LOVELY PROFESSIONAL UNIVERSITY

BANKING AND INSURANCE

Edited By

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SYLLABUS

Banking and Insurance

Objectives: To acquaint the students with various services provided by Banking and Insurance to the business sector and to provide good understanding of the role and working of the Banking and Insurance.

Sr. No.	Description
1.	Indian Banking System: Nature, Public and Private sectors Banks in India, Reserve Bank of India: Organisation, Role and functions, Techniques of credit control
2.	Concept of Retail Banking, Corporate Banking and Wholesale banking, Treasury Management, banking Sector reforms
3.	Commercial Banking Operations: Payment and settlement system-New age clearing and New age payment, RTGS, SWIFT, NTGS, KYC Norms and Anti– Money Laundering, FEMA.
4.	Negotiable Instruments: An overview of -Endorsements, Cheques: Payment and collection, Bills of Exchange and Promissory Notes. Loans and Advances, Priority sector lending
5.	Non Performing Assets: Introduction, Provision for NPAs, Management of NPAs, Basel I & Basel II Norms.
6.	Innovations in Banking: E-banking, Mobile banking, Overview of Micro Finance, New Products & Services-Factoring, Securitisation, Bancassurance, Mutual Funds etc.
7.	Insurance: Definition & nature, its scope and significance, Indian Insurance Industry, Salient features of IRDA Act, Life insurance: Annuities, Measurement of risk and Morality Table,
8.	General Insurance: Meaning and origin, Nature and growth.
9.	Fire Insurance: Meaning, nature, Policies and conditions of fire insurance. Subrogation and Reinsurance; Marine insurance: Meaning, nature, Principles of marine insurance, Policies and conditions to marine insurance,
10.	Accident and motor insurance, Concept of health insurance and Catastrophe insurance

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Unit 1: Indian Banking System

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Objectives

After studying this unit, you should be able to:

- Understand the functioning of a bank in India and an introduction of Reserve Bank of India (RBI).

Notes

- Know the Banker-customer relationship and social responsibility of banks.
- Determine the nature of public and private sector banks in India.

Introduction

H. L. Henry defined a banker as "One who in the ordinary course of business honours cheques drawn upon by persons from and for whom he receives money on current account". This definition is very restrictive in the sense that any person or institution engaged in the business of attracting deposits may be called as bank.

Kinley's Definition: A bank is an "establishment which makes to individuals such advance of money as may be required and safely made and to which individuals entrust money when not required by them for use".

The definition of R. S. Sayers, however, reveals the true character of a modern bank. In his words, "Banks are institutions whose debts usually referred to as bank deposits are commonly accepted in final settlement of other people's debts".

Under British Law "A banker is one who in the ordinary course of his business, honours cheques drawn upon him by persons from and for whom he receives money on current accounts". (Dr. Herbert L. Hart)

Under Indian Law Banking Regulation Act of India, 1949 "Accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawal by cheque, draft, and order or otherwise" (Section 5b).

1.1 Nature and Origin of the Word 'Bank'

The name bank is derived from the Italian word banco "desk/bench", used during the Renaissance by Florentine bankers. These bankers used to make their transactions above a desk covered by a green tablecloth.

There are traces of banking activity even in ancient times. In fact, the word traces its origins back to the ancient Roman Empire, where moneylenders would set up their stalls in the middle of enclosed courtyards called macella on a long bench called a bancuit. It is from here that the words banco and bank are derived.

As a moneychanger, the merchant at the banco did not invest much money but merely converted the foreign currency into the only legal tender in Rome that was the Imperial Mint.

In simple terms, a bank is an institution that accepts various types of deposits and then advances money in form of loans to people requiring it.

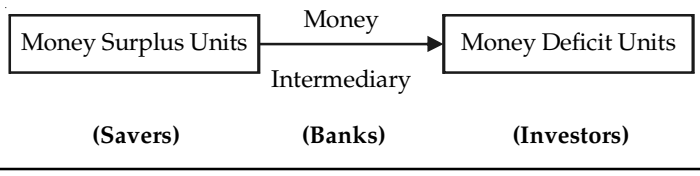
Money and credit provide the pivot (axle) around which all the economic activities revolve. Banks are institutions, which accept deposits and use these funds to grant loans. Banks collect the surplus funds of millions of individual savers who are widely scattered. The money so collected is channelised to the investors i.e. people asking for loans for further investment purposes.

Banks help in money growth and capital formation. They are reservoirs of resources for economic growth and development of the nation. They help in building the infrastructure; boosting the agriculture, setting up industries and aid to global trade. Thus, a bank by discharging its functions effectively enhances productive and industrial capacity of the nation and boosts its pace of growth.

Notes

Banks are a medium through which economic and fiscal policies of the government are materialized. They are the heart of the financial system.

Figure 1.1: Business of Banking



1.2 Public Sector Banks in India

Banking System in India is dominated by nationalized banks. The nationalization of 14 privately owned banks in India took place on 19th of July 1969 by Mrs. Indira Gandhi the then prime minister, with an another installment of nationalization of 6 banks on 15.04.1980. The major objective of nationalization was to ensure mass banking as against class banking with banking infrastructure aimed at hilly tracts and terrains of the country. Prior to 1969, State Bank of India (SBI) was the only public sector bank in India. SBI was nationalized in 1955 under the SBI Act of 1955.

Currently, the following are the public sector banks in India:

- Allahabad Bank
- Andhra Bank
- Bank of Baroda
- Bank of India
- Bank of Maharashtra
- Canara Bank
- Central Bank of India
- Corporation Bank
- Dena Bank
- Indian Bank
- Indian Overseas Bank
- Oriental Bank of Commerce
- Punjab and Sind Bank
- Punjab National Bank
- State Bank of Bikaner & Jaipur
- State Bank of Hyderabad
- State Bank of India (SBI)
- State Bank of Indore
- State Bank of Mysore
- State Bank of Patiala

Notes

- State Bank of Saurashtra
- State Bank of Travancore
- UCO Bank
- Union Bank of India
- United Bank of India
- Vijaya Bank

1.3 Private Banks in India

Prior to nationalization, Banks in India with the sole exception of State Bank of India were in private hands with community and trade orientation. Nationalization of 14 banks in the year '1969 and another set of 6 banks in the year 1980 reduced the importance of private sector banks and public sector banks started playing a major role in extending the horizon of banking services to the nook and corner of the country.

With history repeating itself, private sector banking got a fillip with the Government of India relaxing the conditions for opening of private sector banks in the year 1994, as a part of their liberalization programme. Housing Development Finance Corporation Limited (HDFC) was amongst the first to receive an 'in principle' approval from the Reserve Bank of India (RBI) to set up a bank in the private sector. As on 31st of March 2005, there are 30 private sector banks operating in the country.

Private Banks have been playing a crucial role in enhancing customer oriented products with no choice left with the public sector banks except to innovate and compete in the process. Reserve Bank of India has come out on clear-cut terms their guidelines on ownership and governance in private sector banks.

The broad principle underlying the guidelines on ownership and governance in private sector banks is to ensure that the control of private sector banks is well diversified to minimize the risk of misuse or imprudent use of leveraged funds. The guidelines require that:

- Important shareholders (i.e., with shareholding of five percent and above) are fit and proper as per the Reserve Bank guidelines on acknowledgement for allotment and transfer of shares;
- The Directors and the Chief Executive Officer who manage the affairs of the bank are fit and proper and observe sound corporate governance principles;
- Banks have minimum capital/net worth for optimal operations and systematic stability; and
- Policy and processes are transparent and fair.

Some additional requirements are:

- Banks maintain a net worth of Rs.300 crore at all times;
- Shareholding or control in any bank in excess of 10% of the paid up capital by any single entity or group of related entities requires the Reserve Bank's prior approval;
- Banks (including foreign banks having branch presence in India/financial institutions are not allowed to exceed equity holding of 5% of the equity capital of the investee bank;
- Large industrial houses are allowed to acquire shares not exceeding 10% of the paid up capital of the bank subject to the Reserve Bank's approval;

Notes

- The Reserve Bank would permit a higher level of shareholding on a case by case basis for restructuring of problem/weak banks or in the interest of consolidation in the banking sector; and
- If the shareholding exceeds the prescribed limit of the net worth is below Rs.300 crore in any bank, a time bound programme to reduce the stake or to augment the capital should be submitted to the Reserve Bank.

On the issue of aggregate foreign investment in private banks from all sources (FDI, FII, NRI), the guidelines stipulate that it cannot exceed 74% of the paid up capital of a bank. If FDI (other than by foreign banks or foreign bank groups) in private banks exceeds 5%, the entity acquiring such stake would have to meet the "fit and proper" criteria indicated in the share transfer guidelines and get the Reserve Bank's acknowledgement for transfer of the shares. The aggregate limit for all FII investments is restricted to 24% which can be raised to 49% with the approval of the board/shareholders. The current aggregate limit for all NRI investments is 24%, with the individual NRI limit being five percent, subject to the approval of the board/shareholders.

The following are the list of Private Sector Banks in India:

- Axis Bank
- HDFC Bank
- ICICI Bank
- IndusInd Bank
- ING Vysya Bank
- Kotak Mahindra Bank
- Yes Bank
- Buldana Urban Co-op Society.

1.4 Pre-Reforms Development

1.4.1 Lead Bank Scheme

On the recommendations of FKF Nariman Committee, the Lead Bank Scheme was introduced in December 1969. Under the Scheme, the country was divided into 338 districts and they were distributed among major scheduled banks, mostly in the public sector, to play the 'Lead' role in coordinating the efforts of all credit institutions in the district for planned growth in branch network and credit deployment in the district.

Lead Bank prepares a District Credit Plan (DCP) and subsequently "Annual Action Plan" which stipulates targets to provide credit to priority sectors, weaker sections etc. The performance of the branches within the lead area are monitored by Block Level Bankers Committee at the block level, District Consultative Committee at the district level and State Level Bankers Committee at the state level.

The progress of the branches in the lead area are monitored by well laid down management information and reporting systems. The returns to be submitted by the branches to the lead bank are:

1. ***Lead Bank Return - 1 (service area credit plan):*** It is an annual return submitted by the branch to the BLBC before 26th February every year, giving details of annual credit plan of the branch.

Notes

2. ***Lead Bank Return - 2 (service area operation scroll):*** It is a monthly return submitted by all rural and semi-urban branches giving details of priority sector credit disbursement made each day during the month. It is submitted by the branch to the Lead District Manager.

3. ***Lead Bank Return U2:*** It is the modified version of LBR-2 and is required to be submitted by semi-urban/urban branches once in a quarter.

4. ***Lead Bank Return - 3 (service area recovery and outstanding statement):*** This consists of three types of returns Part A, Deposit and Advance Position - to be submitted on a quarterly basis, Part B, Outstanding under various Priority Sector Advances, to be submitted on a half yearly basis, Part C, Statement of recovery of Priority Sector Advances giving details of demand, collection and balances, to be submitted on an annual basis.

1.4.2 Cooperative Banks

Cooperative banks in India have come a long way since the enactment of the Agricultural Credit Cooperative Societies Act in 1904. It is an important instrument of banking access to the rural masses and is a vehicle for democratization of the Indian financial system.

Cooperative banks mobilize deposits and purvey agricultural and rural credit with a wider outreach and acts as facilitators for upliftment of the weaker sections, particularly carrying out of the subsidy programm*e*s for the poor.

Cooperative banking structure in India encompasses urban-co-operative banks and rural cooperative credit institutions. Urban Cooperative consists of a single tier viz, primary cooperative banks, commonly referred to as urban cooperative banks (UCBs).

The RBI regulates these banks since 1st March, 1966. In light of the liquidity and insolvency problems experienced by some cooperative banks in fiscal 2001, the RBI undertook several interim measures to address the issues, pending formal legislative changes, including measures related to lending against shares, borrowings in the call market and term deposits placed with other urban cooperative banks. The RBI is currently responsible for supervision and regulation of urban cooperative societies, the National Bank for agriculture and Rural Development, state cooperative banks and district central cooperative banks. The Banking Regulation (Amendment) and Miscellaneous Provisions Bill, 2003, which was introduced in the Parliament in 2003, proposed the regulation of all cooperative banks by the RBI. The Bill has not yet been ratified by the Parliament and is not in force.

Notes The RBI regulates these banks since 1st March, 1966.

1.4.3 Regional Rural Bank (RRB)

On the recommendation of Narasimham Committee, the concept of Regional Rural Bank (RRB) was introduced in India. Initially, 5 RRBs were started in UP, Rajasthan, Haryana, Bihar and West Bengal on 2nd October, 1975. Each RRB has a maximum authorized capital of Rs. 5 crore and an issued capital of minimum Rs. 25 lacs and maximum Rs. 1 crore. The share capital of an RRB is subscribed by the Central Government, the State Government and the sponsoring bank in the ratio of 50:15:35 respectively. There are 196 RRBs operating in 26 states across 518 districts with a network of 14,446 branches as on March 31,2004. Majority of the branches of RRBs are located in rural areas. RRBs combine the local feel and familiarity with rural problems, which the cooperatives possess, and the degree of business organisation as well as the ability to mobilize deposits, which the commercial banks possess.

Notes

RRBs are specialized rural financial institutions for catering to the credit requirements of the rural sector. Sponsor Banks have been advised by the Reserve Bank Of India to provide support to their sponsored RRBs in matters relating to efficient management, training of staff, computerization and networking of their activities. Sponsor banks have been made accountable for the performance of RRBs.

In order to enlarge resources available for a variety of purposes especially in the context of programme of financial inclusion, general credit card etc. Reserve Bank of India in January 2006 has advised the sponsor banks to provide them lines of credit at a reasonable rate of interest. Further, it has permitted RRBs to borrow from/or place funds with other RRBs , including those sponsored by other banks, subject to counter -party credit risk and limits. RBI has also directed its own training centres and NABARD training centres to conduct training programmes for RRBs staff in keeping with the requirements of the day.

Did u know? RRBs are specialized rural financial institutions for catering to the credit requirements of the rural sector.

Caution RBI has also directed its own training centres and NABARD training centres to conduct training programmes for RRBs staff in keeping with the requirements of the day.

Self Assessment

Fill in the blanks:

1. ..... defined a banker as "One who in the ordinary course of business honours cheques drawn upon by persons from and for whom he receives money on current account".
2. .....banks in India have come a long way since the enactment of the Agricultural Credit Cooperative Societies Act in 1904.
3. In order to enlarge ..... available for a variety of purposes especially in the context of programme of financial inclusion, general credit card etc.
4. Cooperative banking structure in India encompasses ..... cooperative banks and rural cooperative credit institutions.
5. On the recommendations of FKF ..... Committee, the Lead Bank Scheme was introduced in December 1969.

1.5 Some Financial Institutions

1.5.1 National Bank for Agriculture and Rural Development (NABARD)

Established on 12th July, 1982 as an apex bank for agriculture and rural development in accordance with the recommendations of the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD), NABARD is accredited with all matters concerning policy, planning and operations in the field of credit for agriculture and other economic activities in rural areas. Its paid-up capital as on 31.3.96 of 500 crores was doubled in 1996-97, thereby making it Rs. 1,000 crores.

Notes

1.5.2 Export Import Bank of India (EXIM Bank)

Set up by an Act of Parliament in September 1981, EXIM Bank commenced its operations in March 1982. It is the principal financial institution in the country for coordinating working of institutions engaged in financing exports and imports.

Objectives

The business of Exim Bank is to finance Indian exports that lead to continuity of foreign exchange for India. The banks' primary objective is to develop commercially viable relationships with a target set of externally oriented companies by offering them a comprehensive range of products and services, aimed at enhancing their internationalization efforts.

1.5.3 National Housing Bank (NHB)

It was established on 9.7.1988 as wholly owned subsidiary of RBI under an Act of the Parliament viz, National Housing Bank Act, 1987 to function as a principal agency to promote Housing finance institutions and to provide financial and other support to such institutions. Its authorized capital can be raised to Rs. 500 crores. Its paid up capital at present is Rs. 100 crore. The Act, inter-alia empowers National Housing Bank to:

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

Objectives

NHB has been established to achieve, inter-alia, the following objectives:

- To promote a sound, healthy, viable and cost-effective housing finance system to cater to all segments of the population and to integrate the housing finance system with the overall financial system.
- To promote a network of dedicated housing finance institutions to adequately serve various regions and different income groups.
- To augment resources for the sector and channelise them for housing.
- To make housing credit more affordable.
- To regulate the activities of housing finance companies based on regulatory and supervisory authority derived under the Act.
- To encourage augmentation of supply of buildable land and also building materials for housing and to upgrade the housing stock in the country.
- To encourage public agencies to emerge as facilitators and suppliers of serviced land for housing.

Notes

Notes National Housing Bank operates as a multifunctional development finance institution for the housing sector.

1.5.4 Housing and Urban Development Corporation Ltd. (HUDCO)

It was set up in 1970 as a Government of India undertaking for financing and undertaking housing and urban development. It provides loans to public institutions viz. State Housing Boards, Cooperative Societies etc.

1.5.5 Housing Development Finance Corporation (HDFC)

Background

HDFC was incorporated in 1977 with the primary objective of meeting a social need - that of promoting home ownership by providing long-term finance to households for their housing needs. HDFC was promoted with an initial share capital of Rs. 100 million.

Business Objectives

The primary objective of HDFC is to enhance residential housing stock in the country through the provision of housing finance in a systematic and professional manner, and to promote home ownership. Another objective is to increase the flow of resources to the housing sector by integrating the housing finance sector with the overall domestic financial markets.

Organizational Goals

HDFC's main goals are to a) develop close relationships with individual households, b) maintain its position as the premier housing finance institution in the country, c) transform ideas into viable and creative solutions, d) provide consistently high returns to shareholders, and e) to grow through diversification by leveraging off the existing client base.

HDFC is a professionally managed organization with a board of directors consisting of eminent persons who represent various fields including finance, taxation, construction and urban policy and development. The board primarily focuses on strategy formulation, policy and control, designed to deliver increasing value to shareholders.

1.5.6 Industrial Development Bank of India (IDBI)

It is India's premier Development Financial Institution (DFI) and the 10th largest development bank of the world. It was established on 1.7.64 as a wholly owned subsidiary of RBI. Its ownership was transferred to Government of India on 16.2.76, which now holds 72% of shares. Its authorized capital is Rs. 1000 crores which can be further increased to 2000 crores. During 1995-96, it issued 17.31 lakh shares to the public at a premium of Rs.120 per share.

Developmental Activities of IDBI

Promotional activities

In fulfilment of its developmental role, the bank continues to perform a wide range of promotional activities relating to developmental programmes for new entrepreneurs, consultancy services

Notes

for small and medium enterprises and programmes designed for accredited voluntary agencies for the economic upliftment of the underprivileged. These include entrepreneurship development, self-employment and wage employment in the industrial sector for the weaker sections of society through voluntary agencies, support to Science and Technology Entrepreneurs' Parks, Energy Conservation, Common Quality Testing Centres for small industries.

Technical Consultancy Organisations

With a view to making available at a reasonable cost, consultancy and advisory services to entrepreneurs, particularly to new and small entrepreneurs, IDBI, in collaboration with other All-India Financial Institutions, has set up a network of Technical Consultancy Organisations (TCOs) covering the entire country. TCOs offer diversified services to small and medium enterprises in the selection, formulation and appraisal of projects, their implementation and review.

Entrepreneurship Development Institute

Realising that entrepreneurship development is the key to industrial development, IDBI played a prime role in setting up of the Entrepreneurship Development Institute of India for fostering entrepreneurship in the country. It has also established similar institutes in Bihar, Orissa, Madhya Pradesh and Uttar Pradesh. IDBI also extends financial support to various organisations in conducting studies or surveys of relevance to industrial development.

1.5.7 Industrial Finance Corporation of India (IFCI) Ltd.

Liberalisation - Conversion into Company in 1993

This arrangement continued until the early 1990s when it was recognized that there was need for greater flexibility to respond to the changing financial system. It was also felt that IFCI should directly access the capital markets for its funds needs. It is with this objective that the constitution of IFCI was changed in 1993 from a statutory corporation to a company under the Indian Companies Act, 1956. Subsequently, the name of the company was also changed to "IFCI Limited" with effect from October 1999.

Focus

IFCI has fulfilled its original mandate as a DFI by providing long-term financial support to all segments of Indian Industry. It has also been chiefly instrumental in translating the government's development priorities into reality. Until the establishment of ICICI in 1956 and IDBI in 1964, IFCI remained solely responsible for implementation of the government's industrial policy initiatives. Its contribution to the modernization of Indian industry, export promotion, import substitution, entrepreneurship development, pollution control, energy conservation and generation of both direct and indirect employment is noteworthy. Some sectors that have directly benefited from IFCI's disbursals include:

- Consumer goods industry (textiles, paper, sugar);
- Service industries (hotels, hospitals);
- Basic industries (iron and steel, fertilizers, basic chemicals, cement);

Notes

- Capital and intermediate goods industries (electronics, synthetic fibers, synthetic plastics, miscellaneous chemicals); and
- Infrastructure (power generation, telecom services).

1.5.8 Industrial Investment Bank of India (erstwhile Industrial Reconstruction Bank of India)

Industrial Investment Bank of India Ltd. (IIBI) set up under the Companies Act, 1956, in March 1997 (by converting the erstwhile Industrial Reconstruction Bank of India), is fully owned by Government of India. IIBI assists industry—mainly in medium and large sector through wide ranging products and services. They acquire and/or trade in varied financial instruments from term loans, equity or debentures and bonds, structured products besides providing various services like deferred payment guarantee, loan syndication, merchant banking services such as issue management, underwriting and guarantees, project/reconstruction/one-time-settlement consultancy/appraisal.

1.5.9 Industrial Credit and Investment Corporation of India Bank (ICICI) erstwhile Industrial Credit Investment Corporation of India Limited

ICICI was established by the Government of India in the 1960s as a Financial Institution (FI), other such institutions were IDBI and SIDBI with the objective to finance large industrial projects. ICICI was not a bank—it could not take retail deposits; and nor was it required to comply with Indian banking requirements for liquid reserves. ICICI borrowed funds from many multilateral agencies (such as the World Bank), often at concessional rates. These funds were deployed in large corporate loans.

All this changed in 1990s. ICICI founded a separate legal entity—ICICI Bank which undertook normal banking operations—taking deposits, credit cards, car loans etc. The experiment was so successful that ICICI merged into ICICI Bank ("reverse merger") in 2002.

At the time of the reverse merger, there were rumours that ICICI had a large proportions of Non Performing Loans ("NPA", as they are known in India) on its books - in particular to the steel industry. Since 2002, there has been a general revival in Indian industry (and metal-based industry in particular). It is widely believed that the proportion of NPAs has come down to prudent levels (even if it were high earlier).

ICICI Bank now has the largest market share among all banks in retail or consumer financing. ICICI Bank is the largest issuer of credit cards in India. It was the first bank to offer a wide network of ATM's and had the largest network of ATM's till 2005, before SBI caught up with it.

ICICI bank now has the largest market value of all banks in India, and is widely seen as a sophisticated bank, able to take on many global banks in the Indian market.

The bank is expanding in overseas markets. It has operations in the UK, Hong Kong, Singapore and Canada. It acquired a small bank in Russia recently. It has tie-ups with major banks in the US and China. The bank is aggressively targeting the NRI (Non Resident Indian) population for expanding its business.

Did u know? ICICI Bank now has the largest market share among all banks in retail or consumer financing.

Notes

Self Assessment

State whether the following statements are true or false:

6. It is India's premier Development Financial Institution (DFI) and the 2nd largest development bank of the world.
7. The concept of insuring deposits kept with banks received attention for the first time in the year 1948 after the banking crises in Bengal.
8. Industrial Investment Bank of India Ltd. (IIBI) set up under the Companies Act, 1956, in March 1997.
9. HDFC was incorporated in 1977 with the primary objective of meeting a social need - that of promoting home ownership by providing long-term finance to households for their housing needs.

1.5.10 Small Industries Development Bank of India (SIDBI)

It was established under SIDBI Act 1988 on 2.4.90, as subsidiary of IDBI taking over the latter's activities relating to SSI. The charter establishing it "The Small Industries Development Bank Of India Act, 1989" envisaged SIDBI to be the principal financial institution for the promotion, financing and development of industry in the small scale sector and to coordinate the functions of the institutions engaged in the promotion and financing or developing industry in the small scale sector and for matters connected therewith or incidental thereto.

The business domain of SIDBI consists of small scale industrial units (units in which the investment in plant and machinery does not exceed Rs.10 million). In addition, SIDBI's assistance flows to the transport, health care, hotel and tourism sectors, infrastructure, etc, and also to professional and self-employed persons setting up small-sized professional ventures.

Objectives

The preamble to the Small Industries Development Bank of India Act, 1989 defines the objective of SIDBI as:

"The principal financial institution for the promotion, financing and development of industry in the small scale sector and to coordinate the functions of the institutions engaged in the promotion and financing or developing the industry in the small scale sector and for the matters connected therewith or incidental thereto."

In the SIDBI charter, four basic objectives are set out. They are:

1. Financing
2. Promotion
3. Development
4. Coordination

for orderly growth of industry in the small scale sector.

Notes Today LIC functions with 2048 fully computerized branch offices, 100 divisional offices, 7 zonal offices and the corporate office.

Notes

1.5.11 Infrastructure Development Finance Co. (IDFC)

It was set up in 1997 as a non-government company for financing infrastructure sector with authorized capital of Rs. 5000 crores and initial capital based on Rs.1,600 crores-comprising of Rs. 1000 crores as paid up capital and Rs. 600 crores as long term subordinated debt. Out of the initial paid up capital of Rs. 1,000 crores, Rs. 600 crores have already been contributed by domestic FIs and remaining Rs. 400 crores is to be received from overseas agencies.

1.5.12 Power Finance Corporation (PFC)

PFC was set up in July 1986 as a Financial Institution (FI) dedicated to power sector financing and committed to the integrated development of the power and associated sectors. The Corporation was notified as a Public Financial Institution in 1990 under Companies Act, 1956. The Corporation was registered as a Non Banking Financial Company by RBI and was declared as Mini-Ratna (Category-I) PSU by Govt. of India.

Power Finance Corporation of India is providing large range of financial products and services like project term loan, lease financing, direct discounting of bills, short term loan etc. for various power projects in generation, transmission, distribution sector as well as for renovation and modernization of existing power projects.

Caselet

Trading Services on the Internal Audit of Treasury Operations

A financial institution required assistance in enhancing the internal audit review of its treasury operations. KPMG provided training services to the institution's internal audit staff, covering the audit of both manual and IT controls, complex structured products and valuation methodology, and leading practices in treasury processes. Through a combination of training seminars, facilitated workshops, sample transaction walkthroughs and experience sharing/briefing sessions, the institution's internal audit staff were able to improve their technical knowledge and enhance their auditing skills on treasury operations.

Source: http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/finance_treasury_mgt_0901.pdf

1.6 Summary

This chapter attempts to give an overview of the functions in as simple manner as possible.

- Banks essentially perform the following functions:
  - (i) Accepting deposits from public/others (deposits)
  - (ii) Lending money to public (loans)
  - (iii) Transferring money from one place to another (remittances)
  - (iv) Acting as trustees e.g. keeping valuables in safe custody
  - (v) Government business.

Notes

- In simple terms, a bank is an institution that accepts various types of deposits and then advances money in form of loans to people requiring it.
- RBI has also directed its own training centres and NABARD training centres to conduct training programmes for RRBs staff in keeping with the requirements of the day.
- National Housing Bank raises resources for the housing sector towards increasing new housing stock and provides refinance to a large set of retail lending institutions. These include scheduled commercial banks, scheduled state cooperative banks, special housing finance institutions, apex cooperative housing finance societies and agriculture and rural development banks.
- SIDBI's assistance flows to the transport, health care, hotel and tourism sectors, infrastructure, etc, and also to professional and self-employed persons setting up small-sized professional ventures.
- Exim Bank encourages Indian consultants to gain and enhance their international exposure by assisting them in securing assignments overseas.
- UTI Mutual Fund has come into existence with effect from 1st February, 2003. UTI Asset Management Company presently manages a corpus of over Rs. 34,500 crore.
- The concept of insuring deposits kept with banks received attention for the first time in the year 1948 after the banking crises in Bengal.

1.7 Keywords

Bank: A commercial institution licensed to receive deposits. Banks are mainly concerned with making and receiving payments as well as supplying short-term loans to public and institutions. In most countries, banks are supervised by the national government or the central bank like the RBI.

Bancassurance: A French term referring to the selling of insurance through a bank's established distribution channels. As a result, a bank can offer all banking, insurance, lending, and investment products to a customer.

Bank statement: A periodic record of a customer's account that is issued at regular intervals, showing all transactions recorded for the period in question.

Customer: A customer refers to individuals or households that purchase goods and services generated within the economy.

Demand deposits: An account from which deposited funds can be withdrawn at any time without any notice to the depository institution. This account allows the customer to "demand" money at any time. Most savings accounts are demand deposits, accessible by the account holder at any time.

Fixed deposits: A fixed deposit is meant for those investors who want to deposit a lump sum of money for a fixed period; say for a minimum period of 15 days to five years and above, thereby earning a higher rate of interest in return. Investor gets a lump sum (principal + interest) at the maturity of the deposit.

Gross profit ratio: Gross profit ratio (GP ratio) is the ratio of gross profit to net sales expressed as a percentage. It expresses the relationship between gross profit and sales. Gross profit = Net sales (Total sales-Returns) - Cost of goods sold (Opening stock + Purchases + Direct Expenses - Closing stock).

Notes

Net profit ratio: The ratio of an organization's net profit to its total net sales. Comparing the net profit ratios of companies in the same sector shows which are the most efficient.

Net profit: In business and finance accounting, net profit is equal to the gross profit minus overheads minus interest payable plus/minus one-off items for a given time period (usually: accounting period).

Time deposits: A savings account held for a fixed-term with the understanding that the depositor can only withdraw by giving written notice. The term generally is at least 30 days.

1.8 Review Questions

1. Explain the term banking. Discuss its role in an economy.
2. Describe the functions of bank.
3. Distinguish between
   (i) Banking and other business
   (ii) Demand deposit and time deposit
   (iii) Saving account and fixed deposit account.
4. Write short notes on:
   (i) Bank
   (ii) Hundi
   (iii) Agency function of bank
   (iv) Relation between bank and customer.

Answers: Self Assessment

1.	H. L. Henry	2.	Cooperative
3.	Resources	4.	Urban
5.	Nariman	6.	False
7.	True	8.	True
9.	True		

1.9 Further Readings

Books

Bank Safety and Soundness: The Bergamo Report, Proceedings of the Third International Conference on Financial Services, "Bank Safety and Responsibility Towards the Consumer", Bergamo, Italy, 23 Through 25 September 1993.

Social Responsibility of Banks, By Philip J. Jennings.

The Professionals Banker, The ICFAI University Press, Hyderabad.

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Notes

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Unit 2: Reserve Bank of India

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Objectives

After studying this unit, you should be able to:

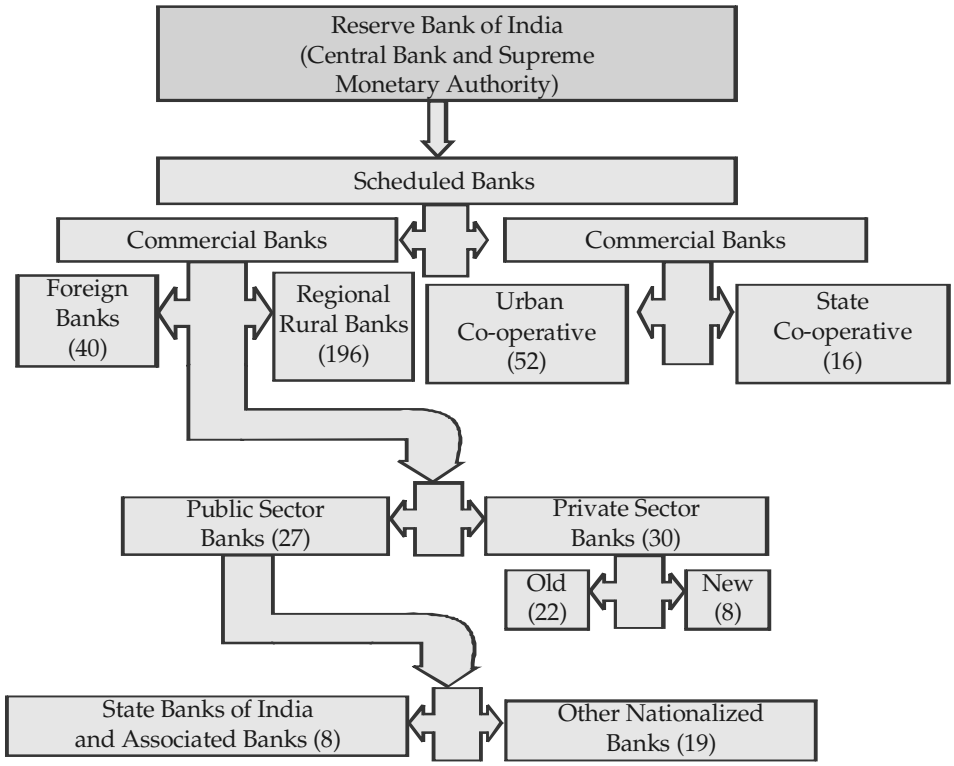
- Determine detailed discussion on Reserve Bank of India (RBI)
- Understand the departments and objectives of RBI
- Understand the differences between central bank and other banks
- Identify selective credit control concept
- Describe nature, functions and risk management of central bank

Introduction

A central bank, reserve bank, or monetary authority, is an entity responsible for the monetary policy of its country. Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized-loan interest rates, and acting as a "bailout" lender of last resort to the banking sector during times of financial crisis. It may also have supervisory powers, to ensure that banks and other financial institutions do not behave recklessly or fraudulently.

Notes

Figure 2.1: The Indian Banking Structure



2.1 Organization of RBI

Establishment

The central bank of our country is the Reserve Bank of India (RBI). The Reserve Bank of India was set up on the recommendations of the Hilton Young Commission. The commission submitted its report in the year 1926, though the bank was not set up for another nine years. It was established in April 1935 with a share capital of Rs. 5 crores. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The government held shares of nominal value of Rs. 2,20,000.

Thus, the Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934. The Central Office of the Reserve Bank was originally established in erstwhile Calcutta but was permanently moved to Mumbai in the year 1937. The Governor of RBI sits in the Central Office, where policies are formulated and finalized. Initially, RBI was privately owned but since nationalisation in 1949, the Reserve Bank is fully owned by the Government of India.

The Bank was constituted to fulfil the following needs:

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

Notes

Preamble

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as:

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

Central Board

A central board of directors governs the Reserve Bank's affairs. The Government of India, in keeping with the Reserve Bank of India Act, appoints this board. The members of the board are:

1. Appointed/nominated for a period of four years
2. ***Constitution:***
   - (i) *Official Directors*
     - (a) Full-time: Governor and not more than four Deputy Governors
   - (ii) *Non-Official Directors*
     - (a) Nominated by Government: Ten Directors from various fields and one government official
     - (b) Others: Four Directors – one each from four local boards.

Did u know? The Reserve Bank of India was established on April 1, 1935 in accordance with the provisions of the Reserve Bank of India Act, 1934.

General Superintendence

General superintendence and direction of the Bank's affairs through:

Local Boards

1. One each for the four regions of the country in Mumbai, Calcutta, Chennai and New Delhi.
2. ***Membership:*** Consist of five members each, appointed by the Central Government for a term of four years.
3. ***Functions:*** To advise the Central Board on local matters and to represent territorial and economic interests of local co-operative and indigenous banks to perform such other functions as delegated by Central Board from time to time.

Caution A central bank, reserve bank, or monetary authority, is an entity responsible for the monetary policy of its country.

Financial Supervision - Board for Financial Supervision (BFS)

The Reserve Bank of India performs financial supervision under the guidance of the Board for Financial Supervision (BFS). The Board was constituted in November 1994 as a committee of the Central Board of Directors of the Reserve Bank of India.

Notes

Objective

The primary objective of BFS is to undertake consolidated supervision of the financial sector comprising commercial banks, financial institutions and non-banking finance companies.

Constitution

The Board is constituted by co-opting four Directors from the Central Board as members for a term of two years and is chaired by the Governor. The Deputy Governors of the Reserve Bank are ex-officio members. One Deputy Governor, usually, the Deputy Governor in charge of banking regulation and supervision, is nominated as the Vice-Chairman of the Board.

BFS Meetings

The Board is required to meet normally once every month. It considers inspection reports and other supervisory issues placed before it by the supervisory departments.

BFS through the Audit Sub-Committee also aims at upgrading the quality of the statutory audit and internal audit functions in banks and financial institutions. The audit sub-committee includes Deputy Governor as the chairman and two Directors of the Central Board as members.

The BFS oversees the functioning of Department of Banking Supervision (DBS), Department of Non-Banking Supervision (DNBS) and Financial Institutions Division (FID) and gives directions on the regulatory and supervisory issues.

Initiatives Taken By BFS

Some of the initiatives taken by BFS include:

1. Restructuring of the system of bank inspections
2. Introducing off-site surveillance,
3. Strengthening of the role of statutory auditors and
4. Strengthening of the internal defences of supervised institutions.

Current Focus

1. Supervision of financial institutions
2. Strong and secure accounting
3. Legal issues in bank frauds
4. Divergence in assessments of non-performing assets (NPAs) and
5. Supervisory rating model for banks.

Task Trace the history of the growth of central banks. In what respects do the present day central banks differ from the initial central banks?

Independence of Central Bank

Advocates of central bank independence argue that a central bank which is too vulnerable to political direction or pressure may encourage economic cycles ("boom and bust"). Politicians may be tempted to boost economic activity in advance of an election, to the disadvantage to long-term health of the economy and the country.

Notes

Independence is usually defined as the central bank's operational and management independence from the government. On the other hand, an independent, privately owned "Central Bank" can, and has been proven in the past to have done as such (the Great Depression), create a boom and bust scenario for the profit of the owners and shareholders of the bank itself.

