joint supervision and follow up exercises. Each entity within the consortium is only responsible to the group in

respect to the obligations that are set out in the consortium's contract. Therefore, every entity under the consortium remains independent in its own normal business operations and has no say over another member's operations that are not related to the consortium. In other words, consortium approach of financing is a joint financing by several banks to finance higher value or large projects to a single borrower on common appraisal, common security, common documentation and joint supervision. The consortium banks elect one of the members as "Lead Bank" who not only arranges periodic meeting of member banks but also takes lead in assessment of borrower's fund requirement, documentation, charge creation, monitoring of the account, set common terms and conditions and intimate the information about borrower's performance to other lenders. The consortium is created to finance a specific project and when the project is complete, the consortium is dissolved.

### 5.3.1 Advantages of Consortium Financing

The main advantages of consortium approach of financing are :

**1. Easy formation-** No formal procedure is followed though the consortium is formed in writing by the execution of a consortium agreement. In addition, no capital is required to create consortium.

**2. Flexibility** - Members of the consortium can change their contractual agreement at any time to suit changed circumstances.

**3. Ease of termination** - Consortium can be set to expire on completion of the project or on the occurrence of certain events without the formal requirements.

**4. Tax transparency-** The consortium is not directly subject to taxation, but the individual members are liable for taxation.

### 5.3.2 Disadvantages of Consortium Financing

There are, however, certain disadvantages of consortium financing.

**1. Liability-** It is difficult for a member of the consortium to restrict or limit its liability. Members may even become liable to third parties for non-performance of other members of the consortium or the debts of such member incurred in undertaking the common project.

**2. External relationship and funding** - Third parties often find it difficult to enter into contract with the consortium which is a non-legal entity. Because it is a non-legal entity, funding is also normally available only to the individual members and not to the consortium.

**3. Lack of permanent structure-** Lack of permanent structure makes it difficult for a consortium to establish long-term business relationship with third parties. In addition, lack of permanence means the consortium agreement which is a crucial document, is not easy to draft.

A consortium is a contractual arrangement specially designed for use when two or more parties wish to share the risk inherent in a common project. Therefore, before entering into a consortium agreement, the parties need to be absolutely clear as to the common purpose of the venture and be completely aware of what elements of the common purpose or project they have agreed to share liability for performance. Thus, a written consortium agreement is crucial and requires to be drafted with utmost clarity.

## 5.4 CREDIT CARD

A credit card is an instrument which provides instantaneous credit facilities to the holder enabling to avail a variety of goods and services at the market outlets. It is a plastic card issued and authorised by a bank or non-banking finance companies to provide credit facility to its customers. Primarily the card is a synthetic card made from a laminated plastic sheet and other materials like paints, magnetic stripe, microchips, etc., and is also called as 'Plastic Money'. It authorises the customer to buy goods and services from merchants, traders and other parties based on credit sanctioned to him. There are, thus, three parties involved, namely

- the issuing bank
- the cardholder
- the member establishments.

Its usage should be within a prescribed credit limit. This limit is set on the basis of earning capacity and creditworthiness of the cardholder. By its usage, customer promises the repayment of credit transactions executed by him. The repayment along with interest if applicable, must be paid to the bank at a later agreed date. Interest will accrue if the payment is not made within the prescribed time period, usually one month.

The definition of credit card is based on general sense, financial perspective and on business or industrial context. From general sense point of view, credit card is a suitable alternative for cash payment or credit payment or deferred (i.e. instalment) payment. It is used to execute transactions complied through electronic devices like a card swiping machine,

computer with internet facilities. From point of view of financial perspective, credit card is a facility provided by a banker or non-banking finance companies to its customers to have a short -term borrowing facility of funds at the point of transaction while purchasing something. From business or industrial point of view, credit card is a laminated plastic card issued by bank or non-banking finance companies to give its customers a preference to borrow funds on short-term basis. The interest is imposed normally after a month.

### 5.4.1 Features of Credit card

The main characteristics or features of credit card are as follows :

**1. Alternative to cash** - Credit card is a better alternative to cash. It removes the worry of carrying cash to pay at different points of trade counters. As an alternative, credit card helps a cardholder to travel anywhere in the world without a need to carry huge amount of cash. It also reduces the possible risk of theft and gives the cardholder a complete peace of mind.

**2. Credit limit** - The cardholder enjoys the facility of a credit limit set on his card. The limit of credit is determined by the credit card issuing authority on analysing the creditworthiness of the cardholder.

**3. Facility of payment in domestic and foreign currency -**Credit card helps the cardholder to make payment in any currency of choice. In other words, it gives the holder a unique facility to make payments either in domestic currency or if necessary also in foreign currency as and when required. Credit card reduces the cumbersome process of currency conversion. It removes the financial complexities of converting a domestic currency into a foreign currency. It is because of this feature, a credit cardholder can make payments to merchants present in any corner of the world.

**4. Record keeping of all transactions** - Credit card issuing authorities keep a complete record of all transactions made by the cardholder. Such a record helps the issuing authorities to raise appropriate billing amounts payable by the cardholder on a monthly or some periodic basis.

**5. Regular charges** - Regular charges are basic routine charges imposed by the credit card issuing entity on the usage of credit card by the cardholder. These charges are nominal in nature. Annual charges are collected on yearly basis and additional charges are collected for other supplementary services provided by the credit card issuing entity. Such services

include, add-on card facility (an additional credit card issued in favour of the spouse or children of the cardholder), issue of new credit cards, etc.

**6. Grace period** - The grace period refers to the minimum number of additional days within which the cardholder has to pay the bill amount for credit availed without incurring interest or financial charge.

**7. Higher fees on cash withdrawals-** Credit card issuing entity makes charges on cash withdrawals made through credit card at the ATM ( Automated Teller Machine ) outlets and other desks. Generally cash withdrawal fees are quite higher than fees charged for regular credit transactions. On cash withdrawal made through credit card, interest is charged from the same day on which cash is withdrawn and usually no grace period is provided in such cases.

**8. Additional charges for delay in payment-** The credit card payment is supposed to be made within a due date as mentioned on the bill of a credit card. If payment is not made on time, the credit card issuing entity charges some additional amount. These charges are made to compensate the interest cost, administrative cost and any other related costs.

**9. Service Tax** - Service tax is included in the total amount charged to the credit cardholder. This mandatory service tax imposed by Government also increases the final cost borne by the cardholder.

**10. Bonus points** - Due to the competition among the credit card providers, various incentives are offered to the cardholders by way of bonus points on the financial value of the transactions effected by the cardholder. After achieving a pre-determined number of bonus points, accumulated bonus points are redeemed by converting them into gifts, cash back offers, etc.

Credit card facility is a very convenient financial short-term lending facility available to a credit cardholder. However, the safety and security of the credit card are also of prime importance. These depend on the physical protection of the credit card as well as in the confidentiality of credit card number, personal identification number (PIN) and other sensitive particulars of the credit cardholder.

### 5.4.2 Add-on Credit Card

An add-on credit card is a supplementary credit card offered to close relatives of the primary cardholder such as, parents, spouse and children (above 18 years of age). The

primary cardholder can assign spending limits to his add-on card. For example, if the overall credit limit on the credit card of the primary cardholder is ₹50,000, he can assign a limit of ₹20,000 to his add-on credit card issued in the favour of his parents or spouse or children. For security reasons, the primary cardholder will receive SMS(Short Message Service) alerts on transactions made by the add-on cardholder. The credit card issuing entity will generate a consolidated statement in the name of the primary cardholder who bears the ultimate responsibility of payment. Add-on cards have the same utility, validity, offers and benefits associated with the primary credit card. Banks may have restrictions on the number of add-on cards that can be issued per credit card.

Add-on cards are ideal for those who undertake secondary spending such as, on spouse and children as it saves the primary cardholder from the hussel of regularly withdrawing cash and pass it on. But credit card issuing entity may charge a nominal fee at the time of issue of add-on credit cards. Annual fees on add-on cards may also be applicable. In some cases, the issue fees may be waived off on one add-on card.

**5.4.3 Advantages of Credit Card**

**1. Quick way to borrow-** If there is a need to buy something expensive that cannot be affordable to pay for at once, a credit card is ideal. If you do not have the cash in hand or even in your bank account, you can pay with a credit card and then spread the cost over a number of months. So borrowing is very quick in credit card. Credit card is also an easy and secured way to pay for internet shopping.

**2. Convenience**- Credit cards can save time for withdrawing cash from bank or ATM and using the cash for purchase. It is a convenient way of making payment for purchase.

**3. Free Borrowing** - Credit cardholder will get the benefit of interest-free loan, if the payment is made within the time allowed by the card issuing entity.

**4. Incentives** - Some credit card issuing entities offer incentives such as, bonus points, cash back offer, etc. for using the credit card.

**5. Record Keeping-** Credit cards issuing entities issue statement of accounts which help the cardholder to keep a track record of expenses incurred by him.

**6. Profitable for the issuing banks**- They get not only commission from the member establishments while paying for the cardholders but also collect huge amount on account of

delayed payments by cardholders. Some banks also collect initial enrolment fee and annual fees from cardholders, Thus credit cards generate good profits for the banks.

**7. Beneficial for member establishment**- They reap benefits in the form of larger turn overs and advantage of large scale purchase. The risk of credit sales is also passed on to the bankers.

### 5.4.4 Disadvantages of Credit Card

**1. Expensive** - Purchases may become much more expensive if the cardholder carry a balance to pay or miss a payment in time since the interest charged for delayed payment is very high. A penalty is also to be paid if the credit limit is exceeded. Besides this, most of the credit card issuing entities charge a fee for withdrawing cash from ATM.

**2. Over-use of credit card -** Credit card issuing entities always encourage to spend money by using the card. When some people get a credit card, they think like getting a jackpot. They never think about the future. So they spend recklessly . This results in spending beyond the means of the cardholder.

**3. Paper work**-The cardholder requires to keep the receipts and verify them with the monthly statements issued by the card issuing entity to ensure that he has not been overcharged.

**4. Fear of theft or misplacement or misuse by others -** The credit cardholder suffers a lot when his credit card is lost or stolen or misplaced or it is misused by some unknown persons. So the cardholder is always in the fear of such kind of unfortunate events. Thus, he has to be very careful while handling the credit card. He should take some precautions to avoid becoming a victim of different types of credit card related fraud. He should never let his credit card out of his sight when carrying out a transaction at the point of sale and take back his card once the transaction is completed. He should not disclose the PIN (Personal Identification Number) of the credit card to anyone. He should memorise the PIN and if he suspects that someone knows the PIN, he should change it immediately. If the card is lost or stolen or retained by a bank machine (ATM), he should immediately inform the card issuing authority.

## 5.5. ATM-CUM-DEBIT CARD

ATM-cum-Debit card is a plastic card issued by a bank to its customers to withdraw money at any time by using the card through an ATM (Automated Teller Machine) and also

to make a payment for the purchase of goods and services at any time. This card is issued to the customers having a bank account. The card serves the purpose like withdrawals, balance enquiry through a mini statement, making deposits through a procedure, making online payments or payment for purchase of goods and services through electronic fund transfer at point of sale. The customer can also transfer funds from his account to the account of any other person having a bank account. It is also to be noted that whenever the customer uses the card for different purposes, an alert message is sent to the mobile of the customer conforming that the card has been used. This message helps the cardholder to cross-check that the transaction is made by him and not by some unauthorised person. The bank provides a number known as Personal Identification Number(PIN) to the customer at the time of issuing the card. This PIN must be entered when the card is used. The bank charges a nominal fee for use of the card.

ATM - cum - Debit card has made our lives much easier as there is no need to carry cash in our pockets. Banks have also opened a number of ATMs in various places including the remote locations which allow to withdraw funds at anytime anywhere. Apart from this, the inter- banking net work is so strong that it enables a customer to use any other bank's ATM to withdraw money. But there is restriction of the number of uses of other bank's ATM. There is also restrictions in respect of the amount of withdrawals on a single day and the amount varies from bank to bank. International debit cards are also issued by banks for the use of the customers at anytime anywhere in the world.

### 5.5.1 Features of ATM - Cum - Debit card

The main features of ATM - cum - Debit card are as follows :

**1. Quick cash withdrawal** -Cash can be withdrawn as quickly as possible when the card is inserted into the Automated Teller Machine and the personal identification number and the amount to be withdrawn are entered.

**2. Balance inquiry and transaction details** - Account balance of the customer can be checked at the ATM and also there is a facility to get a mini statement of your account showing the details of recent transactions carried out in the bank account.

**3. Purchase of goods and services** - Goods and services can be purchased at different shops and payment for the same can be made through the card.

**4. Deposit of cash or cheques** - There in no need to go to the branch of the bank to deposit cash or cheque. This can be done through ATM.

**5. Request for new cheque book**-Request can be made for issue of new cheque book through ATM at anytime instead of going to the branch of the bank and filling up the requisition slip.

**6. Transfer of funds** - Banks also allow the customers to transfer funds from his account to the account of another person having a bank account with the help of the card.

**7. Payment of utility bills** - Most of the banks also provide the facility of making payment for utility bills like electricity bills, telephone bills, etc. with the help of ATM -cum-Debit cards.

**8. Make other payment** - The customers can make payment for credit card bill, payment for taxes, payment for mobile phone recharge, etc. by using ATM -cum-Debit card.

### 5.5.2 Benefits of ATM-cum-Debit card

Main benefits of using ATM-cum-Debit card are:

**1. Save time** - The most important benefit of using the ATM-cum-Debit card is to save time in stead of going to the branch of the bank and writing the cheque or withdrawal slip to perform the transaction.

**2. Convenient** - At the ATM, The customers are not bound to do the transaction within banking hours of the bank. There is no need to worry about bank holidays or public holidays. It is 24 x 7, 365 days a year banking facility.

**3. Withdrawal of cash overseas** - If customer is travelling overseas, then the card can be used to withdraw cash in the currency of the country in which customer is travelling from the ATM. Most of the banks provide this facility to the customer.

**4. Security feature** - The use of ATM is restricted to the person who possesses the card and knows the PIN. Thus, if you keep the PIN confidential, then no one can use the ATM to do the banking transactions.

### 5.5.3 Distinction between Credit card and Debit card

The main points of distinction between credit card and debit card are :

| Basis | Credit Card | Debit Card |
|---|---|---|
| 1. Nature | Credit cards are lines of credit (i.e, a loan). When a credit card is used the cardholder borrows money towards the transaction. | When a debit card is used to buy something, amount is deducted from the account of the customer. He can spend only upto the balance available in the account. |
| 2. Monthly Bill | If purchase is made by using credit card, a bill is prepared every month by the bank and sent for payment to the customer. | No such bills for payment is required. |
| 3. Application Processing for card | Application for credit card is processed and card is issued considering the credit-worthiness of the customer. | No such processing is required and a debit card is issued without any barrier. |
| 4. Spending limit | The credit card limit is set by the issuing bank on the basis of the credit-worthiness of the customer and he can spend upto that limit. | The customer can spend upto the balance available in his account. |
| 5. Interest charged | If a credit card bill is not paid in full within the time allowed by the bank, interest is charged and rate of interest is very high. | No interest is charged as nothing is borrowed. |
| 6. Fraud Libility | Fraud liability is very low. | Fraud liability is high. If someone steals the card and is able to know the PIN and makes purchase or withdraws money, the amount is deduced from the account balance and customer is liable for his own negligence. |

## 5.6. E-BANKING

E-banking refers to transactions carried through electronic banking. It is like e-business is banking industry. E-banking is also called 'online banking' or 'virtual banking'. E-banking involves information technology based banking. Under this system, banking services are delivered by way of computer-controlled system. The customers do not have to visit the bank's premises. The popular services covered under e-banking include :

a. ATM facilities,

b. Credit card facilities,

c. Use of debit cards,

d. Electronic funds transfer system,

e. Mobile banking,

f. Internet banking,

g. Telephone banking, etc.

### 5.6.1 Benefits of E- Banking

The main benefits are:

1. Operating cost per transaction is minimum for the banks.
2. It is convenient for the customers as they are not required to go to the bank's premises.
3. The customers can obtain funds from ATM at anytime.
4. The customers can easily transfer funds from one place to another place or to the accounts of another person electronically.
5. The use of credit cards and debit cards enables the customers to obtain discounts from retail outlets.

## 5.7 ONLINE BANKING / INTERNET BANKING SERVICES

Online banking also known as internet banking, e- banking or virtual banking or web banking, is an electronic based system which enables the customers of a bank or a financial institution to perform a wide range of financial transactions through the bank's or financial institution's website. To access a bank’s online banking facility, a customer requires internet access and would need to register with the bank for the service. In addition to this, passwords and other credentials are required for customer verification. Usually banks allocate customer identification number to the customer. The customer visits the bank's website and enters the online banking facility using the customer’s identification number and passwords previously set up. The types of transactions which a customer may transact through online banking include obtaining account balance, details of recent transactions, payment of utility bills like electricity and telephone bill, funds transfer, etc. The facility may also enable the customers to place order for cheque books, report of loss of debit or credit cards, change of address intimation, etc.

### 5.7.1 Advantages of online /internet banking

The advantages of online or internet banking are :

**1. Anytime access to banking activities** - The traditional banking system allows to operate banking activities only on the working days and during the banking hours.

However the online banking gives the privilege of accessing banking activities at anytime and anywhere. Banking activities can be performed from any place at a time convenient to the customer.

**2. Transactions made easy** - Sometimes the customer has to make payment on the scheduled date failing which he has to pay the penalty for it. In case of traditional banking system, he has to put a reminder for all the future transactions. The online or internet banking system gives the customer freedom from it. The system will automatically remind the customer for all the future transactions, if already set in the system.

**3. Settlement of transactions in no time** - The online banking facility has been developed with an aim to make it user-friendly. If any financial transaction is made through online banking, the transaction will be settled in no time and transaction status will be received by the customer immediately.

**4. Reduction of transaction cost** - The transaction cost of the bank is reduced considerably due to online banking operations. In traditional banking the transaction cost is much more than the online banking system due to increased office and administrative expenses.

### 5.7.2 Disadvantages of Online /Internet Banking

**1. Lack of personal touch**- Banking is altogether a service industry. A service industry always has an upper hand when there is a customer care with human touch. In case of traditional banking system, the banking staff assist the customers in case of difficulties. However the online or internet banking lacks this option.

**2. Fear of lapse of security** - All internet or online banking service providers are leaving no stone unturned to make their service secured and reliable. Still there exists a threat to the internet or online banking. To make the internet banking secured, one has to follow the guidelines issued by the banks and it is advisable not to share the login details with anyone.

## 5.8 TELEPHONE AND MOBILE BANKING SERVICES

Telephone banking is a kind of service provided by a bank or a financial institution enabling the customers to perform financial transactions over telephone without visiting a bank branch or Automated Teller Machine. Telephone banking hours are usually longer than branch working hours. Some banks offer the service on a 24-hour basis. The types of financial transaction which a customer can carry out through telephone banking include obtaining account balance, details of recent transactions, utility bill payments, funds transfer from customer's account to the account of another person. Transactions involving cash or documents

such as cheques, are not able to be carried out using telephone banking and the customer is required to visit an ATM or bank's branch for cash withdrawals and cash or cheque deposits.

A customer must register with the bank for the service of telephone banking. Customers are assigned customer identification numbers and also they may be given or set up their own password for customer verification. The customers have to call a special telephone number set up by the bank to access telephone banking. The service is provided using an automated phone answering system or by live customer service representative. After calling the special telephone number, the customers have to enter customer identification number and password set up on the keyboard of the telephone. Telephone banking reduces the cost of handling transaction by reducing the need for customers to visit a bank's branch for non-cash transactions.

In addition to the facility of telephone banking, banks also offer Mobile Banking Service. Mobile banking refers to the use of a smart phone or other cellular device to perform online banking transactions. The services under mobile banking include monitoring account balances, details of recent transactions, request for issue of cheque book, funds transfer, utility bill payments, locating an ATM, etc.

## 5.9. TRANSFER OF FUNDS THROUGH RTGS AND NEFT FACILITIES

With the emergence of internet, banks have marched ahead with introducing the concept of electronic fund transfer systems which are very convenient and hassle-free. Funds can be transferred under these electronic funds transfer systems either at bank level or through online banking. Besides being convenient, electronic funds transfer modes are considered to be more safe and secured. Electronic transfers are processed immediately with the transferred amount being deducted from one account and credited to the other account, thus saving time and effort involved in physically transferring a sum of money.

Two popular electronic fund transfer systems introduced by Reserve Bank of India and implemented by most of the commercial banks are :

**(i) Real Time Gross Settlement (RTGS) and**

**(ii) National Electronic Funds Transfer (NEFT).**

(i) **RTGS (Real Time Gross Settlement) :** Real Time Gross Settlement is the fastest way to transfer money electronically. Funds are transferred under RTGS from one account to another account on a real time and on gross basis. Real time means the beneficiary bank

(bank of the transferee) receives the instructions for fund transfer immediately and gross settlement means it is not bunched with any other transactions and settlements of fund transfer are made individually. Funds settlement takes place in the books of the Reserve Bank Of India and the payments are final and irrevocable. RTGS system is primarily meant for large value transactions. The minimum amount that can be remitted through this mode is two lakhs rupees and does not have an upper ceiling for transactions. Banks charge a nominal fees for such transfer of funds.

