BANKING AND INSURANCE MANAGEMENT

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DIRECTOR

SYLLABUS

Unit-1 **Management and Principles of Bank:** Banking System in India**,** Principles of Banking, The Banking Regulation Act, 1949, Creation of Money, Electronic Banking System, Role of Reserve Bank of India. **Principles of Insurance:** Introduction, History of Insurance Policies, Types, Policies Conditions and Principles of Insurance

Unit-2 **Management of Bank Policies:** Bank's Investment Policies, Different Loan Policies, Credit Management in Bank. **Nature of Insurance Business:** Nature of Insurance contract Insurance Contract VS Wage sing Contract, Importance of Insurance- Uses of Insurance Business.

Unit-3 **Management of Deposit and Advances.** Opening of a Account, Types of Deposit Account, Importance of CRM, Types of Advances.

Role of Development Officer: Meaning - Importance of Development officer, Duties of Development officer. Principles of General Insurance' Function Personal General Insurance Products, Commercial General Insurance Products.

Unit-4 **Investment Report:** Nature of Bank Investment, SLR Requirement & Investment, Nature and Significance of Investment Management, Fundamental of Security Investment. **Role of Insurance Agents:** Meaning and Definition of Agents Recruitment and selection of Agents, Training of Agents, Duties of Agents, Code of Conduct for Agents, Rights of Agents, Essential Qualifications for successful Agents, Termination of Agents.

Unit-5 **Management of Finance** Bank Accounts, Records, Reports, Statement of Advances, Profit and Loss accounts, Balance Sheet and reports. **Management Principles in Insurance:** Management function in Insurance, hierarchy, Individual and group behaviour, Management of personnel of manager, Management process of selection, Training , Promotion etc.

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UNIT 1 MANAGEMENT OF BANKING COMPANIES

Structure

1.0 OBJECTIVES

After studying this unit you will be able to understand:

- The principles of banking
- Definition of bank
- Creation of money
- Structure of commercial banking system
- Working of banks during 1947 to 1991 and thereafter

1.1.ORIGIN OF BANK

The term Bank is being used since long time but there is no clear conception regarding its beginning. According to one viewpoint, the Italian money lenders were known as 'banechi' or 'bancherri', because these people kept a special type of table to transact their business, called 'Banchi'. According to another viewpoint, the word 'bank' is derived from the German word 'banck' which means heap or a mound. Italian started using the name 'banco' which meant accumulation either of 'money' or of 'stock'.

1.2. MEANING OF BANK

A bank is a financial institution which accepts deposit from the public and leads those who need it thereby making a profit out of it. The lending rate of a bank is higher than the rate it pays to its depositors. A bank, therefore, acts as a reservoir into which the idle surplus money of individuals and households flow and from which loans are given to the needy borrowers. Besides this, a modern bank performs various other functions such as credit creation, agency work and general services besides dealing in money. Using banks and the many services they offer saves an incredible amount of time and ensures that the funds of micro as well as macroeconomic agents "pass hands" in a legal and structured manner. There are also other types of financial institutions that operate just like banks.

1.3. DEFINITION OF BANK

According to the **Oxford Dictionary**, "Bank is an establishment for the custody of money, which it pays out on customer's order".

According to the **Indian Central Banking Enquiry Committee**, "A banking company is one which carries on as its principal business, the acceptance of money deposits on current account or otherwise subject to withdrawal by cheque, draft or order".

In the words of **Cairncross**, "A bank is a financial intermediary, a dealer in loans and debts".

According to the **Banking Companies (Regulation) Act of India, 1949**, "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 or otherwise".

The **Webster's Dictionary** defines Bank as, "An institution which trades ion money, establishment for the deposits, custody and issue of money as also for making loans and discount and faciliating the transmission of remittance from one place to another".

Broadly speaking, banking business implies receiving, consuming and using the funds of the community. It accepts deposits from the public and gives loans to them. Hence, a bank may be defined as an institution which collects surplus funds from the public, safeguards them, and makes them available to the true owner of fund when required. It also lends sums not required by their true owner to those who are in need of money and can provide security.

In short, **a bank is an institution which accepts deposits withdrawable by cheque and makes loans and advances for the purpose of earning profit.**

1.4. FEATURES OF A BANK

Various features of a commercial bank are:

1. **Commercial Establishment:** A commercial bank is a commercial establishmentwhich deals in money. It accepts money as deposits and advances loan in cash and cheques.
2. **Individual or Firm or Company:** A bank may be an individual, a firm or a joint stock company. A banking company refers to a company which is in the business of banking.
3. **Acceptance of Deposits:** A bank accepts money from the customers in the form of deposits which are generally payable on demand or after the expiry of a specified period.
4. **Provide Safety to Money:** A bank provides safety to the money of its clients. It also performs the role of custodian of funds of its customers.
5. **Advancing Loans:** A bank lends out money in form of advances or loans to those who need it for different purposes. The public can borrow from banks to meet their needs and requirements.
6. **Payment and Withdrawal:** A bank offers easy payment and withdrawal facility to its clients through cheques and drafts. It also brings bank money in circulation. This money circulation is in the form of cheques, drafts, etc.
7. **Agency and Utility Services:** A bank offers different banking facilities to its clients which involve general facility services and agency services such as transfer of funds, collection of dividend, payment on behalf of customers, etc.
8. **Profit and Service Organisation:** A bank being a financial intermediary is a profit seeking institution having service oriented approach.
9. **Credit Creation:** A bank can create credit i.e., creation of additional money for lending.
10. **Ever Increasing Functions:** Banking is an evolutionary approach. A bank expands and diversifies regularly as regards the functions, services ands activities.
11. **Banking Business:** The main function of a bank should be to perform banking business which should not be subsidiary of any other business.
12. **Name Identity:** A bank should always add the word ‘Bank’ to its name to enable public to know that it is a bank and it deals in money and debts.

1.5. FUNCTIONS OF A BANK

Banking Regulation Act of India, 1949 defines Banking as "accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheques, drafts and order or otherwise". Deriving from this definition and viewed solely from the point of view of customers, Banks essentially perform the following functions:

1. Accepting deposits from public/others (Deposits).
2. Lending money to public (Loans).
3. Transferring money from one place to another (Remittances).
4. Credit creation.
5. Acting as trustees.
6. Keeping valuables in safe custody.
7. Investment decisions and analysis.
8. Government business.
9. Other types of lending and transactions.

1.6. PRINCIPLES OF BANKING

Banks are financial institutions. Their principal function is to accept deposits from the people and make investment of the deposits. Investment is done with a view to maximizing profits, without sacrificing 'liquidity' and 'security' of the assets. In formulating a general investment policy, banks should take care of the following points:

1. **Principle of Liquidity:** The banks must ensure that they have sufficient liquid power all the time. At any time must be in a position to honour all their commitments of liquidity. The banks should invest only in those sources which have the merit of shiftability without loss. Short period loans have this merit. Banks should, therefore, give loans only to generate working capital. Loans should not be given for fixed assets as it is difficult to convert fixed assets into cash.
2. **Principle of Safety:** Bank should invest its capital its capital only in safe channels. Safe investments are those which do not sink or fall in value. Bank should avoid investing in speculation activity, as it is often highly risky and uncertain. Also, proper management of capital requires that the entire capital is not invested on terms of loans to one individual or firm. Long period investment should generally be avoided.
3. **Principle of Profitability:** While making investment, banks should not care for liquidity and safety alone. Profits should also be maximized. Generally, it is found that liquidity

and profitability are opposite to each other. Capital in cash is a liquid asset, it does not yield any income. On the other hand, long period investments yield much income but are less liquid. An efficient investor must strike a balance between liquidity and profitability. One should not be unnecessarily forgone for the sake of the other. One can thus state that, taking full care of its liquidity and safety, a bank should try to maximize its profits.

4. **Principle of Diversification of Risk:** A bank should not invest its entire capital in one kind of trade or industry. Capital should be invested in different kinds of trade, securities and loans, so that losses at one place could be made up with profits elsewhere. If the entire capital is invested only in one kind of activity or trade, there is always the danger of capital loss. Thus, capital should be invested across diversified activity.
5. **Principle of Marketability of Securities:** A bank must make investment in such securities which are easily sold in the market in times of emergency. Investment should be made in trade bills, ready stocks or shares and debentures of famous companies. These investments not only have the merit of liquidity and safety but also of marketability. Investment in long period loans should be avoided as these loans lack the merit of marketability.
6. **Principle of evaluation of Securities:** A bank must evaluate the securities offered by the borrowers. It must make sure that the value of security exceeds the value of loans. If the value of a security is likely to decrease in the near future, the bank must seek additional security to avoid the possible risk of losses.
7. **Other Principles:** A bank must formulate its investment policy parallel to the investment policy of the central bank of the country. So that in times of emergency, it can seek loans from the central bank. Besides, priority must be given to investment in such securities which are income tax free or which carry less tax.

1.7. CREATION OF MONEY

MEANING

Credit creation is considered to be the main function of commercial banks. Credit creation refers to that power of banks which enables them to expand their secondary deposits through loans, advances and investments, more than their primary deposits. In other words, bank credit refers to the advances in the form of loans, cash credit, overdraft, bills purchased and discounted and investment in approved securities other than government securities. Credit is said to be created when banks through their lending activities, make net addition to the total money supply in the economy. Credit creation refers to the unique power of banks to multiply loans and advances through deposits. With little cash in hand, the commercial banks can create additional purchasing power to a considerable extent. By creating credit, the commercial banks add to the supply of money in the economy which in turn impacts the level of production, consumption and investment and accordingly the process of growth and development of the country.

Commercial banks are able to create credit because the demand deposits are accepted by the public in settlement of their debts. This function is automatically performed by banks while advancing credit or loans or by accepting deposits. Thus, when a bank advances a loan, it does not lend cash but opens an account in favour of the customer and credits the amount to the account. It creates a claim against itself which is acceptable by the public for settlement of debts. As these claims against the banks are accepted by the public for settling their debts, it is an important constituent of money supply. In this process the bank creates money.

DEFINITION

In the words of **Newlyn**, “Credit creation refers to the power of commercial banks to expand secondary deposits either through the process of making loans or through investment in securities”.

According to **G.N. Halm,** “The creation of derivative deposits is identical with what is commonly called the creation of money”.

1.8. BASIC CONCEPTS RELATING TO CREDIT CREATION

1) **Demand Deposits:** These are those deposits with the banks which the depositors can withdraw on demand by issuing a cheque. These are also called ‘chequing deposits’ or ‘chequable deposits’. These are broadly classified into two types:

i) **Primary or Cash Deposits:** The amount deposited in cash or cheque by the public in banks is called cash or primary deposits. It is also called passive deposits because commercial banks have no role in the creation of these deposits. The amount of such deposits depends exclusively on the discretion of depositors.

ii) **Derivative or Secondary Deposits:** Whenever a person approaches a bank for loan he is not given the loan in cash; rather an account is opened in his name and he is allowed to withdraw the required amount by issuing a cheque. Such a deposit is called secondary or derivative deposits. Thus, every loan advanced by the bank creates new deposit. Since the bank plays an active role in the creation of such deposits, they are otherwise known as active deposits. Derivative or secondary deposit is the result of primary deposit because the bank creates secondary deposit by keeping a part of the primary deposit in reserve.

2) **Cash Reserve Ratio – CRR:** No doubt the bank wants to earn maximum profit through advances but it does not mean that it will convert all its liquidity into loans. Those who deposit funds in the bank in cash can withdraw the same any time, because it is their money. Hence, banks always keep some part of the total amount deposited as cash reserve to meet the needs of the depositors. That part of the total deposits which the bank keeps with itself in cash is simply called cash reserves. Ratio of cash reserves to total demand deposits is called cash reserve ratio (CRR).
3) **Excess Reserves:** The amount lying with the bank in excess of the required cash reserve ratio is called excess reserves. The banks use these reserves to expand credit during such periods when demand exceeds supply of credit and returns on loans are high.
4) **Credit Multiplier:** Credit multiplier refers to the ratio of increase in total deposits to increase in primary deposits. If as a result of increase in primary deposit to the tune of Rs.1,000. Credit is created to the extent of RS. 10,000 then credit multiplier is 10. The inverse relation between credit multiplier and cash reserve ratio is shown as under:

$$\text{Credit Multiplier} = \frac{1}{\text{CashReserveRatio}}$$

1.9. ASSUMPTIONS OF CREDIT CREATION

The process of credit creation is based on the following assumptions:

i) All the depositors will not withdraw their funds at one and the same time.
ii) Bank does not pay in cash the amount of credit sanctioned to its customers. These payments are in the form of credit balances in the books of the bank.
iii) All banks strictly maintain Cash Reserve Ratio.
iv) Banks expands credit o. its full amount is transferred to other banks.
v) People deposit their funds in the banks in the form of demand (current deposits).
vi) There is no change in the credit control policy of the central bank.
vii) All banks advance a fixed proportion of their deposits as loans.
viii) All banks act simultaneously. They receive primary deposits simultaneously. In the state of credit creation all banks have excess reserves.
ix) Payments of all trade and other transactions are made by cheques by the people.
x) Commercial and industrial conditions are normal in the country.
xi) Collateral security is free from risk.

1.10. PROCESS OF CREDIT CREATION

The process of credit creation can be divided into two parts:

A. Single Banking System and

B. Multiple Banking System

A. Single Banking system: Single banking system means there is only one bank in the economy. All transactions are done by this very bank. Process of credit creation under this system can be explained in two ways:

i) Basis of Credit Multiplier: Banks often create credit (Creation of Secondary deposits) on the basis of their primary deposits. It can be illustrated with the help of an example. Suppose a person deposits Rs. 1,000 in a bank. To the bank, this amount of Rs. 1,000 constitutes primary deposit or cash deposit. Bank knows by experience that all depositors do not withdraw their money at one time. Supposing, the bank keeps 10% of the total deposits in cash and advances the rest of the amount as loans. In this example, bank keeps Rs. 100 in cash reserve and the remaining amount of Rs. 900 is given as loan to Mr. A. bank does not give this loan in cash but opens a current in his favour and credited this amount of Rs. 900 to it. Bank permits Mr. A to issue cheques upto the amount of Rs.900 only. Let us suppose that Mr. A owes Rs. 900 to one Mr. B and he discharges this liability by issuing him a cheque for Rs.900 only. Mr. B deposits this cheque in the same bank in his account. The bank will debit Rs. 900 lying in the account of Mr. A and credit the same to the account of the Mr. B. in this way, there will be an increase in the deposits of the bank to the extent of Rs.900. the bank will keep 10 % of this deposit as reserve and give a loan of Rs. 810 to yet another borrower Mr. C. Supposing Mr. C owes Rs. 810 to one Mr. D and he pays this amount by issuing him a cheque of Rs. 810. On receipt of this cheque, Mr. D deposits it in his account with the bank. The bank, in turn, will debit the account of Mr. C and credit that of Mr. D. this act will increase the total deposits of the bank by Rs. 810. The process will, thus, go on for a long time. It is evident from the above example that loans create deposits and deposits create loans. In this case, total credit created will be Rs. 9,000 and total bank deposit, i.e., initial primary deposits + secondary deposit (Rs. 1,000 + Rs. 9,000) will be Rs. 10,000.

Process of credit creation by the bank can also be explained with the help of Table 1.

Table 1. Process of Credit Creation

Round	Primary Deposit (Rs.)	Cash Reserve Ratio (10%)	Loans or Secondary Deposits (Rs.)
First Second Third ……	1,000 900 810 ….	100 90 81 …..	900 810 729 …
Total	10,000	1,000	9,000

It is clear from Table 1 that total credit created will be Rs. 10,000 out of which Rs. 1000 will be kept by the bank as Cash Reserve Ratio and the remaining Rs. 9,000 will constitute loans or secondary deposits.

ii) Credit Equation and Credit Multiplier

Credit equation and credit multiplier can be expressed as under:

$$\text{Cash Reserve Ratio} = \frac{\text{Primary Deposit}}{\text{Total Deposit}}$$

or, $\mathrm{r} = \frac{\mathrm{P}}{\mathrm{D}}$

(Here, r = Cash Reserve Ratio; P = Primary deposit; D= Total deposit)

If change in Primary Deposit (P) is expressed as ΔP and change in total deposit (D) is expressed as ΔD, then

$$\mathrm{r} = \frac{\Delta \mathrm{P}}{\Delta \mathrm{D}} \quad \text{or} \quad \frac{\Delta \mathrm{D}}{\Delta \mathrm{P}} = \frac{1}{\mathrm{r}} \qquad \text{(Multiplier)}$$

In every round, there will be increase in credit ΔP (1 – r). If in the beginning P = Rs. 1, 000 and r = 1/10 or 10 percent, then increase in primary deposit of Rs. 1,000 in the first round will lead to increase in secondary deposit by 1,000 $\times\frac{9}{10} = \text{Rs.}\,900$, that is credit amounting to Rs. 9,00 will be created. In the third round, secondary deposit will increase by 900 $\times\frac{9}{10} = \text{Rs.}\,810$, which is credit with Rs. 810 will be created. Finally, total secondary deposit will increase to Rs.9,000. Since primary deposit was Rs.1,000, hence, total deposit will be Rs. 1,000 + Rs. 9,000 = Rs. 10,000. This process can be explained with the help of the following equation:

Total increase in bank deposit = Primary deposit in the first round + secondary deposit in the second round + Secondary deposit in the third round + ……+ Secondary deposit in nth round

$\Delta D = \Delta D_1 + \Delta D_2 + \Delta D_3 + \ldots\ldots + \Delta D_n$ ………. (i) or

$\Delta D = \Delta P + \Delta P\,(1 - r) + \Delta P\,(1 - r)^2 + \Delta P\,(1 - r)^3 + \dots\dots\dots + \Delta P\,(1 - r)^n$ ……..(ii)

The above formula pertains to credit creation. With its help, the process of credit creation given in the Table 1 can be expressed as under:

Total deposit = 1,000 + 900 +810 +729 + ……….

$$=1{,}000 + \frac{9}{10}(1{,}000) + \left(\frac{9}{10}\right)^2 \times 1{,}000 + \left(\frac{9}{10}\right)^3 \times 1{,}000 \dots\dots..$$

$$=1{,}000\left[1 + \frac{9}{10} + \left(\frac{9}{10}\right)^2 + \left(\frac{9}{10}\right)^3 + \cdots\cdots\right]$$

$$= 1{,}000\left[\frac{1}{1-\frac{9}{10}}\right] = 1{,}000\left[\frac{1}{\frac{1}{10}}\right] = \text{Rs. } 10{,}000$$

In this way, we find that of primary deposit (ΔP) = Rs.1,000 and cash reserve ratio ® is 10 percent, then total deposits (ΔD) will be Rs. 10,000. Of this, Rs. 1,000 constitutes primary deposit and Rs. 9,000 represents credit created by the bank, i.e., secondary deposit.

iii) Basis of Balance Sheet of a Bank

The process of credit creation can be made clear from balance sheet. When initially, in a bank primary deposit is of Rs. 1,000 then its balance sheet will be of the following type:

Table 2. Primary Balance Sheet of Bank

Liabilities	**Rs.**	**Assets**	**Rs.**
Primary Deposits	1,000	Reserves	1,000
Total	1,000	**Total**	1,000

Banks reserve of worth Rs. 1,000 gives birth to the liabilities of Rs. 1,000. Bank advances loans from it after keeping 10 percent as minimum reserve fund. Therefore, bank will lend Rs. 900. Bank will open an account in favour of the borrower and credit Rs. 900 in it. Therefore, it is rightly said each loan gives birth to deposit. After lending bank's balance sheet will be of the following type:

Table 3. Bank's Balance Sheet after Lending Loans

Liabilities	**Rs.**	**Assets**	**Rs.**

Deposits	1,000 900	Reserves Loans	1,000 900
Total	1,900	**Total**	1,900

From the above balance sheet, it is clear that when bank advances loan worth Rs. 900 then the assets and liabilities of the bank increases by the same value. To fulfil these liabilities the bank should have 10 percent as cash Reserve Fund. The bank can create new loans by using rest of Rs. 810. After it the bank will give loans to others in the same manner. In the end, the shape of balance sheet will be of the following type:

Table 4. Bank's Final Balance Sheet

Liabilities	**Rs.**	**Assets**	**Rs.**
Deposits 1. 2. 3.	1,000 900 810 729 … …	Reserves Loans 1. 2. 3.	1,000 900 810 729 … …
Total	10,000	**Total**	10,000

From Table 4, it is clear that primary deposit of Rs. 1,000 in bank will create credit of Rs. 9,000 in the economy. In this way, the total deposit will raise Rs. 10,000. It is possible only in that situation when minimum reserve fund is of 10 percent.

2) Credit Creation by Multiple Banking System

In real world, there is not only one bank in an economy, rather there are many banks. A single bank cannot create more credit than its excess reserve. But multiple banking system can create many times more credit than its primary deposits. Study of credit creation can be made in two parts even under multiple banking systems:

i) Basis of Credit Multiplier

Supposing there are many banks in an economy. A person deposits with bank 'A' a sum of Rs. 1,000 in cash. The bank knows by virtue of its experience that all depositors do not withdraw all these money at one time. Supposing the bank keeps 10 percent of the total deposits as cash reserve and gives the rest amount on loan. In this example, Bank 'A' keeps Rs. 100 as cash reserve and gives Rs. 900 to another person who has his account in bank 'B'. That person deposits this cheque of Rs.900 in bank 'B'. Now bank 'B' keeps 10 percent of Rs. 900 that is Rs. 90 as cash reserve and gives the remainder Rs. 810 to a person who has his account in bank C. Recipient of the cheque will therefore, deposit the same in bank 'C'. In this way, the primary deposits of bank 'C' will increase by Rs. 810. Now bank 'C' will keep 10 percent of it, i.e., Rs. 81 in reserve and give the remainder amount of Rs. 729 as loan to another needy person. This process will continue till all banks create credit to the tune of Rs. 9,000 on the basis of a primary deposit of Rs. 1,000 only. Table 5 elucidates the process of credit creation.

Table 5. Credit Creation by Multiple Banking System

Banks	Primary Deposits (Rs.)	Required Reserve (Rs.)	Loans or Secondary Deposits (Rs.)
A B C D E	1,000 900 810 … …	100 90 81 … …	900 810 729 … …
Total	10,000	1,000	9,000

It is evident from Table 5 that an increase in primary deposit amounting to Rs. 1,000 will ultimately enable the banking system to advance loans to the tune of Rs. 9,000, provided 10 percent of the primary deposit is kept as cask reserve. Thus, the total deposits of the banking system will increase to Rs. 10,000 (Rs. 1,000 primary deposit and Rs. 9,000secondary deposits). In other words, credit worth Rs. 9,000 will be created in the banking system as a whole.

ii) Basis of Balance Sheet of Many Banks

Suppose, in an economy there are A, B, C and many other banks. First of all, a customer deposits Rs. 1,000 as primary deposit in Bank 'A'. As such, balance sheet of bank 'A' will be of following type:

Table 6. Primary Balance Sheet of Bank 'A'

Liabilities	Rs.	Assets	Rs.
Deposits	1,000	Reserves	1,000
Total	1,000	Total	1,000

Bank 'A' is keeping 10 percent as reserve fund and advances Rs. 900. Thus, bank 'A' ′s final balance sheet will be of the following type:

Table 7.Final Balance sheet of Bank 'A'

Liabilities	Rs.	Assets	Rs.
Deposits	1,000	Reserves Loans	100 900
Total	1,000	Total	1,000

Customer will deposit this loan of Rs. 900 in Bank 'B'. Bank 'B'′s primary and final balance sheet will be of the following type:

Table 8. Primary Balance Sheet of Bank 'B'

Liabilities	Rs.	Assets	Rs.
Deposits	1000	Reserves	100

		Loans	900
Total	1,000	Total	1,000

Bank, keeping 10 percent reserves of primary deposits, will advance loans of Rs. 810. In this way, its final balance sheet will look as below:

Table 9. Final Balance Sheet of Bank 'B'

Liabilities	Rs.	Assets	Rs.
Deposits	900	Reserves Loans	90 810
Total	900	Total	900

The customer deposits the loan of Rs. 810 in Bank 'C' then the primary balance sheets and final balance sheet of Bank 'C' will be as follows:

Table 10. Primary Balance Sheet of Bank 'C'

Liabilities	**Rs.**	**Assets**	**Rs.**
Deposits	810	Reserves	810
Total	810	Total	810

Bank 'C' will lend Rs. 729 by keeping 10 percent as minimum reserve fund. Therefore, its balance sheet will be as under:

Table 11. Final Balance Sheet of Bank 'C'

Liabilities	**Rs.**	**Assets**	**Rs.**
Deposits	810	Reserves Loans	81 729
Total	810	Total	810

This process will remain same up to bank D, E, F, etc., till the whole deposit is not lent. Thereafter, all banks together generate new deposit worth Rs. 9,000 and total deposit will be Rs. 10,000.

Table 12.

Banks	**New Deposits (Rs.)**	**Required Reserves (Rs.)**	**New Loans (Rs.)**
A B C Other Banks	1,000 900 810 729 …..	100 90 81 … …	900 810 729 … …
Total for the Banking System	10,000	1,000	9,000

In short, total deposits will be Rs. 10,000 due to primary deposits of Rs. 1,000.

1.11. PRESENT STRUCTURE OF COMMERCIAL BANKING SYSTEM IN INDIA

The structure of the Indian banking system that evolved during the pre-Independence period was without any purposive control and direction. At the time of independence, the country had the RBI at the top and a variety of other banking institutions. The Imperial bank of India had a unique position among the commercial banks.

The position of Indian Banking structure has significantly changed since independence. The number of branches of the commercial banks has increased steadily and the banking activity has been gone to all over the country.

The structure of Indian Banking System can be broadly classified into two categories, i.e.,

A. Organised Sector
B. Unorganized Sector

A. Organised Sector

In the organized sector, the main constituents are Reserve Bank of India, Commercial banks, Co-operative Banks and specialised banks.

1. **Reserve Bank of India:** The Reserve Bank of India is the leader of the Indian Banking system. RBI is the Central bank of the country. It is the apex financial institution of India. RBI is the supreme monetary and banking authority in the country. RBI came into existence in 1935 and since then it has been making continuous efforts to improve the bnking system in India. On January 1, 1949 its entire capital was acquired by the Central Government and thus it became a state owned institution. Its traditional functions include issue of currency, bank of bankers, and banker of the Government.
2. **Commercial Banks:** The Commercial Banking System in India now consists of public sector scheduled as well as non-scheduled banks.

   a) **Scheduled Banks:** A scheduled bank refers to a bank which is listed in the second schedule of the Reserve bank of India Act, 1934 in India. Banks not under this schedule are known as non-scheduled banks. Scheduled banks are generally nationalised banks, private banks and foreign banks functioning in India. A scheduled bank is eligible for advances from the Reserve bank of India. The State Co-operative Banks are also now eligible to be included in the Second Schedule of the Reserve bank of India Act on account of the enforcement of the Banking Laws (applicable to Co-operative Societies) Act, 1965.

   Scheduled banks may be classified according to their ownership as:

   i) **Public Sector Banks:** Public sector banks are those banks which are owned or controlled by the government. The public sector commercial banking in India started with setting up of State bank of India in 1955, by taking over the Imperial bank of India. In the next 5 years, the princely state banks were made associate banks of the State Bank of India.

Nationalised Banks: Another important step towards public sector banking was taken in July 1969. The Government of India issued an ordinance Banking Companies (Acquisition and transfer of Undertakings) Ordinance, 1969 and nationalised 14 largest commercial banks with a deposit base of Rs. 50 crore or even more. Again in 1980, six more private sector banks were nationalized bringing up the total number of banks nationalized to twenty. With the second phase of nationalization, the Government of India controlled around 91% of the banking business in India. Later on, in the year 1993, the government merged ‘New bank of India’ with ‘Punjab National Bank’. It was the only merger between nationalised banks and resulted in the reduction of number of nationalized banks from 20 to 19. One of the main objectives of nationalization of the banks has been to help in achieving the balanced regional sectorialand sectional development of the economy and to the remote areas of the country. **Regional Rural banks:** The establishment of RRB’s is one of the important points of the Twenty Point Economic Programme of Mrs. Indira Gandhi during Emergency to cater to the credit needs of rural people. RRB’s were set upon the recommendations of a working group headed by M. Narasihma in 1975 in order to provide employment to the rural educated youth and to bring down the cost of rural banks by recruiting their staff on the same scale of pay and allowances as for the employees of State Government /local bodies. Each RRB has an authorized capital of Rs. 1 crore and issued and paid-up capital of Rs. 25 lakhs. The share capital of the RRB is subscribed by the Central Government (50%), the State Government concerned (15%) and the sponsoring commercial bank (35%).The main objective of Regional Rural Banks was to provide credit and other facilities to small and marginal farmers, agricultural labourers and artisans and small entrepreneurs so as to develop agriculture, trade, commerce, industry and other productive activities in the rural areas todevelop the rural economy. The need was felt as commercial banks and co-operative banks were not able to serve these segments adequately. These are scheduled banks which are governed by Regional Rural Bank, Act, 1976.

ii) Private Sector Banks: Banking sector in India has been dominated by public sector banks. In the post independence period, it was noticed that the private sector banks controlled by industrial houses or business houses were ignoring the rural areas and agricultural sector. This led to the nationalization of 20 banks in 1969 and 1980. However, since liberalization in government banking policy in 1990s, old and new private sector banks have remerged. In January 1993, the Reserve Bank of India announced guidelines for entry of new commercial banks in accordance with the recommendations of the Narasimham committee and as an attempt to deregulate the banking industry. The banking policy was framed for starting new private sector banks for the first time in five decades.

iii) Foreign Banks: Foreign banks have been working in India from British days. ANZ Grindlays Banks has its presence in number of places with 56 branches. The Standard Chartered Bank has 21 branches. All other foreign banks have branches less than 10. These banks have concentrated mainly on corporate clients. Obviously, these banks have been specializing in areas relating to international banking. The presence of these banks in specialized areas like merchant banking is significant. In fact they have been making profits from their special products and international business.

3. **Co-operative Banking Structure:** Another important segment of the Indian Banking System is the co-operative sector banking. It mainly meets the credit needs of rural areas and agriculture. Three tier systems are operating in co-operative banking. State Co-operative bank acts as an apex body at the State level. District co-operative banks are operating at the district level and co-operative societies or banks are operating at the villages and towns level.

a) **State Co-operative Bank:** It is the apex body under three tier structures. Almost all the state and many Union Territories have State co-operative banks.

b) **District Co-operative Banks:** In the middle of the three-tier co-operative credit structure are the district co-operative banks. The main function of the district co-operative banks is to provide credit to the member primary co-operative credit societies. They are also free to make loans to individuals.

c) **Primary Credit Societies:** The primary credit society is the last link in the three-tier system. These societies are the grass root level institutions having a direct link with the people they intend to serve. These societies in rural areas are primarily agricultural societies and they serve the cultivators. The societies provide the cheapest possible credit to the members at a very low rate of interest.

4. **Specialised Banks:** These banks exist outside the commercial banking area. These institutions look after different sectors of the economy. For example, Industrial

development Bank of India, National bank for Agriculture and Rural development, Exim Bank, etc.

B. Unorganised Sector: This sector is classified into two categories:

1. **Indigenous Bankers:** Indigenous bankers are the forefathers of modern commercial banks. These are the individual or partnership firms performing the banking functions. They also act as financial intermediaries. As the name indicates, they are the local bankers. But the geographical area covered by the indigenous bankers was much larger than the area covered by the commercial banks. They e\are found in all parts of the country under different terms, e.g., in West India they are known as Marwari, in South India they are called Chettiars and in North India, they are called Sahukars.
2. **Money Lenders:** Money lenders depend entirely on their own funds for the lending. Money lenders include large, traders, goldsmith, artisans, village shopkeepers, etc.

   Structure of Indian banking System has taken its present shape over centuries beginning with ancient money lenders and sahukars. Many structural changes were recommended by the Banking commission, 1972. The Government of India has taken various steps from time to time to strengthen the banking system such as deposit insurance, social control, nationalization, establishment of rural banks, specialized banks, etc. As a consequence, the banking structure has emerged as a strong system which is in a better position to play its role in the economic development of the country.

1.12. TYPES OF BANKING SYSTEM

Commercial banks can be classified into various categories according to one criteria or the other. The criteria of classification of bank could be

A. Second Schedule of the Reserve Bank of India Act;
B. Domicile;
C. Ownership;
D. Functions or Specialized Area;
E. Organization,etc.

A) **Classification as per Second Schedule of RBI Act:** Banks can be classified into the following categories on the basis of the second Schedule of the Reserve bank of India Act, 1934 —

i) Scheduled Bank: A scheduled bank is one which is registered in the Second Schedule of the Reserve Bank of India Act. A bank must satisfy the following the following conditions to be included in the second Schedule:

a) The bank concerned must be in business of banking in India.
b) A bank must have a paid-up capital and reserves of not less than Rs. 5 lakhs; (Presently, the RBI has prescribed a minimum capital of Rs. 200 crore for starting a new commercial bank).
c) It must satisfy the Reserve Bank that its affairs are not conducted in a manner detrimental to the interest of its depositor; and it is either a company defined in Setion 3 of the Indian Companies Act, 1956, or Corporation or a Company incorporated by or under any law in force in any [place outside India or an institution notified by the Central Government in this behalf.

All scheduled banks come under the purview of the various credit control techniques of Reserve bank of India. Scheduled banks have to keep a minimum balance in their accounts with the RBI and perform certain things prescribed by law.

ii) Non-scheduled Bank: Non-scheduled banks are those banks whose names do not appear in the Second Schedule of the reserve bank of India Act. These are not entitled to all those facilities that the scheduled banks avail from the RBI.

B. Classification on the basis of Domicile: On the basis of domicile, banks are classified into the following types:

i) Foreign Banks: Foreign banks are those banks which are registered or incorporated outside India and having a branch in India. The number of foreign banks has increased with the changes in the banking policy after 1993. These are controlled and supervised by RBI. At present the RBI has allowed the foreign banks to establish the banking business in India through a single mode presence i.e., either branch mode or wholly owned subsidiary mode. Their principal function is to make credit management for exports and imports of the country. Some of the foreign banks having a work place in India are listed below:

1. HSBC
2. Standard Chartered Bank
3. Citibank
4. Bank of America

ii) Domestic Banks: Domestic banks are those banks which are registered or incorporated in India. These banks are the major part of total commercial banks.

C. Classification on the basis of Ownership: On the basis of ownership, banks can be classified into the following three groups:

i) **Public Sector Banks:** Public Sector banks are those banks which are owned by the government. The government runs these banks. In India 20 banks (14+6) were nationalized in 1969 and 1980 respectively. All these banks now belong to the public sector category. Public sector banks dominate commercial banking in India. Social welfare is their principal objective. The public sector banks raise capital from public by making public issues.

ii) **Private Sector Banks:** Private sector banks are those banks which are owned and run by the private sector. Banks which are owned by individuals or corporations and not by government or co-operative societies are included in this category. The major private sector banks are Bank of Punjab, HDFC Bank, Vijaya Bank, Axis Bank,, ICICI Bank, etc. an individual has control over these banks in proportion to the shares of the banks held by him.

iii) **Co-operative Banks:** Co-operative banks constitute another important section of banking. Co-operative banks are those banks which are jointly run by a group of individuals. Each individual has an equal share in these banks. The affairs of the bank are managed by its shareholders. Profits are equally distributed among the shareholders. The principal objective of these banks is the mutual help of the members of co-operative banks. The co-operative banks were started in India with the passing of the co-operative Societies Act, 1912. The co-operative banks perform the most urgent task of financing agriculture and small industry by mobilizing resources from theurban and the rural well to so strata.

The Primary Credit Societies, the Central Co-operative Banks and the State Co-operative Banks constitute the three tier system operating in co-operative banking. The co-operative banks were started with the aim to take the place of money lenders to meet short term capital needs of the agriculturists.

D. **Classification on the basis of Functions:** Banks are classified as under on the basis of their functions:

i) **Commercial Banks:** Commercial banks are the most important constituents of the banking system. These are the banks which do banking business to earn profit. These institutions specialize in the financing of internal trade ands also carry on other ordinary banking business of receiving deposits, advancing loans and of discounting bills. A commercial bank is a profit seeking business firm, dealing in money or rather dealing in claims to money. Commercial banks act as vehicle through which demand deposits act as medium of exchange and circulate among the public. A very large part of money supply is a direct consequence of the profit seeking or money-creating activities of commercial banks. According to Reed and Gill, “A commercial bank is a financial institution that accepts demand deposits ands makes commercial loans and is regulated by a bank regulatory agency”. Thus, a commercial bank is a bank which deals in money and credit for the purpose of earning profit. The State Bank of India, Punjab National Bank, Canara Bank are some of the examples of Commercial Banks.

ii) **Industrial Banks:** Industrial banks are those banks which offer long term and medium term loans to the industries and also work for their development. It helps in the industries in the sale of their debentures, bonds and shares. These banks themselves purchase the shares as well as underwrite the debentures and shares of the industries. Industrial banks give loans to the industries for the purchase of land and machinery. The industrial banks raise funds through long term investments like bonds, deep discount bonds with a maturity period of 20m to 25 years etc. In India, Industrial Development Bank of India, Industrial Finance Corporation, State Finance Corporations, etc., are industrial banks.

iii) **Agricultural Banks:** Agricultural Banks are those banks which give credit to agricultural sector of the economy. These banks provide long and short-finance to agriculturists and farmers. Long term loans are provided to farmers for acquisition and improvement of land and purchase of heavy agricultural equipments. Short term loans are needed by the farmers for the purchase of seeds, fertilizers, manures and payment of wages, etc. Most of the financing in the agricultural sector has been done by Agricultural Co-operative Banks and Land Mortgage Banks or Land Development Banks. In India, the Regional Rural Banks were established to provide rural credit. An important step in this sector was the establishment of the National Agricultural and Rural Development Bank (NABARD). Agricultural co-operatives provide finance for a short term whereas Mortgage Banks or Land Development Bank provides long term credit.

iv) **Exchange Banks:** Exchange banks deals in foreign exchange. Commercial banks which acquire the authorization from the Reserve Bank of India to deal in foreign exchange are exchange banks. The main function of exchange banks is financing and facilitating of foreign trade. These banks buy and sell foreign currencies and titles of foreign currencies in the form of bills of exchange drafts, telegraphic transfers, etc. exchange banks provides the following services:

a) Discounting of foreign bills of exchange;
b) Foreign remittances;
c) Purchasing and selling of gold and silver;
d) Issue of letters of credit;
e) Facilitate and finance international-trade;
f) Providing guidance in obtaining various clearances regarding transactions in foreign currency.

v) Savings Banks: The main aim of savings Banks is to collect small savings across the country and put them to the productive use. These banks aim at inculcating the habit of saving among the working classes i.e., middle and lower sections of the society. These banks receive deposits into saving accounts and also issue postal cash certificates. In India, a department of Post Offices functions as Saving Banks.

vi) Indigenous Banks: These banks found their origin in India. They made a significant contribution to the development of agriculture and industry before independence. Mahajans, rural money lenders and jewellers have been the fore-runners of these banks in India. The indigenous bankers employ their own capital. They generally grant loans against securities such as gold, jewellery, land promissory notes, hundies, etc. they maintain their account according to the "Mahajani" system. Their principle instrument of transacting business is the 'hundi' the internal bill of exchange. The indigenous bankers charge a high rate of interest.

E. Classification on the basis of Organisation Structure: Commercial banks may be classified on the basis of their organization as under—

i) Unit Banking: Unit banking is a system in which a bank operates in a specified area generally small and limited area. A unit bank performs its activities through a single office within limited resources having no branch office. The bank is a complete organization in itself having its own management. Unit banking is often referred to as localized banking. The operations of most of the unit banks are confined to specific places. This banking system was originated in U.S.A.

ii) Branch Banking: Branch banking is the most popular and important commercial banking system. In branch banking, a bank has a large number of branches scattered all over the country. Branch banking refers to that system of banking in which a bank establishes its head office in some big city and operates the various branches all over the country. Some of its branches may also be in foreign countries. Branch Banking System is popular in India, Britain, Canada, France, Germany, etc. In the words of Goldfield and Chandler, “A branch bank is a banking corporation that directly owns two or more banking agencies”. Branch banking is a system in which:

a) A bank renders its banking activities at two or more places.
b) Head office has the overall control over the working of various branches;
c) Branches can be opened in the same city, same state or the country in which the concerned head office is located or at different places;
d) Overall control of all the branches is done by one central authority i.e., board of Directors.

iii) **Group Banking:** Group banking is that banking system in which two or more banks operate under the control of a holding company. Under group banking two or more banks are brought under the control of the same management through a holding company. In the words of Goldfield and chandler, “Group Banking refers to the system in which a corporation or a holding company operates two or more banks simultaneously”. Under group banking, a holding company controls and manages the functioning of its subsidiaries banks. There can be more than one bank under the control and management of the holding company. The holding company is popularly known as parent company and the group of banks operating under holding company is called operating companies or subsidiary companies. This system is prevalent largely in the United States of America.

iv) **Chain Banking:** Chain banking is a banking system where the same banking individual or groups of individuals control two or more banks. In this system, an undivided or a group of individuals buy the bulk of shares of two or more banks and thus, happen to control and manage them. This system of banking became popular in USA in 1920. In this system, every bank in the banking chain has its own identity as well as independent board of management. However, it is possible that one individual is the member of various management boards. In the words of Shapiro, Solomon and White, “Chain Banking is an arrangement by which two or more bank–each of which retains its identity, capital and personnel are brought under common control by any device other than a holding company”.

v) Correspondent Banking: Under Correspondent Banking, small banks serve local communities by depositing fund with joint banks serving in big cities. According to Reed and Gil, "Correspondent Banking is an arrangement that exists among banks throughout the country based on the practice of smaller banks carrying deposits with larger banks in exchange for the performance of various services". Correspondent banks perform the following main functions:

a) To procure currency and coins from the Central Bank for distribution among smaller banks;
b) To help in clearing and collection of cheques for the member banks;
c) To assist in domestic and foreign payments on behalf of the member banks.
d) To render such agency services on behalf of the member banks as sale and purchase of securities, issuing bank drafts and the like.