In addition, it is argued that an independent central bank can run a more credible monetary policy, making market expectations more responsive to signals from the central bank.

An "independent central bank" is one which operates under rules designed to prevent political interference.

Example: The Banco Central de Chile, the Reserve Bank of Australia, the Reserve Bank of India, the European Central Bank, the Bank of Canada etc.

Departments of RBI

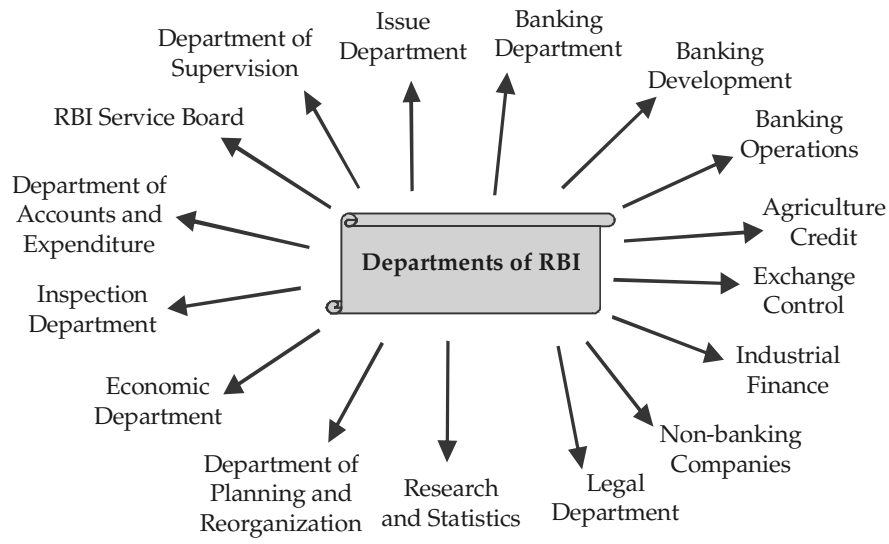
The Reserve Bank of India has sixteen departments. These are:

1. ***Issue Department:*** This department issues paper currency and therefore, it also makes arrangement for the distribution of paper currency. It maintains regular accounts of the notes printed at Nasik Press. It has branches at the Bangalore, Mumbai, Kolkata, Hyderabad, Kanpur, Chennai, Nagpur, New Delhi and Patna.
2. ***Banking Department:*** This department performs two primary functions:
   - (i) Dealing with Government transactions and floating of loans on behalf of the Central and State Governments and arranging remittances of government funds from one place to another; and
   - (ii) The maintenance of cash reserves of scheduled banks, extending financial assistance to them whenever required, and functioning as the clearinghouse for the scheduled banks.
3. ***Banking Development:*** This department is concerned with the expansion of banking facilities in the rural and semi-urban areas. It also imparts training to the scheduled banks employees.
4. ***Banking Operation:*** This department undertakes:
   - (i) Periodical inspections of the scheduled banks
   - (ii) Analyses their balance sheets
   - (iii) Issues licenses for opening of new banks
   - (iv) Considers requests for opening new branches
   - (v) Examines the requests of scheduled banks for increasing the paid up capital
   - (vi) Examines the possibilities for the amalgamation of existing banks and tenders advised to the scheduled banks in their day-to-day functioning.

Notes Department of RBI maintains regular accounts of the notes printed at Nasik Press.

Notes

Figure 2.2: Departments of Reserve Bank of India



5. ***Agricultural Credit:*** This department:

   (i) Studies the problems connected with agricultural credit

   (ii) Conducts research on rural credit problems

   (iii) Formulates rural credit policy of the Reserve Bank

   (iv) Grants rural credit to state governments and state co-operative banks and publish reports on agricultural credit.

6. ***Exchange Control:*** This department regulates and controls the sale and purchase of foreign exchange.

7. ***Industrial Finance:*** This department extends financial assistance to small scale and medium scale industries and also tenders advice to industrial financial corporations for their routine working.

8. ***Non-Banking Companies:*** This department based at is chiefly concerned with the supervision of the non-banking companies and financial institutions in the country.

9. ***Legal Department:*** This department gives advice to the various departments of the Bank on legal matters, prepares directives and official reports of the Bank and gives advice to the Bank on the proper implementation of legal matters relating to banking in the country.

10. ***Research and Statistics:*** This department:

    (i) Undertakes research on problems in the areas of money, credit, finance, production, etc.,

    (ii) Collects statistics about the various sectors of the economy and publishes them,

    (iii) Gives advice to the government for the solution of various economic problems and in the formulation of its economic and financial policies.

11. ***Department of Planning and Reorganization:*** The department formulates new plans and policies. It also reorganizes existing ones in order to make them more effective.

Notes

12. ***Economic Department:*** This department formulates banking policies for better implementation of economic policies of the Government.
13. ***Inspection Department:*** This department undertakes inspection of various offices of the commercial banks.
14. ***Department of Accounts and Expenditure:*** This department maintains proper records of all receipts and expenditures of the Reserve Bank of India.
15. ***RBI Services Board:*** This Board deals with the selection of new employees for different posts in the Reserve Bank of India.
16. ***Department of Supervision:*** This department was set up for conducting proper supervision of commercial banks.

Self Assessment

Fill in the blanks:

1. ..... is usually defined as the central bank's operational and management independence from the government.
2. The BFS oversees the functioning of ..... (DBS), Department of Non-Banking Supervision (DNBS) and Financial Institutions Division (FID) and gives directions on the regulatory and supervisory issues.
3. The ..... performs financial supervision under the guidance of the Board for Financial Supervision (BFS).
4. A central board of directors governs the Reserve Bank's affairs. The ....., in keeping with the Reserve Bank of India Act, appoints this board.
5. The ..... of our country is the Reserve Bank of India (RBI).

2.2 Objectives of RBI

The main objectives of the Reserve Bank of India are:

1. Promotion of monetisation and monetary integration of the economy.
2. Amendment and modification of currency and regulation of foreign exchange.
3. Promotion of specialised financial institutions at national and regional levels to enhance facilities for term finance to industry.
4. Provide support to planning authorities and governments to bring economic development with stability and social justice.
5. Institutionalization of savings through promotion of banking habit.
6. Building up a sound and adequate banking and credit structure.
7. Evolving a well-differentiated structure of institutions for providing credit for Agriculture and Allied (related) activities.

2.3 Reserve Bank and Industrial Finance

For promoting industrialization, the Reserve Bank has been providing finance through various institutions, to large, medium and small-scale industries. For this purpose it has helped in

Notes

establishment of a number of financial institution at the centre as well as in States and provides credit facilities to them. These institutions are:

1. Industrial Finance Corporation of India
2. National Industrial Credit (Long Term Operations) Funds
3. Industrial Development Bank of India (IDBI)
4. Industrial Credit and Investment Corporation of India (ICICI)
5. Industrial Reconstruction Bank of India (IRBI)
6. State Financial Corporation (SFCs)
7. Small Industries Development Bank of India (SIDBI)
8. Exim Bank
9. National Housing Bank (NHB)

The RBI has set many other institutions also in the category of industrial development banks. They are discussed in detail in the chapter "Development Banking".

Differences Between Central Bank and Other Banks

The Central Bank differs from other financial institutions.

Firstly, the people who are more or less closely connected with other organs of government control it.

Second, it does not exist to secure the maximum profit, which is the principal aim of a commercial bank.

Third, the Central Bank must have a special relation with the commercial banks whereby it can influence the functioning and operations of these institutions in the implementation of the government's economic policy.

Fourth, the functions of the Central Bank and the obligations resting upon it are of a very special character, calling for skill, experience and judgment of a kind different from those required from a commercial bank.

Thus, the Central Bank is an organ of the government, which influences the working of financial institutions of the country.

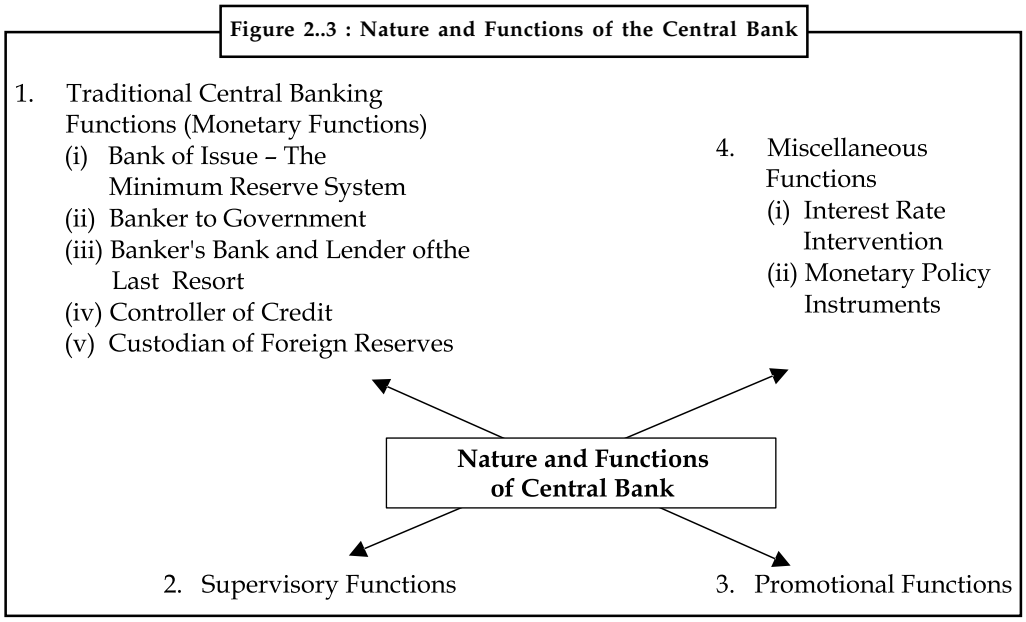
2.4 Nature and Functions of Central Bank

The Central Bank is the apex monetary institution in the money market. It acts as the monetary authority of the country, and serves as the government bank as well as the bankers' bank. It undertakes the major financial operations of the government. It influences the behaviour of financial institutions to ensure that they support the economic policy of government.

The main function of the Central Bank is to regulate the monetary mechanism comprising of the currency, banking and credit systems. For this purpose, the bank is given wide powers. Another important function of the central bank is to conduct the banking and financial operations of the government. Besides, it discharges certain other functions. These functions are performed with the service motive and not for making profits.

Notes

Figure 2..3 : Nature and Functions of the Central Bank



Caution The Central Bank must have a special relation with the commercial banks whereby it can influence the functioning and operations of these institutions in the implementation of the government's economic policy.

Self Assessment

State whether the following statements are true or false:

6. The Central Bank differs from other financial institutions.
7. The main function of the Central Bank is to regulate the monetary mechanism comprising of the currency, banking and credit systems.
8. For promoting industrialization, the Reserve Bank has been providing finance through various institutions, to large, medium and small-scale industries.
9. The main objective of the Reserve Bank of India is to demotion of monetization and monetary integration of the economy.
10. The RBI has set many other institutions also in the category of industrial development banks.

2.4.1 Traditional Central Banking Functions (monetary functions)

Bank of Issue – The Minimum Reserve System

1. The Reserve Bank has a separate Issue Department, which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking department.
2. Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations.

Notes

3. The Government of India makes one rupee notes and coins and small coins and the RBI on its behalf, distributes them all over the country as agent of the government.
4. Originally, the assets of the Issue Department consisted of not less than two-fifths of gold coin, gold bullion or securities provided the amount of gold was not less than Rs. 40 crores in value.
5. The remaining three-fifths of the assets might be in form of rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India.
6. Due to the emergencies of the Second World War and the post-war period, these provisions were considerably modified.
7. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Rs. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

Notes The Reserve Bank has a separate Issue Department, which is entrusted with the issue of currency notes.

Banker to Government

Reserve Bank of India acts as Government banker, agent and adviser.

1. The Reserve Bank is the agent of the Central Government and of all state governments in India, excepting that of Jammu and Kashmir.
2. The Reserve Bank has the obligation to transact government business, to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the government
3. Carry out government exchange remittances and other banking operations.
4. The Reserve Bank of India helps the government – both the Union and the states to float new loans and to manage public debt.
5. It makes ways and means advances (WMA) to the governments for 90 days.
6. It makes loans and advances to the States and local authorities.
7. It acts as adviser to the government on all monetary and banking matters.

Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank:

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

Commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

Notes

(i) The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities.

(ii) Can get financial accommodation in times of need or strictness by rediscounting bills of exchange.

Caution Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Rs. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

Controller of Credit

The Reserve Bank of India is the controller of credit:

1. It has the power to influence the volume of credit created by banks in India by changing the Bank rate or through open market operations.
2. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities.
3. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.
4. Every bank has to get a license from the Reserve Bank of India to do banking business within India.
5. The license can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch.
6. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities.
7. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

These powers of the Bank to call for information are also intended to give it effective control of the credit system.

Custodian of Foreign Reserves

1. The Reserve Bank of India has the responsibility to maintain the official rate of exchange.
2. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at 1sh.6d. Though there were periods of extreme pressure in favour of or against the rupee.
3. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the IMF.
4. The Reserve Bank has to act as the custodian of India's reserve of international currencies i.e. forex balances are acquired and managed by the Bank.
5. The RBI has the responsibility of administering the exchange controls of the country.

Notes

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

1. It holds the cash reserves of all the scheduled banks.
2. It controls the credit operations of banks through quantitative and qualitative controls.
3. It controls the banking system through the system of licensing, inspection and calling for information.
4. It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.
5. Controller of Forex reserves of the country.

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India.

Did u know? According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of certain types of securities.

2.4.2 Supervisory Functions (Non-monetary Functions)

1. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers.
2. RBI has to supervise and control commercial and cooperative banks in relation to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation.
3. The RBI is authorized to carry out periodical inspections of the banks and to call for returns and necessary information from them.
4. The nationalization of 14 major Indian scheduled banks in July 1969 imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realisation of certain desired social objectives.

The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

2.4.3 Promotional Functions (Non-monetary Functions)

Since independence, with economic growth, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking.

1. The Reserve Bank promotes banking habits
2. Extends banking facilities to rural and semi-urban areas
3. Establishes and promotes new specialised financing agencies i.e., Industrial Development Banks
4. Development of the cooperative credit movement to encourage savings and to eliminate moneylenders from the villages and to route its short-term credit to agriculture e.g. Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

Notes

2.4.4 Miscellaneous Functions

1. ***Interest Rate Interventions:*** The most visible and obvious power of many modern central banks is to influence market interest rates; contrary to popular belief, they rarely "set" rates to a fixed number. Typically, a central bank controls certain types of short-term interest rates. These influence the stock and bond markets as well as mortgage and other interest rates.

   The mechanism to move the market towards a 'target rate' (whichever specific rate is used) is generally to lend money or borrow money in theoretically unlimited quantities, until the targeted market rate is sufficiently close to the target. Central banks may do so by lending money to and borrowing money from (taking deposits from) a limited number of qualified banks, or by purchasing and selling bonds.

2. ***Monetary Policy Instruments:*** The main monetary policy instruments available to central banks are open market operation, bank reserve requirement, interest-rate policy, re-lending and rediscount (including using the term repurchase market), and credit policy (often coordinated with trade policy).

   To enable open market operations, a central bank must hold foreign exchange reserves (usually in the form of government bonds) and official gold reserves. It will often have some influence over any official or mandated exchange rates. Some exchange rates are managed, some are market based (free float) and many are somewhere in between ("managed float" or "dirty float").

   Through open market operations, a central bank influences the money supply in an economy directly. Each time it buys securities, exchanging money for the security, it raises the money supply. Opposite to this, selling of securities lowers the money supply. Buying of securities thus amounts to printing new money while lowering supply of the specific security.

   The main open market operations are:

   (i) Temporary lending of money for collateral securities ("Reverse Operations" or "repurchase operations", otherwise known as the "repo" market). These operations are carried out on a regular basis, where fixed maturity loans (of 1 week and 1 month for the ECB) are auctioned off.

   (ii) Buying or selling securities ("Direct Operations") as per need.

   (iii) Foreign exchange operations such as forex swaps.

All of these interventions can also influence the foreign exchange market and thus, the exchange rate.

Capital requirements – Capital Adequacy

All banks are required to hold a certain percentage of their assets as capital, a rate which may be established by the central bank or the banking supervisor. Partly due to concerns about asset inflation and term repurchase agreements, capital requirements may be considered more effective than deposit/reserve requirements in preventing indefinite lending: when at the threshold, a bank cannot extend another loan without acquiring further capital on its balance sheet.

Notes

Reserve Requirements (CRR, SLR)

Another significant power that central banks hold is the ability to establish reserve requirements for other banks. By requiring that a percentage of liabilities be held as cash or deposited with the central bank (or other agency), limits are set on the money supply.

In practice, many banks are required to hold a percentage of their deposits as reserves. Such legal reserve requirements were introduced in the nineteenth century to reduce the risk of banks overextending themselves and suffering from bank runs, as this could lead to knock-on effects on other banks. Even if reserves were not a legal requirement, prudence would ensure that banks would hold a certain percentage of their assets in the form of cash reserves.

Cash Reserve Ratio (CRR)

The present banking system is called a "fractional reserve banking system", as the banks are required to keep only a fraction of their deposit liabilities in the form of liquid cash with the central bank to ensure safety and liquidity of deposits.

The Cash Reserve Ratio (CRR) refers to this liquid cash that banks have to maintain with the Reserve Bank of India (RBI) as a certain percentage of their demand and time liabilities.

Example: If the CRR is 10% then a bank with net demand and time deposits of Rs 1,00,000 will have to deposit Rs 10,000 with the RBI as liquid cash.

The CRR is applicable to all scheduled banks including the scheduled cooperative banks and the Regional Rural Banks (RRBs).

At present, the RBI does not pay any interest to the banks on the CRR deposits. Prior to 1962, a separate CRR was fixed in respect of demand and time liabilities. However, after 1962, the separate CRRs were merged and one CRR came into effect for both demand and time deposits of banks with the RBI.

CRR–A tool of credit control

CRR was introduced in 1950 chiefly as a measure to guarantee safety and liquidity of bank deposits. However over the years it has become an important and effective tool for directly regulating the lending capacity of banks and controlling the money supply in the economy. When the RBI feels that the money supply is increasing and causing an upward pressure on inflation, the RBI has the option of increasing the CRR thereby reducing the deposits available with banks to make loans and hence reducing the money supply and inflation and vice versa.

The RBI has the authority to impose penal interest rates on the banks in respect of their shortfalls in the prescribed CRR. In fact, if the default continues on a basis RBI can even cancel the bank's license or force it to merge with a larger bank.

Statutory Liquidity Ratio (SLR)

Statutory Liquidity Ratio or SLR refers to the amount that all banks require to maintain in cash or in the form of gold or approved securities. Approved securities mean bond and shares of different companies. Thus, Statutory Liquidity Ratio is determined as percentage of total demand and percentage of time liabilities.

The money deposited by commercial banks at the central bank is the real money in the banking system; other versions of what is commonly thought of as money are merely promises to pay

Notes

real money. These promises to pay are circulatory multiples of real money. For general purposes, people perceive money as the amount shown in financial transactions or amount shown in their bank accounts. But bank accounts record both credit and debits that cancel each other. Only the remaining central-bank money after aggregate settlement – **final money** – can take one of two forms:

1. physical cash, which is rarely used in wholesale financial markets
2. central-bank money.

The currency component of the money supply is far smaller than the deposit component. Currency and bank reserves together make up the monetary base, called M_1 and M_2.

Task Write (in 2000 words) about central bank of any three countries of this world.

Exchange Requirements

To influence the money supply, some central banks may require that some or all foreign exchange receipts (generally from exports) be exchanged for the local currency. The rate that is used to purchase local currency may be market-based or randomly set by the bank. This tool is generally used in countries with non-convertible currencies or partially-convertible currencies.

The recipient of the local currency may be allowed to freely dispose of the funds, required to hold the funds with the central bank for some period of time, or allowed to use the funds subject to certain restrictions. In other cases, the ability to hold or use the foreign exchange may be otherwise limited.

In this method, money supply is increased by the central bank when it purchases the foreign currency by issuing (selling) the local currency. The central bank may subsequently reduce the money supply by various means, including selling bonds or foreign exchange interventions.

Selective Credit Control

The Banking Regulation Act confers wide powers on the Reserve Bank of India to control the level and pattern of banks' advances in general or on a selective basis. Under Section 21 of the banking Regulation Act, 1949, the Reserve Bank is empowered to issue directions to the banking companies to determine the policy in relation to advances to be followed by them either generally or by any of them in particular. The Reserve Bank's directives may relate to any/or of the following:

1. The purposes for which advances may or may not be made.
2. The margins to be maintained in respect of secured advances.
3. The maximum amount of advances to any company, firm, individual etc.
4. The rate of interest and other terms and conditions on which advances and other financial accommodation may be given.

The Reserve Bank of India has been operating selective controls since 1956 in respect of certain commodities, which have been sensitive or in short supply. These controls are being enforced with the objective to discourage the use of bank finance for the hoarding of such commodities so as to check an unjustified rise in their prices.

Advances against (1) Food grains, (2) Pulses, (3) Oilseeds, (4) Vegetable oils, (5) Cotton and Kapas and (6) Sugar, Gur and Khandsari have been covered by selective credit controls.

Notes

Techniques of Selective Credit Controls

Three instruments of selective credit controls are discussed below:

Fixation of party wise ceiling on credit: The ceilings are fixed keeping in view the crop prospects, supply position and price trends. After the fixation of ceiling of credit on a party wise basis since November 1972, banks are required to seek the prior permission of the Reserve Bank for (1) granting loans to new borrowers, and (2) increasing the credit limits in case of existing borrowers. Thus, one bank cannot take over a commodity account, which is subject to credit control from another bank without seeking prior approval of the Reserve Bank.

Imposition of minimum margin: In case of advances against commodities subject to selective control, higher margins are prescribed in order to restrict the borrowing capacity of the borrowers. With higher margin, a borrower can get less credit from banks against a certain quantity of stock and thus can finance only a smaller part of it through bank finance. Moreover, different margins may be prescribed for different types of borrowers against the security of the same commodity. A higher margin is generally for those borrowers whose need for credit is not so urgent or larger flow of credit to whom is likely to aggravate the price situation.

Example: Minimum margins were prescribed for advances against food grains, pulses and oilseeds (w.e.f 19th October, 1987) at 45% for processing units/mills and against warehouse receipts and at 60% for others.

Fixation of minimum lending rate: Though the Reserve Bank had prescribed the interest rates on various categories of commercial bank advances which include the maximum rates of interest to be charged in certain cases, the minimum lending rate was prescribed for advances for commodities subject to selective control.

In order to make selective credit controls more successful, clean credit facilities are not allowed to any borrower affected by selective credit controls. Appropriate exemptions from the requirements of the selective credit controls are, however, granted so as to avoid unnecessary hardship to the deserving borrowers.

Example: Advances granted to certain categories of borrowers e.g. state agencies like the Food Corporation of India and State Trading Corporation are exempted from the application of the directives. Exports are exempted from the purview of selective controls.

These restrictions are generally less severe in respect of credit granted to the manufacturing and processing units and are tighter in case of traders. Similarly, advance against the security of or by way of purchase of demand documentary bills drawn in connection with the movement of goods subject to selective controls are exempted, while usance bills are not.

2.5 Risk Management and Central Bank

The survey of central bank risk managers confirms that a high proportion of central banks is currently restructuring their risk management operations. This survey reveals:

1. Increasing integration of risk management;
2. Recognition of the importance of operational risk;
3. A need for clear objectives for the various departments involved in risk management.

Notes

Central banks need to interpret the concept of risk in a very broad sense. Risk includes not only the identification and control of financial market risks and payment systems risks, but also reputation risks, political risks, regulatory risks, technological risks and moral hazards. Thus:

1. The key tasks of all central banks – monetary and exchange rate policy, oversight of payment systems, supervision, and crisis management – all require central banks to manage risk.
2. Central bankers need to identify and manage political and reputation risks.
3. Organize a risk management department so that it can work effectively with the internal audit department, the external auditors and the financial control department.
4. Larger central banks are leading the way in developing risk management procedures and translating this into corporate governance in the central bank.
5. For smaller banks with limited resources, setting up a separate risk management department is often not feasible. In these circumstances, risk has to be assessed and controlled by departmental heads.
6. Rising "risk awareness" is widely recognized as an important step to reducing operational risk for the organization as a whole.

In nutshell, a risk identification and management culture has to be developed in a central bank.

Self Assessment

Fill in the blanks:

11. The Reserve Bank of India has the responsibility to maintain the official .....
12. ..... need to interpret the concept of risk in a very broad sense.
13. The ..... has been operating selective controls since 1956 in respect of certain commodities, which have been sensitive or in short supply.
14. The survey of central bank risk managers confirms that a high ..... of central banks is currently restructuring their risk management operations.
15. The Banking Regulation Act confers wide powers on the Reserve Bank of India to control the level and pattern of banks' ..... in general or on a selective basis.

Case Study

Case: YES Bank

A little about YES Bank

YES Bank Ltd. is the newest entrant in the Indian Banking Sector. It started operations in November 2004 and has already created a presence in the Industry by virtue of its innovative Business Model. YES Bank aims to be a state-of-the-art technology driven, high quality, private Indian Bank catering to Emerging India?

The company's growing pains

With no legacy systems to inherit, YES Bank was looking at associating with a complete IT partner who would:

Contd....

Notes

- Enable the bank to take complete advantage of industry leadership with respect to the technology product portfolio offerings.
- Ensure service with minimum interruption for round-the-clock business operations.
- Provide a high performance and scalable platform.
- Optimise the systems with better manageability.
- Future proof against IT investments.

YES bank needed a one-stop solution for their IT problems.

The IBM solution

YES Bank chose IBM to provide IT infrastructure. To address the bank's challenges, IBM proposed servers based on POWER5 technology. As there were disparate applications and security concerns, different server environments with storage consolidation was the ideal solution. All the servers would connect to the SAN Switches, which in turn would be connected to the IBM Storage for Production environment. The solution had been configured with redundant paths with no single point of failure in the connectivity to the storage and the network.

Details	
Application Core Banking Cash Management	Treasury Application
O.S.	AIX
Platform	eServer pSeries POWER5 System

The business applications powered by IBM eServers were:

- ***Core Banking*** - Retail and Corporate by iFlex - runs on a cluster of p550 as the database servers and x 365 as the application servers.
- ***Cash Management application by Cashtech*** - cluster of 520 servers.
- ***Treasury application by Murex*** - cluster of 520 servers. Additionally, YES Bank also installed IBM ThinkPads and Desktops in all their offices.

The result - YES bank is the future of banking

YES Bank wanted to be geared up to meet its future expansion plans. The scalability of the IBM system and its virtualisation capability fitted the client requirements. The IBM infrastructure on Power5 provided YES Bank with following benefits:

- CMainframe-inspired features that help businesses thrive by providing higher utilisation
- Massive performance enhancements
- Greater flexibility and lower IT management costs
- Consistent, real-time data and information on demand robust, high-availability IT infrastructure with minimum disruption to business

Source: http://www-07.ibm.com/in/casestudies/case_yes.html

Notes

2.6 Summary

- A **central bank**, **reserve bank**, or **monetary authority**, is an entity responsible for the monetary policy of its country. Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized-loan interest rates, and acting as a "bailout" lender of last resort to the banking sector during times of financial crisis (private banks often being integral to the national financial system). It may also have supervisory powers, to ensure that banks and other financial institutions do not behave recklessly or fraudulently.
- The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 (II of 1934) provides the statutory basis of the functioning of the Bank.
- In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given it wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation.

2. 7 Keywords

Agricultural Finance: Loans given to boost agricultural activities.

Boom and Bust: The term boom and bust refers to a great buildup in the price of a particular commodity or, alternately, the localized rise in an economy, often based upon the value of a single commodity, followed by a downturn as the commodity price falls due to a change in economic circumstances or the collapse of unrealistic expectations.

Central Banks: The Central Bank is a financial institution charged with several different functions, the most important of which is managing a country's monetary policy. It is the nation's principal monetary authority that regulates the money supply and credit, issues currency, and manages the rate of exchange. It is a bank that can lend money to other banks in times of need.

Industrial Finance: Loans given to boost business activities.

Monetary Policy: Monetary policy is the process by which the government, central bank, or monetary authority of a country controls (i) the supply of money, (ii) availability of money, and (iii) cost of money or rate of interest, in order to attain a set of objectives oriented towards the growth and stability of the economy. Monetary theory provides insight into how to craft optimal monetary policy.

Open Market Operations: Open market operations are the means of implementing monetary policy by which a central bank controls its national money supply by buying and selling government securities, or other financial instruments in open market. Monetary targets, such as interest rates or exchange rates, are used to guide this job.

Risk Management: Risk Management is the identification, assessment, and prioritisation of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events.

Statutory Liquidity Ratio (SLR): Statutory Liquidity Ratio or SLR refers to the amount that all banks require to maintain in cash or in the form of gold or approved securities. Approved securities mean, bond and shares of different companies. This Statutory Liquidity Ratio is determined as percentage of total demand and percentage of time liabilities.

Notes

Time Liabilities: The liabilities, which the commercial banks are liable to pay to the customers on there anytime demand. The liabilities that the banks are liable to pay within one month's time, due to completion of maturity period, are also considered as time liabilities.

Ways and Means Advances: These are temporary advances (overdrafts) extended by the RBI to the government. Section 17(5) of the RBI Act allows the RBI to make WMA both to the Central and state government. Objective is to bridge the interval between expenditure and receipts. They are not a source of finance but are meant to provide support, for purely temporary difficulties that arise on account of mismatch/shortfall in revenue or other receipts for meeting the govt. liabilities. They have to be periodically adjusted to enable use of such financing for future mismatches.

2.8 Review Questions

1. Discuss the monetary and non-monetary functions of the Reserve Bank of India.
2. What are the main functions of a central bank? Discuss the economic significance of a central bank serving as a banker's bank.
3. What are the main characteristics of a central bank? How does the central banking differ from commercial banking?
4. "A well-organized central bank controls the internal price level, stabilizes the foreign exchange rate and prevents the occurrence of financial and industrial crises." Discuss. How does a central bank do this?
5. Discuss the significance of central bank in the economic development of a country.
6. Describe the constitution and organisational structure of the Reserve Bank of India.
7. How does the Reserve Bank of India regulate currency and credit in India?
8. Explain the working of selective credit control in India.
9. Critically examine the monetary policy of the Reserve Bank of India.
10. What has the Reserve Bank of India done to develop and regulate banking in the country?

Answers: Self Assessment

1.	Independence	2.	Department of banking supervision
3.	RBI	4.	GOI
5.	Central bank	6.	True
7.	True	8.	True
9.	False	10.	True
11.	Rate of exchange	12.	Central banks
13.	RBI (Reserve Bank of India)	14.	Proportion
15.	Advances		

2.9 Further Readings

Notes

Books

RBI Annual Report 2005-06.

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The Professionals Banker, The ICFAI University Press, Hyderabad.

Online links

http://en.wikipedia.org

www.bankofcanada.ca

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Unit 3: Concept of Retail Banking

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Objectives

After studying this unit, you should be able to:

- Explain the meaning of Retail Banking
- Understand Retail Banking - Asset Focused Segment (Advances)
- Understand Retail Banking - Liability Focused Segment (Deposit Accounts)
- Describe Reserve Bank of India's Model Policy on deposit accounts

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Introduction

The relationship between the bankers and the customers is not the same like before. The market has undergone a sea change. The customers have become more demanding today. The transition from sellers market to buyers market has compelled the bankers to understand the pulse and needs of the customers.

It may not be incorrect to say that the banking products and services today are designed by the customers. The luxury of discretion to design the products and services by the bankers is not any more available to the bankers.

Bankers today have no choice except to alter their product mix, delivery channels and corporate structure to serve their functional role. Some of the products which were shunned by the bankers and were treated as inflationary 20 years ago in nature like Housing Loan, consumer durables finance which otherwise were the prerogative of the bank employees have become targets of bank business and area of fierce competition and business mantra. Banks are vying with each other to sell across their ideas and products in the compelling hours of competition and the unexpected quarters say cooperative banks too have joined the fray.

Retail Banking has wider connotation and is not the same as that of retail lending. Retail Banking refers to the efforts of the bankers to reach up to the customers on both fronts of the balance sheet i.e., Liabilities side as well as Assets side. Under the liabilities side, we have deposits. Unless the banker designs the products according to the needs of the customers and facilitate better bargain to them in terms of rate interest, time and delivery channels, it is not easy for them to solicit business in this segment. The age of walk in deposits is gone. With interest deregulation in the sector of deposits with the sole exception of Savings Bank Account, where the apex monetary authority continues to decide the rate of interest, rest of the fields are open for competition.

In the Assets side, we have credit/loan schemes of the various banks. The job of the banker has become very difficult in this segment too. Bankers today are offering various sops to attract the potential customers. For instance, payment of free insurance premium by the bank comes along with the vehicle loan in respect of few banks. Some banks are prepared to offer total credit solutions along with housing loan, we mean here, they have enabled facility of consumer durables finance, vehicle finance in one go the customers who avail of housing loan from them.

This way, we understand retail banking includes designing delivery of customized products from both sides of the balance sheet.

The following channels are effectively utilized by the bankers to mobilize business from the potential clients:

- Premises banking or banking at doorsteps
- Automated Teller Machines
- Debit Cards and Credit Cards
- Telephone banking
- Internet Banking
- Mobile Banking
- Electronic Funds Transfer/Electronic Clearing System debit

3.1 Retail Banking-retail Lending Schemes

There has been a great heat of competition in selling ideas, products and services under this segment between one bank to the other. Retail lending, a departure from conventional advance,

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offers higher yield, quicker turn , the possibility of less incidence of the account going bad or non performing if it is monitored on an ongoing basis. Monitoring of the account is easier in retail lending segment as compared to the conventional advances, for the reason the installments and repayment schedule have to be monitored in respect of retail lending whereas in respect of conventional advances.

Example: An advance to an industrial unit, security verification, conduct of the account by the borrower, compliances with statutory norms by the unit, submission of periodical returns like balance sheet, income tax assessment order and other regulatory ones from time to time.

While novel retail lending products are introduced by the banks to compete effectively in the market, the products which are prevalent in the industry and marketed by the banks are given below, as an illustration:

- Housing Finance.
- Consumer durable finance.
- Vehicle (two-wheelers and four-wheelers) finance
- Personal Loan
- Advance against future lease rentals
- Mortgage Loan
- Pension Loan etc.

Margin: The contribution brought in by the borrower is termed as margin. Margin requirements differ from one type of finance to others and they differ from one bank to the other. There is no standard capsule of margin in this segment.

Interest: The rate of interest has been deregulated by the apex monetary authority which suggests that the rate of interest offered by one bank for a retail lending scheme may not match with the one offered by the other bank. The rate of interest is decided by the individual banks.

3.2 Composition of Retail Lending

3.2.1 Retail Banking – Retail Lending Schemes (Asset Focused Segment)

There has been a great heat of competition in selling ideas, products and services under this segment between one bank to the other. Retail lending, a departure from conventional advance, offers higher yield, quicker turn , the possibility of less incidence of the account going bad or non performing if it is monitored on an ongoing basis. Monitoring of the account is easier in retail lending segment as compared to the conventional advances, for the reason the installments and repayment schedule have to be monitored in respect of retail lending whereas in respect of conventional advances.

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Interest: The rate of interest has been deregulated by the apex monetary authority which suggests that the rate of interest offered by one bank for a retail lending scheme may not match with the one offered by the other bank. The rate of interest is decided by the individual banks.

Composition of Retail Lending

1	Housing	₹ 34654 crores	50%
2	Consumer durables	₹ 6904 crores	10%
3	Loans to Individuals agt Shares etc.	₹ 1762 crores	5%
4	Other Priority Sector/ Personal Loans	₹ 26089 crores	35%
5	TOTAL	₹ 69409 crores	100%

Source: RBI' report on Trend & Progress of Banks 2002-03

3.2.2 Retail Banking – Liability Focused Segment (Deposit Accounts)

Saving Fund Account/Savings Bank Account

A saving fund account may be opened by a properly introduced individual singly or jointly, minors of the age of 10 years and above and minors under natural/legal guardianship.

Saving fund account cannot be opened in the name of any business concern whether proprietary/ company/partnership or association. Savings fund account cannot be opened in the name of:

- Government departments
- Municipal corporations
- Panchayat Samitis
- State housing boards
- Industrial Development Authorities
- State Electricity Boards
- Water/Sewerage and Drainage Boards
- State Text Book Publishing Corporations
- Metropolitan Development Authority
- Housing Corporations/societies
- Any bank including land development banks

Notes

The following are the exceptions to the above. SF account can be opened in the name of the following:

- Companies licensed under Section 25 of Companies Act 1956, which are permitted not to add to their names the word "limited ", e.g., Indian Banks Association
- Societies Registered under Societies Registration Act 1860 or any other corresponding law
- Primary co-operative credit society being financed by the bank
- Any Government dept./body/agency in respect of grants/subsidies released for implementation of schemes sponsored by Central Government subject to production of an authorization from respective Govt departments to open savings fund account, e.g., District Rural Development Agency, Member of Parliament Local Area Development Scheme, Khadi and Village Industries Board, Agriculture Produce Market Committee
- Any trust/institution whose entire income is exempted from payment of income tax
- Any other institution permitted by RBI on application made by the bank
- SF account in the name of Hindu Undivided Family (HUF) can be opened if it is not engaged in business activity
- Development of children and women in rural areas
- Self Help Groups
- Farmers Club
- Banks can also open SF account of state Govt dept./bodies/agencies in respect of grants/ subsidies released for implementation of various State Government plans subject to obtaining an authorization that the department is authorized to open Savings Fund Account from the department itself.

3.3 Minimum Balance/Account Opening Requirements

The minimum balance to be maintained in the account may differ from one bank to the other since this area has been deregulated by the apex monetary body, the Reserve Bank of India.