(ii) **NEFT (National Electronic Funds Transfer)** : NEFT is an electronic fund transfer system that operates on a Deferred Net Settlement (DNS) basis which settles transactions in batches. Under this system, transfer of funds are made from one account to another on net settlement basis. Unlike RTGS system, the settlement takes place in batches (that may include transfer of funds of a group of customers), rather than on individual basis. If somebody initiates a money transfer under NEFT system, it is not settled or processed immediately. The transfer of funds under this mode takes more time as the processing is made in batches. The batches are settled in hourly time slots. Thus, if a customer initiates a transaction after a settlement time, he has to wait till the next settlement time. NEFT mode of fund transfer does not have normally any minimum or maximum limit of amount one can transfer. But the maximum amount is limited to R50,000 for cash-based remittance and remittance to Nepal. Under this system, banks also charge a nominal fees for transfer of funds.

## 5.10 SOCIAL RESPONSIBILITIES OF BANKS

Social responsibility of a business refers to what a business enterprise does over and above the statutory requirements for the benefit of the society. The word 'responsibility' emphasises that a business has same moral obligations towards the society. Similarly Banks also have some responsibilities towards the society. Social responsibility of the banking sector is aimed towards providing financial services to the unbanked areas of the country, socio-economic development of the country by focusing on the activities like poverty eradication, health and medical care, rural area development, self-employment training and financial literacy training, infrastructure development, education and environmental protection, protection of girl child, women empowerment, etc.

Corporate Social Responsibility (CSR) is a concept whereby the companies decide to contribute for a better society and cleaner environment. It is represented by the contributions undertaken by companies to society through its business activities and its social investment.

Now-a-days Corporate Social Responsibility has assumed greater importance in the corporate world including financial institutions and banking sector. Banks and financial institutions start promoting environment-friendly and socially responsible lending and investment practices. Reserve Bank of India in 2007 has also directed Indian Banks to undertake CSR initiatives for sustainable development and also asked banks to begin non-financial reporting which is related to social and environmental practices.

Some of the activities of the banks which contribute towards the development of society being a part of social responsibilities are discussed below :

**1. Rural Branch Expansion** - State Bank of India and most of the nationalised banks carry out the responsibility of establishing branches in rural areas to promote balanced growth of the economy. Expansion of branches in rural area ensures access of financial services by the people of weaker sections of the society and low income group at affordable cost. However, illiteracy and low income savings continue to be a problem in achieving the goal of the banks.

**2. Priority Sector Lending** - Priority sector lending means lending to agriculture sector, cottage industries, artisans, food and agro-based processing industries, education, housing, etc. As per the direction of Reserve Bank of India, the banks are required to lend this priority sector for economic development of the country.

**3. Environmental Protection** - Banks have undertaken some activities for the purpose of protection of the environment by adopting different initiatives. The major activities undertaken by banks in this regard are :

a. Awareness programmes about "Avoiding the usage of plastic bags "and" reduced use of paper in office".

b. Promoting and financing energy saving and solar projects.

c. Assistance for rain water harvesting tanks.

d. Wild animal protection project.

e. Tree plantation drives.

f. Projects related to reduction of carbon emissions.

**4. Education:** Education and poverty are inversely related. The higher the level of education of the population, the lower would be the proportion of poor people in the total

population since education imparts knowledge and skills which are associated with higher incomes. The major activities undertaken by the banks in the field of education are :

a. Support to low income family students with financial assistance, free uniform and books.
b. Motivational camps to induce the students of rural areas to attend school.
c. Concession in interest on education loans for backward class students.
d. Establishing library-cum-reading rooms in rural areas and providing fans, water coolers, etc. for students.
e. Promotion of education for special children with financial support for them.
f. Tie-ups with educational institutes for providing loans, interest subsidy schemes for students belonging to economically weaker section.
g. School adoption projects.
h. Special educational scholarships for girl students.

**5. Community Welfare** - Most of the banks have contributed to the community welfare schemes. Some of the activities in this regard are:

a. Donation to orphanage.
b. Free food distribution to poor patients of government health care centres.
c. Health awareness programmes.
d. Free health check ups campaign.
e. Campaign against usage of druges, alchohols and smoking.
f. Construction of toilets, community halls and dispensaries.
g. Helping disabled persons by donating artificial limbs and wheel chairs, etc.
h. Organising Blood Donation Camps.
i. Donations for disaster relief and accident victims.

**6. Women Empowerment** - Women empowerment refers to the activities in the direction of welfare of women and girl children. Some of the activities undertaken by the banks in the field of woman welfare are:

a. Free or concessional education for poor girl students and scholarship to girl students.

b. Concessions on the interest rate for girl students in respect of education loan.

c. Insurance policies specially for rural and urban poor women.

d. Special credit cards for women.

e. Women empowerment through donation of sewing machines for self employment.

f. Organising training programmes and providing concessional rate of interest on loans for women entrepreneurs.

**7. Farmers Welfare** - Indian economy has always been an agriculture based economy. A large portion of population still depends upon agriculture for its survival. Due to poor economic health of agriculture sector, India witnesses a large number of cases of suicide among the farmers. It has been felt that there is an urgent requirement to promote investment in this sector and welfare of the farmers. Some of the major activities undertaken by the banks as a part of their social responsibility in this regard are as follows :

a. Agriculture Debt waiver and Debt relief scheme.

b. Rural Extension Education Programmes enabling farmers and entrepreneurs to improve their productivity.

c. Establishing Farmers Training Centres.

d. Establishment of Farmers club.

e. Special Credit cards for Farmers.

f. Organising agriculture knowledge sharing programmes.

g. National insurance programmes for agriculture.

h. Financing rural godowns, cold storages and warehouses.

Thus, the banks are making efforts to undertake the above activities in fulfilling their responsibilities towards the society.

## QUESTIONS

1. From the alternatives given below, write the correct answer along with its serial number against each bit :

(i) The various innovations in banking sector does not include:

(a) Debit and Credit cards (b) Internet banking

(c) Advancing loans to the customers (d) Telephone Banking

(ii) Merchant banking does not deal with:

(a) Accepting deposits from customers (b) Portfolio Management

(c) Financial advice (d) Securities management

(iii) Merchant banking deals with :

(a) Accepting deposits from customers (b) Advancing loans to customers

(c) Securities management, underwriting and insurance, portfolio management, financial advice, etc.

(d) Discounting the Bills of exchange of the customers.

(iv) Of the following which is known as plastic money is :

(a) Bearer cheques (b) Credit cards

(c) Demand drafts (d) Gift cheques

(v) Of the following which is not a electronic banking delivery channel is:

(a) Mobile vans (b) Mobile Phone banking

(c) Internet banking (d) Telephone banking

(vi) NEFT means:

(a) National Electronic Funds Transfer (b) National Efficient Funds Transfer

(c) Negotiated Efficient Funds Transfer (d) Negotiated Electronic Foreign Transfer

(vii) We often hear about M-banking. Here 'M' stands for:

(a) Money (b) Memory

(c) Mobile (d) Mobility

(viii) As we know a lot of new concepts are being used in the field of banking these days. Of the following , which is not one such concept/ product directly associated with banks is :

(a) Internet banking (b) Credit card

(c) ATM (d) Number portability

(ix) Merchant banking activity in India was originated in:

(a) 1970 (b) 1972

(c) 1967 (d) 1978

(x) A merchant bank is a financial institution conducting money market activities and deals with :

(a) Securities management (b) Underwriting and financial advice

(c) Portfolio management (d) All of the above

(xi) State Bank of India set up a separate division for merchant banking services in:

(a) 1972 (b) 1967

(c) 1970 (d) 1987

(xii) In India, Merchant banking activity was originated by :

(a) Barclays Bank (b) Grindlays Bank

(c) Bank of America (d) American Express

(xiii) Time period during which no interest is charged on a credit card, is called:

(a) Grace Period (b) Term period

(c) Loan period (d) Sanction period

(xiv) Banking services delivered to a customer by means of a computer system with internet facility is called :

(a) Universal Banking (b) Internet banking

(c) Merchant Banking (d) Branch Banking

(xv) Of the following which does not come under E-banking is:

(a) Electronic Fund Transfer (b) Automated Teller Machine

(c) Credit card (d) Overdraft

2. Express the following in **one** word/term:

(i) The foreign bank started the merchant banking services in India in 1967

(ii) The year in which State Bank of India set up a separate division for merchant banking services

(iii) The time period during which no interest is charged on a credit card

(iv) The card which is issued and authorised by a bank or a non-banking finance company to provide short-term credit facility to its customers

(v) The credit card issued as a supplementary credit card to close relatives of the primary credit cardholders

(vi) The card which is issued by a bank to its customers to withdraw money through ATM and to make payment for the purchase of goods or services at any time

(vii) The electronic banking system enabling the customers of a bank to perform a range of financial transactions through bank's website

(viii) The banking service provided by bank enabling the customers to perform financial transactions over telephone

3. Answer the following questions in **one** sentence each :

(i) What is Merchant Banking ?

(ii) Write one function of Merchant Bank.

(iii) What is consortium approach of financing ?

(iv) What do you mean by 'Credit Card' ?

(v) What is 'ATM - cum - Debit card'?

(vi) Write one feature of credit card.

(vii) State one advantage of credit card.

(viii) Write one disadvantage of credit card.

(ix) State one feature of ATM-cum-Debit card.

(x) Write one benefit of ATM-cum-Debit card.

(xi) Write one point of distinction between credit card and debit card.

(xii) What is 'Add-on-credit card' ?

(xiii) State one popular financial service covered under 'E-Banking'.

(xiv) What is internet banking ?

(xv) Write one financial transaction which a customer can transact through online banking.

(xvi) State the financial transactions which a customer can carry out through telephone banking.

4. Correct the underlined portion of the following sentences :

(i) <u>State Bank of India</u> started the merchant banking services in India in 1967.

(ii) State Bank of India set up a separate merchant banking division in <u>1967</u>.

(iii) Banking services delivered to a customer by means of a computer control system with internet facility at the residence of the customer is called <u>Merchant</u> banking.

(iv) Commercial banking activities include security management, portfolio management, underwriting and insurance, financial advice, project counselling, etc.

(v) Debit card is issued by a bank to provide credit facility to its customers.

(vi) Add-on credit card is a supplementary card offered by the bank to the friends of the primary cardholder.

(vii) Credit card is issued by a bank to its customers to withdraw money through ATM and to make a payment for the purchase of goods or services at any time.

(viii) Internet banking is a service provided by a bank enabling its customers to perform financial transactions over telephone.

5. Fill up the blanks :

(i) The bank rendering a number of services like securities management, portfolio management, underwriting and insurance, financial advice, project counselling etc. is called ______ bank.

(ii) An Indian bank which set up a separate division for merchant banking services in 1972 is ______.

(iii) A plastic card which is issued by a bank or non-banking finance company to provide credit facility to its customers is called a ______.

(iv) An add-on credit card is a supplementary credit card issued in favour of ______ of the primary cardholder.

(v) An ATM-cum-Debit card is used to withdraw money at any time through an ______.

(vi) ______ refers to electronic banking.

(vii) Banking services delivered to a customer by means of a computer control system with internet facility at the residence of the customer is known as ______.

(viii) ______ banking is a service provided by a bank to enable the customers to perform financial transactions over telephone without visiting a bank's branch or Automated Teller Machine.

6. Answer the following questions within **two** sentences each:

(i) What is innovative banking ?

(ii) What do you mean by merchant banking ?

(iii) State two functions of merchant banking.

(iv) Write two advantages of merchant banking.

(v) What is consortium approach of financing ?

(vi) State two advantages of consortium approach of financing.
(vii) State two disadvantages of consortium financing.
(viii) What is a credit card ?
(ix) What do you mean by 'ATM-cum-Debit card' ?
(x) Write two features of credit card.
(xi) State two advantages of credit card.
(xii) Write two disadvantages of credit card.
(xiii) Write two features of 'ATM-cum-Debit card'.
(xiv) State two benefits of 'ATM-cum-Debit card'.
(xv) Write any two points of distinction between Debit card and Credit card.
(xvi) What is E-banking ?
(xvii) What is internet banking ?
(xviii) Write two advantages of internet banking.
(xix) State any two financial services covered under E-banking.
(xx) What is 'Telephone Banking' ?

7. Answer the following questions within **six** sentences each:
(i) Write any three functions of merchant banking.
(ii) State the advantages of merchant banking.
(iii) What is consortium approach of financing ?
(iv) Write three benefits of consortium financing.
(v) State the disadvantages of consortium financing.
(vi) Describe three features of credit card.
(vii) What is 'Add-on credit card' ?
(viii) State three benefits of credit card.
(ix) Write the disadvantages of credit card.
(x) What is 'ATM-cum-Debit card' ?
(xi) Write three features of ATM-cum-Debit card.
(xii) Describe three benefits of ATM-cum-Debit card.
(xiii) State any three points of distinction between Debit card and Credit card.
(xiv) Write three benefits of using internet banking.
(xv) What are the disadvantages of internet banking ?

(xvi) Explain three popular services covered under E-banking.

(xvii) What is Telephone Banking ?

(xviii) Write any three social responsibilities of banks.

**Long Type Questions :**

8. What do you mean by 'Merchant Banking' ? Discuss the advantages and disadvantages of merchant banking.
9. Describe in brief the functions of merchant banking.
10. What is consortium approach of financing ? Describe the advantages and disadvantages of consortium financing.
11. What is a credit card ? Discuss the features of credit card.
12. Explain the advantages and disadvantages of credit card.
13. Write short notes on :
    (a) Add-on credit card
    (b) Telephone Banking.
14. What is ATM-cum-Debit card ? Explain its features and benefits.
15. Distinguish between Debit card and Credit card.
16. What is internet banking ? Discuss the advantages and disadvantages of internet banking.
17. What do you mean by 'E-Banking' ? State the services covered under E-Banking and discuss its advantages.
18. Discuss the social responsibilities of banks.

## ANSWERS

Q.No. 1 (i) c, (ii) a, (iii) c, (iv) b, (v) a, (vi) a, (vii) c, (viii) d, (ix) c, (x) d, (xi) a, (xii) b, (xiii) a, (xiv) b, (xv) d.

Q.No. 2.(i) Grindlay Bank, (ii) 1972, (iii) Grace period, (iv) Credit card, (v) Add-on Credit card, (vi) Debit card, (vii) e-Banking / online banking / internet banking, (viii) Telephone.

Q.No. 4 (i) Grindlay Bank, (ii) 1972, (iii) internet, (iv) merchant, (v) credit, (vi) close relatives, (vii) ATM-cum-Debit card, (viii) Telephone.

Q.No. 5 (i) merchant, (ii) State Bank of India, (iii) credit card, (iv) close relatives, (v) ATM, (vi) E-Banking, (vii) internet banking, (viii) Telephone.

CHAPTER - 6

# RISK AND INSURANCE

**Structure**

6.0 Introduction
6.1 The concept of risk
6.2 Classification of Risk
6.2.1 Financial & Non Financial Risk
6.2.3 Fundamental & Particular Risk
6.2.4 Pure & Speculative Risk
6.2.5 Static and Dynamic Risk
6.2.5 Insurable and Un-insurable Risk
6.3 Risk, Distinguished from Peril & Hazard
6.4 Methods of Handling Risk
6.4.1 Avoidance of Risk
6.4.2 Retention of Risk
6.4.3 Reduction/ Controlling of loss
6.4.4 Transfer of Risk
Questions

## 6.0. INTRODUCTION

Insurance, as an instrument of risk management, dominates almost every sphere of human life - economic as well as uneconomic - business, trade, Industry, commerce, life, property, health, beauty, fiedelity - so on and so forth. Modern business can not be thought of without insurance as business is always risk prone. However, before knowing or understanding what Insurance is, what it does, and why is it so important, we must know the genesis or origin of the term or concept of risk. Before knowing the remedy we must know the cause of the malady.

## 6.1 THE CONCEPT OF RISK

Risk is generally understood as a probability or chance of loss that may occur on accouent of unfavourable out -come / turn out of an event. For instance, a ship with cargo sets on a voyage from Mumbai to Liverpol. The ship may arrive safely at the port of destination or it may meet with an accident and destroyed or damaged causing immense financial loss to its owners. The outcome of the voyage is uncertain. The chance that something unfavourable i.e loss, damage, injury may happen, is the risk. The degree and dimension of the risk differs from event to event.A house where inflammable materials are stored has comparatively a higher degree of risk of catching fire than an empty house or ordinary godown. A man engaged in an underground mine is at greater risk of life than a farmer working in the field, a pilot flying a plane is at grater risk than a driver riding a car and so on. The gravity of the risk depends on the nature of the activity.

'Risk' according to diectionary meaning, is explained as the possibility that something unpleasant or dangerous might happen. For a layman, risk usually means exposure to danger. In business when we say risk, it means chance of loss due to some unforeseen circumstances in future.

According to **Emmet J. Vaughan,** Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for.

According to **S.E. Harrington & G.R. Niehous,** "At its most general level risk is used to describe any situation where there is uncertainity about what outcome will occur."

When we say the degree of risk, usually we mean the probability of the unfavourable outcome involving the event.

From the above discussion it can be concluded that :

- Risk arises out of uncertainity or unpredictability of an event.
- Out come of an event may be favourable or unfavourable.
- When the outcome is unfavourable, it leads to loss - financial or non-financial.

For a business manager, prediction of the products, market or demand is **uncertain**. The demand may **increase** or **decrease**. When it decreases it becomes **unfavourable** for the business and leads to financial **loss**.

Thus uncertainity and chance of loss are the two most important featurs of risk.

## 6.2 CLASSIFICATION OF RISK

Risk can be classified under the following broad groups :

(a) Financial & Non Financial Risks.

(b) Fundmental & Particular Risks

(c) Pure and Speculative Risks

(d) Static & Dynamic Risks

(e) Insurable & Un Insurable Risks

### 6.2.1 Financial & Non Financial Risks

Risks associated with financial loss- that can be measured in terms of money are called financial risks. Thus, risks involving loss of property like building, plant, machinery goods etc. come under financial risks. On the other hand, when the risks do not lead to monetary loss and are either of psychological or abstract in nature, they are called non financial risks.

### 6.2.2 Fundamental & Particular Risks.

Fundamental risks which are also called group risks affect the whole populaton or economy. These are impersonal in origin and consequence. Risks such as unemployment, war, inflation, flood, earthquake, cyclone, famine etc. are examples of fundamental risks. The consequences of fundamental risks affect the whole population and have wide spread effects.

**Particular Risks** which are also called **individual risks** are confined to individual entities or small groups. Theft, robbery, fire, road accident are risks that are particular in nature having limited effects.

### 6.2.3 Pure and Speculative Risk

**Pure risks** refer to a situation where there is only chance of loss but no chance of gain. Example of pure risk includes the uncertainity of damage to property by fire, flood, earthquake etc. or premature death due to accident or illness.

**Speculative risks** on the other hand exist when there is uncertainity about an event that could produce either profit or loss. In speculative risk, there is chance of gain. For example change in price in one direction may bring in profit but in other direction it may bring in loss.

**Difference between Pure Risks & Speculative Risks.**

* Pure risks are insurable where as Speculative risks are not.

* Risks pooling arrangement can be made in case of Pure risks but it is not possible in case of Speculative risks.

* Speculative risks to some extent are advantageous or desirable for the economy but Pure risks like uninsurable calamities are highly damaging and undesirable.

### 6.2.4 Static and dyanamic Risks

**Static risks** involve those losses which arise from destruction of asset due to natural/ unnatural causes or due to act of others like dishonesty, negligence, failure etc.Such losses have no relation to change in social, political or economic environment and occur with a degree of regularity.

**Dyanamic risks,** on the contrary, are the outcome of changes in macro economic variables like inflation, income, output, demand, technology etc. and are very difficult to predict.

### 6.2.5 Insurable & Un-insurable Risks

From the insurance point of view all the risks can be classified as Insurable and Un-insurable Risks.

**Insurable risks** are those risks which can be insured.These risks are predictable, measurable in terms of money and can be transferred.On the basis of degree of risk involved , insurable risks can also be classified as Super standard, Standard and Sub Standard Risk.Super standard risk is less riskier than the standard risk where as Sub standard risks are more riskier than the Standard risks. A risk to become insurable must have the following features.

- **Exposure of a large number of people or units to similar risk :**

The primary requirment for a risk to be insurable is that there must be sufficiently large number of homegenous persons/ units who are exposed to the risk. In case, where limited number of persons, units are exposed to the risk the premium required will be so high that ir becomes totally unacceptable. Therefore, the law of large number plays an important role in making a risk insurable.

- **Loss must be definite, predictable & measurable (Calculable) in terms of money** :

The losses arising from the risk must be fairly predictable and can be measured in terms of money. Losses of abstract nature like peace of mind,tension, emotional sufferings etc can not be measured in terms of money and can not be compensated and hence are not considered as insurable risks.

- **Possibility for calculation of the chance of loss.**

The possibility of happening of an event and probable extent of loss can be calculated using probability distributions based on past statistics. If there is no determinable distribution, it is not possible to calculate the loss and determine the amount of premium and the risk becomes uninsurable.

- **The occurance of the loss must be accidental or fortuitous or random**

The chance of occurance of the loss must be fortuitous or random in nature. Which means it may or may not occur in future. Moreover, it must be beyond the control of the insured.

- **Loss should be of non-catastrophic nature.**

The losses should be non catastrophic in nature. All the individuals or units exposed to the risks must not meet the loss at the same time. If all the insured or a major percentage of them will die due to massive quake or break out of a nuclear war no life insurance company can make good such losses.

- **Economically affordable and feasible premium.**

The cost of insuring the risk must be economically feasible which means the amount of premium must be small enough to be within the reach of majority.

- **Large enough loss to cause hardship.**

The risk involved must be of such nature that. the loss arising out of it will cause imense financial hardship to the individual. Petty losses like breaking of a glass tumbler, loss of a pen or book are not worth the time, effort and expense to be covered under insurance.

**Un-insurable risks** are those risks which do not fulfil the above condition are called non-insurable in nature.Speculative risks usually come under this catagory.