Correspondent Banking is fairly popular in countries like USA.

vi) Universal Banking: Universal banking is a multipurpose and multifunctional supermarket offering both banking and financial services through a single window. It is a system of banking where banks undertake a blanket of financial services like — Investment banking, Commercial banking, Development banking, Insurance and other financial services including functions of merchant banking, mutual funds, factoring, housing finance. As per the World Bank, "In Universal Banking, large banks operate extensive network of branches, provide many different services, hold several claims on firms (including equity and debt) and participate directly in the corporate governance of firms that rely on the banks for funding or as insurance underwriters".

The concept of universal banking is mentioned by the two reports in India in 1998 — the Narasimham Committee Report and the S.H. Khan Committee Report. Both these reports suggested consolidating the banking industry through mergers and integration of financial activities. They suggest a combination of all banking and financial activities. Hence, they advised a universal banking. In 2000, ICICI asked permission from RBI to become a universal bank.

vii) Deposit Banking and Mixed Banking: Deposit banks, as their name suggests, operate largely on the basis of their deposits. In this category, the banks act as custodian or trustees of the depositors.

Mixed banking is a system of banking in which certain banks undertake both commercial and industrial banking functions. It is the combination of deposit banking and investment banking. Germany's banking system is the best example of mixed banking. In India, the banks are permitted to undertake limited investment activity. In USA, commercial or credit banks are not permitted to undertake investment activity.

F. **Retail Banking:** Retail banking refers to a banking activity that is geared basically towards individual customers. The service of retail banking is generally provided by commercial bank. Retail banking strictly focuses on consumer markets. A wide range of personal banking facilities are offered by retail banking. Retail banking products include — offering savings and current accounts; bill paying services; debit and credit cards; personal loans; housing loan; educational loan; vehicle loan etc. The essence of retail banking lies in individual customers.

G. **Narrow Banking:** A 'Narrow Bank' can be defined as the system of banking under which a bank places its funds in risk-free assets with maturity period matching its liability maturity profile. There is no problem relating to asset liability mismatch. The quality of assets remains intact without leading to emergence of sub-standard assets. The concept of narrow banking is practically being implemented by the Indian banking system partly, as a large part of the deposits mobilized i.e., more than 46% by banks, has been deployed in government securities against a prescribed limit of 25% in the form of Statutory Liquidity Ratio as it offers a safe avenue of investment but at a very low return. It keeps the level of NPA low and the requirement of capital adequacy ratio also as the risk weight allotted to such securities is only 2.5% compared to 100 % in loan assets. In short, in narrow banking, a bank may be concentrating only on collection of deposits and lend them or invest the money within a particular region or certain selected activities like investing the funds only in government Securities.

H. **Off Shore Banking:** Off shore bank may be defined as a bank situated outside the country of residence of the depositor. Typically, off shore banks are located in a low tax jurisdiction that offers financial and legal benefits. The benefits include — greater privacy, low or no taxation, easy access to deposits, protection against local political or financial instability. The most off shore banks are located in island nations. Off shore banking unit is a branch of a foreign bank located in an offshore financial centre. It may accept deposits from other foreign banks and make Eurocurrency loans, but may not accept deposits from or make loans to the residents of the country in which it is located. Off shore banks are otherwise unrestricted in their legitimate activities and are free from the monetary controls of the country of location.

I. **Corporate Bankin**g: Corporate banking includes financial services specially offered to corporation such as cash management, financing, underwriting and issuing of stocks, bonds or other instruments. Financial institutions often maintains specific divisions for handling the needs of corporate clients, separate from customers or retail banking activities for individual accounts. The Corporate Bank is a leading provider of financial services to top-tier multinational clients around the globe, serving the financial needs of prominent corporations and financial institutions of world. It refers to the aspect of banking that deals with corporate customers. Commercial banks provide the following products and services to corporations and other financial institutions — loans and other credit products; treasury and cash management services; equipment lending; trade financing; investment banking; project finance; advisory services; shareholding.

J. **Payment Banks:** Payment banks will provide saving, deposit, payment and remittance services targeted towards people without access to formal banking system. On August 19, 2015 Reserve Bank of India gave ‘in principle’ licences to 11 entities to launch payment banks: Aditya Birla Nuvo; Airtel M Commerce Services; Cholamandalam Distribution services; Department of Posts; FINO Pay Tech; National Securities Depository; Reliance Industries; DilipShangvi, Sun Pharmaceuticals; Vijay Shekhar Sharma, Paytm; Tech Mahindra; Vodafone M-Pesa. The ‘in principle’ license is valid for 18 months within which the entities must fulfil the requirements under the guidelines and fulfil the other conditions as may be stipulated by the Reserve Bank of India. The goal behind creating payment banks is to bring about financial inclusion, by making it easier for anyone to get a bank account. The real effect will come to remittance within the country, as it will become easier for people to send money uptoRs. 1 lakh home to smaller towns and villages while working in the city.

K. **Internet Banking:** I-banking involves use of internet as a medium of communication for accessing and utilizing host of banking and financial services. The customer’s demand for personalized service and the concept of “Anywhere and anytime banking” has made internet banking as one of the primary delivery channel available to present day customers. Internet banking has enhanced capabilities like providing Online Utility Bill Presentment and Payment Systems, Online Share trading, Demat and Broking Services, Online Purchases and Auctions, Fund Management and Payment Gateways besides providing the routine Banking Services. Advantages of Internet banking for a customer include convenience, round the clock accessibility, instantaneous transactions, single window view of all accounts with drill down features, etc. Internet Banking is a customer delight which fulfils most of his aspirations.

L. **Core Banking:** Core banking is a banking service offered by a group of networked bank branches. Core Banking stands for "Centralized Online Real-time exchange". It primarily meant that all the branches could access applications from centralized data centres. It means that the deposits made by customer have been reflected immediately on the bank's servers and the customer could withdraw the deposited money from any of the bank's branches. Hence, a core banking system is the software used to support the most common banking transactions. The elements of core banking includes, making and servicing loans; opening new bank accounts; processing of cash deposits and withdrawals; processing of payments and cheques; calculation of interest; customer relationship management (CRM) activities; managing the customer accounts; establishing criteria for minimum balances, interest rates, number of withdrawals allowed and so on; establishing interest rates; maintaining records for all the transactions of bank.

1.13. TRANSACTION BANKING

Transaction banking is the process of money transfer, typically for corporates by banks. It includes commercial banking products, domestic and cross-border payments, professional risk mitigation for international trade and the provision of trust, agency, depository, custody and related services.

Today, you may or you may not know that every day billions of transactions are made around the world. It's a tremendous and an extraordinary amount of money which is being transferred from here to there.

What the word 'transaction' simply means over here is, the process of money transferring from one place to another. Nobody today, especially the corporate world can ever deny that transaction is one of the most critical parts of any business, and therefore the banks all over the world need to be involved in this area, what we call 'transaction/transactional banking.

1.14. TYPES OF TRANSACTION

Here you will find a list of the various types that can be assigned to transactions in Bank. The definitions provided for banking transaction types are relatively loose; although some types force transaction amounts to be either positive or negative, the differences between these types are for the most part nominal. The transaction types for investment transactions are more strictly defined and affect the behaviour of the transactions, so you should use discretion when choosing the appropriate type for these transactions.

Banking account transaction types:

- **ATM:** Deposit or withdraw funds using an ATM.
- **Charge:** Record a purchase on a credit card or withdraw funds using a debit card.
- **Check:** Withdraw funds by writing a paper check. Choosing this type will automatically insert a number in the '#' field (the next number in sequence from the last check recorded).
- **Deposit:** Add funds to an account by any method.
- **Online:** Withdraw funds through a web-based store or online banking service.
- **POS:** Withdraw funds through a point-of-sale transaction (typically a cash or debit card purchase).
- **Transfer:** Move funds from one account to another
- **Withdrawal:** Deduct funds from an account by any method.

Investment account transaction types:

- **Buy:** Withdraw cash and purchase shares of a security.
- **Buy to Close:** Close a short position (opened with "Sell to Open") by withdrawing cash and purchasing security shares or option contracts. Use this transaction type with a price of "0.00" to close a short position for contracts that expired or were exercised.
- **Buy to Open:** Withdraw cash and purchase option contracts (to open a long position).
- **Dividend:** Deposit cash received from the profit made on an investment. Use the funding/distribution type to record a reinvestment instead of a cash dividend.
- **Cap. Distribution:** Deposit cash received as a return of capital distribution that should not be treated as a dividend for tax purposes. The cost basis of the security is also reduced by the same amount.
- **Cap. Gains Long:** Deposit cash received from a mutual fund, partnership, or hedge fund from the sale of long-term security shares (the number of shares you own is not affected).
- **Cap. Gains Short:** Deposit cash received from a mutual fund, partnership, or hedge fund from the sale of short-term security shares (the number of shares you own is not affected).

- **Interest Income:** Deposit cash earned as interest on a security (most commonly a bond).
- **Move Shares:** Add or remove shares of a security without affecting the cash balance of your accounts and without incurring a capital gain or loss. Entering a share price with this transaction type while adding shares will adjust the cost basis for the corresponding security. Use this transaction type for recording gifts of stock, security transfers, and other share adjustments.
- **Sell:** Deduct shares of a security and deposit cash from the sale.
- **Sell to Close:** Close a long position (opened with "Buy to Open") by deducting option contracts and depositing cash from the sale. Use this transaction type with a price of "0.00" to close a long position for contracts that expired or were exercised.
- **Sell to Open:** Open a short position by deducting security shares or option contracts and depositing cash from the sale.
- **Split:** Record a stock split. Enter the number of shares gained as a result of the split, or in the case of a reverse split, enter the number of shares lost as a negative number.

1.15. WORKING OF BANKS DURING 1947 to 1991 AND THEREAFTER

The past four decades and particularly the last two decades witnessed dramatic changes in the field of commercial banking all over the world. Indian banking system has also followed the same trend. In over five decades since independence, banking system in India has passed through five distinct phases, i.e.,

1. Evolution Phase (prior to 1950)
2. Foundation phase (1950-1968)
3. Expansion phase (1968-1984)
4. Consolidation Phase (1984-1990)
5. Reform phase (Since 1990)

Here we shall discuss the working of banks during the period 1947-1990 and thereafter.

Working of Banks during 1947-1969: Prior to independence, the role of commercial banks in India remained confined to providing vehicle for community's saving and attending to the credit needs of only certain selected and limited segments of the economy. After independence, in 1949, Banking Regulation Act was passed for regulation and supervision of banks. It gave wide powers to RBI to regulate, supervise and develop the banking system. In this period, stress was made on the sound and strong foundation of banking system. During 1950 to 1969, two important developments took place, first, the All India Rural credit survey committee, which examined the issue of credit availability at the rural areas, recommended the creation or a State partnered/ sponsored bank entrusted with the task of opening branches in the rural areas. Accepting this recommendation, the State Bank of India Act, 1955 was passed and the Imperial bank was renamed State bank of India. Later in 1959, the State Bank of India (Subsidiary Bank) Act was passed enabling SBI, to takeover 8 princely state associate banks, as the subsidiaries. Now, these are known as Associate Banks of SBI. Secondly, the need about wider diffusion of banking facilities and to change the uneven distributive pattern of bank lending was realized. The scheme of social control, over banks, was announced in the Parliament in December, 1967. The National Credit Control Council was set up in 1968 to assess the demand for bank credit, from various sectors of the economy and to determine their respective priorities in allocation.

Working of Banks during 1969 to 1984: This phase is known as expansion phase and started in mid 1960's but gained popularity only after the nationalization of 14banks in July 1969. It was a phase of 'mass banking'. The Indian banking scene underwent significant changes during the period 1969 to 1990. The social control measures of not less than 51% of the directors of the board of a banking company had to consist of persons with special knowledge or practical experiences in respect of accountancy, agriculture, rural economy, banking, cooperation, economics, finance, law and SSI's, were not considered adequate to achieve the desired social and economic objectives. The Government of India, therefore on 19th July, 1969 nationalised 14 major commercial banks, by an ordinance, having deposits of Rs. 50 crore and above. The objectives of nationalization were growth; reduction in regional imbalance of economic activity; to make the banking system reach out to the small man in rural and semi-urban areas; extending banking facilities to areas hitherto not served by banks so that they not only mop-up potential savings but also meet the credit gaps in agriculture, small-scale industries and other neglected sectors of the economy. The aim was to bring large areas of economic activity within the organised banking system. The two significant aspects of nationalisation were therefore: rapid branch expansion and channelling credit according to priorities

Again in 1980, the Government of India had nationalized another 6 banks, each having deposits of Rs. 200 crore or above. Another important development was the formation of the regional rural banks (RRB's) which were started in 1976 under the Regional Rural banks Act, 1975, as per the recommendations of the Narasimham Committee in 1974. Their ownership vests with the sponsoring commercial bank, the Central Government and the State Government of the area. Under this approach, 196 RRBs were set up.

During nationalization and thereafter, there was wide branch expansion in rural and semi-urban areas, backward regions and under banked states so that inter-regional disparities could be reduced. One of the objectives of branch expansion was to mop-up national savings, both actual and potential and channel them into investments according to Five Year Plan priorities.

Working of Banks during 1984 to 1990: This period is called Consolidation Phase. This phase started in 1985, as a result of weaknesses that emerged during the expansion phase. The RBI started some initiatives in form of relaxation in control, slowed down branch expansion programme, etc. The focus was made on house keeping, customer service, management productivity and profitability. The main objective of these relaxations was to overcome the weaknesses which emerged from fast expansion and strict control of Reserve Bank of India. The banks were asked to introduce, in a phased manner, modern technology in banking operations, following the recommendations of the Rangarajan Committee on computerisation in banks. Emphasis was laid on the financial viability of banks through improvement in profitability, strengthening the capital base of banks and allowing the flexibility in several areas of their operations.

Era of Economic Reforms (1992-2002): This period may be regarded as the present or the current phase in the evolution of Indian banking. Like the phase of 1969-1991. Began with a bang, i.e., nationalization of banks, the current phase also began towards market-oriented banking, as a result of the introduction of financial reforms, especially banking reforms. India's economic reforms programme began as a response to the macroeconomic crisis that developed in early 1991. The crisis manifested itself in rising inflation, high level fiscal deficit, low growth and unsustainable current account deficit and the Gulf war of 1990 precipitated the balance of payments crisis.

The main plank economic reforms comprised:

a) Stabilisation of the economy so as to keep under control inflationary and balance of payment pressures.
b) Deregulation of the real and financial sectors and removal of licence and permit system from all spheres.
c) Liberalization of international trade in various sectors to promote competition and efficiency by removing the high degree of protection enjoyed by the domestic industry and
d) Integration with world economy to attract capital and modern technology.

The banking reforms have the specific task of achieving:

a) A suitable modification in the policy framework within which banks operate,
b) Improvement in the financial health and competitive capabilities of banks,
c) Building financial infrastructure relating to supervision, audit and technology and
d) Upgradation of the level of managerial competence and the quality of human resources.

The basis for banking reforms was proved by the Committee on Financial System (Narasimham Committee) which made recommendations in November, 1991, for transforming highly regulated policy to a more market-oriented system. Such various measures were:

a) Reduction in the pre-emption of funds through lowering of the CRR and SLR from 63.5% to 31.5% (CRR 6.5% and SLR 25%) in Oct. 2001.
b) Redefining and redesigning direct credit programmes.
c) Dismantling administered interests.
d) Establishment of Discount and finance House of India, securities trading corporation of India and negotiated Payment Settlement system.
e) Improving financial health of banks through prescription of risk weighted capital adequacy ratios, recapitalization and restructuring of weak banks.
f) Amendment to the bank branch licensing policy to deal effectively with the loss making branches.
g) Withdrawing the concept of MPBF and increasing the share of loan segment in bank credits.
h) Setting up of special Debt Recovery Tribunals (DRTs) for improving recovery of bank loans.
i) Norms for floating new private sector banks.
j) Deregulation of interest rates on loans over Rs. 2 lakh.

Various measures were taken by RBI and Government for economic reforms as:

a) Introduction of Banking Ombudsman Scheme in 1995.
b) Freedom to banks to decide their Prime Lending rate (PLR).
c) Introduction of the concept of Local Area Banks.
d) Granting of conditional autonomy to the public sector banks.
e) Revision of capital adequacy norms in 1998-99.
f) Deregulation of interest rates on term deposits.
g) Introduction of Voluntary Retirement Scheme (VRS) in public sector banks resulting in about 11 % reduction of employees in 2001.

h) Nationalized banks are permitted to raise capital from public upto 49%of the capital.

i) Introduction of electronic funds transfer schemes for fast cash management, installation of ATM, Internet Banking, credit Cards etc. to provide high quality services to customers.

j) Merger and acquisition of banks and subsidiaries has taken place to strengthen their operation and geographic reach.

There has been a growing presence of private sector banks, more so, after the introduction of financial sector reforms from 1992.

Working of Banks beyond 2002 to date: The first phase of financial reforms laid the basis for a sound banking system. Considerable progress has been made in implementing the reforms and the banking system is now moving towards the second phase. The Indian banking system faces several difficult challenges, viz., high cost of doing business, yearly increase in NPA, low levels of customer satisfaction, phenomenal growth in the volume of capital inflows, etc. Therefore, the banks have to reorient their strategies in light of their own strengths and the kind of market in which they are likely to operate. There are several areas of concern, which need to be addressed.

1. **New Dimension:** Indian banks operate in a deregulated competitive financial sector. Competitive pressure is building up for banks, both from within and from outside. Competition is likely to intensify in the coming years within the industry, from NBFCs and from foreign entities. Competition is not just in term of number of competitors but in terms of proliferation of innovations, specialized markets, cross border trade in financial services and capital inflows.
2. **Transforming the Banking System:** Our reforms have made progress but we have not become competitive internationally. We have to transform the Indian banking system from being a largely domestic to a truly international one and this should enable India to emerge as an international banking centre.
3. **Changes in Product Pricing:** In the changed and liberalized banking environment of the country, the bank products have to be priced on the basis of risk assessment.
4. **Information and Communication Technology:** The worldwide revolution in information and communication technology (ICT) has become the biggest force of change in banking. It is a source of productivity, growth and facilitates effective competition. ICT has reduced costs, increased volumes and has facilitated customized products. It plays an important role in the payments and settlement system. Technology has opened up new avenues in banking for discharging the same functions in a cost

effective manner, 24-hour × 7 days banking, tele banking, internet banking, e-banking and home-banking. The process of technological change is just beginning in Indian banking. Even the use of existing technology is at low levels.

5. **Exposure to Risks:** Asset-liability mismatches expose the banks to various types of risks, i.e., risks of illiquidity and insolvency, risks arising from globalization and deregulation. Risk management is a continuous process of controlling assets and liabilities in terms of size, maturities and yields. As operations in the financial market become varied and complex, banks have to equip themselves with a variety of skills and appropriate technology. The RBI has issued guidelines to banks in April 1999, for asset-liability management which would help the bank management to meet the challenges. Banks are encouraged to prescribe risk parameters and establish effective control system.
6. **Self regulation by Banks:** Under the process of liberalisation, banks have to follow the self regulation through a self regulatory organisation. In any banking system, no bank, howsoever owned, can survive unless it continuously strives to transform its organisation as a self-governing, self-correcting and self-adjusting equity.
7. **Customer Relation:** There are two models, emerging in the banking scenario today. One of them is universal banking in which banks are attempting to provide products and services developed by them to the customers. The second one is Customer Relation Management (CRM). Many retail banks are focusing on new strategies to maximise customer acquisition, cross sell, retain customers, and increase profitability, while increasing customer service and satisfaction levels, reducing product costs and improving distribution. Banks have started selling their customers, online banking and consultation services to add both value to their services and to satisfy their customers.
8. **Pressure on Spreads:** Spread is the difference between interest earned and interest payable. The competition in banking sector will bring pressure on spreads. After liberalisation, banking is going through a metamorphosis. Technology, deregulation, disintermediation and securitisation are the major forces that are producing ripples in the industry. Supported by the latest technology going for core banking solutions, banks are working to identify new business niches, to develop customised services, to implement innovative strategies and to capture new market opportunities.
9. **Business Diversification:** Today, some investment and commercial banking institutions compete directly in money market operations, private placement, project finance, bonds, underwriting and financial advisory work. Furthermore, the modern banking industry has brought greater business diversification. Some banks in the industrialised world are entering into investments, underwriting of securities, portfolio management and the

insurance businesses. Taken together, these changes have made banks an even more important entity in the global business community.

10. **Managing Technology:** After liberalisation, all the new private sector banks have introduced international standard functioning like use of electronic funds transfer scheme for fast cash management, installation of ATMs', Internet banking, credit Cards to provide high quality of products and services to customers. The public sector banks lack such advanced technology in their functioning. Though RBI and the banks have been taking steps in the last few years, computerisation has been mostly directed towards accounting and related activities, without emphasis on critical areas relevant to management and customer-service and customised products. The Indian banking system will have to redouble its efforts to build the technological infrastructure not only to provide cost-effective and competitive customer-service but also to achieve international recognition and status.
11. **Management of Non-Performing Assets:**The level of non-performing assets (NPAs) though declining in recent years, continues to be high by international standards. NPAs have become a first charge on banks for provisioning and these affect banks performance by eating into its profitability. The most important condition for improvement in the profitability of banks is a reduction in the level of NPAs. The response to the efforts at debt recovery and restructuring of assets and other methods has been slow. The strategies for containing the problems of NPAs should emphasise the strict enforcement of prudential norms and requirements, transparency and disclosure and the need for legislation which will make the recovery process smoother. In any effort to build a banking system of international stature, reduction in NPAs should be the priority target.
12. **HRD Rigidities:** Human resource development (HRD) is the most important need for a service industry like banking. The approach to human resources management in banks will have to change in tune with the fast-changing banking environment at home and abroad. While it is difficult to bring about radical changes in the staff structure in the near future, public sector banks can effect improvements in the existing practices of recruitment, training and redeployment. The focus must shift from generalist orientation of the staff to specialist orientation, i.e., the ability to imbibe and absorb technology. Information technology is an area where HRD is now critical. There is also the urgent need for training for upgradation of different types of skills, for redeployment, for changing the mindset and attitudes. It is time that banks revamp their HRD departments and evolves appropriate policies to make the best use of their primary asset, i.e., human resources. The banks have to prepare for tightening of prudential norms as the new Basel Accord becomes effective. According to the New Capital Accord, banks would have to

provide capital in terms of “Economic Capital” rather than the minimum regulatory capital. Bank managements will therefore have to develop internal capital evaluation according to their risk profile.

13. **Corporate Governance:** Corporate governance is assuming greater importance in the banking sector today as a result of uncertain unhealthy developments in recent years. The main focus in corporate governance is how to enhance shareholder value; and this needs to be achieved in a legal and ethical manner leading to contribution to business prosperity. The major ingredients of good corporate governance would be accountability at all levels, transparency and enhancing the image of the organisation in the eyes of the public. Public sector banks have to pay considerable attention to corporate governance in the context of deregulation, prudential norms, risk-based supervision and globalisation.

    The response groups in the banking system are banks, RBI, the government and the customers and the onus is on them to raise Indian banking to international standards.

The Banking sector reforms in India are an integral part of the overall programme of economic reforms aimed at improving productivity and efficiency blended with innovations. Reforms are successful only if it is accompanied by fiscal consolidation, moderate inflation and no sharp appreciation in the real effective interest rate. Improving the profitability and viability is only one aspect of increasing the performance of banks. The other is how adequately and satisfactorily banks are able to meet the demand of customers. The ultimate test of success of the banking reforms is true customer satisfaction.

1.16 SUMMARY

Bank may be defined as an institution which accepts deposits from the public and advances loan to those who are in need and can provide security. According to oxford dictionary bank is an establishment for the custody of money which it pays out on customers order. Commercial banks play a significant role in economic growth and development of developing countries like India. Commercial banks are the nerve-centre of the capital market, industrial and trading activities of a country. The commercial banks are the most important financial institutions and play an important role in the economic development of the country.

Money creation is considered to be the main and important function of commercial banks these days. Commercial banks are able to create credit because the demand deposits are accepted by the public in settlement of their debts. This function is automatically performed by banks while advancing credit and loans or by accepting deposits. Money creation refers to the power of commercial banks to expand secondary deposits either through the process of making loan or through investment in securities.

The structure of Indian banking system that evolved during the pre-Independence period was without any purposive control and direction. At the time of independence the country has

the RBI at the top and a variety of other banking institutions. The imperial bank of India had a unique position among the commercial banks.

The structure of Indian banking system can be broadly classified into two categories i.e. organised sector and unorganised sector. In the organised sector the main constituents are Reserve Bank of India, commercial banks, co-operative banks and specialised banks. Whereas unorganised banking sector is classified into two categories- indigenous bankers and money lenders.

The past four decades and particularly the last two decades witnessed dramatic changes in the field of commercial banking all over the world. India banking system has also followed the same trend. As a matter of fact, the changes here have been more pronounced than elsewhere also. In over five decades since its independence, banking system in India has passed through five distinct phases, i.e.

1. Evolution phase (prior to 1950)
2. Foundation phase (1950-1968)
3. Expansion phase (1968-1984)
4. Consolidation phase (1984-1990)
5. Reform phase (since 1990)

The banking sector reforms in India are an integral of the overall programme of economic reforms aimed at improving productivity and efficiency blended with innovations.

1.17 SELF ASSESSMENT QUESTIONS

1) Define commercial bank and discuss the main functions of commercial banks.
2) What are the main functions of the bank?
3) Discuss the role of banks in promoting economic growth of a country.
4) What do you mean by creation of money? How does commercial bank create credit?
5) How do commercial banks create money in the economy?
6) Briefly explain present structure of commercial banking in India.
7) Explain the different types of banking system.
8) Define unit banking and discuss its merits and demerits.
9) Discuss the impact of reforms in Indian banking in India.
10) Discuss the recommendations of Narasimham Committee 1991.

UNIT2 MANAGEMENT PRINCIPLES IN BANK

Structure

2.0 OBJECTIVES-

After studying this unit you will be able to understand-

- Managerial functions in banks
- Details about board of directors
- Management of deposits
- Management of advances
- Details about investment reports
- Nature of bank investment

2.1 INTRODUCTION TO MANAGEMENT OF COMMERCIAL BANKS

A banking company, like any other company or corporate body, is an artificial person existing only in the eyes of law. It has separate legal entity with no physical existence of its own. It acts through the natural human beings that are termed as 'directors' and collectively designated as 'Board of directors'. It is the supreme authority which manages the affairs of a bank and is responsible for efficient operations and management of the bank. The board of directors, by their efficient management and good organizational structure, aim at improving operating efficiency, increasing profitability, building and retaining public confidence, which will not only attract more deposits but also enhance scope for expanding banking business.

2.2 OBJECTIVES OF BANK MANAGEMENT

The basic objective of the commercial bank's management in the modern set up is not only to maximize profits but also to discharge social responsibilities. Social responsibilities include responsibilities towards shareholders, employees, customers, other banks, government and the weaker sections of the society. An efficient management is a pre-requisite for the success of the commercial banks in achieving the following objectives —

1. **To improve the customer services:** one of the important objectives of bank management is to improve the customer services.
2. **Maximisation of Profitability:** To maximize the profits is the main objective of the bank management.
3. **Introduction of New schemes:** The objective of the bank management is to innovate and introduce new schemes to expand the banking business.
4. **Social Responsibility:** It is the objective of the bank management to discharge social responsibility towards the society, especially its weaker sections.
5. **To Meet Challenges of Competitors:** The changing scenario arising from globalisation and liberalization as well as competitors from within and outside has posed a number of challenges before the bank management , which has to be dealt with in an efficient manner.
6. **Introduction of technology:** The bank management aims at computerizing and adopting new technologies to make banking services more efficient and time bound. The introduction of online banking, ATM facility, internet banking, etc. is the main examples.
7. **Manpower Planning:** It is the objective of the bank management to develop its manpower by giving required training. The bank management also motivates its employees to work efficiently, productively and profitably.
8. **Improvement in the system of Inspection;**The bank management tries to improve the system of inspection and social audit.
9. **Improvement of Productivity:** The bank management makes serious efforts to improve the output of the bank to compete with private banks.

2.3 MANAGERIAL FUNCTIONS OF BANK MANAGEMENT

The fundamental functions of bank management are as follows:

1. **Planning:** Planning is the activity through which a bank decides its future course of action. It refers to a set of objectives or goals of a bank and determines the policies, programmes and procedures to achieve pre-decided objectives. Planning is the bridge between the present and future of a bank. It provides the bank management some goals, aims, objectives, programmes and direction towards the goals.
2. **Organising:** Organizing is the second important function of bank management. Organising is the process of arranging and allocating the bank activities, authority and resources among the bank employees so that they can efficiently achieve the goals of the organisation. Organization involves division of total bank activities into different department for efficient execution.
3. **Staffing:** Staffing is the management of human resources in the organization. Staffing refers to the function of selecting, training, deciding the wages and salary and appraisal of the work of the members of the bank staff. The staffing function is concerned with the provision of right persons, in the right numbers, at the right time and in the right place in a bank. Staffing involves sufficient supply of adequately developed and motivated people to perform their duties and tasks required to meet the banking objectives.
4. **Directing**: In bank management, directing refers to instructing, guiding, counseling and supervising the bank staff. it is concerned with leading, motivating and guiding the staff of bank to perform activities in the most efficient way to achieve the desired goals.
5. **Controlling:** Controlling is the measurement of the performance of the subordinates to ascertain whether or not they have met the objectives of the bank and abided by its established policies and rules. The control process involves the establishment of standards, measuring performance in accordance with these standards and correcting deviations from the established plans and programmes. Controlling also ensures efficient use of scare and valuable resources of the banks. It improves customer services, raises efficiency and controls frauds and scams.
6. **Communication:** it is the process of communicating the established objectives, policies and rules of operation to all who have need of them. Communication is the chain of understanding that integrates the staff members of the bank from top to bottom and bottom to top. Communication is the way of conveying the ideas, views, information and directions from one person to another. Computerisation and online banking have become an important source of communication.

2.4 FUNCTIONAL AREAS OF BANK MANAGEMENT

The functional areas of bank management refer to the important functions to be performed by the staff of the bank. It consists of the following functional areas:

1. **Deposit Mobilisation:** The bank management formulates saving schemes and makes efforts for mobilisation of deposits. The bank management plays an important role in inculcating banking habits.
2. **Credit Management:** The credit management refers to appraisal, sanction, distribution, recovery and administration of the loans and other types of credit.
3. **Liquidity Management:** Liquidity of a bank is the main determinant of bank's reputation and goodwill. It relates to Cash Reserve Ratio (CRR), statutory Liquidity Ratio (SLR), trading in bank receipts and other short term securities.
4. **Financial Management:** The financial management includes cost control, financial planning, management accounting and other related problems.
5. **Profit evaluation:** It is an important functional area of bank management. It requires a dynamic approach. It covers cost benefit analysis, forecasting, flow of funds and estimation of return.
6. **Marketing Management:** The marketing management refers to marketing services, customer services and marketing research.
7. **Investment Management:** Investment management is another important functional area of bank management. The main source of bank's profits is the investment made by the banks of their deposits. It relates to underwriting of securities and investment in equities.
8. **Portfolio Management:** The portfolio refers to the composition of different types of income earning assets. This functional area is mainly related with asset management. The bank management has to select, make appraisal and evaluate different types of assets.

2.5 BOARD OF DIRECTORS

The Board of Directors is the apex management of a commercial bank. The Board is more concerned with policy making and strategic issues of the bank. The directors occupy a pivotal position in the management of the bank and are charged with many operational responsibilities. The Board of Directors frame policies concentrate more on important issues and take strategic decisions. The routine business is left to be done by Officers/Managers. The Board of Directors is ultimately responsible for the overall operations of the bank.

Statutory Provisions regarding Constitution of Board of Directors

The banking companies (Regulation) Act 1949 has laid down some specific provisions to streamline the administration and management of the bank. Section 10A of the Act has laid down certain provisions for constituting the 'Board of Directors' in a commercial bank, in India. It provides that not less than fifty one percent of the total number of directors on the board shall consist of persons having special knowledge or practical experience in respect of one or more of the matters, namely, accountancy, agriculture, rural economy, co-operation, small scale industries, economics, finance, law or any other special knowledge or experience which would be useful to the banking company. The directors so appointed shall not have any substantial interest, association or connection with any large scale or medium size industrial or business undertaking. The chairman of a bank is to be a whole time professional and not an industrialist. His term cannot exceed 5 years, but shall be eligible for re-election or re-appointment.

Prohibitory Provisions regarding Constitution of Board of Directors

Section 10 of the Act provides certain safeguards for the management of the bank and imposes certain prohibition or restriction. This section lays down that

No Banking Company —

a) Shall employ or be managed by a managing agent; or
b) Shall employ or continue the employment of any person
    i) Who is, or at any time has been, adjudicated insolvent, or has suspended payment or has compounded with his creditors, or who is, or has been, convicted by a criminal court of an offence involving moral turpitude; or
    ii) Whose remuneration or part of whose remuneration takes the form of commission or of a share in the profits of the company;

Provided that nothing contained in this sub-clause shall apply to the payment by a banking company of any bonus in pursuance of a settlement or award arrived at or made under any law relating to industrial disputes or in accordance with any scheme framed by such banking company or in accordance with the usual practice prevailing in banking business;

— any commission to any broker, cashier contractor, clearing and forwarding agent, auctioneer or any other person, employed by the banking company under a contract otherwise than as a regular member of the staff of the company; or

    iii) Whose remuneration is, in the opinion of Reserve Bank, excessive, or

c) Shall be managed by any person
    i) Who is director of any other company;
    ii) Who is engaged in any other business or vacation; or

iii) Whose term of office as a person managing the company is for a period exceeding five years at any one time.

Further Section 16 of the Act prohibits the appointment of any person as a director, who is a director

i) of any other banking companies, or
ii) of companies which among themselves are entitled to exercise voting rights in excess 20% of the total voting rights of all the shareholders of the banking companies.

The banking regulation Act has conferred special powers on Reserve Bank and made prior permission obligatory for the appointment, reappointment or removal of chairman, managing or whole time director, manager or chief executive officer.

New Management Scheme of Nationalised Banks

After the nationalization of 14 commercial banks in 1969, the Government introduced a new management scheme called "The Nationalised Bank (Management and Miscellaneous Provisions) scheme 1970 to bring about structural changes in the top management of nationalized banks. According to this scheme, the nationalized banks will be managed by 15 members nominated Board of Directors including Chairman. The committee will comprise of the following —

a) One or two whole-time Directors.
b) One Director who is official of the Central Government.
c) One Director who is an official of RBI.
d) One director to represent workmen (Staff) of the bank.
e) One Director to represent non-workmen (officers) of the bank.
f) Three directors to represent the interest of farmers, workers and artisans.
g) Not more than five directors having special knowledge or practical experience of one or more matters which are likely to be useful for the working of the bank. They may be industrialists, economists, financial experts, management expert, lawyers, co-operators, etc. (though this is not specified in this scheme).
h) One director to represent the depositors of the bank.

Each of the nationalized banks will have separate offices for the rank of the Chairman and the Chief Executive.

Management Committee: The Act was further amended in 1986. The scheme provided for constituting management committee for each bank. The committee will comprise of the following —

i) The Chairman

ii) The Managing Director

iii) Director appointed (one each) by RBI and Central Government

iv) and not more than four directors nominated by the Government holding office for not more than one year at a time. The directors appointed by RBI and Central Government and the chairman would be continuing as members of the society. Other directors will hold position on managing committee by rotation. The scheme also provided for the constitution of Regional Consultative Committee to advise Government and the RBI, regarding problems in respective regions.

2.6 FUNCTIONS OF BOARD OF DIRECTORS OF A BANK

The success of a bank depends upon how efficiently the 'board of directors' perform their functions. Following are the important functions of Board of Directors of a Bank:

1. **Determination of Objectives:** The Board of Directors determines the objectives of banks business which are essential for framing the bank policies.
2. Formulation of Bank Policies: They formulate bank policies which are conducive to the attainment of its objectives.
3. Selection of Officer: The board of Directors selects the officers keeping in mind the policies of a bank.
4. Supervision on Loans and Investment: They provide check on loans and investments and ensure that they are carried out in accordance with the rules and regulations of the banking.
5. **Counselling to Executives:** They provide counselling to bank executives and help them in reaching decisions. It also evaluates the performance of executives.
6. **Business Development Programme:** They provide help to business development programme by

   —their vast professional experience and knowledge; and

   —mobilizing business for the banks by virtue of their influential position in the society.
7. **Constitute Standing Committee:** They constitute standing committee in order to ensure better co-ordination between various departments. Special committees are also constituted to handle exceptional matters.
8. **Delegation of Authority:** They determine authority and duties of executives to perform their functions properly and efficiently.

2.7 DUTIES AND LIABILITIES OF DIRECTORS

The directors occupy a fiduciary position in a bank. They should act honestly and discharge their duties with such care, skill and diligence as is reasonably expected from persons of their knowledge and status. If they fail to do so they will be found guilty of negligence. The duties of Board of Directors are:

I. Duties Under Banking Regulation Act, 1949

A few important duties have been mentioned as under:

i) Not to pay commission, brokerage, discount or remuneration in any form in respect of shares issued by the bank, an amount in excess of the aggregate two and half perent of the paid up value of the said share. (Sec. 13)

ii) Not to create any charge upon the unpaid capital of the bank. (Sec. 14)

iii) Not to pay Dividends until and unless all the capitalized expenses are completely written off (Sec. 15).

iv) To publish accounts, balance sheet along with auditors report in the local newspaper in circulation at a place where principal head office of the bank is situated, within six months from the date of preparation of the same (Sec. 15).

v) Not to grant any loan to any director or any firm in which director is interested or to any individual for whom the director stands guarantor to any firm in which the director is a co-partner (Sec. 20).

vi) To seek prior approval of Reserve Bank for setting up any office of the bank (Sec. 23).

vii) To ensure that the monthly return in the prescribed form and manner showing assets and liabilities at the close of business of the last Friday of every month is sent to the Reserve Bank within 15 days after the end of the month (Sec. 24).

viii) To maintain not less than twenty percent of the total time and demand liabilities of the bank in form of cash, gold or unencumbered approved securities (Sec. 24)

ix) To submit to Reserve Bank, within 30 days after the close of each calendar year, a return in prescribed form and manner of all deposit accounts in India which have been lying dormant for the last 10 years or more (Sec. 26).

x) To prepare and submit such statements and information as is desired by Reserve Bank (Sec.27).

xi) To ensure that the annual accounts of the bank are prepared on last working day of every calendar year as given in the third schedule of the Act (Sec. 29).

xii) To seek prior approval of Reserve bank before appointing, reappointing or removing any auditors of the bank (Sec. 30).

xiii) To furnish three copies of account and Balance Sheet prepared under section 29, along with auditors report within three months from the end of the period to which they refer (Sec.31).

xiv) To make available to the member of the banking company at its Annual General Meeting of statement along with a copy of the Audited Balance Sheet (Sec.223).

II. General Duties of Directors of Bank

Some of the general duties of the directors of a bank are mentioned below:

i) To supervise the general affairs of the Bank.

ii) To direct and control its subordinates.

iii) To attend board meetings.

iv) To examine carefully reports and audit records of officers.

v) To review periodically operations of bank pertaining to loans and investments.

vi) To abstain from making secret profit or using their position for their benefit.

vii) To constitute different committees as and when required and check their functioning.

viii) To investigate credit worthiness of the applicant granting loan and see that security provided is adequate.

ix) To examine thoroughly the statement of condition furnished by the bank executives.

x) To make best efforts to collect slow and doubtful debts.

xi) Not to authorize and permit improvident investment expenditures.

Liabilities of Bank Directors

1. Civil Liability of Bank Directors

a) Liable to outsiders for Ultravires Acts: Directors act as agents of the bank and transact business in the name and on behalf of the bank. Anything done beyond the power of the bank will be ultravires and make them personally liable to outsiders. An ultravires act cannot be ratified even if all its shareholders are willing to do so.

Personal Liability of Directors

A director of a bank is personally liable to third party when

— he makes contract in his own name without indicating that he is acting for and on behalf of bank.