Minimum balance: Maintenance/ Account opening Requirements: Savings Fund Accounts

		Non-Core Banking Solutions Branches	Core Banking Solutions branches
Sl. No.	**Area**	**Minimum balance(Rs)***	**Minimum**
1	Rural	As prescribed by the individual banks	As prescribed by the individual banks
2	Semi Urban	As prescribed by the individual banks	As prescribed by the individual banks
3	Urban	As prescribed by the individual banks	As prescribed by the individual banks
4	Metropolitan	As prescribed by the individual banks	As prescribed by the individual banks

By and large, banks do not insist on the maintenance of minimum balance amount in respect of staff members, pensioners, students, and salaried accounts (where salary is received for credit to the customers' accounts).

Notes

Interest

The interest is calculated on the minimum balance from 10th to the last day of the month. Minimum interest to be paid in the account per half year is Rs.1. The rate of interest to be allowed by the bank is decided by the Reserve Bank of India and this area has not been so far deregulated . The rate of interest payable by the bank on Savings Fund Account as on June 07 is 3.5% p.a. on half yearly basis.

Withdrawal

By and large, banks do not permit withdrawals from a saving fund account during every half year, whether by cheque or otherwise for more than 50 occasions. However, there is no bar that the bank should not allow more than 50 times.

Transfer of Account

An account may be transferred from one branch to another branch of the bank, generally free of charge on written request of the depositor.

Premature Closure of Account

In case the account is closed within a year, except on account of death of the account holder, banks levy certain charges as per their internal guidelines.

3.4 Accounts

3.4.1 Banker Customer Relationship

Bank accounts may have a positive, or credit balance, where the bank owes money to the customer; or a negative, or debit balance, where the customer owes the bank money.

Broadly, accounts opened with the purpose of holding credit balances are referred to as deposit accounts; whilst accounts opened with the purpose of holding debit balances are referred to as loan accounts.

Some accounts are defined by their function rather than nature of the balance they hold. Bank accounts designed to process large numbers of transactions may offer credit and debit facilities and therefore do not sit easily with a polarised definition.

Relation of a Debtor and a Creditor

The general relationship between banker and a customer is that of a debtor and a creditor i.e. borrower and lender. In *Foley v. Hill*, Sir John Paget remarks, "the relation of a banker and a customer is primarily that of debtor and creditor, the respective positions being determined by the existing state of account. Instead of the money being set apart in a safe room, it is replaced by the debt due from the banker. The money deposited with him becomes his property, and is absolutely, at his disposal, and, save as regards the following of the trust funds into his hands, the receipt of money by a banker from or on account of his customer constitutes him merely the debtor of the customer with 'super added' obligation to honour his customer's cheques drawn upon his balance, in so far the same is sufficient and available".

On the opening of an account a banker assumes the position of a debtor. The money deposited by the customer with the bank is in legal terms lent by the customer to the banker who males use

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of the same according to his discretion. The creditor has the right to demand back his money from the banker, and the banker is under an obligation to repay the debt as and when he is required to do so.

A depositor remains a creditor of his banker so long as his account carries a credit balance. But he does not get any charge over the assets of his debtor/banker and remains an unsecured creditor of the banker. Since the introduction of deposit insurance in India in 1962 the element of risk of the depositor is minimized as Deposit Insurance and Credit Guarantee Corporation undertakes to insure the deposits upto a specified amount.

Banker's relation with the customer is reversed as soon as the customer's account is overdrawn. Banker becomes creditor of the customer who has taken a loan from the banker and continues in that capacity till the loan is repaid. As the loans and advances granted by a banker are usually secured by the tangible assets of the borrower, the baker becomes a secured creditor of his customer.

Various Legal Relationships of Banker and Customer

Agent and Principal: Sec.182 of 'the Indian Contract Act, 1872' defines "an agent" as a person employed to do any act for another or to represent another in dealings with third persons. The person for whom such act is done or who is so represented is called "the Principal".

One of the important relationships between a banker and customer is that of an agent and principal. The banker performs various services of the customer, where he acts as the agent:

- Buying and selling securities of customer
- Collection of cheques, bills of exchange, promissory notes on behalf of customer
- Acting a trustee, executor or representative of a customer
- Payment of insurance premium, telephone bills etc.

Trustee and beneficiary: Section 3 of the Trusts Act defines a trustee as one to whom property is entrusted to be administered for the benefit of another called the beneficiary. A banker becomes a trustee under special circumstances. When a customer deposits securities or other valuables in bank for safe custody, the banker acts as trustee of customer.

Bailee and bailor: During certain circumstances banker becomes Bailee. When he receives gold ornaments and important documents for safe custody he takes charge of it as Bailee and not trustee or agent. He cannot make use of them as he is bound to return the identical articles on demand.

Pawnee and pawner: Pawn is a sort of bailment in which the goods are delivered to another as a pawn, to be a security for money borrowed. Thus a banker acts as a Pawnee where a customer delivers the goods to him to be kept as security till the debt is discharged. The banker can retain the goods pledged till the debt is paid.

Mortgagee and mortgagor: The relation between a banker as mortgagee and his customer as mortgagor arises when the latter executes a mortgage deed in respect of his immovable property in favour of the bank or deposits the title deeds of his property with the bank to create an equitable mortgage as security for an advance.

Lessee and lessor: When a customer hires a locker in the bank's safe deposit vault, the bank undertakes to take necessary precaution for the safety of the articles in the locker. The relation between the parties is that of a lessor and lessee.

Guarantor and guarantee: a bank as guarantor gives guarantee to its customer by issuing a 'letter of credit'. It is a kind of credit facility to its customer to facilitate international trade. A

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bank guarantee contains an undertaking to pay the amount without any demur on mere demand of the principal amount on the ground for non-performance or breach of contract.

Fiduciary relationship: Every relation of trust and confidence is a fiduciary relation. A banker who receives a customer's money is under a duty not to part with it which is inconsistent with the customer's fiduciary character and duty. In *Official Assignee v. Rajaram Aiyar*, it was held that where banks old money for a specific purpose of sending it somebody the money is impressed with trust.

3.4.2 Types of Accounts

1. Transactional Account

A transactional account is a deposit account held at a bank or other financial institution, for the purpose of securely and quickly providing frequent access to funds on demand, through a variety of different channels.

Transactional accounts are meant neither for the purpose of earning interest nor for the purpose of savings, but for convenience of the business or personal client; hence they tend not to bear interest. Instead, a customer can deposit or withdraw any amount of money any number of times, subject to availability of funds.

A transactional account is known as a checking account (or chequing account) in North America, and as a current account or cheque account in the United Kingdom, Hong Kong, India and some other countries. Because money is available on demand it is also sometimes known as a demand account or demand deposit account (DDA), except in the case of NOW accounts in the U.S., which are technically distinct.

2. Deposit Account

A deposit account is a current account, savings account, or other type of bank account, at a banking institution that allows money to be deposited and withdrawn by the account holder. These transactions are recorded on the bank's books, and the resulting balance is recorded as a liability for the bank, and represent the amount owed by the bank to the customer. Some banks charge a fee for this service, while others may pay the customer interest on the funds deposited. There are various types of deposit accounts:

- ***Checking accounts:*** A deposit account held at a bank or other financial institution, for the purpose of securely and quickly providing frequent access to funds on demand, through a variety of different channels. Because money is available on demand these accounts are also referred to as demand accounts or demand deposit accounts.
- ***Money market account:*** A deposit account with a relatively high rate of interest, and short notice (or no notice) required for withdrawals. In the United States, it is a style of instant access deposit subject to federal savings account regulations, such as a monthly transaction limit.
- ***Savings accounts:*** Accounts maintained by retail banks that pay interest but can not be used directly as money (for example, by writing a cheque). Although not as convenient to use as checking accounts, these accounts let customers keep liquid assets while still earning a monetary return.
- ***Time deposit:*** A money deposit at a banking institution that cannot be withdrawn for a preset fixed 'term' or period of time. When the term is over it can be withdrawn or it can be rolled over for another term. Generally speaking, the longer the term the better the yield on the money.

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- *Call deposit:* A deposit account which allows to withdraw the money without penalty, mostly without notification to the bank. Often it bears favourable interest rate, but also a minimum balance to take advantage of the benefits.

3. Personal Account

A personal account is an account for use by an individual for that person's own needs. It is a relative term to differentiate them from those accounts for corporate or business use. The term "personal account" may be used generically for financial accounts at banks and for service accounts such as accounts with the phone company, or even for e-mail accounts.

Banks differentiate their services for personal accounts from business accounts by setting lower minimum balance requirements, lower fees, free checks, free ATM usage, free debit card (Check card) usage, etc. The term does not apply to any one service or limit the banks from providing the same services to non-individuals. Personal account can be classified into three categories: 1. Persons of Nature; 2. Persona of Artificial Relationship; 3. Persons of Representation.

At the turn of the 21st century, many banks started offering free checking, a checking account with no minimum balance, a free check book, and no hidden fees. This encouraged Americans who would otherwise live from check to check to open their "personal" account at financial institutions. For businesses that issue corporate checks to employees, this enables reduction in the amount of paperwork.

4. Saving Accounts

Savings accounts are accounts maintained by retail financial institutions that pay interest but cannot be used directly as money in the narrow sense of a medium of exchange (for example, by writing a check). These accounts let customers set aside a portion of their liquid assets while earning a monetary return. For the bank, money in a savings account may not be callable immediately and therefore often does not incur a reserve requirement freeing up cash from the bank's vault to be lent out with interest.

5. Money Market Account

A money market account (MMA) or money market deposit account (MMDA) is a financial account that pays interest based on current interest rates in the money markets.

Money market accounts typically have a relatively high rate of interest and require a higher minimum balance (anywhere from $1,000 to $10,000 to $25,000) to earn interest or avoid monthly fees. The resulting investment strategy is therefore similar to, and meant to compete with, a money market fund offered by a brokerage. The two account types are otherwise unrelated.

6. Joint Account

Joint account is a bank account shared by two or more individuals. Any individual who is a member of the joint account can withdraw from the account and deposit to it. Usually, joint accounts are shared between close relatives or business partners.

Joint accounts are often created in order to avoid probate. If two individuals open a joint account and one of them dies, the other person is entitled to the remaining balance and liable for the debt of that account.

Sometimes a temporary joint account is opened by two parties entering into a transaction where one party needs a security for the fulfilment of the transaction and the other party has to pay the sum (deposit), being the security for the other party. Any payment from the joint account or

Notes

return of the deposit from the joint account, will only be possible if both parties sign a joint written instruction to the bank. It is not possible that only one of the both parties gives instruction for payments of the joint account.

When an account is opened in the name of two or more persons, all of them must sign the Account Opening Form and affix their photograph. The account will be operated in accordance with the instructions contained therein. If such instructions are rescinded by any one of the joint depositors, withdrawals will only be allowed if authorized by all of them.

In the case of joint account payable to either or survivor, if any of the depositor is dead, the balance will be payable to the survivor(s) without any reference to the representatives or heirs of the deceased person(s).

7. Minor Accounts

Savings Fund account in the name of a minor of the age of 10 years and above (with or without cheque books) may be opened in his/her name on obtaining satisfactory proof of his/her age. An account in the name of minor below the age of 10 years may only be opened under the guardianship of his/her father or mother in case both are not alive, a guardian appointed through a will, deed or legislative act in force for the time being. When the minor has attained majority, a fresh account opening form should be taken from him/her. In case of accounts opened in the name of minor(s) under guardianship, the photos of the guardian should be obtained.

8. Blind Customers' Accounts

A blind person may be allowed to open a Savings Fund account singly or jointly with others. In case of opening the account of a person, besides introduction, a witness is also required. Wherever possible, number and details of one or more identification marks of the blind persons i.e. mole or scar will be noted on the Account Opening Form and Specimen Signature Slip. A rubber stamp indicating that the account-holder is blind needs to be affixed on the Account Opening Form, Specimen Signature slip, ledger folio and pass book.

Withdrawals by the Illiterates

When a depositor has to make a withdrawal, he/she will personally call at the bank along with the pass book. The right/left hand thumb impression of the depositor will be taken on the withdrawal slip in the presence of passing official. Before making payment the passing official/ teller/computer terminal operator will ensure by reference to the photograph, pass book, the identification mark, if any, that the withdrawal is being made by the depositor himself/herself. The official will also ascertain the correct amount of withdrawal.

Standing Instructions: Standing instructions are accepted for payments like insurance premium, taxes, rentals, etc. by the banks. Intimation of compliance of standing instructions is also sent to customers immediately. Also, whenever a standing instruction is not carried out for any reason, the account holder is informed at once. However, no charges by and large are levied by the banks in respect of transfer entries within the accounts maintained at the same branch.

9. Current Accounts

A Current Account may be opened by individuals, singly or jointly, partnership firm, company, association, institution, trust, society, etc.

According to the Indian Banks Associations model deposit policy, an illiterate or blind person cannot open a current account. Minor, in their own name can also not open a current account as per the current practice of the banks.

Notes

It is a running account in which customers are free to make any number of transactions subject to maintenance of minimum balance in the account. The target group of current account is one of business segment.

10. Hindu Undivided Family (HUF)

HUF is a family with husband, wife and children (and children's spouses if any) living together. The property owned by this family will be through lineal ascendants or any ancestors. There are a set of laws that govern property ownership, marriages, taxation etc for a legally declared HUF. IT department of India has a format of taxation for a HUF; tax benefits can be availed from this format.

HUF Accounts

Karta of a HUF is the senior most male member of the family and in financial terms he can also be called manager of the family. In this account a corpus is created where every family member can pool their income. The corpus will be handled by or authorized to handle by Karta (head of the family). Signature of karta will be required for every transaction from the bank. These accounts are similar to individual saving bank accounts; there will be various tax benefits that are available for an individual's account while the income of members is being pooled in HUF account.

Features of HUF Account

There are a few features of HUF account that makes it different from regular saving bank accounts.

- Every member of the family can deposit their income in the common corpus
- Single person's authority while participation from entire family
- Tax benefits on deposits under various sections
- Corpus can be divided only on agreement of every coparcener of the family

Documents required for opening HUF account:

There are few documents that will be required for opening an HUF account.

- HUF will have a unique PAN card; this PAN card along with the PAN of Karta should be produced.
- A declaration form will be provided where every member has to make a signature stating the name of Karta and declare
    - They are the only members of HUF.
    - Karta to have sole authority over HUF account
    - Every transaction on behalf of HUF account, made by each member of the family is governed by karta.
- Residential proof of Karta
- Identification proof of Karta

Apart from the points mentioned above there can be other documents or conditions depending on the bank where HUF account is opened.

Notes

11. Married Women

The features are as follows:

- A separate legal entity
- Sec 14 of Hindu Succession Act provides that property of a Hindu female is her absolute property.
- Can raise loans against her own property
- Solvency not related to her husband
- Husband liable for her debts if:
  - a. Has consented and stands surety
  - b. Loans availed for necessities of her life.
- Can be an executor or administrator without any help or guidance.

12. Pardanashin Women

A household woman whether observing purdah or not is known as Pardanashin woman. These ladies are competent to open a bank account in their own name if such a lady is literate and can sign her name there is no difficulty in opening an account but in case of an illiterate woman, it is difficult due to the Problem of verification of her thumb impression and sometime even to identify. There fore the bankers generally avoid opening such an account and suggest the opening such an account and suggest the opening of a joint account with some literate person as an alternative and he operate her account through attorney.

Literate Person:

1. Introduction
2. NIC + Photograph
3. Salaried —— Service Certification
4. Confirmation of Address.

Illiterate Person:

1. Introduction
2. NIC +Photograph Photos
3. Specimen Signature Card
4. Thumb Impression
5. Self Presence
6. No cheque Issuance

13. Intoxicated Person

Features are:

- Contracts made by a person in drunken state are void
- Payment to an intoxicated person is to be made only after taking two independent witnesses regarding the condition of the person.

Notes

14. Executors and Administrators

Features are:

- The person named in the will of the deceased person is the executor and account can be opened on production of probate.
- Person appointed by the court is an administrator and must produce letter of administration.
- Payment can be stopped by any one but withdrawal is possible when both join.
- Upon death of one executor powers are vested in the surviving executor.
- Can borrow for the immediate needs of the property.

15. Trusts

Features are:

- Trust deed to be examined.
- Insolvency of trustee does not affect trust property.
- Transfer of funds from trust account to personal account of the trustee is investigated.
- Allow loans only if allowed in the trust deed and after taking personal guarantee of the trustee.
- Trustees must act jointly as they have no authority to delegate unless specifically mentioned.
- On the death of one trustee trust property passes to the other trustees, court order required.
- Any trustee can stop payment.

16. Societies and Clubs

Features are:

- By-laws to be obtained and read carefully.
- Registration certificate.
- Resolution passed reg opening and conduct of account.
- In case of death of an authorized signatory operation stopped till new resolution is received.
- Bank can open accounts of unregistered clubs, institutions, societies, associations, schools etc. after satisfying themselves about reputation, responsibility and standing of the office bearers.

17. Minor Account

According to law, a person is regarded as a "miner" until he has attend the age of 18 years:

1. The account is made in the name of minor but this signature is observed by the guardian but the title name of the account remains the name of minor "x" and guardian "y".
2. According to sec 2 the Contract Act 1872, a minor is qualified to enter in the Bombay high court declared if qualified person has made a contract for the benefit of the minor. It is a valid contract.

Notes

3. Guardian must enter in this account because they are playing vital role in the whole process as specimen signature is of a guardian.
4. When minor attend the age of 21, he or she can operate account himself.

18. Agent/Attorney

Terminated upon:

- The death/insolvency/insanity of the principal
- If principal revokes agent's authority
- If agent renounces the agency.
- If business of the agency is completed.

19. Joint Accounts

- Appointment of an agent should be confirmed by all.
- Operations to be stopped in case of death, insolvency/insanity of any one. Payment to be nade to survivors the legal of the deceased.
- Anyone can stop payment.
- Alteration in a cheque drawn should be confirmed by the drawer itself.

20. Partnership Firms

Features are:

- Max no of partners are 20; 10 in banking
- Registration not mandatory, but only registered firms can file suits to enforce a contract.
- Minor can be admitted only to the benefits.
- A partner can bind the firm by doing usual business on behalf of the firm.
- A partnership is not treated as a separate entity from the partners.

21. Joint Stock Company

A joint-stock company is a business entity which is owned by shareholders. Each shareholder owns the portion of the company in proportion to his or her ownership of the company's shares (certificates of ownership). This allows for the unequal ownership of a business with some shareholders owning a larger proportion of a company than others. Shareholders are able to transfer their shares to others without any effects to the continued existence of the company.

Private Limited Companies

1. Minimum 2 and maximum 50 shareholders
2. Directors; min 2 max 7
3. Name must end with private limited.

Public Limited Companies

1. Min: Directors 3, shareholders 7, max- no limit
2. Name must end with "Limited"

Notes

Government Companies; (51% or more shares held by the government)

- Documents required for opening account
  - Memorandum of association
  - Articles of association
  - Certificate of incorporation
  - Certificate of commencement of business
- Third party cheques drawn by the company should not be collected to the personal account of the directors.
- Insolvency/death/insanity of a director do not affect the functioning of a company.

3.5 Code of Conduct (KYC norms)

The bank branches are required to obtain a declaration from the prospective account holder in the following manner:

"That I/we/am/are not enjoying any credit facility with any other bank/any other branch of your bank and I/we undertake to inform you , in writing as soon as any credit facility is availed of by me/us from any other bank/any other branch of your bank".

OR

"That I/we/am/are enjoying any credit facility with other bank(s)/ other branch of your bank as per details given in the enclosed sheet."

In case the account holder is enjoying any credit facility from any other bank, the concerned lending bank(s) should be duly informed.

According to the RBI guidelines, bank branches should ensure scrupulously that they do not open current accounts of entities, that they enjoy credit facilities (fund-based or non-fund-based) from the banking system without specifically obtaining a no-objection certificate from the lending bank(s).

RBI has also clarified that banks may open current accounts of prospective customers in case no response is received from the bankers after a minimum waiting period of a fortnight.

Notes Reserve Bank of India has directed the banks not to pay any interest on margin money held in current accounts.

3.6 Term Deposits

Term deposits refer to such deposits which are placed with the bank for a definite time period, although the customers are free to withdraw their deposit as per their requirements.

Banks may accept term deposits for a minimum period of 7 days (one year in case of NRE deposits) and maximum for a period of 10 years. Banks may accept deposit for periods exceeding 10 years in the event of any orders from the competent court of law.

Banks may accept term deposits for a minimum period of 7 days (one year in case of NRE deposits) and maximum for a period of 10 years. Banks may accept deposit for periods exceeding 10 years in the event of any orders from the competent court of law.

Notes

Rate of Interest: Banks may offer differential interest rates on whole sale domestic term deposits of Rs. 15 lakhs and above. For deposits below Rs. 15 lakhs, banks should offer uniform rates for the same maturity.

On domestic term deposits, banks may offer floating rate clearly linked to an anchor rate. Banks to obtain prior approval of its Board or ALM Committee (if powers are delegated to the committee) for fixing rates for various maturities. Unlike Savings Fund Account wherein rate of interest is arbitrated by RBI, in respect of term deposits RBI has vested enough powers to decide upon the rate of interest for deposits of various maturities as above.

Banks are to pay interest at the originally contracted rate on the deposit amount for Sunday/ holiday/non-business working day intervening between the date of expiry of specified term deposit and date of payment of proceeds.

Interest Payable on Deposit Account of Deceased Depositor

According to Reserve Bank of India's guidelines, individual banks can decide upon this issue. However Indian Bank's Association (IBA) in its model deposit policy has laid down that:

1. In case of death before maturity, contracted rate be paid till the date of maturity and from the date of maturity till the date of payment, simple interest at the rate applicable (term deposit) on the date of maturity for the period the deposit remained with the bank be paid.
2. In case of death after maturity, the bank shall pay interest at savings rate applicable on the date of maturity, from date of maturity till the date of payment.

Banks cannot accept interest-free deposit, except for deposit at call; for instance money held in current account of the depositor does not bear any interest.

Banks should not discriminate in matter of interest paid on deposit, except for resident senior citizens and other segments as and when notified by the government.

Individual banks have laid down guidelines in respect of renewal of deposit including, premature renewal, premature withdrawal conversion of term deposit into recurring deposit and vice versa. Banks also have put in place guidelines for splitting of deposits into different names as per the instructions of the customer. Banks have also brought in novel schemes of loans/advances against term deposits.

3.7 Recurring Deposits

Any individual (singly or jointly) or a minor of 10 years and above in his own name otherwise under guardianship, HUF, a firm, a club, association, educational institution, municipality, Panchayat, society, trust etc. can open the account.

As per the practices followed by the banks by and large, it can be opened for an installment of Rs.100/- or more or in multiples thereof for a period ranging from 6 months to 120 months in multiples of 3 months. Since this is a de-regulated area, the scheme of one bank need not be the same with that of the other.

Interest: Interest again is deregulated by RBI and as such, rate of interest offered by one bank for the like amount and period may not be the same with that of the other. In normal recurring deposit, installments are expected to be deposited by the deposit holder on or before the last working day of the month. But in respect of the recurring deposit scheme where there is no stipulation of payment on or before the last working day of the month, the question of fixing any date does not arise. Banks have put in place penalty guidelines in respect of non-payment of installment in time and waiver procedures have also been laid down by the banks.

Notes

As per the prevalent practices relevant to recurring deposit, the deposit shall mature 30 days/ one month after payment of last instalment or on due date whichever is late.

Banks also provide for advances/loan against the recurring deposit, payment of irregular and discontinued recurring deposit account etc. The investor should refer to the related guidelines of the bank where recurring deposit is intended to be opened.

Did u know? Any individual (singly or jointly) or a minor of 10 years and above in his own name otherwise under guardianship, HUF, a firm, a club, association, educational institution, municipality, Panchayat, society, trust etc. can open the account.

Self Assessment

1. A Joint Savings bank account can be operated upon by a Mandate/Power of attorney holder provided:
   (a) The Mandate/Power of attorney is given by all the joint account holders
   (b) The Mandate/Power of attorney is given by any of the joint account holders
   (c) Joint SB account cannot be operated upon by a mandate/power of attorney
   (d) None of the above
   (e) Any one of (a), (b), (c)
2. The mode of operation of Joint Savings Bank account can be altered by:
   (a) All joint account holders
   (b) Any of the joint account holders
   (c) Mode of operation once given cannot be altered
   (d) All of the above
   (e) None of the above
3. In a Joint Savings Bank account when the operational instructions are not given, cheques in the account can be drawn by:
   (a) Any of the joint account holders
   (b) All the account holders jointly
   (c) Cheques cannot be drawn without operational instructions
   (d) Operations in the account cannot be permitted
   (e) None of the above
4. ..... has wider connotation and is not the same as that of retail lending.
5. Banks cannot accept interest-free deposit, except for deposit at call; for instance money held in current account of the ..... does not bear any interest.

Task Discuss the RBI policies in India.

Notes

3.8 Reserve Bank of India's Model Policy on Bank Deposits

One of the important functions of the bank is to accept deposits from the public for the purpose of lending. In fact, depositors are the major stakeholders of the banking system. The depositors and their interests form the key area of the regulatory framework for banking in India and this has been enshrined in the Banking Regulation Act, 1949. The Reserve Bank of India is empowered to issue directives/advices on interest rates on deposits and other aspects regarding conduct of deposit accounts from time to time. With liberalization in the financial system and deregulation of interest rates, banks are now free to formulate deposit products within the broad guidelines issued by RBI.

Caution Banks also provide for advances/loan against the recurring deposit, payment of irregular and discontinued recurring deposit account etc. The investor should refer to the related guidelines of the bank where recurring deposit is intended to be opened.

3.8.1 Types of Deposit Accounts

While various deposit products offered by the bank are assigned different names. The deposit products can be categorised broadly into the following types. Definition of major deposits schemes are as under:

(i) "Demand deposits" means a deposit received by the bank which is withdrawable on demand;

(ii) "Savings deposits" means a form of demand deposit which is subject to restrictions as to the number of withdrawals as also the amounts of withdrawals permitted by the Bank during any specified period;

(iii) "Term deposit" means a deposit received by the bank for a fixed period withdrawable only after the expiry of the fixed period and include deposits such as Recurring/Double Benefit Deposits/Short Deposits/Fixed Deposits/Monthly Income Certificate/Quarterly Income Certificate etc.;

(iv) Notice Deposit means term deposit for specific period, but withdrawable on giving at least one complete banking day's notice;

(v) "Current Account" means a form of demand deposit wherefrom withdrawals are allowed any number of times depending upon the balance in the account or up to a particular agreed amount and will also include other deposit accounts which are neither Savings Deposit nor Term Deposit.

3.8.2 Account Opening and Operation of Deposit Accounts

- The bank, before opening any deposit account will carry out due diligence as required under "Know Your Customer" (KYC) guidelines issued by RBI and or such other norms or procedures adopted by the Bank. If the decision to open an account of a prospective depositor requires clearance at a higher level, reasons for any delay in opening of the account will be informed to him and the final decision of the bank will be conveyed at the earliest to him.
- The account opening forms and other material would be provided to the prospective depositor by the Bank. The same will contain details of information to be furnished and documents to be produced for verification and or for record, it is expected of the Bank

Notes

official opening the account, to explain the procedural formalities and provide necessary clarifications sought by the prospective depositor when he approaches for opening a deposit account.

- Savings Bank Accounts can be opened for eligible person/persons and certain organizations/agencies (as advised by Reserve Bank of India (RBI) from time to time).
- Current Accounts can be opened by individuals/partnership firms/Private and Public Limited Companies/HUFs/Specified Associates/Societies/Trusts, etc.
- Term Deposits Accounts can be opened by individuals/partnership firms/Private and Public Limited Companies/HUFs/Specified Associates/Societies/Trusts, etc.
- The due diligence process, while opening a deposit account will involve satisfying about the identity of the person, verification of address, satisfying about his occupation and source of income. Obtaining introduction of the prospective depositor from a person acceptable to the bank and obtaining recent photograph of the persons opening/operating the account are part of due diligence process.
- In addition to the due diligence requirements, under KYC norms the bank is required by law to obtain Permanent Account Number (PAN) or General Index Register (GIR) Number or alternatively declaration in Form No. 60 or 61 as specified under the Income Tax Act/ Rules.
- Deposit accounts can be opened by an individual in his own name (status: known as account in single name) or by more than one individual in their own names (status: known as Joint Account). Savings Bank Account can also be opened by a minor jointly with natural guardian or with mother as the guardian (Status: known as Minor's Account). Minors above the age of 10 will also be allowed to open and operate saving bank account independently.
- ***Operation of Joint Account:*** The Joint Account opened by more than one individual can be operated by single individual or by more than one individual jointly. The mandate for operating the account can be modified with the consent of all account holders. The Savings Bank Account opened by minor jointly with natural guardian/guardian can be operated by natural guardian only.
- At the request of the depositor, the bank will register mandate/power of attorney given by him authorizing another person to operate the account on his behalf.
- The term deposit account holders at the time of placing their deposits can give instructions with regard to closure of deposit account or renewal of deposit for further period on the date of maturity. In absence of such mandate, the Bank will seek instructions from the depositor/s as to the disposal of the deposit by sending an intimation before 15 days of the maturity date of term deposit.
- Nomination facility is available on all deposit accounts opened by the individuals. Nomination is also available to a sole proprietary concern account. Nomination can be made in favour of one individual only. Nomination so made can be cancelled or changed by the account holder/s any time. While making nomination, cancellation or change.
- Thereof, it is required to be witnessed by a third party. Nomination can be modified by the consent of account holder/s. Nomination can be made in favour of a minor also.
- The bank has statutory obligation to deduct tax at source if the total interest paid/payable on all term deposits held by a person exceeds the amount specified under the Income Tax Act. The bank will issue a tax deduction certificate (TDS Certificate) for the amount of tax deducted. The depositor, if entitled to exemption from TDS can submit declaration in the prescribed format at the beginning of every financial year.

Notes

- ***Minors' Accounts:*** The minor can open Savings Bank Account and the same can be operated by the natural guardian or by minor himself/herself, if he/she is above the age of 10 years. The account can also be opened jointly.
- On attaining majority, the erstwhile minor should confirm the balance in his/her account and if the account is operated by the natural guardian/guardian, fresh specimen signature of erstwhile minor duly verified by the natural guardian would be obtained and kept on record for all operational purposes.
- ***Account of Illiterate/Blind Person:*** The bank may at its discretion open deposit accounts other than Current Accounts of illiterate person. The account of such person may be opened provided he/she calls on the bank personally along with a witness who is known to both the depositor and the bank. Normally, no cheque book facility is provided for such Savings Bank Account. At the time of withdrawal/repayment of deposit amount and/or interest, the account holder should affix his/her thumb impression or mark in the presence of the authorized officer who should verify the identity of the person. The bank will explain the need for proper care and safekeeping of the passbook etc. given to the account holder. The bank official shall explain the terms and conditions governing the account to the illiterate/blind person.
- ***Secrecy of Customer's Accounts:*** The bank shall not disclose details/particulars of the customer's account to a third person or party without the expressed or implied consent from the customer. However, there are some exceptions, viz. disclosure of information under compulsion of law, where there is a duty to public to disclose and where interest of the bank requires disclosure.
- ***Premature Withdrawal of Term Deposit:*** The bank on request from the depositor, at its discretion may allow withdrawal of term deposit before completion of the period of the deposit agreed upon at the time of placing the deposit. The bank shall declare their penal interest rates policy for premature withdrawal of term deposit. The bank shall make depositors aware of the applicable rate along with the deposit rate.
- ***Premature Renewal of Term Deposit:*** In case the depositor desires to renew the deposit by seeking premature closure of an existing term deposit account, the bank will permit the renewal at the applicable rate on the date of renewal, provided the deposit is renewed for a period longer than the balance period of the original deposit. While prematurely closing a deposit for the purpose of renewal, interest on the deposit for the period it has remained with the bank will be paid at the rate applicable to the period for which the deposit remained with the bank and not at the contracted rate.
- ***Renewal of Overdue Term Deposits:*** When a term deposit is renewed on maturity, on renewed deposit interest rate for the period specified by the depositor as applicable on the date of maturity would be applied. If request for renewal is received after the date of maturity, such overdue deposits will be renewed with effect from the date of maturity at interest rate applicable as on the due date, provided such request is received within 14 days from the date of maturity. In respect of overdue deposits renewed after 14 days from the date of maturity, interest for the overdue period will be paid at the rates decided by the bank from time to time.
- ***Advances Against Deposits:*** The bank may consider request of the depositor/s for loan/ overdraft facility against term deposits duly discharged by the depositor/s on execution of necessary security documents. The bank may also consider loan against deposit standing in the name of minor, however, a suitable declaration stating that loan is for the benefit of the minor, is to be furnished by the depositor-applicant.

Notes

- ***Settlement of Dues in Deceased Deposit Account:***

  (i) If the depositor has registered nomination with the bank - the balance outstanding in the account of the deceased depositor will be transferred to the account of/paid to the nominee after the bank satisfies about the identity of the nominee, etc.

  (ii) The above procedure will be followed even in respect of a joint account where nomination is registered with the bank.

  (iii) In a joint deposit account, when one of the joint account holders dies, the bank is required to make payment jointly to the legal heirs of the deceased person and the surviving depositor(s). However, if the joint account holders had given mandate for disposal of the balance in the account in the forms such as "either or survivor, former/latter or survivor, anyone of survivors or survivor; etc., the payment will be made as per the mandate to avoid delays in production of legal papers by the heirs of the deceased.

  (iv) In the absence of nomination and when there are no disputes among the claimants, the bank will pay the amount outstanding in the account of deceased person against joint application and indemnity by all legal heirs or the person mandated by the legal heirs to receive the payment on their behalf without insisting on legal documents up to the limit approved by the bank's board. This is to ensure that the common depositors are not put hardship on account of delays in completing legal formalities.

- ***Interest Payable on Term Deposit in Deceased Account***

  (i) In the event of death of the depositor before the date of maturity of deposit and amount of the deposit is claimed after the date of maturity, the bank shall pay interest at the contracted rate till the date of maturity. From the date of maturity to the date of payment, the bank shall pay simple interest at the applicable rate obtaining on the date of maturity, for the period for which the deposit remained with the Bank beyond the date of maturity; as per the bank's policy in this regard.

  (ii) However, in the case of death of the depositor after the date of maturity of the deposit, the bank shall pay interest at savings deposit rate obtaining on the date of maturity from the date of maturity till the date of payment.

- ***Safe Deposit Lockers:*** This facility is not offered through all bank branches and wherever the facility is offered, allotment of safe deposit vault will be subject to availability and compliance with other terms and conditions attached to the service. Safe deposit lockers may be hired by an individual (being not a minor) singly or jointly with another individual(s), HUFs, firms, limited companies, associates, societies, trusts etc. Nomination facility is available to individual(s) holding the lockers singly or jointly. In respect of lockers held in joint names, up to two nominees can be appointed. Joint locker holders can give mandate for access to the lockers in the event of death of one of the holders on the lines similar to those for deposit accounts. In the absence of nomination or mandate for disposal of contents of lockers, with a view to avoid hardship to common persons, the bank will release the contents of locker to the legal heirs against indemnity on the lines as applicable to deposit accounts.

- ***Redressal of Complaints and Grievances:*** Depositors having any complaint/grievance with regard to services rendered by the bank has a right to approach authority (ies) designated by the bank for handling customer complaint/grievances. The details of the internal set up for redressal of complaints/grievances will be displayed in the branch premises. The branch officials shall provide all required information regarding procedure for lodging the complaint. In case the depositor does not get response from the Bank

Notes

within 60 days from date of complaint or he is not satisfied with the response received from the bank, he has a right to approach Banking Ombudsman appointed by the Reserve Bank of India.

Notes The bank, before opening any deposit account will carry out due diligence as required under "Know Your Customer" (KYC) guidelines issued by RBI and or such other norms or procedures adopted by the Bank.

Self Assessment

State whether the following statements are true or false:

6. Depositors having any complaint/grievance with regard to services rendered by the bank has a right to approach authority(ies) designated by the bank for handling customer complaint/grievances.

7. If the depositor has registered nomination with the bank - the balance outstanding in the account of the deceased depositor will be transferred to the account of/paid to the nominee after the bank satisfies about the identity of the nominee, etc.

8. Safe deposit lockers may not be hired by an individual (being not a minor) singly or jointly with another individual(s), HUFs, firms, limited companies, associates, societies, trusts etc.

9. The bank may not consider request of the depositor/s for loan/overdraft facility against term deposits duly discharged by the depositor/s on execution of necessary security documents.

10. The bank may not at its discretion open deposit accounts other than Current Accounts of illiterate person.

3.9 Corporate Banking

Corporate banking represents a wide range of banking and financial services provided to domestic and international operations of large local Corporates and local operations of multinational corporations.

Services include the following:

- Access to commercial banking products, including working capital facilities such as domestic and international trade operations and funding
- Channel financing, and overdrafts
- Letters of guarantee, etc.
- Structured solutions both onshore and offshore
- Term loans (including external commercial borrowings in foreign currency).
- Domestic and international payments
- Support to client's worldwide operations, ensuring a full understanding of the company's business and financial needs.

Notes

3.9.1 Types of loans granted by commercial banks

Secured loan

A secured loan is a loan in which the borrower pledges some asset (e.g. a car or property) as collateral for the loan, which then becomes a secured debt owed to the creditor who gives the loan. The debt is thus secured against the collateral — in the event that the borrower defaults, the creditor takes possession of the asset used as collateral and may sell it to regain some or all of the amount originally lent to the borrower, for example, foreclosure of a home. From the creditor's perspective this is a category of debt in which a lender has been granted a portion of the bundle of rights to specified property. If the sale of the collateral does not raise enough money to pay off the debt, the creditor can often obtain a deficiency judgment against the borrower for the remaining amount. The opposite of secured debt/loan is unsecured debt, which is not connected to any specific piece of property and instead the creditor may only satisfy the debt against the borrower rather than the borrower's collateral and the borrower.