## 6.3 RISK DISTINGUISHED FROM PERIL AND HAZARD.

The concept of risk may be distingushed from peril and hazard.

As has already been discussed, **risk** refers to a situation where there is uncertainity and possibility of loss. A **peril** on the otherhand is the cause of loss.For example fire, flood theft cause loss to property and are called perils. But **hazard** is a condition that may create or **increase** the chance of loss arising out of the peril. Keeping /Storing fire crackers inside a house is a hazard because it increases the chance of fire (peril) and consequently the loss arising out of it. Hazard can be classified under two heads : (a) **Physical Hazards,** (b) **Intangible Hazards.**

### (a) Physical Hazards.

Physical hazard refers to those hazards that arise out of physical property/condition of material or goods. Storing inflamable chemicals in a residential complex, working inside a mine, sailing in the high seas in a defective vessel etc. are examples of physical hazards.

**(b) Intangible Hazards**

Intangible hazards are abstract/ psycological in nature. These hazards can be classified as :

Moral Hazard and

Morale Hazard

**Moral hazard** refers to increase in the possibility of loss arising from some malafied intention i.e. to deceive, defraud or cheat. For example putting fire to a factory running on losses with an intention to make profit by making exaggerted insurance claims is a moral hazard. It is the individual's mental attitude or dishonesty that leads to loss or severity of loss.

**Morale hazard** is different from moral hazard in the sense that it does not arise out of malafied intention but out of negligence or indifferent attitude of individual concerned. Smoking inside a cooking gas factory, driving while in an inebriated condition are examples of morale hazard.

## 6.4 METHODS OF HANDLING RISK

Risk, as discussed above, is a part of our every day life. It is present in all things at all levels and over all times. "The concept of man free from all risks is as theoritical as the concept of perfection." As such risks can not be totally **eliminated** but only can be **managed**. There are various ways or methods of handling /managing risks. Following four methods are normally used for handling risk.

(a) Avoidance of risk

(b) Retention of risk

(c) Reduction/Controlling of loss and

(d) Transfer of risk

### 6.4.1 Avoidance of risk :

The first method of handling risk is to avoid it totally. One can avoid the risk of fire to ones property by selling it. Similarly one can avoid death by plane or car crash by not travelling in plane or car. But this method of avoidance is not a practicable method and will make life miserable.

### 6.4.2 Retention of risk :

Retention or assumption of risk is another method of managing risk. This is based on the philosophy that as risks can not be avoided it may be retained or assumed as a part and parcel of life. A risk is said to be **actively** retained if the person concerned is fully aware of the risk and its implication and opt to retain it.

On the other hand, retaintion is said to be **passive,** if the individual is unaware of the risk or there is carelessness on his part. When risk is assumed deliberately or under active assumption of risk, provision is some times made against consequences of loss by creation of a sinking fund or reserve fund. When the exposure to loss is very small, a man may be willing to bear it without any worry.

### 6.4.3 Reduction or controlling of risk :

Reduction or controlling of risk aims at reducing the loss by taking preventive measures or precautionary steps. Instalation of fire warning system and fire fighting equipments in an apartment building will no doubt mitigate the loss that may arise out of fire. Similarly instalation of burglar alarm, CCTV in a bank will deter/ prevent burglary.

### 6.4.4 Transfer of risk :

Risks may also be transfered to another person or organisation either by contractual agreements like insurance, derivatives or by forming joint stock companies. In case of joint stock compaanies liabilities of the shareholders are limited to the extent of their share holding in the company and the risk is shifited from the owners to the creditors. In case of insurance, the risk is transferred from the insured to the insurer by entering into a contract. Insurance is a popular and widely acclaimed method of risk management in modern business.

## QUESTIONS

No. 1. From the given alternatives choose the right answer.

a) Insurance is a technique used to

(i) Eliminate Risk (ii) Manage Risk

(iii) Deffer Risk (iv) Retain Risk

b) Speculative risks are those where there is possibility of

(i) Only gain (ii) Only loss

(iii) Either loss or gain (iv) Neither loss or gain

c) Risk arising out of intentional or unintentional injury to the person or damage to their property through negligence or careless is.

(i) Speculative risk (ii) Liability risk.

(iii) Dynamic risk (iv) Tangible risk

d) An event that causes a personal or property loss is a

(i) Peril (ii) Hazard

(iii) Exposure (iv) Risk

e) Risk arising out of natural qualities or physical feature of the subject matter of insurance is

(i) Moral Hazard (ii) Physical Hazard

(ii) Peril (iv) Con-insutable risk

No.2. Correct the following sintences making suitable changes in the under-lined words.

(i) Speculative risks are insurable risks.

(ii) Insurance is a technique of peril management

(iii) Pure risk refers to a situation where there is chance of gain only

(iv) Fundamental risk is also called as individual risk

(v) Dynamic risks are outcome of micro economic variable.

b) Fill in the blanks

(i) Hazard is a condition that may create or increase the chance of loss arising out of the _______.

(ii) Risks which can be insured are called______risk.

(iii) Risks those affect the whole population are called______risks.

(iv) Speculative risks are not_______.

(v) Intagible hazards are ______in nature.

c) Answer the following in **one** word

(i) A risk where there is possibility of both loss and gain

(ii) The cause of loss or the contigency that may cause loss.

(iii) A condition that may create, decrease or increase the chance of loss from a peril.

(iv) An objective feature that increases the chance of loss arising out of a peril.

(v)Risks arising out of changes in macro economic variables.

d.) Answer the following in **one** sentence

(i) What is a risk ?

(ii) What is a peril ?

(iii) What is moral hazard ?

(iv) What is dynamic risk ?

(v) What do you mean by pure risk ?

No.3. Answer the follwoing in **two** sentences.

a) What is speculative risk ?

b) What is physical hazard ?

c) What is moral hazard ?

d) What is particular risk ?

e) What is dynamic risk ?

No.4. Answer the following within **six** sentences.

a) How speculative risk is different from pure risk ?

b) dilterntiate between peril and hazard.

c) What do you mean by dynamic risk ?

d) What are the dilterences between physical hazard and moral hazard ?

e) What do you mean by un-insurable risk ?

**Long type questions :**

5. What is Risk ? Explain different methods of handling risk.
6. What do you mean by risk ? Explain different types of risk.
7. What is a hazard ? How it is different from peril ? Explain different types of hazard with example.
8. What is a speculative risk ? Why it is not insurable ? Explain differences between pure risk and speculative risk.

## ANSWER

No.1. (a) ii (b) iii (c) ii (d) i (e) ii

No.2. a) (i) Ten insurable (ii) Risk (iii) Loss (iv) group (v) mocro

b) (i) Peril (ii) insurable (iii) fundamental/ group (iv) insurable (v) Abstract/Psychological

c) (i) Speculative (ii) Peril (iii) Hazard (iv) Physical hazard (v) Dynamic risk.

CHAPTER - 7

# FUNDAMENTALS OF INSURANCE

**Features**

7.0 Meaning and Definition

7.1 Essential Features

7.2 Mechanism of Insurance

7.3 Different types of Insurance

7.4 Functions of Insurance

7.4.1. Primary Function

7.4.2. Secondary Function

7.5 Importance of insurance

**Questions**

## 7.0 MEANING AND DEFINITION OF INSURANCE

The word Insurance, has no more remained a strange word rather has become in modern times almost a household word and most people understand it as a device for protection against probable risks and losses there from. However, different authors have tried to explain its meaning through different types of formal definitions. While defining it, insurance has been viewed by some basically from functional angle while a few others have defined it purely from legal angle. In consequence, we have found two broad categories of definitions : namely

(a) function based definition

(b) contract based definition

A few definitions of each category have been reproduced below.

### 7.0.1 (a) Function based Definition

**Prof. D.S Hansel** - "A social device providing financial compensation for the effects of misfortune, the payment is being made from the accumulated contributions of all parties participating in the scheme".

**Prof John H. Magee** - "Insurance is a plan by which large numbers of people associate themselves and transfer to the shoulders of all, risk that attach to individual".

**Prof Robert Mehr -** "Insurance is a social device for reducing risk by combining a sufficient numbers of exposure units to make their individual losses collectively predictable. The predictable loss is then shared proportionately by all those in the combinations".

**A.H. Willet -** "Insurance is a social device for making accumulations to meet uncertain losses of capital which is carried out through the transfer of risk of many individuals to one person or to a group of persons".

**Dr. W.A. Dinsdale** - "Insurance is a device for the transfer of risk of indual entities to an insurer, who agrees, for a consideration (called the premium) to assume to a specified extent losses suffered by the insured".

### 7.0.2 (b) Contract based definition

**Dictionary of Business and Finance** states that Insurance is a form of contract or agreement under which one party agrees in return for a consideration to pay an agreed amount of money to another party to make good for a loss, damage, or injury, to something of value in which the assured has a pecuniary interest as a result of some uncertain event.

**Justice Lawrence**– "Insurance is a contract by which one party, in consideration of a price paid to him adequate to the risk, becomes security to the other that he shall not suffer loss, damage or prejudice by the happening of the perils specified to certain things which may be exposed to them.

## 7.1 ESSENTIAL FEATURE OF INSURANCE

In the light of the above definitions we can summerise the followings as the essential features of Insurance–

- **Co-operative device** : Insurance is a co-operative device used to spread the risk of a loss among a large number of people. All people insured are expoed to risk for which they take insurance and pay premium. But all of them do not suffer loss. Only a few among them suffer loss. But all share the loss.
- **Based on a Contract** : It involves a contract between two parties - the Insured, who is exposed to the risk of unexpected loss and the Insurer who undertakes to make good the loss in case of its occurrence or pay the assured sum on the happening of event insured against.

- **Payment of Premium :** The insured pays a certain sum of money which is called premium to the insurer in consideration of the promise or undertaking given by the insurer to make good the loss arising out of the risk.
- **Subject matter of insurance and insurable interest** : Insurance is taken on some thing in which the insured has financial interest. The thing insured may be life, properly, freight cargo, ship etc. which are called subject matter of insurance. The financial interest of the insured in the subject matter is called insurable interact.
- **Payment on happening of contingency :** Agreed sum of money becomes payable only on the occurrence of the event or happening of the contingency.
- **Insurable risk covered :** Insurance always covers all such kinds of risks which are considered insurable.

## 7.2 MECHANISM OF INSURANCE

As has already been told, insurance is a cooperative device and based on the cooperative philosophy "All for one and one for all". It is a voluntary association of people who are exposed to same kinds risk and agree among themselves that loss caused by the risk to any member or members of the association be shared by all the members so as to minimise its effect or burden on the unfortunate member/ members.

The mechanism helps spreading loss of a few over a large group. For example all the 20 house owners living in a locality are exposed to a loss of Rs. 40,000 because of the damage of a house due to the risk of fire every year as per the trend of past long years. In case any boy's house is damaged or destroyed by fire he will suffer huge loss of Rs. 40,000 and no one knows whose house will be damaged ? Under such circumstance if all the house owners join their hands and decide to contribute Rs. 2,000 each every year to a common pool to mitigate the loss caused to the house owner by fire then the burden of the devastating loss is reduced to Rs. 2,000 per head and every one stands to be benefited from the arrangement as all feel relieved from the tension of taking a loss of Rs. 40,000 every year.

The actual sufferer is directly benefited and all other benefit from the feelings of safety and security.

This is how the mechanism of insurance works It is a simple arrangement that converts an individual loss into a group loss for the mutual benefit of the members of the group.

## 7.3 DIFFERENT TYPES OF INSURANCE

Insurance contracts on the basis of their basic nature can be classified under four board groups such as :

(a) Personal Insurance
(b) Property Insurance
(c) Liability Insurance
(d) Guarantee Insurance

### 7.3.1 Personal Insurance :

Life insurance, Accident insurance, Health and Sickness insurance come under the group of personal insurances. In all these insurance the subject matter of insurance remains the person or all of them are person related, Death, Injury, health and sickness of the person are covered under the insurance scheme.

**Life insurance** : is a contract between an insurance policy holder and an insurer (Insurance Company) where the insurer promises to pay a designated beneficiary a certain sum of money in exchange of premium on the death of the policy holder or after a certain period of time which ever is earlier. Life insurance provides financial protection to the family members of a person in case of his untimely or premature death and also is a good investment avenue.

Insurance providing compensation for accidental injury to ones person or death is called **Accident Insurance**. The amount of compensation is determined by the extent of injury and the sum assured.

**Health or Medical insurance** is insurance against the risk of incurring medical expenses by individuals. This insurance provides for recovery from Insurance Company of expenses incurred on account of illness. In case the policy holder suffers from certain disease and incurs medical expenses, then such expenses are borne by the insurance company.

### 7.3.2 Property Insurance

Property insurance provides protection against certain risks to property due to fire, theft, flood, earthquake etc. The subject matter of such insurance always constitutes property of any kind like building, stores, ship, motor car aeroplane, jewelleries etc. Usually property is insured specifically mentioning the causes of losses or perils to be covered in two main ways - **Open perils** and **Named perils**. Open perils cover all the causes of loss not specifically excluded in the policy. **Named perils** cover those causes which are named or "mentioned in the policy". Some of the important, commonly used types of property insurances are - Marine Insurance, Fire Insurance, automobile insurance and Crop insurance.

**Marine insurance** covers the loss or damage of ship cargo and freight due to marine perils like collision, capture, leakage, cyclone etc. There are two major branches of marine insurance - Ocean marine insurance and Inland insurance.

**Fire insurance** provides protection against loss or damage caused to property by fire during a specific period. The contract specifies the maximum amount agreed to by the parties at the time of entering into contract which the insured can claim in case of loss.

**Crop Insurance** aims at compensating loss due to destruction or damage of crop on account of rain, flood, cyclone drought pests and insects during a season. This insurance is devised to protect the farmers against losses arising out of crop failure.

### 7.3.3 Liability Insurance

Liabilities insurance protects the insured from the risk of liabilities imposed by law suits and other similar claims. In some cases, liability insurance is a compulsory requirement. For example, owner and driver of motor cars, must have a third party accident insurance policy; A factory must have workmen compensation insurance. The reason for such mandatory provision is that these people are engaged in activities that put others at risk. Public policy therefore demands that such individuals must buy insurance so that if their activities do cause loss or damage to others money will be available for payment of compensation.

### 7.3.4 Guarantee Insurance

Guarantee Insurance Contracts are those insurance contracts under which the insurer agrees to indemnify the insured against losses arising out of dishonesty, unfaithful performance of duty or breach of contract by a third person having contractual relationship with the insured. Fiedility insurance credit and bond insurance etc. are some of the commonly used forms of insurance which come under guarantee insurance.

**Fiedelity insurance** covers the risks (financial) arising out of fraudulent mis-conduct or dishonesty of an employee during the course of his employment.

**Credit insurance** covers the risks relating to credit sales, hire purchase, overdraft etc. Normally financiers who advance money need such an insurance as security, In case of default by the debtor, the insurers indemnify the loss.

**Bond insurance** is a type of insurance whereby an insurance company guarantees a scheduled payment of interest and principal on a bond or other security in the event of payment default by the issuer of the bond or security.

## 7.4 FUNCTIONS OF INSURANCE

The functions of insurance can be studied under two broad heads :

(a) Primary Functions and

(b) Secondary Functions

### 7.4.1 (a) Primary Functions

*** Spreads Risk**

One of the most important functions of insurance is that it spreads the financial burden arising out of a risk. Loss of an individual is shifted to a large number of persons who are also exposed to same type of risk. It converts an individual loss to a group loss and thus reduces its adverse impact on individual basis.

*** Provides Protection**

Insurance does not eliminate risk but it provides protection against the loss and its consequential adverse effects on individual. Property insurance safeguards the property owner against the fear of loss as well as actual loss that may arise out of some unforeseen event causing damage or loss to the property.

*** Provides Certainty**

By assuring the insured to make good the financial loss that may arise in future in lieu of a small payment, insurance brings in an environment of tension free certainty. It relieves tension and worries of individuals arising out of fear of loss Uncertainty of huge loss is converted to certainty of a small loss (premium paid).

### 7.4.2 Secondary Functions

The secondary or axillary functions of insurance may be stated as under :–

*** Prevention of loss**

Insurance can not totally eliminate the risk or loss arising out of the destruction of the subject matter insured. But it helps in preventing loss and reducing risk. Installation of fire fighting equipments in a building provides no guarantee against fire but in case fire breaks out it will no doubt help in reducing the quantum of loss. Insurance companies while undertaking to make good the loss advise the insured to take all preventive measures like installation of close circuit cameras and burglary alarm against theft, police verifications of identity and past records of employees against infidelity etc. All these measures help in checking the overall loss to the society. The insured as well as the insurer are benefitted by it.

**Provides capital**

The accumulated insurance fund is invested in capital market and thus help in the growth of business and industry by meeting their capital requirements. The insured, the insurer and the society every body stands to gain from productive channelisation of insurance fund.

It **Enhances Efficiency** helps in increasing efficiency by protecting people from the vagaries of uncertainty and losses and creating a congenial business atmosphere, it increases the operational efficiency of the people. They need not be worried about possible losses in future and thus can work peacefully.

**Helps economic progress and property.**

By preventing losses, increasing efficiency, meeting the capital requirements of business and industry, insurance provides a strong foundation for economic growth and progress.

**Provides employment :** With insurance organisations expanding, more and more avenues of employment is created for people to act as emprogress, agents, advertisers etc.

**Promotes saving habits :** With a view to get protected against future risks, people get tempted to buy insurance. For this they are compelled to make necessary savings and pay regular premium. This is more true in case of life insurance.

**Facilitate international trade** : By covering all risks of transportation by ships, tankers & bogies international trade is facilitated by insurance.

## 7.5 IMPORTANCE OF INSURANCE

Importance of insurance can also be analysed from the view point of

(a) Individual (b) Society (c) Business and Industries

### 7.5.1 (a) Individual.

From the individual point of view, insurance is considered important for the following reasons :–

- It protects him against financial loss arising out of certain risks.
- By safeguarding against loss it takes care of his worries and tension and enables him to live with peace of mind.
- Lite insurance encourages savings and provides him a good avenue for investment
- It helps in individual tax planning
- It relieves from the worries of future education, marriage etc. of children.

### 7.5.2 (b) Society

The importance of insurance from the society's point of view can be summersed as follows :

- Insurance accelerates the process of economic growth by encouraging savings and investment
- It generates directly and indirectly huge employment for large number of people.
- It helps in development of trade and commerce.

- It encourages foreign trade by reducing it risk factor.
- It provides solution to a number of social problems like industrial accidents, workmens, compensation, old age, disability health care, premature death etc.
- Insurance companies help in spreading education in the society directly and indirectly by spending money on different educative programmes like family planning personal hygiene, disease prevention etc.

**7.5.3 (c) Business and Industry**

Business and industry may be considered as one of the biggest beneficiary of insurance. Its importance for business and industry can be briefly mentioned as follows :

- By making available huge funds, it enable this sector to grow.
- By reducing the uncertainty of business losses it helps in better planning and management of business and resultant increase in efficiency.
- The job of employees welfare which is an important duty of business manager is taken care of by insurance
- Insurance of business assets enhances the credit worthiness of the business.
- By protecting transport related risks, insurance helps business and industry in faster transportation of their products.

## QUESTIONS

No.1. Choose the correct answer from the given alternatives.

a) Insurance aims at mitigating

(i) all losses (ii) financial losses only

(iii) non financial losses (iv) emotional losses.

b) The person who purchases insurance policy is called

(i) Insurer (ii) Re-insurer.

(iii) Insured (iv) Assignor

c) The mechanism of insurance involves transfer of individual risk to

(i) another (ii) a group

(iii) to relatives (iv) friends

d) Considerations paid by the insured to the insurance company is known as:

(i) Insured sum (ii) Premium

(iii) Compensation (iv) Honourarium.

e) Financial loss arising out of misconduct or dishonesty of an employee comes under

(i) Property insurance (ii) Liability Insurance

(iii) Fiedelily insurance (iv) Crop insurance

No.2. a) Correct the following sentences making suitable changes in the underlined word.

(i) The <u>insured</u> promises to make good the loss in a contract of insurance.

(ii) Burglary insurance is a kind of <u>guarantee</u> insurance.

(iii) Employee's Accident Insurance is a type of <u>property</u> insurance.

(iv) Insurance is a contract between <u>three</u> parties.

(v) Insurance simply is an arrangement that converts individual loss into <u>private</u> loss.

b) Fill in the blanks:

(i) Marine insurance covers the losses or damages arising out of marine ________.

(ii) Workmen's Compensation insurance is a _________ insurance.

(iii) The money paid by the insured to the insurer is known as ________.

(iv) Accident insurance comes under ________ insurance.

(v) The party who promises to make good the loss under a contract of insurance is known as _________.

c) Express the following in **one** word.

(i) Property insurance that covers the losses due to fire.

(ii) Property insurance covering losses during voyage.

(iii) Insurance policy that protects the purchaser from fines imposed by law suits and similar claims.

(iv) Policy covering risk arising out of fraudulent misconduct or dishonesty of an employee during the course of employment.

(v) The consideration paid by the insured to the insurer for purchasing insurance cover

d) Answer the following in **one** sentence each.

(i) What is fiedelity insurance ?

(ii) What is 'open peril' insurance ?

(iii) What do you mean by 'named peril' insurance

(iv) What do you mean by credit insurance ?

(v) What is personal insurance ?

No. 3. Answer the folowing in **two** sentences.

(i) What is cargo insurance ?

(ii) What is crop insurance ?

(iii) What do you mean by property insurance ?

(iv) What is Health insurance

(v) What do you mean by catastrophic loss ?