— he exceeds his power or imrings the restrictions imposed upon him since an outsider may presume that the transaction are apparently regular and he is not expected to look behind the articles.

b) **Liability for mis-statement in prospectus:** The directors are liable to shareholders for any misrepresentation or any false statement in prospectus made by them which has induced the shareholders to subscribe to share of the bank. Similarly, if a person has been induced to give credit to a bank following some misrepresentation on the part of anyone or more of its directors and in case the money is lost, he can claim damages from the responsible directors.

c) **Liability for breach of Trust:** the directors will be held liable for breach of trust if they fail to act honestly and in the interest of the bank. In the following cases the director is liable for breach of trust which causes a loss to the bank—

i) Liability for making secret profit in the course of the management of the bank.

ii) Liability for loss caused by his negligence.

iii) Liability for misappropriation and misapplication of funds of the banks which may arise in the following cases–

   a) Payment of dividend out of capital.

   b) Using funds of bank for ultravires purposes.

   c) Misfeasance or breach of trust.

2. Criminal Liability of Directors

The criminal liability of directors of a bank will arise in the following circumstances —

–False entries, false statement and false certification of cheques.

–theft, embezzlement or misapplication of funds.

–Non-compliance with certain provisions of the Companies Act.

The liability of a guilty director for criminal acts can be extended to a fine of Rs. 50,000/- or imprisonment for a period upto two years or both. Besides this, there could be further liability under the Indian Penal Code also.

2.8 MANAGEMENT OF DEPOSITS AND ADVANCES

A. Deposits Mobilization

Introduction: Commercial banks play an indispensable role in the development of the country. The main function of a commercial bank is management of its liabilities and assets. Liability management consists of the activities involved in getting funds from depositors and other creditors and determining the appropriate mix of funds for a particular bank, whereas asset management refers to allocation of the funds among investment alternatives. It is concerned with advances and loans.

Deposits are the most important source of funds for commercial bank. Commercial banks almost completely rely on deposits for funds. The survival of a bank is based on the quantum of deposit held by it and the manner in which deposits are managed. Banks mobilize savings from people in urban and rural areas and make funds available for lending. Banks are always engaged in working out new plans, policies to raise more and more funds from people.

Management of Deposits

According to Oxford dictionary, "The term deposits means to lay down in particular place, store or entrust for keeping". It means money deposits in banks are known as bank deposits. Deposits are the chief source of funds of the banks. Deposit Management consists of the activities involved in obtaining funds from depositors.

Importance of Deposit Management

The importance or need of the deposit management is discussed below:

1. **Life Blood of Banks:** Deposits are the life blood of commercial banks. They are the main and very important inputs of banks. No commercial bank can survive without accepting deposits.
2. **Basis of Lending:** Lending and investment operations of a bank are influenced by the magnitude of deposits, their composition and ownership. Deposits are the main inputs for loan output.
3. **Mobilizing of Saving:** Banks mobilize savings of the people through deposits. The deposits mobilized are money of people, which needs to be managed well. Deposits enable a bank to pool together the savings of a large number of savers.
4. **Investment in Government Securities:** The deposits make it possible for commercial banks to make investment in government securities. Banks provide necessary funds to government for developmental activities.
5. **Role of Intermediary:** The commercial banks play the role of an intermediary between depositors and investors. This intermediary role of banks is very important fore the economic development of the country.
6. **Contribution to Developmental Activities:** Mobilisation of resources forms an integral part of the development process in India. Banks have to depend upon mobilization of deposits from the public to finance development programmes.

2.8 TYPES OF DEPOSIT ACCOUNT

1. **Demand Deposits:** Demand deposits or checkable deposits are also known as current accounts. These deposits can be withdrawn by the depositor or transferred to someone else at any time. Withdrawals and transfer to third parties usually are made by cheque. No interest is paid by the bank on demand deposits.
2. **Savings Deposits:** Savings account aim at the promotion of thrift. Regular saving accounts can be maintained by individuals and not profit institutions. Saving accounts do not have specified maturity dates or size limits. The accounts terminate when the holders decides. In savings accounts, deposits and withdrawals are made at anytime. Saving accounts are also known as "Pass book Accounts" because traditionally depositors receive a book known as pass book in which all the entries related to deposits and withdrawals are recorded. Interest is paid on this account.
3. **Time Deposits or Fixed Deposits:** Time deposits are those deposits that are deposited with banks for a certain period of time. Banks pay higher rate of interest on these deposits. Time deposits cannot be withdrawn by cheque but must be converted into cash or demand deposits. These deposits are specified both as to maturity and amount. Fixed deposits receipt is the most common type of time deposit. It is a receipt issued for funds deposited with the bank for a specified period of time and on which bank pays interest if left till maturity. Some of the time deposit schemes are monthly income scheme, cash certificates, annuity, retirement scheme, recurring deposits, cumulative deposits, etc.

The factors determining deposits with banks can be classified into two categories i.e., external factors and internal factors.

I. External Factors

External factors emerge from the environment and surrounding areas in which banks have to operate. External factors are those factors which are beyond the control of the banks. These factors are discussed briefly below;

1. **State of World Economy:** Globalisation of economy means the integration of Indian economy with the world economy. As the globalization of economy takes place, global factors will influence the level of deposits in Indian banks either directly or indirectly. For example, higher rate of interest and better opportunities in India will attract NRI deposits in Indian banks or vice-versa.
2. **State of National Economy:** The level of deposits with the banks is also influenced by the prevailing conditions in the country. During period of boom and prosperity, there is

more demand for credit from businessmen leading to increase in deposits including derivative deposits. On the other hand, during the period of decline, the demand for loan decreases and the process of credit contraction sets in and derivative deposits shows a sharp decline.

3. **Character of Local Economy:** The level of deposits with bank is also influenced by the character of local economy. Local economy is also influenced by the general economic conditions prevailing in the country to some extent. The deposits of a bank operating in local area will be affected by peculiar characteristics of that region.
4. **Saving Habits:** The savings of the economy will be an important factor in deciding the level of bank deposits. The level of deposits of banks will depend upon the habits of savings of the population. Saving s can be held in the financial assets like currency, bank deposits, Government's small saving schemes, provident funds, life insurance contributions, deposits with other financial institutions, Government securities, equities and bonds. The deposits can be increased by targeting the organized market saving which are idle or wasted or used in creating assets. Therefore, the attitude and habits of population regarding the use of their savings will be an important factor in determining deposit levels.
5. **Role of Government:** The central, state and local governments also influence the level of deposits with banks. The government plays the role of promoter in providing economic and social infrastructure which is very essential for economic development of the country. The government itself has been playing an important role by directly participating in trade and industry.
6. **Change in Population:** The migration of people from one place to another also affects the level of deposits with bank. Therefore, changes in population can have direct effect on bank deposits. For example, the deposits must have been shifted with migration of people from Punjab due to militancy.

II. Internal Factors

Internal factors are related to the internal conditions of a bank such as physical facilities, staff, services rendered, policies and financial position, etc. the internal factors are controllable factors which can be changed by the management of bank according to changing working environment and working conditions. The important internal factors are mentioned below:

1. **Service facilities:** the level of deposits of a bank is influenced by the service facilities provided by the bank such as long banking hours, over draft facilities, locker facilities, quick collection of cheques, discounting bill, teller facility, taking less time in operating account, ATM service facility, quick transmission of funds, etc.
2. **Physical Facilities:** The physical facilities such as building structure, comfortable sitting arrangements, comfortable counters, décor, proper lighting, ventilation, arrangement for drinking water, fresh air, etc., play an important role in attracting customers.
3. **Staff:** Bank personnel should be friendly and efficient in the performance of their job. A bank will be in a better position to attract more deposits than its competitors whose staff is kind and cooperative with the customers. Lot of emphasis is laid on good public relations by the banks. Banks hold training programmes for its staff as to tell how to deal with customers. Most of the banks have set up public relation department and customers' service cells to live upto the expectations of the deposits.
4. **Bank Policies:** policies have an influence on the confidence of the public, which is very important for attracting more deposits. Public confidence is the biggest asset with a bank. Bank policies regarding loans, investments and other matters provide an important yardstick to judge the competence and capacity of the management. A bank may enjoy increased deposits because of its favourable policies and strategies towards its customers.
5. **Competitive Interest Rates:** A commercial bank which provides high interest rate is in a position to attract more deposits than its competitors. The Reserve Bank of India has opined that the interest rates influence the quantum of deposits.
6. **Location:** The level of deposits also depends on the location of the branch of the bank. People generally prefer to deposit their money in those branches which are located near to their residence.
7. **Momentum of an Easy Start:** Generally, an old established bank has an advantage over the new banks for attracting more deposits. People generally prefer to deal with those banks with which their parents have the accounts. Once such ties are established, they are difficult to break.

2.10 DEPOSIT MOBILIZATION

Capital formation in an economy is an essential determinant of economic growth and development. The capital formation of an economy depends on the savings and savings-income ratio of a population. Commercial banks are always engaged in mobilizing savings of people and lending in productive channels. Saving invested in non-productive assets play no role in economic development of the country. The commercial banks follow the directives of Reserve Bank. After the nationalization of banks the responsibility of banks has further increased. The commercial banks have received great success in mobilizing deposits and in inculcating banking habits in India.

Deposit Mobilization Strategy

In the face of competition as a result of liberalization of the economy, each and every bank has to formulate a suitable strategy for mobilization of deposits by keeping focus on the segment of population from which deposits are intended to be mobilized. The formulation of deposit mobilization strategy involves a number of steps such as —

1. **Identify the Saving Potential:** The bank must identify the saving potentials of the people. For this purpose, the bank must know the strength of working people, their sources of income, their economic conditions, habit of saving, family income, preference of investment, etc. high income group will provide more money for deposits in bank than lower income group of society.
2. **Motivation for Saving:** The bank should also take into account motivation forsavings to attract more deposits. As Banking Commission 1972 has said that some of motivations for saving could be :
   i. To own a house;
   ii. To provide for children education and marriage;
   iii. To provide for old age; and
   iv. To provide for medical expenditure and so on.

   To make a socially gainful use of such motivations, the banks should introduce the deposit schemes which are able to exploit the motivation.
3. **Formulating Deposit Mobilization Schemes:** The bank should know the needs of people and tailor different schemes according to their needs, requirements and preferences of deposits. For example, daily wage earners and small vendors or traders prefer to spare some money daily as their savings. Neither it is convenient nor could they afford to go to bank daily to deposit small money. In such cases, the bank should introduce schemes of daily collection and depute its own employees for the collection of the money. Different banks have floated different schemes to mobilize savings from public taking into account the accessibility, convenience, feasibility and capacity of depositors.

4. **Deciding the Market Strategy:** After formulation of mobilization schemes, the banks should decide the market strategy. Different banks have different strategies due to competition among them. The marketing strategy should be formulated within the framework of corporate objectives and overall strategy of the bank. The success of marketing strategy will depend upon the involvement and effort of the staff. Therefore, all those involved in the promotion of products of the bank should understand the strategy for its proper implementation.

Fundamental Principles of Deposit Mobilization of Schemes

To attract more deposits, the banks have to formulate new schemes of different nature and suitability to the different classes of investors in both rural and urban centres. These schemes must satisfy the following fundamental principles of –

1. **Mobility:** It includes mobile bank schemes, small deposit scheme, cash collection agent scheme, etc.
2. **Flexibility:** It refers to providing morning services, evening services, Sunday and holiday services.
3. **Convenience to Customers:** It includes those facilities which make banking services convenient to customers. These include opening of branches in residential areas, shopping complexes, industrial complexes and campus of educational institutions.
4. **Automatic Facility:** It includes the use of technical devices and computerization of services.
5. **Reduction of Cash dealing:** It refers to traveller cheques and use of credit cards, etc.

2.11 IMPORTANT DEPOSIT SCHEMES

Following are some of the various deposit schemes offered by banks to attract deposits:

1. **Current Account:** The current account is meant for those customers who can withdraw their deposits at any time. There is no limit on the number of withdrawals. This scheme is mostly suitable for businessmen for their day to day business transactions. No interest is paid on these deposits.
2. **Saving Account:** The saving account is meant for the deposits of small depositors. The depositors can withdraw money from this account as per rules fixed by the bank. Interest is paid on these deposits.

3. **Fixed Deposits:** fixed deposits are those scheme on which higher rate of interest can be earned. The funds are deposited with the bank for a specified period of time under this scheme. Higher rate of interest is paid on fixed deposits.
4. **Cash Certificates:** Cash certificate scheme is also a kind of fixed deposit scheme. Interest is included in the final payment. In fact, maturity value payable is discounted at the interest rates payable on long term deposits. The discounted amount is the value which a customer is asked to pay to get a cash certificate.
5. **Daily Saving Scheme:** this scheme is meant to attract the deposits of very small depositors. Daily collections are made by the agents of the bank at the doors of the depositors. The accumulated amount together with the interest is repaid after five years.
6. **Minor saving scheme:** This scheme was introduced as an attempt to encourage children to develop the habit of savings. Withdrawal facility is available in the scheme, e.g., Kiddy Bank scheme of Andhra bank.
7. **Monthly Interest Income Schemes:** These schemes are fixed deposits on which interest is paid monthly instead of yearly or half-yearly. Interest is paid either by way of cash or is credited to the current account or saving deposit account also.
8. **Retirement scheme:** In this scheme, monthly deposits are collected for a number of years. After a certain period, the interest amount is doubled and paid annually as monthly instalments.
9. **Farmer Deposit Scheme:** This scheme is introduced to attract the deposits of the farmers. Under this scheme, the farmers can deposit their income once or twice a year. They can also spend one-tenth of their deposits in every month.
10. **House Safe Saving Scheme:** This scheme is introduced recently by the banks. A small portable safe is provided to the depositor at the residence. Key of the safe is kept by the bank. Depositor puts his small savings in it as convenient to him and after sometime hands the same over to bank and gets it entered in his account.
11. **Housing Deposit Scheme:** This scheme is suitable to those who want to acquire or construct their own houses. Account holders have to deposit monthly instalments for fixed period and at maturity the depositor can obtain the loan in a predetermined multiple of the amount of the deposit at concessional rates.
12. **Marriage/ Educational Saving Scheme:** This scheme is planned to enable the account holder to meet a liability, in future, by saving regularly over a given period of time, e.g. children’s education, marriage, etc.

13. **Insurance Linked Scheme:** This scheme provides life insurance protection on the life of an account holder covered under a special Insurance Linked Saving Bank Account. Men not below 18 years of age and not above 49 years of age and women in the same age group, if they have an independent regular income by way of salary, professional income, and rent dividend on shares are eligible for opening an account under this scheme.

Problems in Deposit Mobilisation

The main problems in deposit mobilization are discussed below:

1. **Lack of Innovative Deposit Schemes:** The strategy for deposit mobilization depends upon the formulation and implementation of various deposit schemes of the banks. All the deposit schemes are identical in their content and differ only in name. There is need for formulation of new schemes of a different nature according to different classes of depositors.
2. **Schemes only for Urban Depositors:** Most of the current deposit mobilization schemes are meant for the urban depositors. They neglect the potential rural depositors. The banks should formulate the schemes according to the needs and requirements of rural depositors also to mobilize rural savings.
3. **Lack of Publicity Techniques:** Most of the banks have used the same publicity techniques related to deposit mobilization both for rural and urban areas. But the rural areas require a different type of publicity.
4. **Lack of Trained Staff:** The bank staffs at various levels are not adequately aware of different deposit mobilization schemes. As a result, the customers do not get adequate guidance regarding the profitability of these schemes.
5. **Lack of Services Facilities:** Banking is a service oriented industry. The customers are not able to receive satisfactory services from the staff. Customer service is an important problem in the mobilization of deposits. It should be handled properly.

2.12 MANAGEMENT OF LOANS AND ADVANCES IN COMMERCIAL BANKS

Introduction

Lending or advancing loans is one of the two basic functions of the commercial banks. Lending is the profit or earning process of the commercial bank. Lending policy of bank is governed by monetary policy of Reserve Bank of India. The banks lend money out of deposits received from the customers. Deposits are repayable on date of maturity or on short notice or on demand by customer. Hence, the bank cannot lend money for a longer period out of deposits for short period. A commercial bank is essentially a medium or short term lender. It is clear that a commercial bank cannot lend for long period any substantial part of funds which have been borrowed for short period from depositors. On the basis of the past experiences, the bank management knows how to use their assets in the best possible manner.

The principal profit making activity of commercial banks is making loans to its customer. The primary objective of loan management is to earn income by serving the credit needs of the community.

Importance of Management of Loans and Advances

One of the most important activities of commercial bank is the management of loans and advances. A commercial bank generate near about 65 to 70 percent of its income through the lending activity. The success of a bank is heavily dependent on its lending programmes. Some of the important contributions of loans and advances to economy are as follows:

1. **Agents of Indirect Production:** Bank loans are called the agent of indirect production. The producers purchase raw materials, machinery, hire labour and other means of production through these loans advance by the bank.
2. **Generates Employment:** Commercial banks have increased employment opportunities. Through their lending functions, they have contributed to mass production, mass distribution and mass consumption.
3. **Improvement in Standard of Living:** Bank loans and advances may be used to increase production and employment. This will result in higher income and improve the living standard of the people.
4. **Contribution to Economic Development:** The loans advanced by the banks promote the economic development of the country. Bank lending contributes to develop infrastructural facilities to promote production, distribution and boosts exports and imports.
5. **Raise the Level of Consumption:** Banks also increase the level of consumption through their consumer loans. Banks provide consumer loans for creating a constant demand for consumer goods like houses, furniture, appliances, fixtures etc. in addition to the financing of agricultural, commercial and industrial activities.
6. **Source of Bank's Profit:** Banking lending also plays an important role in the gross earnings and net profits of commercial banks. It is the most profitable as well as risky

function performed by commercial banks. Therefore, it must be done efficiently, profitably and safely.

2.13 CLASSIFICATION OF LOANS IN COMMERCIAL BANKS

The bank loans may be classified into the following categories:

1. **Purpose:** A common classification of loans is by way of purpose or by use of borrowed funds. The loans may be advanced for productive activities such as agriculture, industry, trade and transport and for consumption purposes such as purchasing of automobiles, real estate and houses.
2. **Secured and Unsecured Loans:** The commercial banks may also advance secured loans and unsecured loans. Secured loans involve the pledge of specific collateral securities. Pledged collateral security for secured loans may be real estate, plants and equipment, fixed deposit receipt, corporate stocks and bonds. The main reason for getting a security against loan is to reduce the risk of loss in the event that the borrower is unable to reply the loan. The amount of loan can be recovered by sale of pledged security in case of non-payment of loan. Whereas unsecured loans are those loans which are not supported by any security. These loans are advanced to borrowers on his integrity, financial condition, expected future conditions and past record of repayment.
3. **On the basis of Maturity Period:** Bank loans can be classified on the maturity period of the loan. Banks advance:
   a) Short term loans: These loans are with maturity period of one year or less.
   b) Intermediate loans: These loans mature in more than one year and upto four or five years.
   c) Long term loans: These loans are for more than five years of maturity period.
4. **Method of Repayment:** Bank loan may be repaid in one lump sum or on instalment basis. Under lump sum method, entire loan is to be repaid on one final maturity date. On the other hand, instalment loans require periodic payment of principal amount. Investment can be paid monthly, quarterly, half yearly or yearly.
5. **Origin:** The loan portfolio of commercial banks is derived from many sources. The sources may be capital, reserves, deposits, Borrowings, etc.

2.14 TYPES OF ADVANCES

The credit assistance provided by a banker is mainly of two types: one is fund-based credit support and the other is non-fund-based. The difference between fund-based and non-fund-based credit assistance provided by a banker lies mainly in the cash outflow. While the former involves immediate cash outflow, the latter may or may not involve cash outflow from a banker.

Banks may allow fund-based facilities to customer in any of the following manners:

a. By allowing overdrafts (clean/secured)
b. By sanctioning cash credit limit
c. By way of demand loan
d. By granting term loan
e. By purchasing/ discounting bills.

a. Overdraft: When a customer, who has a current account, is allowed by the bank to draw more than his deposits in the account, such facility is called an overdraft facility. In this facility, the customer is permitted to withdraw the amount as and when he needs it and to repay it by means of deposits in his account as and when it is convenient to him. Overdraft is generally granted against government or other securities, fully paid shares, fixed deposits, etc. It may also be allowed for short/temporary periods without security in which case the same is known as clean overdraft.

b. Cash Credit/Cash Credit Merchandise: A cash credit account is a drawing account against a fixed credit limit granted by the bank and is operated exactly in the same manner as a current account with an overdraft facility. Cash credit limits are granted by banks against pledge/hypothecation of goods/ book debts/ documents of title to goods, etc., depending upon the nature of requirement of a borrower. Under the system, the bank specifies a limit for the customer, up to which the customer is permitted to borrow against the security of assets after compliance of prescribed terms and conditions and keeping prescribed margin against the securities. The customer withdraws from his cash credit account as and when he need the funds and deposits any amount of money which he finds surplus with him on any day. The cash credit account is thus, an active and running account to which deposits and withdrawals may be effected frequently.

c. Demand Loans: A demand loan is an advance for a fixed amount and no debts to the account may be made subsequent to the initial advance for the interest, insurance premium and other sundry charges. Generally, banks provide the demand loan for periods not longer than 12 months.

d. Term Loan: A term loan is an advance for a fixed period to person engaged in industries, business or trade for meeting their requirements like acquisition of fixed assets like land, building and machinery. Such loans may also be allowed to individuals for the purpose of purchasing houses/ consumer durable in which cases the same are termed as housing loans/personal loans, etc. the repayment of term loans may be made in instalments which are fixed by the bank taking into consideration the repayment capacity f the borrower. A term loan may be sanctioned for a medium term, (i.e., 3 to 5 years) or for a long term (i.e., up to 20 years.

e. Purchase/ Discount of Bills: Banks may allow bills purchasing/discounting facility to customer by either purchasing demand bills or discounting usance bills. After purchasing/discounting bills, the banker may send the bill for collection of proceeds from the drawee of the bill and on receipt of proceeds, the bills are adjusted. In case the bills are not paid by the drawee, the banker recovers the amount of the bill and interest thereon from the borrower.

Banks may allow non-fund-based facilities to customer in any of the following manners:

a. Letters of Credit
b. Letters of Guarantee

a. Letters of Credit (LC) or Banker's Commercial Credit: A letter of credit is a mechanism, which helps a trade transaction to be put through between a seller and a buyer. A letter of credit is an arrangement whereby a banker acting on the request of a customer, undertakes to pay a third party, by a given date, according to the agreed stipulations and against presentation of documents, the counter value of the goods and services rendered otherwise. The banker after making payment of the bill to the seller presents it to the buyer and obtains payment of it.

The buyer who establishes the letter of credit is known as the opener of LC. The banker who establishes the LC at the request of the buyer is called the LC opening bank and the seller in whose favour the LC is established is known as the beneficiary of the credit. LCs may be issued by banks on DP or DA terms, for import/domestic transactions.

Bank charges commission for the service and the facility rendered /commitment made by him. There are various types of LCs, viz., acceptance credit/revocable credit/irrevocable credit/ confirmed credit/with recourse and without recourse credit/transferable credit/back-to-back credit/red-clause credit/green clause credit/revolving letter of credit, etc.

b. **Letters of Guarantee (LG):** In commercial transactions, bank's customers are sometimes required to give a bank guarantee mainly as an alternative to provide cash security against a contract entered with another party. The third party that seeks the guarantee not being aware of the customer's financial standing prefers a bank guarantee. In turn, the banker who understands the financial standing of the customer undertakes to guarantee the customer's financial commitments or the performance of the contract by him. LGs issued by a bank may be in the nature of Performance Guarantee, Financial Guarantee, Deferred Payment Guarantee, Statutory Guarantee, etc., depending upon the nature of contract and commitment. The banker issuing the guarantee charges commission for the services rendered and the commitment made by him. There is bank's obligation in guarantee to pay primary. Commitments of banks must be honoured free from interference by the Courts.

2.15 PRINCIPLES OF SOUNDBANK LENDING

The business of lending carries inherent risks. While lending his funds, a banker, therefore, follows a very cautious policy and conducts his business on the basis of certain principles of sound lending in order to minimize the risks. There are certain cardinal principles of good lending that have been followed by commercial banks since long. These are the principles of safety, liquidity and profitability, spread/diversification, purpose and security.

1. **Principle of Safety:** 'Safety First' is the most important principle of good lending. As the bank lends funds entrusted to it by the depositors, the first and foremost principle of lending is to ensure the safety of funds lent. By safety is meant that the borrower is in a position to repay the loan along with interest, according to the terms of the loan contract, which depends upon the borrower's capacity and willingness to pay. While the capacity of the borrower depends upon his tangible assets/financial strength and success of his business/earning of profit from business to repay the loan, the willingness to repay depends upon the honesty and character of the borrower.

   The banker should, therefore, take utmost care in ensuring that the enterprise or business for which a loan is sought is a sound one and the borrower is capable of carrying it out successfully and also that the borrower is a person of integrity, good character and reputation. In addition to the above, the banker should consider the security of tangible assets owned by the borrower to ensure the safety of his funds.
2. **Principle of Liquidity:** Liquidity refers to the readiness with which a bank can convert its assets into cash with no or nominal loss. A loan will be liquid. It is not enough that the

money will ultimately comeback; it is necessary that bit must come back more or less on demand or within settled schedule of repayment programme under which loan was granted. Banks are mainly intermediaries for short-term funds and, therefore, generally they lend funds for short periods and mainly for working capital purposes. The borrower must be in a position to repay within a reasonable time after a demand for repayment is made.

3. **Principle of Profitability:** Equally important is the principle of 'profitability' in bank advances. Commercial institutions, banks must make profits. Firstly, they have to pay interest on the deposits received by them. They have to incur expenses on establishment, rent stationary, etc. they have to make provision for depreciation of their fixed assets and also for any possible bad or doubtful debts. After meeting all these items of expenditure which enter the running cost of banks, a reasonable profit must be made to carry to the reserves and payment of dividend to the shareholders. Banks, therefore, grant advances for those transactions which are on the whole secured and profitable for the bank.
4. **Spread of Risks –Diversification:** Another important principle of good lending is the diversification of advances. An element of risk is always present in every advance, however, secure it might appear to be. To safeguard the bank's interests, a banker follows the principle of 'spread of risks' based upon the maxim 'Do not keep all the eggs in one basket'. It means that a banker should not grant advances to a few big units only and should spread the risks involved in lending over a large number of borrowers, over a large number of industries and areas and over different type of securities.
5. **Principle of Purpose:** While granting loans, a banker must ensure that the purpose of loan should be productive so that the money not only remains safe but also provide a definite source of repayment. Banker must closely scrutinize the purpose for which the money is required, and ensure that the money borrowed for a particular purpose is applied by the borrower accordingly.
6. **Principle of Security:** While granting advances, banks consider the availability of security as one of the important guiding principles. Security is considered as insurance or a cushion to fall back upon in case of an emergency. Since banks deal in the public money, it is very important to pay proper attention to the security offered against the loan/advance. A good security must have qualities (MAST characteristics) such as marketability, ascertainability, stability and transferability.

2.16 PREPARATION OF INVESTMENT REPORTS

Commercial banks can gather information on the creditworthiness of the applicant by preparing financial reports. The information provided in a typical credit report includes:

i) Name and address of borrowing firm;

ii) Date of formation;

iii) The type of business;

iv) The financial structure;

v) Management;

vi) Bankers and

vii) Credit rating

In America and England, there are a large number of credit rating agencies, which publish detailed reports on companies in their periodicals. Dun and Bradstreet are the most important credit rating agencies which reports on more than 3 lakhs business houses in a year. In addition to its rating services, Dun and Bradstreet supplies credit reports on request to individual firms on the history of the business, the biography of owners, a description of method of operation, a simple balance sheet and recent payment experience of suppliers of the firm.

In India for the first time the Credit Rating Information Services of India Ltd was established in 1987 to rate companies as well as fixed interest bearing securities coming to the capital market. This will provide individual as well as corporate investors a useful tool in making investment decision.

Types of Reports

1. **Bank's own Records:** If the applicant happens to be the customer of bank, the lending officer can prepare the report by studying his past records with bank. Every bank maintains a central file of all depositors and borrowers. An examination of the record of customer provides an insight into his past dealings with bank, i.e., the customer's paying habits of previous loans and he balance carried by him in current and saving accounts. If the examination of the applicant's account reveals that bills discounted for him have always been duly honoured, this will count as a plus point in his favour.
2. **Bazaar Reports:** Reports on the applicant can be obtained from the various markets, particularly from businessmen carrying on the same trade and from suppliers — those from whom the borrower buys for his firm. The bank may ask these businessmen and suppliers about the payment habits of the applicant, the promptness of the borrower in

repayment, his practices in availing of all cash discounts, etc. some businessmen may happen to be the borrower's friends, others his rivals. Some may, therefore, give exaggerated reports about the applicant's means, while others may try to run him down. All such reports, sometimes contradictory to each other have to be weighted independently and a balanced opinion has to be framed about the creditworthiness of the applicant.

3. **Reports from other Banks:** The credit department of the bank may check with other banks with which the borrower had dealing in the past. Such a check with the other banks reveals the character, ability and management of the applicant.
4. **Other Sources:** Other sources of credit information on business firms, especially the larger ones, may be trade4 journals, periodicals, newspaper, trade directories, public records such as income-tax statements, wealth tax returns, sales tax returns, reports about actions and decrease in the Government Gazette, registration, revenue and municipal records.

2.17 NATURE OF BANK INVESTMENT

The concept of wealth from the investment banking standpoint is perhaps the simplest and may therefore be used as starting point. By wealth is meant, any economic good or service which satisfies a human need, and has, consequently, the power of commanding other goods or services in exchange. The exchange value resulting from the fact that a given object or service is desired must, however, be measured in terms of some unit, and the rate of exchange between goods is their price.

One such good is money, which marks money a form of wealth devised for the special purpose of acting as a means of promoting exchange and of measuring the value of commodities in exchange. We thus include money under the head of wealth, but of course, cannot regard wealth in any sense as money except that it is indirectly a means of commanding money.

Production is the process of ringing wealth into existence- that is to say, of changing the character or form of goods and services so as to adopt them for use. Consumption, on the other hand, is the application of these goods and services to their specific objects. That is, to the satisfaction of human needs or desires.

Capital comprises forms of wealth especially adopted for further production as tools and machines, which themselves do not satisfy any consumption desires. Ordinarily, savings are defined as that part of the periodic production of wealth which is devoted to the creation of capital.

Investment is the process of applying such savings to the creation of specific forms of capital. There has been a long controversy about the question whether savings are or are not, in fact, practically equivalent to investments. The use made of the term, however, differentiates the two concepts and regards saving as his mere decision not to consume produce goods, whereas investment is the actual use of the savings thus made to some specified purpose.

The profitability of banks depends upon the able manner and avenues in which its resources are invested to yield maximum income. Banks cannot simply keep the resources with them without investing them profitably outside. On the deposits received which form the bulk of resources, interest have to be paid to depositors. Therefore, it is necessary for banks to invest their funds at a rate of interest higher than rates paid to depositors. Following are the main sources from which funds became available to banks for investment:

a) Paid-up capital.
b) General Reserve and other funds.
c) Deposits of all types as fixed, saving, current and cash certificate.
d) Borrowing from money market and other banks at call sale.
e) Borrowings from IDBI i.e., refinance.
f) Borrowing from RBI.

Bank can get maximum profit by proper investment of its resources and it is necessary particularly when till recently there was a ceiling on lending rate imposed by RBI as wages bill are going on increasing. In order to maximize its profits, a bank must effectively utilize its resources in best possible manner despite factor that come in way of investment in avenues or portfolio where yield is heavy. The statutory restrictions preventing all its resources from being lent to borrowers without maintaining prescribed liquidity and CRR.

According to directives issued by RBI, banks are required to maintain liquidity ratio of 38% of demand and time liabilities. In addition to this, every bank is required under Section 42 of RBI ACT to maintain 3 % of DIL in balances of RBI. Thus, it is observed that 27.4 % of bank's deposit liabilities are required by law to be maintained in a liquid form so that 62% of deposits are available for other investment such as:

1. Advances, includes loan, overdraft, cash-credit, bills discounting/cheque.
2. Call loans.

3. Government Securities.

The competition in financial services industry brings a downward pressure on bank's profit. It is necessary to see that utmost care is taken to ensure that bank investments are managed well, so that:

1. Liquidity of bank is ensured.
2. Right amounts of cash resources are available in the right place at the right time in such a way as to minimize exposure to interest exchange risks.
3. Returns on surplus funds are maximized.
4. Financial costs are minimized.

2.18 OBJECTIVES OF COMMERCIAL BANK MANAGEMENT

Investment is the sacrifice of certain present value for the uncertain future reward. It entails arriving at numerous decisions such as type, mix, amount, timing, grade etc. of investment and disinvestment. Further, such decision making has not only to be continuous but rational too. Broadly speaking, an investment decision is a trade-off between risk and return. All investment choices are made at points of time in accordance with the personal investment ends and in contemplation of an uncertain future.

Since investments in securities are revocable, investment ends are transient and investment environment is fluid, the reliable bases for reasoned expectations become more and more-vague as one conceives of the distant future. Investors in securities will, therefore, from time to time, reappraise and re-evaluate their various investment commitments in the light of new information, changed expectations and ends.

Investment decisions are found to be the outcome of three different but related classes of factors. The first may be described as **factual or informational premises**. The factual premises of investment decisions are provided by many streams of data which are taken together, represent to an investor the observable environment and general as well as particular features of the securities and firms in which he may invest.

The second class of factors entering into investment decisions may be described as **expectational premises**. Expectations relating to the outcomes of alternative investments are subjective and hypothetical in any case but their foundations are necessarily provided by the environmental and financial facts available to investors. These limit not only the range of investments which may be undertaken but also the expectations of outcomes which may legitimately be entertained.

The third and final class of factors may be described as **valuational premises**. For investors generally these comprise the structure of subjective preferences for the size and regularity of the income to be received from and for the safety and negotiability of specific investments or combinations of investments as these are appraised from time to time. "Investment" or "Investing", like "value" is a word of many interpretations.

2.19 SIGNIFICANCE OF INVESTMENT MANAGEMENT IN COMMERCIAL BANKS IN INDIA

In view of the increasing size of investment, investment management has assumed significance for commercial banks in India.

(i) Pursuant to the policy of economic liberalization, deregulation of interest rates, removal of entry barriers and integration of domestic financial market to international financial markets, risks in financial markets tended to increase in recent few years. The commercial banks are now grappling with hitherto unknown risks especially market risks stemming out of fluctuations in interest rates.

(ii) Buoyancy of the Government securities market because of the decision of the government to borrow at market-related interest rates on the lines suggested by the Narsimham Committee.

(iii) Availability of new and more attractive instruments for investments such as short-term government papers and zero coupon bonds.

(iv) Marketization of government securities with the adoption of the auction system for all central government securities and Treasury bills of different maturities.

(v) Policy intervention for creation of liquidity in the Gilt-edged securities market through direct dealing by the RBI, the establishment of Securities Trading Corporation of India, introduction of screen based trading system on the National stock exchange, the computerization of SGL operations with the Delivery vs. Payment faculty for settlement, introduction of Primary satellite Dealers, etc.

(vi) Removal of exposure ceilings on the investment by banks in the PSU bonds and permitting banks to invest in stock market securities up to 5 % of their incremental deposits over the position of the preceding year.

(vii) Introduction of capital adequacy norms requiring banks to maintain certain amount of capital to back their assets risks.

(viii) Subjecting public sector banks to stock market discipline by permitting them to source their capital from capital markets.

(ix) Increased competition in the banking industry with the entry of new players — both domestic and foreign.

(x) Squeezing of the net interest margins in the traditional banking business due to competition and disintermediation.

(xi) Increasing contribution of the investment operations to the income of banks.

(xii) Growing professionalization in the banking industry and increasing automation of banking operations.

2.20 PRINCIPLES OF INVESTMENT MANAGEMENT OF COMMERCIAL BANK

Management of assets and liabilities of a bank that maximizes profit without sacrificing liquidity and solvency is termed as portfolio management. A bank has to decide the pattern of assets and liabilities in such a manner that there would be optimum contribution of profit, liquidity, stability and safety. Following is the main objectives of investment management:

1) **Liquidity:** Liquidity of assets is one of the principal objectives of investment policy or by the commercial banks. Every commercial bank keeps a sizeable amount of its assets in the form of liquid assets such as cash reserves with themselves, with other commercial banks or with the central bank of the country. High degree of liquidity is essential with a view to maintaining trust of the general public in banking operations. Obviously, money is the most liquid asset. Liquidity of assets implies how quickly assets can be converted into money.

   Requirement of liquidity in portfolio management is conditioned by various factors such as payment of cheques drawn on the bank, to cater to cash needs of the depositors and to tide over financial difficulties in times of emergency. A high degree of liquidity is essential to maintain security and solvency of the banking operations.

   Degree of liquidity depends on various factors such as cash reserve requirement and statutory liquidity ratio, nature of money market, banking habits of the people, nature of deposits, structure of banking — unit banking or branch banking, nature of money market, past experience, seasonal requirement, existing facilities of Clearing House as well as the liquidity policy of other financial intermediaries. For example, if cash reserve requirement is high percentage of demand deposits, banks will have a high liquidity ratio. If depositors withdraw their deposits quite frequently, a high degree of liquidity becomes essential. If money market is fairly developed and banks can easily get cash in times of emergencies, liquidity ratio should be low.

   Treasury bills, cash reserves with the central bank of the country and with other commercial banks, short term securities and money-at-call are some of the most liquid assets of the banks. Long period securities, advances and investments are relatively less liquid assets. A bank can enhance its liquidity at any point of time through borrowings from other commercial banks or from the Central bank of the country. If a bank can borrow money at short notice, it need not expand its own liquid assets, particularly those which do not generate any income.

A bank should so manage its asset portfolio that it has a high degree of liquidity. This necessitates holding of assets in the form of cash reserves or government securities. Government securities are one of the most liquid assets of the banks as these can be encashed any time without losses. Though a high degree of liquidity is required from the viewpoint of security of banking operations, it is not always desirable from the viewpoint of profitability. Increased liquidity always implies reduced profitability. Commercial banks are, thus, to strike a balance between liquidity and profitability.

2. **Safety or Solvency:** Safety implies the ability of the commercial banks to timely and promptly honour all their cash obligations towards their depositors. With a view to ensuring safety, commercial banks should invest their funds in a manner that minimizes the degree of business risks. Of course, the banks have to make certain investments for generating income. But the safety consideration requires that risk factor should not be increased even when it implies less returns on the investment funds. Banks should, thus, indulge only in safe investments. A bank is said to be solvent if the amount of its assets exceeds or equals to its liabilities. It is very difficult for a bank to maintain its solvency as its liabilities are fixed in terms of the monetary unit of the country while its assets are liable to change in value terms. A considerable fall in the value of the assets may drag a bank to insolvency. Various reasons that cause insolvency are:

   a) Misappropriation of cash due to dishonest employ or robbery
   b) Risk of non-payment by the borrowers
   c) Change in the rate of interest

   Various effects of insolvency are — insufficiency of assets endangers creditors' claims and it shatters public confidence which in turn threatens the very existence of the bank.

   Banks can fulfil safety objective in two ways: Safe investments and diversification of portfolio.

   Safe Investment: Safety consideration requires that banks make only safe advances, even when it implies sacrificing some interest income. Safe advances are those which are sure to be returned within the stipulated time period. Banks should offer loans only on the basis of suitable tangible securities as well as guarantees. The ideal situation calls for an appropriate balance between safety and profitability considerations.

Banks should take following precautions in the context of their safe investment policy:

a) Bulk loans should not be offered to an individual firm or a group of firms even when financial status of the firms appears to be sound,
b) Prior to making advances, banks should fully satisfy themselves regarding business conduct of the borrowers and
c) Banks should also satisfy themselves on the credentials of the guarantors of the borrowers.

Diversification of Portfolio: Diversification of portfolio is another means of safety of portfolio management. Distribution of assets across various channels should certainly minimize the risk of investment. Thus, the bulk of investment should not be poured in one type of investment channel or in one type of business enterprise. Failure of one enterprise would then mean failure of bank's portfolio management. Banks should, thus, distribute their investment funds across a variety of enterprises. Such a distribution of investment should defuse the degree of risk. Even when an industry or two fail, portfolio management of the banks should not get seriously injured. Spreading investment across different channels also ensures continuity of liquidity which is an added dimension of safety of banking operation.

3. Profitability

No doubt, profitability is the chief consideration of commercial banking operations. Every bank desires to maximize its profits. The bulk of banking capital is in the form of deposits which involve the payment of interest to the depositors. Banks are, therefore, to ensure that their investment policy yields them enough of income over and above their interest obligations. Strong profits are necessary to pay stockholder dividends and build stockholders equity, to offset loan losses, to pay ongoing operating expenses and to expand products and services. However, bank profitability entails more than striving for immediate maximum returns; rather, it is the profitable management of the bank's assets and liabilities over both the short and long term. To be profitable, a bank must show healthy short-term earnings, but it must also manage liquidity, risk and earnings through recurring business cycles for long-term survival.

4. **Stability**

Commercial banks need a high degree of stability of the principal in their investment portfolio. Because of their thin equity cushion, they cannot afford any loss or shrinkage in the value of securities. Security investment is subject to money rate risk, besides the credit risk. The money rate risk involves the movement in market values and changes in interest rates.