Mortgage loan

A mortgage loan is a very common type of debt instrument, used to purchase real estate. Under this arrangement, the money is used to purchase the property. Commercial banks, however, are given security - a lien on the title to the house - until the mortgage is paid off in full. If the borrower defaults on the loan, the bank would have the legal right to repossess the house and sell it, to recover sums owing to it.

In the past, commercial banks have not been greatly interested in real estate loans and have placed only a relatively small percentage of assets in mortgages. As their name implies, such financial institutions secured their earning primarily from commercial and consumer loans and left the major task of home financing to others. However, due to changes in banking laws and policies, commercial banks are increasingly active in home financing.

Changes in banking laws now allow commercial banks to make home mortgage loans on a more liberal basis than ever before. In acquiring mortgages on real estate, these institutions follow two main practices. First, some of the banks maintain active and well-organized departments whose primary function is to compete actively for real estate loans. In areas lacking specialized real estate financial institutions, these banks become the source for residential and farm mortgage loans. Second, the banks acquire mortgages by simply purchasing them from mortgage bankers or dealers.

In addition, dealer service companies, which were originally used to obtain car loans for permanent lenders such as commercial banks, wanted to broaden their activity beyond their local area. In recent years, however, such companies have concentrated on acquiring mobile home loans in volume for both commercial banks and savings and loan associations. Service companies obtain these loans from retail dealers, usually on a non-recourse basis. Almost all bank/service company agreements contain a credit insurance policy that protects the lender if the consumer defaults.

Did u know? In the past, commercial banks have not been greatly interested in real estate loans and have placed only a relatively small percentage of assets in mortgages.

Unsecured Loan

Notes

Unsecured Loans are monetary loans that are not secured against the borrower's assets (i.e., no collateral is involved). These may be available from financial institutions under many different guises or marketing packages:

- Bank Overdrafts

An overdraft occurs when money is withdrawn from a bank account and the available balance goes below zero. In this situation the account is said to be "overdrawn". If there is a prior agreement with the account provider for an overdraft, and the amount overdrawn is within the authorized overdraft limit, then interest is normally charged at the agreed rate. If the POSITIVE balance exceeds the agreed terms, then additional fees may be charged and higher interest rates may apply.

- corporate bonds
- credit card debt
- credit facilities or lines of credit
- personal loans

What makes a bank limited liability company

A corporate bond is a bond issued by a corporation. It is a bond that a corporation issues to raise money in order to expand its business. The term is usually applied to longer-term debt instruments, generally with a maturity date falling at least a year after their issue date. (The term "commercial paper" is sometimes used for instruments with a shorter maturity.) Sometimes, the term "corporate bonds" is used to include all bonds except those issued by governments in their own currencies. Strictly speaking, however, it only applies to those issued by corporations. The bonds of local authorities and supranational organizations do not fit in either category. [clarification needed] Corporate bonds are often listed on major exchanges (bonds there are called "listed" bonds) and ECNs like Bonds.com and Market Axes, and the coupon (i.e. interest payment) is usually taxable. Sometimes this coupon can be zero with a high redemption value. However, despite being listed on exchanges, the vast majority of trading volume in corporate bonds in most developed markets takes place in decentralized, dealer-based, over-the-counter markets. Some corporate bonds have an embedded call option that allows the issuer to redeem the debt before its maturity date. Other bonds, known as convertible bonds, allow investors to convert the bond into equity. Corporate Credit spreads may alternatively be earned in exchange for default risk through the mechanism of Credit Default Swaps which give an unfunded synthetic exposure to similar risks on the same 'Reference Entities'. However, owing to quite volatile CDS 'basis' the spreads on CDS and the credit spreads on corporate bonds can be significantly different.

3.10 Wholesale Banking

Wholesale banking is the provision of services by banks to the likes of Mortgage Brokers, large corporate clients, mid-sized companies, real estate developers and investors, international trade finance businesses, institutional customers (such as pension funds and government entities/ agencies), and services offered to other banks or other financial institutions. (Wholesale finance means financial services, which are conducted between financial services companies and institutions such as banks, insurers, fund managers, and stockbrokers.)

Notes

Modern wholesale banks are engaged in: finance wholesaling, underwriting, market making, consultancy, mergers and acquisitions, fund management.

Wholesale banking in India is set for a period of sharp growth. Revenues from wholesale banking activities are likely to more than double over the next five years as infrastructure investment, expansion by Indian companies overseas, and further "Indianisation" of multinational businesses, among other trends, drive new business. Foreign players and the country's domestic banks, however, will find themselves in a tough commercial environment and must overcome a range of challenges if they are to maintain, or assume, a leading position in the market.

Prospects for India's wholesale banking market are intriguing. Wholesale banking revenues, which in India account for close to 30 percent of total banking revenues, are expected to more than double, from roughly $16 billion in fiscal 2010 to between $35 billion and $40 billion by 2015.

Self Assessment

11. In case of premature withdrawal of an FDR, interest is payable if the deposit has remained with the bank:

    (a) For a period more than 15 days

    (b) For a period more than 45 days

    (c) No interest is payable on premature payment

    (d) None of the above

12. Mr. X has given a power of attorney to his son Y to operate the account, you learn Mr. X is now admitted to mental hospital due to his lunacy. In this case—

    (a) Mr. Y can operate the account

    (b) Mr. Y cannot operate the account

    (c) Mr. X can operate the account

    (d) Mr. X or Y cannot operate the account

13. Payment in a deceased deposit account can be made when—

    (a) All the legal heirs jointly submit the succession certificate

    (b) Legal heirs submit death certificate and indemnity only

    (c) Both (a) and (b) above

    (d) None of the above

14. If the banker makes payment in violation of stop payment instruction of the account holder, the same may be regarded as a deficiency in the bank's service—

    (a) Yes

    (b) No

15. The ..... is the bank's primary representative to a customer or client.

Notes

Task Suppose you want to open an account in a bank. What kind of formalities you will fill at that point of time? Discuss.

Case Study

ABN AMRO Bank, Technology led Excellence

Key Business Drivers

ABN AMRO Bank started its India operations and like other foreign multinational banks, focused primarily on wholesale banking, to service top-tier corporate clients. This changed in the 1990s, when strategic business imperatives and an increased level of competition both from domestic and multinational banks in India led the bank to look at retail banking as a key area for growth. In an effort to strengthen its retail banking presence, ABN AMRO acquired Bank of America's retail banking operations in India. As part of the acquisition, the bank migrated to Bank of America's technology infrastructure, which was based on ICBS solution from Fiserv, running on an IBM AS/400 platform. However, the existing solution was not flexible enough to meet the requirements of a competitive consumer banking environment, where offering a range of products and services to customers across multiple delivery channels is critical. With frequent maintenance requirements, the platform was also proving to be a drain on the bank's resources. At the same time, the focus at the bank was on reduction of TCO (Total Cost of Ownership) and therefore, a mere upgrade to a newer version of the existing, aging system would not have met the objective. As a result, the bank decided to replace the legacy system with a new generation, robust core banking solution.

The cornerstone of a successful consumer banking strategy is to have a technology platform that can offer anytime, anywhere banking through multiple delivery channels like the Internet, ATM, mobiles and call centers. ABN AMRO Bank required a platform that could easily support existing delivery channels and add new ones, while seamlessly integrating them to provide a relationship view of customers' interactions across all delivery channels. Being a multinational bank, ABN AMRO Bank was also keen to adopt best practices being followed in other countries, such as the ability to roll out new products and services in line with domestic market requirements. Equally important was the need to roll out these customizations rapidly so as to gain critical time-to-market advantage. This could only be achieved by deploying a platform that was flexible and easily extensible. After intense discussions and evaluation, ABN AMRO chose Finacle, the new-generation universal banking solution from Infosys, to address its needs in core banking and consumer e-banking spaces.

Solution Overview

Some of the key features that Finacle offered were:

True 24x7 banking

Finacle enabled zero downtime at both the central and branch level server, ensuring that ABN AMRO was up and running on a 24x7 basis, across electronic delivery channels and branches. Finacle's architecture also enabled offering of basic consumer banking services to customers, either during the planned End of Day (EOD) black out windows, unscheduled

Contd....

Notes

outages of the central data center of the bank or during disruptions in branch network connectivity.

Leveraging Straight-Through-Processing (STP)

Finacle provided an interoperable and open architecture that ensured tight integration with all delivery channels using standard message protocols. The powerful STP feature ensured that several transactions were completed end-to-end, without manual intervention. Turnaround times have drastically reduced for issuing cheque books and account statements, thereby enhancing productivity and customer satisfaction.

Unique extensibility features

Finacle's unique Extensibility tool kit comprising Scripting Engine, Workflow, and Remote Application Interface (RAI) provided the much needed flexibility to ABN AMRO Bank, enabling it to easily and rapidly add new business rules, launch new products, and modify processes. Using this tool kit, ABN AMRO developed a loyalty reward program for its customers wherein, the bank offered incentives like charge free demand drafts based on certain business rules like maintaining specified minimum balances. Such programs have helped the bank reap the twin benefits of customer retention and an increase in low cost funds. Some of the modules that have been quickly rolled out by ABN AMRO are:

- ***Direct Sales Agent (DSA) Module:*** To track the performance of Direct Sales Agents (DSA's) of the bank and have customized commission computation logic for the DSA's based on predefined parameters like product type, geography and hierarchy.
- ***Complaint and Request Tracking System (CARTS):*** To track customer request and complaints without manual intervention and assign priority, based on customer profile and severity of request, by seeking reference from the Finacle core banking database.
- ***Card Management System (CMS):*** This is a repository of customer card information and acts as a focal point in various events relating to cards, like issue, reissue and maintenance. An additional feature of this module is the ability to communicate on an on-line basis for activities like 'hot carding' a card, activation/deactivation of cards, etc.

Reaping the Benefits

For ABN AMRO Bank, the choice of an enterprise banking platform hinged on factors like flexibility translating into ease of customisation, availability of an integration infrastructure with multiple delivery channels and reduced TCO. Finacle has delivered on all of these points along with giving crucial time-to-market advantage and business agility to the bank, thus helping script a retail banking success story.

3.11 Summary

- Bankers today have no choice except to alter their product mix, delivery channels and corporate structure to serve their functional role.
- There has been a great heat of competition in selling ideas, products and services under this segment between one bank to the other.
- Retail lending, a departure from conventional advance, offers higher yield, quicker turn, the possibility of less incidence of the account going bad or non performing if it is monitored on an ongoing basis.
- There has been a great heat of competition in selling ideas, products and services under this segment between one bank to the other.

Notes

- Retail lending, a departure from conventional advance, offers higher yield, quicker turn, the possibility of less incidence of the account going bad or non performing if it is monitored on an ongoing basis.
- Corporate banking represents a wide range of banking and financial services provided to domestic and international operations of large local Corporates and local operations of multinational corporations.
- In order to administer a client company's banking business and anticipate further financial needs, you must be informed about its business situation.
- Corporate bonds are often listed on major exchanges (bonds there are called "listed" bonds) and ECNs like Bonds.com and Market Axes, and the coupon (i.e. interest payment) is usually taxable. Sometimes this coupon can be zero with a high redemption value.

3.12 Keywords

A corporate bond: It is a bond issued by a corporation. It is a bond that a corporation issues to raise money in order to expand its business.

Current Account: It means a form of demand deposit wherefrom withdrawals are allowed any number of times depending upon the balance in the account or up to a particular agreed amount and will also include other deposit accounts which are neither Savings Deposit nor Term Deposit.

Demand deposits: It means a deposit received by the bank which is withdrawable on demand.

Notice Deposit: It means term deposit for specific period, but withdrawable on giving at least one complete banking day's notice.

Retail Banking: It refers to the efforts of the bankers to reach up to the customers on both fronts of the balance sheet i.e., Liabilities side as well as Assets side.

Savings deposit: It means a form of demand deposit which is subject to restrictions as to the number of withdrawals as also the amounts of withdrawals permitted by the Bank during any specified period.

Term deposits: It refers to such deposits which are placed with the bank for a definite time period, although the customers are free to withdraw their deposit as per their requirements.

3.13 Review Questions

1. Discuss the operation of opening an account in a bank.
2. Discuss in detail the concept of retail banking.
3. Define the following terms:
   (a) Term loans
   (b) Current account
   (c) Fixed account
   (d) Saving deposit
   (e) Demand deposit
4. Explain the types of loans provided by commercial banks.

Notes

5. Elaborate wholesale banking.
6. Corporate banking represents a wide range of banking and financial services provided to domestic and international operations of large local Corporates and local operations of multinational corporations. Elaborate this statement.
7. Discuss the RBI policies on bank deposit accounts.

Answers: Self Assessment

1.	(a)	2.	(a)
3.	(b)	4.	retail banking
5.	depositor	6.	true
7.	true	8.	false
9.	false	10.	false
11.	(a)	12.	(d)
13.	(c)	14.	(a)
15.	loan officer		

3.14 Further Readings

Books

RBI Annual Report 2005-06.

Social Responsibility of Banks, By Philip J. Jennings.

The Professionals Banker, The ICFAI University Press, Hyderabad.

Online links

www.investopedia.com/terms/w/wholesalebanking.asp

www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=23441.11 Further Readings

www.wisegeek.com/what-is-wholesale-banking.htm

www.tmb.in/doc/sb_rules.pdf

Unit 4: Treasury Management & Banking Sector Reforms

Notes

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4.14 Summary

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Objectives

After studying this unit, you should be able to:

- Understand what is Real Time Gross Settlement and how does it operate
- Define Impact of RTGS operations on the Financial Sector
- Define National Financial Switch as the facilitator of connectivity

Notes

- Define Role of Structured Financial Messaging System-SFMS in financial message communication
- Describe Various terminologies used in Banking Technology

Introduction

Treasury management (or treasury operations) includes management of an enterprise's holdings, with the ultimate goal of maximizing the firm's liquidity and mitigating its operational, financial and reputational risk. Treasury Management includes a firm's collections, disbursements, concentration, investment and funding activities. In larger firms, it may also include trading in bonds, currencies, financial derivatives and the associated financial risk management.

Most larger banks have whole departments devoted to treasury management and supporting their clients' needs in this area. Until recently, larger banks had the stronghold on the provision of treasury management products and services. However, smaller banks are increasingly launching and/or expanding their treasury management functions and offerings, because of the market opportunity afforded by the recent economic environment (with banks of all sizes focusing on the clients they serve best), availability of (recently displaced) highly-seasoned treasury management professionals, access to industry standard, third-party technology providers' products and services tiered according to the needs of smaller clients, and investment in education and other best practices.

4.1 Objectives of Treasury Management

- To exploit potentials in markets which are becoming integrated and consequently volatile.
- To manage funding costs and efficient resource allocation.
- To optimisation of profitability through improving rate of return on portfolio, securities trading and achieving moderate capital gain.
- To controlling and minimizing market and credit risks.
- To use information technology for the entire gamut of activities.
- Comply with the requirements of regulators.
- Adhere to internal policy guidelines on money market and investments.
- To achieve above objectives, individual banks have to have following policies linked to overall business strategies and plans.
- Specific treasury policies and goals.
- Specific guidelines for managing various risks.
- Specific guidelines to build I.T. and analytical capabilities.
- Specify earning targets on ROE & ROA and acceptable risk levels and limits.
- Specify internal structure and decision-making roles.

4.1.1 Organisation Structure

Basic functions of treasury are:

(i) Dealing

(ii) Back; and

(iii) Research and Risk Analysis

Notes

All the three are watertight in their activities. Again these three functional departments have different personnel to man:

(i) Money Market

(ii) Equity

(iii) Forex

The three Functional Offices are called:

(i) Front office

(ii) Back office and

(iii) Middle office respectively

The Front Office - has the exclusive role in market related activity of buying/selling and/ lending/borrowing.

The Back Office - looks after the accounting and settlement of the transactions carried out by the Front Office. It also has the responsibility of having a second look at the prices/rates at which dealers have transacted and how these rates/prices are in relation to market movements.

Research and Risk Analysis Segment Facilities

(i) Scenario evaluations

(ii) Review of counter party limits

(iii) compliance with regulations

(iv) monitoring risk factors

(v) guidance to dealer regarding market movements/developments

4.1.2 Stock Lending

1. Involves transfer of securities/shares for a temporary period in exchange for collateral which may be securities or cash.
2. It does not involve a sale repurchase but only a loan.
3. Though transfer of title and Noting rights takes place. The benefits of ownership including dividend and coupon payments remain with the lender.
4. The borrower is legally bound to pass on any benefits received.
5. Securities taken as collateral are marked to market on a daily basis and value of collateral is required to be maintained.
6. Generally long term investors like insurance companies and pension funds are the lenders in the market.
7. The assets held by such investors with custodial agencies or clearing houses are used for stock lending.
8. This is done by a general or specific permission to lend.
9. The additional income supplements the earnings on such blocked investments.

Did u know? Stock lending does not involve a sale repurchase but only a loan.

Notes

4.2 Functions of Treasury Management

The various functions of domestic treasury are—

(a) Maintenance of CRR/SLR

(b) Deployment of surplus money in S.T. or L.T. instruments - Liquidity Management

(c) Drawls of refinance limits - Liquidity Management

(d) Maximizing returns through trading and retailing in securities -Investment Management

Maintenance of CRR

1. Section 42(1) of the RBI Act empowers the RBI to stipulate ratio to be maintained - presently 4.75% w.e.f. 02.08.2012.
2. Can be any ratio between 3 and 20%.
3. Ratio is required to be maintained on the Demand and Time liabilities of banks excluding inter-bank dealings.
4. Balances with the RBI and also those in currency chests are eligible for computation but not balances with other banks and liquid cash held by individual banks.
5. Required to be maintained on 14 days period on a fortnightly average basis.
6. 70% on daily average basis to be maintained throughout the fortnight.
7. Defaulting banks are not allowed access to refinance/rediscounting facilities.

Maintenance of SLR

1. RBI has authority to stipulate SLR up to 40% of NDTL of banks - presently 23% w.e.f. 02.08.2012.
2. Investments in approved liquid assets are eligible for computation.
3. Required to be maintained on daily basis but amount calculated on the basis of NDTL of second preceding fortnight.
4. Cash held by banks in their safes, other banks and held by them with RBI in excess of CRR requirements are eligible for SLR requirements.

4.3 Liquidity Management

1. Treasury branch/department works out the liquidity requirements on a day to day basis taking into account the likely inflows and outflows which can be as under:

	Inflows	Outflows
(a)	Refinance availed	Refinance repaid
(b)	Currency chest deposits	Currency chest withdrawals
(c)	Net Clearing receipts	Net Clearing payments
(d)	Food Credit repayment	Food credit disbursal
(e)	Remittance received in RBI A/cs	Remittances made out of RBI A/cs
(f)	Call lending's repaid	Call borrowings repaid

Notes

(g) Proceeds of investment sales Investments made

(h) Interest on investments

(i) Other receipts in RBI A/cs Other drawings in RBI A/c

2. Depending on whether the net position needs borrowings or lendings, treasurer has to choose the option from following alternatives:

   (a) Interbank Call money market

   (b) Liquidation of investments

   (c) Repos

   (d) Refinance/Rediscounting Window

3. Call money sources has the following limitations:

   (i) Any indication to market regarding illiquidity - which is indicated when this market is tapped frequently - would increase costs.

   (ii) Since the lenders being competitors, they may not be prepared always to lend.

   (iii) Illiquidity may suddenly emerge in the market due to sudden developments.

4. Liquidity management should be governed by a well laid out policy covering

   (i) Control of cash flows

   (ii) Monitoring of undrawn limits

   (iii) Control of short term borrowing capacity

   (iv) Management of portfolio of liquid assets

   (v) Contingency plan

4.4 Investment Management

Deposits mobilized by banks are required to be deployed either in loans & advances or in investments. While doing this every bank has to take care of credit risk, market risk. The portion of such deposits which are not lent are invested either in SLR securities and non-SLR securities. Since SLR securities are more risk free and there is a compulsion to invest their return is generally low. Non-SLR and SLR security investments are to be shuffled both within and between themselves taking into account the interest rate movements and connected price movements.

Caution Deposits mobilized by banks are required to be deployed either in loans and advances or in investments.

Investments are therefore required to be invested in a professional manner keeping in mind the RBI's and the bank's own policy directives and operative guidelines. Functions of the investment department can be mentioned as:

1. Maintenance of SLR
2. Maximisation of yield on investment
3. Matching maturities of investments with those of deposits and borrowings
4. Prediction of interest rate movements and analysis of their impact on investment portfolio

Notes

5. Managing SLR/Non-SLR investment portfolio for profit maximization
6. Managing investments in capital markets
7. Optimisation of interest costs through repos in case of sudden shortages.

4.5 Specific Procedural Guidelines for Dealing in Some Products

Government Securities

1. While bidding for government securities in primary market, opinion from fellow banks, Primary Dealers is sought.
2. In case of secondary market acquisitions, the market movement in the scrip under consideration is looked into and also likely future price movements.
3. If deal is through broker, the broker empanelment, broker exposure, brokerage are also verified.
4. Since substitution of a counter-party is not permitted, the credit worthiness of the counter party is required to be gone into.
5. Needed authority for investment is required to be obtained.
6. Deal slips-for transactions put through should indicate critical particulars like-price, particulars of securities, date and time of deal, whether sale or purchase, value date, broker's name and brokerage, counter party and whether physical or SGL delivery - are acquired to be incorporated.
7. Back office obtains the confirmation from the counter party.

Shares

1. Deals are done only through approved brokers/NSE members.
2. Deal slip includes details of date and time, name of the share, quantity, purchase or sale, net rate and time of deal.
3. Settlement and delivery of shares transacted takes place as per practice of the concerned stock exchange.
4. Shares identified for investment are:
   (i) from companies with sound track record, promoted by professionals and/or reputed group of businessmen;
   (ii) project is reliable and economic viability;
   (iii) market perception of the industry;
   (iv) product marketability;
   (v) existence or otherwise of an underwriting;
   (vi) price movements for last 52 weeks in case applicable.

Debentures

1. Availability and quality of rating
2. Past record regarding interest payments

Notes

3. ROI and maturity
4. Minimum asset coverage of 1.25 times in case of secured debentures
5. Exposure limits as per the bank's policy

Public Sector Undertaking Bonds

1. Availability and quality of rating
2. Track record and efficiency in management of the issues
3. Since rating wouldn't be available in private placement method, it has to rely only on financial strength
4. Industry profile of issuer's line of business
5. Past track regarding servicing of such bonds
6. Availability of put/call options and their suitability
7. Tax benefits available, if any.

4.6 Relevance of Profitability in a Commercial Bank

Should Banks Earn Profit?

Banking is a service-oriented industry. Similar to a business enterprise, profit is an essential element in banking industry also. Economic surplus (profit) is an indicator of efficient and effective utilisation of resources. Essentially the revenue must exceed expenditure incurred in the process of earning that revenue.

A bank is a financial intermediary engaged in purchasing and selling of funds. It is expected to earn a reasonable return to the savers, supply funds to investors and generate sufficient profit margin for itself after covering cost of services.

Profit provides cushion to the bank to support its credit risk and face the contingencies. Profit is also required by a banking organisation to finance its growth and diversification programmes in future. Since profitability is an index of efficiency of a banking enterprise, a profit-making bank can only infuse confidence in public at large, which is necessary for its survival and growth.

Should Banks Concentrate Only on Social Objectives?

It is usually argued that bank being a socio-economic institution; profit earning should not be the prime consideration. It should primarily focus on fulfilling social obligations and promoting development of the economy. Hence it should channelise its resources and efforts towards social ends.

Pursuit of social obligations will interfere with the pursuit of economic goals to the extent that they prevent the bank from making economically optimal decisions. Acceptance of social responsibility increases the costs and risks of doing business which mean decline in profit (as discussed in chapter on priority sector lending). For meeting social obligations managerial time, talent as well as scarce economic resources is substantially diverted. Thus, what is socially desirable may be economically suicidal.

Notes

Profitability and Social Obligations Must Go Hand In Hand

There is no doubt that social obligations increase cost of operations and hence unfavorably affect profitability of the bank. But in the long run, economic goals and social responsibilities are compatible with each other and they reinforce each other.

Social actions of a bank enhance its image and creditability in the society and thus ensure its existence. Rendering satisfactory services to customers at reasonable price and ensuring them enough safety, security and liquidity helps the bank to acquire (garner) adequate resources comfortably.

The profit making goal of a bank contributes directly and indirectly to social welfare and development. We must appreciate the fact that major social responsibility of a bank is to operate profitably and efficiently utilize the resources at its disposal. Society does not stand to gain if bank's performance suffers.

A commercial bank can serve society and help economy to develop only when it operates successfully. Generation of adequate operational surpluses by banks is also necessary to provide cushion against their credit risks and also to supplement the finances of the Government.

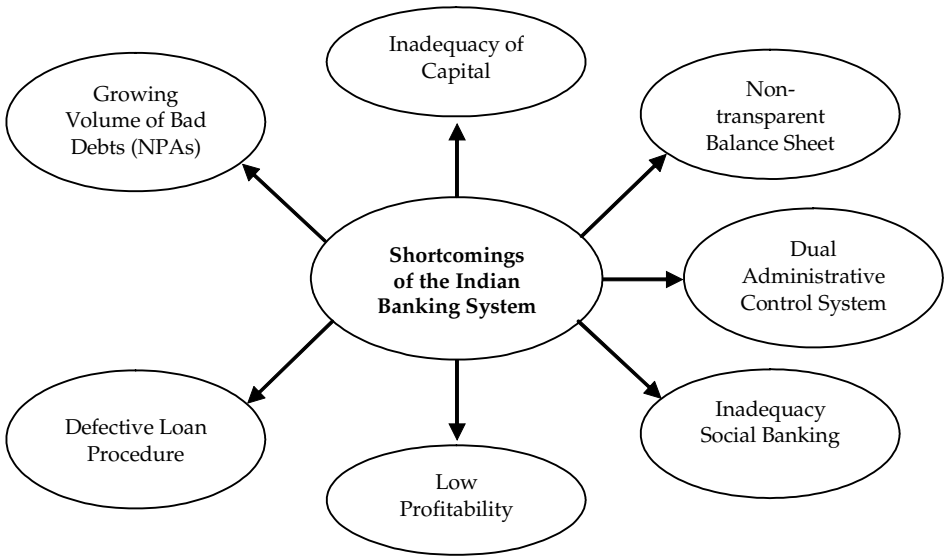
Thus, a bank to survive successfully in the long run has to give due importance to profit as well as social goals. There should be a conscious and deliberate planning of the bank's income, expenditure and overall productivity of human resources.

Notes A commercial bank can serve society and help economy to develop only when it operates successfully.

4.7 Shortcomings of the Indian Banking System

There is no doubt that the Indian commercial banks have made praiseworthy progress during recent decades. However, they still suffering from a number of shortcomings. These are:

Figure 4.1: Shortcomings of Indian Banking System



Notes

1. ***Growing Volume of Bad Debts (NPAs):*** The volume of bad debts of the commercial banks has been rapidly increasing. These bad debts are also called non-performing assets. They include:
   (i) Debts recalled;
   (ii) Suit filed accounts, i.e., where recovery proceedings have been initiated;
   (iii) Debts classified as bad and doubtful; and
   (iv) Decreed debts, that is, where suits have been filed and decrees obtained. Such debts accounted for 1.5 per cent of outstanding bank credit at the end of March 1995.
2. ***Inadequacy of Capital:*** The capital base of the Indian commercial banks was neither uniform nor adequate. There has been no increase in the capital of the 28 public sector banks since nationalisation.
3. ***Non-transparent Balance Sheets:*** Despite necessary audit of banks many banks continue to manipulate their balance sheets by falsely increasing their deposits in the last week of the financial year.
4. ***Defective Loan Procedure:*** Some commercial banks have shown undue favour to certain companies in granting loans and advances, which more often turn into bad debts. Often these loans and advances are made due to political considerations. The extension of letters of credit and guarantees limits without following reliable and authentic commercial procedure has also become a routine affair.
5. ***Low Profitability:*** Irregularities in maintaining accounts, corruption in lending operations, frauds, increasing operating costs, misappropriation, have all led to considerable decline in profitability of commercial banks.
6. ***Inadequate Social Banking:*** Despite of a well-defined policy for priority sector lending, commercial banks have been mainly catering to the needs of the corporate sector.
7. ***Dual Administrative Control System:*** The Indian banking system is at present being administered by two authorities, the Ministry of Finance (MOF) and the Reserve Bank of India (RBI). Consequently, all the investing and lending programmes and appointments of Chief Executives and Directors are determined by orders from higher authorities resulting in delayed decisions.

Self Assessment

Fill in the blanks:

1. _____ taken as collateral are marked to market on a daily basis and value of collateral is required to be maintained.
2. There is no doubt that social obligations increase cost of operations and hence unfavorably affect _____ of the bank.
3. The Indian banking system is at present being administered by two authorities, the _____ (MOF) and the Reserve Bank of India (RBI).
4. Despite necessary audit of banks many banks continue to _____ their balance sheets by falsely increasing their deposits in the last week of the financial year.
5. A _____ can serve society and help economy to develop only when it operates successfully.

Notes

4.8 Factors Contributing to Sharp Decline in Profitability

As stated earlier, profitability is an important index of the performance of an organization. An analysis of the profitability of a bank provides a close insight into its effectiveness in utilisation of funds and its managerial efficiency. But Indian banks have seen sharp decline in profitability during last years.

The factors contributing to this sharp decline in the profitability of the nationalised banks may be classified in two broad groups:

1. ***Factors Contributing to a Decline in the Level of Earnings:*** Among various factors that contributed to decline in level of earnings of the nationalised banks, monetary and credit policies of RBI increased lending to priority and preferred sectors, mounting overdue and incidence of sickness have been the major ones.
   - (i) Liquidity Policies and Credit Policies of RBI
   - (ii) Increased Lending to Priority and Preferred Sectors
   - (iii) Mounting and Overdue repayments of loans advanced
   - (iv) Increased incidence of industrial sickness.
2. ***Factors Contributing to Rise in Operational Costs:*** Among the various factors that contributed to rise in cost of operations of the nationalised banks are:
   - (i) Changes in deposit mix (shift from current accounts to saving deposits) leads to increased interest burden on banks
   - (ii) Rapid expansions of branch Network in rural areas has landed the nationalised banks in considerable loss
   - (iii) Rise in establishment cost i.e., heavy expenditure on acquiring sites for building, furnishing, salaries etc. especially in urban/metropolitan areas where there is intense fierce competition among the banks.

In addition to the above, unwise management of funds and investment portfolio, lack of proper costing of services, absence of appropriate systems and procedures lead to increasing bad and doubtful debts and thereby more legal expenses. This ultimately results in losses of revenue and increasing expenditure.

4.9 Measures Suggested to Improve Profitability of the Banks

The foregoing analysis of profitability and performance of the nationalised banks reveals that our banks are operating today on a thin margin, which is progressively getting thinner. They are not healthy, viable and profitable. Several factors - exogenous and endogenous - have been responsible for the current terrible conditions.

This tendency has to be attacked without loss of time so as to save the giant financial structure from becoming a national liability and facilitate it to serve the national objectives and priorities efficiently. Both macro and micro level efforts will have to be made to render the banking industry workable and profitable. A brief discussion of each of these efforts is presented below:

At the macro level,

1. The RBI should lower down the cash reserve ratio and statutory liquidity ratio so as to increase the lendable funds of the nationalised banks and improve their profitability.

Notes

2. Further, interest rate on government securities, in which substantially large amount of funds of the banks is presently invested, should also be raised.
3. Upward revision should be made in the limit fixed for the rate of interest chargeable by the nationalised banks on the loans granted to medium and large industries and whole trade sectors. This will improve the profitability of the nationalised banks without disturbing the social objectives.
4. The current policy of cross subsidization by the nationalised banks to the weaker sections should be reviewed in the light of the range of beneficiaries and the extent of subsidization enjoyed by various sectors and sub-sectors of the economy and unwarranted subsidization should be minimized.
5. Interest subsidy through the banking system is not the rational way of assisting the priority sectors. There is a need to examine the whole problem of financing the weaker sections objectively.

Recognizing the need for improving the profitability of commercial banks the GOI as well as the RBI undertook several measures.

Measures taken by the Government

1. For banks engaged in operations outside India, deductions are allowed on amounts transferred to special reserves up to 40% of the total income. This relief is, of course, for the notified banks only.
2. The banks, other than those which are notified above, are entitled to deduction for bad and doubtful debts up to 2% of the advances granted from rural branches or 10% of the total income; whichever is higher.
3. Interest tax under the Interest Tax Act has already been totally abolished from March, 31, 1985.
4. Interest rate on Government securities has also been increased.

Caution The RBI's decision to revise banks' investments limit from 1.5% (see latest figures too) of annual incremental deposit to 5% has opened up a new avenue of profitability for the banks. With the raised limit, banks will now be able to avail of the opportunities of investing in privately placed shares and debentures of large and profitable corporate bodies, which are under the financial institutions.

Self Assessment

State whether the following statements are true or false:

6. For banks engaged in operations outside India, deductions are not allowed on amounts transferred to special reserves up to 40% of the total income.
7. Banks should not develop efficient methods of appraisal of the applicants.
8. The RBI's permission to commercial banks to undertake leasing factoring and hire purchase business to get additional business and earnings.
9. The RBI should lower down the cash reserve ratio and statutory liquidity ratio so as to increase the lendable funds of the nationalised banks and improve their profitability.

Notes

4.10 Narasimham Committee Recommendations Regarding Restructuring the Banking System

The Government of India constituted a Committee under the Chairmanship of

Sh. M. Narasimham, former governor, Reserve Bank of India to examine the structure and functioning of the existing financial system of India and suggest suitable reforms.

The Committee submitted its report in 1991. Its recommendations are summarized as follows:

1. Structure of the banking sector should be revamped so as to have three or four large banks.
2. Eight to ten national banks with a network of branches throughout the country should be engaged in 'Universal' banking. Rural banks should confine their operations only to rural areas mainly to finance agriculture and allied activities but their eye should be on profitability.
3. Local banks should operate only in their specific region.
4. Regional rural banks should be permitted to undertake all types of banking business.
5. One or more rural banking subsidiaries should be set up by each public sector bank to take over all its rural branches.
6. The policy of branch licensing should be abolished and individual banks should have the freedom to open or close any branch.
7. Appointment of Chief Executives and Directors of the banks should be depoliticised (without political involvement).
8. Progressive reduction of cash reserve ratio be done.
9. Statutory liquidity ratio should be brought down to 25 per cent over the next five years.
10. The priority sector should be redefined.
11. Interest rates should be deregulated so as to reflect emerging market trends.
12. Banks should adopt uniform accounting practices.
13. Balance sheets of banks should be highly transparent.
14. The commercial banks should achieve a minimum 4 per cent capital adequacy ratio in relation to risk-weighted assets by March 1993.
15. The government should constitute special tribunal for the quick recovery of loans.
16. An Assets Reconstruction Fund should be established to take over from banks and financial institutions a portion of their bad and doubtful debts at a discount.
17. Suggestions were given regarding Regional Rural Banks (RRBs):
    (i) Structure of rural credit will have to combine the local character of the RRBs and other resources like the skills and organizational/managerial abilities of the commercial banks.
    (ii) Each public sector bank should set up one or more rural banking subsidiaries to take over all its rural branches and, where appropriate, swap its rural branches with those of other banks.
    (iii) Such rural banking subsidiaries should be treated on par with RRBs in regard to CAR/SLR requirements and refinance facilities from NABARD and sponsor banks.

Notes

(iv) RRBs should be allowed to engage in all types of banking business, but major focus should continue to be to lend to the target groups.

(v) The move towards this revised system should be market driven and based on profitability considerations.

(vi) A process of mergers and acquisitions will help to attain the above.

(vii) The interest rate structure of the RRBs should be in line with those of the commercial banks.

Did u know? The Government of India constituted a Committee under the Chairmanship of Sh. M. Narasimham, former governor, Reserve Bank of India to examine the structure and functioning of the existing financial system of India and suggest suitable reforms.

4.11 Measures Taken to Improve the Banking System

In pursuance of the recommendations of the Narasimham Committee, the following measures have been taken to reform the Indian banking system.

1. Capital adequacy norms (explained above)
2. Prudential (sound, careful and sensible) accounting norms
3. Recapitalisation (adopting a new capital structure)
4. Recovery of debts
5. Partial privatisation of public sector banks
6. Freedom to open branches
7. Entry of private sector banks in Indian banking sector
8. Department of Supervision (RBI)
9. Banking Ombudsman (independent authority for dispute settlement) Scheme
10. Board for Financial Supervision (RBI)
11. Scheme of disclosure regarding defaulting borrowers
12. Central Board of Bank Frauds
13. Consortium arrangement (Joint financing arrangements)
14. Liberalisation of lending norms
15. Measures to streamline working of banks

Some special Measures:

1. ***Liberal Credit Control Measures:*** Statutory liquidity ratio on incremental net demand and time liabilities has been reduced to 25 per cent (see latest figures also).

   (i) Banks permitted to fix their deposit and lending rates.

   Freedom to invest in corporate shares, debentures and units of mutual funds not exceeding 5 per cent of their incremental deposits (see latest figures too.).

   (ii) Banks can also purchase shares and debentures of companies from the secondary market.

Notes

2. *New Private Banks:* Revised guidelines of RBI (2001)
   (i) The bank should have a minimum paid-up capital of Rs. 200 crore to be raised to Rs. 300 crore within three years of the start of business.
   (ii) The promoters' stake should be 40 per cent.
   (iii) NRI contribution in primary equity not to exceed 40 per cent.
   (iv) The new bank cannot be promoted by any large business house, but individual companies can contribute up to 10 per cent equity.
   (v) NBFCs with AAA rating and 12 per cent capital adequacy can function as a bank.
   (vi) The new bank will have to maintain a capital adequacy ratio of 10 per cent.
   (vii) The total net bank credit 40 per cent will be for priority sector lending.
   (viii) 25 per cent branches of the new bank will be in rural/semi-urban areas.
3. *Entry into Insurance Business:* Any bank fulfilling the above criteria, and with a minimum network of Rs. 500 crore, can undertake insurance business.