No. 4. Answer the following in six sentences each.

a) What do you mean by personal insurance ?

b) Explain liability insurance.

c) What do you mean by insurance ?

d) What is guarantee insurance ?

e) How does insurance help in economic development ?

**Long Type Questions :**

No. 5. Briefly explain the different types of insurance.

No.6. Explain different functions of insurance.

No.7. What do you mean by insurance ? Explain the importance of insurance for society and business

No.8. Define insurance and explain the mechanism of insurance.

No.9. Explain the importance of insurance.

## ANSWERS

No.1. a) ii b) i c) ii d) ii e) ii

No.2. a) (i) Insurer (ii) Property (iii) Liability (iv) Two (v) Group

b) (i) Peril (ii) Liability (iii) Premium (iv) Personal (v) Insurer

c) (i) Open peril (ii) Named peril (iii) Liability Insurance (iv) Fiedelity (v) Premium.

CHAPTER - 8

# BASIC INSURANCE CONCEPTS

**Structure**

8.1 Re-insurance
8.1.1. Cardinal Principles of Re-insurance
8.1.2. Functions of Re-insurance
8.1.3. Techniques of Re-insurance
8.2. Double Insurance
8.2.1. Difference between Reinsurance and Double Insurance
8.3 Co-Insurance
8.3.1 Difference between Reinsurance and Coinsurance
8.4 Insurance Market
8.4.1 Main Players in Insurance
8.4.2 Evolution market of Insurance Market
**Questions**

## 8.1 RE-INSURANCE

Literally re-insurance means insurance against insurance or insuring something which is already insured. This usually happens when an insurance company transfers a part of its insurance risk to other insurance company or companies to reduce its overall burden. This risk sharing arrangement of the original insurance company with other company or companies is called reinsurance. This can also be called as 'insurance of insurance'. Like insurance contract, reinsurance is also a contract but between the original insurance company and other insurance companies under which other insurance company or companies undertake to share the risk of the loss that insurer may sustains under its policy or policies of insurance. The insurer transfering the risk is called **principal, ceding or original office** and the insurer to whom the risk is transferred is called **reinsurer or guaranting office**.

Like all insurance contracts, re-insurance is also a contract between the original insurer and the re-insurer under which the re-insurer undertakes to compensate the original insurer a

part of the loss as agreed upon on consideration of premium being received against risk undertaken by it. This can be explained by an example Shyam insurers his factory building with Bharat Insurance Company for Rs. 50 lakhs. Bharat Insurance Company feels that the risk undertaken by it is a very big risk which he may find difficult to handle. Hence to reduce a part of the risk burden he takes a policy on the same factory for Rs. 20 lakhs from Indian Insurance Company and pays premium out of the premium being received from Shyam. Here, Bharat Insurance Company is the principal or original insurer and Indian Insurance Company is the re-insurer and the transfer process of risk through Second Insurance is called re-insurance. If the factory is destroyed, the total loss of Rs. 50 lakhs shall be paid to Shyam by Bharat Insurance Company. But Bharat Insurance Company shall recover Rs. 20 lakhs from Indian Insurance Company as per re-insurance contract.

**Basic features of re-insurance :**

From the discussions above, it is clear that re-insurance has the following features :

1. It is an insurance against insurance.
2. It is a contract between an original insurer and another insurer or insurers.
3. It involves transfer of a part of the risk from the original insurer to another insurer.
4. It is usually done when the risk is considered unmanageable and too high by the original Insurer.
5. It is applicable to all branches of insurance.

**8.1.1. Cardinal principles of re-Insurance :**

A contract of reinsurance is governed by the following cardinal principles.

**Principle of Utmost good faith** : The parties to a reinsurance contract i.e the ceding office and the guaranting office must disclose all the material facts and maintain trust and confidence as in case of an ordinary insurance contract.

**Principle of Indeminity** : The principle of indeminity automatically applies to cantract of reinsurance. At the time of loss, the reinsurer indemnifies the loss to the extent of reinsurance amount only.

**Principle of No reinsurance without retention :** This principle suggests that the original insurer must retain a part of the risk and he is not allowed to transfer the risk in its entirety. Complete retention of the risk is allowed but complete transfer is not allowed.

**8.1.2. Benefits or Functions of reinsurance**

The important benefits or functions of reinsurance can be summerised as follows :

**Risk Transfer :** Reinsurance allows an insurance company to transfer a part of the risk to a third party and thus help in limiting its liability. Reinsurance facility helps an insurer to undertake greater amount of risks than its size would otherwise have allowed it.

**Stabilisation of income :** Reinsurance helps in smoothening the wide fluctuations in profit and loss margin which is inherent in insurance business. Competition in insurance market and varieties of new insurance products have made it very difficult for the insurance companies to asses the cost and revenue accurately, which leads to wide fluctuations in operating results. Reinsurance provides a mechanism to stabilise the operating results.

**Capacity Increase :** The underwritting capacity of an insurance company is usually determined by the amount of surpluses i.e. difference between income and expenditure. However, rapidly growing companies often face the timing problem between expenses - which must be debited immediately and income which must be credited over time, generated by new business. This reduces their surplus and becomes a handicap in expanding business. By reinsuring, a company can overcome such difficulty as the reinsurer shares immeditely a part of underwriting expenses.

**Catastrophic Protection** : Re insurance provides protection against catastrophic loss - like earthquake, flood, cyclone etc. When catastropic losses are covered, to protect itself against the disruptive loss effect, the insurance company must make careful use of re-insurance.

### 8.1.3. Techniques of Reinsurance :

Reinsurance agreements are made in two ways - On Propotional Basis and On Excess Loss Basis.

When Reinsurance contract is made on ***Proportional Basis***, all premium losses and expenses are proportionately shared between the insurer and the reinsurer as pre arranged.

When reinsurance is made on **Excess Loss Basis,** the primary insurer keeps all losses to a predetermined retention amount and the reinsurer reimburses the insurer for any loss above the retention amount but it is limited to reinsurance limit.

## 8.2 DOUBLE INSURANCE

It means insuring the same subject matter for the same period, for more than once with the same insurer or other insurers. Hence when a policy holder purchase more than one policy on the same subject matter for the same period, it is called double insurance. The policy may be purchased from the same insurance company or different companies. Under such circumstance, as it happens in all property insurance, the principle of indeminity is also applied here. The insured in such cases can only claim his loss from each insured, but the total claim in no case shall exceed the amount of total loss or the total insured value which ever is smaller. If the insured receives his total claim from one insurer then such insurer is entitled to receive contribution from other insurers. A person buys more than one insurance only when he doubts the financial stability or soundness of the insurer.

Since life insurance is not a contract of indeminity, the principle of indeminity is not applicable in double insurance cases. Hence the problem of calculation of loss and contribution does not arise at all. A person can purchase as many policies as he can on his life and also realise the amount of each policy from the insurer on maturity.

### 8.2.1 Difference between Reinsurance and Double Insurance

The difference between reinsurance and double insurance can be stated as follows.

| Reinsurance | Double insurance |
|---|---|
| 1. Reinsurance is a mechanism used to transfer risk by one insurer to another insurer. | 1. Doubleinsurance involves insuring of the same risk and same subject matter with more than one insurer during the same period by the same owner. |
| 2. In reinsurance, the original insured cannot claim any part of his loss from the reinsurer. | 2. In double insurance the insured can claim from all the coinsurers. |
| 3. Reinsurance is an insuirance of insurance | 3. Double insurance is multiple insurance of the same subject matter by different insurers or same insurer. |
| 4. It is an agreement between insurance companies or insurers. | 4. It is agreements between the insured and many insurance companies. |
| 5. Reinsurance contract terminates once the original insurance lapses. | 5. In double insurance it does not happen if one insurer has paid the claim he can ask other for contribution. |
| 6. Reinsurance is purchased to lessen the burden of risk of the insurer. | 6. Double insurance is purchased by the insured when he doubts the financial soundness of the insurer. |

## 8.3 COINSURANCE

Coinsurance is a provision in an insurance policy that provides that the insurance company and the insured will apportion between them any loss covered by the policy according to a fixed percentage of the value for which the property of the person is insured.

Where insurance cover is provided by a consortium of insurers it is called coinsurance. The consortium consists of a lead insurer and other co-insurers. The risk and the premium is shared among the insurers as per an agreed ratio or percentage. The lead insurer acts as the leader of the consortium and directly deals with the insured or his agent. In case of loss the insured receives payment from the leader and the leader in his turn collects the agreed percentage from all the co-insurers as per the agreement.

In USA, coinsurance is a very popular clause in property as well as health insurance. Here coinsurance refers to a split in loss sharing. In property insurance, the property owner is to carry insurance up to an amount determined under the co-insurance clause - which is usually expressed as a percentage like 80% or 90% of the property value. The insured is required to purchase insurance for that value or more to claim full compensation in case of loss. Otherwise the compensation amount is reduced proportionately. For example A property worth Rs 1,00,000 is insured for Rs 80,000 the coinsurance percentage being 90%. The property is partially damaged and a claim for Rs 54,000/- is filed. Under such circumstance the compensation amount will be proportionately reduced and will be 80,000/90,000×54,000 = Rs. 48,000 only. If the policy would have been purchased for Rs 90,000 then the entire claim would have been paid by the insurer.

### 8.3.1 Difference between Reinsurance and Coinsurance

Difference between a contract of reinsurance and coinsurance can be stated as follows :

| Reinsurance | Coinsurance |
|---|---|
| 1. Reinsurance is a contract between the insurance companies under which one promises to undertake a part of the risk originally insured by the other in exchange of some consideration agreed by them. | 1. Coinsurance is a contract between the insured and more than one insurance companies under which the insurers promise to undertake the risk jointly and severally in case the contingency arises. |
| 2. In reinsurance, the insured can not claim any part of loss from the reinsurer as there is no contract between them. | 2. In coinsurance the insured can claim its loss from one or all coinsurers. |
| 3. The objective of reinsurance is to transfer a part of the risk as a precautionary measure. The original insurer decides how much he will retain and how much he will transfer. | 3. The objective of co insurance is to share business among co insurers. The co insurers together decide how much risk each of them will undertake. |
| 4. Reinsurance involves two contracts in two stages. First between the insured and the insurer and the second between the insurer and the reinsurer. | 4. Co insureance is a single contract between the co insurers or a consortium of insurers and the insured. |

## 8.4 INSURANCE MARKET

Ordinarily the term market refers to a place or area where buyers and sellers meet to trade commodities. It is known in different names in different countries like 'Souk' in Arabia, 'bazaar' in India. 'Morcado' in Spain and so on. But when we say Insurance market we mean it as the sum total of actions and interaction among all buyers, sellers and intermediates those who are engaged in insurance related activities revolving round buying and selling of 'insurance'. It is not confined to a specific or fixed place or building like the commodity market. The buyers and sellers of insurance are spread over a wide geographical area and operate from different places. Thus insurance market can be defined as the sum total of all activities and process through which the insurance products or services are marketed by the service providers (Insurance companies / sellers) to the users of the service (Policy holders / buyers) with the dierct or indirect involvement of many other agencies like intermediaries and Regulating authorities.

### 8.4.1 Main players in the Insurances Market :

There are four categories of principal players in the insurance market connected in one way or the other in marketing of insurance products and services. They are (a) Insurance companies, (b) Buyers, (c) Intermediaries and (4) IRDA.

**(a) Insurance companies** : There are about 52 insurance companies operating in the insurance market as sellers of different types of insurance products in India.

**(b) Buyers of insurance** comprise of individuals, societies, clubs, Government, public and private bodies. All of them require different type of insurance cover for their different kinds of concerns and needs.

**(c) The intermediaries** include approved insurance agents, licensed corporate agents. brokers, surveyors and third party administrators serving health insurance claims. They constitute the 'field force' of the insurance market and as middle men they introduce the buyers with the sellers and vice-versa. As the field force, their role in growth and development of insurance market is considered very very important.

**(d) IRDA** - IRDA is the apex national controlling and regulating authority of insurance market and business in India. The details about IRDA is discussed in Chapter 10.

### 8.4.2 Evolution of Insurance Market :

Technological revolution, industrialisation and globalisation etc. have brought out dramatic changes in every field of human life. With risks and uncertainties increasing and spreading in different dimensions, the demand for insurance as a precautionary safeguard, has increased

significantly boosting the size as well as the number of suppliers of such services. The horizon of the insurance market has, therefore, increased to a great extent in recent years. New players and new insurance products are entering into the market every now and then, keeping in view the growing requirements of the people and their preference for different types of insurance products. A strong and vibrant insurance market is considered as a much needed support base for the economic development of a country. Therefore, all the countries world over, regulate and monitor their insurance market for their healthy growth and development.

Prior to the year 2001, the Indian insurance market was purely monopolistic in nature. After the nationalisation of life insurance business in 1956 and general insurance in 1973 the control of the entire insurance market in India came under two public sector giants, namely the Life Insurance Corporation of India (LICI) and The General Insurance Corporation of India (GICI). They were the only sellers in the insurance market. But in 2001 the scenario changed. With the passing of the Insurance Regulatory and Development Authority Act 1999 and subsequent steps for opening up the closed market, major structural changes were made in the insurance sector. Private companies are allowed to carry on insurance business along side the public sector giants. Foreign Direct Investment in insurance was also encouraged for speedy and healthy growth of insurance business. As a matter of fact, the insurance market of India today consists of 52 insurance companies of which 24 are in life insurance business and 28 are in non-life or general Insurance business. Among the 24 Life Insurance Companies Life Insurance Corporation of India is the only public sector Company and the rest 23 are in private sector.

Out of 28 non-life insurance Companies, there are 6 public sector companies which include two specialised insurers namely Agriculture Insurance Company ltd. for crop insurance and Export Credit Guarantee Corporation of India (ECGC) for credit insurance. Moreover there are 5 private sector insurers which are registered to underwrite policies exclusively in Health, Personal Accident and Travel insurance segments, They are Star Health and Allied Insurance Company Ltd., Apollo Munich Health Insurance Company Ltd., Max Bupa Health Insurance Company Ltd., Religare Health Insurance Company Ltd. and Signa TTK Health Insurance Company Ltd.

Among all such insurance companies, there is only one national agency namely General Insurance Corporation India which alone is authorised to deal with reinsurance business.

## 8.4 QUESTIONS

No. 1. a) In re-insurance, the insurer transferring business is called :

(i) Re-insurer (ii) Co-insurer

(iii) Ceding Office (iv) Guaranteeing Office

b) In reinsurance, the insurer to whom business is transfered is called :

(i) Re-insurer (ii) Principal

(iii) Original office (iv) Ceding office

c) Purchasing more than one policy on the same subject matter for the same period is called :

(i) Co-insurance (ii) Double insurance

(iii) Re-insurance (iv) Multiple insurance

d) The principal, in case of re-insurance contract, transfers :

(i) The whole risk (ii) Only 50% of risk

(iii) Part of the risk (iv) Only 25% of the risk.

e) Re-insurance is a mechanism used to transfer risk by :

(i) One insurer to other insurer

(ii) Insured to other insured

(iii) Insured to other insurer

(iv) Insurer to insured

No.2. a) Correct the following sentences making suitable changes in the underlined word.

(i) Re-insurance is purchased to reduce the burden of the risk of the insured

(ii) Re-insurance is an agreement between insureds

(iii) Double insurance is insurance of a property with the same or different insurers for different period of time.

(iv) Reinsurance allows a insurance company to transfer whole of the risk to a third party.

(v) In re-insurance the party transferning business is called re-insurer.

B) Fill in the blanks

(i) Re insurance is an insurance of_____.

(ii) The ceding office and guaranting office must maintain ulmost______.

(iii) No re-insurance is allowed without______of risk.

(iv) Double insurance is an agreement between the property owner and________insurance Companies.

(v) In double insurance same property is insured with more than one insurer for_______period of time.

c) Answer the following in **one** sentence each.

(i) Insurance of insurance is known as

(ii) When a property is insured with more than one insurer for the same period it is a case of

(iii) When the loss is shared between the insurer and insured in an agreed percentage it is called

(iv) The insurer transfering a part of the risk to another insurer is called.

(v) In contract of reinsurance the re-insurer is also known as.

d) Answer the following in **one** sentence each.

(i) What is re-insurance ?

(ii) What do you mean by double insurance ?

(iii) What is ceding office ?

(iv) What is co-insurance clause ?

(v) In contract of reinsurance the re-insurer is also known as.

No. 3. Answer the following in **two** sentences.

(i) What is the use of re-insurnace ?

(ii) Why is double insurance purchased ?

(iii) What is re-insurance on 'Proportional loss' basis ?

(iv) What is re-insurance on 'excess-loss' basis

(v) State one difference between reinsurance and double insurance.

No.4. Answer the following in **six** sentences

a) Explain any two uses of reinsurance

b) Explain any two differences between double insurance and re-insurance.

c) What is co-insurance clause ?

d) What are the cardinal principles of re-insurance ?

e) What is the rationale behind double insurance ?

**Long Type Questions :**

No.5. What is re-insurance ? Explain the functions of re-insurance.

No.6. What is double insurance ? Explain the differences between double insurance and re-insurance.

No.7. What doyou mean by re-insurance ? Explain the cardinal principles of re-insurance.

No.8. Explain co-insurance and the rationale behind the co-insurance clause.

No.9. What is re-insurance ? Why is it necessary ?

## ANSWERS

No.1 a) iii b) i c) ii d) iii e) i

No. 2. a) i) Insurer ii) Insurers iii) Same iv) part v) principal/ceding office.

b) i) Insurance ii) good faith iii) Retention iv) Multiple v) Same

c) i) Re-insurance ii) Double Insurance iii) Co-insurance iv) Ceding office/principal

v) Guaranting Office.

CHAPTER - 9

# INSURANCE CONTRACTS AND FUNDAMENTAL PRINCIPLES OF INSURANCE

**Structure**

9.0 Insurance Contract
9.1 Fundamental Principles of Insurance
9.1.1 Principle of Utmost Good Faith
9.1.2 Principle of Indeminity
9.1.3 Principle of Insurable Interest
9.1.4 Principle of Mitigation of loss
9.1.5 Principle of or Doctrine of Subrogation
9.1.6 Principle of Attachment of risk
9.2 Insurance Contract and Wagering Contract
9.3 Insurance Contract and Contingent Contract
**Questions**

## 9.0 INSURANCE CONTRACT

All contracts involve two parties and as such all contracts of insurance are basically contracts between two parties namely the insurer and the insured. Being basically contracts such contracts must fulfil the requirements of a valid contract as laid down under the Indian Contracts Act 1872. These requirements can be mentioned as follows in brief.

1. There must be valid offer and acceptance.
2. There must be an intention to create legal relationship.
3. There must be lawful consideration.
4. The parties must be competent to contract.
5. There must be free consent.

6. The object of the contract must be lawful.

7. There must be certainty or possibility of performance.

8. Legal formalities like writing, registration, attestation, stamp duty etc. must be observed.

## 9.1 FUNDAMENTAL PRINCIPLES OF INSURANCE

In addition to the above mentioned requirements, all insurance contracts being a special category of contracts are also governed by certain other fundamental principles. These are :–

(a) Principle of Utmost good faith or Uberrimae fidei.

(b) Principle of Insurable Interest.

(c) Principle of Indeminity.

(d) Principle of Mitigation of loss.

(e) Principle of Subrogation.

(f) principle of Attachment of risk.

(g) principle of Causa proxima and

(h) principle of contribution.

### 9.1.1 Principle of Utmost Good Faith or Uberrimae fidei

The principle of utmost good faith requires that parties to the insurance contract must maintain mutual trust and confidence. They are obliged under the law to disclose all material facts i.e. very important and vital information regarding the subject matter of insurance which would likely to influence the other's decision to enter into contract. Without any suppression or concealment of fact, they should reveal the whole truth and truth alone as it is vital for both the parties to decide whether to enter into the contract or not. Any deviation in this regard will make the contract voidable at the option of the aggrieved party. In contract of insurance usually the assured is in a vantage position. He knows more about the subject matter of the contract than the insurer. As a matter of fact, it is his prime responsibility to disclose all the material facts honestly, truthfully and completely so that the insurer can make proper assessment of the risk, decide whether to accept it or not and also fix the quantum of premium.

### 9.1.2 Principle of Indeminity

All contracts of insurance except life, personal, accident and sickness insurance are considered as contract of indeminity. This principle basically suggests that the insured should not be allowed to make a gain by getting more compensation than the actual loss suffered by him. This means, in case of loss the insured should be compensated with the actual amount of loss or the sum assured which ever is less. The main objective of the principle of indeminity

is to place the assured in the same financial position as nearly as possible after the loss, as if the loss had not taken place at all. This principle acts as a deterrant against over insurance as well as under insurance. The 'actual loss' factor discourages people to over insure their property and make a higher claim at the time of loss. Similarly, the factor 'sum assured' discourages under insurance as in case of loss the maximum compensation limit becomes the sum assured or the actual loss which ever is lower.

A contract of life insurance is not a contract of indeminity. Here, in case of death or after the expiry of a certain period, the sum assured is paid to the nominee or the insurer, as the case may be. The reason being, it is not possible to measure the actual value of one's life in terms of money, Hence the principle of indeminity becomes meaningless in case of life insurance.

Insurance aims at safeguarding people against unforeseen financial losses. It must not be misused for making profit out of loss. The principle of indeminity aims at enforcing this philosophy.

**9.1.3 Principle of Insurable Interest**

To enter into a contract of insurance, the insured must have insurable interest in the subject matter of insurance. This means, he must be in such a relationship with the subject matter of insurance that if the subject matter is destroyed, damaged or lost, he will suffer financial loss and is benefitted by its safety and security. Presence of such financial or pecuniary relationship with the subject matter confers a person the legal right to insure the subject matter i.e property or life or any liability. For example A can not insure the house of B, because A is not going to suffer any financial loss if B's house is destroyed or damaged by fire. A has no insurable interest is the property. Suppose A has taken B's house property on lease. Then he has limited financial interest in the property (the lease amount) and can insure the property to extent of that amount. Thus the real test of insurable interest depends upon the nature of financial or pecuniary relationship of the insured with the subject matter.