2.21 MANAGEMENT OF BANK INVESTMENT PORTFOLIO

An effective management of the investment portfolio in a bank calls for the formulation of a comprehensive policy and a strong internal organization. In performing the investment function, a banker has to strike a balance among the conflicting objectives of safety, liquidity and profitability and stability.

An astute banker brings about this compromise by a careful planning and preparation of a judicial investment policy and programme and by a proper organisation of the investment department to carry into effect the investment policy. A study of how the investment policy in a bank is formulated and is put into practice would provide an understanding of the management of the investment portfolio.

1. **Formulating Investment Policy**

The formulation of an investment policy is the responsibility of the Board of Directors. Though, the Board is legally responsible for the management of the investment portfolio but in actual practice, it delegates this task to the investment committee or senior officers of the bank. Every commercial bank has an investment policy to guide its investment officers in the management of the investment portfolio. The policy may be written or oral. Investment policies, which differ from bank to bank, depend on size, location, condition and management capabilities. However, investment policies of a bank should focus on the following: selecting out investment objective; reviewing investment needs of the bank; formulating policies in different areas.

a) Setting out Investment Objective: The first section of the investment policy statement should define the objective of the investment function and to obtain and to maintain liquidity. While income needs cannot be decisive in bank investment decisions, that importance cannot be ignored. A bank, with relatively large reserve and capital, is in a strong position to absorb losses on the investment account and can lay greater emphasis on the income aspect than on liquidity. But the liquidity objective will receive the major emphasis in a bank which experiences sizeable fluctuations in the level of deposits and in the loan demand. Further, where a bank can make satisfactory income from its loan activity, it can lay stress on the liquidity objective, whereas the bank which has to depend for its sizeable income on investment will lay more emphasis on income as the goal of its investment policy. Therefore, the objective is really a compromise between the maximum income consistent with liquidity, which a banker has to arrive at after giving due consideration to many factors.

b) Reviewing Investment Needs of the Bank: Once the objectives are set, a concrete programme suiting the characteristics and conditions of the individual bank for its achievement has to be laid. The next step to the establishment of objectives, the management must identify the portfolio needs of the bank.

2. **Identifying the Portfolios:** The first step in the process of inventoring the investment portfolio needs is the identification of the portfolio. In common practice, the investment account of a bank refers to the holding of securities, including securities held for liquidity purposes and those held for income purpose. It is a common practice for the bank management to send to the board of directors only a list of the bank's security holdings, showing their book values, their market prices and the range of maturities. On the basis of the length of their maturity periods, one can distinguish between the two classes of investments: securities maturing in a short period may be categorized under investment for liquidity purposes and long-term securities may be included under investment for income purposes. The securities held for meeting expected deposit withdrawals and increased demands for loans may, therefore, be separated from other assets so that the investment portfolio may represent the investment of surplus funds for income.
3. **Assessing the Risk Option:** The management must assess the element of risk with which the bank can assume before determining the size of its investment account and its composition. This would be done in the light of the amount of risk that the bank has already assumed, its capital position in relation to the assets it already holds, and the quality of investment available.
4. **Determining the Tax Position:** the third logical step in reviewing the portfolio needs of bank is to estimate the bank's net taxable income and to compute the amount of additional tax-exempt income, if any, that the bank may profitably use. Since tax-exempt income is usually obtained at some sacrifice of gross revenue, it is obviously poor planning to have tax exempt income in excess of the current operating income. The objective should be to minimize the tax burden within the boundaries of the law without

compromising the bank's obligation to provide sound loans to local borrowers and its ability to support risk assets with sufficient capital.

5. **Coordinating Investment and Liquidity Planning:** The bank management must also decide whether its investment strategy would have any co-ordination with its liquidity position. In fact, some banks makes plan to provide funds for the investment portfolio in exchange for quality securities which are close enough to maturity to qualify as liquidity assets. The banks following a space-maturity programme generally adopt this strategy.
6. **Estimating the Need for Diversification:** Diversification is a vulnerable rule governing the investment policy of banks. It implies holding an assortment of securities by an investor rather than a limited number of issues. Diversification may take the form of unit, industry, maturity, geography type of security and management. By diversification of investments, a bank may reduce its investment risks if it cannot avoid them altogether. If unanticipated losses occur by pure chance, the holding of investment issues spreading over a wide enough area will tend to reduce the losses to about their average probable value.

   The bank management has to decide on the type of diversification the bank should seek in its investment portfolio and the degree of such diversification. This is to be decided by weighing the advantages of diversification against the possible expertise of evaluation which the bank management may have obtained in areas of concentration.

2.22 FORMULATING INVESTMENT PORTFOLIO POLICIES

While formulating investment policies and taking investment decisions, the RBI has advised banks to exercise due caution in deciding to subscribe to debentures, bonds, shares etc., and refer to the defaulters lists to ensure that investments are not made in companies/entities who are defaulters' to banks/financial institutions. After reviewing the portfolio policy needs of the bank, the Board of Directors should lay down the portfolio policies in the following areas:

i) **Size of Investment Portfolio:** The volume of the investment portfolio should be designed in the light of liquidity requirements, the credit needs of the economy, the fluctuations in deposits and the size of the capital account. Further, the RBI policy regarding investment ceiling for a bank should be kept in view. As per the RBI guidelines issued in 2000, the ceiling of 5 percent was made applicable to total exposure of a bank to stock markets with sub ceilings for total advances to all stock brokers and market makers as well as individual stock broking entities, its associate/ inters connected companies. Legally, a commercial bank in India is required to hold 38.5% of its funds in liquid assets in addition to its cash reserve of 10.5% kept with RBI.

Of late, banks have been permitted by the RBI to extend financial assistance to Indian companies for acquisition of equity in overseas joint venture/wholly owned subsidiaries or in other overseas companies, new or existing, as strategic investment in terms of a Board approved policy, duly incorporated in the loan policy of the bank.

In November, 2006, the RBI issued directive to banks in India including foreign banks that they cannot hold more than 10% of the paid-up equity capital of a deposit taking NBFC and not more than 5 percent of their net worth. Further, the aggregate exposure of a bank to all NBFCs should not go beyond 40 percent of the bank's net worth.

In December, 2006, the RBI increased the existing bank ceiling of 5% its net owned funds in single NBFC to 10% and the base has been changed to the bank's capital funds from their net worth

ii) Pattern of Investment Portfolio: The policy statement should spell out the make-up of the investment portfolio, i.e., the type of securities in which funds will be invested and their relative proportion to the portfolio. This has to be determined by taking into account the objective of the investment and the portfolio needs of the bank. If the objective of the investment policy of the bank is to make higher earnings, it may invest largely in high-yielding corporate securities. But where a greater stress is laid on liquidity the management will have to restrict its investments to high-grade bonds and highly marketable securities. The other factors which determines the shape of the policy on the composition of the investment portfolio includes risk position of the bank, tax position of the bank, liquidity position and the quality of securities.

iii) Diversification of Portfolio: Diversification has been accepted as one of the basic rules of bank's investment policy because of the fact that it is a device for minimizing the credit and money rate risks of the investment portfolio, a banker seeks to limiting the proportion of funds flowing into issues of a particular unit, industry, region or management.

2.23. SUMMARY

The basic objective of commercial bank management in the modern set up is not only to maximize profit but also to discharge social responsibilities. Social responsibilities include responsibility towards shareholders, employees, customers, other banks, government and the weaker section of the society.

The functional areas of bank management refers to the important functions to be performed by the staff of a bank like deposit mobilisation, financial management, credit management, investment management, profit evaluation, etc.

Deposits are the most important source of funds for commercial bank in fact deposits are the vital source of funds. Commercial banks almost completely rely on deposits of funds. The survival of a bank is based on the quantum of deposit held by it and the manner in which deposits are managed. Banks are always engaged in working out new plans, policies to raise more and more funds from people.

Lending policy of bank is governed by monetary policy of Reserve Bank of India. The banks lend money out of deposits received from the customers. Deposits are repayable on date of maturity or on short notice or on demand by customers. It is clear that a commercial bank cannot lend for long period any substantial part of funds which have been borrowed for short period. On the basis of past experiences the bank management know how to use their assets in the best possible way. The primary objective of loan management is to earn income by serving the credit needs of the community.

Investment management is the professional asset management of various securities and other assets in order to meet the specified investment gaols for the benefits of the investors. It refers to the handling of financial asset and other investments not only buying and selling them. Management includes devising a short or long term strategy for acquiring and disposing of the portfolio holding. It can also include banking, budgeting and tax services and duties as well.

Report can be defined as a form of statements which presents and examines facts relating to an event problem, progress of action, state of business affairs and for the purpose of conveying information, reporting findings, putting forward ideas and making recommendations at the basis for actions.

The profitability of banks depends upon the able manner and avenues in which its resources are invested to yield maximum income. Banks cannot simply keep the resources without investing them in profitable outside. On the deposits received which form the bulk of resources, interest have to be paid to depositors. Therefore it is necessary for banks to invest their funds at rate of interest higher than rates paid to depositors. Banks can get maximum profits by proper investment of its resources and it is necessary particularly when till recently there was a ceiling on lending rate imposed by RBI as wages bill are going on increasing up.

2.24. SELF ASSESSMENT QUESTIONS

1. What do you mean by bank management? Explain the objective of bank management.
2. Explain the important functions of bank management.
3. What is board of director? Discuss the duties and liabilities of a bank.
4. What is meant by management of deposits?
5. Explain the need of deposit management in commercial bank.
6. Discuss the different types of deposits of the commercial banks.
7. What do you mean by deposit management? Discuss various problems in deposit management.
8. Explain the importance of management of loans and advances.
9. What is the classification of loan in commercial banks?
10. Briefly explain the principles of bank lending.
11. Explain bank investment and discuss the importance of investment management in commercial bank.
12. What is bank investment? Discuss the principles of investment management in commercial bank.
13. Describe the concept of investment report?

UNIT-3 MANAGEMENT OF FINANCE

Structure

3.0 OBJECTIVES

After studying this unit you will be able to understand —

- Management of finance
- The concept of Bank accounts
- Meaning , definition of reports and records
- Statement of advances
- Statement of profit and loss account
- Preparation of balance sheet and financial reports

3.1 MEANING OF FINANCIAL MANAGEMENT

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

3.2 SCOPE/ELEMENTS OF FINANCIAL MANAGEMENT

1. **Investment decisions** includes investment in fixed assets (called as capital budgeting). Investment in current assets is also a part of investment decisions called as working capital decisions.
2. **Financial decisions** - They relate to the raising of finance from various resources which will depend upon decision on type of source, period of financing, cost of financing and the returns thereby.
3. **Dividend decision**s - The finance manager has to take decision with regards to the net profit distribution. Net profits are generally divided into two:
    a. Dividend for shareholders- Dividend and the rate of it has to be decided.
    b. Retained profits- Amount of retained profits has to be finalized which will depend upon expansion and diversification plans of the enterprise.

3.3 OBJECTIVES OF FINANCIAL MANAGEMENT

The financial management is generally concerned with procurement, allocation and control of financial resources of a concern. The objectives can be-

1. To ensure regular and adequate supply of funds to the concern.
2. To ensure adequate returns to the shareholders which will depend upon the earning capacity, market price of the share, expectations of the shareholders.
3. To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
4. To ensure safety on investment, i.e, funds should be invested in safe ventures so that adequate rate of return can be achieved.
5. To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between debt and equity capital.

3.4 FUNCTIONS OF FINANCIAL MANAGEMENT

1. **Estimation of capital requirements:** A finance manager has to make estimation with regards to capital requirements of the company. This will depend upon expected costs and profits and future programmes and policies of a concern. Estimations have to be made in an adequate manner which increases earning capacity of enterprise.

2. **Determination of capital composition:** Once the estimation have been made, the capital structure have to be decided. This involves short- term and long- term debt equity analysis. This will depend upon the proportion of equity capital a company is possessing and additional funds which have to be raised from outside parties.
3. **Choice of sources of funds:** For additional funds to be procured, a company has many choices like-
   a. Issue of shares and debentures
   b. Loans to be taken from banks and financial institutions
   c. Public deposits to be drawn like in form of bonds.

   Choice of factor will depend on relative merits and demerits of each source and period of financing.
4. **Investment of funds:** The finance manager has to decide to allocate funds into profitable ventures so that there is safety on investment and regular returns is possible.
5. **Disposal of surplus:** The net profits decision has to be made by the finance manager. This can be done in two ways:
   a. Dividend declaration - It includes identifying the rate of dividends and other benefits like bonus.
   b. Retained profits - The volume has to be decided which will depend upon expansional, innovational, diversification plans of the company.
6. **Management of Cash:** Finance manager has to make decisions with regards to cash management. Cash is required for many purposes like payment of wages and salaries, payment of electricity and water bills, payment to creditors, meeting current liabilities, maintenance of enough stock, purchase of raw materials, etc.
7. **Financial controls:** The finance manager has not only to plan, procure and utilize the funds but he also has to exercise control over finances. This can be done through many techniques like ratio analysis, financial forecasting, cost and profit control, etc.

3.5 MEANING OF BANK ACCOUNT

A bank account is a financial account maintained by a bank for a customer. A bank account can be a deposit account, a credit card account, a current account, or any other type of account offered by a financial institution, and represents the funds that a customer has entrusted to the financial institution and from which the customer can make withdrawals. Alternatively, accounts may be loan accounts in which case the customer owes money to the financial institution.

The financial transactions which have occurred within a given period of time on a bank account are reported to the customer on a bank statement and the balance of the accounts at any point in time is the financial position of the customer with the institution.

The laws of each and every country specify the manner in which accounts may be opened and operated. They may specify, for example, who may open an account, how the signatories can identify themselves, deposit and withdrawal limits and many other matters.

Form of Business in which Banking Companies may Engage

Section 6 of the Act states in addition to the business of banking, a banking company may engage in any one or more of the following forms of business, namely:

1. The borrowing, raising or taking up money;
2. The lending or advancing of money either upon or without security;
3. The drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundies, promissory notes, coupons, drafts bills of lending, railway receipts, warrants, debentures, certificates, scrips and other instruments and securities whether transferable or negotiable or not.
4. The granting and issuing of letters of credit, travelers'cheques and circular notes.
5. The buying, selling and dealing in bullion and specie.
6. The buying and selling of foreign exchange including foreign bank notes.
7. The acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debenture stock, bonds, obligation, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on belief of constituents or others;
8. The receiving of all kinds of bonds, scrips or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults;
9. The collecting and transmitting of money and securities;
10. Acting as agents for and government or local authority or any other person or persons; the carrying on of agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise acting as an attorney on behalf of customers;
11. Contracting for public and private loans and negotiating and issuing the same;
12. The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private, or state, municipal or other loans or of shares,

stock, debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue;

13. Carrying on the transactions every kind of guarantee and indemnity business;
14. Managing, selling, realizing any property which may come into the possession of the company in satisfaction or part of any of its claims;
15. Acquiring and holding and generally dealing with any property or any right, little or interest in any such property which may form the security of part of the security for any loans or advances or which may be connected with any such security;
16. Undertaking and executing trusts;
17. Undertaking and administration of estates as executor, trustee or otherwise.

3.6 ACCOUNTS AND AUDIT

The provisions of the Act relating to annual accounts and audit of banking company are given in sections 29-33 and are follows:

1. **Preparation of Annual Accounts:** On 31st March each and every banking company incorporated in India, in respect of all business transacted by it, and every banking company incorporated outside India, in respect of all business transacted through its branches in India shall prepare with reference to that year a balance sheet and profit and loss account as on working day of the year in the forms set out in Third Schedule or as near thereto as circumstances admit. Form A in third schedule is the Balance Sheet and Form B is the Profit and Loss Account. Form A and B have been revised w.e.f. 1st April, 1991. In other words, the annual accounts for the year ending 31st March, 1992 and onwards are to be prepared in new formats as given in the book.
2. **Audit of Accounts:** The balance sheet and the Profit and Loss Account of a banking company is required to be audited by a Chartered Accountant. The appointment of the auditor of a banking company is made as per the provisions of the companies Act, 1956. His powers, duties and liabilities are also governed by the Companies Act, but the auditor's report on the accounts of a banking company must include certain additional particulars.
3. **Filling of Accounts:** Three copies of the audited Balance Sheet and Profit and Loss Account together with the Auditors' report shall be furnished as returns to the RBI within three months from the end of the accounting year to which it relates. This period of three months can be extended by the Reserve Bank for a further period up to three months.

Reserve Bank is authorized to call for any further information as it may think proper from a banking company relating to the business of such company.

4. **Publication of Accounts:** The Balance sheet, Profit and Loss Account and the Auditor's report of each banking company shall be published in any newspaper circulating at the place where it has principal office, within six months from the end of the accounting year.
5. **Accounting System:** The accounting system of a banking company is different from that of a trading or manufacturing enterprise. A bank has a large member of customers whose accounts are to be maintained in such a way so that these should be kept up-to-date and checked regularly. The following are the main features of am bank's accounting system.
   a) Entries in the personal ledgers are made directly from the vouchers.
   b) From such entries in the personal ledgers each day summary sheets in total are prepared which are posted to the control accounts in the general ledger.
   c) The general ledger trail balance is extracted and agreed every day.
   d) All entries in the personal ledgers and summary sheets are checked by persons other than those who made the entries with the result that most clerical mistakes are detected before another day begins.
   e) A trail balance of detail personal ledgers is prepared periodically (generally after two weeks) and get agreed with the general ledger control accounts.
   f) Two vouchers are prepared for every transaction not involving cash –one debit voucher and another credit voucher.

3.6 TYPES OF BANK ACCOUNT

1. Saving Account
2. Regular Savings
3. Current Account
4. Recurring Deposit Account
5. Fixed Deposit Account
6. DEMAT Account
7. <u>NRI Accounts</u>

1) SAVINGS ACCOUNT:-

a) Basic Savings Bank Deposit Accounts (BSBDA)

- This account will be considered as normal banking service.
- For this account, maintenance of minimum balance is not required.
- ATM card/ ATM cum Debit card, Rupay card will be given for the account holders.

- There are going to be no limit on the number of deposits that can be made in a month but, account holders will be allowed most of 4 withdrawals in a month, which includes ATM withdrawals also.
- The above facilities will be given without any charge. There will be no charge levied for non-operation/ activation of in-operative basic saving bank deposit account.
- For this account, overdraft facility will be provided up to Rs. 5000/-.

b) Basic Saving bank Deposit Accounts Small scheme (BSBDS)

- These are accounts with relaxed KYC, with a minimum document requirement of self-attested address proof & photograph.
- Total credit should not exceed 1Lakh rupees in a year.
- Maximum balance should not exceed Rs. 50,000/- at any time.
- Cash withdrawals & transfers must not exceed Rs.10, 000/- in a month.
- Remittance from foreign account cannot be credited to this account without completing normal KYC formalities.
- This account can be opened only at Core Banking Solution linked branches of banks or at such branches, where it is possible to manually monitor the fulfilments of the conditions.

2) REGULAR SAVINGS BANK ACCOUNT

- Any resident individual- single accounts, two or more individuals in joint accounts, Associations, clubs etc., are eligible for this account.
- Modest credit option available to the depositor.
- Two free cheque books will be issued per year.
- Internet banking facility will be provided without any charge.
- Balance enquiry, NEFT, Bill payment, Mobile recharge etc., are provided through mobile phones.
- Students can open this account with zero balance by providing the required documents.

3) CURRENT ACCOUNT

- Any resident individual- single accounts, two or more individuals in joint accounts, Associations, Limited companies, Religious Institutions, Educational Institutions, Charitable Institutions, clubs etc., are eligible for this account.
- Payments can be done unlimited number of times.
- Funds can be remitted from any part of the country to the corresponding account.
- Overdraft facility will be available.

- Internet banking facility is available.

4) RECURRING DEPOSIT ACCOUNT

CUMULATIVE DEPOSIT SCHEME

- Any resident individual- single accounts, two or more individuals in joint accounts, Associations, clubs, Institutions/Agencies specifically permitted by the RBI etc., are eligible to open this account in single/joint names.
- Periodic/Monthly instalments can be for any amount starting from as low as Rs.50/- onwards.
- Account can be opened for any period ranging from 6 months to 120 months, in multiple of 1 month.
- The amount selected for instalment at the start of the scheme will be payable every month.
- The number of instalments once fixed, cannot be altered.
- Approved rate of interest is compounded every quarter.
- The amount after maturity will be paid to customers one month after the deposit of the last instalment.
- Pass book will be given to the depositor.
- TDS will be applicable on the interest, as per the latest changes in the Income Tax Act on cumulative deposits also.

5) FIXED DEPOSIT ACCOUNT

a) SHORT DEPOSIT RECEIPT

- Banks accepts deposits from customers varying from 7 days to a maximum of 10 years.
- The period of 7 days & above but not exceeding 179 days deposits is classified as ‘Short Deposits’.
- The minimum amount that can be deposited under this scheme is Rs. 5 lakhs for a period of 7-14 days.

b) FIXED DEPOSIT RECEIPT

- Any resident individual- single accounts, two or more individuals in joint accounts, Associations, Minors, societies, clubs etc., are eligible for this account.
- The minimum FDR in metro & Urban branches is Rs. 10,000/- & in rural & semi urban & for Senior citizens is Rs.5000/- .

- For the subsidy kept under the government sponsored schemes, Margin money, earnest money & court attached/ordered deposits, minimum amount criteria will not be applicable.
- Depositors may ask for repayment of their deposits before maturity. Repayment of amount before maturity is allowable.
- Interest rate differs from bank to bank depending upon the tenure of the deposits & as when the bank changes the rate.
- Additional interest of 0.50% is offered for senior citizens on deposits placed for a year & above.

5) DEMAT ACCOUNT

- Used to conduct stress-free transactions on the shares.
- An individual, Non-Resident Indian, Foreign Institutional Investor, Foreign National, Corporate, Trusts, Clearing Houses, Financial Institution, Clearing Member, Mutual Funds, Banks and Other Depository Account.
- For opening this account, an individual has to fill a form, submit a photo of the applicant along with a photocopy of Voter ID/ Passport/ Aadhar card/ Driving License & Demat account number will be provided to the applicant immediately after the completion of processing of the application.
- Facilities provided under this account are- Opening & maintaining of Demat accounts, Dematerialization, Rematerialization, Purchases, sales, Pledging &Unpledging, safe custody.

7) NRI ACCOUNTS:-

- NRO (Non-Resident Ordinary Rupees) Account
- NRE (Non-Resident External Rupees) Account
- FCNR (Foreign Currency Non-Resident) Account

Specifics	FCNR	NRE	NRO
Account Opening	NRIs/PIOs/OCIs(Individuals/entities of Bangladesh / Pakistan require prior approval of RBI	NRIs/PIOs/OCIs(Individuals/en-tities of Bangladesh/Pakistan require prior approval of RBI	Any Individual resident outside India

Joint Account	In the names of two or more non-resident individuals. With a local close relative on 'former or survivor basis'	In the names of two or more non-resident individuals. With a local close relative on 'former or survivor basis'	In the names of two or more non-resident individuals. With a local close relative on 'former or survivor basis'
Money in which account is denominated	US dollar, pound sterling, Yen, Euro, Australian dollar & Canadian dollar	Indian Rupees	Indian Rupees
Nomination	Allowable	Allowable	Allowable
Account Type	Term Deposit only	Savings, Current, Fixed, Recurring deposit	Savings, Current, Fixed, Recurring deposit
Interest Rate	Banks are allowed to determine interest rates for Deposits	Banks are allowed to determine interest rates for Deposits	Banks are allowed to determine interest rates for Deposits
Fixed deposits-period	not less than 1 year and not more than 5 years	Min-1year Max- 10 years	As applicable to resident accounts
Specifics	**FCNR**	**NRE**	**NRO**
Income Tax	Not Taxable	Not Taxable	TDS on Interest received on NRO deposits to be deducted at 30.90%
Repatriability	Repatriable	Repatriable	Not Repatriable
Loans in India **1)To account holder** **2)To third parties**	Without any financial ceiling on the loan amount subject to standard margin requirements	Without any financial ceiling on the loan amount subject to standard margin requirements	1)Permitted 2)Permitted
Loans in Abroad **1)To account holder** **2)To third parties**	1) Without any financial ceiling on the loan amount subject to standard margin requirements 2)Not Permitted	Without any financial ceiling on the loan amount subject to standard margin requirements	1)Not permitted 2)Not permitted
Foreign Currency loans India **1)To Account holder** **2)To third parties**	1) Permitted 2) Not permitted	1) Not permitted 2) Not permitted	1) Not permitted 2) Not permitted

3.8 LEGAL REQUIREMENTS AFFECTING FINAL ACCOUNTS

What is a banking company?

Sec.5 of the Banking Regulation Act, 1949, defines a banking company as any company which transacts the business of banking in India. It further says that the word ‘banking’ used with reference to the above definition of banking company “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”. Therefore, any company which is engaged in the manufacture of goods or carries on any trade and which accept deposits of money from the public merely for the purpose of financing its business as manufacturer or trader shall not be deemed to transact the business of banking.

Minimum paid-up-capital: No banking company can carry on business in India unless its subscribed capital is at least half of its authorized capital and its paid-up capital is at least half of its subscribed capital.

Payment of commission, brokerage, etc: A banking company is prohibited from paying the commission, brokerage, discount or remuneration in any form on issue of its shares in excess of 2.5 % of the paid-up value of such shares.

Payment of Dividend: No banking company can pay dividend on its shares until all the capitalized expenses (including preliminary expenses, share-selling commission, brokerage, amounts of losses incurred, any other item of expenditure not represented by tangible assets) have been completely written off.

A banking company is, however, permitted to pay its dividend without writing off the following items:

a) The depreciation in the value of its investment in approved securities where such depreciation has not actually been capitalized or otherwise accounted for as a loss;
b) The depreciation in the value of investments in shares, debentures or bonds (other than approved securities) where adequate provision for such depreciation has been made to the satisfaction of its auditors, and
c) The bad debts, if any, where adequate provision for such bad debts has been made to the satisfaction of its auditors.

Statutory Reserve: It is compulsory for every banking company to make a transfer of 20% of profit before declaring any dividend every year to reserve called ‘statutory reserve’. However, if the aggregate amount of reserve and share premium account is not less than the paid-up capital, a company may be exempted from this restriction only on the leave granted by the Central Government.

Cash Reserves: Banks are statutorily required to maintain cash reserves with RBI. At present banks are expected to maintain 15% of their time and demand liabilities with RBI in the form of CRR. Over and above this, they are also expected to maintain a certain percentage of their time and demand liabilities in certain prescribed liquid states. This is familiarly known as statutory liquidity reserve (SLR) requirement. The present ratio is 38.5%. In respect of the incremental deposits, the ratio is reduced from 38.55 to 30.0% with effect from 1st April 1992.

Disclosure of Accounting Policies: with the nationalization of major commercial banks and the recent changes in the economic and financial policies of the government, the environment in which the bank operated has undergone change. With effect from the accounting year ending 31st March, 1991, it has been made obligatory for the banks to disclose accounting policies regarding key areas of its operations at one place along with notes on accounts in their financial statements. It is believed that such disclosure brings the true financial position to its pointed focus to study and have meaningful comparison of their positions. The Reserve Bank of India has circulated specimen form indicating broadly the areas where the accounting policies followed by each bank should be disclosed. The banks are free to make necessary modification to suit their individual needs.

3.9. SPECIMEN FORM OF ACCOUNTING POLICIES

Principal Accounting Policies

1) **General:** The accompanying financial statements have been prepared on the historical cost basis and confirm to statutory provisions and practices prevailing in the country.
2) **Transactions involving Foreign Exchange**

a) Monetary assets and liabilities have been translated at the exchange rates prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost.
b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year.
c) Profit or loss on pending forward contracts has been accounted for.

3) **Investments**

a) Investments in Government and other approved securities in India are valued at the lower of cost or market value.

b) Investments in subsidiary companies and associate companies (i.e., companies in which the bank holds at least 25 % of share capital) have been accounted for on the historical cost basis.

c) All other investments are valued at the lower of cost or market value.

4) Advances

a) Provisions for doubtful advances have been made to the satisfaction of the auditors:–

i. In respect of identified advances, based on a periodical review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit Guarantee Corporation, the export Credit and Guarantee Corporation and similar statutory bodies.

ii. In respect of general advance, as a percentage of total advance taking into account guidelines issued by the Government of India and the Reserve bank of India.

b) Provisions in respect of doubtful advances have been deducted from advances to the extent necessary and the excess has been included under “Other liabilities and provisions”.

c) Provisions have been made on a gross basis. Tax relief which will be available when the advance is written off will be accounted for in the year of write-off.

5) Fixed Assets

a) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the values determined on the basis of such revaluation made by professional valuers. Profit arising on revaluation has been credited to Capital Reserve.

b) Depreciation has been provided for the straight line/diminishing balance method.

c) In respect of revalued assets, depreciation is provided for on the revalued figures and an amount equal to the additional depreciation consequent on revaluation is transferred annually from the Capital Reserve to the General Reserve/Profit and Loss Account.

6) **Staff Benefits:** Provision for gratuity/pension benefits to staff has been made on an accrual basis. Separate funds for gratuity/ pension have been created.

7) Net Profit

a) The net profit disclosed in the Profit and Loss account is after:

i. provisions for taxes on income in accordance with statutory requirements.

ii. provision for doubtful advances,
iii. adjustments to the value of "current" investments in government and other approved securities in India valued at lower of cost or market value.
iv. transfers to contingency funds.
v. other usual or necessary provisions.

b) Contingency funds have been grouped in the Balance sheet under the head "Other Liabilities and Provisions".

Form Accounting: The final accounts of banks have to be prepared in the forms prescribed in the third Schedule to the Banking Regulation Act, 1949. Hitherto banks were not showing provision for bad and doubtful debts and provision for income tax as it was permitted by law. There was also non-disclosure due to aggressive window dressing adopted by management without regard to generally Accepted Accounting Principles. With a view to improve transparency in financial statements, the forms have been revised and are to be adopted by the banks with effect from the financial year 1991-92. Incidentally now banks follow the financial year as the accounting year. Earlier it was Calendar Year. The new forms have been devised with a view to ensure greater disclosure and better presentation of accounts and thus benefit the users to enable them to make economic decisions. As the new forms are mandatory now, only the new forms are given in the book.

3.10. MEANING OF RECORD

Document that memorializes and provides objective evidence of activities performed, events occurred, results achieved, or statements made. Records are created/received by an organization in routine transaction of its business or in pursuance of its legal obligations. A record may consist of two or more documents.

Records include accounts, agreements, books, drawings, letters, magnetic/optical disks, memos, micrographics, etc. Generally speaking, records function as evidence of activities, whereas documents function as evidence of intentions.

Characteristics of records systems

To operate effectively, records systems should have the following characteristics:

Characteristics	**The records system should...**
Reliable	• routinely capture records within the scope of the business activity it supports • routinely create process metadata • provide adequate information about the records within them • have controls that will ensure accuracy and quality of records

	created, captured and managed • present records in useable and readable form • provide timely access to records • prevent unauthorised access, use, alteration, concealment, deletion, destruction or removal of records • manage and store records for as long as they are needed
Secure	• allow setting up access and permission controls to protect records from unauthorised use, alteration, deletion or removal, such as user registration/deregistration • have security controls that allow logging, monitoring and termination of access and use. The logs should be protected from tampering.
Compliant	• be designed and managed in compliance with legal and regulatory requirements that apply to the business documented within them. Please note that the records system's compliance should be regularly monitored and assessed.
Comprehensive	• create, capture and manage records and associated metadata resulting from the business activities supported by the system
Fixity	• capture and preserve records as an accurate, unaltered record of the business activity or systems event it documents in a fixed point in time. Records may be captured through the process metadata which shows information on the changes made to the record, when and who changed the records.

3.11. FUNCTIONS OF RECORDS SYSTEMS

In addition to having these characteristics, records systems must be capable of performing a range of standard functions.

Functions	The records system is able to...
Registration	• create and/or capture records by assigning them unique identities and when necessary allow users to provide additional description, such as a title and date of the record • create and/or capture process metadata such as date of creation and/or capture and by whom.
Indexing	• build a list of keywords or index, associated with the record. The index aids in searching and retrieval of records and may be built using metadata or the record content.
Search and retrieval	• provide a mechanism to identify and show records in response to search queries.
Access and security monitoring	• assign and implement rights or restrictions that protect records against unauthorised or inappropriate use or access
Tracking	• log, monitor and show events such as user access, additions, alterations and deletions carried out on the record, date of the action

	and by whom.
Disposal	• facilitate authorised disposal of records • log and show information on disposal actions such as date and time of disposal and by whom.
Export	• extract select or all records (including associated metadata, when needed) regardless of format without loss or degradation of content or metadata
Reporting	• generate any reports deemed necessary by the organisation

3.12. MEANING AND DEFINITION OF REPORT

Report is a message presented before the management after making detailed inquiry or investigation with or without opinions or recommendations. In other words, report conveys the information which is used to find the fact or to assist in decision making or solving any business problems. Generally, report is prepared and presented according to the needs of the top management. The word "Report" is derived from the Latin word of "reportare" which means carry back. Re means back and portare means to carry. Therefore, a report is a description of an event carried back to someone who was not present on the scene. A report is an **organized statement of facts** relating to a particular subject prepared by reporter(s) after making independent inquiry or investigation with or without opinions or recommendations.

DEFINITION OF REPORT

According to **M.C Shukla**, "A report is any written or oral communication in which according to the nature and purpose of the report, the reporter presents a collection of facts or a number of alternative propositions, states his conclusions and (if called upon to do so) submits his recommendations".

According to **Rohini Aggarawal**, "A report is an orderly and objective presentation of information that helps in decision making and problem solving".

According to **C.A Brown**, "A report is a communication from someone who has some information to someone who wants to use this information".

3.13. CHARACTERISTICS OR FEATURES OF A REPORT

The followings are the features of the Report.

1. **Precise**: The reporter should be very clear in drafting a report. If so, he/she may present the report very precisely with coherence and makes it a valuable document.
2. **Accuracy**: The construction of sentences brings accuracy of the disclosed information. Besides, there is no ambiguous in understanding. Spelling mistake irritates the reader. Faulty punctuation may mislead the meaning.

3. **Only Facts**: The management is going to take a decision on the basis of the factual information available in the report. Inaccurate facts may lead to faulty decisions.
4. **No Grammar Mistake**: All the rules relating to grammar should be followed while drafting a report. The quality and validity of the report is affected due to grammar mistake.
5. **Relevance**: Only relevant information must be included in the report. Irrelevant information should not be included in the report. If relevant information is not included, the report is incomplete. If irrelevant information is included the readers are confused.
6. **Simple Language**: Simple sentences can be used for drafting a report. Lengthy sentences should be avoided. A report should be understood by an ordinary layman.
7. **Unambiguous Language**: The report should be free from ornamental language. Unknown words, unfamiliar words and double meaning words should not be used while drafting a report. Idioms and Phrases may be used if required for proper understanding of the subject.
8. **Reader Orientation**: It is necessary to keep in mind the person(s) who is (are) going to read the report. There must be an attraction in the report while reading the same.
9. **Arrangement of Matters**: The subject matter of the report should be symmetrically arranged. If so, the readers can understand the report in the right direction.
10. **Clarity**: Clarity depends on proper arrangement of facts. The report can be presented in the order of introduction about the preparation of the report, objectives of report, sources of data, methodology used for collecting the data, findings and finally recommendations. These are presented in the form of short paragraphs with suitable main headings and sub-headings to achieve greater clarity.

3.14. OBJECTIVES OF REPORTS

Transmitting Information: Business report is very important for transmitting information from one person to another or form one level to another. Although a manager can personally collect required information in a small scale enterprise, it is not possible in the context of a large scale organization. In the latter case, the managers rely on reports for obtaining necessary information

Interpretation and Explanation of event: Report provides interpretation and explanation of information. As a result, readers can easily understand it.

Making decisions: A report is the basic management tool for making decisions. The job of a manager is nothing but making decisions. Reports supply necessary information to managers to solve problems.

Communication with external stakeholders: In addition to internal use, reports also communicate information to the external stakeholders like shareholders, creditors, customers, suppliers, government officials and various regulatory agencies. In the absence of formal business report, such stakeholders would remain at dark about the organizations.

Development of information base: Reports also contribute to the development of information base in organization. It develops information base in two ways. Firstly, day to day information is recorded permanently for writing reports. Secondly, the written reports are preserved for future reference. In these ways, reports help in developing a strong and sound information base.

Developing labour-management relationship: Reports also help to improve labour-management relationship particularly, in large organizations. In a large organization, there is little opportunity of direct communication between top-level management and employees. In this case, report is used as mechanism of keeping both sides informed about each other and improving their relationships.

Controlling: Controlling is the final function of management. It ensures whether the actual performance meets the standard. In order to perform the managerial function of controlling, report serves as a yardstick. It supplies necessary information to impose controlling mechanism.

Recommending actions: Reports not only supply information but also recommend natural actions or solutions to the problem. When someone is given the charge of investigating a complex problem and suggesting an appropriate remedy, the investigator usually submits a report to the concerned manager.

Above discussion makes it clear that reports are the commonly used vehicles that help mangers in planning, organizing, staffing and controlling. In a nutshell, report is indispensable for carrying out the management functions. Report is the nerve of an organization that circulates information.

3.15. PURPOSE OF REPORTS

Bank reports are prepared and written to serve the following purposes:

i) **Means of Communication:** Reports are means of upward communication. It is a communication from some one who has the information to someone who needs that information for carrying out functions of management. Reports provide information to executives, government agencies, shareholders, creditors, customers or general public.

ii) **Serve as Record:** Reports provide valuable records for future reference Reports record facts and results of investigations. The facts can be of great importance in future.

iii) **Legal Requirements:** Reports are also written and submitted to fulfil legal requirements. For instance, Annual report of Company's Accounts is necessary to be furnished to shareholders under Companies Act, 1956. Similarly, audit report of accounts must accompany the income-tax return under Income Tax Act, 1961.

iv) **To Develop Public Relations:** Reports of general progress of banking business and utilisation of national resources to public helps in increasing the goodwill and developing public relations.

v) **Basis to Measure Performance:** Routine reports about the work performance of bank employees help the management to measure performance in view of the objects. The reports on performance shall become the basis of promotions and incentives.

vi) **Control Purposes:** Reports are the basis of any control process. It is on the basis of reports actions are initiated and instructions are given to improve the performance.

3.16. TYPES OF BANK REPORTS

Bank reports can be divided in following kinds:

1. **Statutory Reports:** such reports are prepared in prescribed forms under various legal provisions. These are submitted periodically to various government agencies. The method of preparing such report is prescribed under the rules relevant to the Act.
2. **Non-Statutory Reports:** The reports which are required under law are non-statutory in nature. The remaining reports stated in following categories fall in this classification.
3. **Routine Reports:** These are prepared in routine manner and submitted to the management for information sake. Such reports are repetitive in nature and submitted periodically. Thesereports contain facts regarding performance of employees and departments. The purpose of such report is to maintain flow of information for planning and control. These may be submitted daily, weekly or monthly. Another name for such reports is Periodical reports or Repetitive reports or Information reports.
4. **Special Reports:** Such reports are written in the case of special events or state of business affairs. The purpose of these reports is to collect facts and analysis of facts to interpret the causes. Bank management can take its decisions on the basis of recommendations made in the report. The examples of such reports are labour turnover

report, accident report, management audit report, etc. these reports are non-repetitive and analytical in nature.

5. **Formal Reports:** These are official reports and are required under office routines. These reports are part and parcel of information system in any banking organization. Such reports may be statutory, routine or special.
6. **Informal Reports:** These are un-official reports may be written or oral. Such reports constitute informal communication. These are furnished in personal capacity. The examples of such reports are progress report, justification report, etc. the flow of such information may be upward, downward or lateral.
7. **Technical Reports:** These reports contain information of technical nature. These are prepared by experts for some specific purpose.
8. **Factual Reports:** Also called statistical reports, these include presentation of facts without any analysis or comments. Such reports are prepared if management requires.
9. **Analytical Reports:** If data shown in factual or statistical reports is analysed and interpreted, then such reports will be called analytical reports.
10. **Functional Reports**: These reports relate to each function of the bank management. For instance, if report is submitted for the purpose of control then it will be called 'Control Report'. If the object of report is related with finance then it is called as 'Financial Report'.

3.17. PROCESS OF REPORT WRITING

The process of writing and designing a report consists of three stages. These stages are:

1. Deciding the nature and purpose of the report.
2. Structuring of the report.
3. Drafting of a report.

These stages are explained as follows:

1. **Deciding the nature and purpose of the report:** The first stage is to know the type of report, whether the report is statutory or non-statutory. Its type shall determine the nature and shape of the report. It is also very essential to know the purpose or object of the report. The purpose shall determine the other two stages.
2. **Planning Structure of the Report:** There is one way to design the structure of the report. But following parts are common in any part.
   - **i) Heading:** A short, clear, meaningful and attractive heading or title is necessary for a report. Title or heading should indicate the subject-matter of the report.

ii) **Address:** Every report is written for some one. So it is essential to write the name of reader or readers. Report must be addressed to some person or body of persons.

iii) **Contents:** It is a list of chapters of the report. The contents of the report are listed in serial order along with page numbers on which such contents are to be found. Contents should be arranged logically.

iv) **Terms of Reference or Introduction:** It gives the reasons for writing a report. Brief description of the problem is stated. The object and scope of investigation are also given in this part.

v) **Body of the Report:** This part is most important and lengthy. The writer represents here the facts and data collected by him. Use of tables, graphs, diagrams can be made here on in appendices. The analysis of data is shown in this part.

vi) **Recommendations:** This part is the summary of the report and consists of conclusions and recommendations. The conclusions are made on the basis of the facts and collected data. Recommendations or suggestions are given on the basis of conclusions.

vii) **Reference and Appendices:** It is customary to mention list of references and bibliography indicating the sources from where the writer has taken material for writing the report. Appendices contain diagrams, statistical tables, specimen forms etc.

viii) **Signature:** Every report should be signed by the person responsible for its preparation. Any report submitted by a committee should be signed by the chairman. It is advisable to mention date on the report.