   Finally, new ways and methods will have to be determined in order to successfully respond to the new challenges particularly, the growing demands from customers for high quality service". Consequently, the banks will be required to:
   (i) Give better returns on the savings of the depositors
   (ii) Generate greater revenues
   (iii) Create new services for reducing unforeseen risks
   (iv) Improve income-cost ratios and
   (v) Improve profitability and reduce the NPAs

4.12 Principles for the Management of Credit Risk

Credit Risk (or counterparty risk): Credit risk is the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. Financial institutions have faced difficulties over the years for numerous reasons. The major cause of serious banking problems continues to be directly related to lax (faulty) credit standards for borrowers and counter parties, poor portfolio risk management, or a lack of attention to changes in economy.

Banks are increasingly facing credit risk (or counterparty risk) in various financial instruments whether loans, or others including acceptances, interbank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.

Credit Risk Management: Management of credit risk by use of various monetary and non-monetary tools is called credit risk management.

Objectives of Credit Risk Management: Maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters.

4.12.1 How to Perform Credit Risk Management?

Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred.

Notes

1. Banks must manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions.
2. Banks should also consider the relationships between credit risk and other risks.
3. It should be considered as a critical component of a comprehensive approach to risk management.

It is essential to the long-term success of any banking organisation.

The Basel Committee issued this document in order to encourage banking supervisors globally to promote sound practices for managing credit risk (in lending business as well as in any other business also).

Suggested sound practices are as follows:

1. Establishing an appropriate credit risk environment;
2. Operating under a sound credit-granting process;
3. Maintaining an appropriate credit administration, measurement and monitoring process; and
4. Ensuring adequate controls over credit risk.

Although specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management programme will address these four areas. These practices should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk, all of which have been addressed in other recent Basel Committee documents.

The Committee stipulates in Sections II through VI of the paper, principles for banking supervisory authorities to apply in assessing bank's credit risk management systems. In addition, the appendix provides an overview of credit problems commonly seen by supervisors.

4.12.2 Credit Risk Relating to the Process of Settling Financial Transactions (Settlement Risk)

If one side of a transaction is settled but the other fails, a loss may be incurred that is equal to the principal amount of the transaction.

If one party is simply late in settling, then the other party may incur a loss relating to missed investment opportunities. Settlement risk (i.e. the risk that the completion or settlement of a financial transaction will fail to take place as expected) thus includes elements of liquidity, market, operational and reputational risk as well as credit risk.

Thus, the level of risk is determined by the particular arrangements for settlement. Factors in such arrangements that have a bearing on credit risk include: the timing of the exchange of value; payment/settlement finality; and the role of intermediaries and clearing houses.

Notes Narasimham Committee was appointed to examine the effectiveness of the existing financial system of the country and suggest reforms.

Notes

4.13 Results of Implementing the Suggestions/Recommendations Regarding the Structure of the Banking System

A restructuring of the banking system along the lines suggested in above paragraphs may result in the following advantages:

1. Geographical specialisation by zonal banks would lead to compactness of branch network and to better management and control. This would ensure better co-ordination without a diffusion of responsibilities at local levels and ensure better and more intensive efforts at the integrated development of the zone through priority sector lending and by active participation in the implementation of the 20 point programme.
2. As the all India banks would confine themselves to metropolitan cities, urban areas, port towns and free trade zones, where communication services are fairly good, the responsiveness of these banks to the banking needs of the clientele in these areas would improve.
3. Geographical specialisation by banks would automatically lead to their functional specialisation to a large extent. In this process, the utilisation of skilled manpower will be optimized and the quality of customer service will improve.
4. Owing to the built-in elasticity in geographical specialisation by banks, the customers located in different areas will have a choice of two or more categories of banks and a healthy competition within the banking system will prevail.
5. The administrative costs of banks would also be lower because of the geographical coverage of their branch network, and control over branch operations by the respective central managements would more effective.

For the success of the above scheme, a comprehensive review of the legislative enactments applicable to the banking system in India may be undertaken so as to simplify the laws, wherever possible. The loaning programmes of banks for the weaker sections of society would gain further momentum if the legal formalities associated with documentation, creation of a charge on security, recovery, etc., are simplified.

Task Discuss asset management at ABN Amro Bank.

Self Assessment

Fill in the blanks:

10. This is the revised RBI Guidelines for private banks as The bank should have a minimum paid-up capital of Rs. .....crore to be raised to Rs. ..... crore within three years of the start of business.
11. ..... specialisation by banks would automatically lead to their functional specialisation to a large extent. In this process, the utilisation of skilled manpower will be optimized and the quality of customer service will improve.
12. The Committee stipulates in .....through VI of the paper, principles for banking supervisory authorities to apply in assessing bank's credit risk management systems.
13. .....is the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.

Notes

14. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately ..... for risks incurred.

Case Study

Cash Management in a Credit Crisis

by Helen Sanders, Editor

Every treasurer has been forced to review how they manage their cash and liquidity since the crisis first struck. In this case study, we use a real-life example of a global insurance company and explore how treasury has dealt with the changing marketplace.

Cash management background

As an insurance company, the firm has substantial operational cash flow together with fiduciary money owed to insurance carriers. With such high cash balances managed by the company but owed to third parties, the financial and reputational risk of counterparty default is huge. Cash management and short-term investment is a priority for treasury, and principle preservation is the primary investment objective.

With many of the banks experiencing a downgrade in credit rating, treasury is increasingly finding that it needs to spread its bank exposure risk. This is easy to do for short-term investment activity such as deposits, but it becomes more difficult when it comes to cash management. Corporates need to make decisions about the banks they want to work with based on those that are most likely to be around in the future. Like many other firms, the company has needed to focus carefully on where to place the company's cash. Even in situations when a national government has stepped in to support a bank, and not every bank can be bailed out, it could easily take three to four months to retrieve the cash, creating potentially serious liquidity problems, FX risk and a loss of return over this period. A company in this position may have to borrow to cover the liquidity gap or lose out on business investment opportunities.

Short-term investments

Treasury has considered government securities as investment vehicles; however, these are typically only issued in three currencies which normally create the fewest difficulties. It uses money market funds (MMFs) in Latin America, Europe and the United States. It is important to be familiar with the investment portfolio in each fund, so treasury receives regular updates on fund assets and reviews both individual holdings and asset classes to ensure that there is nothing of concern and that decisions comply with internal investment policies.

Challenges remain in Latin America and Asia, where there are fewer repositories for local currencies. Treasury is looking at money market funds in Asia in recognition of the benefits of a diversified, high quality investment product, but this involves seeking regulatory approval to place client money in these funds. The same issues apply to Middle East and Africa, and treasury is working to address these needs as well.

Implementing notional cash pooling

Cash pooling has been a significant way in which the company has leveraged its group cash position both before and during the current crisis. The company has had in-country

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cash pools in place for a number of years across Europe. In the US, treasury has established a daily sweeping structure, allowing for centralised investment activity of US cash balances.

Outside the US, the situation has been more decentralised, with some countries maintaining local autonomy, resulting in external borrowings and trapped cash in-country. One of treasury's objectives is to repatriate funds more effectively and gain greater control over the global cash position. To achieve this, the company has implemented a multi-currency global notional pooling arrangement. An important element of this is the ability to allow self funding, provide cash visibility, and centralise the management of surplus cash. The pool is now functional in 50 countries across 25 currencies. Furthermore, as central banks remove some of their countries' fiscal constraints, further countries may be added in the future in either their functional or non-functional currencies.

This structure was not easy to implement, and initially, business units were worried that they would lose autonomy over their financial management, but these concerns have not been justified. Local finance departments still manage their day-to-day bank relationships and cash management, but have access to cash internally at a known benchmark rate based on a recognised market index, rather than having the uncertainty of trying to borrow externally. Business units which are net investors benefit from market-based overnight returns, and cash remains within their own accounts. As people came to understand the structure more fully, they also recognised the time savings which allowed them to concentrate more on their core business. Treasury uses their bank's system for payments.

For example, a depositor will put in a credit advice for the amount it wishes to deposit, to which an overnight return is applied on receipt by treasury. The system then treats the credit as an overnight rolling deposit and applies interest accordingly. When cash is required, the business unit can make a payment request which is processed by treasury and treated effectively as an overdraft position when the account balance goes negative.

Outcomes of notional cash pooling

This solution has proved very effective. At a local level, business units have reliable income on investments or borrowing rates. Treasury can net intercompany payables and receivables, reducing the number of external transfers and limiting the impact on the balance sheet. When the structure was first implemented, treasury saw a significant decline in external debt, which has since remained steady even though the company has embarked on significant merger and acquisition activities. With the current cost and uncertainty of borrowing, this has had a marked effect on the business, and there has been a considerable change to the debt to capital ratio which would be difficult to refinance in the present conditions.

By implementing this structure, the company's exposure has moved from the external banks (with the exception of the cash pool bank) to the company's internal entities, a risk which it is in a greater position to control. Although in theory there is an exposure to the bank providing the global notional pool, if the bank were to default, there is a set-off clause to other participants so only a net cash position would be at risk. Surplus cash is invested in other money market funds each day to diversify investment risk, so the only risk to the cash pool bank is dealing and settlement risk.

Rationalising bank relationships

Another way in which the company is seeking to manage its cash and liquidity risk more effectively is to limit the number of banking partners with which it works to the highest quality banks. The company has a large number of cash management banks in place,

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Notes

which can be as high as 10-20 banks per country in some places. In the past, treasury has been careful to avoid significant changes to cash management banking in order to minimise disruption to its clients. However, since the downgrading of many banks, treasury now looks at the financial strength of banking partners above all other considerations. Furthermore, the financial crisis has meant that clients have a greater understanding of the reasons why the company might need to change its banks, although there is still some education and preparation for change required.

As the company operates internationally, treasury has had to prioritise its cash management focus, starting with the countries with the largest exposures. The aim is to rationalise its banking partners to a preferred partner or two in each country. In reality, there are very few banks (in some countries, only one or two) with asset bases of a sufficient scale to withstand extreme market conditions.

In a pilot country, for example, treasury has appointed a primary banking partner and a limited number of collection banks for retail activities, which is a model it would like to adopt more widely.

Conclusion

The strategy that the company has deployed, which involves working with fewer, high quality banking providers, and pooling cash in a notional pooling structure, has reduced liquidity risk and increased the security of cash considerably. With credit becoming less readily available and more expensive, particularly at a local level, the ability to conduct self funding has been extremely valuable; similarly, as business units deposit with the notional pool, investments can be made centrally using diversified investment vehicles, increasing security of cash.

Source: Cash Management in a Credit Crisis: http://gftt.com/events/pdf/ctm_new.pdf

4.14 Summary

A commercial bank can serve society and help economy to develop only when it operates successfully. Generation of adequate operational surpluses by banks is necessary to provide cushion to support their credit risks and also to supplement the finances of the government.

Thus, a bank in order to survive successfully in the long run has to give due importance to profit as well as social goals. There should not be problem for a banker to strike satisfactory balance of the two goals if funds are properly managed and there is a conscious and deliberate planning of the bank's income, expenditure and overall productivity of human resources. Thus, profit constitutes the base of growth and contributes to inner strength.

Indian banking sector is having a serious problem of non-performing assets. The earning capacity and profitability of the banks are highly affected due to this.

The level of non-performing assets (NPAs) of the banking system in India has shown a decline in recent years, but it is still too high. Part of the problem is the carry-over of old NPAs in certain declining sectors of industry. The problem has been further complicated by the fact that there are a few banks, which are fundamentally weak and where the potential for return to profitability, without substantial restructuring, is doubtful.

Narasimham Committee was appointed to examine the effectiveness of the existing financial system of the country and suggest reforms.

The fundamental objective behind the capital adequacy calculation and fixing up the related norms is to strengthen the soundness and stability of the banking system.

Notes

4.15 Keywords

Capital-Assets Ratio: Ratio of capital employed to assets.

Credit Risk: Risk of non-recovery of loans.

Insolvency Risk: The risk of insolvency of debtor.

Narasimham Committee: A Special committee appointed by RBI to suggest banking sector reforms.

Shareholder Wealth: Owners' wealth i.e. capital, profits and reserves.

Social Banking: Banking done for social development and advancement of the masses.

Speculation in Shares: Buying and selling of shares in anticipation (rise/fall) in their prices.

4.16 Review Questions

1. Explain the rationale of banking sector reforms.
2. Critically appraise the important banking sector reforms that have been implemented till date.
3. Give a summary of the recommendations of the 2nd Narasimham Committee.
4. Classify NPAs according to their quality. Critically examine the measures taken to reduce such assets.
5. Explain briefly recent trends in the Indian banking system.
6. Explain the main features of Innovative banking in India.
7. What are the principal defects in the Indian banking system? Give suggestions to remove them.

Answers: Self Assessment

1.	Securities	2.	Probability
3.	Ministry of Finance	4.	Manipulate
5.	Commercial bank	6.	False
7.	False	8.	True
9.	True	10.	200/300
11.	Geographical	12.	Section II
13.	Credit risk	14.	compensated

4.17 Further Readings

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Notes

Unit 5: Payment and Settlement System

CONTENTS

Objectives

Introduction

5.1 Payment and Settlement Systems in Banks

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Objectives

After studying this unit, you should be able to:

- Understand the concept of payment system
- Explain the meaning of Clearing House, Clearing Process
- Describe Role of ATMs, Credit/Debit Cards in payment systems
- Explain how the credit card operates and the guidelines of RBI relating to credit card operations
- Explain Operations relating to Electronic Funds Transfer (EFT), Electronic Clearing Service (ECS) MCR Clearing , Core Banking Solutions and their uses
- Explain Meaning of Cheque Truncation and its uses
- Explain Role of Reserve Bank of India in payment systems
- Describe Vision Document of RBI for payment systems- 2005-2008
- Describe an overview of Payment and Settlement System

Introduction

The central bank of any country is usually the driving force in the development of the national payment system. The Reserve Bank of India (RBI) as the central bank of the country has been

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playing this developmental role and has taken several initiatives for a safe, secure, sound and efficient payment system.

A payment system is a mechanism that facilitates transfer of value between a payer and a beneficiary by which the payer discharges the payment obligations to the beneficiary. Payment system enables two-way flow of payments in exchange of goods and services in the economy.

Payment systems include instruments through which payments can be made, rules, regulations and procedures that guide these payments, institutions which facilitate payment mechanisms and legal systems etc. that are established to facilitate transfer of funds between different participants.

5.1 Payment and Settlement Systems in Banks

Payment systems are used by individuals, banks, companies, governments, etc. to make payments to one another. In other words, anybody who has to make a payment to anyone else can use one or the other form of payment system to make such a payment.

Payments can be made in India in the form of cash, cheque, demand drafts, credit cards, debit cards and also by means of giving electronic instructions to the banker who will make such a payment on behalf of his customers. Electronic payments can be made in the form of Electronic Funds Transfer (EFT), Electronic Clearing Service (ECS) for small value repetitive payments and through Real Time Gross Settlement (RTGS) System for large value payments. A few banks in India have begun to offer certain banking services through the Internet that facilitate transfer of funds electronically.

The process of cheque payment starts when a payer gives his personal cheque to the beneficiary. In order to get the actual payment of funds, the receiver of the cheque has to deposit the cheque in his bank account. If the beneficiary has an account in the same bank in the same city then the funds are credited into his account through internal arrangement of the bank. If the beneficiary has an account with any other bank in the same or in any other city, then his banker would ensure that funds are collected from the payer's banker through the means of a clearing house.

Clearing House

A clearing house is an association of banks that facilitates payments through cheque between different bank branches within a city/place. It acts as a central meeting place for bankers to exchange the cheque drawn on one another and claim funds for the same. Such operations are called as clearing operations. Generally one bank is appointed as in-charge of the clearing operations. In the four metros and a few other major cities, the Reserve Bank of India is looking after the operations of the clearing house. Each clearing house has uniform regulations and rules for the conduct of its operations as prescribed by RBI. There are more than a thousand clearing houses operating all over the country facilitating cheque payments. These are managed by the RBI, State Bank of India and other public sector banks.

Clearing Process

Generally, if a cheque is to be paid within the same city (local cheque), it would take 2-3 days. In some large cities, there is a system called High Value Clearing which facilitates completion of cheque clearing cycle on the same day and the customer depositing the cheque is permitted to utilize the proceeds next day morning. However, coverage of this High Value Clearing is very limited and usually available at the branches in the main business area; say Fort and Nariman Point area in Mumbai and Connaught Place in New Delhi.

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In the case of outstation cheques, the time taken would vary from three to ten days. RBI has advised all the banks to publicize their cheque collection policy so that customers have an idea as to when the proceeds would be available for utilization by the customer. For delay beyond the normal period, banks are required to compensate the customer (even without customer asking for the same).

Clearing Charges

The person receiving payment by means of cheques would incur some charges to realise the funds through this bank. In case of local cheques, no charges are levied. In case of outstation cheques, the bank would take some processing/collection charges depending upon the amount of the cheque and the place from where it has to be realised. The charges levied by the banks are generally decided by the Indian Banks' Association or the banks themselves. Banks are also required to publicize the schedule of service charges.

Payments without use of Cheque and Cash

Payments can be made between two or more parties by means of electronic instructions without the use of cheques. Retail payment mechanisms available to facilitate such payments are the Electronic Funds Transfer, Electronic Clearing Service, credit/debit cards etc.

Role of ATMs in Payment and Service Process

In addition to cash withdrawal, ATMs can be used for payment of utility bills, funds transfer between accounts, deposit of cheques and cash into accounts, balance enquiry and several other banking transactions which the bank/s owning the ATMs might want to offer.

ATMs of other banks can also be used by the customer if the customer's bank has an arrangement with the bank owning him ATM. In case of such use, normally a service charge called "interchange fee" is levied on the customer.

5.2 Role of Credit/Debit Cards in Payment Systems

Credit/Debit cards are being widely used in the country as they provide a convenient form of making payments for goods and services without the use of cheques and cash. Banks issue credit cards to their customers. The merchant establishment who accepts credit/debit card payments will claim the amount from the customer's bank through his own bank.

Did u know? In addition to cash withdrawal, ATMs can be used for payment of utility bills, funds transfer between accounts, deposit of cheques and cash into accounts, balance enquiry and several other banking transactions which the bank/s owning the ATMs might want to offer.

Debit Card vs. Credit Card

Debit Card is a direct account access card (amount transacted gets debited immediately). The amount permitted to be transacted in debit card will be to the extent of the amount standing to the credit of the card user's account. On the other hand, a credit card involves provision of credit to the card user which is paid by the card user on receipt of the bill either in full or partially in installments.

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5.3 Credit Card Operations

The working group of Regulatory Mechanism for cards constituted by the Reserve Bank had suggested various regulatory measures aimed at encouraging growth of credit cards in a safe, secure and efficient manner as well as to ensure that the rules, regulations, standards and practices of the card issuing banks are in alignment with best customer practices. Based on the recommendations of the Group as also the feedback received from the members of the public, card issuing banks and others, guidelines on credit card operations have been framed by RBI. All credit card issuing banks/non-banking financial companies (NBFCs) have been advised by RBI to implement these guidelines immediately.

Each bank, Non Banking Financial Companies should have a well documented policy and a Fair Practices Code for credit card operations and should widely disseminate its contents, including through their websites, latest by November 30, 2005.

Issue of Cards

While issuing credit cards, banks/NBFCs should ensure that:

- The credit risk is independently assessed while issuing cards especially to students and others with no independent financial means. Add-on cards should be issued with the clear understanding that the liability will be that of the principal cardholder.
- The maximum credit limit for a credit card holder should be assessed taking into account the limits enjoyed by him/her on credit cards issued by other banks, on the basis of self declaration/credit information.
- The card issuing banks/NBFCs would be solely responsible for fulfilment of all 'know your customer' (KYC) requirements, even where direct selling agents (DSAs)/direct marketing agents (DMAs) or other agents solicit business on their behalf.
- The terms and conditions for issue and usage of the credit card are mentioned in clear and simple language (preferably in English, Hindi and the local language) comprehensible to a card user. The Most Important Terms and Conditions (MITCs) termed as standard set of conditions should be highlighted.

Interest Rates/other Charges

Card issuers should ensure that:

- Bills are promptly dispatched.
- Annualized percentage rates (APR) are quoted on card products (separately for retail purchase and for cash advance, if different) the method of calculation of APR and late payment charges is prominently indicated.
- Any charge that was not explicitly indicated to the credit card holder at the time of issue of the card and getting his/her consent is not levied.
- The terms and conditions for payment of credit card dues, including the minimum payment due, are stipulated so as to ensure that there is no negative amortization.
- Changes in charges (other than interest) are made only with prospective effect giving at least one month's notice.

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Billing

- The card issuing bank/NBFC should ensure that wrong bills are not raised and issued to customer.
- In case, a wrong bill is issued and the customer protests, they should provide an explanation and, if necessary, documentary evidence to the customer within a maximum period of sixty days.
- To obviate frequent complaints of delayed billing, the credit card issuers should consider providing bills and statements of accounts on-line.

Direct Selling Agents (DSAs)

- When outsourcing the various credit card operations, banks/Non Banking Financial Companies (NBFCs) should be extremely careful that the appointment of such service providers does not compromise with the quality of customer service.
- They should ensure that the DSAs maintain confidentiality of the customer's records, respect customer privacy and adhere to fair practices in debt collection. They would be responsible as the principal, for all acts of omission or commissions of their DSAs and recovery agents.

5.4 Customer Rights

Right to Privacy

Credit card issuing banks/NBFCs should ensure that:

- Unsolicited cards are not issued. In case an unsolicited card is issued and activated without the consent of the recipient and he/she is billed for it, the charges are reversed forthwith and also a penalty without demur to the recipient amounting to twice the value of the charges reversed is paid.
- Unsolicited loans or other credit facilities are not offered to credit card customers. In case an unsolicited credit facility is extended without the consent of the recipient and he/she objects to it, the credit limit is withdrawn and a penalty as considered appropriate is paid.
- Credit cards are not upgraded and credit limits enhanced, unilaterally.
- A Do Not Call Registry (DNCR) containing the phone numbers (both cell phones and land phones) of customers as well as non-customers (non-constituents) who have informed them that they do not wish to receive unsolicited calls/SMS for marketing of their credit card products is maintained.
- The intimation for including an individual's telephone number in the DNCR is facilitated through their website or on the basis of a letter received from such a person.
- The list of numbers their DSAs/DMAs as well as call centres intend to call for marketing purposes should be obtained and after referring to the DNCR only those numbers which do not figure in the Registry should be cleared for calling. The bank/NBFC would be held responsible if a Do Not Call Number (DNCN) is called on by its DSAs/DMAs or call centre/s.

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Customer Confidentiality

- The card issuing bank/NBFC should not reveal any information relating to customers obtained at the time of opening the account or issuing the credit card to any other person or organization without obtaining their specific consent, as regards the purpose/s for which the information would be used and the organizations with whom the information would be shared.
- Before reporting default status of a credit card holder to the Credit Information Bureau of India Ltd (CIBL) or any other credit information company authorized by the Reserve Bank, banks/NBFCs should ensure that they adhere to a procedure, duly approved by their Board, including issuing of sufficient notice to such card holder about the intention to report him/her as defaulter to the credit information company.
- The disclosure to the DSAs/recovery agents should be limited to the extent that would enable them to discharge their duties. Personal information provided by the card holder but not required for recovery purposes should not be released.

Debt Collection

- While recovering dues, banks/NBFCs should ensure that they, as also their agents, adhere to the Reserve Bank's instructions of May 2003 on Fair Practices Code for Lenders as well as their own code for collection of dues.
- While appointing third party agencies for debit collection, the card issuers should ensure that such agents observe strict customer confidentiality and refrain from any action that could damage their integrity and reputation. All letters issued by recovery agents must contain the name and address of a responsible senior officer of the card issuing bank whom the customer can contact at his location.
- Banks/NBFCs and their agents should not resort to intimidation or harassment of any kind, either verbal or physical, against any person in their debt collection efforts, including acts intended to humiliate publicly or intrude upon the privacy of the credit card holders' family members, referees and friends, making threatening and anonymous calls or making false and misleading representations.

Grievance Redressal

- Generally, a time limit of sixty days should be given to the customers for referring their complaints/grievances.
- The card issuing banks/NBFCs should constitute an internal grievance redressal machinery and give wide publicity to it through electronic and print media. The grievance redressal procedure and the time frame fixed for responding to complaints should be placed on their website. The name, designation, address and contact number of important executives as well as the grievance redressal officer should also be displayed on their website. A system of acknowledging customers' complaints for follow-up such as complaint number/docket number, even if the complaints are received on phone, should also be devised.
- If a complainant does not get satisfactory response from the bank/NBFC within a maximum period of thirty days from the date of his lodging the complaint, he would have the option to approach the office of the concerned banking ombudsman for redressal of his grievance/s.

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Monitoring

- Banks/NBFCs and their Standing Committee on Customer Service should review on a monthly basis the credit card operations including reports of defaulters to CIBIL and credit card related complaints.
- They should also put up a detailed quarterly analysis of credit card related complaints to their top management.

Self Assessment

Fill in the blanks:

1. ..... include instruments through which payments can be made, rules, regulations and procedures that guide these payments, institutions which facilitate payment mechanisms and legal systems etc. that are established to facilitate transfer of funds between different participants.
2. The central bank of any country is usually the driving force in the ..... of the national payment system.
3. Payments can be made between two or more parties by means of ..... instructions without the use of cheques.
4. The card issuing ..... should constitute an internal grievance redressal machinery and give wide publicity to it through electronic and print media.
5. The process of ..... payment starts when a payer gives his personal cheque to the beneficiary.

Task Discuss the functioning and services of NBFC.

Penalty

The Reserve Bank reserves the right to impose any penalty on a bank/NBFC under the provisions of the Banking Regulation Act, 1949 for violation of any of these guidelines.

Caution Banks/NBFCs and their Standing Committee on Customer Service should review on a monthly basis the credit card operations including reports of defaulters to CIBIL and credit card related complaints.

1. ***Electronic Fund Transfer:*** In absence of the electronic mode of transference of funds from the bank accounts of one customer to another customer as and when such requests emerged, intercity transfer of money of the customers was done by the banks through the medium of demand drafts, mail-transfer and telegraphic transfers. These mediums of transfers had

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their own limitations. In order to facilitate speedy intercity money transfer of funds and ensure effective customer service, the Reserve Bank of India introduced an Electronic Funds transfer mechanism.

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

Scope of Transfer of Funds under EFT

As of now, EFT facility is available for transfer of funds between bank branches in about 15 major cities and towns across the country. Under another special scheme called Special EFT, many more select branches (which are on the computer network of the banks) in over 200 cities have been brought' into the fold of funds transfer electronically. The RBI displays in its website the details of the banks and the cities where EFT facility is available.

Time Duration of Funds Transfer under EFT

Funds transfer normally takes place on the same day or at the most the next working day depending upon the time of requesting/effecting such funds transfers. The customer should confirm this aspect from his bank at the time of requesting the funds transfer.

Benefits of EFT

- EFT is a faster mode of transfer of funds which facilitate transference of funds within 24 hours.
- The system is customer-savvy as no paperwork is involved and delay is witnessed.
- There is absolutely no requirement for the beneficiary to go to the bank since the beneficiary's account is credited automatically.
- In-built security systems ensure safer mode of transference of funds.

Electronic Funds Transfer-Charges

The banks generally charge some processing charges for EFT just as in the case of other services like demand drafts, pay orders, etc. The actual charges depend upon the amount and the banker-customer relationship. However, for the present, the RBI has waived all its charges on EFT that were being recovered from the banks for processing such funds transfer transactions at the clearing houses run by RBI. This has certainly reduced the processing cost for the banks also.

2. ***Electronic Clearing Service (ECS):*** Electronic Clearing Service (ECS) is a retail payment system that can be used to make bulk payments/receipts of a similar nature especially where each individual payment is of a repetitive nature and of relatively smaller amount. This facility is meant for companies and government departments to make/receive large volumes of payments rather than for funds transfers by individuals. The ECS facility is available in 47 centres across India operated by RBI at places where it manages the clearing houses and by SBI and its associates in other centres. The ECS is further divided into two types - ECS (Credit) to make bulk payments to individuals/vendors and ECS (Debit) to receive bulk utility payments from individuals.

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Notes The banks generally charge some processing charges for EFT just as in the case of other services like demand drafts, pay orders, etc.

Electronic Clearing Service - Credit Transfer

Under ECS (Credit) one entity/company would make payments from its bank account to a number of recipients by direct credit to their bank accounts. For instance, companies make use of ECS (Credit) to make periodic dividend/interest payments to their investors.

Similarly, employers like banks, government departments, etc. make monthly salary payments to their employees through ECS (Credit). Payments of repetitive nature to be made to vendors can also be made through this mode. For this purpose, the company or entity making the payment has to have the bank account details of the individual beneficiaries. The payments are affected through a sponsor bank of the company making the payment and such bank has to ensure that there are enough funds in its accounts on the settlement day to offset the total amount for which the payment is being made for that particular settlement. The sponsor bank is generally the bank with whom the company maintains its account.

Electronic Clearing Service - Debit

ECS (Debit) is mostly used by utility companies like telephone companies, electricity companies etc. to receive the bill payments directly from the bank account of their customers.

Instead of making electricity bill payment through cash or by means of cheque, a consumer (individuals as well as companies) can opt to make bill payments directly into the account of the electricity provider/company/board from his own bank account.

For this purpose, the consumer has to give an application to the utility company (provided the company has opted for the ECS (Debit scheme), providing details of bank account from which the monthly/bi-monthly bill amount can be directly deducted. Such details have to be authenticated by the bank of the customer who opts for making payments through this mode.

Once this option is given, the utility company would advise the consumer's bank to debit the bill amount to his account on the due date of the bill and transfer the amount to the company's own account.

This is done by crediting the account of the sponsor bank which again is generally the bank with whom the company receiving the payments maintains the account with. The actual bill would be sent to the consumer as usual at his address as before.

Electronic Clearing Service - Charges

As in the case of EFT, RBI has waived all its processing charges to the banks for the present. The banks, however, are free to charge a fee from their corporate customers for use of this facility.

Remittance of Money by NRI into India

As an NRI, an individual can remit funds into India through normal banking channels using the facilities provided by the overseas bank. Alternately, an NRI can also remit funds through authorised Money Transfer Agents (MTA). Of late, a good number of banks have launched their inward remittance products which facilitate funds transfer in matter of hours.

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Payments Done by the Banks for their own Transactions

Ordinarily, the transactions among banks (not pertaining to customer transactions) would be for large values. Hence, such transactions are called as large-value funds transfers. The actual transfer of funds will take place through the accounts which the banks maintain with the RBI. For this purpose, banks can give cheques drawn on their account maintained with RBI to one another, which will then be processed through the clearing house. Alternatively, they can also make use of large value payment system called as Real Time Gross Settlement System where funds transfer takes place instantaneously, based on electronic instructions just like EFT in the case of individuals and companies.

Did u know? EFT facility is available for transfer of funds between bank branches in about 15 major cities and towns across the country.

3. ***MICR Clearing:*** This is one of the automated clearing systems used by banks. Under this system, specific type of paper is used for printing the cheque. The cheque conforms to required specification as laid down and are having two white bands at the top and another at the bottom. Between these bands, the details of the cheque are encoded with special magnetic ink and that is how it has come to be known as MICR cheques i.e., magnetic ink character recognition cheques. The machine with sophisticated software engaged for the purpose captures the image of the cheque and enables automated clearing function. While the Reserve Bank of India at the start facilitated the function, it has now given the responsibility to undertake MICR on its behalf to leading banks of the country which are capable of demonstrating the clearing function at certain centres.

5.5 Core Banking Solutions or Centralised Banking Solutions (CBS)

The revolution in the field of internet has brought in another banking product at the service of the customer called as Core Banking Solutions or Centralised Banking Solutions wherein the customers can transact business any banking branch of the country which is under the system. Core Banking Solutions is a process that is conducted at a centralized environment, which means that all the information is stored at the central server of the bank which is connected to the branches through net working system. This makes withdrawal of funds or deposit of funds or transaction of business anywhere in the country from a branch connected under CBS possible.

Example: Let us take two branches of XYZ bank one at Bangalore and the other at Guwahati. It is assumed that these branches are connected to the central server through CBS system. In this case, the customer of Guwahati branch can withdraw money from the Bangalore branch without any hassle. Any banking transaction of the Guwahati branch customer can be carried out at Bangalore in one go.

5.5.1 Cheque Truncation

Cheques are here to stay. They are still one of the widely used instruments. The chief reasons for the use of cheque by common masses are that they do not require a computer or debit card at the point of sale.

- Post dating feature capability
- Facility of dual signatures
- Many people still distrust modern electronic modes of payment

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Despite the reasons for the popularity, they are not without problems. The basic problems associated with the cheques are:

- Inherent manual handling process
- High cost for banks
- High courier/transportation costs between parties

It is here that the need for a Cheque Truncation mechanism arises. Cheque Truncation is a system of cheque clearing and settlement between banks based on electronic data/images or both, without physical exchange of instrument.

It may be defined as the replacement of the physical cheque flow with electronic information within all four legs of the clearing cycle (Outward Clearing, Inward Clearing, Outward Returns and Inward Returns).

Key benefits of Cheque Truncation

- Efficient and streamlined processing of images
- Elimination of transportation of physical cheque
- Shorter clearing cycles
- Extended cut off time for cheque submission
- Real time clearing positions available to banks throughout the day
- Economies of scale with centralized National Image Archive
- Automated inward signature verification process
- Fraud prevention measures
- Kiting made difficult
- Black listed accounts flagged
- Built in anti money laundering features Specific Benefits to Customers of the Bank

The bank customers would get their cheques realised faster as T+0 local clearing and T+1 inter-city clearing is possible in Cheque Truncation System (CTS). As straight through processing and automated payment processing are enabled by CTS faster realisation is accompanied by a reduction in costs for the customers and the banks. It is also possible for banks to offer innovative products and services based on CTS. The banks have additional advantage of reduced reconciliation and clearing frauds.

Self Assessment

State whether the following statements are true or false:

6. The ECS is further divided into two types - ECS (Credit) to make bulk payments to individuals/vendors and ECS (Debit) to receive bulk utility payments from individuals.
7. The bank customers would not get their cheques realised as faster as T+0 local clearing and T+1 inter-city clearing is possible in Cheque Truncation System (CTS).
8. The need for a Cheque Truncation mechanism arises. Cheque Truncation is a system of cheque clearing and settlement between banks based on electronic data/images or both, without physical exchange of instrument.

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9. The chief reasons for the use of cheque by common masses are that they do not require a computer or debit card at the point of sale.

10. Ordinarily, the transactions among banks (not pertaining to customer transactions) would be for smaller values.

5.6 Role of RBI in Payment Systems

The RBI, apart from the role of regulator and supervisor of payment systems, also plays the role of a Settlement Bank apart from being a catalyst, an operator and a user. The RBI has been taking initiatives in introducing new modes of more efficient and safe means of effecting payments in the country on a continuous basis. The RBI introduced the system of Magnetic Ink Character Recognition (MICR) based cheque clearing during late 80s for four metropolitan cities (Mumbai, New Delhi, Chennai and Kolkata). During the mid 90s, electronic payment systems like ECS and EFT were introduced. During 2004-05, RTGS was introduced. Besides introducing these newer mechanisms or systems, the RBI has also been constantly ensuring that the existing systems are upgraded/refined to increase their efficiency and to meet the requirements of customers. Taking advantage of advancements in technology, the RBI has brought in additional safety measures in these systems to make them secure and also to maintain the integrity of such transactions.

Besides operating the various components of payments systems, RBI also participates in these systems as a user. RBI acts as a service provider and after the system stabilises, the responsibility is handed over to other banks/institutions for further development. RBI also has the role of regulating and supervising the various payment systems.

RBI as regulator of Payment System: The Board for regulation and supervision of Payment and Settlement Systems (BPSS) is a subcommittee of the Central Board of the RBI and is the highest policy making body on payment system. The Board is assisted by a technical committee called National Payments Council (NPC) with eminent experts in the field as members. The Board as well as the council are assisted by a newly created department—the Department of Payment and settlement Systems (DPSS). The Board has been entrusted with the responsibility to authorize, prescribe policies and set standards for all existing and future payment systems in the country. The Board also has the powers to determine membership criteria to these systems and related policies.

5.7 Payment and Settlement Systems in India - Major developments in the past decade

During the last decade, payment system services offered by banks to the common persons as well as the corporate bodies have improved substantially. It is partly due to increased use of technology in service delivery and partly due to procedural changes necessitated in the wake of competition amongst the banks.

Changes visible are the following:

First, cheque clearing system has vastly improved. Time taken for collecting a local cheque has now reduced to two or three days. It used to take 4 or 5 days earlier. In 42 large cities, automated cheque processing centres have been set up where cheques received by all bank branches in the city are processed at night. Time taken for collection of outstation cheques has also been reduced. Now it takes 4 to 10 days depending on location of the paying centres. It used to take 10 days to one month earlier.

Second, during the 90s, a few variants of electronic payment products were introduced. Electronic Clearing Service (ECS) helped large corporate bodies to pay their dividend, interest and refunds

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electronically on the due date. Not only the investing public could get the payment on the due date, but also the corporates could save substantially by not having to print paper instruments. One can imagine the extent of savings from the fact that 36 million of such transactions were routed through ECS during the year 2005-06. Similarly, the utility bodies are now in a position to collect their bills through ECS right on the due date. Cash flow management is getting easier. There were 16 million such transactions during 2004-05.

Third, extension of electronic funds transfer (EFT) facility by the banks has altered the money transfer scenario. Using the EFT infrastructure laid by the Reserve Bank, commercial banks have started offering same-day funds transfer facility to their customers. Bank customers at 15 major centres can transfer funds to one another using this facility. A variant of EFT called Special-EFT has been designed specially for the networked branches which facilitates funds transfer on the same day within the closed group of computerized and networked branches located anywhere in the country. Banks with Internet banking infrastructure are receiving requests from their customers for EFT and executing the requests in a straight-through manner.