In case of life insurance, the insured must have insurable interest in the 'life' to be insured. He should stand to gain financially from safety and survival, and lose financially form death or disability of the life. Thus, a man has insurable interest in his own life, life of his wife, children, parents, a creditor has insurable interest in the life of a debtor, an employer on the life of his employees etc.

In fire insurance, insurable interest must be present at the time of entering into the contract as well as at the time of claim but in life insurance, presence of insurable interest is mandatory at the time of entering into the contract not at the time of maturity. In case of

marine insurance, the insured must have insurable interest in the insured subject matter at the time of loss.

Insurable interest is necessary in all forms of insurance contract to guarantee that the policy is purchased by genuine persons who are likely to suffer financial loss in case the contingency arises. It checks people from buying insurance with ulterior motives.

### 9.1.4 Principle of Mitigation of loss

This principle of insurance requires that the insured must take all necessary steps to mitigate or minimise the loss, just as any prudent person would do in his own case, in the event of some mishap to the insured property. For example, a house properly which is insured catches fire. The insured must not be a silent spectator to it. He must take all necessary steps, as an ordinary man would have taken under such circumstances, to minimise the loss. This principle does not allow the insured to be negligent or careless. He must act as a prudent rational man and take all necessary steps to reduce the loss as if the property is not insured at all. If he does not do so, the insurer can avoid the payment for loss caused due to the negligence. Thus, the insured must do his best to minimise the loss but it does not mean that he will do it putting his life at risk. He is required to do everything which are reasonable and expected from all normal and prudent persons.

### 9.1.5 Principle of or Doctrine of Subrogation

The principle of subrogation is corollary to the principle of indeminity and hence applied to property insurance only. According to this principle the insurer after indemnifying the losses of the insured automatically becomes entitled to all the rights and claims of the insured as regards the subject matter of insurance. The insurer steps in to the shoes of the insured for salvaging the damaged property and acquire rights for claiming damage from third parties if any. For example a motor car which was insured, met with an accident and damaged irrepairably due to negligent driving by another car driver. After making an inquiry, the insurance company settles the claims of the car owner. According to the 'doctrine of subrogation' now the insurance company will take possession of the remains of the damaged car and has all the rights to sue and claim compensation from the negligent driver / owner of the other car. Before the payment of claims, these rights were with the car owner but after settlement of the claim those rights are automatically acquired by the insurance company. In absence of the 'doctrine of subrogation' the purpose of indemninity would have been defeated. The insured is likely to have received more than the loss he suffered had he been allowed to retain the damaged portion for setting and getting some more money.

### 9.1.6 Principle of Attachment of risk

According to the principle of attachment of risk, a contract of insurance is only enforceable if the risk has been attached. Attachment of risk usually means commencement of the risk. Normally the risk runs from the time the premium is accepted by the insurance company. But if the risk is not run or could not run due to any reason, the insurance company must return back the premium. For example the owner of a ship purchases insurance for a voyage from Bombay to London. While buying the insurance he did not know that the ship has already arrived at London safely. Hence, the risk could not run and the insurance company must return back the premium. Similarly, suppose a man purchases a life insurance policy and sends the insurance premium by cheque. Before collection of premium and issue of acknowledgement receipt, the man dies. Here the insurance company can not be forced to pay the claim as the risk has not commenced or attached when the man died. Thus, for enforceability of a contract of insurance, the risk must have commenced or run or attached.

### 9.1.7 Principle of Cause Proxima or Proximate Cause

Proximate cause is defined as the active and efficient cause that sets into motion a chain of events which bring about a result without the intervention of any force stated and working effectively from a new and independent source. In other worlds, for a valid claim there must be an efficient cause which brings about a loss with no other intervenning cause or causes breaking the chain of events. The efficient cause must be the proximate cause. Proximate does not necessarily mean nearest in time but it is the direct, dominant, operative and efficient cause. The insured is required to prove that the proximate cause of loss is an insured peril. For example, fire breaks out in a godown that was insured. While extinguishing the fire, firemen removed some undamaged goods and kept them in the open yard. Subsequently due to heavy rain the goods are damaged. Here the question is whether the proximate case is fire or rain ? In this case if the damage due to rain has occurred before the insured has an opportunity to save the goods from rain then the proximate cause is fire. But if the goods are left uncared for days in the open and subsequently loss occured due to rain then the proximate cause is rain and not fire and hence no claim can be made under fire insurance.

When loss occurs due to a number of causes, determination of the proximate cause becomes important for settlement of claim. For example a factory during a war was bombed by the enemy and destroyed by fire. Here there are two causes 1. Bombing, 2. fire. Fire is the latest cause and insured and bombing by enemy is the distant cause and un insured. Here through fire is the nearest cause it is not the dominate operative and efficient cause. Hence proximate cause is bombing by enemy action and no valid claim can be made under fire insurance.

### 9.1.8 Principle of Contribution

The principle of contribution is corollary to the principle of indeminity as it is applicable where more than one insurer is involved in the policy. If an insured buys more than one policy on the same subject matter from two or more insurers covering the same risk, he can not recover the same loss from all the insurers so that the total compensation received is more than the actual loss. He is entitled to the actual loss only and can receive it from one insurer or all the insurers ratebly. The insurer who is making payments to the insured, has the right to ask the co-insurers to contribute proportionately for the payments made by him to the insured. This doctrine ensures equitable distribution of losses among the insurers. Four essential conditions must be satisfied for the application of the principle of contribution and they are :

i. The insured must be the same person.

ii. The policies must have covered the same peril

iii. The subject matter of the policies must be same

iv. Policies must be in force at the time of loss.

The right of subrogation arises only after the insured is paid his claim either by one or all the insurers.

## 9.2 INSURANCE CONTRACT & WAGERING CONTRACT

Insurance contracts are very often confused with wagering agreements as they bear a superficial resemblance on account of the fact that both deal with uncertain events and payments are linked with the happening of the event.

According to Sec. 30 of the Indian Contract Act, a wagering is defined as "an agreement between two parties by which one promises to pay money or money's worth on the happening of some uncertain event in consideration of the other party's promise to pay if the event does not happen". For example if A and B enter into an agreement that A shall pay Rs. 500 to B if it rains on Monday and that B shall pay the same amount if it does not rain.

Thus under a wagering agreement a person promises to pay a certain agreed amount of money or property upon the happening or non happening of an uncertain event. It is basically speculative in nature. The main points of differences between the two are :

- In insurance contract, the insured has an insurable interest in the subject matter where as in wagering agreement there is no such insurable interest.
- Insurance contracts are legal and enforceable in the court of law whereas wagering agreements are void.

- Insurance contracts are contracts of indeminity i.e the insured gets the actual loss & loss alone in case the contingent event occurs. In wagering agreement, however, there is no question of indeminity. It is a contract to either win or lose.
- Insurance is a contract of utmost good faith. The parties to it must disclose every thing In wagering agreement good faith need not be observed.
- Insurance contracts have a social objective. It provides protection against adverse effects of some unforeseen event. But wager creates additional risk and is harmful for the society.
- In insurance, both the parties are interested in the protection of the subject matter where as in a wagering agreement it is only one of the parties who is interested in its protection.

A contract of insurance is based on scientific calculation of risk where as wager is mere gambling.

## 9.3 INSURANCE CONTRACTS AND CONTINGENT CONTRACT

According to Section 31 of the Indian Contract Act, "a contract to do or not to do some thing, of some event, collateral to such contract, does or does not happen". This means it is a kind of the performance of which depends upon the happening or non-happening of an uncertain event, is called contingent contract. For example A agrees to sell a certain plot to B of he can recover it from C who has occupied it. So, here there is a probability factor of happening and non-happening.

Insurance contracts are considered as contingent contracts because they possess all the following three essential characteristics of a contingent contract.

1. The performance depends upon the happening or non-happening of some future event.
2. The event is always uncertain.
3. The event must be collateral or incidental to the contract.

All insurance contracts, contracts of indeminity and guarantee, thus, comes under contingent contract. All wagering contracts also come under contingent contract as per its definition but all contingent contracts are not wagering Contracts.

## QUESTIONS

No. 1. Choose the correct answer from the given alternatives

a) A contract of insurance is a

(i) Wagering agreement (iii) Void Contract

(ii) Contingent Contract (iv) Voidable contract

b) Insurable interest is a

(i) Financial interest (iii) Non Financial Interest

(ii) Simple interest (iv) Compound interest.

c) Insurance is a contract of

(i) Caveat emptor (iii) Uberimai fedei

(ii) Buyer Beaware (iv) Laisez fare

d) Principal of indeminity is based on the philosophy that the insured must

(i) Make profit out of the loss (ii) Get the actual loss

(iii) Get more than the loss (iv) Compensated for non financial loss

e) The doctrine of subrogation is a corollary to the principle of

(i) Insurable interest (ii) Indemnity

(iii) Utmost Good faith (iv) Contribution

No. 2. a) Correct the following sentences making suitable changes in the underlined word.

(i) Insurable interest is <u>non-financial</u> in nature.

(ii) All insurance contracts are <u>wagering</u> agreement.

(iii) A contract not enforceable in the court of law is a <u>voidable</u> contract.

(iv) Wagering agreements are <u>valid</u> contracts.

(v) <u>Life Insurance</u> contracts are contracts of indemnity.

b) Fill in the blanks

(i) Principle of indeminity is not applicable in case of _________ insurance.

(ii) All insurance contracts are ________ contracts.

(iii) Parties to an insurance contract must maintain utmost ________.

(iv) In case of life insurance the insured must have insurable interest in the ________ to be insured.

(v) Normally the risk runs from the time the ________ is accepted by the insurance company.

c) Answer the following in **one** word :

(i) A contract which is not enforceable in the court of law.

(ii) A contract the performance of which depends upon happening or non happening of an uncertain event.

(iii) The active and efficient cause that sets into motion a set of events that results in loss.

(iv) The interest of the insured in the subject matter of insurance.

(v) The principle of insurance that aims at making good the loss and loss alone is :

d) Answer the following in **one** sentence each.

(i) What is material fact ?

(ii) What is a contingent contract ?

(iii) What is an wagering agreement ?

(iv) What is insurable interest ?

(v) What is proximate cause ?

No.3. Answer the following in **two** sentences each.

(i) What is mitigation of loss ?

(ii) What do you mean by subrogation ?

(iii) What is indeminity ?

(iv) What is utmost good faith ?

(v) What is attachment of risk ?

No.4. Answer the following within **six** sentences each.

(i) What are the differences between insurance and wagering agreement ?

(ii) What is doctrine of subrogation ?

(iii) Explain the principle of utmost good faith.

(iv) What do you mean by contribution ?

(v) Explain the principle of causa-proxima.

**Long Type Questions**

No. 5. Briefly explain the important principles of insurance.

No. 6. Define the contract of insurance and explain how it is different from a wagering agreement.

No. 7. Explain the essential features of an insurance contract.

No. 8. Explain any three important principles of insurance.

No. 9. Explain the principle of indeminity and state why it is not applicable in case of life insurance.

## ANSWERS

No.1. a) ii (b) i, (c) iii, (d) ii, (e) ii.

No.2. a) (i) finaincial, (ii) contingent (iii) void, (iv) void, (v) property

b) (i) life, (ii) contingent (iii) good faith, (iv) subject matter, (v) premium

c) (i) void contract (ii) contingent contract, (iii) proximate cause (causa proxima)

(iv) insurable interest (v) Principle of Indemnity.

CHAPTER - 10

# INSURANCE ACT AND IRDA

**Structure**

10.1 The Insurance Act, 1938
- 10.1.1 Prohibition on Conduct of Insurance business.
- 10.1.2 Licensing Conditions
- 10.1.3 Capital Requirement
- 10.1.4 Accounts and Returns
- 10.1.5 Investments
- 10.1.6 Powers of Investigation
- 10.1.7 Advance payment of premium
- 10.1.8 Licensing of Surveyor or Loss Assessor
- 10.1.9 Penalties

10.2 Insurance Regulatory and Development Authority (IRDA)
- 10.2.1 Composition of the IRDA
- 10.2.2 Tenure of the members
- 10.2.3 Removal of members
- 10.2.4 Duty, Power & Functions of the IRDA
- 10.2.5 Finance, Accounts and Audit

**Questions**

## 10.1 THE INSURANCE ACT, 1938

Though the history of insurance business in India dates back to 1818 when the first insurance Company "The Oriented Life Insurance" was established at Calcutta, an attempt to regulate insurance business was made only in 1912 with the enactment of The Life Insurance Companies Act 1912 by the British India Government of that time. This regulatory coverage was later broad based with the enactment of a new Act, namely, The Insurance Act that came

into force in the year 1938. This Act has been amended saveral times according to the changing needs of time.

Some important provisons of the Insurance Act 1938 may be mentioned as under in a nut shell.

### 10.1.1 Prohibition on Conduct of Insurance business.

Section 2(c) of the Act prohibits any agency to carry on insurance business unless it is

a. A public company

b. A registered Society

c. A body corporate registered under the law in any country outside India not being in the nature of private company.

### 10.1.2 Licensing Conditions

Under the Act, it is mandatory that only an Indian Insurance company can carry on an insurance business in India. An Indian insurance company is a company registered under the Indian Companies Act 1956 where the aggregate foreign equity share holding does not exceed 26%, and whose sole purpose is to carry on a life, general or reinsurance business.

**Licensing Process :** The licensing procedure involves two stages. In the 1st stage a requisition for registration is made and if granted, in the 2nd stage an Application for Registration is submitted to the authority. For requisition purpose, information like promoters back ground, financial strength, shareholders agreement, reason for entering into business of insurance, directors background capital structure etc. are to be provided along with the required fee for requistion. In the 2nd stage also along with application for registration, the following documents are to be submitted with the authorities.

- Proof of paid up Capital of Rs 100 crore.
- Proof of Deposit
- Marketing and distribution information
- Operating information such as: information technology, internal control, personels etc.
- Information on investment philosophy strategy and ground level arrangements.
- Information regarding reinsurance approach and terms.
- Information regarding expenditure : the manner in which the administrative expenditure is estimated, the proposed expenses as a percent of premium at different levels etc.

After going through all the documents and information if the authority is satisfied then a License to carry on insurance business is granted to the Company. However, in case of rejection of the application, a Company can make an appeal to the Central Government against the decision of the Authority and the decision of the Central Government shall be final and binding.

### 10.1.3 Capital Requirement

Under the Act, minimum paid up equity capital required to carry on life insurance business is Rs. 100 crore and for reinsurance it is Rs. 200 crore. The capital contributed must be only in the form of equity shares. Issue of preference share is prohibited.

### 10.1.4 Accounts and Returns

An Insurance Company is required to keep a separate account of all receipts and payments in respect of each type of insurance business i.e. life, marine, fire and other miscellaneous insurance conducted by it. At the end of each financial year the Company is required to prepare the following accounting statements in prescribed form.

a. Balance Sheet

b. Profit and Loss Account

c. A revenue account for each class of insurance business.

These accounts are required to be audited by an auditor, printed and 4 copies are to be submitted to the IRDA authorities within six months from the end of the financial year. Certified copies of the minutes of all the General meetings of the company should also be submitted to the IRDA authorities within 30 days of such meeting. The Act provides detail guide lines for maintaing records regarding policies premiums, claims, endorsements, bank guarantees, agents commissions, employees, investments, losses etc.

### 10.1.5 Investments

Insurers or Insurance Companies are required to invest only in schemes approved under the provisions of the Act. They are also required to submit returns in prescribed format to the authority every year on or before 31st March.

### 10.1.6 Powers of Investigation :

Under the Act, the Government of India may at time by order in writting direct the Authority or any other person specified in the order to investigate the affairs of any insurer and report to the Government.

### 10.1.7 Advance payment of premium

The Act has prescribed that no insurer shall assume any risk unless and until the premium is received in advance or is guaranted to be paid or a deposit is made in advance in the prescribed manner.

### 10.1.8 Licensing of Surveyor or Loss Assessor

An insurance company under the Act must appoint Surveyor or Loss Assessor holding valid License from the Licensing authority. Before admitting any claim over Rs. 20,000/- a general insurance company must obtain a report on the loss from the assessor.

### 10.1.9 Penalties

The Act has prescribed penalties on the insurers for contravention of different provisions of Law like–

- Failure to furnish documents, statements and returns required under the Act.
- Failure to comply with investment norms
- Failure to maintain solvency margins
- Furnishing false documents or false statements
- Failure to carry out rural and social sector obligations
- Failure to comply with direction of the Authority, if any.

## 10.2 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (IRDA)

IRDA is an apex statutory body constituted by an Act of the Indian Parliament in 1999. The aim of the authority is "to protect the interest of holders of insurance policies, to regulate, promote and ensure orderly growth of insurance industry and for matters connected therewith or incidental thereto."

### 10.2.1 Composition of the IRDA :

The IRDA is constituted by members as per details given below :

* Chairman
* Not more than 5 whole-time members
* Not more than 4 part-time members.

These persons are appointed by the Central Government from amongst persons of ability, integrity and standing who have knowledge or experience in the field of life insurance, general insurance, actuarial science, finance, economics, law, accountancy administration or other disciplines which would be in the opinion of Government useful to the Authority.

**10.2.2 Tenure of the members :**

The tenure of the Chairperson will be for 5 years who would also be eligible for reappointment till he/she attains the age of 65 years.

The tenure of appointment of members will also be for 5 years and he/she is eligible for reappointment till he/she attains 62 years of age.

**10.2.3 Removal of members :**

The Central Government is empowered to remove any member of the IRDA including the Chairman under the following circumstances. If he/she–

a. is declared bankrupt,

b. has become physically and / or mentally incapable of acting as a member,

c. has been awarded punishment by any court,

d. has acquired such financial and other interest which affects his/her function as a member,

e. has abused his/her position as to render his/her continuation in office detrimental to public interest.

**10.2.4 Duty, Power & Functions of the IRDA**

**Duty :**

The most important duty of the IRDA is to regulate, promote and ensure orderly growth of insurance and reinsurance business.

**Power & Functions**

The power and functions of the authority can be stated as follows :

(i) Issue of certificate of registration, renewal, modification, withdrawal, suspension or cancellation of such registration of insurance company, insurance agents, brokers, surveyors etc.

(ii) Protection of interest of policy holders concerning settlement of claim, surrender value, assignment, nomination or any other terms and conditions of insurance contract.

(iii) Specifying requisite qualifications, code of conduct and practical training for insurance brokers, agents, surveyors etc.

(iv) Promoting efficiency in conduct of insurance business.

(v) Promoting and regulating professional organisations connected with insurance and reinsurance business.

(vi) Levying fees and other charges on insurance companies, agents, brokers, surveyors and third party administrator.

(vii) Inspection, audit and investigation of insurers, insurance intermediaries and other organisations connected with insurance business when necessary.

(viii) Control and regulation of rates, advantages, terms and conditions offered by the insurers in respect of general insurance business.

(ix) Prescribing the form and manner in which books of accounts shall be maintained by the insurers and other insurance intermediaries.

(x) Regulating investments of fund by insurance companies.

(xi) Regulating maintenance of margin of solvency.

(xii) Settling dispute between insurer and intermediaries or among insurance intermediaries.

(xiii) Supervising the function of Tariff Advisory Committee (TAC).

(xiv) Specifying the percentage of premium income of insurer to finance schemes for promoting and regulating professional organisations.

(xv) Specifying the percentage of insurance business to be undertaken by the insurance companies in different social sector.

### 10.2.5 Finance, Accounts and Audit

Finance for IRDA shall be made available by the Central Govt. in the form of Fund, known as 'IRDA' Fund and it should include

i. Government grants, fees and charges

ii. Money received by IRDA from other sources specified by the Central Government

iii. Premium income received from the insurer.

Such funds shall be utilised for–

(a) paying salaries and allowances to workers, officers and employees of IRDA

(b) Meeting other legitimate expenses of the IRDA.

The IRDA is required to maintain Books of Accounts and prepare Annual Financial Statement as per norms prescribed by the Central Government in consultation with the CAG.

The Accounts of the IRDA is to be audited by the CAG according to their schedule and expenditure on such audit has to be borned by the IRDA.

## QUESTIONS

No. 1. Choose the correct answer from the given alternatives.

a) The Insurance Act deals with

(i) Registration of Insurers (ii) Investment of insurance funds

(iii) Licencing of agents (iv) All of the above.

b) The IRDA Act was passed in the year

(i) 1939 (ii) 1972 (iii) 1999 (iv) 1956

c) The LIC of India was formed in the year

(i) 1972 (ii) 1956

(iii) 1973 (iv) 1938

d) ECGC of India deals with

(i) Life insurance (iii) Credit Insurance

(ii) Property insurance (iv) Liability insurance

e) The only company dealing with reinsurance business in India is.

(i) LIC (iii) SBI Life

(ii) ECGC (iv) GIC.

No. 2. (a) Correct the following sentences changing the underlined words.

(i) GIC is a private sector undertaking.

(ii) ECGC deals with crop insurance business.

(iii) The tenure of the IRDA Chairperson is for 4 years.

(iv) Agriculture Insurance Company Ltd. deals with only credit insurance.

(v) The IRDA consists of not more than 4 whole time members.

b) Fill in the blanks:

(i) ECGC is a ____Sector company.

(ii) General Insurance business in India was nationalised in the year_____.

(iii) The member of IRDA are appointed by____.