3. **Drafting a Report:** Drafting of a report is an important stage in report writing. This stage includes following considerations:

   I) Collection of data and its analysis: First step in drafting is collecting information, facts and data necessary for the purpose of them report. Data is collected by investigations, observations, interviews or by surveys, etc. Collected data has to be classified, tabulated, edited and analysed. The collected data has to be arranged logically and conclusions are drawn.

   II) **Format of a report:** The format of a report refers to structure of a report which has already been explained. It is concerned with the layout of the report and arrangement of the data. It can be standardized for the purpose. If report is in a 'letter form' then it has salutation and a complimentary close. If report is in memorandum form, both salutation and complimentary close may be dispensed with.

III) Writing of report (guiding principles): Report writing is an art which can be developed by practicing report writing and by studying the reports of other writers. Reports are written for others so the needs and style preferred by the reader should be kept in mind while writing a report. Following guidelines shall help the writer :

a) The purpose of the report should bee known to the writer.
b) The report should contain correct information.
c) The report should be concise but comprehensive.
d) Complete information should be stated in a report
e) It should be written in clear and convincing language.
f) Use of short sentences and simple language will help the readers to understand the report.
g) Report should be written in first person. However, if report is prepared by a committee then it is written in third person.
h) Positive expression should be used while writing.
i) Emotional language and passive voice should be avoided.
j) Use of necessary phrases like ‘in this regard’, ‘on the other hand’, ‘we mean to say’, etc. is avoided.
k) Avoid duplication and repetition of ideas and sentences.
l) Take care of punctuations.

IV) Presentation of Report: General layout of a report should be pleasing to the eye. Report may be typewritten, printed or handwritten depending on the number of copies required. Sufficient space and margin should be kept on the left hand side. Reports should be written onone side of the paper with double spacing. Pages, paras and sections should be numbered. Use of diagrams, illustrations, charts, tables may be made and these should be numbered. If report is voluminous or is liable to constant handling, it should be in bound form.

3.18. STATEMENT OF ADVANCES

The advance of a specified sum of money to an individual or business (the borrower) by a commercial bank, savings bank, etc. (the lender). A bank loan is a form of credit that is often extended for a specified period of time, usually on fixed interest terms related to the base interest rate, with the principal being repaid either on a regular instalment basis or in full on the appointed redemption date. Alternatively, a bank loan may take the form of overdraft facilities under which customer can borrow as much money as they require up to a prearranged total limit and are charged interest on outstanding balances. In the case of business borrowers, bank loans are used to finance working capital requirements and are often renegotiated shortly before expiring to provide the borrower with a revolving line of credit. Depending upon the nature of the loan and the degree of risk involved, bank loans may be unsecured or secured, the latter requiring the borrower to deposit with the bank collateral security (e.g. title deeds to a house) to cover against default on the loan.

3.19. CLASSIFICATION OF LOAN OR ADVANCES

In April 1992, RBI introduced new asset classification standard for Indian Banks on the international lines. Now the banks are required to classify the loan assets into four categories, viz.,

a) **Standard Assets:** Standard asset is one which is not a non-performing asset and which does not disclose any problem, nor carry more than normal risk attached to the business.
b) **Sub-standard Assets:** Assets which have been classified as non-performing assets (NPA) for a period not exceeding two years. There is no promise of recovering the dues in full, having regard to the value of security or current net worth of the borrower/guarantor. In the case of term loans, those where instalments of principal are overdue for periods not exceeding two years should be treated as sub-standard.
c) **Doubtful Assets:** These are assets classified as NPA for a period exceeding two years. In case of term loans, those where instalments of principal have remained overdue for a period exceeding two years should be treated as doubtful. Asset rescheduling does not entitle the bank to upgrade the quality of advance automatically.
d) **Loss Assets:** A loss assets is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly or partly.

Such an asset is considered uncollectable and of such little value that its continuance as a bankable asset is not warranted, although there may be salvage or recovery value.

Provisioning: The essential idea in the above classification of bank assets is to make adequate provision on the basis of the quality of the asset, the prospect of realization of then security and the erosion in the value of security charged to the banks. If this is not done the balance sheet does not have a healthy look. The RBI has directed the banks to make provision in the manner indicated below:

a) **Loss Assets:** These will have to written off entirely or alternatively if retained in the books for some reason, then provision should be made for 100% of the amount.

b) **Doubtful Assets:** To the extent the debt is not covered by security 100 % provision has to be made. In addition for secured portion of the doubtful asset, provision to be made between 20 percent and 50 percent depending upon the period given below:

Period for which the advance has been considered doubtful	% of provision
Up to one year	20
One to three years	30
More than three years	50

c) **Sub-standard Assets:** A general provision of 10% of total outstandings should be made in this category.

d) **Standard Assets:** Since they are sound no provision is required.

In the balance sheet all such provisions made for tax, provisions required in respect of loss assets, etc., depreciation in securities are shown under the heading 'Other Liabilities and Provisions'– sub head 'Provisions'. However, in the case of provision for bad and doubtful debts, instead of showing the provision on the liabilities side of the balance sheet, the same may be deducted from the item 'Advances' on the assets side, as is the practice of banks.

Title

Statement of Advances

Schedule 9 – Advances

		As on 31.3…. (current Year)	As on 31.3…… (provisions year)
A.	i) Bills purchase and discounted ii) Cash credits, overdrafts and Loans repayable on demand **iv)** Term Loans Total		
B.	**i)** Secured by tangible assets **ii)** Convered by Bank/ Government guarantees **iii)** Unsecured Total:		
C.	I. Advances in India i) Priority sectors ii)Public sector 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 (C.I & II)		

3.20. THE MEANING OF PROFIT AND LOSS ACCOUNT OF BANKS

The basic function of a bank is to accept deposits and give out loans. On the loans that it gives out, it charges an interest rate. This interest earned is the key revenue source for a bank. This term is known as 'interest income'.

Apart from interest income from loans advanced, it also earns interest from certain investments that it makes. In addition, a bank is also required to keep a certain amount of its cash reserves with the RBI. However, it must be noted that a bank's interest income from investments depends upon some key factors like monetary policies (Cash reserve ratio and statutory liquidity ratio limits) and credit demand.

Cash reserve ratio (CRR) is a certain percentage of deposits which a bank is mandated to maintain with the RBI. Statutory liquidity ratio (SLR) is the second part of regulatory requirement, which requires banks to invest in G-Secs. The bank's revenues are basically derived from the interest it earns from the loans it gives out as well as from the fixed income investments it makes. If credit demand is lower, the bank increases the quantum of investments.

Apart from interest income being the key revenue source for a bank, it also earns income in the form of fees that it charges for the various services it provides. These services include processing fees for loans and forex transactions, amongst others. It is believed that banks derive nearly 50% of revenues from this stream in developed economies. In India, the story is very different. This stream of revenues contributes about 15% to the overall revenues.

Now that we have covered the income part of the profit and loss account, we shall move on to the expenditure aspect of the same. The key expense of a bank is interest on deposits that are made with it. These could be in the form of term (fixed) or savings bank account deposits. The second biggest expense head for a bank would be its operating expenses. This head would include all operational costs, which even non-financial companies expend. Some of include employee costs, advertisement and publicity costs, administrative costs, rent, lighting and stationary.

Under expenses, there is also an item called 'provisions and contingencies' that is included. In the simplest terms, these are liabilities that are of uncertain timing or amount. This includes provisions for unrecoverable assets. In accounting terms, such provisions are called as 'Provisions for Non-performing assets (NPAs)'. Apart from NPAs, these provisions also include provision for tax and also depreciation in the value of investments.

After removing these heads from the income generated, we simply arrive at the profits figure. The process of appropriation thereafter is similar to that of non-financial companies.

1. **PROFIT AND LOSS ACCOUNT** • A summary of the revenues, costs and expenses incurred during a specific period of time • Prepared to calculate the profit or loss of the Organisation during one financial year.
2. **FUNCTIONS OF A BANK** 1. Receiving deposits from the public 2. Granting loans and advances 3. A bank performs certain functions as an agent for and on behalf of its customers. 4. Other functions: • Issuing letters of credit to its customers • Issuing bank drafts • Issuing travellers cheques • Lockers
3. **PROFIT AND LOSS ACCONT OF BANKING COMPANIES** • Banking Business in India is governed by the Banking Regulations Act 1949 • Section 29 of this Act lays down the provisions regarding Accounts and Balance Sheet of a banking company • The profit and loss account is shown in 'Form B' of Schedule III of this Act
4. **SCHEDULES RELATED TO PROFIT AND LOSS ACCOUNT** The schedules related to the calculation of income and expenses of a bank are as follows: • Schedule 13: Interest Earned • Schedule 14: Other Incomes • Schedule 15: Interest Expended • Schedule 16: Operating Expenses
5. **FORM B: PROFIT AND LOSS ACCOUNT** I. Income Interest earned (Schedule 13) Other income (Schedule 14) Total II. Expenditure Interest expended (Schedule 15) Operating expenses (Schedule 16) Provisions and contingencies Total III. Profit / Loss Net profit / loss (-) for the year IV. Appropriations V. Balance carried over to Balance Sheet
6. **SCHEDULE 13:** INTEREST EARNED • Interest/discount on advance/bills • Income on investments • Interest on balances with Reserve Bank of India and other Inter bank funds • Others

7. **SCHEDULE 14:** OTHER INCOME • Commission, exchange and brokerage • Profit on sale of investments (Less: Loss on sale of investments) • Profit on revaluation of investments (Less: Loss on revaluation of investments) • Profit on sale of land, buildings and other assets (Less: Loss on sale of land, buildings and other assets) • Profit on exchange transactions (Less : Loss on exchange transactions) • Income earned by way of dividends, etc. from subsidiaries/ companies and/or joint ventures abroad/ in India • Miscellaneous income
8. **SCHEDULE 15:** INTEREST EXPENDED • Interest on deposits • Interest on Reserve Bank of India/Inter bank borrowings • Others
9. **SCHEDULE 16:** ORERATING EXPENSES • Payment to and provisions of employees • Rent, taxes and lighting • Printing and stationery • Advertisement and publicity • Depreciation on bank's property • Director's fees, allowances and expenses `
10. **Cont.** • Auditor's fees and expenses (including branch auditors) • Law charges • Postages, Telegrams, Telephones, etc. • Repairs and maintenance • Insurance • Other expenditure
11. **APPROPRIATION OF PROFITS** • Transfer to statutory reserves • Transfer to other reserves • Transfer to government/ Proposed dividend = Final Balance Transferred to the Balance Sheet (Transferred to the liabilities side under the head 'Reserves and Surplus')

FEATURES OF PROFIT AND LOSS ACCOUNT

- It is a financial statement **prepared** at the end of the accounting period.
- It is prepared to calculate the net profit or net loss of the business by **matching** incomes and expenses for a given accounting period.
- It **starts** with the balance from Trading Account (i.e., either gross profit or gross loss).
- All **indirect expenses** or losses (like office and administrative expenses, selling and distribution expenses, loss by fire and theft, etc.) are debited to Profit and Loss Account.
- All **indirect expenses** (like discount received, commission received, interest received, etc.) are credited to Profit and Loss Account.
- The difference of the two sides of the Profit and Loss Account is either **net profit** or net los for a given accounting period.
- The net profit or net loss is **transferred** to the capital account of the proprietor. Net profit increases the capital and net loss decreases the capital.

- It shows the net results of the operations of the business or the financial performance of the business.

NEED AND IMPORTANCE OF PROFIT AND LOSS ACCOUNT

The need and importance of preparing Profit and Loss Account can be briefly summarised as follows:

i) **To determine net profit or net loss:** Profit and Loss Account is prepared to provide information about the net profit earned or net loss suffered by the business during a particular accounting period.

ii) **To show financial performance:** Profit and Loss Account shows the financial performance of the business, i.e., net results of the business operations during a particular period.

iii) **To know the change in profitability:** Profitability of the current year can be compared with previous years to know the changes so that steps would be taken to improve profitability.

iv) **To provide control over expenses and revenues:** The expenses and the incomes shown in the Profit and Loss Account can be analysed and compared with previous years to know the changes and to exercise control over them.

v) **To forecast the future performance:** The Profit and Loss Account helps to estimate the profit to be earned during next accounting period. On the basis of the profits earned during the current year, the future financial performance of the business is determined

3.21 PREPARATION OF PROFIT AND LOSS ACCOUNT

Prescribed Form: This has been given in the form B of the Third Schedule to the Banking Regulation Act, 1949. The form is in a summary fashion and the details are given in the schedule. RBI has given guidelines for compilation of both the profit and loss account and the balance sheet. Below are given the form of profit and loss account, the schedules showing the details and the instruction of RBI for compiling the profit and loss account and in that order.

Banking Regulation Act, 1949

FORM B: - Profit and loss account for the year ended on 31st March (year)

Schedule No. ....

Year ended on 31-3-19....... (current year)

year ended on

31-3-19....... (previous year)

I. Income

Interest earned

Other income

Total

II. Expenditure

Interest expended

Operating expenses

Provisions and contingencies

Total

III. Profit / Loss

Net profit / loss (-) for the year

Profit / loss (-) brought forward

Total

IV. Appropriations

Transfer to statutory reserves

Transfer to other reserves

Transfer to government/ Proposed dividend

Balance carried over to Balance sheet

Total

13

14

___________ ____________

__________ ____________

15

16

____________ ____________

_____________ _________

_____________ ___________

_____________ __________

____________ _____________

___________ ____________

Schedule 13: Interest earned

As on 31-3-19...... As on 31-3-19.......

(current year) (previous year)

I. Interest/discount on advance/bills

II. Income on investments

Ill. Interest on balances with Reserve

Bank of India and other inter-bank funds

IV. Others

Total

_____________ ____________

____________ _____________

Schedule 14: Other income

As on 31-3-19....... As on 31-3-19.....

(current year) (previous year)

I. Commission, exchange and brokerage

II. Profit on sale of investments

Less: Loss on sale of investments

III. Profit on revaluation of investments

Less: Loss on revaluation of investments

IV. Profit on sale of land, buildings and other assets

Less: Loss on sale of land, buildings and other assets

V. Profit on exchange transactions

Less: Loss on exchange transactions

VI. Income earned by way of dividends, etc. from subsidiaries/companies and/or joint ventures abroad/ in India

VII. Miscellaneous income

Total

_______________ _____________

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

Schedule 15 : Interest expended

As on 31-3-19....... As on 31-3-19.......

(current year) (previous year)

I. Interest on deposits

II. Interest on Reserve Bank of India/Inter bank borrowings

III. Others

Total

Schedule 16 : Operating expenses

As on 31-3-19..... As on 31-3-19.....

(current year) (previous year)

I. Payment to and provisions of employees

II. Rent, taxes and lighting

III. Printing and stationery

IV. Advertisement and publicity

V. Depreciation on bank's property

VI. Director's fees, allowances and expenses

VII. Auditors' fees and expenses (including branch auditors)

VIII. Law charges

IX. Postages, Telegrams, Telephones, etc.

X. Repairs and maintenance

XI. Insurance

XII. Other expenditure

Total:

3.22. SALIENT FEATURES OF PROFIT AND LOSS ACCOUNT

1) In pursuance of the policy of greater disclosure, provisions for bad debts and taxation are not deducted from the income on the credit side but debited to the account under the head provisions and contingencies. Although this is an improvement over the previous position, still it is not possible for a user to find out the details of bad debts etc.

2) Director fees, allowances etc. are shown separately and are not mixed up with salaries, etc paid to employees.
3) The Appropriation Account under the revised form is part of profit and loss account. Previously the profit was taken directly to the balance sheet and appropriations were shown therein.
4) Insurance is to be shown separately in the schedule covering 'operating expenses'. Every bank seeks insurance cover for its deposits and pays premium to Deposit Insurance and Credit Guarantee Corporation. Banks also insure their property and also possible embezzlement of moneys by its employees. Premia paid on these policies is also under this heading.
5) Provisions for tax and bad debts are now shown under the head 'Provision and Contingencies'. However details of such provisions are not given as there is no schedule for this item. Provision for bad debts is deducted from Advances and Provision for that is shown under the heading 'Other Liabilities and Provisions' in the Balance sheet.

3.23. BALANCE SHEET

Meaning

Balance Sheet is a summary statement which shows the financial position of a business on a particular date. It is also a Statement of Financial Position. Financial Position refers to the position of a business in terms of what it owns, i.e., assets and what it owes to outsiders and the owner, i.e., liabilities and capital. Excess of assets over liabilities to outsiders represents the capital and is indicative of the financial soundness of a business.

Features of a Balance Sheet

- It is a **statement** and not an account. It has no debit side or credit side.
- It is **prepared** only after the preparation of Profit and Loss Account.
- It is usually prepared on the **last day of the year** by taking into account real and personal accounts existing in the trial balance.
- It shows the **financial position** of a business in terms of what it owns (assets) and what it owes (liabilities) on a particular date. It is not prepared for a particular period.
- It reveals the financial position (or **health**) of the business and not of the owner.
- The financial position as disclosed by a Balance Sheet holds good **at a given date** i.e., on the date of preparation. On the next day, the financial position may change.

- Both the sides of a balance sheet should **always agree**. If it is not, there are certainly some errors.

Need and Importance of Balance Sheet

The main functions of preparing a Balance Sheet are as follows:

- **To know the nature and value of assets:** The Balance Sheet shows the nature and value of the resources/assets of a business as on a particular date.
- **To ascertain the nature and amount of liabilities:** The Balance Sheet shows the nature and amount of liabilities, i.e., what the business owes on a particular date.
- **To know the capital:** The Balance Sheet shows the capital which is the owner's claim on the business as on a particular date.
- **To show the health of the business:** The Balance Sheet shows the financial position or health of a business as on a particular date.

3.24 PREPARATION OF BALANCE SHEET

Balance Sheet is prepared after the preparation of Trading and Profit and Loss Account. All nominal accounts are shown in Trading and Profit and Loss Accounts. The remaining accounts in the Trial balance represent real and personal accounts which are taken to Balance Sheet. All real and personal accounts showing debit balances represent assets and are shown on the right hand side of the Balance Sheet called Asset side. Similarly, all the personal accounts having credit balances represent liabilities and are shown on the left hand side called Liabilities side. The net profit as shown by the Profit and Loss Account is added to the capital on the liabilities side. In case Profit and Loss Account shows net loss, it is to be deducted from capital. Drawings made by the proprietor are also deducted from capital.

Legal Form: The Balance Sheet of a banking company is to be prepared in Form A given in the third schedule to the Act. Unlike the previous form, the present one is devoid of details, the latter being shown in the schedules. RBI has given guidelines for compiling the balance sheet. Below are given Form A, the schedules there under and the instructions of RBI and in that order.

Balance sheet of a bank is made with the rules and regulations of banking laws. In India, banking regulation act 1949 has given some rules for making balance sheet of any bank who is working in India or whose corporate office in India. This law's schedule III and its form A will be given as guide for making balance sheet of a bank. We are explaining liabilities and assets according to this.

Liabilities Side of Balance Sheet of a Bank

Schedule 1: Capital of a Bank

We have to show paid up capital of bank. If bank is incorporated outside India, then its start up capital will be shown under this schedule in balance sheet's liabilities side.

Schedule 2: Reserves and Surplus

a) Statutory reserve

b) Capital reserve

c) Share premium

d) Revenue and other reserve

e) balance of profit and loss account

Schedule 3: Deposits

Deposits of customers in bank will be the liability of bank. This liability will be classified in saving banks deposit, term deposits, demand deposits.

Schedule 4: Borrowing

Sometimes bank takes loan from RBI or other banks. All these borrowings are the liabilities of bank.

Schedule 5: Other Liabilities and Provisions

In these liabilities, we can include bill payable, outstanding interest and provision for taxes.

Assets Side of Balance Sheet of a Bank

Schedule 6: Cash and Balance with RBI

RBI has made rule of depositing some money with him. So, cash and balance with RBI will be the asset of a bank.

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

Above Schedule 3 is deposit liability. But some of these deposits bank keeps in his pocket in cash form or money at call or short notice. So, this is the asset of bank.

Schedule 8: Investment

Bank is not doing social activities. It is doing business. Most of his deposit is invested in good and profitable schemes. All investment of bank will be the asset of bank. It will be shown under schedule 8. In investment of bank, we can include investment in govt. securities, investment in shares, bonds, debentures and investment in subsidiaries.

Schedule 9: Advances

Bank gives advance to other banks in the form of cash credit, bank overdraft and loan payable on demand. All these advances are the assets of a bank and will be shown under schedule 9 in the asset side of balance sheet of a bank.

Schedule 10: Fixed Assets

Banks all branch offices building and land will be part of its fixed asset, if these are own of bank. Bank may have other fixed assets like furniture, fixtures, equipment, computers and ATM Machines. All addition in it will add in the opening balance of fixed asset. All deduction will deduct from the balance of fixed asset. We deduct depreciation of each fixed asset except land.

Schedule 11: Other Assets

In other assets, we can show stock of stationery and stamps, tax paid in advance, interest receivables, and bills for collections.

Schedule 12: Contingent Liability

Liabilities on partly paid shares, debentures, etc. will be included in this head. It claims against the bank not acknowledged as debt.

BANKING REGULATION ACT, 1949

FORM A: - Form of Balance Sheet

Balance sheet of ....(enter name of banking company)

Balance sheet as on 31st March ....(Year)

(000's omitted)

Capital and liabilities

schedule

As on 31-3-19.... As on 31-3-19....

(current year) (previous year)

Capital

Reserve and surplus

Deposits

Borrowings

Other liabilities and provisions

ASSETS

Cash and balances with Reserve

Bank of India

Balance with banks and money at

Call and short notice

Investment

Advances

Fixed assets

Other assets

Contingent liabilities

Bill for collection .

Total :

Total :

1

2

3

4

5______________ ______________

_______________ ______________

6

7

8

9

10

11___________ ______________

___________ ______________

12

Schedule 1 Capital

As on 31-3-19.... As on 31-3-19.....

(current year) (previous year)

I. For Nationalized 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)

(ii) Amount of deposit kept with the RBI under section 11(2) of the Banking Regulation Act, 1949

Total

III. For Other Banks

Authorized capital
(...............shares of Rs. ....each)
Issued capital
(.............shares of Rs. ....each)
Subscribed capital
(............... shares of Rs. ....each)
Called-up capital
(............... share of Rs. .... each)
Less : Calls unpaid
Add : Forfeited shares

Schedule 2: Reserves and Surplus

As on 31-3-19..... As on 31-3-19......

(Current year) (Previous year)

I. Statutory reserves

Opening balance

Additions during the year

Deductions during the year

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 year

IV. Revenue and other reserves

Opening balance

Additions during the year

Deductions during the year

V. Balance in Profit and Loss

Account

Total: (I + II + III+ IV + V)

Schedule 3: Deposits

As on 31-3-19...... As on 31-3-19......

(Current year) (previous year)

A. I. Demand deposits

(i) From banks

(ii) From others

II. Savings bank deposits

III. Term deposits

(i) From banks

(ii) From others

Total: (I + II + III)

B.(i) Deposits of branches in India

(ii) Deposits of branches outside India

Total___________ ____________

Schedule 4: Borrowings

As on 31-3-19...... As on 31-3-19......

(Current year) (Previous year)

I. Borrowings in India

(i) Reserve Bank of India

(ii) Other banks

(iii) Other institutions and agencies

II Borrowings outside India

Total (I + II)

Secured borrowings included in I and II above – Rs.

____________ __________

____________ ___________

Schedule 5: Other liabilities and provisions

As on 31-3-19...... As on 31-3-19......

(current year) (previous year)

I. Bills payable

II. Inter-office adjustments (net)

III Interests accrued

IV. Others (including provisions)

Total :

_____________ _____________

______________ _____________

Schedule 6: Cash and balances with Reserve Bank of India

As on 31-3-19...... As on 31-3-19......

(current year) (previous year)

Cash in hand

(including foreign currency notes)

Balances with Reserve Bank of India

(i) in current account

(ii) in other accounts

Total (I + II)

Schedule 7: Balances with banks and money at call &short notices

As on 31-3-19...... As on 31-3-19......

(current year) (previous year)

1. In India

(i) Balances with banks

(a) in current accounts

(b) in other deposit accounts

(ii) Money at call and short notice

(a) with banks

(b) with other institutions

Total (I + II)

Outside India

(i) in current accounts

(ii) in other deposit accounts

(iii) Money at call and short notice

Total (I + II + III)

Grand total: (I + II)

Schedule 8: Investments

As on 31-3-19...... As on 31-3-19......

(current year) (previous year)

1. Investment in Indian in

(i) government securities

(ii) Other approved securities

(iii) shares

(iv) Debentures and Bonds

(v) Subsidiaries and/or joint ventures

(vi) Other (to be specified)

Total :

II. investment outside India in

(i) Government securities (including local authorities)

(ii) Subsidiaries and/or joint venture abroad

(iii) Other investments (to be specified)

Total

Grand Total (I+II) ______________ _____________
______________ _____________
____________ ___________
___________ ___________
________________ ______________

Schedule 9: Advances

As on 31-3-19...... As on 31-3-19......

(current year) (pervious year)

A (i) Bills purchased and discounted

(ii) Cash credits, overdrafts and loans repayable on demand

(iii) Term loans

Total

B. (i) Secured by tangible assets

(ii) Covered by bank / government guarantees

(iii) Unsecured

Total:

C.I. Advances in India

(i) Priority sector

(ii) Public sector

(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 + CII)

Schedule 10: Fixed assets

As on 31-3-19...... As on 31-3-19.......

(current year) (previous year)

I. Premises

At cost on 31st March of the preceding Year

Additions during the year

Deductions during the year

Depreciation to date

II Other fixed assets (including furniture and fixtures)

At cost as on 31st March of the preceding year

Addition during the year

Deductions during the year

Depreciation to date

Total (I+ II)

Schedule 11: Other assets

As on 31-3-19...... As on 31-3-19......

(current year) (previous year)

I Inter office adjustment (net)

II Interest accrued

III. Tax paid in advance y tax deducted at source

IV Stationery and stamps

V.Non-banking assets acquired in satisfaction of claims

VI. Others

Total:

* In case there is any unadjusted balance of loss the same may be shown under this item with appropriate foot-note

Schedule 12: Contingent liabilities

As on 31-3-19......
(current year)

As on 31-3-19.......

(previous year)

I. Claims against the bank not acknowledge as debts

II. Liability for partly paid investments

III. Liability on account of outstanding forward exchange contracts

IV. Guarantee given on behalf of constituents

(a) in India

(b) outside India

V. Acceptances, endorsements and other Obligations

VI. Other items for which the bank is liable

3.24. SALIENT FEATURES OF BALANCE SHEET

1. **Liquidity order:** It will be seen that the asset side of the balance sheet is arranged in the order of liquidity — starting with cash the most liquid ones and ending with fixed assets and other assets which are least liquid. On the liabilities side, items are arranged in the order of descending urgency. The most urgent liability is shown in the last and capital which is paid only in the event of winding up is shown first.
2. **Information regarding "In India" and "Outside India":** From the schedules, it is clear that with respect to deposits and Borrowings on the liabilities side and balances with banks and money at call and short notice, investments and advances on the assets side, information must be given separately with respect to the position in India and outside India.
3. **Gold and Silver:** Investment in Gold appears under the heading 'Investments'. The new forms are silent about silver. The student may continue to show this item under the heading 'Other assets'. Commercial paper also appears under the heading 'Investments'.

4. **Investments:** Government securities must be shown at book value and any difference between book and market values must be indicated in the notes to the accounts. Other securities may be valued at cost or market price but disclosure must be given about the mode of valuation.
5. **Schedule of advances:** The old forms prescribed a very detailed 'Schedule of advances'. The new forms are simpler in this respect but advances in India must be classified into priority sector, public sector, banks and others.
6. **Inter-office adjustments:** The debit balance on this account appears under the heading 'Other Assets'. If the balance is credit, it will figure under 'Other Liabilities'.
7. **Interest accrued but not due:** The item on deposits and borrowings should be shown under "Other liabilities'. Interest accrued but not due on 'Investments' and 'Advances' appear under the heading 'Other Assets'. Interest due but not collected on investments is also shown under the heading 'Other assets'. Interest due ton advances will be part of advances. Similarly interest due on deposits will be credited to deposits and will not be shown separately.
8. **Contra items:** Bills for collection will appear as a separate item at the foot of the balance sheet. The other contra item 'Acceptances, endorsements and other obligations' will appear under the heading contingent liabilities, details being given in the schedule.
9. As before advances appear net of bad debts provision made to the satisfaction of the auditors. Any surplus provision for bad and doubtful debts, contingency funds, secret reserves etc. which are not netted off against the relative assets should be shown under the heading 'Other Liabilities and Provisions' and sub-heading 'others' (including provisions).

3.25. EXPLANATION OF SOME TERMS RELATING TO BALANCE SHEET

1) **Money at call and short notice:** This is the second heading on the assets side of balance sheet. It consists of loans — i) at call and ii) at short notice. These are revealed to inter-bank transactions. Under this arrangement, money is borrowed by one bank from another bank usually for 3 to 31 days. Banks having surplus money advance such loans. There is a regular and a large business on this account. Banks having short supply of money contact brokers for the fulfilment of their requirements. Brokers, who are in the knowledge of day-to-day position of the banks, immediately arrange money for them, from the banks having surplus money.

Investments: Investments in India are shown under the headings Government securities, other approved securities, shares, debentures and bonds, Investment in subsidiaries/joint ventures and others. The last category includes gold, commercial paper and other investments in the nature of shares/debentures/bonds. Investments outside India are shown under three headings, namely, Government Securities, subsidiaries and /or Joint ventures abroad and others. Old forms required information about quoted and unquoted investments. This is dispensed within the new forms.

2) **Advances:** Advances comprise Bills discounted and purchased; cash credits, overdrafts and loans repayable on demand and term loans. The total figure is shown in the balance sheet and the details are given in the schedule. The schedule also gives the break-up of the total according to the nature of security as secured by tangible assets; covered by bank/Government guarantee and unsecured Advances are further classified into priority sectors, public sector, banks and others. Advances outside India are classified into those due from the bankers and those due from others. The details in the new form are simpler than those under the old form.

3) **Cash credit loans and bank overdrafts:** These three items form one part of advances. The three terms are explained as under:

   Cash credit is an arrangement by which the banks agree to lend money up to a certain limit. It is not always necessary that the money should be withdrawn to that extent immediately. However, the bank has to keep the amount (to the extent of limit allowed) always ready under the fear that money may be demanded at any time. With a view to compensate, at least to some extent, the loss of interest on idle amount, the bank charges interest on the actual amount withdrawn at a little higher rate than charged on loan.

   Loan is an advance of a fixed amount to be withdrawn in lumpsum. It may or may not be secured by some assets of the borrowing company. The rate of interest on it is lower than that charged on cash credit as the bank has not to keep the amount idle.

   Bank overdraft: This is granted when the client has got the current account in the bank. Bank overdrafts are granted within the limit fixed by the bank authorities. Interest charged on the actual overdrafts is always at a higher rate than that charged on loan which is justified on the same ground advanced in favour of cash credit. It is a short period arrangement.

4) **Bills for collection:** These days a large amount of business is carried on with the help of banks. This becomes necessary, because the buyer is not ready to make the payment to

the seller until the goods are delivered to him and the seller is not ready to deliver goods until the payment is received by him. Since this business forms a very large part of total business of the bank, it keeps a register for recording the details of all the bills received for collection purposes. When bills are collected, journal entry is passed by debiting cash account and crediting clients account. Entry for the commission is also passed by debiting client's account and crediting commission account.

On 31st March bills and other instruments which are received from collection and not adjusted are shown as 'Bills for collection' at the foot of the summary balance sheet.

5) **Acceptances, endorsements and other obligations:** In the course of trade, the seller may not part with the goods unless the bill is accepted or endorsed by the banker. In all these cases, the primary liability is that of the buyer at whose instance the bill is accepted or endorsed or guaranteed for payment by the banker. Therefore, all acceptance, endorsements and guarantees given on behalf of the constituents are shown under the heading contingent liabilities at the foot of the balance sheet.

6) **Bills payable:** Bankers provide instruments like demand drafts telegraphic transfers, mail transfers and traveller cheques for remitting funds from one place to another. All such instruments which are outstanding are shown as bills payable. Banker's cheques are also shown under this heading. Letters of credit and bills accepted by customers on behalf of customers are shown under the heading 'Acceptances, endorsements and other obligations'.

   Banker's cheques are issued by banks for payments of their own and also when customers request the same in lieu of cash.

7) **Inter-office Adjustments:** The balance may be debit or credit. Debit balance is shown under 'Other Assets' and a credit balance is shown under 'Other Liabilities'. Only net position of inter-office accounts, inland as well as foreign, should be shown here. This balance will mostly deal with items in transit and unadjusted items.

8) **Rebate on Bills Discounted:** This can also be called by other names as 'discount received in advance' or 'Unexpired discount' or 'Discount received but not earned' and its treatment is the same as that for interest received in advance. 'Rebate on bills discounted account' like interest received advance account is personal in nature and thus if it appears –

   a) In the trial balance, it is taken direct to the balance sheet on the liability side under the heading other liabilities.

b) Under adjustments, it is taken to two places like any other adjustment. One part of this is taken to the balance sheet on the liability and the other part is taken to the profit and loss account and is deducted from the income from interest and discount. The net amount of income then is taken to the outer column of the profit and loss account.

3.26 FINANCIAL REPORTING

Definition of Financial Reporting

Financial Reporting involves the disclosure of financial information to the various stakeholders about the financial performance and financial position of the organization over a specified period of time. These stakeholders include – investors, creditors, public, debt providers, governments & government agencies. In case of listed companies the frequency of financial reporting is quarterly & annual.

Financial Reporting is usually considered an end product of Accounting. The typical components of financial reporting are:

1. The financial statements – **Balance Sheet**, **Profit & loss account**, **Cash flow statement** & **Statement of changes in stock holder's equity**
2. The **notes** to **financial statements**
3. **Quarterly** & A**nnual reports** (in case of listed companies)
4. **Prospectus** (In case of companies going for IPOs)
5. **Management Discussion & Analysis** (In case of public companies)

The Government and the Institute of Chartered Accounts of India (ICAI) have issued various accounting standards & guidance notes which are applied for the purpose of financial reporting. This ensures uniformity across various diversified industries when they prepare & present their financial statements. Now let's discuss about the objectives & purposes of financial reporting.

Objectives of Financial Reporting

According to **International Accounting Standard Board (IASB)**, the **objective** of **financial reporting** is "to *provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.*"

The following points sum up the objectives & purposes of financial reporting –

1. Providing information to the management of an organization which is used for the purpose of planning, analysis, benchmarking and decision making.

2. Providing information to investors, promoters, debt provider and creditors which is used to enable them to male rational and prudent decisions regarding investment, credit etc.
3. Providing information to shareholders & public at large in case of listed companies about various aspects of an organization.
4. Providing information about the economic resources of an organization, claims to those resources (liabilities & owner's equity) and how these resources and claims have undergone change over a period of time.
5. Providing information as to how an organization is procuring & using various resources.
6. Providing information to various stakeholders regarding performance management of an organization as to how diligently & ethically they are discharging their fiduciary duties & responsibilities.
7. Providing information to the statutory auditors which in turn facilitates audit.
8. Enhancing social welfare by looking into the interest of employees, trade union & Government.

Now let's discuss few aspects about importance of financial reporting.

Importance of Financial Reporting

The importance of financial reporting cannot be over emphasized. It is required by each and every stakeholder for multiple reasons & purposes. The following points highlights why financial reporting framework is important –

1. In help and organization to comply with various statues and regulatory requirements. The organizations are required to file financial statements to ROC, Government Agencies. In case of listed companies, quarterly as well as annual results are required to be filed to stock exchanges and published.
2. It facilitates statutory audit. The Statutory auditors are required to audit the financial statements of an organization to express their opinion.
3. Financial Reports forms the backbone for financial planning, analysis, benchmarking and decision making. These are used for above purposes by various stakeholders.
4. Financial reporting helps organizations to raise capital both domestic as well as overseas.
5. On the basis of financials, the public in large can analyze the performance of the organization as well as of its management.
6. For the purpose of bidding, labour contract, government supplies etc., organizations are required to furnish their financial reports & statements.

3.27. SUMMARY

A bank account is a financial account maintained by a bank for a customer. A bank account can be a deposit account, a credit card account, a current account, or any other type of account offered by a financial institution, and represents the funds that a customer has entrusted to the financial institution and from which the customer can make withdrawals. Alternatively, accounts may be loan accounts in which case the customer owes money to the financial institution.

Document that memorializes and provides objective evidence of activities performed, events occurred, results achieved, or statements made. Records are created/received by an organization in routine transaction of its business or in pursuance of its legal obligations. A record may consist of two or more documents.

A Report is an **organized statement of facts** relating to a particular subject prepared by reporter(s) after making independent inquiry or investigation with or without opinions or recommendations.

Preparation of profit and loss account refers in form B of the third schedule of Banking Regulation Act 1949. RBI has given guidelines for compilation of both profit and loss account and the balance sheet.

The Balance Sheet of banking companies is to be prepared in form A given in third schedule to the act. RBI has given guidelines for compiling the Balance Sheet

3.27. SELF-ASSESSMENT QUESTIONS

1. Define management of finance and discuss its characteristics.
2. Discuss the legal requirements affecting final accounts.
3. Discuss the preparation of profit and loss account.
4. Discuss the preparation of Balance Sheet.
5. Provision relating to advances, fixed assets.
6. Define bank report? Explain the purpose of report.
7. Define bank report and explain the types of bank reports.
8. Explain the process of report writing.
9. Define bank record and discuss its characteristics.
10. What is the difference between Balance sheet and financial reports?
11. Define financial report. Discuss types of financial report.

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UNIT IV LIFE INSURANCE

Structure

4.0 OBJECTIVES

After studying this unit you will be able to understand —

- Meaning ,definition and features of life insurance
- Classification of life insurance
- Life insurance products
- Principles of health insurance
- LIC of India
- Marketing life insurance

4.1 INTRODUCTION

The human life is uncertain. The rule of uncertainty of life applies not only to human beings but also to everything that is present on this earth in any shape, size or form. For instance, any human being or property which is present today may not remain in the same form tomorrow or day after tomorrow. Uncertainty dominates everything around us. This uncertainty creates a sense of loss and fear around us. This fear arising out of uncertainty has to be eliminated to make life meaningful and worth living. This feeling of loss cannot be eliminated completely but it can definitely be minimized. This minimization of loss can be done either by providing monetary help to the family of the deceased or by purchasing new property in place of the lost one. The medium through which loss arising due to uncertainty of life can be minimized is known as "Insurance".

4.2 MEANING AND DEFINITION

A contract is an agreement between two parties which can be enforced by law. Like any other contract, an insurance contract is governed by the Indian Contract Act, 1872.

Life insurance or life assurance is a contract between the policy owner and the insurer, where the insurer agrees to pay a sum of money upon the occurrence of the insured individual's death or other event, such as terminal illness or critical illness. In return, the policy owner (or policy payer) agrees to pay a stipulated amount called a premium at regular intervals or in lump sums. There may be designs in some countries where bills and death expenses plus catering for after funeral expenses should be included in Policy Premium. In the United States, the predominant form simply specifies a lump sum to be paid on the insured's demise.

As with most insurance policies, life insurance is a contract between the insurer and the policy owner (policyholder) whereby a benefit is paid to the designated Beneficiary (or Beneficiaries) if an insured event occurs which is covered by the policy. To be a life policy the insured event must be based upon life (or lives) of the people named in the policy.

A few definitions of life insurance are cited below:

1. According to **J.H.Maggi,** "The life insurance is a contract to which the insurer, in consideration of a premium, undertakes to pay to the person for whose benefit the insurance is effected a sum of money on the death of the person whose life is insured or on his attaining a certain age."
2. According to Section 2 (12) of the Life Insurance Act, "By life insurance business, we mean the business which perform the insurance of human life."

3. According to **S. C. Sahoo and S. C. Das**, "A contract in which the insurer, in consideration of a certain premium – either in lump sum or other periodical payments, agrees to pay to the assured or to the person for whose benefits, agrees to pay to the assured or to the person for whose benefits the policy is taken, a stated sum of money, on the happening of a particular event contingent on the duration of human life."