Fourth, launching of Real-Time Gross Settlement (RTGS) system by RBI has added a new dimension to EFT scenario. Corporate bodies and other bank customers have now the option to transfer funds to designated branches (around 9600 at present) instantaneously. According the RTGS operating rules, if the credit cannot be applied, it should be returned within two hours-meaning thereby that the maximum delay can be two hours.

Fifth, there has been a rapid growth in installation of ATMs in the country. Bank customers can now access their accounts for withdrawal of cash, deposit of cash, balance enquiry, requisition of cheque books, issue of stop-instruction etc. on 24X 7 basis. The ATM population is around 16,000 in the country at present and is increasing by a few hundreds each month.

Sixth, In the last three or four years there has been a phenomenal growth in use of payment cards (debit and credit cards) as a payment medium in the country. As at the end of December 2004, there were 4.33 crore payment cards in the country. The increasing use of cards is not only due to the safety and convenience aspect but on account of retail consumer boom which has taken place in the country.

Notes Cheque clearing system has vastly improved. Time taken for collecting a local cheque has now reduced to two or three days.

5.8 Customer Grievances Redressal under Payment System

The customer may approach the bank concerned to redress the complaint. In case of lack of response/satisfactory redressal by the bank, the customer may approach the Grievance Redressal Cell in the local RBI office, if any. The customer may also approach the office of the Banking Ombudsman for redressal of his complaint.

5.9 Payment Systems Vision Document (2009-2012)

I. Introduction

1.1 Safety, security, soundness and efficiency of the payment systems assume critical importance from the angle of systemic stability. Smooth functioning of payment systems becomes vitally important in the light of inter-linkages they have with other financial systems. As indicated in the Report on "interdependencies of payment and settlement systems"

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published by the Committee on Payment and Settlement Systems (CPSS) of the Bank for International Settlements (BIS) in June 2008, smooth functioning of an individual system often depends on smooth functioning of other related systems. The Reserve Bank of India (the Bank) shall continue its initiatives for ensuring smooth operations and proper conduct of the payment systems. It is of prime importance thus, to be assured that the payment and settlement systems in the country are duly authorised and operating within the framework of guidelines applicable to them. The Bank shall also continue to discharge its oversight, regulatory and developmental responsibilities, apart from raising efficiency standards and improving performance benchmarks.

1.2 The Approach to be followed on aspects relating to oversight, safety and efficiency and the various initiatives proposed to be operationalised in the various payment system components and products in the near-to-short-term are detailed in this Vision Document. The Vision Document would guide the payments system-related activities of the Bank and concisely convey the intended direction to realise the Mission Statement components.

1.3 The Mission Statement articulated for payments system objectives of the Bank has six distinct and succinct components that would be integrated to form the universe of scope and premise of action. To briefly elucidate, the components represent -

- *Safety* – Keeping the risks in various payment system products minimum and manageable if they are necessary and unavoidable.
- *Security* – Giving confidence to stakeholders that the payment systems can be trusted and are reasonably protected from threats and vulnerabilities.
- *Soundness* – Demonstrating the capability and ensuring the payment systems function in a non-disruptive manner.
- *Efficiency* – Providing measures to assure that the payment systems are cost-effective, reliable and promote financial and economic stability.
- *Accessibility* – To ensure reach of various payment systems at reasonable cost to various segments of the populace.
- *Authorisation* – Granting entities authorisation to operate payment systems in accordance the provisions of the Payment and Settlement Systems Act and the Regulations framed thereunder.

1.4 The Board for Regulation and Supervision of Payment and Settlement Systems (BPSS), is the apex body for regulation and supervision of payment systems in the country. The vision would be achieved under the overall guidance, direction and supervision of the BPSS.

II. Payments System Initiatives

2.1 Several initiatives taken by the Bank for migration of cash payments to the non- cash mode notwithstanding, use of cash is still substantial. The endeavour to migrate cash mode of payment to the non-cash modes, be it paper or electronic, will continue. There have been consistent efforts to move away from paper-based payments to the safer and more efficient electronic modes of payments.

2.2 Outreach of existing payment system products to cover more geographical areas and more segments of the populace in the country shall continue to be focused upon.

2.3 The Bank continues to play an important role in introducing customer service initiatives. Towards this end, the recent steps taken in various payment system segments include –

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card payments (increasing card security), ATM payments (increasing accessibility to the public, bringing transparency and reasonableness in charges), rationalising charges for electronic payments (NEFT / RTGS) and collection of outstation cheques, mobile payments (issuance of 'Mobile Banking transactions in India - Operative Guidelines for Banks'), prepaid payment instruments (guidelines on 'Issuance and Operation of Pre-paid Payment Instruments in India (Reserve Bank) Directions, 2009'), etc.

2.4 Competition, encouraging alternate methods of accomplishing the payment requirement and facilitating new initiatives of payment system providers to bring in more efficiency in the existing/new payment systems remain the thrust areas.

III. Payments System Oversight

3.1 The guiding principles while pursuing the oversight goal will continue to be objectivity, simplicity and transparency. Streamlining operating instructions, prescribing uniform practices, laying down minimum benchmarks, insisting on adequate redundancies and requiring effective business continuity plans will be vigorously pursued. Focus will be on monitoring implementation of guidelines both in letter and spirit.

3.2 The Payment and Settlement Systems Act, 2007 (the Act) (effective from August 12, 2008) prohibits any entity from commencing or continuing to operate a payment system without the approval of the Bank. The Bank may accord approval to the payment system, based on the need for the proposed activity, the services proposed to be undertaken / offered and the efficiency it will bring to functioning of the payments systems in the country. The Bank, while authorising payment systems, would advise the criteria and prescribe the terms and conditions under which the said systems shall operate.

3.3 It is imperative that payment systems are operated in a safe and efficient manner as well as in the best interests of the public. The Bank shall endeavour to –

- Enhance the security, integrity and resilience of the payment system infrastructure in the country by ushering in new initiatives or necessitating standards through a consultative process and balancing with the suggestions of various stakeholders. The approach will be need-based and appropriately calibrated to reflect rational expectations.
- Comply with the general principles enunciated in the 'Report on Central Bank Oversight of Payment and Settlement Systems' published by the Committee on Payment and Settlement Systems duly taking into account our practices and requirements. The general principles of oversight are (i) transparency, (ii) international standards, (iii) effective powers and capacity, (iv) consistency, and (v) co-operation with other authorities. The Bank would accordingly make public the requirements and the criteria for the various payment systems.
- Adopt the recommendations and principles enunciated by international institutions like the BIS, FATF, etc., while developing or approving systems, issuing operational guidelines or mandating requirements in new or existing payment systems. For the purposes of wider dissemination and transparency, the Bank would be placing on its website the names of entities to whom authorisation to operate payment systems has been approved and the conditions of authorisation subject to which only such entities can operate.
- Put in place appropriate off-site monitoring/surveillance and on-site audits/ inspections/scrutinies to ensure compliance with the laid down prescriptions.

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3.4 These measures are expected to facilitate an orderly growth and functioning of the payment systems thereby instilling confidence among the various stakeholders.

IV. Risk Mitigation

4.1 With increase in reach, size and significance of payment systems the Bank is committed to assuring their safe and efficient functioning by identifying various risks, addressing risk-reduction by putting in place risk-mitigation measures and mandating appropriate risk-management practices.

4.2 The risks in payment systems viz. concentration risk, counter-party risk, credit risk, legal risk, liquidity risk, operational risk, regulatory risk, settlement risk and systemic risk will continue to be addressed by the Bank.

4.3 Towards this end, emphasis will be on advocating –

- Mitigating concentration risk in both large value as also retail payment systems by way of limiting operations of multiple payment systems by a single entity as also one bank acting as settlement bank for multiple payment systems or alternatively putting in place measures for risk mitigation wherever necessary. Important large value payment systems are now being operated by Clearing Corporation of India Limited (CCIL), which also acts as a central counterparty for systemically important payment systems. This calls for very close monitoring of the activities and functioning of CCIL and continuously reviewing the need for an additional/alternate central counterparty operating some of the payment systems with each capable of taking over the operations of the other in case of eventuality. The risk of concentration of settlement in the form of a single central counterparty needs to be carefully looked into. The retail payment systems are operated by various entities, and the focus would be to ensure that there is no concentration of a single bank acting as settlement bank for multiple payment systems. The other issue that needs to be addressed as part of concentration risk is in the outsourcing arrangements entered into by system participants with service providers. Reliance on a single or few service providers gives rise to concentration risk and could emerge as a significant single-point-of-failure. Proper risk mitigation measures in this regard would be pursued in consultation and co-ordination with all the regulatory departments.

- Risk mitigation measures to address operational risk would be by way of (a) using latest and relevant technology, (b) having straight-through-processing interfaces, (c) placing controls in the form of maker-checker practices and building proper audit trails, (d) encouraging vendor-neutral platforms and products, (e) addressing scalability issues by monitoring adequacy of infrastructure and performance, etc.

- Approaches to mitigating counterparty liquidity and settlement risks by regulating access (access criteria, credit ratings, exposure limits, net debit cap, etc.), guaranteed settlement by committed lines of credit, settlement guarantee fund using central counterparty, preventing volatility (margins, haircuts, calling for additional securities, etc.) and secure netting systems.

4.4 With the move towards consolidation of infrastructure and integration of various payment systems, isolating and mitigating operational risk assumes importance. Risk- containment is the plan and as part of this exercise, exacerbation and transmission to other systems will be analysed and prevented both in Bank-operated and others- operated systems. The participants in such systems will also be expected to institutionalise similar practices.

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V. Other Initiatives

5.1 The Bank shall continue its initiatives towards information dissemination, policy and product outreach, co-ordination with other regulators/international/regional bodies, both within the country (SEBI, IRDA, etc.) and abroad (central banks, CPSS, SAARC Payments Council, etc.).

5.2 The Bank will contribute to international oversight and co-operation initiatives as a member of the CPSS, the SAARC Payments Council and such other similar bodies. The Bank shall also encourage and support partnership programs with neighbouring countries and regional institutions for reforms in payment systems in the region.

5.3 The Bank shall publish the Red Book on Payment Systems for India in collaboration with CPSS-BIS.

5.4 The First Report on Oversight of Payment Systems in India was released during the year 2007. The Second Report on Oversight of Payment Systems in India will be brought out.

5.5 A Review of Categorisation of Systemically Important Payment Systems (SIPS) and System-Wide Important Payment Systems (SWIPS) was carried out during 2002. A Review of SIPS and categorisation of SIPS was also carried out by the Committee on Financial Sector Assessment as part of the Financial Sector Assessment Program during 2008-09. It shall be the endeavour to repeat this exercise and bring out a Review of Large-Value Payment Systems in the country as well.

5.6 The various initiatives undertaken would have to be reviewed periodically to ascertain their impact on smooth functioning, taking corrective measures, if required, etc. For the purpose, the following studies are planned to be undertaken –

- Impact of rationalisation of charges on the use of various payment systems.
- Growth in use of prepaid payment instruments consequent upon issuance of guidelines and authorisation of various entities to issue such instruments.
- Bank-group-wise usage of Intra-Day Liquidity for smooth settlement of RTGS transactions.
- Impact of closure of High Value Clearing on MICR Clearing and migration of large-value transactions to electronic mode (RTGS / NEFT).
- Increased usage of cards for making payments and corresponding decline in use of cash for retail transactions.

5.7 As part of the Information System Policy framework, the pre-requisites of a policy for preservation and storage of data/information generated and maintained both in respect of the paper and electronic clearing modes is being finalised in consultation with the Bank's Legal Department. This is expected to ensure uniform practices at various clearing locations in terms of preservation of records and availability thereof.

VI. Action Plan

6.1 With the above agenda in mind, the following action points have been targeted to be achieved in the next one-to-three years' time. The Bank's response would be proactive and to dovetail its initiatives depending on cooperation and support from various stakeholders, expectations of the system, capabilities and preparedness of participants, and developments from time to time.

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6.2 Authorisation of payment systems

6.2.1 Notification of the Payment and Settlement Systems Act, 2007 empowers the Bank to regulate and oversee all payment systems. The existing and proposed payment systems will need to obtain authorisation from the Bank to continue/commence operations. The central bank is expected to lay down operational and technical standards for the functioning of these systems, empowered to issue directions, call for information/returns, revoke authorisation and impose penalties/initiate prosecution proceedings for violations of the Act, the Regulations, the directions issued by it and the terms and conditions of authorisation.

6.2.2 For the purpose the Bank shall –

- Bring all payment systems in operation in the country under its regulatory purview.
- Authorise new payment systems and operators of payment systems only if they add efficiency, increase customer convenience, expand the outreach and bring in improvements to the payment system scope and activities in the country. Assessment will be made vis-a-vis efficiency parameters like need, technology to be used, benefits to the economy, expertise of the operator, financial soundness, composition of management, adherence to corporate governance, compliance with legal/regulatory guidelines, etc.
- Refuse authorisation and revoke authorization of payment systems if the need therefor is not felt or their operations are not satisfactory. This will be done in a transparent manner and in accordance with the provisions of the Act.

6.3 Smooth functioning of existing payment systems

6.3.1 Endeavour will be to ensure that the systems authorised to operate function in a smooth and non-disruptive manner. This would be achieved by –

- Streamlining access criteria prescriptions for all retail and large value payment systems like MICR, ECS/NECS, NEFT and RTGS. The existing access criteria parameters will be constantly reviewed and modified, wherever necessary.
- Ensuring redundancies to handle business continuity requirements. The redundancies in the form of additional/alternate arrangements will address both processing and settlement requirements. Periodic assessment by way of conducting drills, switch-over of the operations/settlements will be carried out and business continuity plans will be documented and suitably modified.
- Putting in place appropriate mechanism for on-site inspections/off-site surveillance.

6.3.2 Banks need to indicate in their Cheque Collection Policies (CCPs) the time frame for collection of local and outstation cheques, apart from other aspects advised to them from time to time. The CCPs need to be widely publicised and also published in the respective banks' websites. The CCPs framed by banks will be made comprehensive in terms of scope, coverage, transparency and dissemination. It will be ensured that banks strictly operate within the meaning and intent of the CCPs especially in regard to time frame for collection, grievance redressal mechanism and penalties for non- conformity.

6.3.3 In addition to the time frame specified for collection of US-Dollar Denominated Instruments, guidelines will be framed and advised for collection of foreign-currency denominated cheques payable in UK and/or locations that have significant volumes.

6.3.4 Charges levied for offering various payment products will be constantly reviewed and appropriate interventions will be considered if the charge-structure is found to be non-transparent or unreasonable.

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6.3.5 The Payment and Settlement Systems Act, 2007 provides legal basis for finality of settlement i.e. it lays down the point of time when the settlement will be deemed final. The Reserve Bank in order to provide operational clarity is in the process of issuing a Settlement Finality Directive.

6.3.6 One of the focus areas would be to ensure optimal operation of clearing entities. Recognising the role played by clearing and settlement facilitating entities such as the CCIL, the Bank would continue to closely monitor and oversee the operations of such entities. Insofar as the activities of CCIL are concerned, the operations have grown manifold and the organisation has been responding well to the changing requirements. Given the criticality of CCIL in the financial stability of the country, it would be necessary to review the shareholding pattern and the management structure to further strengthen efficiency levels so as to result in better confidence among users.

6.4 Infrastructure building and improvement

6.4.1 The Reserve Bank of India will render its views / opinion to National Payments Corporation of India (NPCI) in preparation of its roadmap. NPCI has been set up as an umbrella organisation by the banking community to take over the retail payment system activities in the country. NPCI will be authorized for all the systems set up by it / taken over by it.

6.4.2 Back up arrangements by way of identifying alternate banks to take over processing and settlement operations in the event of non-availability of the main bank would ensure availability of clearing infrastructure during strikes / disruptions. Back up arrangements by way of first / second alternate banks both for processing and settlement of clearing transactions will be operated in all major Clearing Houses in the country. Such arrangements will be put in place at the top 100 Clearing Houses in the country in terms of volumes handled.

6.4.3 Putting in place alternate settlement arrangements in the event of non-availability of RBI as a settlement bank will also be explored.

6.4.4 Single Window Facility will be extended to all member banks that are part of Clearing Houses managed by major banks. This will enable member banks to view balances maintained by them with these banks at different Clearing Houses and also initiate funds transfer requests from / to their own accounts.

6.4.5 Secured Web Site (SWS) facility will be extended to cover all MICR-CPCs. The SWS facility will be used by CPCs / member banks to upload / download clearing data reports. Hard copies of clearing reports by the CPCs will be provided only in exceptional and need-based circumstances.

6.5 Promoting electronic modes of payment

6.5.1 All large-value and time-critical payments will be processed only through the electronic mode.

6.5.2 All bank branches will be enabled with IFSC and MICR codes. The intention is to leave the user with the choice of product for retail and small-value transactions viz. use MICR for NECS and IFSC for NEFT.

6.5.3 Reach of electronic products like RTGS, NEFT and NECS will be extended to cover all the branches of banks, including Regional Rural Banks.

6.5.4 Operating hours of RTGS will be reviewed and considered based on market / user expectations and stakeholder feedback.

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6.5.5 Number of settlements in NEFT will be reviewed and further increased / rationalised depending on analysis of volumes, user requirements and efficiency perspectives.

6.5.6 Efforts would be made to provide positive acknowledgement to the remitter confirming credit to the beneficiary's account for transactions initiated in NEFT. This would give comfort to the remitter and enhance his usage.

6.5.7 Electronic modes of payments have the benefits of safety, speed, efficiency, low cost and audit trails. The Bank will therefore endeavour to facilitate the electronic modes.

6.5.8 Local ECS operating in a number of centres will gradually be subsumed in NECS.

6.5.9 The introduction of Regional ECS (RECS) (introduced in Bangalore) will be explored in centres where the users (payer and payee) are based in the same region.

6.5.10 Further to the initiatives taken to operationalise Indo-Nepal Remittance Facility Scheme (for one-way migrant remittances from India to Nepal), operationalisation of electronic products like NEFT and ECS / NECS in Bhutan will be taken up. In addition, the possibility of extending National Financial Switch (NFS) to cover banks operating in Bhutan will also be actively explored.

6.5.11 The Centralised Funds Management System (CFMS) as it presently exists, facilitates centralised balance viewing of and funds transfer between own accounts of a member bank maintained with the Bank at different locations. It will be examined if CFMS can be enabled to facilitate funds transfer between member banks as well.

6.6 Reducing risks in paper-based clearing

6.6.1 Over a period of time, efficiency has been brought into the paper mode of clearing by way of introduction of MICR processing, computerised settlement, truncating the movement of physical cheques, etc. Operations across all Clearing Houses in the country will be fully computerised. Magnetic Media Based Clearing System (MMBCS) software will be used to computerise processing and settlement operations at all Clearing Houses in the country. All new Clearing Houses will function only on MMBCS mode.

6.6.2 Operationalising MICR-Cheque Processing Centres (MICR-CPCs) will be considered at all locations where it is viable and have a daily volume of 10,000 instruments or more. Such CPCs could be made part of the grid-based CTS. Cheques processed by MICR-CPCs will cover over 95% of volume and value of cheques processed in the country.

6.6.3 Given the various risks associated with paper-based clearing especially for large- value transactions, and the advantages available in the electronic products like NEFT / RTGS, conduct of High Value Clearing will be discontinued at all locations in the country.

6.6.4 Speed Clearing to clear outstation cheques at the centre of presentment will be extended to cover 100 major centres in the country.

6.6.5 The Bank run Inter-City Clearing will be discontinued at all locations.

6.6.6 Cheque Truncation System (CTS) will be rolled out at Chennai. National roll-out of CTS will be considered once this project is operationalised.

6.6.7 The prospect of bringing various Clearing Houses in a region (covering adjacent states) using a Grid-based approach is being examined. Grid-based cheque clearing system to cover nearby MICR-CPCs and Clearing Houses under the Chennai-grid (covering southern states) will be implemented. The New Delhi-grid will also be operationalised by extending the jurisdiction of New Delhi Bankers' Clearing House to cover nearby cities / states.

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Extending the concept of grid-based clearing to cover other regions in the country will be reviewed based on experience gained from the operationalisation and functioning Chennai and New Delhi grids.

6.6.8 Cheque standardisation will be endeavoured which would build more security features to cheques and thus reduce incidence of frauds. Standardisation will also facilitate OCR capture of information contained in the cheques, thereby enabling straight- through-processing and least manual intervention. Cheques with enhanced security features when presented through CTS will provide the level of comfort expected by presenting banks and drawee banks alike.

6.6.9 All cheques in the country, including the cheques used by the Government departments will be completely migrated to the MICR mode. Non-MICR clearing presently operational in a few locations in the country (on a once-per-week basis or otherwise) will be discontinued.

6.6.10 The clearing infrastructure in place at various locations have the advantages of faster clearing cycle, low cost, uniform practices, better dispute resolution and are functioning since long. Bilateral arrangements function outside the clearing infrastructure and do not contribute to the efficiency of the system in all situations. Therefore, all the Bilateral Clearing arrangements between banks would be reviewed and allowed to continue only where necessary.

6.7 New frontiers

6.7.1 There has been an increase in the various new payment systems initiatives / products. Introduction, usage and acceptability of the new on-site and off-site delivery channels viz. Core Banking Solutions (Branch Banking), Computers (Net Banking), Cards (Prepaid Payment Instruments), Mobiles (Mobile Banking), Automated Teller Machines, Points-Of-Sale Terminals, Hand-held Devices, Interactive Voice Response Modes and the like will be carefully monitored, nurtured and actively pursued. Some of these initiatives have been very popular on account of low cost, convenience and high efficiency. The increasing popularity is reflected in their fast increasing customer / user base.

6.7.2 Effectiveness and reach of Business Correspondents (BCs) and various modalities including eligibility criteria, area of operations, appointment of subagents, etc., will be periodically reviewed and streamlined, if necessary, in the interest of increased outreach and expansion of banking services to the rural populace.

6.7.3 Review of the policy on ATMs in terms of increasing the number, criteria for setting up on-site and off-site ATMs, levy of charges, safety of transactions on ATMs, activities permitted to be carried out through ATMs, security features for ensuring the privacy and safety of transactions, resolution of grievances, complaint handling, accessibility of other-bank ATMs, inter-ATM networks, etc., will be closely watched and appropriate measures will be put in place to protect usage and prevent misuse.

VII New Projects / Major Initiatives

7.1 Major projects intended to be pursued would include -

- *Implementing a new and feature rich RTGS system* – The need to migrate to a new version of RTGS that could leverage on advancements in technology, provide for scalability in volumes, parameterise more features in line with similar facilities available in other countries, result in more flexibility in operations, better liquidity saving features, etc., would be pursued.

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- *India MoneyLine* – A 24x7 system for one-to-one funds transfers – The existing NEFT system operates during weekdays from 9 am to 5 pm and on Saturdays from 9 am to 12 noon. The Bank would pursue the suggestion to consider the need to extend NEFT to function on a 24x7 basis or to develop a new system akin to the Faster Payments Service in the UK which operates on a 24x7 basis.
- *India Card* – A domestic card initiative – The concept of a domestic payment card (India Card) and a PoS switch network for issuance and acceptance of payment cards would be looked into. The need for such a system arises from two major considerations (a) the high cost borne by the Indian banks for affiliation with international card associations in the absence of a domestic price setter and (b) the connection with international card associations resulting in the need for routing even domestic transactions, which account for more than 90% of the total, through a switch located outside the country.
- *Redesigning ECS to function as a true Automated Clearing House (ACH) for bulk transactions* – Currently, Local ECS (to facilitate bulk electronic transactions with one-to-many and many-to-one variants) is operational at 76 centres. Centralisation of this process is already underway with the launch of credit variant of NECS at Mumbai (and RECS on a pilot basis). The debit variant is also being planned for implementation. The ECS / NECS solution is internally developed and has been in use since long and the need for building a technology and feature-rich ACH network by totally redesigning the existing ECS to provide end-to-end processing in a straight-through manner would be examined.
- *Mobile payments settlement network* – Mobile phones are expected to emerge as an important channel for transmission of payment instructions. Efficient mobile payments would require real time transfer of funds with adequate security. Currently all inter-bank mobile transfers are payment instructions for settling funds through existing payment systems. This would require building a national infrastructure for facilitating real time mobile payments.
- The India MoneyLine, India Card, ACH and Mobile payments settlement network initiatives would be taken forward in coordination with the NPCI.

Roadmap for Implementation

The time frame for reaching the various milestones is encapsulated below. The aspects which would be attended to on an ongoing basis are indicated under the 'Ongoing' category.

Ongoing

1. Grant of authorization to operate 'payment system' under the Payment and Settlement Systems Act.
2. Publishing the list of entities authorized under the Payment and Settlement Systems Act, 2007.
3. Oversight of payment systems – including issue of directions, guidelines, minimum benchmarks, etc., for operating payment systems.
4. Identifying various risks, addressing risk-reduction by putting in place risk- mitigation measures.
5. Information dissemination, coordination with other regulators / regional bodies, within the country and abroad.

Notes

By June 2010

1. Carrying out review of increased usage of cards and the decline in use of cash for retail transactions.
2. Finalising information system policy framework for storage of data/information – for paper and electronic clearing modes.
3. Framing guidelines for collection of foreign-currency denominated cheques payable in locations that have significant volumes.
4. Guiding/Advising NPCI on the roadmap for various retail payment system development initiatives - 24x7 funds transfer system, redesigned ECS/ACH, etc.
5. Discontinuing High Value clearing at all locations in the country.
6. Review and progressively discontinue bilateral clearing arrangements between banks.

During the year July 2010-June 2011

1. Putting in place appropriate framework for off-site monitoring/surveillance and on-site audits/inspections/scrutinies to ensure compliance with the laid down prescriptions.
2. Publishing the Red Book on Payment Systems in India in collaboration with the Committee on Payment and Settlement Systems, BIS.
3. Reviewing and categorising the Systemically Important Payment Systems (SIPS) and System-Wide Important Payment Systems (SWIPS).
4. *Reviewing*
   (a) Impact of rationalization of charges on the use of various payment systems
   (b) Growth in the use of prepaid payment instruments
   (c) Bank group-wise usage of IDL
   (d) Impact of closure of High Value clearing on MICR clearing and electronic mode.
5. Monitoring of the activities of CCIL including reviewing the shareholding pattern and management.
6. Putting in place a BCP arrangement for top 100 clearing houses in the country. Also, considering alternate settlement arrangements in the event of non- availability of RBI as settlement bank.
7. Enabling Single Window facility for all member banks that are part of the clearing houses managed by major banks for viewing and transfer of funds from / to their own accounts.
8. Extending the facility of Secured Web Site to cover all MICR-CPCs.
9. Taking steps for migrating all large value and time critical payments to the electronic mode.
10. Enabling all bank branches in the country with IFSC and MICR codes.
11. Reviewing number of settlements in NEFT based on volume / requirement / efficiency.
12. Providing confirmation to the remitter on credit to beneficiary account in NEFT transactions.
13. Commencement of various Government payments through electronic modes in coordination with Central / State Governments.

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14. Operationalising NEFT and ECS / NECS in Bhutan. Examining the feasibility of extending NFS to cover banks operating in Bhutan.
15. Examining inter-bank funds transfer using CFMS.
16. Implementing grid-based clearing.
17. Strengthening and standardising security features on cheques to enable straight- through-processing.

During the year July 2011-June 2012

1. Extending electronic payment products to cover all branches of banks, including RRBs.
2. Facilitating government transactions through RTGS / NEFT for RBI-based payments / receipts.
3. Enabling NECS coverage to all core-banking branches in the country. NECS (Debit) operationalisation to be separately pursued.
4. Exploring implementation of RECS (Debit) in a few locations.
5. Migrating all cheques in the country to the new MICR standards.
6. Encouraging NPCI to start India Card, PoS Switch and Mobile Payments Settlement Network.

Abbreviations used in the Document

- ATM Automated Teller Machines
- BCs Business Correspondents
- BIS Bank for International Settlements
- BPSS Board for Regulation and Supervision of Payment and Settlement Systems
- CCIL Clearing Corporation of India Limited
- CCPs Cheque Collection Policies
- CenECS Centralised ECS
- CFMS Centralised Funds Management System
- CPCs Cheque Processing Centres
- CPSS Committee on Payment and Settlement Systems
- CTS Cheque Truncation System
- ECS Electronic Clearing Service
- FATF Financial Action Task Force
- IFSC Indian Financial System Code
- IRDA Insurance Regulatory and Development Authority
- MICR Magnetic Ink Character Recognition
- MMBCS Magnetic Media Based Clearing System
- NECS National Electronic Clearing Service

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- NEFT National Electronic Funds Transfer
- NFS National Financial Switch
- NPCI National Payments Corporation of India
- RECS Regional ECS
- RTGS Real Time Gross Settlement

Self Assessment

Fill in the blanks:

11. While launching of Real-Time Gross settlement (RTGS) system by ..... has added a new dimension to EFT scenario.
12. The RBI, apart from the role of regulator and supervisor of payment systems, also plays the role of a Settlement Bank apart from being a ....., an operator and a user.
13. The ..... for regulation and supervision of Payment and Settlement Systems (BPSS) is a subcommittee of the Central Board of the RBI and is the highest policy making body on payment system.
14. During the mid ....., electronic payment systems like ECS and EFT were introduced.
15. It is here that the need for a ..... Truncation mechanism arises.
16. Cheque ..... is a system of cheque clearing and settlement between banks based on electronic data/images or both, without physical exchange of instrument.

Notes The more frequently affirm must refinance debt, the greater is the risk of its not being able to obtain the necessary financing.

Task Discuss the latest vision document for payment system.

Case Study

HSBC

HSBC was a founder member of the Faster Payments Service. Rather than regarding it as a compliance issue, the bank embraced the real-time technology as a way of introducing new and improved services to their customers and unlocking new revenue opportunities.

The challenge

This project provided a significant challenge for the industry and for some it has acted as a catalyst to modernise business processes and back-office procedures in order to support the real-time model. For others, like HSBC, where this process was already underway, it provided the opportunity to complement their existing technology and investment with an advanced payment mechanism.

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The challenge for HSBC was to implement this real-time technology, in an efficient manner, with a strong focus on how the service would be utilised by both the retail and corporate customer base. This foresight enabled HSBC to provide a seamless transition for their customers, whilst delivering a strong foundation, which allows for further development of compelling value propositions.

HSBC's current personal customer offering is to provide free Faster Payments at the point of delivery, which does not provide an area where additional revenues could be easily achieved. However, it has delivered benefits in the form of improved customer loyalty, retention and recruitment. For the corporate market, HSBC quickly realised the opportunities that the Faster Payments Service presents.

"We are delighted to have seized the commercial advantages of Faster Payments early. From the outset we regarded this as a technical project with tangible business benefits".

The benefits

The HSBC proposition for the Faster Payments Service embraced the benefits for retail and corporate customers. HSBC envisaged that retail customers would welcome the speed, certainty and convenience of Faster Payments, which can be effected on-line, by telephone or through the branch network. HSBC is one of a few participants in the Faster Payments Service to offer confirmation of when the beneficiary will receive the payment. This feature provides certainty and transparency for retail customers. It was also vital that the new service was introduced with minimal service disruption to customers and strong internal controls were implemented to mitigate risk.

HSBC focussed on areas within the corporate sector where Faster Payments can deliver immediate value, this focuses on two different payment options. Firstly, where businesses have an urgent need to pay their customers quickly and with confidence, they are prepared to pay a premium to send the payments via the Faster Payments Service.

Low-cost, immediate payments also contribute to businesses and individuals managing their cash better. Retail customers can potentially make payments later, in the knowledge that beneficiaries will receive cleared funds within two hours. New payments have been attracted to the Faster Payments Service, from other non-premium payment channels.

HSBC's obvious commitment to the service helps drive the universality of the service– firstly through their competitive customer proposition, which encourages other financial institutions to follow suit, which in turn which makes the HSBC offering more consistent to all. Further, HSBC is already driving revenue through enabling agency banks to access the Faster Payments Service, effectively creating a virtuous circle of investment for HSBC.

Secondly, HSBC has focussed on receivables propositions, which provide value to corporate clients, through focussing on the presentation and reconciliation of data supplied to their customers. Delivering itemised data in near real time or fast batch is the current offering, this provides clear opportunities for customers to integrate their current reconciliation processes to improve cash flow management and provide more flexible services to their own customers.

Future Roadmap

HSBC has identified several areas that have the potential to deliver further value to both corporate and retail customers. Some of the key areas for future development include:

- An increase in the cap limits, from £10,000 with the goal of achieving £100,000 within the medium term

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- The Faster Payments Service platform has multicurrency capability and while this has not been enabled there are likely to be benefits for customers
- There is a strong potential for the Faster Payments Service to play a pivotal role in cheque replacement. In particular, mobile Faster Payments could provide a suitable offering for person-to-person payments and person-to-business payments. Developments are likely to occur over the next few years.
- The further identification of retail and corporate customers paying behaviour can provide additional benefits in the delivery of customer centric value propositions, with the payment method at the core of each real-time transaction.

Operation and Risk Management

As with any project of this magnitude there was always the possibility of teething problems. During the first few months of launch, fraudulent attacks were a concern, as online banking controls were probed by fraudsters as is usual with new products/services. However, processes and controls were introduced to mitigate these risks, and these have been refined when needed to deal with changes in fraudulent activity. HSBC has had very few complaints about the Faster Payments Service, and of these, most complaints were raised when a customer found that the Faster Payments Service could not reach a particular destination. As the service achieves near universality, these concerns are reducing fast.

The Outcome

Whilst the implementation of the Faster Payments Service has been embraced extremely positively, there is still further work for the industry. HSBC has embraced the service since launch and is adopting a strategic approach which delivers a compelling roadmap to drive customer value propositions. This creates a competitive advantage by improving retail customer service and driving revenue from a receptive corporate and institutional community. HSBC has capitalised on the opportunity presented by the Faster Payments Service and recognises that payback will be achieved in a reasonable time.

Source: http://www.pwc.com/en_GX/gx/banking-capital-markets/transaction-banking-compass/pdf/tomorrow-happened-yesterday.pdf

5.10 Summary

- Payments can be made in India in the form of cash, cheque, demand drafts, credit cards, debit cards and also by means of giving electronic instructions to the banker who will make such a payment on behalf of his customers.
- In the four metros and a few other major cities, the Reserve Bank of India is looking after the operations of the clearing house. Each clearing house has uniform regulations and rules for the conduct of its operations as prescribed by RBI.
- In case, a wrong bill is issued and the customer protests, they should provide an explanation and, if necessary, documentary evidence to the customer within a maximum period of sixty days.
- Credit/Debit cards are being widely used in the country as they provide a convenient form of making payments for goods and services without the use of cheques and cash
- In the last three or four years there has been a phenomenal growth in use of payment cards (debit and credit cards) as a payment medium in the country. As at the end of December 2004, there were 4.33 crore payment cards in the country.

Notes

- Generally, a time limit of sixty days should be given to the customers for referring their complaints/grievances.
- Banks/NBFCs and their Standing Committee on Customer Service should review on a monthly basis the credit card operations including reports of defaulters to CIBIL and credit card related complaints.

5. 11 Keywords

Core Banking Solutions or Centralised Banking Solutions: wherein the customers can transact business any banking branch of the country which is under the system.

Credit Card : credit card involves provision of credit to the card user which is paid by the card user on receipt of the bill either in full or partially in instalments.

Debit Card: Debit Card is a direct account access card (amount transacted gets debited immediately).

Electronic Funds Transfer (EFT): Electronic Funds Transfer (EFT) is a system whereby anyone who wants to make payment to another person/company etc. can approach his bank and make cash payment or give instructions/authorization to transfer funds directly from his own account to the bank account of the receiver/beneficiary.

MICR Clearing: Under this system, specific type of paper is used for printing the cheque. The cheque conforms to required specification as laid down and are having two white bands at the top and another at the bottom.

Payment System: A payment system is a mechanism that facilitates transfer of value between a payer and a beneficiary by which the payer discharges the payment obligations to the beneficiary.

5.12 Review Questions

1. Discuss the payment and settlement system in banks.
2. Differentiate between debit card and credit card.
3. Explain Customer Grievances Redressal under Payment System.
4. Describe the major developments in payment and clearing system of India.
5. Define clearing house and its working.
6. Define the terms:
   (a) MICR clearing
   (b) cheque truncation
7. What do you mean by direct selling agents?
8. Discuss the credit card operations.

Answers: Self Assessment

1.	Payment systems	2.	Development
3.	Electronic	4.	Banks/NBFCs
5.	Cheque	6.	True

Notes

7.	False	8.	True
9.	True	10.	False
11.	RBI	12.	Catalyst
13.	Board	14.	90s
15.	Cheque	16.	Truncation

5.13 Further Readings

Books

RBI Annual Report 2005-06.

Social Responsibility of Banks, By Philip J. Jennings.

The Professionals Banker, The ICFAI University Press, Hyderabad.

Online links

en.wikipedia.org/wiki/Debit_card

kalyan-city.blogspot.com/2011/07/electronic-funds-transfer-eft.html

www.hdfcbank.com/personal/making_payments/making.../gts8mitl

www.osscard.com/.../OSS%20Card%20CustomersGrievanceRedressal...

Unit 6: New Age Clearing and New Age Payment

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Objectives

After studying this unit, you should be able to:

- Understand What is Real Time Gross Settlement and how does it operate?
- Explain Impact of RTGS operations on the Financial Sector
- Explain National Financial Switch as the facilitator of connectivity
- Identify Role of Structured Financial Messaging System-SFMS in financial message communication
- Describe Various terminologies used in Banking Technology

Introduction

Real Time Gross Settlement Systems (RTGS) are funds transfer systems where transfer of money or securities takes place from one bank to another on a "real time" and on "gross" basis. Settlement in "real time" means payment transaction is not subjected to any waiting period. The transactions are settled as soon as they are processed. "Gross settlement" means the transaction is settled on one to one basis without bunching or netting with any other transaction. Once processed, payments are final and irrevocable.