(iv) The maximum age limit of the chairman of IRDA is ___years.

(v) Agriculture Insurance Company Ltd. deals with ____insurance.

c) Answer the following questions in **one** word.

(i) The income earned for brokering is.

(ii) The income earned by insurance agents are called.

(iii) The science that deals with construction of mortality table and calculation of premium.

d) Answer the following questions in **one** sentence each :

(i) Mention the maximum age of the chairperson of IRDA.

(ii) What is the main objective of IRDA.

(iii) Who are the market intermediaries in the insurance market.

(iv) The IRDA has power to amend which Acts

(v) Name the public sector companies in India involved in life insurance business.

No.3. Answer the following in **two** sentences each

(i) How is the IRDA composed ?

(ii) Write any two conditions for removing a member of IRDA.

(iii) Who can carry on insurance business under the Insurance Act 1938 ?

No.4. Answer the following questions in **six** sentences each.

(i) Explain the conditions for removal of a member of IRDA.

(ii) How is the IRDA constituted ?

(iii) Write any three functions of IRDA.

**Long type questions :**

No. 5. Briefly explain the provisions of Indian Insurance Act, 1938.

No. 6. Explain the power and functions of IRDA.

No. 7. How IRDA is constituted ? Explain the important functions of IRDA.

## ANSWERS

No.1. (a) iv (b) iii, (c) i, (d) iii (e) iv.

No. 2. (a) i. public ii. credit iii. 5 years iv. 65 v. crop

(b) i. public ii. 1973 iii. Central Governent iv. 65 v. crop

(c) i. Brokerage ii. Comissioon iii. Actuarial.

CHAPTER - 11

# LIFE INSURANCE

**Structure**

11.0 Introduction
11.1 Meaning
11.2 Definitions
11.3 Features
11.4 Elements of Protection and Investment
11.5 Importance
11.6 Types of Life Insurance Policies
11.7 Procedure for effecting a life insurance
**Questions**

## 11.0 INTRODUCTION :

Life insurance is different from other types of insurances as the subject matter covered under this insurance is always the life of human beings. Life is the most precious property of the society as well as of an individual. In view of this, Life Insurance enjoys maximum attention these days and every body is becoming conscious about the safety of their lives. As a dependable device insurance eliminates risk, substitutes certainty for uncertainty and ensures timely aid to the family at the premature death of the bread winner or gives adequate amount at the old age when regular means of support gets dried up.

## 11.1 MEANING :

Life insurance is referred to as a contract between the insurer and the insured under which the insured takes policy on his/her life with the insurer who assures him to pay an agreed sum if he lives beyond the agreed period or to his legal heir if he dies within the agreed period. The consideration, the insurer receives in exchange for such assurance from the insured, is called premium. Thus, in other sense, life insurance may be considered as a better way of making investments along with the benefits of protection against the risk of advanced age or death.

## 11.2 DEFINITION :

According to section 2 of Indian Insurance Act, 1938 “Life insurance business is defined as the business of effecting contract upon human life.”

Life insurance contract may also be defined as a contract whereby the insurer in consideration of premium paid, either in lump sum or in periodic instalments, undertakes to pay a certain sum of money either on the death of the insured or on the expiry of a fixed agreed period which ever is earlier.

In simple term, life insurance contract is a contract where the insurance company in consideration of periodical premium received from policy holder agrees to pay a certain amount either on his (policy holder) death or on the maturity of the policy whichever is earlier.

## 11.3 FEATURES :

The features of life insurance can be studied under the following heads :

**1. Based on a valid contract** : Life insurance is a long term contract between two parties, namely, insuer and insured. Being a contract, it has to comply with all the essential elements of Indian Contract Act, such as offer and acceptance, capacities of the parties, free consent, valid consideration, legality of the object etc.

**2. Principle of indeminity not applicable :** An insurance contract binds the insuer to pay the insured sum and not to idemnify loss. The principle of indeminity which is a basic principle of insurance provides that the sum paid to insured should never exceed the actual loss sanctioned by him. But as the loss caused by death can neither be calculated in monetary terms nor is money any compensation for the loss of one’s life This principle of indemnity is not applicable for life insurance.

**3. Presence of insurable interest** : Insurable interest means the financial, monetary or pecuniary interest which a person has in the subject matter of insurance. As per law a person can not insure the life of another unless he has an insurable interest in him. Therefore, insurable interest must be present in the person insured at the time when policy is taken but there is no necessity that insurable interest must be present at the time of insured’s death. However, an individual always has an insurable interest in his own life. Its presence is not required to be proved.

**4. Observation of utmost good faith** : Insurance contract is a contract of Uberrimaefidei or a contract of utmost good faith. The insured must disclose all the material facts and figures

about himself known to him but unknown to the insurer. Similarly, the insurer must in the same good faith disclose the scope of insurance and other things of interest to the insured.

**5. Payment of Premium :** Premium is the price charged and collected by the insured for the risk of loss undertaken by him. The insured in life insurance is under obligation to pay periodically the amount of premium till his death or of the expiry of the period of policy, whichever is earlier.

**6. Provision for assignment and nomination :** The assured is free to assign or transfer his policy by the execution of endorsement on the policy itself or by a separate deed. Notice for this purpose must be given to the insurer. Similarly, insured can either at the time of effecting policy or at any subsequent time before the policy matures, nominate the person or persons to whom the money secured by the policy shall be paid in the event of his death.

**7. Attachment of conditions :** Life insurance contract is a conditional contract as it contains many conditions. Hence, insurance policy remains valid only when the assured or his heir complies the different conditions incorporated in the policy.

**8. It contains element of protection and investment** : Life insurance provides double edged services to its policy holder - protection and investment which are discussed in more details in the following paragraphs.

### 11.4 ELEMENTS OF PROTECTION & INVESTMENT

Protection, when used in general sense, means an act of shielding, sheltering or defending some one or something from a probable threat or risk. But when used in the context of insurance, protection means an act of assuring coverage against certain insured risk with promise of compensation for such risk related losses when they occur. Similarly the term 'investment' when used in general sense means the act of using the saved money for earing more money on it in the form of returns on deposits or stocks and shares wherein the money is put. But when used in the context of insurance, investment means the benefit of extra earning or returns received against the premiums regularly paid so that at the maturity of the policy, the amount received normally remains always much higher than the total amount paid in the form of premiums.

Life Insurance is the only type of insurance which has the unique feature of having both the combined elements of protection as well as investment. These combined protection and investment elements are not attached with other types of insurance like fire, marriage, motor vehicle, crop and all other types of property insurance. It is true that the element of protection is an integral part of all types of insurances because all types of insurances are basically devices for ensuring protection against future risks and uncertainties and compensating losses on the happening of

insured events. But here also life insurance stands a little differentiated from other types of insurances. Protection in other types of insurance is generally made available for a very short period mostly on yearly basis as compared to long periods of coverage in life insurance. Further, the protection is given for paying compensation only for exact losses suffered. But in life insurance, not only the duration or tenure of protection extends for a long period as all life contract are long term contracts but also protection is given for payment of the total assured sum on maturity of the policy. Therefore, life insurance not only has element of protection like all other types of insurance but it is also available in a more expanded and extensive form.

As far as element of investment is concerned it is an exclusive feature of life insurance, not available with any other form of insurance. This is so because usually the life insurance contracts are long term contracts where the insured is required to pay premiums regularly till the maturity of policy or his death. All the premiums collected annually are not kept idle in the insurance company. Even after paying assured amount to some whose policies mature and meeting other regular expenses, the insurance companies are still left with huge premium money. So they are invested in different avenues like purchasing of share, debentures, loans to Govt. etc. and a huge amount of money is earned on such investments. In a way the insurance company serves as medium for using your deposited money for investments which individually would have done with much difficulty and with great risk. So the money paid as premium gives a guarantee of protection and also serves as a means for investments. The interest or return earned on investments are shared with the policy holders in the shape of bonus or on profit sharing basis. This is the reason why a policy holder on maturity of policy always gets a much higher amount of money than what he has paid in the shape of premium through out the tenure of the policy.

**Relationship between element of investment and element of protection**

It is interesting to note that there exists a kind of opposite or inverse relationship between the two elements. In the earlier periods while the investment element stands at the lowest level, the protection element stands at the highest level. Thus with every payment of premium, the investment elements increases and the protection element gradually decreases and reaches zero on maturity of policy.

## 11.5 IMPORTANCE OF LIFE INSURANCE

The importance or significance of life insurance can be stated as under :

**1. Protection against risk of loss of earnings :** In life insurance, protection is given against the risk of loss of earnings due to the death of the insured. The family members of the

insured get the full assured sum from the insurer irrespective of the amount of premium paid by the insured till his death. Thus by getting a sizeable amount, the course of life of the insured's family is not dislocated. Such privileges are missing in other saving plans where only accumulated amount till date is given.

**2. Encourage thrift** - Life insurance encourage savings habit. This is because life policies are invariably taken for longer duration which requires policy holders to deposit the premium amount on regular basis and for this they are compelled to save. Under the Salary Saving Scheme where the premium payment for the insured is made by his employer. So the deductions made by the employer for payment of premium becomes a compulsory saving for the insured.

**3. Option for the loan :** Whenever the insured is in the need of money, he can arrange such amount on the basis of the surrender value of the policy from the insurer. Even for commercial purposes loan can be raised from banks and other institutions by pledging the insurance policy as the security.

**4. Easy settlement of debt :** The financial liablity of the insured can be settled easily with the help of life insurance policy. On the maturity, the life insurance policy can be assigned in favour of the creditor to settle the debt. Even at the time of taking loan the insured can nominate the name of the creditor to whom the policy money would be payable in the event of his death.

**5. Tax benefit :** Under Income Tax Law relief is available to insured for the amount paid as premium for life insurance. As per Section - 80C of Income Tax Act, 1956 the premium paid is allowed as deduction from Gross Total Income. Contribution to pension plan qualifies for deduction under Section 80 CCC. Also, 100% of the premium paid is deductable as expenditure from business income. These benefits not only reduce the insurance cost substanitally but also present life insurance as the most suitable avenue for saving in comparison to PPF, NSC etc.

**6. Social security** - As discussed above life insurance companies extend financial support to the families of insureds in the event of their premature death. These supports help the bereaved families to escape from clutches of uncertainties and suffereings. These companies also provide financial help against the risk of accident and disabilities to insureds to restore their normal course of life. Sometimes insurance companies are giving financial assistance to different agencies which are engaged for different social causes like education, sanitation, communication and other social benefits.

**7. Investment Element :** Life insurance companies hold the reputation as an assured avenue for investment. The premium which the insured pays is well protected as insurance

companies are created with legal sanction. No possibility is there for any manipulation. Moreover, when the policy matures the insurer refunds the assured amount along with additional bonus which makes the total amount sizeable one.

**8. Supports to Government :** Life insurance companies extend long term financial support particularly to develop infrasturucture provisions in the country. This, in fact, creates a strong base for the promotion of trade and industry in the country whcih in turn creates employment opprtunities.

**9. Option for better future planning :** A life insurance provides wide varities of policies to cater to specific needs which may emerge in future such as child education, daughter's marriage etc. Similarly, the life insurance policy can be so arranged that its maturity date can coincide with one's retirement date so that he can be relieved from all the anxieties of post retirement liability when his usual sources of income ceases.

**10. Helps to lead a peaceful life :** Life insurance plays a vital role in ensuring a tension free life of the insured. This is because, as discussed above, it ensures the safety of insured's investment which are given by them in the form of premium and gives guarantee for financial support to the insured's family in the event of his premature death. Finally, life insurance assures the insured a sizeable amount at the maturity of his policy. All these acts of life insurance certainly brings stability and peace to the state of mind of the assured.

## 11.6 TYPES OF LIFE INSURANCE POLICIES

People differ from each other in their likes and dislikes, choices and preferences and as such in matters of their buying decision, they feel more comfortable and also highly motivated when the market offers variety of products with widely differing attributes. Wide varieties enlarge the space and scope for accommdating the choices and preferences of all varieties of customers. This is the basic reason why marketeers of goods and services compete with each other constantly through modifying and developing new products.

Insurance organisation are well aware of this basic psychology of customers. In respect of their insurance products, they know well that the choice and preferences of customers would greatly differ from one another :

- Some would like to protect themselves only against risk of loss of income.

- Some may like for protection of their family against the risk of loss of income after their untimely death.

- Some may like to pay the price for the products i.e premium, in one lump sum while others may want it to be paid in instalments.

-Some may like to take policy for a limited period while some may like to take it for the whole life period.

Keeping in view such differences in the choice and preferences of people, the insurance organisations all over the world have designed and introduced varieties of insurance products in the form of insurance policies each having specific features and alternatives. All such policies may be broadly classified under the following basis.

1. On the basis of tenure or time covered.
2. On the basis of timing of payment of premium.
3. On the basis of participation in profit
4. On the basis of number of persons insured

### 11.6.1 Classification the basis of tenure or time

Following are the different plans of life insurance issued with different time durations.

**Term Life Policy** - This form of policy provides protection for life for an agreed term or period only. In case the person whose life is insured dies during the term, benefits are payble under the policy. If he survives till the end of the agreed term, the policy normally expires without any benefit payable to him. For example, if a person insures his life for 5 year term insurance contract, the insurer does not have any obligation to pay any thing, if the insured survives the 5-year term. All the premiums paid by the insured are considered to be fully earned by the insurer. At the end of the term, the policy has no further value. In view of this nature of the policy, the premium amount is relatively low. The policy has several options like convertibility, renewability or re-entry guarantee/options.

**Whole life polices** - In these policies, life insurance protection is provided over the life time of the insured. The essence of this policy is that it provides for payment of the assured sum upon the death of the insured regard-less of when it occurs. Thus, the payment of assured sum is certain but in contrast, the time of payment of assured sum is uncertain.

Whole life policies are available in different forms such as participative and non-participative, ordinary, limited payment, convertible, etc.

**Endowment Insurance Policies** - This policy is designed primarily to provide a living benefit and only secondarily to provide life insurance. Normally, the policy is taken for a fixed

period, known as endowment term or period and matures on the event of death of the assured or on the completion of the fixed period which ever is earlier. Thus, the policy is for fixed term. The policy is popular because it covers two benefits which accrue simultaneously, namely investment and protection. During old age when sources of income get dried up, it stands as the only source of money to meet the ends.

There may be different type of endowment policies like Ordinary Endowment, Double Endowmwnt, Pure Endowment, Moneyback with profit policy, Joint Endowment, Triple Benefit Endowment, Marriage Endowment, Education, Annuity etc.

**11.6.2 Classification on the basis of payment of premium.**

Basing on the mode of payment of premium, the policies are of different types which are given below :

**1. Single Premium Policy** - This policy is useful to those who desire or are capable of paying the entire amount of premium in one instalment at the time of taking the policy. This policy matures on the death of the assured or on his attainment of agreed terms or period which ever is earlier.

**2. Level Premium Policy** - In this policy, regular and equal premiums are paid at a definite interval like annually, halfyearly, quarterly or monthly. This policy is suitable for those persons who are having regular earrings. The level premium policy may be either a continuous level premium or a limited level premium policy.

**11.6.3 Classification on the basis of participation in profit.**

**1. With profit policies or participating policy.**

In this type of policy, the policy holder is entitled to get a share of profit of the insurer. The sum assured with profit shall become payble to the insured either on the maturity of the policy or on the death of the insured which ever is earlier. The rate of premium is comparatively higher than non-participating policies. In India LIC distributes 95% of its profit amount to the participating policy holders.

**2. Without profit or non-participating polices.**

These policies do not provide any privilege to the assured to get a share in the profit of the insurer. Only the assured sum is payble to the assured on the maturity of the term or the death of the assured which ever is earlier.

### 11.6.4 Classification on the basis of number of persons insured

Policies on the basis of number of persons assured are of two types, namely :

**1. Single life Policies** - This policy is designed to cover the risk of life of an individual. It may be issued on one's own life or on the life of another. The policy amount is payable to insured on attaining the agreed term or on his death which ever is earlier.

**2. Multiple Life Policies** - This policy may be Joint Life Policy or Last Survivership Policy. Joint Life Policy covers the risk of more than two individuals. The sum assured is payable at the time of maturity or at the death of the first assured which ever is earlier. This policy is useful to partners of a firm or couple of a family. In case of Last Survivership Policy, the sum assured is payble at the death of last surviver or on the date of maturity if earlier.

## 11.7 PROCEDURE FOR EFFECTING A LIFE POLICY :

Insurance is a contract. Therefore, life insurance is effected by submitting an offer in the form of a proposal whcih is accepted later by the insurance company. In between the process of offer and acceptance, the agent plays the role of a link man since insurance contract cannot be effected directly with the insurer. Whenever one desires to have life policy he has to meet with the agent or sometimes the agent on his own meets the client as his marketing strategy to float the proposal for life policy. Once the client agrees to purchase the policy, the procedure to effect the life policy starts with the following steps :

**1. Filling of proposal form :** Printed proposal forms are available with the insurance companies which contatin different columns requiring information on varieties of aspects about the proposer, such as name, address, nationality, habit, age, occupation, purpose of insurance, sources of income, type of policy intended, health conditions, family history etc. The agent normally meet the prospects with the proposal forms. He explains the contents of the form and also helps the proposer to fill up the form.

**1.a. Disclosure of all information :** As per the basic principle of "full disclosure of all material facts in good faith" the insured must disclose all important facts as required in good faith. The proposer must fill up the form in his own handwriting with much care and try to furnish correct information as far as possible. Any information proved wrong can later may risk cancellation of proposal. The agent also verifies the proposal form with the documentary support furnished by the proposer. The whole exercise is to see that the proposal form contains all the correct information adequate enough to convince the insurer to effect the policy without any hesitation. The proposal form is complete when it is signed by the proposer after making a

declaration that the information given by him in the proposal form are true to the best of his knowledge.

**2. Age Proof :** Scrutiny of age is an important concern for life insurer. It determines the degree of risk in the proposal and the premium to be charged. This is because the people with higher age are more susceptible to death than the younger ones. Correct age proof is therefore essential to effect the life policy. Generally matriculation or high school certificate is considered as the most assured source of age proof. Sometimes other documents such as records of different agencies like Panchayat Office, NAC office, Election Commission (voter identity card) are also accepted as age proof.

**3. Medical examination :** The insurer goes through the proposal form received from the proposer and decides about the medical examination of the proposer. If he is satisfied with the documentary evidence of the proposer, he may drop the idea of examination or if he decides for examination the proposer is sent to the authorised doctor with the proposal form in a sealed cover for examination which is free of charges. A printed proforma of medical report is sent through post to the doctor for this purpose. The Proforma has two parts. The first part is to be filled up by the proposer to furnish his personal information in details for doctor's knowledge. The second part is meant for medical report. The doctor puts different questions to proposer about his past medical history and present conditions. He also makes an exhaustive physical and clinical examination of the proposer. The impression of the doctor is finally reflected on the second part of the proforma which the doctor writes in his own handwriting. The medical report carries much importance since it may be instrumental in cancelling the proposal or reducing the sum assured or increasing the premium amount.

**4. Agent Report** : Agent acts as the negotiator between the proposer and insurer. Though the proposal emerges through his initiative but before that he confirms himself about the genuineness of the proposal by taking an exhaustive enquiry about the matter. As he holds expertise knowledge about these matters well, his view carries much weight in the eyes of the insurer. Normally, the insurer seeks a report from the agent to strengthen his view about the proposal. The agent's report highlights about the financial, social and physical status of the proposer and also his final comment on the proposal.

**5. Other reports :** Sometimes insurer requires report from other sources to know more about the proposer. This is because there are certain issues like hazardous state of proposer's

residence, risk associated with proposer's occupation etc., which are also necessary for proper assessment of proposal.

**6. Assessment of proposal :** After getting the completed application form along with requisite reports, the insurer makes an indepth study about the acceptability of the proposal. The life style, health condition, financial position, occupational and residential hazards and environmental factors are the common issues normally figured in the analysis by the insurer. On the basis of such analysis, the insureds are classified as (a) persons having standard lives, (b) persons having substandard lives, (c) persons having non-insurable lives. If a proposer is found having non-insurable life, it is outright rejected but if the proposal is found to be too risky or financial condition of the proposer is doubtful or proposer is of over age and suffering from multiple diseases, the insurer may cancel the proposal or ask for reducing the sum assured or to increase the premium amount. In this manner the insurer scrutinizes the proposal from various angles and finalises the one that satisfies all tests.

**7. Finalisation of the proposal :** This is the final stage of processing of the proposal by the insurer. Once he is satisified with the feasibility of the proposal, he compares the risk involved with the sum assured and the premium to be charged. He makes proper balalnce between these elements and finalizes the proposal. However if he observes that the risk involved is too much, he may share a portion of risk with another insurance company through a mechanism called reinsurance.

**8. Issuing of 'Cover Note' followed by the issue of Insurance Policy :**

Once the proposal has been finalized and the insurer feels that the risks covered under the proposal is within his limit, premium amount is calculated from premium table. A letter is issued to the proposer to pay his first premium within the stipulated time. If the proposer honours the insurer's instructions, he becomes insured and the contract of life insurance becomes operational. Normally, in the beginning, the life policy is not issued because of complicacies associated with its preparation. A **Cover Note** is issued in its place as an interim adjustment. Once the permanent policy is issued, the cover note becomes invalid automatically.