- **Basic Terminology of Insurance**
  - **a) Insurer:** One who does the insurance, i.e., who takes the responsibility of risk.
  - **b) Insured:** one whose insurance is done, i.e., whose responsibility of risk is taken by the insurer.
  - **c) Premium:** The fee charged by the insurer on account of providing services is called premium.
  - **d) Policy:** Document of contract of insurance in which terms and conditions related to the contract of insurance are mentioned is known as policy.
  - **e) Sum Assured: A**mount for which the insurance policy is taken is known as Sum Assured.

All the above terms can be explained through the following example.

Mr. Amit gets his car insured for Rs. 3, 00,000 from the oriental Insurance Co., Dehradun. The annual insurance premium is Rs. 3,500. After some days, the car met with an accident. The expenses for repairing the car which are to be paid amounted to Rs. 25,000. This amount will be paid by the insurance company. In this example, the Oriental Insurance Co. is the Insurer. Rs. 3,00,000 is the sum assured, Rs. 3,500 is the insurance premium and the document containing the terms and conditions of insurance is known as the policy.

4.3 FEATURES OF LIFE INSURANCE

The following are some of the characteristics of insurance which are, generally observed in case of life, marine, fire and general insurances.

1. **Sharing of Risk:** Insurance is a device to share the financial losses which might befall on an individual or his family on the happening of a specified event. The event may be death of a breadwinner to the family in the case of life insurance, marine-perils in marine insurance, fire in fire insurance and other certain events in general insurances, e.g., theft in burglary insurance, accident in motor insurance, etc. the loss arising from these events if shared by all the insured in the form of premium.
2. **Co-operative Device:** The most important feature of every insurance plan is the co-operation of large number of persons who, in effect, agree to share the financial loss

arising due to a particular risk which is insured. Such a group of persons may be brought together voluntarily or through publicity or through solicitation of the agents. An insurer would be unable to compensate all the losses from his own capital. So, by insuring or underwriting a large number of persons, he is able to pay the amount of loss. Like all cooperative devices, there is no compulsion here on anybody to purchase the insurance policy.

3. **Value of Risk:** The risk is evaluated before insuring to charge the amount of share of an insured, herein, called, consideration or premium. There are several methods of evaluation of risks. If there is expectation of more loss, higher pre3mium may be charged. So, the probability of loss is calculated at the time of insurance.
4. **Payment at Contingency**: The payment is made at a certain contingency insured. If the contingency occurs, payment is made. Since the life insurance contract is a contract of certainty, because the contingency, the death or the expiry of term, will certainly occur, the payment is certain. In other insurance contracts, the contingency is the fire or the marine perils etc., may or may not occur. So if the contingency occurs, payment is made, otherwise no amount is given to the policy holder. Similarly, in certain types of life policies, payment is not certain due to uncertainty of a particular contingency within a particular period. For example, in term insurance, payment is made only when death of the assured occurs within the specified term, may be one or two years. Similarly, in Pure Endowment payment is made only at the survival of the insured at the expiry of the period.
5. **Amount of Payment:** The amount of payment depends upon the value of loss occurred due to the particular insured risk, provided insurance is there up to that amount. In life insurance, the purpose is not to make good the financial loss suffered. The insurer promises to pay a fixed sum on the happening of an event. If the event or the contingency takes place, the payment does fall due if the policy is valid and in force at the time of the event, like property insurance, the dependents will not be required to prove the occurring of loss and the amount of loss. It is immaterial in life insurance what was the amount of loss at the time of contingency. But in the property and general insurances, the amount of loss as well as the happening of loss is required to be proved.
6. **Large Number of Insured Persons**: To spread the loss immediately, smoothly and cheaply, large number of persons should be insured. The cooperation of a small number of persons may also be insurance but it will be limited to smaller area. The cost of

insurance to each member may be higher. So, it may be unmarketable. Therefore, to make the insurance cheaper, it is essential to insure large number of persons or property because the lesser would be cost of insurance and so, the lower would be the premium. In past years, tariff associations or mutual fire insurance associations were found to share the loss at a cheaper rate. In order to function successfully, the insurance should be joined by a large number of persons.

7. **Insurance is not a gambling:** The insurance serves indirectly to increase the productivity of the community by eliminating worry and increasing initiative. The uncertainty is changed into certainty by insuring property and life because the insurer promises to pay a definite sum at damage or death. From a family and business point of view, all lives possess an economic value which may at any time be snuffed out by death and it is reasonable to ensure against the loss of this value as it is to protect oneself against the loss of property. In the absence of insurance, the property owners could at best practice only some form of self-insurance, which may not give him absolute certainty.

   Similarly, in absence of life insurance, saving requires time; but death may occur at any time and the property and family may remain unprotected. Thus, the family is protected against losses on death and damage with the help of insurance. From the company's point of view, the life insurance is essentially non-speculative; in fact, no other business operates with greater certainties. From the insured point of view, too, insurance is also the antithesis of gambling. Nothing is more uncertain than life and life insurance offers the only sure method of changing that uncertainty into certainty. Failure of insurance amounts to gambling because the uncertainty of loss is always looming. In fact, the insurance is just the opposite of gambling. In gambling, by bidding the person exposes himself to risk of losing, in the insurance; the insured is always opposed to risk and will suffer loss if he is not insured. By getting insured his life and property, he protects himself against, the risk of loss. In fact, if he does not get his property or life insured he is gambling with his life on property.

8. **Insurance is not Charity:** Charity is given without consideration but insurance is not possible without premium. It provides security and safety to an individual and to the society although it is a kind of business because in consideration of premium it guarantees the payment of loss. It is a profession because it provides adequate sources at the time of disasters only by charging a nominal premium for the service.

9. **Sharing of Risk:** Insurance is a device to share the financial losses which might befall on an individual or his family on the happening of a specified event. The event may be death of a breadwinner to the family in the case of life insurance, marine-perils in marine insurance, fire in fire insurance and other certain events in general insurances, e.g., theft in burglary insurance, accident in motor insurance, etc. the loss arising from these events if shared by all the insured in the form of premium.
10. **Co-operative Device:** The most important feature of every insurance plan is the co-operation of large number of persons who, in effect, agree to share the financial loss arising due to a particular risk which is insured. Such a group of persons may be brought together voluntarily or through publicity or through solicitation of the agents. An insurer would be unable to compensate all the losses from his own capital. So, by insuring or underwriting a large number of persons, he is able to pay the amount of loss. Like all cooperative devices, there is no compulsion here on anybody to purchase the insurance policy.
11. **Value of Risk:** The risk is evaluated before insuring to charge the amount of share of an insured, herein, called, consideration or premium. There are several methods of evaluation of risks. If there is expectation of more loss, higher pre3mium may be charged. So, the probability of loss is calculated at the time of insurance.
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    Similarly, in absence of life insurance, saving requires time; but death may occur at any time and the property and family may remain unprotected. Thus, the family is protected against losses on death and damage with the help of insurance. From the company's point of view, the life insurance is essentially non-speculative; in fact, no other business operates with greater certainties. From the insured point of view, too, insurance is also the antithesis of gambling. Nothing is more uncertain than life and life insurance offers the only sure method of changing that uncertainty into certainty. Failure of insurance amounts to gambling because the uncertainty of loss is always looming. In fact, the insurance is just the opposite of gambling. In gambling, by bidding the person exposes himself to risk of losing, in the insurance; the insured is always opposed to risk and will suffer loss if he is not insured. By getting insured his life and property, he protects himself against, the risk of loss. In fact, if he does not get his property or life insured he is gambling with his life on property.

16. **Insurance is not Charity:** Charity is given without consideration but insurance is not possible without premium. It provides security and safety to an individual and to the society although it is a kind of business because in consideration of premium it guarantees the payment of loss. It is a profession because it provides adequate sources at the time of disasters only by charging a nominal premium for the service.

4.4 GROWTH AND DEVELOPMENT OF INDIAN INSURANCE INDUSTRY

The story of insurance is probably as old as the story of mankind. The early history of insurance in India can be traced back to the Vedas. The Sanskrit term 'Yogakshema' (meaning well being), the name of Life Insurance Corporation of India's corporate headquarters, is found in the Rig Veda. Though the concept of insurance is largely a development of the recent past, particularly after the industrial era – past few centuries – yet its beginnings date back almost 6000 years.

Life Insurance in its modern form came to India from England in the year 1818. Oriental Life Insurance Company started by Europeans in Calcutta was the first life insurance company on Indian soil. All the insurance companies established between the period 1818 and 1869, were brought up with the purpose of looking after the needs of European community and Indian natives were not being insured by these companies. However, later with the efforts of eminent people like BabuMuttylal Seal, the foreign life insurance companies started insuring Indian lives. But Indian lives were being treated as sub-standard lives and heavy extra premiums were being charged on them. Bombay Mutual Life Assurance Society heralded the birth of first Indian life insurance company in the year 1870 and covered Indian lives at normal rates. Moreover, in 1870, the British government enacted for the first time the Insurance Act, 1870. Other companies such as the Oriental Government Security Life Assurance Company, the Bharat Insurance Company and the Empire of India Life Insurance Company Limited, were set up between 1870 and 1900.

The Swadeshi movement of 1905-1907, the non-cooperation movement of 1919 and Civil Disobedience Movement of 1929 led to increase in number of insurance companies. The United India in Madras, National Indian and National insurance in Calcutta and the Co-operative Assurance in Lahore were established in 1906. The Indian Mercantile, General Assurance and Swadeshi Life (later Bombay Life) were some of the companies established during the same period. Prior to 1912, India had no legislation to regulate insurance business.

In the year 1912, the Life Insurance Companies Act and the Provident Fund Act were passed. The Life Insurance Companies Act, 1912 made it necessary that the premium rate tables and periodical valuations of companies should be certified by an actuary.

The first two decades of the twentieth century saw a lot of growth in insurance business. From 44 companies with total business-in-force as Rs. 22.44 crore, it rose to 176 companies with total business-in-force as Rs. 298 crore in 1938. The Insurance Act 1938 was the first legislation governing not only life insurance but also non-life insurance to provide strict state control over insurance business. The demand for nationalization of life insurance industry gathered momentum in 1944. However, it was much later on the 19th of January, 1956, that life insurance in India was nationalized. The Life Insurance Corporation of India (LIC) was set up in 1956. The nationalization of life insurance was followed by general insurance in 1972. The General Insurance Corporation of India and its subsidiaries were set up in 1973. These nationalized companies enjoyed monopoly for decades. They did a commendable job in extending the distribution network and successfully handled a large volume of business. But with 20 percent of the population insured, there was a vast potential untapped. Besides as sequel to the reform process and to tap the insurance sector as a source of long term funds, the government decided to introduce reforms in the insurance sector.

The government set up, in 1993, a committee under the chairmanship of R.N. Malhotra, the former insurance secretary and the RBI governor to evaluate the Indian insurance industry and recommend its future direction. This committee suggested the re-opening of the insurance sector to private players.

Recognising the global trend of competitive, market driven insurance industry and the recommendations of the Malhotra Committee, the insurance industry was opened up in August 2000. There are at present 23 life insurance and 23 general insurance companies operating in India with more players expected to come in. The IRDA, constituted in April 2000 under the IRDA Act, 1999, is vested with the power to regulate and develop the insurance and reinsurance business.

The Indian insurance industry is governed by the Insurance Act, 1978, the General Insurance Business (Nationalisation) Act, 1972, Life Insurance Corporation Act, 1956 and Insurance Regulatory and Development Authority Act, 1999.

4.5. PRINCIPLES OF LIFE INSURANCE CONTRACT

A life insurance policy is a contract, in terms of the Indian Contract Act, 1872. A contract is an agreement between two or more parties to do, or not to do, so as to create a legally binding relationship. A simple contract must have the following essentials — offer and acceptance; consideration; capacity to contract; consensus 'ad idem' (genuine meeting of minds); legality of object or purpose; capability of performance; and intention to create legal relationship.

Insurance is a specialized type of contract. Apart from the usual essentials of a valid contract, insurance contracts are subject to two additional principles viz., Principle of utmost good faith and principle of Insurable interest.

The fundamentals principles of life insurance are:

- **Essentials of a Valid Contract:**

  Insurance is a contract between two parties. Hence, all elements of a valid contract (such as offer and acceptance, capacity to contract, free consent, consideration, etc.,) should be present in every insurance contract.

- **Principle of Insurable Interest:** According to this principle, the person who is taking life insurance policy should have insurable interest in the life of the person for whom he is taking life insurance policy. This means that if the person for whom policy has been taken suffers any loss of his life, then the person who has taken the policy will incur some economic loss. Insurable interest must be present at the time of taking the insurance policy.

  Insurable interest is pecuniary interest present in a life or property. Therefore, a person can't insure the life of others unless he has insurable interest. This principle refers that there must be such a relationship between the insured and the subject-matter of insurance that the insured stands to benefit by its safety and to lose by its loss. For a valid insurance contract, it is essential that the insured has full interest in the property or life so insured by him. This means that if there is any damage to life or property so insured, the insured will have to incur loss due to this damage and the insured will be benefitted if full security is being provided. In the absence of insurable interest, insurance contract is void. There are various instances of insurable interest like,

  a) A person in his own life
  b) A husband in his wife's life
  c) A wife in his husband's life
  d) A creditor in her debtor's life
  e) If parents help their son financially, then the son in his parents' life
  f) If a son takes care of his parents, then the parents in their son's life.

Insurable interest differs with every contract of insurance. For instance, (1) In case of life insurance, a husband gets his wife insured. Later on, he divorces his wife. With this divorce, he doesn't have any insurable interest in his former wife. Now the insurance contract will not be held void only on such a condition. Hence, in case of life insurance, presence of insurable interest is required only at the time of taking the insurance policy.

(2) In case of fire insurance, insurable interest is required at the time of taking the insurance policy as well as at the time of occurrence of loss.

(3) In case of marine insurance, insurable interest has to be there at the time of occurrence of loss.

- **Principle of Utmost Good Faith:** The contracts of insurance are included in the category of the contracts *uberrimaefidie,* i.e., those contracts which require absolute and utmost good faith on the part of the parties concerned. This principle means that insured and insurer must not hide any fact and information related to insurance contract from each other. If one party fails to do so, the other party has the right to rescind the contract. However, the validity of the policy can not be questioned, after three years of its operation on the ground of violating good faith. For instance, without disclosing that he is suffering from TB, Mr. A gets himself insured against death for Rs. 10, 00,000. He lives for another 3-4 years and dies due to TB. The insurance company comes to know about Mr. A's illness only after his death. Now, under these circumstances, the insurance company is not liable to pay anything to the dependents of Mr. A as the contract between the insurance company and Mr. A is void. In this instance, Mr. A did not follow the principle of the utmost good faith. Hence, the insurance company can cancel the contract.
  Insurance company should also clearly disclose all the terms and conditions related t6o the insurance policy taken by the insured. If it is not done, the insured can also cancel the contract.
- **Principle of Indemnity:** It refers that the insured can get only the compensation against actual loss and he cannot make profit out of insurance. Except for the contract of life insurance, estimation regarding loss can be made on all other contracts. Hence, the principle of indemnity applies to all contracts except the contract of life insurance.
- **Principle of Subrogation:** This principle is also known as 'Doctrine of Rights Substitution'. It is an extension of principle of indemnity. Subrogation is the transfer of rights and remedies of the insured in the subject matter (property) to the insurer after indemnification.

In other words, the insurer steps into the shoes of the insured and becomes entitled to all rights of action against the third party to cover the loss from the responsible person regarding the subject matter of insurance after the claim of the insured has been fully settled and paid. The principle of subrogation refers to the right of the insurer to stand in the place of the insured after the settlement of a claim. The insurer can recover the loss from the third party. There always exists a possibility of getting something in addition to the claim received from the insurer by the insured e.g., value of scrap, damages from the person responsible for the loss and several other alternatives.

- **Principle of CausaProxima:** The principle of proximate cause is also called 'causaproxima'. The term causaproxima is a latin word which means 'the nearest cause' or 'proximate cause' or 'immediate cause'. It helps in deciding the actual cause of loss when a number of causes have contributed to the occurrence of loss.

  While deciding the liability of the insurer, the direct, nearest or proximate cause and not the remote or indirect cause of the loss is to be taken into account. This doctrine is in fact based on the law of 'cause' and 'effect', which means that having proved that cause and effect thereof, there remains no need to proceed further.
- **Principle of Mitigation of Loss:** Mitigation of loss means to minimize or to decrease the severity of loss. Under this doctrine, it is prescribed that whenever the event insured against occurs, it will be the duty of the insured to take all such steps to minimize the loss as he would have taken when the subject matter was not insured.

  According to the principle, the insured must act reasonably to make the loss less severe and try to make each and every effort and arrangement to minimize the loss in the event of loss.
- **Principle of Contribution:** contribution is the right of an insurer who has paid claim under a policy to call upon other insurers for the same loss to contribute. This principle is applicable to all contract of indemnity except the life insurance.

  Sometimes, a person gets his property insured with more than one insurer called the 'Double Insurance' whereby in the event of damage, he cannot claim anything more than the total loss from all the insurers put together. In such cases, the total loss suffered by the insured is contributed by different insurers in the ratio of the value of policies issued by them for the same subject matter. This doctrine of contribution ensures an equitable distribution of losses between different insurers.

4.6. IMPORTANCE (ADVANTAGES) OF LIFE INSURANCE

Insurance plays a vital role in every aspect of life. Medium losses can be minimized through it. Insurance business is rapidly expanding these days. The life insurance is really a boon not only for the individuals but also for the business and the society. The importance of life insurance is studied under the following three heads:

A. Importance to individuals
B. Importance to the business
C. Importance to the society

A. Importance to individuals

- **Provides Security and Safety:** The basic objective of insurance is to provide safety and security against loss. The life insurance provides security against premature death and payment during old age. It protects the family members or dependants at the time of distress due to death of the insured. It compensates for the loss of earning at death or old age.
- **Encourage Savings:** life insurance encourages thrift. Systematic saving is possible as premiums are to be paid regularly without fail in order to save the policy from lapse. Secondly, unlike bank deposit the insurance premium can not be withdrawn during the tenure of the policy. This forceful deposit of life insurance premium is the best way of saving for future.
- **Profitable Investment**: Payment of life insurance premium is also considered as a profitable investment. All the features of good investment – regular savings, capital formation and return of capital with additional bonus are found in life policies. When the policy matures, the policy holder not only gets back his capital but also he is given bonus. The bonus in life policies form a substantial amount as 95% of the Life Insurance Corporation is distributed among the policy holders in the form of bonus. Unlike investment in equity shares, it also does not carry risks.
- **Borrowing Facility**: Money can easily be borrowed on the strength of the policy. At the time of necessity, the policy can be mortgaged with the insurer to obtain loan. These loans can be repaid on easy instalments. If the loan is not repaid, it can be deducted from the policy money when the policy becomes a claim. Thus, the life insurance policies can be utilized to overcome temporary financial needs.
- **Tax Relief**: The Income Tax Act, 1961 allows some rebate u/s 80 for the amount of life insurance premium paid by the policy holders. A person with higher income can get a

relief of 30% of the amount of premium paid. Thus, in fact the rate of premium is very less. It may be mentioned here that people in the lower, income bracket can get a tax relief of 10% or 20% depending on the level of income.

- **Brings Peace of Mind**: The life insurance removes the uncertainty and worries about future. By undertaking a policy, the insured becomes certain that his dependants will get financial benefit from the insurer if he dies at an early date. This brings peace to the mind of the insured which helps him to carry out his activities freely without any tension.
- **Fulfils Certain Special Needs**: Besides fulfilling the family needs and needs at old age, the life insurance also fulfils certain special needs. These are: a) education for children and

  b) marriage of daughter.

  A careful planning anticipating children's education cost6 and marriage expenses of the daughter can be taken care by undertaking endowment policy. The duration of the policy should match the above two. The matured value of the policy can be utilized for the above purposes by paying a small premium regularly.
- **Provision for Death and Estate Duty:** At times, insurance policies are also undertaken to meet the expenses of ritual ceremony. Upon death of the insured, his dependants get the maturity value, which is used to meet this expense. Similarly, when a person dies his nominees are required to pay duty on the assets and properties left behind him. The policy money becomes a source of strength to them to pay the estate duty.

B. Importance to the Business

- **Business Continuity:** A person who is not sure of life and death can not continue his business for a longer period to support the dependants. Life insurance is very much useful for sole-trading and partnership firm. In case of sole-trader, his heirs get a lump-sum amount after the death of the owner which helps them to continue the business operations. Similarly, partners can undertake a life policy jointly. In the event of death of a partner, the other partners get the assured sum which is used to pay the claim of the dead partner.
- **Credit Facility:** Like an individual, a businessman can also get loan by pledging the life policy. When the policy matures, the loan amount can be easily paid with interest with the maturity value. If the borrower is unable to pay the loan, he can surrender the policy to repay the loan. It may be noted here that loan can be borrowed up to the cash value of the policy.

- **Insurance of Key man:** A person with high expertise, experience and ability to control the business is termed as a key man. If death occurs to such a person, a business suffers a lot. The provision for potential loss to be suffered and the amount payable to his dependants can be made by taking a policy on the life of such person.
- **Welfare of Employees:** Early death, disability and provision fore old age of the employees can be made by a business by undertaking a group insurance. The premium is paid by the employer. Various policies can be undertaken to cover accident, sickness, pension, etc. so, by paying a small premium, the owner becomes free from these botheration of making payment when the above contingencies arise.

C. Importance to the Society

The benefits of insurance to the society can be understood from the following points:

- **Protects Human Wealth:** The human resources – owner, employees, children, etc. are well protected through life insurance policies. Each and every member is protected against death and old age, children get their education, working class is free from the botheration of accident and physical disability. This prevents the society from deterioration of human wealth. So a nation prospers.
- **Ensures Economic Growth:** Adequate fund of the insurers collected by way of premium accelerates the production cycle as they invest such money in the industrial sector. Credit is expanded, losses are protected and loss of human capital is protected. This ensures all-round development of the economy.
- **Reduces Inflation:** The contribution of life insurance towards controlling inflation is great. It does so by restricting spending and by channelizing the fund of the insurers for productive purposes.
- **More Employment:** Insurance provides employment to many people. Thousands of people work as marketing agents of insurance companies and earn bread and butter for their families.

4.7 TYPES OF INSURANCE

There are two main kinds of insurance business in India: i) Life Insurance and (ii) Non-life or General Insurance.

The non-life insurance is further divided into following divisions:

a) Fire insurance

b) Marine insurance

c) Motor Vehicle insurance

d) Personal Accident insurance
e) Health insurance
f) Industrial All Risks insurance
g) Professional Indemnity cover
h) VideshYatra insurance
i) Travel insurance
j) Office Risk Coverage insurance
k) Personal Accident insurance

i) Life Insurance – It covers the human life and mostimportant income earning source. It needs tobe protected much before other assets which the human capitalgenerates.Human life can be lost through unexpectedly early death or sickness and disabilities caused by accidents. Accidents may or may not occur, death is certain but its timminingis uncertain. It happens around the time ofone's retirements, when it could be expected that the income will normally cease, the person concerned could have made some other arrangements to meet the continuing needs. But when it happens much earlier, when thealternate arrangements are not in place, Insurance is necessary to help those dependent on income. In cases, where he/she has made arrangements for his/her needs afer retirements, these would have been made on the basis of some expectations like he/she may live for another15 years or so or that his/her childen (especially sons) will lookafter. If any of these expectations would become inadequate and there could be difficulties. There are the risks which need to be safeguarded against, life insurance takes such care.

At present, life insurance enjoys maximum scope because life is the most important property of the society. The lifein surance provides protection to the family at the premature death of family head or gives adequate amount at the old age when earning capacities are reduced. The life insurance is not only a protection but is a sort of investment because a certain sum is returnable to the insured at the expiry of a specified period. It provides financial protection against the risk of early death.

There are different kinds of plans under life insurance viz.,

1. Term plans
2. Fundamental plans
3. Money Backplans
4. Unit-linked insurance plans (ULIPS)
5. Guaranteed plans

6. Pension plans.

ii) Non- life or General insurance: Insurance other life insurance is called non-life or general insurance. General insurance, unlike life insurance provides insurance against theft, fire, marine, accident, etc. General insurance is done mainly of the properties such as car, stock- in-trade building, scooter, T.V., houses, jewelleries, etc. general insurance can be classified as fire insurance, marine insurance, fidelity insurance, crop insurance, motor insurance, credit insurance, social insurance, health insurance, liability insurance, etc.

4.8 CLASSIFICATION OF INSURANCE

Different types of insurance have come about by practice with the insurance companies. Various insurances can be classified as follows:

A. Classification on the Basis of Nature of Insurance:

On the basis of nature, insurance may be divided into the following categories:

1. **Life Insurance:** Life insurance may be defined as a contract in which the insurer agrees to pay to the insured or his nominee the assured sum of money on the happening of a specified event contingent on human life i.e., death or expiry of certain period, in consideration of a certain premium. In life insurance, the risk assured is death. The life insurance company pays the sum assured to the nominee of the insured in the event of death. The life insurance provides protection to the family at the premature death of the head of the family or gives adequate amount at the old age when earning capacities are reduced. The life insurance is not only a protection but is a sort of investment because a certain sum ism returnable to the insured at the expiry of a specific period.
2. **Fire insurance:** Fire insurance is a contract of indemnity and the insured cannot claim anything more than the value of goods lost or damaged by fire or the amount insured, whichever is less. The contract does not help in controlling or preventing the happening of the event but it is a promise to compensate the loss caused by fire.

   A fire insurance is an agreement between the insurer and the insured under which the insurer agrees to indemnity the loss caused by fire, to the insured, in consideration of certain payment called premium.
3. **Marine Insurance:** The businessman and the owner of ship always want to ensure the safe arrival of their cargo and ships. Marine insurance covers a large number of risks including sinking, burning of ship, standing or going astray of the ship, accident, stormy winds, collision of ships, jettison, explosion, sea dacoities etc., causing losses to the ships and cargo and many other perils of the sea. Therefore, marine insurance is an arrangement

by which the insurance company agrees to indemnify the owner of the ship or cargo against the risks involved in marine venture.

4. **Social Insurance:** Social insurance has developed to provide economic security to weaker sections of the society who are unable to pay the premium for an adequate insurance. The social insurance is an obligatory duty of the nation with the increase in the socialistic philosophy in the country. The main aim of social insurance is to help the community to fight against the risks of disease, old age, industrial accidents, unemployment and above all the evils of poverty. Various forms of social insurance are sickness insurance, accident insurance, disablement insurance, maternity insurance, old age insurance, unemployment insurance, etc.
5. **Motor Vehicle Insurance:** Motor vehicle insurance comes under miscellaneous types of insurance. It is a tariff type of business. Motor insurance provides protection to the owner of vehicle against
   - damages to his/her vehicle and
   - pays for any third party liability decided as per law against the owner of the vehicle.
6. **Health Insurance:** Health insurance may be defined as coverage that provides for the payments of benefits as a result of sickness or injury. It includes insurance for losses from accident, medical expense, disability or accidental death and dismemberment.

   Under health insurance, a person or a group acquires health care coverage in advance by paying premium. The type and amount of health care costs that will be covered by the health insurance company are specified in writing, in a member contract or "Evidence of Coverage" booklet for private insurance or in a national health policy for public insurance. The amount of policy is paid by the policy holder in the form of premium to the health plan to purchase health coverage.
7. **Liability Insurance:** Liability insurance is an essential segment of general insurance system of risk financing. It protects the insured (policy holder) from the risks of liabilities imposed by lawsuits and similar claims. Liability insurance is designed to provide particular protection against third party insurance claims under which payment is made to someone suffering loss and who is not a party to the insurance contract of insured. Liability insurance is a compulsory form of insurance in many countries for those at risk of being sued by third parties for negligence. Liability insurance policies do not cover the damage caused intentionally as well as contractual liability.

B. Classification of Insurance from Business Point of view:

Insurance can be classified into two broad categories from business point of view:

1. **Life Insurance:** life insurance may be defined as a contract in which the insurer in consideration of a certain premium, paid either in a lump sum or by periodical payments, agrees to pay to the insured or the person for whose benefit the policy is taken, a assured sum of money on the happening of a specified event contingent on the human life or at the expiry of certain period, whichever is earlier.
2. **General Insurance:** general insurance business refers to fire, marine and other insurance business whether carried on singly or in combination with one or more of them.

C. Classification of Insurance from Risk Point of View:

Insurance can be classified into four categories from risk point of view:

i) Personal Insurance: Personal insurance refers loss to life by accident or by sickness to individual which is covered under the policy. The insurer undertakes to pay the sum insured on the happening of the certain event or on maturity of the period of insurance. The subject matter of personal insurance is the person. The life or health of a person is insured under personal insurance. Under personal insurance, the insured or hiss nominee is compensated financially in the event of death or total or partial disablement of the insured. The law of indemnity does not apply to life and other types of personal insurances.

ii) Property Insurance: under this contract, the insurer undertakes to compensate to the other party against financial loss caused by certain risks in consideration of a certain periodical payment in form of premium. Property is the subject matter of such contract of property insurance. The insured cannot claim anything more than the value of property lost or the amount of policy, whichever is lower. Important types of property insurance are, fire insurance, marine insurance, motor insurance, live stock insurance, theft insurance, agriculture insurance, etc

iii) Liability insurance: This has been briefly mentioned earlier.

iv) Fidelity Guarantee Insurance: This insurance policy protects the employer from risks presented by any of his employees such as fraud, dishonesty, embezzlement during the course of employment. The industries where secrecy and confidentiality of operations is vital for a company's success, this policy will ensure the concealment of business procedures from other competitors who may be successful in poaching their rival's employees.

4.9 LIFE INSURANCE PRODUCTS

Life insurance products are usually referred to as 'plans of insurance'. These plans have two basic elements. One is the 'Death cover' providing for the benefit being paid on the death of the insured person within a specified period. The other is the 'Survival Benefit' providing for the benefit being paid in survival of a specified period. Plans of insurance that provide only death cover are called 'Term Assurance' plans. Those that provide only survival benefits are called "Pure Endowment' plans. All insurance plans are combinations of these two basic plans. There are four broad types of insurance policies to choose from – **endowment, money-back, whole life and term insurance**.

Endowment Plan: Under this plan, insurance cover is available for a specific period or term. The sum assure4d is payable even if the assured dies during this tenure period. In other words, the sum assured together with bonus is payable on the date of maturity or in the event of death of the insured, whichever is earlier. The endowment policies are the most popular of all the life policies not only in India but world over they are perceived as savings instrument.

Money-back Policies: Money-back policies are also popular in India. Under this policy, the sum assured is returned as lumpsum after defined intervals of time. In other words, the assured receives a fixed sum at fixed intervals during the term of the policy. Both endowment and money-back policies are by far the most expensive products.

Whole-life Policies: As the name suggests, it covers risk for whole life and is an insurance cover against death. It primarily caters to protection of a policyholder's entire life. The policyholder pays premium through out his life and on his death, the money is handed over to his family. This policy is not very popular popular as it does not take into consideration the increasing needs of the insurer during his post-retirement years. Moreover, the cost of insurance is higher. For instance, the annual premium is Rs. 3,000 per annum for a sum assured of Rs. 1 lakh. To balance this high cost, insurance firms combine this policy with other types of policies.

Term Insurance Policy: Term insurance is a pure risk product. This policy is a whole-life policy but offers risk cover for definite periods. This policy comes at a very low premium as the sum assured is payable only if the policyholder dies within the policy term. If he survives, he is not entitled to any payment on maturity, irrespective of premium payment made earlier. Term insurance is the cheapest form of insurance. A term policy is taken either by young people as a life cover or as a security of their family against a long-term outstanding loan. This policy is not popular among investors as there are no maturity benefits available on survival until the end of the term.

The life insurers now offer money-back options, pension plans and unit-linked insurance, often with health insurance riders with premium collected through either lumpsum payments or in multiple instalments.

Unit-linked Insurance Policies: These policies are becoming increasingly popular, unit-linked policies are those where part of the premium is invested in a fund (similar to mutual fund) and the return is linked to the performance of the fund. The investors are given a choice of three funds — a debt fund, a balanced fund and an equity fund for investment. Unit-linked plans are more flexible and transparent compared to traditional insurance plans. Combining the protection and tax advantages of life insurance with the prospect of investing in securities, unit-linked plans dominate a large chunk of the insurance companies' portfolio. These products are sold both under the individual single premium and non-single premium segments. Some common types of funds available in ULIPs are Bond Fund, Protector Fund, Balanced Fund, Growth Fund, Index Fund and enhancer Fund. Major benefits to investors in ULIP is to have the benefit of appreciation of the investment, benefits of tax rebate as provided under section 80CC of the IT Act and above all, a life cover.

Group Insurance Policies: Individual life insurance business is divided into three main business segments— individual regular business, single premium business and individual pension business. The group insurance segment mainly comprises of regular group insurance, corporate gratuity and superannuation plans. Regular group insurance policies cover groups of people such as employees in a firm. Corporates purchase these policies to cover their employees. These policies are popular as the premium per employee turns out to be low. The group gratuity and superannuation plans are a result of statutory obligation.

Universe Life Insurance: Universal life insurance (UL) is a relatively new insurance product intended to provide permanent insurance coverage with greater flexibility in premium payment and the potential for a higher internal rate of return. A universal life policy includes a cash account. Premiums increase the cash account. Interest is paid within the policy (credited) on the account at a rate specified by the company. This rate has a guaranteed minimum but usually is higher than that minimum. Mortality charges and administrative costs are charged against (reduce) the cash account. The surrender value of the policy is the amount remaining in the cash account less applicable surrender charges, if any.

Variable Universal Life Insurance: Variable universal life insurance (VUL) is not the same as universal life, even though they both have cash values attached to them. These differences are in how the cash accounts are managed. The cash account within a VUL is held in the insurer's "separate account' (generally in mutual funds, managed by a fund manager).

Joint Life Policy: This type of policy is taken upon the joint lives of two or more persons. The sum assured becomes payable at the end of a specified term of years or on the first death of either of the lives assured whichever is earlier, to the survivor. This type of policy is particularly useful for partners in a partnership firm where the death of one partner can have serious financial repercussions for the other partners.

Annuity Policy: This policy is an endowment policy with the difference that here the full amount of the policy is not payable in a lump sum but is payable in the form of annuities for a specified number of years or till the death of the assured. This policy is good for providing regular income.

Education/Marriage Endowment Policy: such a policy is affected for the purpose of meeting the education or marriage expenses of children. As is usual, here also the assured insures his own life but the purpose is different, such a policy is always for a specified period. The premiums are payable for a selected term of years or until death of the policy holder if it occurs earlier within that period. The sum assured is payable only after the expiry of the fixed term even if the policy holder dies earlier. It is important to note that after the expiry of that stipulated term the claim is payable even if the child also dies before that date. In the case of education endowment policy, the policy amount is payable for a period of five years in half yearly instalments. In the case of marriage endowment policy, the whole amount is payable in a lump sum. The purpose of this type of policy is to ensure the education or marriage of children, even in case of premature death of father.

Riders: Riders are modifications to the insurance policy added at the same time the policy is issued. These riders change the basic policy to provide some feature desired by the policy owner. A common rider is accidental death, which used to be commonly referred to as "double indemnity", which pays twice the amount of the policy face value if death results from accidental causes, as if both a full coverage policy and an accidental death policy were in effect on the insured. Another common rider is premium waiver, which waives future premiums if the insured becomes disabled.

Investment Policies: i. **With – profits Policies**: Some policies allow the policyholder to participate in the profits of the insurance company. These are called with-profit policies. Other policies have no rights to participate in the profits of the company; these are called non-profit policies. With - profit policies are used as a form of collective investment to achieve capital growth. Other policies offer a guaranteed return not dependent on the company's underlying investment performance; these are often referred to as without-profit policies which may be construed as misnomer.

ii. Insurance/Investment Bonds

- **Pensions:** Pensions area form of life assurance. However, whilst basic life assurance, permanent health insurance and non-pensions annuity business includes an amount of mortality or morbidity risk for the insurer, for pensions there is longevity risk. A pension fund will be built up throughout a person's working life. When the person retires, the pension will become in payment and at some stage the pensioner will buy an annuity contract, which will guarantee a certain pay-out each month until death.
- **Annuities:** An annuity is a contract with an insurance company whereby the purchaser pays an initial premium or premiums into a tax-deferred account, which pays out a sum at predetermined intervals. There are two periods: the accumulation (when payments are paid into the account) and the annuitisation (when the insurance company pays out). For example, a policy holder may pay Rs. 1,00,000 and in return receive Rs. 2000 each month until he dies or Rs. 10,000 for each of 14 years or death benefits if he dies before the full term of the annuity has elapsed.

4.10. PRINCIPLES OF HEALTH INSURANCE

1. **Actuarial Study:** Health insurance insures against the risk of incurring medical expenses. For the health insurance company to be able to afford these expenses they have to know how much money they will be expected to pay out and have the financial resources to do so. An actuarial study is a statistical analysis of a population based on its utilisation of healthcare services and demographic trends of the population. The results of this study are used to estimate healthcare plan premiums or costs. An actuary is a trained professional who specialize in determining policy rates, calculating premiums and conducting statistical studies.

2. **Appeal:** An appeal is a formal process or request to reconsider a decision made not to approve an admission or healthcare services, reimbursements for services rendered or a patient's request for postponing the discharge date and extending the length of stay . Different insurance policies have different appeal rights and processes.
3. **Extra-contractual benefits:** Extra-contractual benefits are benefits that are given to the insured, which are not covered under the health plan. This is almost always done as a cost savings to the insurance plan.
4. **Medical necessity:** Insurance will only cover healthcare that is medically necessary. The specifics of what are deemed medically necessary will vary by insurance plan. In general, medically necessary services are those which are reasonable, necessary, appropriate and based on evidence based standards of care.
5. **Precertification:** Precertification or preauthorization is the process of obtaining and documenting advanced approval from the health plan before the medical services occur. When planning the patients care, it is important for the Case manager to know if precertification is required and if so which benefits require it.
6. **Coordination of Benefits (COB):** To prevent double payment for services when a subscriber has coverage from two or more sources the National Association of Insurance commissioners has created COB guidelines. Although following these guidelines is not mandatory, most states and commercial insurances choose to utilize these COB provisions to determine which insurer is primary and secondary. The primary plan is initially responsible for payment of benefits for covered services as if there was no other plan. After the primary has paid, the balance is passed to the secondary company which will pay according to their contract.

4.11. HEALTH INSURANCE

The total health expenditure per capita in India is quite low in comparison to other developed and developing countries. On one hand, the country is gripped with communicable and non-communicable diseases resulting out of changing life styles, while on the other hand, health care costs are escalating making access to quality health care difficult. With government expenditure on health declining, health insurance has emerged as an alternative mechanism for financing health care.

Health insurance or health care is defined in the Registration of Indian Insurance Companies Regulations, 2000, as the effecting of contracts which provide sickness benefits or medical, surgical or hospital expense benefits, whether in-patient or out-patient, on an indemnity reimbursement, service, prepaid, hospital or other plans, including assured benefits and long-term care.

According to the Health Insurance Association of America, “health insurance is defined as coverage that provides for the payments of benefits as a result of sickness or injury. It includes insurance for losses from accident, medical expense, disability or accidental death and dismemberment”.

A heath insurance policy is a contract between an insurance company and a person. The contract can be renewable e.g., annually, monthly or lifelong in case of private business. The type and amount of health care costs that will be covered by the health insurance company are specified in writing, in a member contract or “Evidence of coverage” Booklet for private insurance or in a national health policy for public insurance. The amount of policy is paid by policy holder in form of premium to the health plan to purchase health coverage.

Both life and non-life insurers registered with the IRDA can transact health insurance business. Star Health and Allied Insurance Company is the first company to focus exclusively on health insurance. It offers health insurance as a stand alone product. Star Health is capitalized at Rs. 105 crore and has a non-life insurance license. IRDA has granted license to three other insurance companies to operate as stand alone health insurance companies viz., Apollo Munich health Insurance Co. Ltd., Max Bupa Health Insurance Co. Ltd. and Religare Health Insurance Co. Ltd. All the companies have received certificate of registration to carry on general business to underwrite exclusively in the health, personal accident t and travel insurance segment.

4.12. Factors Responsible to Promote Health Insurance

The following factors are accountable to promote health insurance in India.

1. **Serious Health Problems:** Individuals are suffering from serious health diseases due to aggravation of environmental pollution.
2. **Changed Lifestyle:** In these days, the life style of people has changed which leads to many dangerous diseases like AIDS, Cancer, heart attack, etc.
3. **Costly Medical Treatment:** The medical treatment and hospitalization is very expensive. The new middle class families in India face difficulties in meeting the expenditure of medical treatments. It also encourages the public to go for health insurance.
4. **Taxation Benefits:** Government also provides different tax benefits to individuals. The policies and regulations of government have also assisted in promoting the health insurance in India.

5. **As a Service Benefit:** Many business corporations offer the benefit of heath insurance to their employees. This type of service incentive also boosts the demand of health insurance.

4.13 TYPES OF HEALTH INSURANCE POLICIES

The first health policies were Mediclaim Policies. The Government of India liberalized the insurance sector in 2000 and allowed private insurers into insurance industry. Many new and innovative policies like floater plans, top-up plans, critical illness plans, hospital cash and top up policies have been introduced by many private insurance companies in India.