6.1 Real Time Gross Settlement Systems (RTGS)

The acronym "RTGS" stands for Real Time Gross Settlement. RTGS system is a funds transfer mechanism where transfer of money takes place from one bank to another on a "real time" and

Notes

on "gross" basis. This is the fastest possible money transfer system through the banking channel. Settlement in "real time" means payment transaction is not subjected to any waiting period. The transactions are settled as soon as they are processed. "Gross settlement" means the transaction is settled on one to one basis without bunching with any other transaction. Considering that money transfer takes place in the books of the Reserve Bank of India, the payment is taken as final and irrevocable.

6.2 RTGS vs Electronic Fund Transfer System (EFT) or National Electronics Funds Transfer System (NEFT)

EFT and NEFT are electronic fund transfer modes that operate on a Deferred Net Settlement (DNS) basis which settles transactions in batches. In DNS, the settlement takes place at a particular point of time. All transactions are held up till that time.

Example: NEFT settlement takes place 6 times a day during the week days (9.30 am, 10.30 am, 12.00 noon, 1.00 p.m, 3.00 p.m and 4.00 p.m) and three times during Saturdays (9.30 am, 10.30 am and 12.00 noon). Any transaction initiated after a designated settlement time would have to wait till the next designated settlement time.

Contrary to this, in RTGS, transactions are processed continuously throughout the RTGS business hours.

RTGS Transactions

The RTGS system is primarily for large value transactions. The minimum amount to be remitted through RTGS is Rs.1 lakh. There is no upper ceiling for RTGS transactions. No minimum or maximum stipulation has been fixed for EFT and NEFT transactions.

Time Consumed for Funds Transfer under RTGS

Under normal circumstances, the beneficiary branches are expected to receive the funds in real time as soon as funds are transferred by the remitting bank. The beneficiary bank has to credit the beneficiary's account within two hours of receiving the funds transfer message.

Acknowledgement of Funds Transfer

The remitting bank receives a message from the Reserve Bank that money has been credited to the receiving bank. Based on this the remitting bank can advise the remitting customer that money has been delivered to the receiving bank.

Refund of Money in Case of non-credit to the Beneficiary

It is expected that the receiving bank will credit the account of the beneficiary instantly. If the money cannot be credited for any reason, the receiving bank would have to return the money to the remitting bank within lacking of Remittance Transaction under RTGS by the Remitter.

It would depend on the arrangement between the remitting customer and the remitting bank. Some banks with internet banking facility provide this service. Once the funds are credited to the account of the beneficiary bank, the remitting customer gets a confirmation from his bank either by an e-mail or by a short message on the mobile.

Notes

Notes No minimum or maximum stipulation has been fixed for EFT and NEFT transactions.

Advantage for Companies

Apart from cutting down on paper work, big companies are expected to save over Rs. 2,000 per

Rs. 1 crore worth of transactions using RTGS. It reduces the risk of country party default and boosts investor confidence, apart from helping companies manage their working capital requirements more effectively. In short, it allows companies to collect funds from customers and move money to and from plant site faster, thereby helping the bottom-line.

Advantage for Investors

The RTGS network, with its main hub at the Reserve Bank of India headquarters in Mumbai, will enable settlement of stock market deals the next day, instead of the current two days, which, it is hoped, will boost trading volumes. The decision to implement RTGS promoted the largest pension fund in US, Calpers to add India as an investment decision in April '04.

Caution Apart from cutting down on paper work, big companies are expected to save over Rs. 2,000 per Rs. 1 crore worth of transactions using RTGS.

Did u know? The RTGS network, has its main hub at the Reserve Bank of India headquarters in Mumbai.

Self Assessment

Fill in the blanks:

1. The ..... bank receives a message from the Reserve Bank that money has been credited to the receiving bank.
2. The ..... system is primarily for large value transactions.
3. ..... are electronic fund transfer modes that operate on a deferred net settlement (DNS) basis which settles transactions in batches.
4. Once the ..... are credited to the account of the beneficiary bank, the remitting customer gets a confirmation from his bank either by an e-mail or by a short message on the mobile.
5. The acronym "RTGS" stands for .....

6.3 RTGS Operations-impact on the Financial Sector

The RTGS system has brought about some significant benefits to the Indian financial system. Apart from enhancing the stability of the financial system, it has improved the efficiency of the system in terms of efficient cash management by banks, immediate transfer to the customer's account and reduction in transactions cost.

Notes

In the pre-RTGS regime, banks settled their inter-bank obligations by issue of paper based instrument which used to be cleared in a net clearing system called 'inter-bank clearing'. Efficiency of the inter bank clearing was highly dependent on efficient transportation of paper instrument and use of a good number of staff either to collect or to hand over the instruments. Fragmented inter-bank clearing settlement taking place at different centres in the country also interfered with efficient cash management systems in banks and placed an additional burden of pooling of funds at a centralized account.

The RTGS system ensures settlement finality in the books of the Reserve Bank on a real time basis, thereby providing confidence to the sending bank as well as the receiving bank that the payment transaction has been completed and the receiving bank can make use of the funds so received immediately. The RTGS also altered the scenario by providing a platform of settling all inter-bank transactions at Mumbai. The time window for settling inter-bank transactions has also been widened from the earlier position of within the banking hours to the RTGS operating hours of 9.00 am to 5.00 p.m on week days and 9 am to 2.30 p.m on Saturday.

The RTGS system is also used for customer transactions. No minimum or maximum limit has been fixed on such transactions so far. Technically, time critical transactions of smaller value can also be routed through the RTGS. In terms of RTGS operating guidelines, the receiving banks are required to apply credit to the customers account as quickly as possible or return the transactions within two hours, if the credit cannot be applied for some reason. Thus, banks are supposed to credit the beneficiary's account within two hours.

Utilizing this RTGS infrastructure, a good number of banks have developed payment products for their customers. Customers of Internet-enabled banks making requests for funds transfer through the Internet within the RTGS hours can find the beneficiary's account credited within a few minutes if the receiving banks have also built straight through processing engines at their end. One bank has developed a product which facilitates remittance of funds from Gulf countries in a straight through processing mode from end to end, facilitating credit to customers' accounts within two hours.

National Financial Switch

The RBI's Institute of Development and Research in Banking Technology, Hyderabad has set up a National Financial Switch that would enable sharing common technology infrastructure. NFS would serve as a main common switch and facilitate connectivity as an e-Commerce payment gateway both for Internet, ATM and mobile commerce thereby helping in authenticating and providing route payment details between banks and various parties.

The National Inter Bank Payment Gateway Project will function as an integrated payment service system between the parties concerned. Some of the major benefits of the new system include:

- 24 × 7 × 365 convenience.
- Real time authorization of credit/debit cards.
- Rapid, efficient transaction processing.
- Secure flow of transaction details among buyers, sellers and financial institutions.
- Flexible, powerful real time reports generation.
- Multi-currency settlements.

Notes

- Provision for multiple interfaces.
- Ability to provide value added services to business community.
- Access to card hot list to filer out fraudulent deals.

The payment gateway will provide a mechanism to manage both volumes based as well as value based transactions at both micro and macro levels. Various banks in India, handling a multitude of payment instruments will share it.

Structured Financial Messaging Solution (SFMS)

Structured Financial Messaging Solution is a modularized web enabled software for financial message communication. This is a flexible architecture that facilitates centralized or distributed deployment, secured messaging and routing based on store and forward principles.

The Institute for Development and Research in Banking Technology (IDRBT), Hyderabad, an autonomous centre for development and research in Banking established by the Reserve Bank of India in 1996, aims at providing Indian Financial Network (INFINET) as a reliable communication backbone for National Payments System catering to inter-bank applications like RTGS, government transactions.

Advantages

- SFMs facilitates faster intra/inter-bank communications.
- SFMs for all practical purposes enables reliable communication.
- It is a secured messaging system where file transfer is possible from one end to the other end.

Messages

Messages sent through the mode of SFMS by the bankers may relate to any or all the following areas:

- Customer Payments and Cheques
- Financial Institution Transfers
- Treasury Markets, Foreign Exchange, Money Market, Derivatives
- Collections and cash letters
- Securities Market
- Precious Metals and Syndications
- Documentary credits and Derivatives
- Travellers Cheques
- Cash Management and customer status
- Common Group Messages

Notes

Notes The Institute for Development and Research in Banking Technology (IDRBT), Hyderabad, an autonomous centre for development and research in Banking established by the Reserve Bank of India in 1996, aims at providing Indian Financial Network (INFINET) as a reliable communication backbone for National Payments System catering to inter-bank applications like RTGS, government transactions.

6.4 Delivery Notification, Message Query and Viewing Facilities

SFMS system provides for delivery notification in respect of

- every user message
- Inter-Bank Messages
- Intra-Bank Messages
- Inquiry regarding the status of a message
- Query of Archived Messages

Report Generation

The following report generation facility is enabled in SFMS:

- Delivery Reports
- Message History
- Message Traffic Report
- User Profile Report

Entities in SFMS

- Hub
- Gateway
- Branch Servers
- Thin or Thick Clients

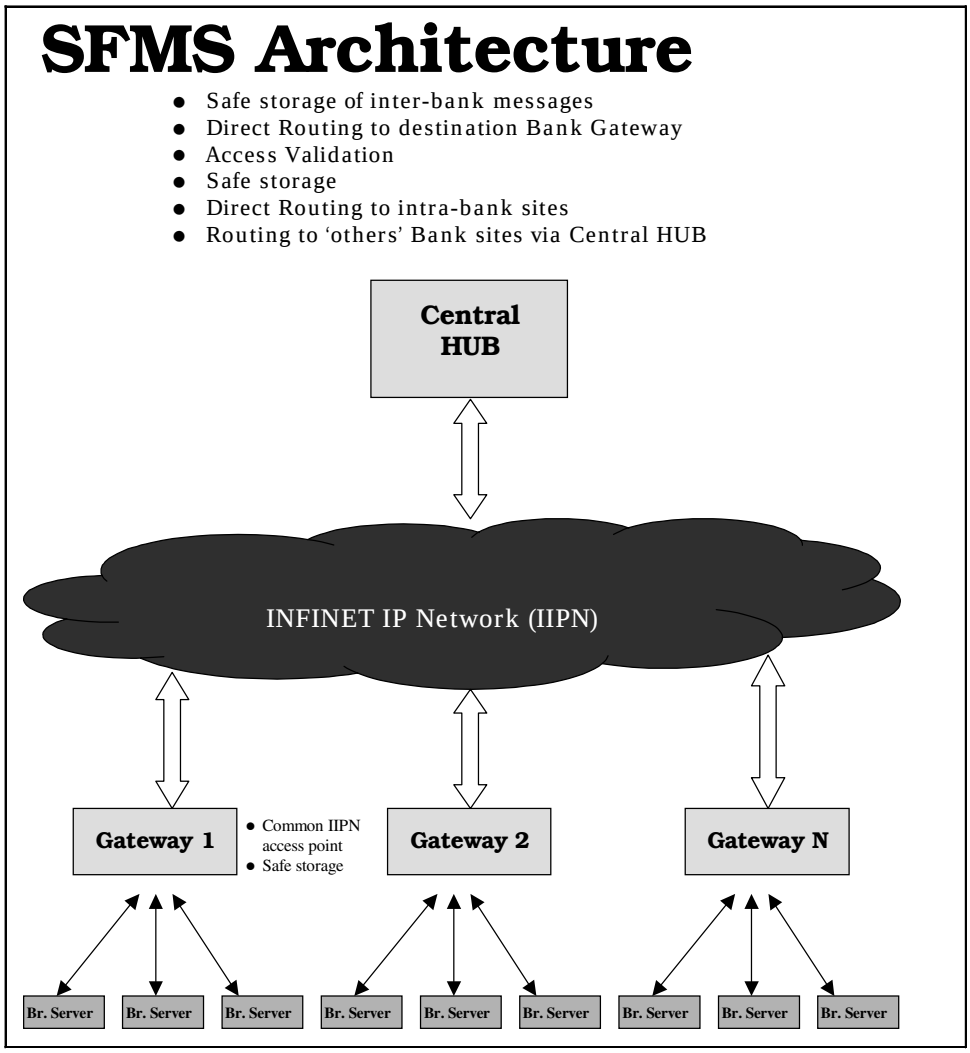
Privacy and Confidentiality

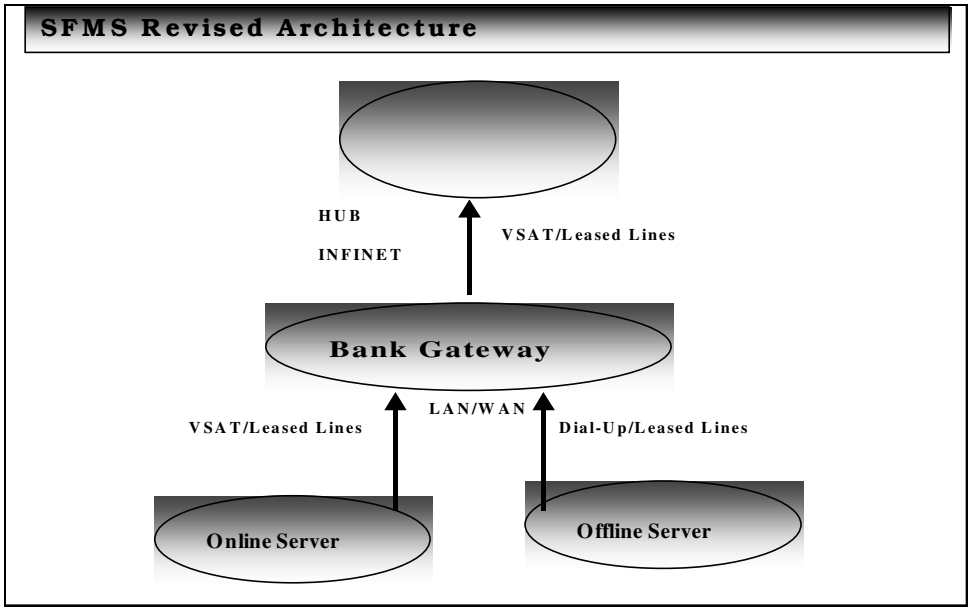
- Sender encrypts the message
- Receiver decrypts the message
- Nobody other than the sender and receiver will be able to understand the message
- Provides evidence of genuineness of the sender
- Identity of the sender is established

Integrity and Non-Repudiation

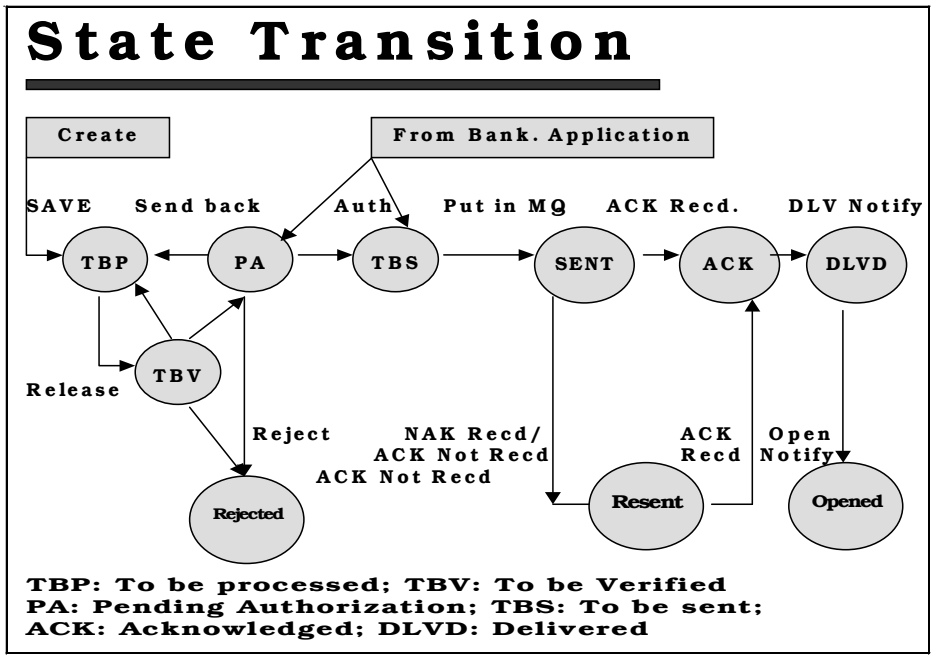
- Confirms that the message received is not tampered by anyone in the middle
- Prevents the sender from claiming at a later date that the message was never sent by him/her.

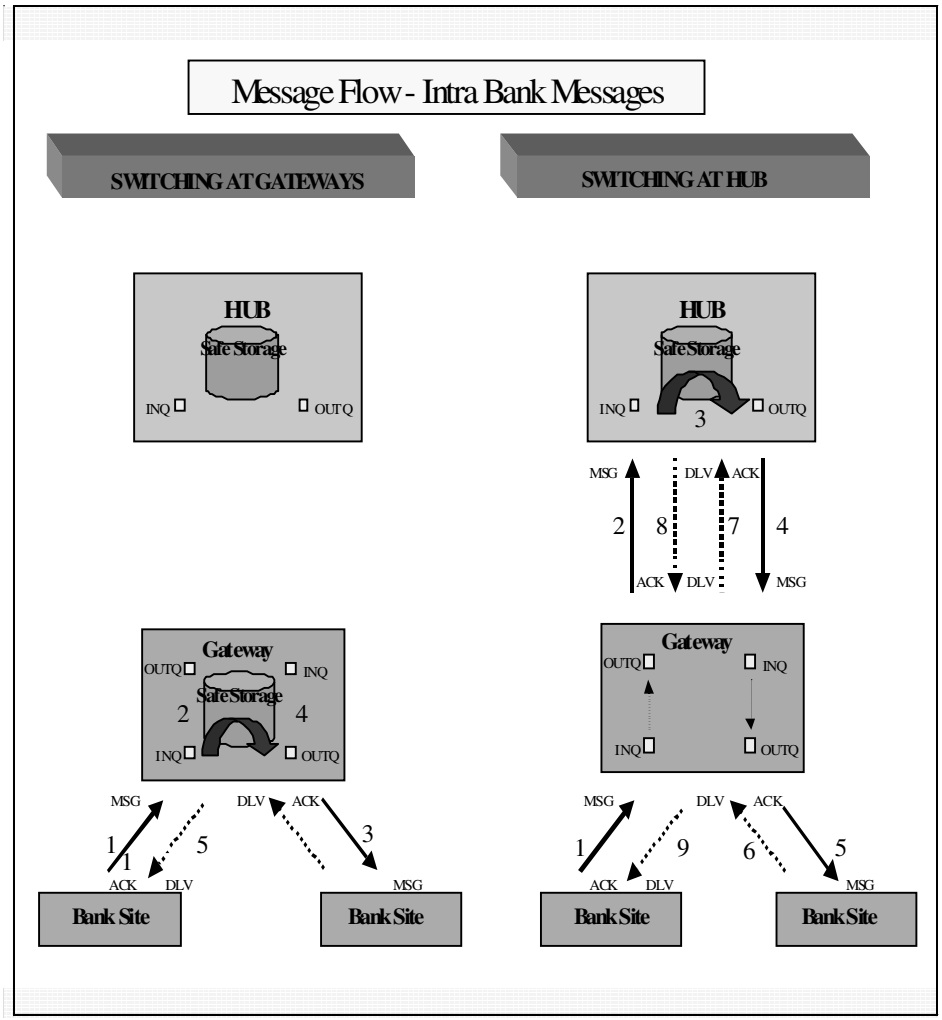
Notes


SFMS Architecture
Safe storage of inter-bank messages
Direct Routing to destination Bank Gateway
Access Validation
Safe storage
Direct Routing to intra-bank sites
Routing to 'others' Bank sites via Central HUB
Central HUB
INFINET IP Network (IIPN)
Gateway 1
Common IIPN access point
Safe storage
Gateway 2
Gateway N
Br. Server
Br. Server
Br. Server
Br. Server
Br. Server
Br. Server
Br. Server
Br. Server
Br. Server


SFMS Revised Architecture
HUB
INFINET
VSAT/Leased Lines
Bank Gateway
LAN/WAN
VSAT/Leased Lines
Dial-Up/Leased Lines
Online Server
Offline Server

Notes


State Transition
Create
From Bank. Application
SAVE
Send back
Auth
Put in MQ
ACK Recd.
DLV Notify
TBP
PA
TBS
SENT
ACK
DLVD
TBV
Release
Reject
NAK Recd/
ACK Not Recd
ACK Not Recd
ACK
Recd
Open
Notify
Rejected
Resent
Opened
TBP: To be processed; TBV: To be Verified
PA: Pending Authorization; TBS: To be sent;
ACK: Acknowledged; DLVD: Delivered


Message Flow - Intra Bank Messages
SWITCHING AT GATEWAYS
SWITCHING AT HUB
HUB
Safe Storage
INQ
OUTQ
HUB
Safe Storage
INQ
OUTQ
3
MSG
DLV
ACK
2
8
7
4
ACK
DLV
MSG
Gateway
OUTQ
INQ
Safe Storage
2
4
INQ
OUTQ
Gateway
OUTQ
INQ
INQ
OUTQ
MSG
DLV
ACK
1
1
5
3
ACK
DLV
MSG
Bank Site
Bank Site
MSG
DLV
ACK
1
9
6
5
ACK
DLV
MSG
Bank Site
Bank Site

Self Assessment

Notes

State whether the following statements are true or false:

6. The RTGS system has brought about some significant benefits to the Indian financial system.
7. Messages sent through the mode of SFMS by the bankers may not relate to customer payment and cheques.
8. The RBI's Institute of Development and Research in Banking Technology, Hyderabad has set up a National Financial Switch that would enable sharing common technology infrastructure.
9. The RTGS system is not used for customer transactions.
10. The National Inter Bank Payment Gateway Project will function as an integrated payment service system between the parties concerned.

6.5 Society for World-Wide Interbank Financial Telecommunication (SWIFT)

SWIFT stands for: Society for Worldwide Interbank Financial Telecommunications. SWIFT is a Cooperative Society registered in May 1973 in Brussels, Belgium. In an era of information technology SWIFT offers unique message processing services and provides a very fast, accurate and authenticated transfer of financial messages on global basis. It is a cooperative society of international banks and operates a computerized telecommunication system, which allows rapid, economical, secure and accurate transmission system for essential financial data. SWIFT services enable the retail as well as corporate customers to transfer funds around the world.

Brief History

A non-profit cooperative of about 239 banks of Europe, North American and Asia came together and decided to form SWIFT. The objective of the society was to standardize the funds transfer delivery of payment instructions, enhance the security level of such transactions, cut down the cost of message transmission payment/settlement system round the clock, seven days a week, 52 weeks a year.

In 1977 around 586 banks were on line on SWIFT system. Now the live participants are 1859 and live users are 7125 with 2288 members in 192 countries.

Swift Operations

The main objective of Society was to standardize formats for day-to-day International transactions. SWIFT ensures the uniformity in international standards. The Society devised ten categories of message from 0 to 9.

Of these messages category - 9 message is an unauthentic message. Other message categories 1,2,4,7 are informative while sending messages are authentic and need not to be separately tested. Messages in these categories can be sent to only those banks having bilateral agreement to that effect known as Bilateral Key Exchange (BKE). The messages under category 9 can be sent or received by any SWIFT member. Bank Identification Code (BIC) directory is supplied by SWIFT.

Notes

Category	What It Represents
0	System Message
1	Customer payment and cheques
2	Financial Payment and cheques
3	Financial Trading
4	Collections and cash letters
5	Securities
6	Precious metals and syndicates
7	Documentary Credit and Guarantees
8	Traveller's cheques
9	Cash Management and Customer Status

The 10 categories of message type are further divided to take care of maximum possible combinations. There are more than 120 such messages with a fixed format called "Message Type".

Message Type

There can be any number of message types in each category, and each message is identified by a three digit number. The first digit of each message type represents the category it belongs to:

Category I

MT-100 - Customer Transfer

MT -111 - Request for stop payment of a cheque

Category 2

MT-202 - General Financial Institutions Transfer

MT-203 - Multiple General Financial Institution Transfer

Category 4

MT-400 - Advice of payment

MT-410 - Acknowledgement

MT 412 - Advice of Acceptance

MT-416 - Advice of Non-payment/Non Acceptance

MT 420 - Tracer

MT-422 - Advice of Fate and request for instructions

MT-430 - Amendment of instructions

MT-456 - Advice of Dishonour

Category 7

MT-700 & 701 - Issue of Documentary Credit

MT-705 - Pre-advice of a documentary credit

Notes

MT 707	- Amendment to a Documentary Credit
MT-730	- Acknowledgement
MT -734	- Advice of Refusal
MT- 740	- Authorization to reimburse
MT-742	- Reimbursement Claim
MT-756	- Advice of Reimbursement
MT-760	- Guarantee

Category 9

Common Group Message

n92	- Request for cancellation
n95	- Queries
n96	- Answers
n99	- Free format message

Where 'n' can be any number in any of the said categories.

Message Format/Authentication

Each message text is divided into different parts called 'fields' for easy identification and also to indicate the specific action associated with that part. Some of these fields are mandatory while others are optimal. In the PC connected application each field is identified by a code work mandatory field/optional field (MF/OF) indicating the mandatory optional usage of the concerned field. Each message comprises of (a) Header, (b) Message Text, (c) Authenticator, and (d) Trails.

For every message conveyed to the computer, a numerical figure called 'Checksum" is calculated automatically by the computer, based on certain set mathematical formulae (algorithm) fed along with the software. The computers automatically add this 'checksum' as a part of the trailer of every message and on receipt at the destination, the receiving computer again checks it automatically to ensure that message text has remained unchanged during transmission.

6.6 Bank Identification Code (BIC)

All member banks and those of their branches which are connected to SWIFT are automatically assigned specific Bank identification code (BIC) for easy identification both for sender and receiver. This BIC is drawn in accordance with norms/instructions of international organization for standardization (ISO) and International Chamber of Commerce.

Message Flow in SWIFT System

- All those branches of a member bank in one country, which are connected to Swift, are linked to one nominated focal office of that bank which is called CBT. Each branch prepares and sends the messages to CBT for that bank. The computer based system at each Swift branch as also communication between the CBT of the bank and its various branches is decided at the discretion of each individual member bank.

Notes

- Focal point (CBT) for each bank is provided with computer. The computer is subject to the technical specification/capacities as approved by Swift and is fully automatic in operation. The focal point for each bank is called the Computer Based Terminal (CBT) for that bank. Our CBT is located at FEO, Nariman Point, Mumbai.
- All CBTs for individual member banks are connected to a centralized computer system of Swift, which is generally located in the same country. This is usually termed as Transport Network Box (TNB). TNB for India is located at World Trade Centre, Mumbai to which CBTs of all member banks are connected.
- TNB from each country is in turn connected to centralized Swift computers, which are called Regional Processors (RP).
- Each RP is in turn connected to another computer system called Slice Processor (SP). SPs are storing and also forwarding communications received from/to RPS.
- All RPs for various countries and the SP are located at two centres in the US and Netherlands.
- At both these places, i.e. the US and Netherlands, there are computers called System Control Processor (SCP) to control and monitor the various RPs and SPs.
- These two locations in the US and Netherlands housing the SCP, RP and SP are called System Control Centres (SCCs).
- SCCs in Netherlands and the US are totally connected with each other under fully automatic system and are one system (despite geographical distance) for all practical purposes for Swift user member.
- Swift is now introducing modified systems in their network which have designed as SWIFT II. This is being done in stages for various countries.
- India has entered SWIFT II directly and as such all instructions/guidelines related to SWIFT II are applicable for India.
- However, both SWIFT I and SWIFT II are fully compatible with each other i.e. adjustments/ requirements for communicating between the two systems are automatically being taken care of by the computers located at SCC.

Message Security

- Swift ensures a very high level of security and efficiency, i.e. safety, privacy, accuracy, reliability and deliver of messages within certain specified time schedule.
- Swift assumes full financial liability for delivery of accurate, complete and validated messages from the point of entry of the message at RP to the point of delivery of message to CBT. For ensuring this high level of security, Swift maintains a multi level combination of physical, technical and procedural measures as explained in the following points.
- Access to the Swift network is through a very elaborate authorization process using secret password codes to which every user bank has to confirm. Each message is assigned an Input Sequence No. (ISN) on entry of message and on Output Sequence No.(OSN) is given on exit.
- In case this sequence (ISN) is disturbed and/or gets disrupted for any reason, Swift rejects the message and shows the status of message as rejected after which no further action is taken by Swift.
- After being assigned ISN, all messages are ENCRYPTED (i.e., given some random codes) and transmitted through the system in the form of those codes. These codes are converted

Notes

back automatically into original words at the receiving time. This ensures that even while the message is flowing through Swift system, its privacy is ensured and even the staff of Swift is not aware of the contents. Even the information stored by Swift for future use/ reference is stored in encrypted form.

- Each message is also assigned an Authentic on being given ISN to guarantee the identity of sender and receiver.
- This authentication is based on a complex mathematical formula (algorithm) provided by (a) Swift and (b) on bilateral codes exchanged between any two correspondent banks.
- These "authenticator codes" for each different bank are automatically provided by CBT on being commanded to do so by the CBT user and then exchanged between two banks through postal/courier channels on confidential basis.

Advantages

- Swift is the latest mode of inter-bank exchange of messages on a global basis. It is cost effective reliable and secure communication system, which, inter alia, indemnifies the bank in case of any misuse of the system. It provides immediate transfer of funds, LCs, balance reports, statement of accounts etc. resulting in improved customer service, lower costs and better funds management.
- Swift handles approximately 220.1 million messages per month, average daily traffic 9081423 messages on global basis. This high volume ensures a very low per message cost.
- Swift message is treated as an operative instrument and does not need any telex/mail/ courier confirmation.
- In most foreign centres, where banks are fully computerized (specially in Europe and USA) the Swift message is received and automatically processed by the receiving bank's internal computer'. This results in a much lower processing/handling changes of foreign banks apart from ensuring priority processing of the message.
- All messages are authentic and also verified at the receiving end.
- A message can be delivered within 20 seconds if the sender and receiver are both operational on Swift at that time.

6.7 Swift in India

The initiative to introduce SWIFT was taken in 1982 by Indian Banks Association and RBI. The dream was transformed into reality when SWIFT was formally inaugurated on 2nd December, 1991 as a result of persistent efforts by IBA. Richard Frohlich, the then Chairman of Board of Directors, SWIFT made himself available to the banking industry in India. The message transmission traffic is improving in India now. There are 64 financial institutions/banks enacted on SWIFT in India. At present all the major banks are connected through SWIFT as it is impossible for them to answer the current demands of retail as well as corporate customers who need services at speed of thought.

Notes The initiative to introduce SWIFT was taken in 1982 by Indian Banks Association and RBI.

Notes

Fedwire

This is another US payment system operated by Federal Reserve Bank, operated all over the US states, since 1918, and handles majority of domestic payments. It is an automated computer based messaging and payment system, working on gross settlement basis. All US banks maintain accounts with Federal Reserve Bank, and are allotted an "ABA numbers" to identify the senders and receivers of payments.

As compared to CHIPS, this is a large system, with over 9,500 participants, and handles a large number of payments across the US, covering interbank transfers out of New York, local borrowings and lending, commercial payments, as also some securities transaction related payments for domestic banks.

Chaps

Clearing House Automated Payments System (CHAPS), is a British equivalent to CHIPS, handling receipts and payments in London. This system works on the same principles as CHIPS, working on the net payment settlement system. CHAPS is used by a large number of banks in UK, with about 20 member banks and over 400 indirect members, using the system through some large bank.

Did you know: At present all the major banks are connected through SWIFT as it is impossible for them to answer the current demands of retail as well as corporate customers who need services at speed of thought.

Target

Trans-European Automated Real-Time Gross Settlement Express Transfer system is an EURO payment system comprising 15 national RTGS systems working in Europe. These are interconnected by common procedures and uniform platform for processing high value payments by over 30,000 participating institutions across Europe. This facilitates receipts and payments of funds across the Euro zone (all member countries).

RTGS-plus and EBA

These are other Euro clearing systems, with RTGS plus, being a German hybrid clearing system and operating as an European oriented real time gross settlement and payment system. RTGS plus, has over 60 participants.

The EBA-EURO 1, with a membership of over 70 banks, in all EU member countries, works as a netting system with focus on cross border Euro payments. For retail payments, EBA has another system, called STEP 1, with over 200 members across EU zone.

STEP 2 is also in use in EU zone, which facilitates straight through processing (STP) to member banks, using industry standards.

Notes The more frequently affirm must refinance debt, the greater is the risk of its not being able to obtain the necessary financing.

Task analyze the EFT & NEFT transactions of a particular bank.

Self Assessment

Notes

Fill in the blanks:

11. _____ handles approximately 220.1 million messages per month, average daily traffic 9081423 messages on global basis.
12. These are other Euro clearing systems, with _____ plus, being a German hybrid clearing system and operating as an European oriented real time gross settlement and payment system. RTGS plus, has over 60 participants.
13. The _____, with a membership of over 70 banks, in all EU member countries, works as a netting system with focus on cross border Euro payments.
14. Trans-European Automated Real-Time Gross Settlement Express Transfer system is an _____ payment system comprising 15 national RTGS systems working in Europe.
15. SWIFT is a Cooperative Society registered in May 1973 in Brussels, _____.

Case Study

COBIT Case Study: Society for Worldwide Interbank Financial Telecommunication (SWIFT)

Abstract

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) used COBIT in an audit of its customer support centers located in the Netherlands, Singapore and United States. This was a 16 person-week audit effort.

Background

SWIFT is a Belgium-based cooperative owned by 3,000 banks for secure interbank financial messaging services and interface software. SWIFT's global network handles approximately 3.5 million messages daily with an average daily transaction total of several trillion US dollars.

The SWIFT customer support function had recently been re-engineered and new tools and processes were put in place. The audit plan provided room for auditing tools and processes. COBIT had been used to audit the processes, but not the tools.

Process

At first management's reaction to the COBIT IT governance and control model was rather negative because of timing. But auditees often think that audits come at a bad time. During the audit, though, this attitude was reversed and the approach became well-accepted. This change was confirmed by senior management after they received the draft audit report.

Managers were particularly impressed by the process orientation that was used instead of the traditional way of focusing on confidentiality/integrity/availability. The most apparent outcome of the COBIT approach is the logical set-up and sequence of interviews which make the process more efficient because auditors build their knowledge in an appropriate order.

It had taken lengthy discussions to obtain senior and line management approval of the audit scope because the COBIT framework was leading an investigation into previously untapped areas. Managers questioned the audit team's ability to perform an objective

Contd....

Notes

audit in these new fields. The department previously only looked at IT security issues, with security broadly defined. The COBIT approach focused on management of the process and process control issues.

We constructed a matrix using the COBIT control objectives. A risk assessment helped us determine which objectives would be verified during the audit. We then crosschecked the objectives withheld for the audit with (a) scopes from previous audits, (b) industry standards and (c) checklists provided by external auditors.

Based on the matrix, we constructed the audit program. The COBIT framework enabled us to prioritize audit activities and areas under review, using the primary/secondary ratings provided by COBIT.

Conclusion

Implementing the COBIT framework in this comprehensive audit was a major change for auditors and management. While change often creates adversity and criticism, the process orientation was quickly appreciated by management, and the auditors are planning to use it again.

COBIT will be used more and more in future audits, certainly now that the audit committee has ratified it as the IT audit reference. It is certainly being regarded as a good basis for SAS70-type reviews.

In parallel, COBIT has also found its way into the IT organisation of the enterprise after the CIO, upon coming across the framework by accident, ordered it for all the service IT managers. It supported his ideas and plans for moving the IT organisation towards increased measurability and process excellence.

COBIT is also finding immediate and practical use. When looking for input on defining the mission and objectives for a new systems planning group, the CIO came to me and said, "Give me your COBIT detailed objectives to help do this!" I only had to point him to the PO1 through PO5 sections. He had asked me for input on this mission and objectives previously, so why hadn't I thought of this myself?

Source: http://www.isaca.org/Knowledge-Center/cobit/Pages/Society-for-Worldwide-Interbank-Financial-Telecommunication-SWIFT-.aspx

6.8 Summary

- In an era of information technology SWIFT offers unique message processing services and provides a very fast, accurate and authenticated transfer of financial messages on global basis.
- The acronym "RTGS" stands for Real Time Gross Settlement. RTGS system is a funds transfer mechanism where transfer of money takes place from one bank to another on a "real time" and on "gross" basis.
- The RBI's Institute of Development and Research in Banking Technology, Hyderabad has set up a National Financial Switch that would enable sharing common technology infrastructure.
- The focal point for each bank is called the Computer Based Terminal (CBT) for that bank. Our CBT is located at FEO, Nariman Point, Mumbai.
- This is another US payment system operated by Federal Reserve Bank, operated all over the US states, since 1918, and handles majority of domestic payments.

Notes

- Trans-European Automated Real-Time Gross Settlement Express Transfer system is an EURO payment system comprising 15 national RTGS systems working in Europe.
- These are other Euro clearing systems, with RTGS plus, being a German hybrid clearing system and operating as an European oriented real time gross settlement and payment system. RTGS plus, has over 60 participants.
- In 1977 around 586 banks were on line on SWIFT system. Now the live participants are 1859 and live users are 7125 with 2288 members in 192 countries.

6.9 Keywords

Bank Identification Code: This BIC is drawn in accordance with norms/instructions of international organization for standardization (ISO) and International Chamber of Commerce.

Clearing House Automated Payments System (CHAPS): This is a British equivalent to CHIPS, handling receipts and payments in London.

Deferred net settlement: This concept settles transactions in batches. In DNS, the settlement takes place at a particular point of time.

EFT and NEFT: These are electronic fund transfer modes that operate on a deferred net settlement (DNS) basis.

Gross settlement: It means the transaction is settled on one to one basis without bunching with any other transaction.

RTGS system: This system is a funds transfer mechanism where transfer of money takes place from one bank to another on a "real time" and on "gross" basis.