## QUESTIONS

1. From the following alternatives given below in each bit, write serially the correct answer along with its serial number :

a. Life insurance contract is a :

i. contingent contract ii. contract of indemnity

iii. wagering agreement iv. contract of sale of goods

b. Insurance contract is characterised by both the elements of investment and :

i. compensation ii. protection

iii. identification iv. subrogation

c. In life insurance the insurable interest must be present at the time of

i. death of the policy holder ii. policy is taken

iii. maturity of the policy iv. both policy is taken and death of the policy holder

d. In life insurance, the principle of ideminity is :

i. applicable ii. not applicable

iii. applicable at the time of the maturity of the policy

iv. applicable at the time of death

e. Life insurance policy qualifies for surrender value after the expiry of a term of :

i. 2 years ii. 3 years iii. 5 years iv. 7 years

f. The other name of contract of Uberrimae fidei is :

i. contract of indemnity, ii. contract of subrogation,

iii. contract of utmost good faith, iv. contract of insurable interest

g. The document the insurance company issues before the issue of full fledged insurance policy to insured is called :

i. receipt note, ii. cover note, iii. report note, iv. advance note

h. Re-insurance means :

i. making two insurance policies, ii. renewal of old policy,

iii. sharing risk of the subject matter with another insurer.

iv. sharing the premium received with another insurance company.

i. Proposal form is complete when it is :

i. submitted with the insurer, ii. signed by the agent.

iii. signed by the proposer, iv. accepted by the insurer,

2. Answer the following questions as per the direction :

(a) Answer the following questions within **one** word / term each :

i The process through which policy holder transfers his right in the policy to his preferred person.

ii. What is the name of the document the insurer issues before the issue of the final policy ?

iii. What is the other name of insurable interest ?

iv. Name the principle of the insurance where both insured and insurer must disclose the material facts to each other.

b. Answer the following questions within **one** sentence each :

i. What is the principle of indemnity ?

ii. Name the tax benefits the life insurance earns.

iii. Who is an insurance agent ?

c. Fill in the blanks :

i. The principle of ______ depicts that the insured must disclose all the material facts to the insurer.

ii. ______ is the price for the risk undertaken by insurer.

iiii. ______ plays the link-man between the insured and insurer.

iv. After the payment of ________ premium the proposer becomes insured.

d. Correct the underlined portion of the following sentences.

i. The proforma of medical examination report has <u>four</u> parts.

ii. The proposer of life insurance becomes insured when he pays the <u>final</u> premium.

iii. Proposal forms are available with the insurance <u>company</u>.

3. Answer the following questions in not more than **three** sentences each :

a. Define life insurance.

b. Explain two important features of life insurance.

c. Show two elements regarding the significance of life insurance.

d. What are the different sources of age proof ?

e. How is the proposal for life insurance finalised ?

f. Why is the principle of indemnity not applicable for life insurance ?

g. Give any two examples of protection element of life insurance.

n. What is Agent's report ?

4. Answer the following questions in not more that **six** sentences each.

a. How is medical examination process conducted by insurer ?

b. How is life insurance is considered as an element of social security ?

c. How is premium paid under life insurance considered as investment ?

d. How life insurance encourages saving habits ?

e. Why Agent's Report carries much importance to the insurer ?

f. How life insurance becomes instrumental in framing useful future plan for the insured ?

**Long type Questions :**

Answer the following questions.

5. Define life insurance. Explain its different features.

6. What do you mean by life insurance. Discuss its significance to different sections of the beneficiaries.

7. Briefly state the procedure adopted to effect the life insurance contract.

8. Explain the dual aspects of life insurance - investment and protection with suitable examples.

## ANSWERS

1. a) i, b) ii c) ii d) ii e) ii f) iii g) ii h) iii i) iii.

2. a) i) assignment ii) cover note iii) pecuniary interest iv) utmost good faith.

   c) i) utmost good faith ii) premium iii) Agent iv) first.

   d) i) two parts, ii) first iii) Agent.

CHAPTER - 12

# POLICY CONDITIONS

**Structure**

12.0 Policy Conditions
12.1 Proof of Age
12.2 Days of grace
12.3 Commencement of Risk
12.4 Ante-Dating
12.5 Non-forfeiture
12.6 Paid-up value
12.7 Surrernder value
12.8 Extended Term Assurance
12.9 Revival
12.10 Assignment
12.11 Nomination
12.12 Loan
12.13 Foreclosure
12.14 Alternation
12.15 Lost Policy
12.16 Indisputability of the policy
**Questions**

## 12.0 POLICY CONDITIONS :

All insurers or insurance companies undertake to protect the insured against risks and uncertainties and pay the assured amounts on the happening of the contingency only on the basis of acceptance and compliance of certain terms and conditions. The contract document in the form of an insurance policy that the insurer issues to the insured contains all such terms and conditions and it is called insurance policy document.

Compliance of such terms and conditions are essential for the execution of the insurance contract. Any non-compliance of any of the conditions may put the insured in a difficult position to settle his claim. Following are some of the commonly attached conditions in the insurance policies under the life insurance contract.

## 12.1 PROOF OF AGE

Age of the insured is considered very important for the calculation of the premium. Proof of age is generally available from several records like school certificate, horoscope, certificate from local bodies etc. Normally the tenth certificate or certificate issued by Birth and Death - Registrar is used as common proof. The premium amount is more or less determined on the basis of proof of age.

## 12.2 DAYS OF GRACE

Premium is paid either annually, halfyearly or quartelry or monthly. Insurance companies specify the date known as due date for the payment of premium. Premium can be paid in any form - cash, cheque, drafts etc. Although premium is to be paid on the due date, insurance companies allow some extra days, known as grace period, beyond the due date to pay the premium. Generally, grace period of one month not less than 30days is allowed for the payment of yearly, halfyearly or quarterly premium and 15 days for monthly premium. Non-payment of premium within the grace period is considered as default on the part of the policy holder. In case the dealth of the assured is taking place during the grace period, full assured sum less unpaid premium is payable to the legal heir.

## 12.3 COMMENCEMENT OF RISK :

Once the proposal is accepted by the insurer, a letter of acceptance is issued to the proposer to pay the first premium. The date on which the proposer pays his first premium and it is accepted by the insurer, the risk under the policy commences. In the event, the acceptance letter is conditional, on the fulfillment of such condition by the proposer, the risk under the policy commences.

## 12.4 ANTEDATING :

Anti-dating means putting earlier date than the usual date. In life insurance the insurer ante-dates the commencement of risk in order to help the insured to avail the benefit of lower rate of premium for a period of three months in a calendar year. In case the insurer extends more than the three month duration in a calender year an interest is charged for the extended period.

## 12.5 NON-FORFEITURE :

When the premium is not paid within the days of grace, the policy holder becomes defaulter and his policy lapses. No claim is entertained and the amount of premium paid earlier is forfeited. Insurance Act 1938 does not permit such default and the law provides safeguard against such default under a clause called non-forfeiture provision. This provision has provided two options– first option is to return the policy holder an amount which represents the reserve or surrender value. Second option is provided under section 113 of the Insurance Act which states that every policy where premium has been paid continuously for at least three years shall acquire guaranteed surrender value. It is the minimum amout which has to be paid to the policy holder and has to be stated in the policy as a part of policy condition.

## 12.6 PAID-UP VALUE :

The sum assured is proportionately reduced when the insured discontinues the premium payment after covering the minumum required paying period of three years. This reduced sum-assured is called paid up value. It is calculated as a percentage of premium paid to premium payable to sum assured plus bonus if any. The formula used is–

$$\frac{\text{No. of premiums paid} \times \text{sum assured}}{\text{No. of premiums payable}} + \text{Bonus (if any)}.$$

Insurance companies state that policy must acquire some minimum value (say Rs.500/-) to become paid-up. In case the paid-up value worked out to be lower than minimum value, this benefit will not be available. The policy holder will only be entitled to surrender value as guaranteed under the provision of law.

## 12.7 SURRENDER VALUE :

When the assured is unable to continue the payment of premium for any reason, he surrenders the policy to the insurer and gets back a portion of the premium that he has paid earlier which is called surrender value. This brings the termination of the contract of insurance. However, a policy can be surrendered provided it has been kept in force for at least three years from the date of payment of first premium.

The method of calculation of surrender value differs from company to company but in most cases it is limited to the total amount of premium paid at the time of surrender. Some insurers mention a surrender value in the prospectus or in the policy condition. Rates of surrender value are given by various insurers which is a certain percentage of premium paid or a percentage of paid-up value. However, the amount of surrender value is determined on the basis of the nature of policies, its duration and reserve value.

## 12.8 EXTENDED TERM ASSURANCE :

When the policy lapses for any reason, an option is there to convert the lapse policy into a Single Premium Term Assurance policy for the original sum assured. The duration of the policy will be for such extended period as the net surrender value is sufficient to bear the premium amount. The premium in case of extended term assurance, is calculated after taking into consideration the age of the policy holder at the time of the lapse. However, at maturity, the amount payable will not be the origianl sum assured. In view of this discourging element in the option, many insureds prefer only paid-up option discussed above under non-forfetiure regulation.

## 12.9 REVIVAL :

Once the policy has lapsed for any reason, it can be revived to the full policy amount at any time during the life time of the assured but before the expiry of a period of five years from the date of first unpaid premium. The arrear of outstanding premium with compound interest has to be paid to revive the policy.

No medical examination is required where the policy is to be revived within six months from date of lapsing or policy is in force for at least five year where revival is required within one year of lapsation or the policy is about to mature within one year. Against the stated conditions, if the revival is sought after one year but before five years of lapsation, the insured has to submit a medical report regarding insurability of his health at his own cost. On the basis of such report the insurer enquires in detail about assured's health, habit, temperament and financial standing etc. If he gets satisfaction after such investigation the lapsed policy may be permitted to be revived.

## 12.10 ASSIGNMENT :

Assignment is the transfer of beneficial interest, right and title under a policy from Assigner to Assignee. Assinger is the policy holder who transfers the title and the assignee is the person who derives the title from the assigner Assignment is made only for consideration for money or money's worth, love and affection.

Assignment can be done either by endorsement upon the policy itself or by a separate duly stamped deed. Assigner must be a major and must have an absolute right over the policy. Assignment must be in writing and the Assigner's signature with a witness is a must Notice of assignment should be submitted to the insurer.

There are two types of assignment - Absolute and Conditional. Absolute assignment is one where all rights, title and interest which the assigner has in the policy passes on to the Assignee without reversion to the Assigner or his estate in any event. Absolute assignment is usually effected for valuable consideration.

In case of Conditional assignment the Assigner and the Assignee may agree that on the happening of a specified event which does not depend on the will of the Assigner, the Assignment may be suspended or revoked wholly or in part. Conditional assignment is usually effected for consideration for natural love and affection.

**12.11 NOMINATION :**

Section 39 of Insurance Act 1938 authorises the policy holder to nominate a person to whom the policy money will be given in the event of his death during the tenure of the policy. Nomination can be done at the proposal stage or any time there after before the maturity of the policy. Change of nomination can be made by the policy holder any time during the term of the policy and any number of times. In all cases of nomination, the insured must get it registered with the insurer.

Generally nomination is made in writing in the policy itself or by making a separate statement to the insurer. Nomination can be cancelled without giving prior notice to the nominee but intimation to this effect should be given to the insurer. If the nominee dies where the policy holder is still alive then the nomination is ineffective. Nomination has no effect if the policy holder has survived beyond the maturity period. In case the nominee dies after the death of the policy holder but before receiving policy money, there also nomination becomes ineffective and only the legal heir of the policy holder can claim money.

**12.12 LOAN :**

The facility of obtaining loan against the policy is also permitted under life insurance policies. The policy holder has to submit an application in the prescribed proforma along with the policy bond to the insurance company for loan. The surrender value of the policy is generally considered as the base to decide about the amount of loan. Approximately 85% of surrender value is given as loan along with the requisite interest charge. The policy holder must refund the loan amount plus interest regularly. In the event of default, the total of loan and interest outstanding will be deducted from the claim money payable. If the policy is not kept in force due to the non payment of premium, the loan amount along with interest charge may exceed the surrender value. At this stage foreclosure action is taken on the policy.

**12.13 FORECLOSURE :**

Foreclosure means closure or writing off of the policy before the date of maturity. As stated above when the policy holder stops the payment of premium, there will be no substantial increase in the amount of surrender value. As a result after some time surrender value may be

insufficient to cover the outstanding amount of loan and its interest. This may necessiate the foreclosure action.

Generally, before enforcing the foreclosure action a registered notice is given to the policy holder to clear the outstanding amount of loan and interest. If no response is received within the stipulated time limit, foreclosure action is taken by adjusting outstanding loan and interest amount from surrender value.

A foreclosure policy can also be reinstated following the ordinary revival procedure excepting that instead of premium arrear, interest arrear will have to be paid. On foreclosure, nomination ceases to operate. If the assured dies before receiving the balance surrender value after the execution of foreclosure action, the amount will be given only to the legal heir of the assured and not to the nominee.

### 12.14 ALTERNTAION

Whenever the policy holder wants any change in the terms of the policy, he is to request the insurer in the presecribed proforma. The insurer has the discretion either to accept or reject the request without assigning any reason. Once the request has been accepted the changes are incorporated in the policy. The request for changes are normally made for the conversion of whole life policy to endowment policy and vice-versa, mode of payment of premium etc.

### 12.15 LOST POLICY

Insurance policy is an important document. Inspite of much care if it is lost or destroyed, immediately the matter should be informed to the insurer along with information about the measures taken to trace-out the lost policy or to prevent the destruction of the policy. If the insurance company is satisfied with the explanation, a public notice is given in this regard and a duplicate policy is issued to the policy holder with a fee charged for it.

### 12.16 INDISPUTABILITY OF THE POLICY

Generally as a proposer if the insured has furnished any incorrect information or had concealed any material fact in the proposal form the insurance contract becomes null and void and policy ceases to operate. The premium paid there under, qualifies for forfeiture.

However, section 45 of Insurance Act 1938 provides that after two years from the date of effecting the policy, it cannot be questioned on grounds of incorrect or false statement or any non-disclosure in the proposal form or in other documents unless it is shown to be on a material matter and fradulently and deliberately made. This provision exists to protect the polilcy holder and claiment’s interest.

## QUESTIONS

1. From the following alternatives given below in each bit, write the correct answer with its serial number.

a) State the duration of grace period allowed when the payment of premium is on monthly basis.

(i) 30 days (ii) 25 days (iii) 20 days (iv) 15 days

b) State the time limit from the date of lapsation of policy when no medical examination of insured is required to revive the policy.

(i) 3 months (ii) 6 months (iii) 9 months (iv) 12 months

c) Name the type of assignment when it is being effected for valuable consideration.

(i) Absolute (ii) Conditional (iii) Partial (iv) Unconditional

d) Policy qualifies for surrender value when the premium has been paid continuously from the date of payment of first premium for at least.

(i) 1 Year (ii) 2 Years (iii) 3 Years (iv) 4 years

e) Name the term used when the policy in written off before the date of maturity.

(i) abandonment (ii) cancellation (iii) drop out (iv) foreclosure.

f) State the term when the insurer shares the risk of the proposal with another insurer.

(i) double insurance (ii) re-insurance
(iii) endowment (iv) assignment.

g) What is the maximum duration allowed from the date of first unpaid premium for the revival of a default policy ?

(i) 5 years (ii) 6 years (iii) 7 years (iv) 10 years

h) There are two types of assignments–one is called conditional and the other one is :

(i) absolute (ii) partial (iii) incomplete (iv) ante-dating.

**No. 2 Answer the following questions as per direction.**

a) Answer the following questions within **one** word/ term each.

(i) Name the extra time the insured gets beyond the due date to pay premium.

(ii) Name the assignment which is effected for the consideration of natural love and affection.

(iii) Name the term when the insurer prepones the starting date of the risk of the policy in order to help the insured to pay premium at a lower rate for three months.

b) Answer the following questions with in **one** sentence each:

(i) Why is the payment of first premium of the policy important ?

(ii) Why is proof of age required ?

(iii) What are the alternatives before the insurer when the risks in the proposal are beyond his capacity ?

c) Fill in the blanks :

(i) The grace period allowed in case of yearly, half yearly and quarterly payment of premium is _____days.

(ii) No medical examination is required where the policy is to be revived with in______months from the date of lapsation.

(iii) The maximum amount of loan in allowed against the life policy, is _______% of its surrender value.

(iv) On foreclosure________ ceases to operate.

d) Correct the underlined portion of the following sentences :

(i) The period the insurance company allows beyond the due date for the payment of premium is called <u>extra time</u>.

(ii) When the insured discontinues to pay the premium after the three years of insurance contract, the sum assured is reduced which is called <u>insurable value</u>.

(iii) The process through which the beneficial interest, right and title of the life policy is transferred from insured to his preferred one is called <u>nomination</u>.

No.3. Answer the following questions in not more than **three** sentences each :

a) Why is proof of age of the proposer important ?

b) At which point of time the insurer undertakes the risk of the proposal ?

c) Why ante-dating facility is allowed to policy holders ?

d) What do you mean by assignment of life insurance policy ?

e) What is nomination ?

f) What is surrender value ?

g) Is loan can be allowed against the security of life insurance policy ? If yes, state the ceiling limit.

No. 4. Answer the following questions in not more than **six** sentences each :

a) Describe the significance of grace period.

b) What do you mean by non-forfeiture provision ?

c) What are the terms and conditions for the revival of a life policy ?

d) Explain the provisions of two types of assignments– absolute and conditional.

e) What is fore-closure clause ?

f) How a new policy is issued against a lost policy ?

g) What is the meaning of indisputability clause in life insurance ? How is it enforced ?

**Long Type questions**

5. Briefly explain different policy conditions which are associated with life insurance contract.

6. Explain the assignment and nomination provisions associated with life insurance policy.

7. Write short notes on :

a) Fore-closure.

b) Surrender value

c) Revival of life insurance policy.

d) Non-forfeiture.

## ANSWERS

1. a) iv, b) ii c) i d) iii e) iv f) ii g) i h) i.

2. a) i) Grace period ii) conditional iii) Ante-dating

c) i) 30 days ii) 6 months iii) 85% iv) nomination

d) i) Grace period ii) Surrender value iii) Assignment.

CHAPTER - 13

# PREMIUM COMPONENTS AND COMPUTATION

**Structure**

13.0 Premium

13.1 Components of Premium

13.2 Computation of Premium

13.3 Broad factors considered for computation of Premium

13.4 Computation Process

**Questions**

## 13.0 PREMIUM :

The premium is the amount of money the insured pays to the insurer for the consideration of certainties against uncertainties. In other words, premium is the price paid by the insured for purchasing the insurance policy i.e., the plan and the terms of assurance for the sum assured chosen by him.

## 13.1 COMPONENTS OF PREMIUM :

The premium that the insured pays for taking life policy is computed taking into consideration three components, namely (a) Mortality charges, (b) Expenses and (c) Investment or Interest as explained below.

**a. Mortality charges :** It is that part of the premium calculated on the basis of mortality table to provide life cover to the individual. In fact, it covers a major part of the cost of the risk for payment of assured amount upon death of the policy holder. This amount varies with age, health of policy holder, coverage amount, tenure of policy, occupation of the individual etc.

**b. Expenses :** The insurer incurs various types of expenses from the beginning of the policy till its maturity. These expenses may be of two fold : (1) Premium related expenses and (2) Policy related expenses. The premium related expenses includes agent's commission, underwriting

charges, medical examination fees, renewal of policy charges, fund managers fees etc. The policy related expenses are the office expenses which the insurer incurs for proper maintenance of the policy matters.

**c. Investment / interest :** There exists a time gap between the inception of the policy and the maturity claim of the policy. Insurer takes advantage of this time gap and invests the premium amount to earn interest. The interest amount is considered at the time of premium calculation. In other words premium reflects the time value of money which can be understood by going through the following example.

**Example :** If at the age of 30 years, mortality rate is 0.00117, it means that out of 1,00,000 persons 117 are expected to die before reaching the age of 31 years in the first year of the policy. If these 1,00,000 persons want to have a policy of Rs1,00,000 each for a term of one year, the premium rate will be Rs. 117 (117,00,000/1,00,000) per person. If the company considers only the mortality rate and decides to invest the premium at the rate of 6% interest, the company has to collect only 110.38 lakhs (1171.06) instead of Rs. 117 lakhs from one lakh policy holders which make the premium rate per person of Rs. 110.38.

## 13.2 COMPUTATION OF PREMIUM :

Premium, as explained above, is the price paid to the insurer by the insured for the services of protection it provides. In insurance, pricing for the service is calculated and paid not the way it is calculated or fixed and collected for ordinary goods and services that we generally purchase. There are two basic differences in collection and payment of price for insurance services.

1. The cost of services is calculated in a more complicated way and also the components included in the cost are totally different than in the ordinary methods of pricing for general goods and services.

2. The payment of price is not ordinarily effected in one time but spread over a number of years depending upon the period for which policy is taken. It is a kind of instalment payment in the form of monthly, quarterly, half yearly or annual premium.

So the computation or calculation of cost or price for insurance services known as “Premium” is a very complicated job that needs the services of experts known as actuaries in the field. It also requires use of a lot of mathematical and statistical tools and techniques.

## 13.3 BROAD FACTORS CONSIDERED FOR COMPUTATION OF PREMIUM :

Before the process of computation begins, certain factors which have a positive bearing on the appropriate computation are considered. These factors are :

**a. Type of policy :** There are different types of policies having different benefits. These benefits are payable under different circumstances. The expected cost of these benefits, based on the risk of claims, helps to determine the amount of premium. For example the premium amount is lower in case of term assurance policy than equivalent endowment policy. The reason is that in long term, insurance claim results only in case of death whereas in endowment, claim is made on the expiry of the period of insurance or death which ever happens earlier.

**b. Age :** The age is associated with the risk of death. The risk of death increases with age. Therefore, the premium rate usually increases with age.