Health policies available in India can be broadly classified into —

Indemnity Based—Mediclaim, health guard, healthwise, etc— are the examples of indemnity based policies. These policies provide for reimbursement of expenses incurred necessarily as a direct result of hospitalization necessitated by a covered disease, illness or injury.

Benefit type– daily allowance, hospital cash, critical illness (stand alone) or as a rider with the life insurance policy. Such policies provide for lump-sum payment on happening of an event insured against by the policy.

1. **Standard Health Insurance Policy**: Most of the health insurance policies available in the market provide cover against the risk of hospitalisation. While this has been the basic structure of the product right since its inception in late 1980s, some changes have taken place as regards the fringe benefits and exclusions, with the advent of private players in the insurance market.

The operative clause of a standard health insurance policy offers the insured against hospitalization expenses incurred by him at a hospital or nursing home upon the advice of a duly qualified medical practitioner as a result of an illness, disease or injury contracted during the policy period.

2. Reimbursement and Cashless Policies

Reimbursement policies: This is the conventional method of indemnity in almost all non-life insurance policies. The insured initially bears all the expenses which is later on reimbursed by the insurance company, provided the claim is admissible as per the policy. Preliminary notice of claim with particulars relating to policy number, name of the insured person in respect of whom claim is made, nature of illness/injury and name and address of attending medical practitioner/hospital/nursing home has to be given by the insured to the Company within 7days from the date of hospitalization.

Cashless Policies: Cashless model of hospitalization is a novel concept in India that allows a policyholder to avail medical treatment at any of the network hospitals of the insurer without paying cash. Insurers have a panel of third party administrators (TPAs), who typically offer services across cities. Thus, a TPA is a point of contact for a settlement of claims. They facilitate the smooth operation of a health cover by acting as a link between the insurance companies and their clients and hospitals. They enable cashless payment of claims to the insured wherein they settle claims with hospital instead of insurers. The hospital bills are paid by the TPA directly to the hospital, thus relieving the insured from the hassle of arranging funds in the event of a major hospitalization.

3. **Floater Policy:** This feature is introduced in the post-liberalisation period. As per the standard health insurance product, separate sums had to be specified for each member of the family even in cases where the entire family was opting for insurance. While a common policy was issued, specific sum insured was to be mentioned against the names of each member. This system ignored the internal diversification of risk among the family and the consequent risk reduction. Since standard premium rates were being applied to all family members, every member was considered to be an independent exposure unit. However in reality, the probability of all family members in a family falling ill in a single year is very low. Due to this phenomenon, people used to either exclude their family members from coverage or go for a lesser sum insured for spouse and children. Due to this indirect adverse selection, insurers were deprived of the benefit of internal diversification in terms of reduced loss frequency.

A family floater policy attempts to solve all these aberrations. This policy provides for a common sum insured for the entire family. The sum insured or the coverage amount can be used for the principle insured or together form the family members. Thus, having a family floater would imply that the entire family could claim up to the sum insured during the policy period. Technically, a family floater policy considers the family as a single exposure unit as against the individual family members. Because of this the premium chargeable for a family floater policy is much less than a conventional policy with individual sum insured. As a result, more families are attracted to buy this policy.

4. **Group Mediclaim Policy:** The Group Mediclaim Policy is available to any Group/Association/Institution/Corporate Body of more provided it has a central administration point and subject to a minimum number of persons to be covered. The

coverage under the policy is the same as under Individual Mediclaim with the following differences:

a. Cumulative bonus and Health check up expense are not payable.
b. Group discount in the premium is available.
c. Renewal premium is subject to Bonus/Malus clause.
d. Maternity benefit extension is available at extra premium.

5. **Cancer Medical Expenses Insurance Policy:** Two types of policies are devised for covering medical expenses in relation to treatment of cancer. One policy is available to members of Indian cancer Society and another one for members of Cancer Patients Aids Association.
6. **Health Riders under Life Insurance:** Under this, riders are add-on benefits attached to the main policy. In most cases, whatever is offered in form of 'health riders' is nothing but critical illness or hospital daily cash allowance covers. The indemnity cover providing for reimbursement of hospitalization expenses is nowhere to be seen. The salient features of health riders with life insurance policies are summarized below:
   a. This rider is added to a life insurance policy to protect the insured in the event of a critical illness.
   b. Generally, the extra cover is equal to the sum assured on the base policy and is paid upon diagnosis of the illness.
   c. The plan is also renewal till the age of 65 years without any medical examination, with premiums increasing only once in every 5 years.
   d. While the illness covered and the premiums vary among insurers, most insurers cover cancer, coronary artery bypass, heart attack, kidney/renal failure, major organ transplant and paralytic stroke.
   e. Before adding this rider, one must check illness covered and the exclusions.
   f. And a few insurers terminate the base policy once a claim is made on the rider. Thus, a plan that continues to give you life cover, at marginally higher premium on the rider, is preferable.
   g. Under a critical illness policy, the amount of insurance has to be selected by the client. It is at 4 levels —Rs. 5 lakhs, Rs. 10 lakhs, Rs. 20 lakhs and Rs. 25 lakhs.
   h. The premium paid for this rider qualifies for tax deduction under section 80 D of the IT Act.

Health is of prime concern not only for a person but also for the society as ideally the health insurance should not limit itself to the expenses or the pecuniary losses sustained by a person. Health insurance needs to have a holistic view to address not only the loss aspect but to actively engage in the prevention of the prevalence of diseases. The national goal of health for all can only be achieved by congruence of all the state, the agencies, stakeholders on a common platform to ensure affordable, transparent and accountable healthcare to the whole society. The insurers have tried to bridge the gap by several permutations, combinations in an effort to provide better coverage. Separate benefit type covers like hospital cash (daily allowance), critical care and overseas travel insurance have been introduced. Low budget health insurance schemes like Jan Arogya, Universal Health Insurance were introduced at the government's behest. NagreekSuraksha— a combination of Personal Accident and Injury related hospitalization is available in the market, so is Rasta Aapati – a personal accident and road accident triggered hospitalization cover. The Narendra Modi government has announced the Ayushman Bharat Programme, a health care programme for the poorest segment of the society.

The private players in a bid to gain entry in to the health insurance market, came out with innovative products to address the growing need for increasing the options for more depth in coverage.

The health insurance plans are broadly classified into following categories.

1. Hospitalisation Benefit Plan

Hospitalisation benefit plan is also known as individual mediclaim. Hospitalisation benefit policies are indemnity plans. These plans pay the hospitalization expenses and medical costs of the insured subject to the sum insured in case of sudden illness or accident and extend to pre-hospitalisation of 30 days and post-hospitalisation of 60 days. These plans are available to any individual in the age group of 5-80 years. However, the children aged 3 months to 5 years can also be covered till one or both of the parents are covered at the same time. The premium paid on hospitalization plan is exempted upto Rs. 10,000 from income tax.

2. Hospital Daily Cash Benefit Plan

The policy aims to provide cover against the additional expenses such as, transport, lodging and boarding, charges levied by the hospital for attending family member, hiring of personal attendant, etc. this cover is available as standalone cover with some companies and as an in-built in the health insurance cover with others. It should always be taken as an addition/extension of the regular health insurance rather than being considered as a substitute.

The policy provides for cash allowance per day ranging from Rs. 500 to Rs. 5,000 per day in case of hospitalization due to illness or injury suffered by the insured person. For this purpose, hospitalization means a continuous stay in the hospital as an in-patient for 24 hours. Certain policies have provisions for paying twice the daily limit per day in case of admission in ICU or ICCU for a period not exceeding 7 days. The cover can be taken for the entire family i.e., the proposer, spouse and dependant children in the age band of 3 months to 21 years. Under section 80D of Income Tax Act, premium amounts of upto Rs.15, 000 carries tax benefit.

3. Critical Illness Covers

The critical illness cover provides for a lump sum on the onset of the listed diseases. The number of diseases covered varies according to the market and the provider. Depending upon the type of policy, the number of diseases covered may vary from 5-35 in the policies available in the Indian market. The basic critical illness policy covers the following listed diseases: cancer, Coronary Artery Bypass Graft/Surgery, first Heart Attack, Kidney failure, Major organ transplant (as a recipient), Stroke and Paralysis. This plan covers the individuals in the age group of 6-59 years for a minimum sum assured of Rs. 50,000 and a maximum of Rs. 50, 00, 000. Under this policy, benefits are paid in advance whereas in other health insurance plans, expenses incurred are reimbursed as claim settlement. The amount of premium paid is exempted under Section 80D of Income tax Act. The critical illness policies are sold either on standalone basis or as a rider to the life insurance policy.

4. Health Guard Plan

Cashless benefit and medical reimbursement of hospitalization expenses are provided to insured under Health Guard Plan. The cashless facility can be availed by the insured at different networked hospitals across the country. On submission of all required documents, hospitalization expenses incurred by insured are reimbursed within 14 working days. This plan also covers relevant 90 medical expenses incurred 60 days before and 90days after hospitalization. Under section 80D of Income Tax Act, the premium paid under policy are subject to tax rebate. The policy is available for the age group of 5-75 years.

4.14. LIC OF INDIA

The Parliament of India passed the Life Insurance Corporation Act on the 19th of June 1956. On January 19, 1956, 154 Indian insurers, 16 non-Indian (foreign) insurers and 75 president societies operating in India, were taken over by the central government and then nationalized on September 1, 1956. The Life Insurance Corporation of India came into existence on September1, 1956, as an autonomous body with five zonal offices, 33 divisional offices and 212 branches and sub-offices all over India at 97 centres. Since life insurance contracts are long term contracts and during the currency of the policy it requires a variety of service need was felt in the later years to expand the operations and place a branch office at each district headquarter. Re-organisation of LIC took place and large numbers of new branch offices were opened. As a result of re-organisation servicing functions were transferred to the branches and branches were made accounting units.

Today LIC functions with 2048 fully computerized branch offices, 106 divisional offices, 8 zonal offices and the corporate office. LIC's Wide Area Network covers 100 divisional offices and connects all the branches through a Metro Area Network. LIC has tied up with some Banks and Service providers to offer on-line premium collection facility in selected cities. LIC's ECS and ATM premium payment facility is an addition to customer convenience. Apart from on-line kiosks and IVRS, Info Centres have been commissioned at Mumbai, Ahmedabad, Bangalore, Chennai, Hyderabad, Kolkata, New Delhi, Pune and many other cities. With a vision of providing easy access to its policyholders, LIC has launched its SATELLITE SAMPARK offices. The satellite offices are smaller, leaner and closer to the customer. The digitalized records of the satellite offices will facilitate anywhere servicing and many other conveniences in the future.

The Life Insurance Corporation of India was set up with the objective of spreading life insurance much more widely and, in particular, to the rural areas and to the socially and economically backward classes with a view to reaching all insurable persons in the country and providing them adequate financial cover against death at a reasonable cost. The role of LIC was to maximize mobilization of people's savings by way of premia and ensuring the welfare of the country including the policyholder by investing and directing the funds in activities which contribute to the economic prosperity of the country.

In the era of liberalisation, privatization and globalization, it has redefined its vision, mission and objectives broadly.

Vision A trans-nationally competitive financial conglomerate of significance to societies and pride of India.

Mission Explore and enhance the quality of life of people through financial security by providing products and services of aspired attributes with competitive returns and by rendering resources for economic development.

4.15 OBJECTIVES OF LIC

- Spread life insurance much more widely and in particular to the rural areas and to the socially and economically backward classes with a view to reaching all insurable persons in the country and providing them adequate financial cover against death at a reasonable cost.
- Maximize mobilization of people's savings by making insurance-linked savings adequately attractive.
- Bear in mind, in the investment of funds, the primary obligation to its policyholders, whose money it holds in trust, without losing sight of the interest of the community as a whole; the funds to be deployed to the best advantage of the investors as well as the community as a whole; keeping in view national priorities and obligations of attractive returns.
- Conduct business with utmost economy and with full realization that the money belongs to the policyholders.
- Act as trustees of the insured public in their individual and collective capacities.
- Meet the various life insurance needs of the community that would arise in the changing social and economic environment.
- Involve all people working in the corporation to the best of their capability in furthering the interests of the insured public by providing efficient service with courtesy.
- Promote amongst all agents and employers of the corporation a sense of participation, pride and job satisfaction through discharge of their duties with dedication towards achievement of corporate objectives.

The Life Insurance Corporation of India is still a monolith. It enjoys a tremendous brand equity and a high reach with a strong distribution network which consists of 8 zonal offices, 106 divisional offices, 323 satellite offices, 2,048 branch offices and more than 11.93 lakh agents. The zonal offices look into the development, planning and review of business valuations, recruitment, training of staff and supervision of divisional offices. The divisional offices procure new business, plans and execute various new business operations, underwrite new business as well as securities and settles claims. Under each divisional office, there are a number of branch offices which procure new business

LIC has a three-tier marketing set up with the agent at the base who is recruited, trained and supervised by a development officer. An assistant branch manager (sales) normally supervises the development officers. These development officers strive to develop and increase the production of new life insurance business in the areas allotted to them by developing a suitable agency force.

4.16. LIC SUBSIDIARIES

LIC has three subsidiaries: Life Insurance Corporation (International) EC, LIC Mutual Fund and LIC Pension Fund.

LIC Insurance Corporation (International) EC: It was established in 1989 as an offshore company by Life Insurance Corporation of India, in partnership with M/s International Agencies Co. Ltd, a leading business enterprise in Bahrain. The share capital of the company is BD 1,100,000 out of which 90 percent is held by LIC of India. The objectives of the company are to cater to the life insurance needs of non-resident Indians and to help non-resident Indians obtain housing loans for purchase/construction of houses/flats in India through LIC Housing Finance Limited, India. It is also operating in Saudi Arabia, Kuwait and UAE through chief agents and in Qatar through a broker arrangement.

LIC Mutual Fund: It was set up in June 1989 as a separate trust by LIC of India with a view to providing accessibility of various investment media, including the stock markets to all sections of investors, particularly the small investors in rural and semi-urban areas. For LIC Mutual Fund schemes, JeevanBimaSahayog Asset Management Company Limited (IBSAMC) incorporated on April 20, 1994 acts as investment manager.

LIC Pension Fund Limited It is the first company incorporated in India to manage pension funds under the new pension plan.

Overseas Ventures LIC's overseas ventures include LIC (Nepal) which begun operation in December, 2001 and LIC (Lanka) Limited, a joint venture between LIC and Bartlect group was set up in 2002.

LIC received Rs. 100 crore from the government for expanding further into foreign markets. LIC set up a full-fledged offshore unit at Mauritius which acts as a holding company for its forays into Africa. LIC has set up a joint venture in Nepal— LIC (Nepal) Limited, with the Vishal Group of Companies, a leading industrial house of Nepal. LIC has offices in UK, Fiji, Bahrain, Saudi Arabia, Kenya, Qatar, Oman, Kuwait and the UAE.

4.17. LIC PRODUCTS

LIC offers a wide variety of insurance plans to both individuals and groups. It now offers pension plans also to individuals.

Individual Plans

- Whole life schemes
- Endowment schemes
- Term assurance plans
- Periodic money-back plans
- Plan for high-worth individuals and keymen
- Medical benefits linked insurance
- Plans for the benefit of handicapped
- Plans to cover housing loans
- Joint life plan-JeevanSaathi Plan
- Plans for children's needs
- Capital market linked plan — Unit Linked Plan — Money Plus I, Fortune Plus and Profit Plus
- Special Money Back Plan for women

Group Schemes These schemes are ideal for employers, associations and society. They enable individuals to enjoy benefits at low cost.

- Group term insurance scheme
- Group insurance scheme in lieu of EDLI, 1976
- Group insurance scheme in corporation with superannuation scheme
- Group gratuity scheme
- Group superannuation
- Group savings linked insurance scheme
- Group leave encashment scheme
- Group mortgage redemption assurance scheme
- Gratuity Plus
- Group Critical Illness Rider

Social Security Group Insurance Schemes

- Landless Agricultural Labourers Group Insurance Scheme (LALGI)

- JanashreeBimaYojana (JBY) for the rural and urban poor persons below the poverty line and marginally above the poverty line. This scheme was launched on August 10, 2000 and is implemented with the help of non-governmental organizations and self-help groups who help in identifying the groups to be covered.
- KrishiShramikSamajikSurakshaYojana, 2001
- ShikshaSahayogYojana
- AamAadmiBimaYojana
- JeevanMadhur- a micro insurance policy for the under privileged sections.

Pension Plans

- JeevanNidhi
- JeevanAkshay V
- New JeevanDhara I
- New Jeevan Suraksha I

Special Plans

- New Bima Gold
- BimaNivesh 2005
- Jeevan Saral
- Health Plus

LIC commands a 97 per cent market share in endowment and money-back policies.

4.18 ACHIEVEMENTS OF LIC

The Life Insurance Corporation had a monopoly over the life insurance market till 2000. But its market share declined with the entry of private sector players. Its market share declined to 71 per cent in 2004. It regained its market share through aggressive marketing of its insurance products and expanding the distribution channel. For efficient customer servicing, it has connected all the branches through a Metro Area Network. LIC has tied up with some banks and service providers to offer on-line premium collection facility in selected cities.

LIC has set up a Wide Area Network (WAN), which enables policy holders to view their policy details and make payment of premium from any branch office. It has also provided Interactive Voice Response System (IVRS) to provide information about polices to policy holders on telephone and fax. It has installed on line kiosks in prominent places of big cities to provide information regarding LIC’s products and organization. These on-line kiosks also provide facility of depositing the cheques. The website of the corporation has been made more interactive and informative. LIC launched Corporate Active Data Warehouse (CADW) in 2006 which will house the entire IT infrastructure relating to all core applications of LIC. LIC has emerged as the second largest user of computers and information technologies in India.

4.19 MARKETING LIFE INSURANCE

As products can be marketed and sold, so also is insurance service. Here the insurance companies develop new plans, price them, promote and distribute the same among the potential customers. Now the insurers have shifted from selling to market orientation. The purpose of all business is to create and retain customers. Marketing means the activities that are focused on the customer. Business, therefore, has to inform the likely customers through media that reach them, make the goods and services available at convenient outlets, convince them of the cost for benefits from the services through meaningful presentations and ensure that the customers experience satisfactions while using them.

The marketing approach in relation to life insurance refers basically tom four steps:

1. Research to determine customers' financial insecurity;
2. Design new services (policies) or innovate old ones;
3. Market services to the customers for whom they were researched and designed (pricing, promotion and distribution) at a profit; and
4. In doing so, satisfy the customer's needs.

Marketing Mix in Insurance

Marketing of insurance products revolves around four P's i.e., product, price, promotion and place (distribution).

Product Design: Insurance company's success results from how well its products and services meet the needs of customers. In order to reach the maximum possible number of customers having diverse needs, products must be differentiated. Product features that are used to differentiate them include maximum and minimum face values i.e., sum assured, principal and supplementary benefits of the policy, embedded or inbuilt options available under the policy, the possible riders being included to increase death benefits and flexibility, premium paying modes available, policy term, settlement of the policy may be arranged and the other provisions under the policy. All these product features constitute life insurance product design. Life insurance product designs three broad attributes:

a. Kind of Contingencies Covered: various contingencies like death, accident, disability, living too long

b. Pattern of Premium Payment: Single, level annual, half-yearly, quarterly, monthly, limited term
c. Pattern of Benefits Received: Participating in profits, non-participating, tax, death/survival benefit, accident benefit, etc.

Time to time, it is highly necessary to design new products as per market requirements. Children plans, endowment plans, term plans, ULIP are few examples of product variety.

Pricing: Premium is the price which the person seeking insurance pays to the insurers for purchasing the life insurance cover. It is the consideration paid by each insured for building up a certain asset called the 'sum assured' with the insurer. Life insurance premium increases with age since the probability of death increases. However, the insurers, for the convenience of the clientele and their own administrative conveniences, charge a level premium uniform throughout the contract period. The premium may be paid in lump sum or over a period of yearly, half-yearly, quarterly or monthly basis.

Placing (Distribution) and Promotion: Distribution is concerned with the activities involved in transferring the products leading up to the sale to the customer. Simply put, it bridges the distance between the producer and the end customer. In the case of life insurance, marketing force comprising of agents and development officers (or whatever names given by the insurers) forms the distribution channels.

Marketing systems refer to the various methods for selling and marketing insurance products. These methods of selling are also called distribution systems.

An efficient distribution system is essential to an insurance company's survival. Life insurance marketing distribution systems for the sale of life insurance products have changed dramatically over time. Major life insurance distribution systems:

- Personal Selling systems
- Financial Institution distribution systems
- Direct response system
- Other distribution system

Personal Selling systems: The majority of life insurance policies and annuities sold today are through personal selling distribution systems and include the following —

- Career agents are full time agents who usually represent one insurer and are paid on a commission basis.

- Multiple Line Exclusive Agency system: Under this system, the agents who sell primarily property and casualty insurance also sell individual life and health insurance products.

Financial Institution Distribution Systems: Many insurers today use commercial banks and other financial institutions as a distribution system to market life insurance and annuity products.

Direct Response System: It is a type of marketing system by which life and health insurance products are sold directly to consumers without a face-to-face meeting with an agent. Potential customers are solicited by television, radio, mail, newspapers, Internet.

Other Distribution Systems:

- Worksite Marketing: Individual sales interviews on site with employees interested in purchasing insurance products
- Stock brokers are licensed to sell life insurance products.
- Financial Planners provide advice clients on investments, estate planning, taxation, wealth management and insurance.

A successful sales force is the key to success in the financial services industry. Most insurance policies are sold today by the intermediaries. They are the vital link between the insurer and the insured. The intermediaries associated with the insurance business are the agents, and surveyors and loss assessors, brokers, third party administrators and banks.

Agents: Agents are just like retailers of any consumer product who help in selling and distributing the product. An agent is a person licensed by the Controller of Insurance to do insurance business. An agent is someone who legally represents the principal and has the authority to act on the principal's behalf.

Surveyors and Loss Assessors: They are independent professionals appointed by an Insurance company to assess the loss or damage when a claim is notified under a policy issued by them. The duties of a surveyor are to investigate and confirm the cause of loss, assess the quantum of loss, determine the liability of the insurers, advise the insured to take necessary steps to contain the loss and action behalf of the insurance company in disposal of salvage to realize maximum value. The surveyors also serve as risk advisers to the general insurance companies. They advise these companies on how the risk can be minimized, based on their technical knowledge and practices.

Brokers: Brokers are just like agents but with a difference. Unlike agents, they can sell policies of several life and non-life insurance companies at a time.

Insurance brokers are professionals who assess risk on behalf of their clients, provide advice on mitigation of the said risk, identify the optimal insurance policy structure, bring together the insurer and the insured, carry out the preparatory work for entering into the insurance contracts and facilitate processing where claims arise. The brokers are retained by the insureds and are thus primarily responsible to them.

The functions of the brokers are specified by the IRDA and include provision of technical advice, advice on developments in insurance market and the law, providing written acknowledgements and progress reports and assisting in the negotiation of claims. They play a key role in designing the insurance cover and documentation of the insurance policy to ensure that all terms agreed at the time of striking the deal are covered in the policy.

Agents are the representatives of the insurers through whom they sell their insurance products while brokers are representatives of the insurance buyer to whom they provide the service of comparing the policies offered by different insurers with expertise. Brokers are free to source the best product, service and price arrangement from any insurance company in India. They are also free to deal with multiple insurance companies.

The insurance companies employ insurance agents and brokers to sell their insurance policies and products. A work license from the insurance regulation department is must to sell any insurance plans. The insurance premiums offered vary from company to company and also, from the policy to policy. The premium asked depends on the risk factor involved.

The insurance jobs include an insurance quote by the insurance company, usually conveyed by the insurance broker or agent, filling up of forms for your complete information and contact details, written documents for the insurance premium offered in the quote, term of insurance taken, the prices charged fore the services and a brief on the details of the claim process and settlement terms. The insurance claims can be made as direct claim or third party claims; information regarding this is given by your insurance providers.

One can also contact an insurance agency for information on the types of insurance available, the estimate prices of the insurance policies and a lead on the insurance product best suited for his/her requirement. Besides this, many websites also provide this information and also an online insurance estimator along with the ratings for the top insurance companies in India that helps you in deciding the insurance company from where to buy the insurance product chosen.

Third Party Administrators: Third party administrators (TPAs) are the middlemen in the healthcare delivery chain, which links physicians, hospitals clinics, home health, long-term care facilities and pharmacies. In the US, most insurance companies have their own TPAs, while, in India, TPAs are separate external entities. They serve more than one insurer at a time.

The TPAs are distributors of insurance products in the health insurance sector. They facilitate the smooth operation of a health cover by acting as a link between the insurance companies and their clients and hospitals. The IRDA has set up the minimum cap of Rs. one crore for TPAs. They enable cashless payment of claims to the insured wherein they settle claims with hospital instead of insurers.

Bancassurance: It refers to tying up of insurance companies with banks to sell insurance products. Bancassurance is an innovative distribution channel in India. In France, over half of the insurance products are sold through banks, while the share of bancassurance in Hongkong is 23 percent, UK 18 percent and Singapore 15 percent. In the US, banks lease space to insurers and retail products of multiple insurers just similar to a retailer selling different products of different companies under one roof.

The RBI, in recognition of the symbiotic relationship between banking and insurance industries, identified three routes of participation in the insurance business, namely, (i) providing fee-based insurance services without risk participation, (ii) investing in insurance company for providing infrastructure and services support and (iii) setting up a separate joint venture insurance company with risk participation. Bancassurance emerged as a preferred route for banks as other routes involve compliances to stringent entry norms. Over 20 banks have tied up with public and private sector insurance companies to sell their products. The synergy between some products (such as insurance cover for housing loans) makes banks ideal partners of insurance companies. In addition, through this partnership, new insurance companies get a readymade consumer data-base and higher reach to compete with public and private sector insurance companies.

Cooperative banks cover more than 65 percent of the rural population. These banks can serve as important vehicles for distributing insurance products in rural areas. The private and foreign banks are aggressive sellers of insurance products as commissions are over 35 percent of the first year premium. Looking to the attractive margins in bancassurance, the public sector banks are focusing on this business.

In order to expand their reach, life insurance companies are coming up with alternative distribution channels.

Direct Marketing: The insurance company gets a data base of potential customers, contacts them on the telephone to market different policies of the company. Companies are increasingly targeting customers of foreign banks as they are accustomed to telemarketing. ICICI Prudential Life Insurance Company sent 50,000 direct mailers to office-goers in Mumbai through their lunch boxes.

Automobile Manufacturer Tie-ups: Non-life insurers have tied up with automobile manufacturers to provide 'free insurance' through their authorized car dealers for all new cars sold. Under the scheme of free insurance the insured does not pay the first premium but it is paid by the car dealer who is taken compensated by the manufacturer.

Forex Dealers: Large travel-related relationship services such as Thomas Cook and Western Union who have wide distribution networks are tapped by insurance companies to canvass and sell overseas travel insurance policies.

Worksite Marketing: Insurance companies through their skilled marketing sell tailor-made insurance policies to individual employees of large organizations.

Internet: insurance companies sell products such as motor insurance, home insurance and personal accident insurance over the net.

Departmental Stores/Retailers of White Goods: Insurance companies tie up with large departmental chains such as Shopper's Stop or Westside to sell their products.

Marine Cargo Insurance through Clearing and Forwarding (C&F) Agents/Transporters/Carrier Companies: Insurance companies provide these agents technology support which enables them to issue marine policies anywhere and anytime.

Internet Marketing: Internet has been looked as the supportive medium. Websites are just giving information regarding companies and its products. And hardly, the customers are motivated by internet. As of current status, internet marketing is secondary and acting as a supportive medium in direct marketing. Now companies are not only giving product information but also facilitating premium calculation, policy status, covers, tax, advantage, terms and conditions and information about newly launched product. In fact, the Indians feel insecure in making financial transactions through net.

Tele Marketing: It is another way of insurance marketing. Web insurance marketing is another good strategy to promote insurance policies. In this process, a tele-caller usually makes a ring to the persons named in yellow pages. The primary function of a tele-caller is to tell the customer regarding the features of most attractive products of the company. The telecaller thereafter requests the prospective customer for giving sometime for meeting with company’s advisor. Telemarketing is just like persuading prospective customers over telephone. The effectiveness of telephone marketing depends upon the attitude, presentation and product knowledge of the tele caller.

Community Life Insurance Marketing: It is another way to get promotion and a high recognition for the life insurance company. Eminent workers join local community institutions, such as chamber of commerce and by signing up there one can help out various projects that take place. These kinds of activities and social works on behalf of the life insurance company helps the company to get free publicity as their names are published in newspaper and in media also. Doing charity work also helps the insurance companies to come across various people who act as volunteers and can act as their potential insurance clients.

Shopassurance: After developing bancassurance channels, the latest buzzword among insurance companies is shopassurance– selling insurance through supermarkets and retail chains. Today, supermarkets and retail chains are not only selling groceries and other consumer goods but also a wide range of financial products such as insurance, mutual funds, loans, investments and savings instruments. These chains have now become the biggest and most powerful business tools in the country. These markets and chains have a special appeal as they deal with different categories of customers on the basis of mutual relationships. Pantaloons, WestSide, Big Baazar, Food World, Reliance Fresh, Shoppers’ stop, Spencers and Subhiksha have built strong reputations on the shopassurance front. Many financial business houses, especially insurance companies are connected with these chains. For instance, Kishore Biyani’s future Company Group, which owns Pantaloons and Big Bazaar, is a stakeholder in Future Generali India Life Insurance Company and Future Generali India Insurance Company. The company is planning to sell its insurance products through Big Bazaar. Ambani’s Reliance Fresh is into life and non-life insurance while ITC has an insurance brokering venture called ITC Choupal.

Below mentioned is a comprehensive list of the most popular insurance companies in India.

- Bajaj Allianz Life Insurance
- AMP Sanmar Life Insurance
- Birla Sun Life Insurance
- Aviva Life insurance
- HDFC Life Insurance4
- ICICI Prudential Life Insurance

- Max Newyork Life Insurance
- Metlife India Insurance
- Reliance Life Insurance
- Shiram Life Insurance
- Tata AIG Life Insurance
- SBI Life Insurance
- Bharti AXA life Insurance
- ING Vysya Life Insurance
- Sahara Life Insurance
- Kotak Mahindra insurance
- General Insurance Corporation of India
- Royal Sundaram Insurance

4.20. SUMMARY

The main purpose of life insurance is to provide the financial losses caused by disability old age and death. Life insurance deals with permanent stoppage of earning power due to death or sickness. Every life insurance plan is a method of spreading a possible financial loss over a large number of persons. Life insurance seek to reduce the financial uncertainties, risk events arising from the natural contingencies i.e. old age, illness, death, etc. life insurance may be defined as a guarantee by one person to another against accidental loss – death. Life insurance undertakes to protect the insured's family, creditors or other against pecuniary loss growing out of death of the insured. Under life insurance life insurance, insurance company agrees to pay stipulated sum upon the death of the insured or maturity of policy in consideration of payment of a certain amount of premium.

The term health insurance is generally used to describe a form of insurance that pays for medical expenses. It is sometimes used more broadly to include insurance covering disability or long term nursing care needs. Health care has always been a problem area for India, a nation with a large population and a larger percentage of this population living in urban slums and in rural areas below the poverty line.

Insurance is limited to only a small proportion of people in the organized sector covering less than 10 percent of the total population. Much of the focus of the existing schemes is on hospital expenses. Health insurance suffers from problems like adverse selection, moral hazards, cream – skimming and high administrative cost. This is coupled with the fact that in the absence of any costing mechanisms, there is a difficulty in calculating the premium. Health insurance can improve access to good quality health care only if it is able to provide for health care institutions with adequate facilities and skilled personnel at affordable cost.

LIC is about to enter the health insurance market by selling long term health insurance with attractive products features as an adjunct to life insurance. Linking savings and investment to health cover is another innovative idea to explore.

4.21. SELF- ASSESSMENT QUESTIONS

1. Define life insurance and discuss the main features of life insurance.
2. Explain the principle of utmost good faith in life insurance.
3. Discuss various classification of life insurance.
4. Describe life insurance products.
5. Discuss various principle of health insurance.
6. What are the factors responsible to promote health insurance?
7. Define various health insurance policies.
8. Define LIC of India.
9. What are the achievements of LIC?
10. Discuss the concept of marketing in Life Insurance?

UNIT V PRINCIPLES OF GENERAL INSURANCE

Structure

5.0 OBJECTIVES

After studying this unit you will be able to understand –

- Origin and growth of general insurance
- Establishment of general insurance
- Functions of general insurance
- Products of general insurance
- Commercial general insurance product

5.1. INTRODUCTION TO GENERAL INSURANCE

Insurance other than life insurance is called general insurance. General insurance, unlike life insurance, provides insurance against theft, fire, marine, accident, etc. general insurance is done mainly of the properties such as car,, stock-in trade, building, scooter, T.V., house, jewelleries, etc. General insurance can be classified as fire insurance, marine insurance, fidelity insurance, crop insurance, motor insurance, credit insurance, etc.

5.2 ORIGIN OF GENERAL INSURANCE

It was in the 14th century that the idea of insurance was first conceptualized at that time, it was used as a tool for protection against financial loss of sea features involved in foreign trade. The origin of general insurance is lost in antiquity. The earliest traces of insurance in the ancient world are found in the form of marine trade loans or carrier’s contracts, which included an element of insurance. Evidence is on record that arrangements embodying the idea of insurance were made in Babylonia and India at quite an early period. The codes of Hammurabi and Manu had recognized the advisability of provision for sharing the future losses. However, there is no proof that insurance in the present form was practiced prior to 14^{th} century. The code of Manu indicates that there was the practice of marine insurance carried out by the traders in India with those of Sri Lanka, Egypt and Greece.

Marine insurance is the oldest form of insurance followed by life insurance and general insurance. The earliest transaction of insurance as practiced today can be traced back to the 14^{th} century A.D in Italy when ships were only being covered. It gradually spread to London and during 16^{th} century it was established in the mercantile business.

5.3 GROWTH OF GENERAL INSURANCE IN INDIA

Non-life insurance was brought by Britishers in India. Their operation was through agents. In India, the non-life insurance started working since 1850 with the establishment of the Triton Insurance, Calcutta. Again, in 1861, the North British and Mercantile catered to the requirements of non-life insurance business. Foreign companies had a monopoly in the insurance business upto the close of the nineteenth century. The first Indian company to transact general business was Indian Mercantile Insurance Company Limited in Bombay in 1907. It was to transact all types of general insurance business. Thereafter, a large number of both Indian and foreign insurance companies were set-up in the country. Till independence, near about 40% of the insurance business was held by foreigners mainly Britishers.

It was felt that there should be a code of conduct to be followed by the insurance companies in order to ensure fair and sound business and prevent unethical practices with the setting up of a large number of insurance companies. As a result, in 1957, Insurance Association of India framed a code of conduct for insuring fair transactions of general insurance business. A Controller of Insurance was appointed to implement this code of conduct. Its head office was located at Delhi with branch offices at Mumbai, Kolkata and Chennai. In 1956, Indian Reinsurance Corporation was established to retain maximum business in India.

Set-up of Indian Guarantee and General Insurance Company: In 1961, the Indian Guarantee and General Insurance Company Limited, a government company along with India Reinsurance Corporation were notified as Indian reinsurers. The insurance companies voluntarily ceded to each of them 10% of their gross direct premium. In 1961, the Government of India made it mandatory for every insurer to cede 20% in fire and marine cargo, 10% in marine hull and miscellaneous insurance and 55 in credit and solvency business to these two insurers.

In 1966, Indian reinsurance companies formed the Reinsurance Pools in Fire and Hull departments for retention of higher premiums in the country the member companies ceded a specific percentage of premium to the respective pools which were managed by the two statutory reinsurers.

Amendment of Insurance Act, 1938: A number of insurance companies indulged in unfair practices and hence, the Insurance Act, 1938 was amended in 1968. This amendment empowered the Controller of Insurance to regulate deployment of assets, provide for minimum solvency margin, issue licenses to surveyors, investigate, search and seize their books of accounts, to pay premium before the commencement of risk, etc. a Tariff Advisory Committee was set-up under the Chairmanship of the Controller of Insurance to control and regulate the rates, terms and advantages of General Insurance business in India.

General Insurance Business (Nationalisation) Act 1972: After independence, the General Insurance Business was Nationalizes with effect from January 1, 1973 through the General Insurance Business (Nationalisation) Act, 1972 to meet the national objectives of growth, equality, resource mobilization, employment generation, etc.

Under the provisions of this Act, the General Insurance Corporation of India was established for the purpose of directing, controlling and carrying on the general insurance business and all the 107 insurers including branches of foreign companies operating in India were merged with one or the other of four subsidiaries of the general insurance Corporation of India, namely:

1. National Insurance Company ltd., with its head office at Kolkata.
2. The New India Assurance Company Ltd., with its head office at Mumbai.
3. The Oriental Insurance company Ltd., with its head office at Delhi.
4. The United India Insurance Company Ltd., with its head office at Chennai.

The Government of India set-up these four subsidiary companies with the following twin objectives:

a) To ensure that these are so situated as to render their combined services effectively and in all parts of India; and
b) To ensure proper service to the public through mutual competition.

5.4 ESTABLISHMENT OF GENERAL INSURANCE COMPANY

The General Insurance Company was formed as a holding company in November 1972. The GIC was constituted for the purpose of superintending, controlling and carrying out the business of general insurance. The whole capital of GIC was subscribed by the Government and that of four companies by the GIC on behalf of the Government of India.

The growth of the general insurance business is hampered by lack of product innovation. Lack of quality data on risks and associated parameters handicaps product innovation.

Functions

The functions of GIC are:

1. Carrying on of any part of general insurance business, if it thinks desirable to do so.
2. Helping, assisting and advising the acquiring companies in the matter of setting up of standards of conducts and sound practices in general insurance business and in the matter of rendering efficient service to holders of policies of general insurance.
3. Advising the general insurance companies in the matter of controlling their expenses including the payment of commission and other expenses.
4. Advising the acquiring companies in the matter of investment of their funds and
5. Issuing direction to acquiring companies in relation to the conduct of the general insurance business.
6. Issuing directions and encouraging completion among the acquiring companies in order to render their services more efficiently.

5.5 PRINCIPLES OF GENERAL INSURANCE

A contract of general insurance has the features of a general contract like proposal, acceptance, consideration, etc. General insurance is also governed by some fundamental principles which are briefly discussed below:

1. **Principle of Utmost Good faith:** Utmost good faith implies that both the parties should have trust and believe in each other. The insured must disclose to the insurer, before the contract is signed, every material facts known to him. It also means that there should not be any concealment, misrepresentation, half disclosure or fraud regarding the subject matter to be insured. Otherwise the contract would be null and void.

   For example, in marine insurance, the offer is required to disclose the following information about the subject matter of insurance — nature of goods, method of packing, particulars of vessel carrying the goods, the port of shipment and destination along with route of journey, insurance cover required and condition of insurance, sum to be insured, past claim information and experience. The insurance company finds a better way to cancel the contract or dismiss the claim on account of non-disclosure of material facts and as a consequent breach of utmost good faith. Similarly, the insured may also avoid contract, in case the insurance company does not conduct good faith in disclosing the scope of insurance.

In case of fire insurance also, this principle is applicable.

2. **Principle of Insurable Interest:** No person can enter into a valid contract of insurance unless he had insurable interest in the object to be insured. If it were not so, and if every one were at liberty to take out an insurance policy on any object or life in the world irrespective of his insurable interest, the contracts of insurance would have been reduced to mere gambling. In such case, insurance contracts would be reduced by wagering contracts which are not valid and cannot be enforced in a court of law.

   Insurable interest is understood as an interest in the preservation of a thing or continuation of a life, recognized by law. Whosoever has such interest in an object or a life may insure that object or life. Insurable interest is in the nature of pecuniary or financial interest in an object or life.

   For example, in marine insurance, a person can take insurance policy on his ship, an owner of goods can take policy on the cargo and the person entitled to receive freight can take policy on the freight. Marine insurance contracts specifically provide that insurable interest must exist at the time of the loss but need not exist when the insurance is effected.

   In fire insurance, insurable interest is as under:

   a) The owner of the property in his property.
   b) Every partner has an equitable interest in the properties of the firm.
   c) An agent has an insurable interest in the property of his principal.

Insurable interest in case of fire insurance must exist when insurance is effected as well as when the loss occur.

3. **Principle of Indemnity:** All insurance contacts except for life insurance are contracts of indemnity. The basic principle of insurance is to transfer the loss of a person to the insurance company which can easily be spread over a large number of policy holders. It is therefore, necessary that a person will get exactly the same amount as he has lost due to the loss of his goods or damage to the property. Insured cannot be permitted to make profit out of his loss. For example, if the goods are insured for Rs. 10,000 and the insured suffer a loss of Rs. 5000, he will be compensated for Rs. 5000 only. But if the insured has taken a policy for a smaller value than the actual loss, the insurance company is bound to

pay only the amount of the policy and the actual loss. According to the principle of indemnity, the insured can get only the actual loss of goods or property destroyed or the insured amount, whichever is less.

4. **Principle of Subrogation:** It is an extension of the principle of indemnity. Subrogation is the transfer of rights and remedies of the insured in the subject-matter (property) to the insurer after indemnification. In other words, the insurer steps into the shoes of the insured and become entitled to all rights of action against the third party to cover the loss from the responsible person regarding the subject matter of insurance after the claim of the insured has been fully settled and paid. Principle of subrogation gives a right to the insurance company to recover from a third party the amount paid under the policy. Thus, if the insured person possesses any rights against a third party for recovery of his loss, the insurance company becomes subrogated to these rights. For example, if an insured asset has been damaged by a third party, then the insurer will pay the loss amount to the insured and the rights on that asset will be with the insurer.
5. **Principle of CausaProxima**: The term causaproxima is a Latin term which means, 'the nearest cause' or 'proximate cause' or 'immediate cause'. It is helpful in deciding the actual cause of loss when a number of causes have contributed to the occurrence of loss. If the real cause of loss is insured, the insurer is liable to compensate the loss; otherwise the insurer may not be responsible for the loss. In other words, while deciding the liability of the insurer, the direct, nearest or proximate cause and not the remote or indirect cause of the loss is to be taken into account. For example, in fire insurance, if the proximate cause of loss is fire, the loss is recoverable. But if it is not fire but some other cause remotely connected with fire, the loss is not recoverable unless specifically provided for. Thus, loss caused by explosion is not covered by fire policy unless explosion actually causes ignition which spreads into fire.

5.6. FUNCTIONS OF INSURANCE

The functions of insurance may be classified into three types:

A. Primary functions
B. Secondary functions
C. Other functions

A. Primary Functions

1. **Insurance provides Certainty:** The main function of insurance is to provide certainty by reducing risks or uncertainties of events. Insurance is a means to compensate the losses

caused by uncertain events. The insured can convert his uncertainties into certainties by paying premium to the insurer. Insurance provides certainty of payment for the risk of loss.

2. **Insurance provides Protection:** Another important function of insurance is to provide protection against the probable chance of loss. The insurance guarantees the payment of loss and thus protects the insured against suffering. The insurance cannot prevent the happening of the risk and event but can compensate for losses arising at the happening of the risk event.
3. **Risk Sharing:** the concept of insurance is based on the law of cooperation to share the loss. When risk takes place, the loss is shared by all persons who are exposed to the risk. The share is obtained from each and every insured in the shape of premium without which the insurer does not guarantee the protection.
4. **Insurance provide security:** Another function of insurance is to provide security to the persons against the risks of uncertain events. The insurance provides a feeling of security against the evil effects of the uncertain events i.e., risks.
5. **Assistance to business enterprises:** Insurance provides help to business houses. There is heavy capital investment in modern industry especially in building, machinery, plant equipments. This investment is exposed to loss or damage by fire, theft, accident or other perils. The provision for these losses may be very costly. Insurance provides protection to these assets in return for a small payment called ‘premium’.

B. SECONDARY FUNCTIONS

1. **Prevention of loss:** The insurance companies assist financially to the health organization, fir brigade, educational institutions and other organizations, which are engaged in preventing the losses of masses from death or damage. Insurance not only secures the losses but also advices to adopt various methods and techniques which help in reducing the losses.
2. **Provides capital:** Insurance provides capital to the industry. It provides funds for investments. The surplus amount, received on account of premium by various insurance companies is made available for the industrial development of the country. Investment is made in share capital of the companies, providing long term loans to companies and advance3 loans by hypothecation of the insurance policies. The industry, business and individuals are benefitted by the investment and loans by the insurers.

3. **Improves Efficiency:** Insurance improves the efficiency in business by reducing the risks or fear of losses. The insurance eliminates worries and miseries of losses to provide a sense of security in the business community, which in turn becomes a source for the growth and diversification of industry. The management can devote its body and soul together for better achievement of results.
4. **Economic Progress:** The insurance provides an initiative to work hard for the betterment of masses by protecting the society from huge losses of damage, destruction and death.
5. **Judging the Profitability of Major Projects:** Insurance also helps in judging the viability of major projects. Before insuring the assets or property of any organization, the insurer conducts a viability investigation of assets or project as a whole with a view to judge the profitability of the project.

C. Other Functions

In addition to the primary and secondary functions, insurance performs various other functions for the benefits of the common man, business community and nation as a whole.

1. **Expansion of Foreign Trade:** Insurance promotes foreign trade and helps in earning valuable foreign exchange by providing security to the international traders, shipping companies, banking and financial institutions, who work in the field of foreign trade. Indian insurance is transacted in overseas countries particularly in the Middle East, Africa and South-East Asia through branches, which also contributes to earn foreign currency.
2. **Encourages savings:** Insurance makes saving possible. These days insurance is considered to be a better alternative to investment of surplus funds in insurance policies for future saving and to get the benefits of income-tax deductions. Insurance premiums are free of tax expenditure.
3. **Check Inflation:** Insurance helps in checking the inflation also. Forced saving in the form of premium, reduces the spending of the individuals. The saved scare source of production i.e., capital, is used for the national development by investing them in a better way.
4. **Feeling of self-Confidence and Goodwill:** insurance creates self-confidence in insured by providing a feeling of security and safety to the. Insurance provides protection against risks. It also provides capital to the insured which becomes a source of financial stability and strength. Insurance increases self-confidence, reputation and goodwill of the insured.

5. **Social Security and Publication of Education:** Insurance provides an instrumental force to fight against evils of poverty, unemployment, disease, old age, fateful accidents of persons and property, etc. insurance helps in spreading education among masses regarding adoption of techniques for minimizing the happening of controllable uncertain events.
6. **Credit facilities:** traders are in a position to collect loans from various financial institutions and banks by pledging their insurance policies.
7. **Employees Cooperation:** Employers can have good relation with employees by insuring employees against life, accident and sickness, etc. satisfied employees are the assets of an organization.

5.7 GENERAL INSURANCE PRODUCTS

General insurance or non-life insurance helps one to safeguard himself and the things around him which he values a lot. These may include his home, car and other valuables like money lending, professional casualties other than death, etc. these valuables carry a lot of financial risks. Therefore, general insurance plans provide financial protection from the impact of fire, storm, flood, earthquake, car accidents, theft and other travel accidents. It also covers us from the expenses spent on the legal actions. Where life insurance looks after risks of death and its consequences, general insurance helps in protecting risks due to other aspects of life and its diverse aspects.

Non-life or general insurance companies have a range of approximately 150 products and offer coverage from goat to satellite and failed-well to offshore rigs. The various products supplied by the general insurance industry fall under the following broad categories —

- Fire Insurance – Includes policies for stocks consequential loss policies/reinstatement policies, in addition to standard fire policies.
- Marine Insurance – Ocean marine/Hull/Cargo/Freight insurance/Inland Marine such as goods –transit/mobile equipment and property/etc.
- Property and liability insurance – Torts liabilities/statutory liabilities
- Rural insurance – aquaculture/cattle/failed-well/farmer's package/fisheries/floriculture/plantation-horticulture/poultry
- Project and Engineering Insurance – Commercial risk/operational risk/disparity risk/general risks like ventor's failure to utilize/political risk/marine cum errection/dismantling cover express delivery/cross liability cover/clearance and removal

of debris/machinery breakdown/advance loss of profit/public liability/boiler/storage cum errection/contractors all risk/explosion/ all risks insurance

- Social insurance –Janashree Bima for groups of 25 persons/KrishiBimaYojana/personal accident social security/unemployment insurance/Shiksha Sahayog Yojana 2001/unit-linked gratuity plus – 2006.
- Motor Vehicle Insurance – Liability towards third party bodily injury maximum Rs. 7.50 lakh/liability towards bodily injury of passengers of the vehicle/liability towards employees of the vehicle owner while travelling against bodily injury as per workman's compensation Act/loss of damage to the vehicle/liability towards employees under fatal accidents Act/personal accident benefits for owner-passengers and employees.
- Miscellaneous Insurance – Burglary/fidelity/jewellery/baggage/personal accident/bankers indemnity/Aviation – aircraft comprehensive – Airlines (Hull and liability)non-traditional insurance horse/cycle rickshaw/pedal cycles/plate glass/household appliances/shopkeepers policy/LPG dealers/office umbrella/electronic equipments/gun insurance/baggage insurance/ travel/industrial all risk insurance/mediclaim insurance/off shore drilling/satellite/overseas mediclaim/stock brokers insurance.

The coverage period for most general insurance policies and plans is usually one year, whereby premiums are normally paid on a one-time basis.

There are two categories of general insurance products, one which falls under the commercial lines offered to businesses/corporations and the second one is offered under personal lines, designed specifically for the public.

5.8 PERSONAL GENERAL INSURANCE PRODUCTS

1. Motor Insurance

Motor insurance provides protection to the owner of vehicle against

- Damages to his/her vehicle and
- Pays for any third party liability decided as per law against the owner of the vehicle.

Third party insurance is a compulsory requirement. Under Motor Vehicle Act, the owner of the vehicle is legally liable fore any injury or damage to third party or property caused by or arising out of the use of the vehicle in a public place. As per the Motor Vehicles Act, 1988, all vehicles running on the Indian roads are mandatory to be insured. The Motor Vehicles Act, 1939 has made it compulsory for the motorists to insure against the risk of liability to third parties. Vehicles for the purpose of insurance are classified as below:

i) Private Car (not used for carrying passengers for hire or reward)

ii) Commercial vehicles such as goods carrying vehicles, passenger vehicles, tractors and others.

iii) Motor cycles, Scooters and auto cycles.

Types of Motor Insurance policies: The policies under motor insurance are as follows –

A. Act Liability Only

B. Third Party Only

C. Comprehensive Policy.

A. Act Liability Policies: This policy is designed to meet the requirements of Motor vehicles Act, 1939, which provides the compulsory insurance in regard to liabilities arising out of motor vehicles in a public place. This type of policy is limited to bodily injury or death of the third parties.

B. Third Party Insurance Policy: This policy covers the liabilities of the third parties who have suffered loss in connection with the damage of property and personal injury or death. So, this policy indemnifies the insured against his legal liability in respect of damage to property of third parties over and above Rs. 2000. The policy may be extended to include –

a. Fire;

b. Theft risks;

c. Legal liabilities to persons employed in connection with the operation and/or maintenance and/or loading and/or unloading of motor vehicles.

C. Comprehensive Policy: the comprehensive policy covers the following risks –

i) Damage to car parts or body.

ii) Removal charges for repairs.

iii) Third Party Liabilities.

iv) Cost and Expenses incurred with risk

v) Repair charges.

vi) Medical expenses.

On the payment of extra premiums, the following risks are also covered –

i) Death or injury to family members who are above 16 years and below 65 years.

ii) Riots, strikes, thefts, larceny, etc.

iii) Loss of Rugs.

2. Fire insurance

Fire insurance is a contract of indemnity and the insured cannot claim anything more than the value of the goods lost or damaged by fire or the amount insured, whichever is less. The contract of the fire insurance does not help in controlling or preventing the fire but it is a promise to compensate the loss caused by fire. Fire insurance is an agreement between the insurer and the insured, under which the insurer agrees to indemnify the loss caused by fire, to the insured, in consideration of certain payment, called premium. Different policies issued under fire insurance business are as follows —

a. **Valued Policy:** The value of the property tom be insured is determined at the inception of the policy. In this case, the insurer pays the total admitted value irrespective of the market value of the properties. The measure of indemnity is not valued at the time of fire, but according to a value agreed at the inception of the policy. The insurer pays the insured a fixed sum following the destruction of the insured property. The amount fixed may be greater or less than the actual market value of the property destroyed by fire at the time of loss. In this policy, the measure of indemnity is based on the value of the properties rather than on the market value of the property destroyed. The policy is used for insuring artistic pictures sculptures, works of art, jewellery, rare things and articles of everyday use.
b. **Valuable Policy:** Valuable policy is that policy in which policy amount is determined according to the market value of the property at the time of loss. The amount of loss is not determined at the time of commencement of the risk but is determined at the time and place of loss.
c. **Specific Policy:** In such a policy, a specific sum is insured for a specific property for a specified period. The whole of the actual loss is payable provided it does not exceed the insured amount. The value of the property insured is not considered in arriving at the measure of indemnity in a specified policy and the insured sum sets a limit upto which the loss can be made good.
d. **Floating Policy:** The floating policy is the policy taken to cover one or more types of goods at one time under one sum assured for one premium and in relation to the same owner. The policy is useful to cover fluctuating stocks in different localities. These types of policies are specially taken by big manufacturers or traders whose merchandise might be lying in parts at warehouse, godown, port or railway station.
e. **Average Policy:** Policy containing ‘average clause’ is called an average policy. The amount of indemnity is determined with reference to the value of the property insured. If the policyholder has taken policy for lesser amount than actual market value of the

property, the insured will be deemed to be responsible fore the an\mount of under-insurance. The insurer will pay only such proportion of the actual loss as his insurance amount bears to the actual market values of the property at the time of loss.

$$\text{Claim} = \frac{\text{InsuredAmount}}{\text{ValueoftheProperty}} \times \text{Actual Loss}$$

The average clause is operative only in case of an under-insurance.

f. **Excess Policy:** Sometimes, the stock of a businessman may fluctuate from time to time and he may be unable to take one policy or specific policy. If he takes policy for a higher amount, he will have to pay a higher premium. On the other hand, if he takes insurance for lower amount, he will have to bear the proportional amount of loss. In this case, insured can purchase two policies i.e., 'First Loss Policy' and 'excess Policy'. The 'First loss Policy' will cover that stock below which the stock never goes. The minimum level of stock can be found out from the past experience and for the other part of stock which exceeds the minimum limit; he can purchase another policy called 'excess policy'. The actual value of the stock is declared every month. The amount of premium is calculated on the average monthly excess amount. As the chances of payment on the excess amount are very remote, the rate of premium is also very nominal.

g. **Declaration Policy:** The declaration policy will give a better protection in such cases where the stocks fluctuate from time to time. Under this policy, the insured takes out insurance for the maximum amount that he considers would be at risk during the period of the policy. On a fixed date of every month or a specific period, the insured furnishes a declaration of the amount. The premium is provisionally paid to 75 % of the annual premium amount. Practically, the annual premium is determined on the average of these declarations.

h. **Adjustable Policy:** This policy is nothing but an ordinary policy on the stock of the businessman with liberty to the insured to vary amount at his option. The premium is adjustable pro-rate according to the variation of the stock. In case of declaration policy, since the excess premium is refundable at the end of the year, the insured party may put fire to the property. This danger is avoidable in an adjustable policy. This is issued for a definite term on the existing stock.

i. **Maximum value with Discount Policy:** Under this policy, no declaration or adjustment of the policy is required, but the policy is taken for a maximum amount and full premium is paid thereon. At the end of the year, in case of no loss, one-third (1/3) of the premium is returned to the policyholder. This policy is not issued on all types of commodities and is confined only to selected items.

j. **Reinstatement of Policy:** This policy is issued to avoid the conflict of indemnity. In other types of policies only the market value of the damage or loss is indemnified, but this policy undertakes to reinstate the insured property lost by fire to old condition irrespective of its value at the time of loss. This policy is also called 'New for Old' policy because the old property is replaced by new properties. Such policies are issued only on building, plant and machinery.

k. **Comprehensive Policy:** This policy undertakes protection not only against the risk of fire but also provides protection against risk of burglary, riot, civil commotion, theft, damage from pest, lightening. This policy is also termed as 'All in one policy'.

l. **Consequential Loss Policy:** The fire insurance policy is originally purchased to indemnify the material loss only. The intangible interest was not indemnified. This provided a check on the insured to exercise a greater care with respect to the property. However, the settlement of a loss covering material damage only was not sufficient. The consequential loss was also to be provided. So, the consequential loss policy includes the loss of tangible and intangible properties. This policy provides an indemnity to the insured for loss of profits, payment of standing charges and expenditure in respect of increased cost of working. This policy is to compensate the insured against financial loss which may be sustained due to the interruption of his business following a fire.

m. **Sprinkler Leakage Policies:** This policy insures destruction of or damage to by water accidentally discharged or leaking from automatic sprinkler installation in the insured premises.

3. **Medical and Health Insurance**

Health care costs are increasing every year. Sedentary lifestyle and stress at work negatively affects the health and can result in a critical illness or medical emergency**.** Such a scenario is sure to adversely affect one financially, due to the massive outlay of money on medical expenditure. A health insurance policy is the only way to mitigate the financial risks, apart from leading healthy lifestyle. Health insurance guarantees peace of mind in times of crisis and helps secure own health and that of one's family. Health insurance covers the medical and surgical expenses of the insured individual due to hospitalisation from an illness. Additional riders enhance the benefits and scope of the cover. Health insurance often includes cashless facility at empanelled hospitals, pre and post hospitalization expenses, ambulance charges, daily cash allowance, etc. Common types of health insurance policies include: Individual Policy, Family Floater Policy, Surgery Cover, Comprehensive Health Insurance.

4. **Personal Accident Insurance**

Personal accident insurance is one of the popular classes of accident insurance and as a supplement to life insurance. It provides an ideal protection against death or disability. This policy has been found favourable to employers who offer personal accident insurance benefits as a part of the service benefits to their employees. Industrial accidents are more frequent due to rapid industrialization and use of complex machinery. Different types of policies are available to cover the risks from industrial accidents. Individuals are provided this risk cover under an individual personal accident insurance policy.

a) **Personal Accident and Specified diseases Insurance:** In addition to the death and disablement arising out of accidental bodily injury, insurance may also provide for benefits for disablement arising out of specified diseases. This is provided by issuing personal accident and specified diseases insurance policies. These policies contain the usual personal accident.

b) **Medical benefits and Hospitalisation Schemes**: As a part of their service benefits, many employers reimburse to their employees the expenses incurred for medical treatment. Insurance has devised medical benefits and hospitalization policies which they offer to the employers. There is a tendency on the part of many employers to buy such insurance policies rather than electing to reimburse the employees from their funds because such policy reduce the cost of providing medical facilities for the employees and cut out clerical work for them.

5. **Travel Insurance**

Travel within the country or abroad, whether on vacation or business can turn into a nightmare if one experiences contingencies like loss of baggage, loss of passport, delay in flight, medical emergency etc. Such eventualities take the fun away from travelling. Travel insurance covers one against unseen medical and non-medical emergencies during overseas travel, ensuring a worry-free travel experience. It protects the insured against misfortunes while travelling. Different types of travel insurance policies include: individual travel policy; family travel policy; student travel policy; senior citizen’s travel policy. In addition to the above, some insurance companies offer special plans like a corporate travel policy or comprehensive policy for travel to special destinations like Asia and /or Europe.

5.8 COMMERCIAL GENERAL INSURANCE PRODUCTS

1. LIABILITY INSURANCE

Liability insurance is an essential segment of general insurance system of risk financing. It protects the insured (policyholder) from the risks of liabilities imposed by lawsuits and similar claims. Liability insurance is designed to provide particular protection against third pay insurance claims under which payment is made to someone suffering loss and who is not a party to the insurance contract instead of insured. Liability insurance policies do not cover the damage caused intentionally as well as contractual liability.

Types of Liability Insurance Policies: The following types of liability insurance policies are available in the market to meet the diversified requirements of society.

a. **Public Liability Act Policy:** Public Liability Insurance Act, 1991 is designed to provide for public liability insurance for the purpose of providing immediate relief to the persons affected by accident occurring while handling hazardous substance and for matters connected therewith or incidental thereto. The limit as prescribed in the Act for the insurance are

- Per accident minimum paid-up-capital subject to maximum Rs. 5 crore;
- Annual limit is 3 times of per accident limit subject to maximum of Rs. 15 crore.

b. **Public Liability (Industrial and Non-Industrial) Policy:** Industrial risks are manufacturing premises including godowns, warehouses etc. forming part thereof. On the other hand, non-industrial risks are:

i. Hotels, Motels, Club Houses, Restaurants, Boarding and Lodging houses.
ii. Cinema hall, Auditoriums. Theatres, Public Halls, Open Air Theatres.
iii. Residential premises.
iv. Office/Administrative Premises, Medical establishment, research institutes and laboratories.
v. Schools, educational institutes, Public Libraries.
vi. Exhibitions, fairs and fetes.
vii. Permanent amusement parks.
viii. Film studios – indoor and outdoor, circus, Zoos.
ix. Depots, Warehouses, Godowns, shops and similar other non-industrial risks.

The policy indemnifies the insured against their legal liability other than liability under the Public Liability Insurance Act, 1991 or any other statute that may come into force after the issue of the policy to pay compensation including claimant's costs, fees and expenses anywhere in India in accordance with Indian Law and in respect of accidents which cause death or injury or damage to property of third parties.

c. **Product Liability Policy:** The demand for products liability insurance has increased due to the wide variety of products manufactured and sold to the public in modern industrial society which may cause death, bodily injury or illness or even damage to property if find defective. A product manufacturer may also attain product liability insurance to cover them if a product is harmful and causes damage to the purchasers or any other third party.

d. **Commercial General Liability (CGL) Policy:** CGL is a standard insurance policy issued to business houses to protect them against liability claims for bodily injury and property damage arising out of premises, operations, products and completed operations and advertising and personal injury liability. The CGL policy was introduced in 1986 and replaces the "Comprehensive" general liability policy.

e. **Errors and Omissions/Professional Liability Policy:** It id\s designed to provide protection to professional people against their legal liability to pay damages arising out of negligence in the performance of their professional duties. The policy is ideal for those engaged in service industry such as — medical practitioners; engineers, architects and interior decorators; chartered accountants, financial consultants, management consultants; software firms.

f. **Directors and Officers Liability Policy:** Under this policy, a legal liability protection is provided for the directors and officers of the company for wrongful acts committe4d by them in the supervision and management of the affairs of the company. The policy is specifically designed to provide protection to Directors and Officers against their personal civil liability. This policy does not provide insurance coverage for liabilities arising out of criminal wrongs, prior or pending litigations, infringement of intellectual property rights.

g. **Employer's Liability Insurance Policy:** It is also known as Workmen's Compensation Insurance. The policy projects the employers against their legal liability for payment of compensation arising as a result of death or disablement of the employees arising out of and in the course of employment who falls in the category of workman as defined in the Workmen Compensation Act.

2. **FIRE BUSINESS INTERRUPTION INSURANCE**

   Also known as consequential loss insurance, Fire Interruption Insurance provides indemnity to the insured in respect of loss of profit. Any loss under the material damage policy will affect the business interruption insurance as this will lead to interruption in the business in terms of loss of production sales and consequently earnings. The insurance can only be taken together with fire insurance (refer to fire insurance under personal lines.)

3. **GOODS IN TRANSIT INSURANCE**

   This policy covers any loss or damage to goods conveyed on land by road or rail or by boat for short journeys. The cover provided on all risks basis, indemnifying the insured for loss or damage to goods by fire, accident, theft or pilferage while being loaded or unloaded from any vehicle or passenger or goods train of temporarily housed in the ordinary course of transit, whether on or off conveyance.

4. **MONEY INSURANCE**

   This policy covers for loss of money whilst in the transit and whilst kept in locked drawers, safe or strong rooms or due to any hold up whilst on the business premises. Money will comprise cash, bank notes, currency notes, cheques, postal orders or money orders.

5. **FIDELITY GUARANTEE INSURANCE**

These types of policies indemnify the employers against direct pecuniary loss that he may sustain through acts of fraud or dishonesty by an employee in the course of his employment. In industries where secrecy and confidentiality of operations is vital for company's success, this policy will ensure the concealment of business procedures from other competitors who may be successful in poaching their rival's employees. The fidelity guarantee Insurance Policy can be recommended to banks, companies or organizations that have a sizeable number of employees to cover them against financial loss suffered because of their employee's defalcation, forgery or fraudulent conversation

This insurance policy insures the employer from risks faced owing to his employees such as fraud or obtaining advantage through unfair means, dishonesty or breach of trust, forgery or illegal alteration, embezzlement or misappropriation of money or goods, larceny or dishonest means of possession, default or failure to perform specific duties.

Under the commercial fidelity guarantee, three types of covers namely, individual, collective and floater, are available. The option to choose any one or all of them lies with the policyholder. The following **types of policies** are in general demand:

a. **Individual Policy:** This type of policy is used where only one individual is to be guaranteed.
b. **Collective Policy:** A collective policy is issued where the entire staff or a number of selected individuals are to be covered.
c. **Floating Policy:** It is an extension to the collective form of contract in which the names and duties of the individuals to be covered are inserted in a schedule but instead of individuals' amount of guarantee, a specified sum of guarantee is floated on the whole group.
d. **Positions Policy:** This is similar to a collective policy with the difference that instead of using names, the position is guaranteed for a specified amount so that a change in the person holding the position does not affect the cover. The liability of the insurers in respect of each position remains limited to the amounted guaranteed irrespective of the number of persons acting in that position.
e. **Blanket Policy:** This policy covers the whole staff without showing the names or positions. No enquiries about the employees are made by the insurers. Such policies are only suitable for an employer with a large staff and the organization to make adequate enquiries into the antecedents of employees.
f. **Excess Floating Policy:** Excess floating policy is a combination of collective policy and a floating policy.
g. **Service Security Policy:** Another important policy of fidelity guarantee business is guaranteeing a minimum period of service an employee has agreed to render to an employer in return for the training given to him to acquire qualifications. In the event of failure of the employee to honour his commitment, the insurer has to pay the amount guaranteed.

6. ENGINEERING INSURANCE

Engineering insurance refers to the insurance that provides economic safeguard to the risks faced by the ongoing construction project, installation project and machines and equipment in project operation. Product categories: Depending on the project, it can be divided into construction project all risks insurance and installation project all risks insurance; depending on the attribute of the object, it can be divided into project all risks insurance and machinery breakdown insurance.

5.9 TYPES OF POLICIES

a. **Machinery Breakdown Insurance (MB):** This policy covers the sudden and unforeseen damage to the insured machinery, plant or equipment whilst either at work or at rest and during the cleaning, maintenance, overhauling, inspection or removal; to another position within the premises. It will exclude gradual damage and loss from any cause which is foreseeable. This insurance was developed to grant industry effective insurance cover for expensive plant, machinery and mechanical equipment. This insurance is important for everyone who operates the machines.

b. **Machinery Breakdown Loss of Profits Insurance:** This policy compliments the machinery breakdown policy by providing cover for resultant loss arising from material damage claim. It also covers the loss of profits from the damaged covered under the machinery breakdown policy.

c. **Boiler and Pressure Vessel Insurance**: This policy covers explosion or collapse of the insured plant including damage (other than fire) belonging to the insured but does not cover rupture of tubes inside the boilers. It also includes liability at law for damage in respect of bodily injury to any person not arising out of /on in the course of employment of such person in the service of the insured and damage to the third party property which is caused by explosion or collapse.

d. **Contractors All Risk Insurance (CAR):** This is an all risks policy covering any unforeseen and sudden physical loss or damage to contract works, construction plant, an equipment and/or construction machinery from any cause whilst at site during the period of insurance unless specifically excluded under the policy. The CAR insurance policies generally issued for all types of civil engineering projects. Although a CAR policy may be taken by the principal or by the contractor, but usually, under the terms of the agreement between the contractor and the principal, it is obligatory on part of the contractor to effect a CAR insurance in their joint names before the commencement of the project.

   The sum insured under the policy must not be less than the full value of the contract works at the completion of contract inclusive of all materials, wages, freight, custom duties, construction cost and material or items supplied by the principal.

e. **Erection All Risks Insurance (EAR):** This policy covers loss or damage to the contract works, predominately erection of machinery coupled with testing, including legal liability to third parties, arising out of the performance of the contract. Certain exclusions can be extended subject to the payment of additional premium. EAR insurance provides a very wide and comprehensive insurance cover to the client in respect of any sort of contingency from the moment the ,material unloaded at the site of the project and continues during storage, physical erection, commissioning, testing and maintenance(if covered). Since the duration of the cover can be as long as 36 months or even more, care must be taken while negotiating the proposal as well as assessing the moral hazard of the client.

f. **Electronic Equipment Insurance (EEI):** The Electronic equipments such as computers, Microprocessors, Word processors, Telecommunication equipment, machines meant for medical use and other miscellaneous, equipments like films, television studio equipments can be covered under this policy. This insurance indemnifies the insured against any physical loss or damage due to location perils (fire, lighting, explosion, flood, storm, etc.); breakdown (any electrical/mechanical breakdown); faults (faulty design, faulty materials, faults in manufacturing/ assembly erection); effect of moisture; carelessness; riot and strike; burglary.

7. MARINE INSURANCE

The marine insurance policy is issued only when the contract is finalized and it constitutes a legal document. A contract of marine insurance is defined by the Marine Insurance Act, 1963, as "an agreement whereby the insurer undertakes to indemnify the assured, in the manner and to the extent thereby agreed, against losses incidental to marine adventure. It may cover loss or damage to vessels, cargo or freight". Thus, marine insurance covers loss or damage to vessels or to cargo or passengers, during transportation on the seas. The risks insured against are those commonly known as perils of sea.

Marine insurance covers the loss or damage of ships, cargo, terminals and any transport or cargo by which property is transferred, acquired or held between the points of origin and final destination.

Types of Marine Insurance

There are two major branches of marine insurance: **Ocean Marine Insurance and Inland Marine Insurance.** The ocean marine insurance covers ships, cargoes and freight of both ocean going and inland ships, while inland marine insurance is written to insure three broad types of business namely, domestic shipments, instrumentalities of transport and communication and property floater policies. Under domestic shipments or transportation insurance goods in transit are insured through annual transit policy, tri transit policy, blanket motor cargo insurance shipper, parcel-post forms, registered mail forms, etc.

Marine insurance can be broadly classified as either **property or liability insurance**. Property insurance insures against financial loss resulting from damage to or destruction of property in which the insured has an insurable interest. Liability insurance insures against financial loss resulting from some person or organization making a claim against the insured for damages because of bodily injury, death, property damage or some other injury for which the insured is allegedly responsible.

The insurance of property in marine insurance may be divided into three broad categories: Hull Insurance (refers to the insurance of the ship or vessel and its machinery as it moves from one port to another and is subject to the marine risks or perils of the sea.); Cargo Insurance (covers goods carried on ship); Freight Insurance (policy purchased by the freight receiver to protect freight)

Liability Insurance can also be divided into three categories: **Collision Liability** (covers the liability of the insured vessel for damage to another vessel and property thereon resulting from collision between the insured vessel and the other vessel); **Protection and Indemnity Insurance** (protects the insured against liability for bodily injury or property damage arising out of specified types of accidents and certain unexpected vessel-related expenditures); **Other Liability Insurance** (includes Liability insurance for maritime businesses such as ship repairs, stevedores, marine operators, boat dealers and terminal operators, Charterer's liabilities policies and excess liability policies).

Different classes of policies issued in marine insurance are briefly discussed here:

a) **Voyage Policies:** When the contract is to insure the subject-matter at and from, or from one place to another, the policy is called a voyage policy. This policy is issued to cover a particular voyage from one port to another and from one place to another. The policy mentions the port of departure and the port of destination between which the risks are underwritten. The policy is used mostly in case of cargo insurance. The goods remain covered even when the ships halts at intermediate ports. The liability of the insurer continues during landing and re-shipping of the cargo. The risks at the port of departure and at the port of destination may also be covered by including suitable clauses in the policy. This policy is not suitable for hull (or ship) insurance as a ship generally does not operate over a particular route only.

b) **Time Policies:** When the contract is for insuring a subject-matter for a definite irrespective of the number of voyages made, the policy is called a time policy. The policy is generally taken for one year. It may be taken even for less than one year. This policy is commonly more used for ship insurance than the cargo insurance. The time policy may be taken in case of goods and other movable vessels.

c) **Voyage and Time Policy:** It is also known as mixed policy. Under this policy, the elements of voyage policy and time policy are combined. It is useful both to ship and to cargo insurance. The reference is made for certain period after completion of voyage.

d) **Valued Policies:** This policy specifies or expressly declares the agreed value of the subject-matter insured under this policy, the value of loss to be compensated is fixed and remains constant throughout the risk except when there is fraud and excessive over-valuation. The value of subject-matter is agreed between the insurer and the insured at the time of taking insurance policy. It is also called insured value or agreed value. It forms the measure of indemnity at the time of loss. The insured value is not necessarily to be the actual value. It may be the total of invoice e.g., cost of goods, freight, shipping charges, insurance and certain percentage of margin to cover anticipated profits.

e) **Unvalued Policies:** In such a policy, the value of the policy is not determined at the time of commencement of risk but is left to be valued when the loss takes place. The value that left to be decided later on is called the insurable value or unvalued policy or valuable policy. The invoice cost, freight, shipping and insurance charges are included in deciding the value of policy. No profit margin as anticipated profit is included. The unvalued policies are not very common in marine insurance because evaluation of loss at the time of damage poses a difficult problem. It is extremely difficult when consignment goes nearer the port of destination.

f) **Floating Policies:** This policy describes then general terms and leaves the amount of each shipment and other particulars to the dispatch of shipment. The policy is taken for a round large sum which is specified at each declaration and is attached to each shipment. With each declaration, the amount will be reduced till it is completely exhausted when the insured sum is said to be closed and the policy is 'fully declared' or 'run off'.

   The most popular form of contract is 'open cover'. It is an agreement between the insured and the insurer by which the insured on his part agrees to declare and the insurer on his part agrees to accept all the shipment falling within the scope of the ‘open cover’ which is merely an original ship. All declarations are written on the back of the policy.

g) **Blanket Policies:** The policy is taken to cover losses within the particular time and place. The policy is taken for a certain amount and premium is paid on the whole of it in the beginning of the policy and is readjusted at the end of the policy according to the actual amount of risk. If the actual coverage of risk is less than the total amount of insurance, the premium related to the excess amount is returned to the insured. On the other hand, if the amount of shipment is greater than the insured sum, additional premium is charged over the excess protection.

h) **Named Policies:** Under this policy, the name of the ship and the amount od insured cargo are mentioned. These policies are specific policies.

i) **Single Vessel and Fleet Policies:** A ship or a fleet of ship is insured in a single policy. When one policy is issued, it is called single vessel policy and when a fleet of ship is insured in a single policy, it is called fleet insurance policy. The advantages of the fleet policies are that

   Even old and weak ships are also covered. This insurance facilitates easy and smooth functioning of insurance benefits.

j) **Block policies:** This policy insures incidental inland risks too along with the marine perils. For example, cotton is insured from the time of processing to the time when it is delivered at the point of destination.

k) **Currency Policy:** A policy issued in foreign currency is called currency policy, where the sum assured is stated in foreign currency. This policy avoids the fluctuation in foreign currencies because the claim amount is determined in the foreign currency and the fluctuations in the exchange rates of the inland and foreign currencies u p to the period of the policy are meaningless.

l) **P.P.I. Policy:** The policy is issued to avoid the complication of the principle of insurable interest. This is called ‘Policy Proof of Interest’ and is honoured by the insurer even in the absence of insurable interest. This policy is based on mutual understanding, therefore it is called honoured policies. This is also called wagering policies because insurable interest is not required. Consequently, it cannot be legally enforceable.

m) **Port Risk Policy:** A port policy is that which covers the ship when it is anchored in a port. Thus, all policies or damages to the subject-matter of insurance after the arrival of the ship on the port are covered during a certain period.

8. **AVIATION INSURANCE**

This class of insurance has been introduced mainly because of the steep increase in the values of aircrafts and the consequent phenomenal increase in the limits of indemnity under third party and other legal liability covers. Flights operated on scheduled routes by recognized airlines as also chartered flights are covered. The rate of premium for chartered aircrafts is higher because of the greater hazard involved.

A. **Aircraft Comprehensive Policy**

The policy is divided into three sections —

i. **Loss of or damage to aircraft:** The compensation is provided for loss of or damage to the aircraft by any cause whatsoever except those that are specially excluded by the policy. The cover is also granted in respect of standard component parts of the aircraft temporarily detached in connection with overhaul or repair while in the custody or control of the insured. The cover is operative while the aircraft is in flight or in taxing or is on the ground or in moored.

ii. **Third Party Legal liability:** Insurer indemnify the insured or any member of the operative crew of the aircraft acting in the course of their duties against all sums which they may become legally liable to pay in respect of death, sickness or disease and bodily injury sustained by any person and caused by an accident arising out of the ownership, maintenance or use of the aircraft.

iii. **Passenger Legal Liability**: Insurers indemnify the insured or any member of the operative crew of the aircraft acting in the course of his duties with insured in respect of all sums which insured or any such member of the crew, shall become legally liable to pay as compensation in respect of –

- Death, personal injury, sickness or diseases caused to any passenger by an occurrence arising out of the ownership, maintenance or use of such aircraft by which such passenger is entering into being carried in or alighting from the aircraft.
- Loss of or damage to passenger's baggage and personal effects whether registered or personally retained by the passengers while in the course of carriage by the insured.

B. **Freight Liability Policy:** The aircraft carries baggage of passengers, cargo and mail in addition to the passengers and the crew. The airline operating the aircraft is liable if the baggage, cargo or mail is lost or damaged. The freight liability policy mainly deals with the cargo carried on the aircraft. In terms of provisions of this policy, the insurers indemnify the insured against all sums which the insured may become legally liable to pay to the owners of cargo as a result of loss or damage to cargo or delay in delivery of cargo or the mishandling of cargo. The limits of compensation that appears in the freight liability policy range from Rs. 1 lakh to Rs. 25 Lakhs for any one accident.

C. **Airmail Liability Policy**: This is similar to freight liability policy. This policy provides cover per liability in respect if mail carried on the aircraft. The limits of the liability that appear in the airmail liability policy range from Rs. 1lakh to Rs. 5 lakhs.

D. **Personal Accident Policy for Crew Members:** The crew members can be granted personal accident insurance cover under this policy. Under this policy, pilots, flight navigators, radio officers, air hostesses, etc. are covered.

9. BURGLARY/THEFT INSURANCE

Burglary insurance is one of the major classes of businesses underwritten in the miscellaneous department and accounts for a sizeable part of premium income of the department.

The **main types of policies** are as follows:

a. **Business Premises Policy:** policies issued to business premise over stock-in-trade, goods-in-trust or on commission, fixtures and fittings, tools of trade such as typewriters, calculators and other similar property and cash and currency notes in locked safe against the risk of burglary and house-breaking. In regard to stock-in-trade and other goods, the policy may be issued on full values basis or on “first loss” basis. A ‘First Loss Policy’ insures the property upto a specified amount only which is calculated to be the maximum likely loss on any one occasion. First loss policies are usually taken for bulk commodities. The amount insured is always specified as a certain percentage of the full value.

b. **Jewellery and valuables Insurance Policy:** This type of insurance policy covers risks in respect of jewellery, plate, watches, personal ornaments and other valuables. Under this policy loss or damage by any accident or misfortune including fire, theft, robbery, defective settings or fastening and accidental damage are thus covered.

c. **Money in Transit Policy**: This is a modified version of Burglary Insurance policy covering money or securities in transit between the insured’s premises and bank or post office or other specified place or between the premises of insured and branch premises. The cover is granted only to commercial and industrial establishments.

10. **Property Insurance:** It provides protection against most risks to property, such as fire, theft and some weather damage. This insurance safeguard's insured's financial future if certain damages occur to his property or a third party files a negligence suit for damages suffered on his property. This includes specialized form of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, boiler insurance, etc. commercial property insurance policy offers protection to commercial establishments against a myriad of risks and perils. The scope of commercial business insurance extends to the building as well as the contents inside the office. Protection is also offered for loss of income due to business interruption and losses caused by fraud and dishonesty committed by any salaried employee.

5.10 SUMMARY

In 1972, the General Insurance Business Nationalisation Act 1972 was passed by government of India. Under the provision of this act GIC of India was established for the purpose of directing, controlling and carrying on the general insurance business and all the 106 insurers were merged with one or the other of the four subsidiaries of the General Insurance Corporation of India namely-

1. National Insurance Company limited
2. The New India Assurance Company Limited,
3. The Oriental Insurance Company Limited,
4. The United India Insurance Company Limited.

The Government of India set up these above four companies with the following objectives-

1. To ensure that these are so situated as to render their combined services effectively and in all parts of India.
2. To ensure proper service to the public through mutual competition.

Generally there are three types of non-life insurance business such as —

i) Marine Insurance, ii) Fire Insurance, iii) Miscellaneous insurance.

Marine Insurance provides protection against the loss of marine perils. These perils cause damages, destruction of disappearance of the ship and cargo and non-payment of freight. So marine insurance ensures cover ship, cargo and freight.

Fire Insurance is the branch of general insurance dealing with providing financial protection against loss, damage to the property / assets from various risks. The property may be an individual or business organization.

In twentieth century many types of other non-life insurance started operating i.e. motor insurance, engineering insurance, public liability insurance, crop liability insurance, special insurance, etc.

The government took over the management of all the operating companies in 1971 through general insurance emergency provision act 1971. The emergency act provided for the appointment of custodians who were empowered to exercise controls over these companies subject to the direction of the central government at the time of nationalization of these companies. There were a total of 106 companies operating general insurance business in India.

5.11. SELF ASSESSMENT QUESTIONS

1. Discuss the origin and growth of general insurance in India.
2. Discuss the growth of general insurance in India.
3. Explain the weakness in general insurance sector.
4. Discuss the various types of marine insurance policies.
5. Discuss various functions of insurance.
6. Discuss various general insurance products.
7. What are the principles of general insurance?
8. What are the commercial general insurance products?
9. Describe various personal general insurance products.
10. What are the types of policies?
11. Describe establishment of general insurance company.