**c. Term of the policy :** In case of plan like endowment, the longer the term, the lesser is the tabular premium when other conditions like age, sum assured are remaining equal. Similarly, as regards pure protection plan like term insurance, longer the term the higher is the tabular premium, other things (age, sum assured etc.) remaining equal.

**d. Additional benefits :** When the policy is associated with additional benefits like double accident benefits or extended permanent disability benefits along with the basic plan, additional charges will be there. These charges should be included in premium.

**e. State of health, occupation and hazard :** When the state of health of the insured is classified as non-standard an additional premium rate may be charged. Similarly, when the occupational or professional activities of the life of assured is hazardous or exposes him to any additional risk, an extra premium may be charged.

**f. Sum assured** - The amount of sum assured determines the premium rate. Higher the sum assured, higher is the premium rate.

**g. Mode of payment of premium :** This is about the frequency of payment of premium. When the premium is paid annually, the amount of premium is comparatively less than the sum of premium paid per year for policies with more frequent premium payments like quarterly, half yearly, etc.

## 13.4 COMPUTATION PROCESS OF PREMIUM :

The computation of premium is very much crucial as wrong calculation may either result in over changing which may highly enhance the financial burdens on insured and scaring them away or in case of under charging which may bring financial losses to the insurer as they would be paying more than receiving. Further, insurance market being a highly competitive one, high premium may result in loosing the market to others or failing in attracting more customers. For all there reasons proper computation of premium is always considered very much important and crucial.

The computation process involves two broad steps and they are :

(A) Determination of tabular premium rate and (B) Calculation of Premium.

### A. Determination of tabular premium rate :

Normally the insurance companies publish the table of premium rates. These tables indicate Tabular Premium. The tabular premium evolves through four stages :

1. In the first stage RISK PREMIUM is determined on the basis of mortality table. This is the amount required to meet the risk of death for a given age for a period of one year.

2. Risk Premium amount is then adjusted against the interest components earned against the investments as discussed earlier which gives the NET PREMIUM.

3. When the amount of administrative expenses, unexpected contingencies and fluctuations are considered and added with net premium then what is arrived at is called OFFICE PREMIUM.

4. Finally, with the modification of office premium, considering several of the factors, for example sometimes the actual experience may turn out to be worse than the assumption on mortality rate etc. which may affect the premium compution, TABULAR PREMIUM is computed.

### B. Calculation of Premium :

Once the above factors which determine the premium amount is well understood and tabular premium rate is settled, following steps may be followed to calculate the premium.

**Step - 1:**

Find the tabular premium for the sum assured from the appropriate table for the given age and the selected term.

**Step - 2 :**

Deduct rebates for large sum assured and for mode of payment.

The usual rebates allowed are :

Rs. 25000 - Rs. 49999 - Re 1 per 1000 sum assured

Rs. 50000 plus - Rs. 2 per Rs. 1000 Sum assured

Rebate for the mode of payment :

Yearly - 3% of Tabular premium

Half yearly - 1.5% of Tabular premium

For monthly mode of payment extra 5% may be charged.

**Step - 3 :** Find out the balance premium per Rs. 1000 of sum assured.

**Step - 4 :** Multiply this balance premium with sum assured (in thousands only) which gives the annual premium.

**Step - 5 :** Add an extra premium on the entire sum assured for accident extra, health extra, and occupation extra, if they are chargeable.

**Step - 6 :** Calculate the final annual premium.

**Step - 7 :** Divide the premium by 2 or 4 or 12 to get half yearly or quarterly or monthly premium.

**Example :** A person who is of 35 years of age wants to take a life insurance policy for a term of fifteen years. He wants a sum assured of Rs. 25000 and to have the extra privilege of Double Accident Benefit. He prefers the half yearly mode of premium payment. Calculate the premium amount if :

a) Tabular premium is Rs. 36.55

b) Double Accident Benefit is extra Re. 1 per Rs. 1000 Sum assured

c) Rebate for sum assured of Rs. 25000 is Re. 1 per Rs. 1000 Sum assured

d) Rebate for half yearly mode of payment is 1.5% of Tabular Premium

**Solution :**

Tabular Premium - Rs 36.55

Less adjustment for sum assured - Re.1.00

Less adjustment for half yearly mode of payment 1.5% - Re. 0.5482

Balance premium per Rs. 1000 sum assured - Rs. 35.0018

{36.55 - (1 + 0.5482)}

Balance × sum assured - Rs 875.045

(35.00018 × 25)

Add Double Accident Benefit charges - Rs.25

Total Premium - Rs. 900.045

(Rs. 875.045 + Rs. 25.00)

For half yearly premium - Rs. 450.02

(900.045/2)

Therefore, the amount to be paid every half year as premium is Rs. 450.00.

## QUESTIONS

1. From the following alternatives given below in each bit, write the correct answer along with its serial number :

a. The consideration the insurer gets against the insurance contract is called :

i. premium, ii. bonus,

iii. sum assured, iv. dividend

b. In term insurance policy the claims result only when there is :

i. maturity of the policy. ii. death of the insured

iii. surrender of the policy iv. compliance of policy conditions

c. Risk premium is determined on the basis of :

i. mortality table ii. statistical data

iii. policy conditions iv. policy tenure

d. The office premium when is modified on the basis of the actual experience of the insurance company is called :

i. Risk Premium ii. Net premium

iii. Tabular premium iv. Final premium

e. Underwriting charges is an example of :

i. service related expenses, ii. premium related expenses,

iii. risk related expenses, iv. policy related expenses.

f. Age is associated with the risk of :

i. sum assured, ii. accident,

iii. disease, iv. death

g. In comparison to half yearly and quarterly premium rates annual premium rate is :

i. Same, ii. fluctuating,

iii. lower, iv. higher

h. When are the administrative expenses added with the net premium, it is called :

i. Total Premium, ii. Tabular Premium,

iii. Risk Premium, iv. Office Premium

**2. Answer the following questions as per the direction :**

(a) Answer the following questions within **one** word / term each :

i. Name the premium which is determined on the basis of mortality table in the process of calculating the tabular premium.

ii. Name the premium which emerges after making all adjustments with the Risk premium by the insurance company.

(b) Answer the following questions within **one** sentence each :

i. Why extra premium is charged when the health of the insured is adjudged as non-standard ?

ii. What are mortality charges ?

iii. Why is the premium rate of term insurance policy less than endowment policy ?

iv. Why are over aged insured charged with high rate of premium ?

(c) Fill in the blanks :

i. Tabular premium evolves through _____ stages.

ii. The amount for which the insured takes policy on his own life is called ________.

(d) Correct the underlined portion of the following sentences.

i. Agent's commission is considered as policy related expenses.

ii. Mortality charges are computed on the basis of statistical tables.

iii. Premium reflects the insurable value of the money.

3. Answer the following questions serially in not more than **three** sentences each :

a. What is premium ?

b. Explain the expenses included in the calculation of insurance premium.

c. Why is the annual premium rate lower than the half yearly and quarterly premium rate ?

d. Why age of the insured is considered for framing the insurance contract ?

e. Why the premium amount reduces in case of endowment policy with the increase in its duration ?

f. Explain different modes of payment of premium with their respective implications.

g. How are premium amount for different term settled after the finalization of annual premium ?

h. Name two additional benefits associated with the basic plan of life insurance contract.

4. Answer the following questions serially in not more than **six** sentences each :

a. What are the different components of premium ?

b. Explain the procedure followed to determine the Tabular premium.

c. Discuss any two important factors which determine the calculation of premium.

d. How terms of policy determine the premium amount ?

e. How is premium considered as an element of investment in life insurance plans ?

f. What expenses are considered in computing premium in case of life insurance contract ?

g. What factors determine the amount of mortality charges ?

**Long Type Questions :**

Answer the following questions.

5. What is premium ? Explain different components of premium.

6. Explain the computation of premium with a suitable example.

7. Explain the factors which should be viewed before the computation of premium.

8. Write short notes on :

   a. Tabular premium

   b. Investment / interest in life insurance contracts

   c. Expenses associated with premium calculation.

## ANSWERS

1. a) i, b) ii c) i d) iii e) ii f) iv g) iii h) iv

2. a) i) risk premium ii) Net premium

   c) i) four ii) sum assured

   d) i) premium, ii) mortality iii) time.

CHAPTER - 14

# MORTALITY TABLE

**Structure**

14.0. Mortality Table
14.1 Features
14.2. Importance
14.3. Criticisms
14.4. Process of construction
14.5. Types of Mortality table
**Questions**

## 14.0 MORTALITY TABLE

Mortality table shows the duration for which people at different age groups are expected to live. In other sense, it is the table that exhibits the death rates at different age groups. According to Mayerson, "Mortality table is a statistical representation showing at each age the rate of mortality." In the similar way the Federation of Insurance Institute of India defines Mortality table as "a table giving probabilities of survival and death at successive ages". Thus, in simple terms Mortality Table is a statistical presentation about the probability of living or dying of people at different age groups. These information is playing an important role in determining the premium rate as assessed by the insurance companies.

## 14.1 FEATURES OF MORTALITY TABLE :

Following are the features of a mortality table which enlightens the conceptual clarity of the Table.

**1. A statistical table** : Mortality table is totally based on the concepts and principles of statistics. It makes full use of different statistical tools and techniques for its construction. For example, the Theory of Probability, the Law of Averages etc. are used to project the survival and death rates of people belonging to different age groups.

**2. Yearly estimation** - Each year is considered as the base for the calculation of death and survival rate of people of different age groups under mortality table. This helps the insurance companies for proper assessment of premium.

**3. Average date** - It is quite natural that some people may live for longer period than others who may be living for very short period. In the construction of the mortality table the information on ages of all are not reflected rather average life span of the people is taken into account. Therefore, the information reflected in mortality table is not specific rather average in nature.

**4. General observation** - Mortality table does not predict the death or survival of a particular person. It observes the possibility of death or survival of people at large belonging to different age groups. This prediction is related neither to a person nor to a person of a particular age.

**5. Point of commencement and ending :** Mortality table starts at a point where there is full survival and ends at a point where there is no survival i.e. death.

## 14.2. IMPORTANCE OF MORTALITY TABLE :

The use of mortality table is a common feature in the life insurance business and also indispensable and unavoidable. This universality or common use of mortality table is due to several reasons which are stated below:

**1. Reliable :** The process of construction of mortality table is based on certain procedures or methods which are already proved to be correct in different areas such as mathematics, statistics, science etc. As a result, the information furnished in mortality table are accurate and reliable.

**2. Encourages new insurance plans :** Mortality tables present the probable death rates of people of different age groups. This helps the insurance companies to draw different attractive plans for different age groups to cater to their preferences. For example, long term plans with varieties can be drawn for age groups with low mortality rates. Similarly, attractive short term plans can be offered for age groups with high mortality rates.

**3. Determines costs :** By providing the probable death rate of an age group, mortality table helps the insurer to assess the amount of compensation it will bear in a particular year. This helps the insurer to fix and finalise the premium amount to meet the compensation amount, related expenses as well as to earn some margin.

**4. Determines the risk :** Whenever the insurer gets any proposal for insurance, mortality rate helps him to assess the risk (probability of death) involved in that proposal. If he finds the

risk is within his fold, he accepts the proposal or refers or shares the risk with another insurer under re-insurance mode.

**5. Scope for extra income :** Mortality table helps the insurer to assess the number of death - claims and the time of payment of claims in a year. This advance information gives the opportunity to the insurer to measure the time gap between the premium received and the payment of claims. He makes the full use of the time gap to invest the idle premium amount in some direction to magnify his income.

**6. Effective management** : Mortality table furnishes varieties of information like income, losses, risks and probable claims in a year in advance to the insurer. This makes the insurer alert about the future and helps him to prepare plans and policies accordingly to counter such challenge and avail the opportunities for the benefit of the business.

## 14.3 CRITICISMS :

Each element has two sides, positive and negative. Mortality table is not an exception. It has certain shortcomings which are discussed below :

1. The construction of mortality table is a difficult job. This is because it requires vast and exhaustive information about large number of persons of different age groups. The collection of such huge information, their appropriate processing and finally, determining mortality table is not an easy task.

2. Normally census records are used as the basic source of information. But it is not beyond doubt because there is every possibility of over estimation and under estimation of information in some cases. Moreover, the age proof is doubtful because members of certain sections of society are unaware of their age.

3. Another problem is to know the actual death of persons belonging to different age groups. Due to ignorance and social custom, people do not like to reveal death of different persons in their locality. As a result the actual death rate belonging to different age groups may be much higher than recorded.

4. Census is conducted at the interval of each ten years. The information furnished by census records are not of recent times. The construction of mortality table basing on such data does not provide upto date position of the information and this may put the insurance companies in problems.

5. Census records give statistics of all types of persons without any classification from insurance angle while insurer requires mortality of only insurable ones. Moreover, insurer requires

mortality of standard lives and sub standard lives which is also not furnished in the census records.

6. Finally, the construction of mortality table is both expensive and time consuming. This is because collection of huge data and to follow a lengthy procedure for its finalisation requires huge amount of money and a lot of time.

## 14.4 PROCESS OF CONSTRUCTION OF MORTALITY TABLE

The construction process of Mortality Table is not an easy job. It is lengthy and cumbersome. However, a brief account of its procedure is given below in stepwise form.

**1. Identification of objective -** The objective for the construction of mortality table must be well understood and should be clearly defined. This will help in the collection of required data and their proper processing. The objectives may be for determination of premium, evaluation of mortality or some other objectives.

**2. Selection of statistical methods** - Once the objective is clearly set, proper or appropriate statistical methods must be selected. Several statistical methods are there for different purposes of calculation. The method most suitable for the desired purpose must be finalised.

**3. Selection of sources of information** : This step carries much weight since proper identification of source is essential and very crucial. This is because, the quality, precision and adequancy of information of the sources determine the usefulness of the mortality table. Several sources are available for the collection of data. However, proper attention should be given to the pros and cons of each source while selecting a particular source for the collection of information. Principally, there are two sources - census records and experience data of insurance companies.

**4. Determination period of record :** The longer the duration of mortality table, the possibility of obsolescence is more. Similarly, shorter the life span lesser will be the utility of mortality table. Therefore, a period must be selected to make proper balance between the two extremes.

**5. Method of construction of morality table :** There are different methods available for the construction of mortality table such as (a) life year method, (b) calender year method (c) insurance policy method, (d) census method etc. Keeping the objective and availability of information in view, appropriate method must be finalised for the construction of the mortality table.

**6. Analysing risk of the person to be included in the mortality table :** There should be thorough investigation of the death rate of persons going to be included in the mortality table to determine the mortality rate.

**7. Determination of mortality rate :** Once the number of persons whose risk factors have been identified and included, the ratio of death is determined for the formation of the mortality table.

After determining a series of mortality rates, different points are constructed on the mortality table. Then the construction of age, number of survivors, number of deaths during the year, mortality rate etc. are made.

## 14.5 TYPES OF MORTALITY TABLE

There are three types of mortality table (1) Aggregate Table, (2) Select Table and (3) Ultimate table.

**1. Aggregate Table** : When a table is constructed without distinguishing between the select and ultimate lives it is called aggregate mortality table. In this table, the mortality rate of lives are derived from the mixture of select lives and ultimate lives. The aggregate rates stand between select and ultimate rates for the age attained. In fact, the rates are lighter than the ultimate rates but heavier than the select rates. Aggregate table is also called Mix or General Mortality Table.

This form of table is suitable where no selection is required or non-medical policies are assumed. It is also used in Group insurance. This table does not differentiate new or old insured of a particular age group and the mortality rate for the whole group insured is identified. For example, 20,000 persons at the age of 18 years had insured five years back. Today another 10,000 persons of the age of 23 years get insured. As per this table, total number of insured now reached 30,000 and mortality rate for 30,000 insured will be identified. To construct this form of table, insureds are selected not on the basis of health consideration rather on the basis of claim experience in the past of a number of insurance companies.

**2. Select Table :** The table which gives rate depending on both age and duration lapsed since entry, is called Select Mortality Table. The creator of this Table is Dr. Spreg. He observed that among the insured of similar age groups, differences can be found in the mortality rate accordingly to the period so far completed by the policies. Then the mortality rate will increase according to the time spent after effecting insurance.

A Select Mortality table shows the rate of mortality not only by age but also by duration of insurance i.e. time since selection. Less rate of premium is recovered from new assured of same age group in comparison to old assureds. Hence this type of mortality table has much importance at present time of competition. This table can also be used to determine the paid-

up value of the policy. But the defect of this table is that it is effective for a short period of 5 to 10 years.

**3. Ultimate Table :** A Mortality Table in which the rates in the select period are omitted and only the ultimate rates are tabulated, it is called as ultimate mortality table. In other words, figures for policies that still have the effects of selection are not included. A comparative table is given below for better understanding of select mortality and ultimate mortality tables.

**Table**

**Mortality Rate per 1000**

| Select Mortality Table | | | | | | Ultimate Mortality Table | |
|---|---|---|---|---|---|---|---|
| | Years of Insurance | | | | | | |
| **Age** | **1** | **2** | **3** | **4** | **5** | 6 years and above | age attained |
| 20 | 2.73 | 3.3 | 3.80 | 3.96 | 4.13 | 4.31 | 25 |
| 21 | 2.78 | 3.66 | 3.86 | 4.01 | 4.18 | 4.35 | 26 |
| 22 | 2.83 | 3.72 | 3.61 | 4.07 | 4.29 | 4.38 | 27 |
| 23 | 2.86 | 3.76 | 3.06 | 4.08 | 4.24 | 4.41 | 28 |

An analysis of the above table reveals that mortality rate is 2.86 per thousand at age 23 years during 1st year after selection, 3.72 for thousand at 22 during 2 years after selection, 3.86 per thousand of age 21 during 3 years after selection and 3.96 per thousand at age 20 years during 4 years after selection. But under ultimate mortality table irrespective of the duration of selection, the mortality rate remains almost constant.

The Ultimate Table is used for valuation purposes where insurer wants to have a reasonable safety margin and where policies are participating ones. It gives maximum possible rate of death.

## QUESTIONS

1. From the following alternatives given below in each bit, write the correct answer with its serial number.

a. Mortality table exhibits the populations :

i. birth rate ii. literate rate

iii. death rate iv. accident rate

b. Mortality Rate is the calculation per :

i. Monthly ii. Half-yearly

iii. Quarterly iv. Yearly

c. The information furnished in the Mortality Tables are in the nature of :

i. average ii. absolute

iii. partial iv. specific

d. Census are conducted at the interval of

i. 5 years ii. 10 years

iii. 15 years iv. 20 years

e. One of the methods used in the construction of a Mortality Table is :

i. Life year method ii. Survival rate method

iii. Surrender value method iv. Policy revival method

f. The other name of General Mortality Table is :

i. Aggregate Table ii. Select Table

iii. Ultimate Table iv. Survival rate Table

g. Which mortality table is used when policies are participating ones is :

i. Aggregate Table ii. Ultimate Table

iii. Select Table iv. Survival rate Table

h. The mortality table which is suitable for group insurance is :

i. Select table ii. Ultimate table

iii. Aggregate table iv. Survival table

**2. Answer the following questions as per direction :**

(a) Answer the following questions within **one** word/ term each :

i. Which mortality table shows higher rate of premium for existing insured than fresher ones, even though they belong to the same age group ?

ii. Name the mortality table which is constructed without distinguishing the select and ultimate lives in life insurance.

iii. Which table starts at a point where, there is full survival and ends at a point where, there is no survival i.e. death ?

(b) Answer the following questions within **one** sentence each :

i. What is mortality table ?

ii. Name the different types of mortality table.

iii Explain any one of the features of mortality table.

iv. Why mortality table is reliable ?

(c) Fill in the blanks:

i. Information furnished in mortality table are _______ in nature.

ii. The use of ________ table is a common practice in life insurance contract.

iii. The duration for which the mortality table is generally prepared for one _______.

(d) Correct the underlined portion in the following sentences :

i. Mortality tables are prepared for a period of ten years.

ii. Mortality Table starts at a point where there is no survival.

iii. ______ record plays a vital role in the construction of Mortality table.

3. Answer the following questions in not more than **three** sentences each :

a. How Mortality Table opens the opportunity for the insurer to invest the premium to multiply its income ?

b. Why is the construction of mortality table expensive and time consuming ?

c. Name the methods used to construct the mortality Table.

d. How the Mortality Table assists the insurer to manage the risks effectively ?

e. Why Mortality Table fails to exhibit the correct information about the death rate ?

f. Explain any one step as regards the procedure for the construction of the Mortality Table.

g. What is the basic idea in the construction of the Select Table ?

4. Answer the following questions in not more than **six** sentences each :

a. How is Mortality Table instrumental in encouraging the insurer to introduce new insurance plans ?

b. State reasons in support of the reliability of Mortality Table.

c. Explain the way the Mortality Table helps the insurance companies to manage their business effectively.

d. Why is the construction of Mortality Table a difficult task ?

e. Why are census records unable to provide effective support for the construction of Mortality Table ?

f. How Mortality Table helps the insurance companies to generate extra income over and above their usual income ?

g. How is Mortality Table helpful to the insurer in determining the cost of each proposal ?

**Long Type Questions :**

5. What is Mortality Table ? Discuss its features in detail.

6. Explain the significance of Mortality Table from the point of view of the insurer and also state the criticisms against it.

7. State in brief the procedure adopted in the construction of a Mortality Table.

8. Write notes on :

a. Aggregate Mortality Table

b. Select Mortality Table

c. Ultimate Mortality Table

## ANSWERS

1. a) iii, b) iv c) i d) ii e) i f) i g) ii h) iii

2. a) i) Select Mortality Table ii) Aggregate Mortality Table iii) Mortality Table.

 c) i) average ii) Mortality iii) year.

 d) i) one ii) full iii) census.

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