Structured Financial Messaging Solution: It is a modularized web enabled software for financial message communication.

SWIFT: It stands for: Society for Worldwide Interbank Financial Telecommunications.

6.10 Review Questions

1. Discuss the terms real time gross settlement and gross settlement.
2. Explain the concept of RTGS system.
3. What do you mean by EFT and NEFT transactions?
4. Describe the role and functioning of SWIFT.
5. What do you mean by Bank Identification Code?
6. Discuss the role of SWIFT in India.
7. Explain the concept of SFMS.

Answers: Self Assessment

1.	Remitting	2.	RTGS
3.	EFT/NEFT	4.	Funds
5.	Real time gross settlement	6.	True
7.	False	8.	True

Notes

9. False
10. True
11. Swift
12. RTGS
13. EBA-EURO1
14. EURO
15. Belgium

6.11 Further Readings

Books

The Professionals Banker, The ICFAI University Press, Hyderabad.

RBI Annual Report 2005-06.

Social Responsibility of Banks, By Philip J. Jennings.

Online links

www.indianbank.in/pdfs/faq/faq_rtgs.pdf

www.onlinesbi.com/osbi_rtgs_faq.html

www.indiastudychannel.com/.../51932-Know-about-RTGS-NEFT-EF...

wiki.answers.com › ... › Personal Finance › Money Management › Banking

www.swift.com/solutions/applications/banking_markets.../index.page

Unit 7: KYC Norms and Anti Money Laundering

Notes

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Objectives

Introduction

7.1 Policy on Know Your Customer Standards/Anti-Money Laundering Measures

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7.5 Retail Lending

7.6 Introduction of Foreign Exchange Management Act (FEMA)

7.7 Residential Status

7.8 Summary

7.9 Keywords

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7.11 Further Readings

Objectives

After studying this unit, you should be able to:

- Know RBI's Policy on Know Your Customers
- Know Objectives and Key elements of the policy
- Understand Concept of Money Laundering
- Understand Obligations of the banking institutions under Prevention of Money Laundering Act 2002

Introduction

Know Your Customer (KYC) refers to both:

- The activities of customer due diligence that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information pertinent to doing financial business with them
- And the bank regulation which governs those activities

In the USA, KYC is typically a policy and process implemented to conform to a customer identification program (CIP) mandated under the Bank Secrecy Act and USA PATRIOT Act. Know your customer policies are becoming increasingly important globally to prevent identity theft, financial fraud, money laundering and terrorist financing.

Notes

7.1 Policy on Know Your Customer Standards/Anti-Money Laundering Measures

The RBI u/s 35 A of Banking Regulation Act has issued directive to banks to put in place KYC policy and adopt anti-money laundering measures.

Preamble

On the recommendations of the United Nations, the Government of India has enacted Prevention of Money Laundering Act 2002. Money laundering is the process whereby proceeds of crimes, such as, drug trafficking, smuggling, etc. are converted into legitimate money through a series of financial transactions making it impossible to trace back the origin of funds. Further, the technological advancements have helped money launderers to adopt innovative means and move funds faster across continents making detection and preventive action much more difficult. The international community considers money laundering a serious crime. This calls for a dynamic approach in tracking the crime. Bank officials need to be even more vigilant and prudent in knowing their customers. Bank employees have to undertake enhanced due diligence while opening accounts and also monitor operations more closely. "Know Your Customer" also means knowing whom he deals with.

Objectives

The objectives of the policy are to prevent criminal elements from using the bank for money laundering activities by enabling the bank to know/understand the customers and their financial dealings better, which, in turn, would help the bank to manage risks prudently and to put in place appropriate controls for detection and reporting of suspicious activities in accordance with the laid down procedures so as to comply with applicable laws and regulatory guidelines.

Money Laundering - Risk Perception

The inadequacy or absence of KYC standards can subject the bank to serious customer and counter-party risks:

- ***Reputation Risk:*** Risk of loss due to severe impact on the bank's reputation. This may be of particular concern given the nature of the bank's business which requires the confidence of depositors, creditors and the general market place.
- ***Compliance Risk:*** Risk of loss due to failure of compliance with key regulations governing the bank's operations.
- ***Legal Risk:*** Legal risk is the possibility of lawsuits, adverse judgments or contract resulting from failure to observe mandatory KYC standards or from the failure to practice due diligence. Consequently, the banks can suffer fines, criminal liabilities and special penalties imposed by supervisor.

Caution The international community considers money laundering a serious crime. This calls for a dynamic approach in tracking the crime. Bank officials need to be even more vigilant and prudent in knowing their customers.

Notes

7.2 Obligations under Prevention of Money Laundering Act 2002

Section 12 of PML Act 2002 has placed certain obligations on every banking institution and intermediary, which include - (i) Maintaining a record of prescribed transactions, (ii) Furnishing information of prescribed transactions to the specified authority, (iii) Verifying and maintaining records of the identity of its clients (iv) Preserving records in respect of (i), (ii) and (iii) above for a period of ten years from the date of cessation of transactions with the clients.

Definition of Customer

A customer for the purpose of this policy is defined as: (i) a person or an entity that maintains an account and/or has a business relationship with the Bank; (ii) one on whose behalf the account is maintained (i.e. the beneficial owner); (iii) beneficiaries of transactions conducted by professional intermediaries, such as Stock Brokers, Chartered Accountants, Solicitors, etc. as permitted under the law; and (iv) any person or entity connected with a financial transaction which can pose significant reputational or other risks to the bank.

Notes Section 12 of PML Act 2002 has placed certain obligations on every banking institution and intermediary.

Key Elements of the Policy

(i) Customer Acceptance Policy

(ii) Customer Identification Procedures

(iii) Monitoring of Transactions and

(iv) Risk Management

Customer Acceptance Policy: The Bank will: (i) classify customers into various risk categories and based on risk perception decide on acceptance criteria for each category of customers; (ii) accept customers after verifying their identity as laid down in Customer Identification Procedures; (iii) not open accounts in the name of anonymous/fictitious/benami persons; and (iv) while carrying out due diligence, ensure that the procedure adopted will not result in denial of banking services to the general public especially those who are financially or socially disadvantaged.

Customer Identification Procedures: The first requirement of customer identification procedures to be satisfied that (i) a prospective customer is who he/she claims to be, (ii) The second requirement of customer identification procedures is to ensure that sufficient information is obtained on the nature of the business that the customer expects to undertake, and any expected, or predictable, pattern of transactions and the information collected will be used for profiling the customer, (iii) the identity is to be verified for: (a) the named account holder; (b) the beneficial owners; (c) the signatories to an account; and (d) the intermediary parties, (iv) The Customer Identification Procedures are to be carried out at the stages: (a) While establishing a banking relationship; (b) When the bank feels it is necessary to obtain additional information from the existing customers based on the conduct or behavior of the account.

Documents to verify the name/identity of the customer: (a) passport, (b) PAN card, (c) voter identity card, (d) driving license with photograph, (e) identity card, (f) letter from a recognized public authority verifying the identity and residence of the customer to the satisfaction of the branch official authorized to open the account, (g) confirmation/letter from employer/other bank (subject to satisfaction of the branch official authorized to open the account).

Notes

Documents to verify the address are: Telephone bill, bank account statement, electricity bill, ration card, letter from employer to the satisfaction of the bank.

Obtention of proper Introduction: The introducer must know and identify the customer and his profession; he himself should have satisfactorily operated account for at least six months and in his account, KYC norms must have been fulfilled.

Photograph: A set of two photographs should be obtained from customer.

Wherever applicable, information on the nature of business activity, location, mode of payments, volume of turnover, social and financial etc. will be collected for completing the profile of the customer.

Risk Perception: Risk in various accounts will be based on: (I) Type of customer, (II) Type of products and services availed by the customer, and (III) Country where the customer is domiciled.

Customers will be classified into three risk categories namely High, Medium and Low, and Negligible based on the risk perception. The risk categorization will be reviewed periodically. Customer Identification Procedures will also be carried out in respect of non-account holders approaching bank for high value one-off transaction.

High Risk Category: High Risk Customers; Customers engaged in certain professions; firms with sleeping partner(s), politically exposed persons of foreign origin; close relatives of politically exposed persons; trusts, charities, NGOs, religious/social organizations and the organizations receiving donations; where accounts are opened/operated through a mandate or power of attorney; persons/entities with dubious reputation as per the information available in public domain, non-face-to-face customers.

High Risk Countries: Without anti-money laundering and regulations; Politically unstable regime with high level of public/private sector corruption; known to be drug producing or drug transit countries; non-cooperative country as classified by Financial Action Task Force (FATF).

Medium Risk category: Medium Risk country (nationality is irrelevant); Current Account customers where credit or debit summations exceed Rs. 50 lakh per annum in their accounts, but they do not provide sufficient documentary proof and other deposit account customers where credit or debit summations exceed Rs.10 lakh per annum in their accounts, but they do not provide sufficient documentary proof.

Low Risk category: All customers not falling under the category of High/Medium Risks are to be classified under Low Risk category. All borrowal customers, where due diligence is exercised at the time of granting the credit facilities.

Negligible Risk category or Applicability of reduced KYC Procedure: Where a customer intends to keep balance not exceeding Rs 50,000/- in all his/her accounts taken together in the Bank and total credit in all the accounts taken together not expecting to exceed Rs.2 lakh in a year. More so, he is not in a position to produce documents for the purpose of opening of account.

Task Analyze the KYC norms of a particular bank.

Self Assessment

Fill in the blanks:

1. Any person or entity connected with a ..... transaction which can pose significant reputational or other risks to the bank is called customer.

Notes

2. All customers not falling under the category of ..... Risks are to be classified under Low Risk category.
3. Risk in various accounts will be based on: (I) ....., (II) Type of products and services availed by the customer, and (III) Country where the customer is domiciled.
4. ..... will be classified into three risk categories namely High, Medium and Low, and Negligible based on the risk perception.
5. The technological advancements have helped money launderers to adopt innovative means and move funds faster across continents making ..... action much more difficult.

7.3 Monitoring of Transactions

Monitoring of transactions will be conducted taking into consideration the risk profile of the account. Special attention will be paid to all complex, unusually large transactions and all unusual patterns, which have no apparent logical or visible lawful purpose. Transactions that involve large amounts of cash inconsistent with the normal and expected activity of the customer will be subjected to detailed scrutiny.

After due diligence at the appropriate level in the Bank, transactions of suspicious nature and/or any other type of transaction notified under PML Act, 2002 will be reported to the appropriate authority and a record of such transactions will be preserved and maintained for a period as prescribed in the Act.

Branches would be maintaining a close watch on cash transactions (whether deposits or withdrawals) of Rs. 10 lakh and above in all deposit and loan accounts and recording the same separately in the prescribed register. Besides, the branches would also be reporting all cash transactions of Rs. 10 lakh and above with full details to their controlling offices through a periodical statement, on fortnightly basis. The controlling offices would scrutinize the same and, if required, make enquiries from the branches in case the cash deposit/withdrawal is not in consonance with the known profile of the customer and follow up with the branches till logical end. In case, the controlling offices find that the report is in order, no further action would be taken and the designated officer in RO/ZO would close the report.

Risk Management

Concurrent/Internal Auditors shall specifically check and verify the application of KYC/AML procedures at the branches and comment on the lapses observed will be put up before the Audit Committee of the Board at quarterly intervals. The Principal Officer designated by the Bank in this regard will have an important responsibility in managing oversight and coordinating with various functionaries in the implementation of KYC/AML policy.

Did u know? Branches would used to reporting all cash transactions of Rs. 10 lakh and above with full details to their controlling offices through a periodical statement, on fortnightly basis.

Action Points

1. ***Customer education:*** The Banks should spread awareness on KYC, Anti-Money Laundering measures and the rationale behind them amongst the customers.

Notes

2. The Branches will be applying the revised KYC/AML norms diligently to the existing customers falling under high and medium risk categories.

3. This policy shall also apply to the branches, subsidiaries and majority owned joint ventures located abroad, to the extent local laws permit. Based on this policy, each foreign office is required to put in place an Anti-Money Laundering Policy (duly approved) which shall also contain the KYC guidelines and suspicious activity reporting (SAR) Procedures as may be required by the rules and regulations of the host country.

4. Since our Bank is dealing with a number of correspondent banks, an appropriate due diligence procedure will be laid down keeping in view KYC standards existing in the country where the bank is located and the track record of the bank in the fight against money laundering and terrorist financing.

Caution Concurrent/Internal Auditors shall specifically check and verify the application of KYC/AML procedures at the branches and comment on the lapses observed will be put up before the Audit Committee of the Board at quarterly intervals.

7.4 Principal Officer (Money Laundering Reporting Officer)

In light of the seriousness of the issue, individual banks are to designate a senior officer as Principal Officer who shall be responsible for implementation and compliance of the policy. His illustrative duties will be as follows:

(i) Monitoring and reporting of all transactions and sharing of information as required under the law.

(ii) Maintaining close liaison with law enforcement agencies, banks and any other institution which are involved in the fight against money laundering and combating.

(iii) Ensuring submission of periodical reports to the Top Management/Board/Audit Committee of Board or any other authority, as may be required from time to time.

Record Keeping

In terms of the rules contained in the notification dated 01.07.2005 relating to Prevention of Money Laundering Act issued by the Government of India, the following records shall be maintained/retained for a period of 10 years from the date of cessation of the transaction between the client and the branch:

Record (nature and value) of

(a) All cash transactions of the value of more than rupees ten lakh or its equivalent in foreign currency;

(b) All series of cash transactions integrally connected to each other which have been valued below rupees ten lakh or its equivalent in foreign currency where such series of transactions have taken place within a month;

(c) All cash transactions where forged or counterfeit currency notes of bank notes have been used as genuine and where any forgery of a valuable security has taken place;

(d) All suspicious transactions whether or not made in cash and by way as mentioned in the rules.

Notes

Maintenance and Preservation of Record

Banks should ensure that records pertaining to the identification of the customer and his address e.g. copies of documents like passports, identity cards, driving licences, PAN card, Utility bills obtained while opening of the account and during the course of business relationship are properly preserved for at least 10 years after the business relationship is ended.

Reporting

Reporting to Financial Intelligence Unit India through Banks' Principal Officers:

(a) Cash Transaction Report (CTR) for each month by 15th of succeeding month,

(b) The suspicious Transaction Reports to be sent within 7 days of arriving at a conclusion that such transaction is of suspicious nature.

Notes In terms of the rules contained in the notification dated 01.07.2005 relating to Prevention of Money Laundering Act issued by the Government of India, the following records shall be maintained/retained for a period of 10 years from the date of cessation of the transaction between the client and the branch.

Self Assessment

State whether the following statements are true or false:

6. Monitoring and reporting of all transactions and sharing of information are not required under the law in Anti money lending law.
7. Banks should ensure that records pertaining to the identification of the customer and his address obtained while opening of the account and during the course of business relationship are properly preserved for at least 10 years after the business relationship is ended.
8. Branches would be maintaining a close watch on cash transactions (whether deposits or withdrawals) of Rs. 25 lakh and above in all deposit and loan accounts and recording the same separately in the prescribed register.
9. Monitoring of transactions will be conducted taking into consideration the risk profile of the account.
10. Transactions that involve large amounts of cash inconsistent with the normal and expected activity of the customer will not be subjected to detailed scrutiny.

7.5 Retail Lending

What is Retail Lending

- An attractive Market Segment
- Large number/Varied class of customers
- Low business volume per customer
- Individual and Small Units focused

Notes

- Customized and Wide ranging Products
- Technology based banking
- Thrust on Marketing/Relationship

Retail Lending vis-a-vis Retail Banking

- In retail lending an attractive market segment like wholesale banking
- Retail Banking has wider connotation; it also include designing, developing and marketing of customized products/services
- Wide and Customized products for both sides of B/S in retail lending.
- Retail lending is one part of Retail Banking

Why Retail lending ?

- Risk Dispersion
- Good Recovery %
- Increased competition: Untapped potential
- Lower NPAs: Assured Income stream
- Surplus deployable funds
- Availability of Technology
- Higher Spread (Risk vs Return)

Composition of Retail Lending

- All round increase in Economic activity
- Increase in Purchasing power
- India has 200 million households and 400 million middle class population
- More than 90% savings come from Household sector
- Falling interest regime resulted in shift: Now people wants to save less

Scope for Retail Lending

- Nuclear families concept gaining ground
- Tax benefits available
- Traditional lending to corporate sluggish/High NPA risk
- Treasury profits losing shine
- Only 18% of the potentials exploited so far; HL constitutes only 5.6%, personal loans 4.2%, consumer loans 1.1% of total bank lending

Channels for Retail Lending

- Premises banking
- ATMs

Notes

- Debit/Credit Cards
- EFT/ECS etc.
- Telephone Banking
- Internet Banking

Some cautions

- 'One size fits all' be avoided
- Maintain database, study customers behaviours and needs
- Manage risks properly
- Improve appraisal technique
- Transform weak collection strategies
- Improve MIS through technology

7.6 Introduction of Foreign Exchange Management Act (FEMA)

FEMA has stipulated a transition period of two years for replacing FERA by FEMA. After the expiry of two years from the date of enforcement of FEMA, i.e., w.e.f. 01.06.2002, any Court or Adjudicating Authority would not try any offence under FEMA.

Section 49(3), FEMA holds that notwithstanding anything contained in any other law for the time being in force, no court shall take notice of any contravention under Section 51 of the repealed Act after the expiry of a period of two years from the date of the commencement of this Act.

FERA contained 81 sections (some were deleted by 1993 amendment), out of which 32 sections were relating to the operational part and the rest were rating to penalties, Enforcement Directorate etc.

FEMA with 49 sections has been divided into seven chapters. The first three chapters (Chapters (i), (ii) and (iii) with 12 sections) relate to operational part and the balance four chapters (Chapters (iv) to (vii) with sections 13 to 49) deal with penalties, adjudication, appeals, Enforcement Directorate etc.

Did u know? FEMA has stipulated a transition period of two years for replacing FERA by FEMA.

7.7 Residential Status

Section 2(v) of FEMA provide: "person resident in India" means:

1. A person residing in India for more than one hundred and eighty two days during the course of the preceding financial year but does not include -
   - A person who was gone out of India, or who stays outside India, in either case:
     - (a) for or on taking up employment outside India, or
     - (b) for carrying on outside India a business or vocation outside India, or

Notes

(c) for any other purpose, in such circumstances as would indicate his intention to stay outside

India for an uncertain period.

- A person who has come to or stays in India, in either case, otherwise than:
  - (a) for or on taking up employment in India, or
  - (b) for carrying on in India a business or vocation in India, or
- for any other purpose, in such circumstances as would indicate his intention to stay in India for an uncertain period.

2. Any person or body corporate registered or incorporated in India.
3. An office, branch or agency in India owned or controlled by a person resident in India.

Section 2 (iv), FEMA holds that a person for the purpose of the Act means:

1. An individual
2. An H.U.F.
3. A company
4. A firm
5. An association of persons or a body of individuals, whether incorporated or not
6. Every juridical person, not falling within any of the preceding sub-clauses, and
7. Any agency, officer or branch owned or controlled by person.

The financial year has not been defined under FEMA, but for this, reference may be taken of the Income Tax Act. The latter holds a financial year to commence from 1st April to 31st March.

Notes FERA contained 81 sections (some were deleted by 1993 amendment), out of which 32 sections were relating to the operational part and the rest were rating to penalties, Enforcement Directorate etc.

Self Assessment

Fill in the blanks:

11. The financial year has not been defined under ....., but for this, reference may be taken of the Income Tax Act.
12. .....Banking has wider connotation; it also include designing, developing and marketing of customized products/services.
13. FEMA holds that a person for the purpose of the Act means an ..... of persons or a body of individuals, whether incorporated or not.
14. Section .....FEMA holds that notwithstanding anything contained in any other law for the time being in force, no court shall take notice of any contravention under Section 51 of the repealed Act after the expiry of a period of two years from the date of the commencement of this Act.
15. In retail lending an ..... market segment is just wholesale banking.

Notes

Caselet

Shell companies and Corporate Service Providers

During a two-year period, financial institutions in a European country made suspicious transaction reports to the relevant financial intelligence unit. The reports identified large cash deposits made to the banks, which were exchanged for bank drafts made payable to a shell corporation based and operated from an Asian jurisdiction. The reports identified transfers totally approximately US$1.6mn to an account held by the shell corporation at a financial institution in the Asian jurisdiction.

At the same time, police had been investigating a group in that country which was involved in importing drugs. The following year, police arrested several persons in the group, including the principal, who controlled the company within the Asian jurisdiction. They were charged with conspiring to import a large amount of cannabis. A financial investigation showed that the principal had made sizeable profits, and a large percentage of this was traced and restrained. A total of approximately US$2mn was sent from the European country to the Asian jurisdiction, and subsequently transferred back to bank accounts in Europe where it was restrained.

Two methods were used to launder the money. The principal purchased a shell company in the Asian jurisdiction which was operated there by a secretarial company on his instruction. The shell company opened a bank account, which was used to receive the cashier's orders and bank drafts which had been purchased for cash in the country of origin. The principal was also assisted by another person who controlled (through the same secretarial company) several companies, which were operated for both legitimate reasons and otherwise. This person laundered part of the proceeds by selling the funds on to several other jurisdiction, and used non face to face banking (computer instructions from the original country) to do so.

Seven persons including the principal were put on trial in the European country on charges of drug trafficking, and the principal and the three other persons faced money laundering charges.

Key Learning

This example shows how attractive and easy it is for criminals (even if not part of international organized crime) to use corporate entities in other jurisdictions, and to transfer illegal proceeds through several other jurisdictions in the hope of disguising the origin of the money.

It demonstrates the ease with which company incorporation services can be obtained, and shows that many of the companies which sell shell companies, as well as the secretarial companies which operate them, are not likely to be concerned about the purpose for which the shell company is used.

It highlights the need for the financial institutions to have a system which identifies suspicious transactions not just at the front counter, but also for non face to face transactions, such as occurred in this case.

It can take some time to conduct international financial investigations and to trace the proceeds of crime transferred through several jurisdictions, and there is a consequent risk that, during the investigations, funds will be dissipated.

Notes

Case Study **Briefing on Compliance to 'KYC Norms and AML Measures'**

April 12, 2006 - Hotel Hilton Towers, Mumbai

9.30 a.m. - 2.00 p.m.

A briefing on know your customer (KYC) norms and anti-money laundering (AML) measures was organised by the Indian Banks' Association (IBA) and IBS Intelligence, the consulting arm of IBS Publishing, at Mumbai on April 12, 2006. Chaired by IBS Intelligence, over 130 bankers representing compliance and inspection functions of banks participated in the event, which brought the banking regulator Reserve Bank of India (RBI) and the Financial Intelligence Unit - India (FIU-IND) together as part of the compliance focused forum. Mr. M. R. Umarji, Chief Advisor-Legal, IBA, commenced the briefing with opening remarks that highlighted the responsibility of bankers to monitor and control KYC compliance programs.

Mr. Sanjeev Singh, Additional Director, FIU-IND, made a detailed presentation to bankers outlining the role and responsibilities of the agency. FIU-IND was set up under the Ministry of Finance vide Government of India's Office Memorandum dated November 18, 2004, to coordinate and strengthen the collection and sharing of financial intelligence through an effective national, regional and global network to combat money laundering and related crimes. A multi-disciplinary unit headed by a director, its core functions include intelligence management, relationship management, policy review and development. The framework comprises of inputs from diverse sources that span supervisory and regulatory agencies (RBI, SEBI, DCA, IRDA); reporting entities (banking companies, financial institutions, intermediaries); and intelligence and enforcement agencies; with the dissemination of information back to the sources except to the reporting entities.

Covering the legal framework, the areas touched included PMLA 2002, the role of principal officers, scheduled offences under PMLA, and KYC guidelines. Mr. Singh also listed challenges within KYC in verification of identity. Providing further insight into the need for furnishing information, cash transactions and suspicious transactions were expounded in further detail. Analysing suspicious transactions, he mentioned, can be categorized into six specific areas that encompass identification of clients, background of clients, multiple accounts, activity in accounts, nature of transactions and value of transactions. In an effort to encourage banks to comply, FIU-IND has also facilitated easy reporting formats to ensure compatibility with transactional data generated by banks.

The FIU-IND website (www.fiuindia.gov.in) provides exhaustive information that spans the scope of PMLA, as well as other informative inputs useful to bankers. With the Financial Action Task Force (FATF) currently in India for dialogue with the Ministry of Finance, Singh shared his expectations that India would soon be a part of the Egmont Group by June 2006. Expanding the current definition of the FIU, India's role is expected to increase with combating terrorist financing.

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With remarkable alacrity, FIU-IND has ramped up on infrastructure and resources. By December 2005, the FIU set up its office in Delhi, and by January 2006 it had completed compilation of the list of reporting entities comprising of banks, financial institutions and intermediaries. By February 2006, it completed its reporting formats. FIU-IND is now in the process of hiring a consultant to prepare and implement a detailed project roadmap. The FIU-IND roadmap includes plans for a secure gateway and information security standards (BS7799). In a futuristic look at its vision, FIU-IND seeks the development of systems that can intuitively link independent triggers that span cash transaction reports, suspicious transaction reports, hotlists and permanent account number (PAN) data.

While FIU-IND has been set up to monitor and analyse instances of potential money laundering, RBI has been instrumental in clamping down on defaulters with deterrents and penalties. In his presentation titled 'IPO Scam - A Lesson for Banks', Mr. Lalit Srivastava, General Manager, department of banking operations and development, RBI, urged bankers to understand the spirit behind RBI guidelines and policies, sensitizing banks to the impact of failure of systems and non-compliance. Mr. Srivastava elaborated on the need to counter creative techniques used by money launderers in committing financial crimes, discerning between a normal transaction and those facilitated by banks tainted by the IPO scam.

Describing the modus operandi used in the initial public offering (IPO) scam, Srivastava said that current accounts were opened in the name of multiple companies on the same date in the same branch of a bank with a sole person authorised to operate all these accounts, who was also a director in all the companies. Further, identities were disguised by spelling the same name differently in various companies and multiple accounts opened in different banks by the same group of joint account holders.

Huge amount of funds transferred from companies accounts to the individual's account were invested in IPOs. Loans and overdrafts were sanctioned to multiple names to bypass the limits imposed by RBI. Also, loans were sanctioned to brokers in direct contravention of RBI guidelines. At the request of brokers, several accounts were opened for funding the IPO, most of them in fictitious names. Refunds received were credited in brokers' accounts, indicating suspicions of a nexus between merchant bankers, brokers and banks.

The regulator also spelt out operational deficiencies, pointing out to factors that facilitated the scam -including unsatisfactory levels of training, incomplete customer identification, lack of customer profiling based on risk classification, ineffective monitoring and control, and the absence of accountability of bank officials responsible for opening accounts and complying with KYC procedures. Commenting on the impact of penalties levied on banks tainted by the IPO Scam, Mr. Srivastava clarified that in the initial stages, more than the quantum of penalties it is the signal sent out by the regulator, that banks need to recognise.

Emphasizing measures to prevent such scams, the regulator spelt out areas that spanned the need for classification of customer risk, and the need to determine beneficial ownership. Srivastava drew the attention of banks in India to a recent move by US banks - under the US Patriot Act - to review all correspondent bank relationships. From an outsourcing perspective, the regulator also clarified the limited role of direct selling agents (DSA) in capturing customer data and validating it, thereby ensuring that KYC compliance remains the onus of the banks.

Mr. Jay Jhaveri, Director, World-Check (Asia) - an organisation dedicated to maintaining hotlists on politically exposed persons (PEP) - shared insights on the cost of non-compliance among banks globally. Citing the case of Riggs Bank, which laundered funds belonging to Chilean dictator Pinochet, the total cost of non-compliance went over US$200 million,

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before resulting in the bank having to fold up operations. While fines and settlements totalled US$59 million, legal and consulting fees topped US$35 million, and resulted In a 20 per cent drop in the banks share price. Clarifying that KYC is not limited to individuals, but encompasses companies, trusts and charities, both offshore and onshore, Mr. Jhaveri further elaborated that KYC is not confined to customers and extends to correspondents, credit cards, insurance, mortgages and service providers. He also pointed out the imperative to also know the customer's customer, by monitoring transactions and deposits extending to guarantors and referees. Endorsing the regulator's warning, Mr. Jhaveri pointed out that cross border risks of noncompliance have resulted in OFAC fines and blacklisting.

The next leg of the briefing is likely to be held in early June in Bangalore, to enable banks in South India to attend it.

Source: www.iba.org.in/events/write-up1.doc

7.8 Summary

- The objectives of the policy are to prevent criminal elements from using the bank for money laundering activities by enabling the bank to know/understand the customers and their financial dealings.
- FEMA has stipulated a transition period of two years for replacing FERA by FEMA. After the expiry of two years from the date of enforcement of FEMA, i.e., w.e.f. 01.06.2002, any Court or Adjudicating Authority would not try any offence under FEMA.
- Retail Banking has wider connotation; it also include designing, developing and marketing of customized products/services.
- The Banks should spread awareness on KYC, Anti-Money Laundering measures and the rationale behind them amongst the customers.
- FEMA holds that a person for the purpose of the act means Any agency, officer or branch owned or controlled by person.
- FERA contained 81 sections (some were deleted by 1993 amendment), out of which 32 sections were relating to the operational part and the rest were rating to penalties, Enforcement Directorate etc.

7.9 Keywords

Customer lending: Alternative term for consumer loan.

FEMA Act: Foreign exchange management is associated with currency transactions designed to meet and receive overseas payments.

FERA Act: An act to regulate certain payments dealing in foreign exchange, securities, the import & export of currency and acquisition of immovable property by foreigners.

KYC Norms: The activities of customer due diligence that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information pertinent to doing financial business with them.

Retail banking: Savings accounts, consumer loans, credit cards, etc., and other such services provided to individuals also called consumer banking. See also corporate banking and wholesale banking.

Record keeping: The maintenance of a history of one's activities, as financial dealings, by entering data in ledgers or journals, putting documents in files, etc.

Retail lending: It is the practice of loaning money to individuals rather than institutions.

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7.10 Review Questions

1. What do you mean by KYC norms? Discuss in detail.
2. Describe the difference between retail lending and retail banking.
3. What are the rules and regulation for anti money lending concept?
4. What requirements must be fulfilled for residential status under FEMA Act?
5. What are the channels for retail lending?
6. Discuss the concept of FEMA Act.

Answers: Self Assessment

1.	Financial	2.	High/medium
3.	Type of customer	4.	Customers
5.	Detection/preventive	6.	False
7.	True	8.	False
9.	True	10.	False
11.	FEMA	12.	Retail
13.	Association	14.	49(3)
15.	Attractive		

7.11 Further Readings

Books

The Professionals Banker, The ICFAI University Press, Hyderabad.

RBI Annual Report 2005-06.

Social Responsibility of Banks, By Philip J. Jennings.

Online links

http://www.businessdictionary.com/search-terms.php?q=Foreign+exchange+management+act

http://www.ehow.com/about_6658752_definition-foreign-exchange-management.html#ixzz1wzWFCkw2

bankofceylon.in/Bank_Policies%5CVPC-KYC.pdf

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Unit 8: Negotiable Instruments

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Objectives

After studying this unit, you should be able to:

- Explain the meaning of negotiable instruments;
- Identify the various features of negotiable instruments;
- Describe the various types of negotiable instruments; and
- Differentiate between bills of exchange, promissory notes, and cheques.

Introduction

The Negotiable Instruments Act was enacted, in India, in 1881. Prior to its enactment, the provision of the English Negotiable Instrument Act were applicable in India, and the present Act is also based on the English Act with certain modifications. It extends to the whole of India except the State of Jammu and Kashmir. The Act operates subject to the provisions of Sections 31 and 32 of the Reserve Bank of India Act, 1934. Section 31 of the Reserve Bank of India Act provides that no person in India other than the Bank or as expressly authorised by this Act, the Central Government shall draw, accept, make or issue any bill of exchange, hundi, promissory note or engagement for the payment of money payable to bearer on demand. This Section further provides that no one except the RBI or the Central Government can make or issue a promissory note expressed to

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be payable or demand or after a certain time. Section 32 of the Reserve Bank of India Act makes issue of such bills or notes punishable with fine which may extend to the amount of the instrument. The effect or the consequences of these provisions are:

1. A promissory note cannot be made payable to the bearer, no matter whether it is payable on demand or after a certain time.
2. A bill of exchange cannot be made payable to the bearer on demand though it can be made payable to the bearer after a certain time.
3. But a cheque {though a bill of exchange} payable to bearer or demand can be drawn on a person's account with a banker.

8.1 Meaning of Negotiable Instruments

To understand the meaning of negotiable instruments let us take a few examples of day-to-day business transactions. Suppose Pitamber, a book publisher has sold books to Prashant for Rs. 10,000 on three months credit. To be sure that Prashant will pay the money after three months, Pitamber may write an order addressed to Prashant that he is to pay after three months, for value of goods received by him, Rs.10,000/- to Pitamber or anyone holding the order and presenting it before him (Prashant) for payment. This written document has to be signed by Prashant to show his acceptance of the order. Now, Pitamber can hold the document with him for three months and on the due date can collect the money from Prashant. He can also use it for meeting different business transactions. For instance, after a month, if required, he can borrow money from Sunil for a period of two months and pass on this document to Sunil. He has to write on the back of the document an instruction to Prashant to pay money to Sunil, and sign it. Now Sunil becomes the owner of this document and he can claim money from Prashant on the due date. Sunil, if required, can further pass on the document to Amit after instructing and signing on the back of the document. This passing on process may continue further till the final payment is made.

In the above example, Prashant who has bought books worth Rs. 10,000/- can also give an undertaking stating that after three month he will pay the amount to Pitamber. Now Pitamber can retain that document with himself till the end of three months or pass it on to others for meeting certain business obligation (like with sunil, as discussed above) before the expiry of that three months time period.

You must have heard about a cheque. What is it? It is a document issued to a bank that entitles the person whose name it bears to claim the amount mentioned in the cheque. If he wants, he can transfer it in favour of another person.

Example: If Akash issues a cheque worth Rs. 5,000/ - in favour of Bidhan, then Bidhan can claim Rs. 5,000/- from the bank, or he can transfer it to Chander to meet any business obligation, like paying back a loan that he might have taken from Chander. Once he does it, Chander gets a right to Rs. 5,000/- and he can transfer it to Dayanand, if required. Such transfers may continue till the payment is finally made to somebody.

In the above examples, we find that there are certain documents used for payment in business transactions and are transferred freely from one person to another. Such documents are called Negotiable Instruments. Thus, we can say negotiable instrument is a transferable document, where negotiable means transferable and instrument means document. To elaborate it further, an instrument, as mentioned here, is a document used as a means for making some payment and it is negotiable i.e., its ownership can be easily transferred.

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Thus, negotiable instruments are documents meant for making payments, the ownership of which can be transferred from one person to another many times before the final payment is made.

Definition of Negotiable Instrument

According to section 13 of the Negotiable Instruments Act, 1881, a negotiable instrument means "promissory note, bill of exchange, or cheque, payable either to order or to bearer".

Did u know? The Negotiable Instruments Act was enacted, in India, in 1881?

8.2 Types of Negotiable Instruments

According to the Negotiable Instruments Act, 1881 there are just three types of negotiable instruments i.e., promissory note, bill of exchange and cheque. However many other documents are also recognized as negotiable instruments on the basis of custom and usage, like hundis, treasury bills, share warrants, etc., provided they possess the features of negotiability. In the following sections, we shall study about Promissory Notes (popularly called pronotes), Bills of Exchange (popularly called bills), Cheques and Hundis (a popular indigenous document prevalent in India), in detail.

8.2.1 Promissory Note

Suppose you take a loan of rupeess five thousand from your friend Ramesh. You can make a document stating that you will pay the money to Ramesh or the bearer on demand. Or you can mention in the document that you would like to pay the amount after three months. This document, once signed by you, duly stamped and handed over to Ramesh, becomes a negotiable instrument. Now Ramesh can personally present it before you for payment or give this document to some other person to collect money on his behalf. He can endorse it in somebody else's name who in turn can endorse it further till the final payment is made by you to whosoever presents it before you. This type of a document is called a Promissory Note.

Section 4 of the Negotiable Instruments Act, 1881 defines a promissory note as 'an instrument in writing (not being a bank note or a currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument'.

Specimen of a Promissory Note

Rs. 10,000/- New Delhi

September 25, 2002

On demand, I promise to pay Ramesh, s/o RamLal of Meerut or order a sum of Rs 10,000/- (Rupees Ten Thousand only), for value received.

To, Ramesh Sd/Sanjeev

Address…….. Stamp

Notes

Parties to a Promissory Note

There are primarily two parties involved in a promissory note. They are

1. ***The Maker or Drawer:*** The person who makes the note and promises to pay the amount stated therein. In the above specimen, Sanjeev is the maker or drawer.
2. ***The Payee:*** The person to whom the amount is payable. In the above specimen it is Ramesh.

   In course of transfer of a promissory note by payee and others, the parties involved may be:

   (a) *The Endorser:* The person who endorses the note in favour of another person. In the above specimen if Ramesh endorses it in favour of Ranjan and Ranjan also endorses it in favour of Puneet, then Ramesh and Ranjan both are endorsers.

   (b) *The Endorsee:* The person in whose favour the note is negotiated by endorsement. In the above, it is Ranjan and then Puneet.

Features of a Promissory Note

Let us know the features of a promissory note:

1. A promissory note must be in writing, duly signed by its maker and properly stamped as per Indian Stamp Act.
2. It must contain an undertaking or promise to pay. Mere acknowledgement of indebtedness is not enough. For example, if some one writes 'I owe Rs. 5000/- to Satya Prakash', it is not a promissory note.
3. The promise to pay must not be conditional. For example, if it is written 'I promise to pay Suresh Rs 5,000/- after my sister's marriage', is not a promissory note.
4. It must contain a promise to pay money only. For example, if some one writes 'I promise to give Suresh a Maruti car' it is not a promissory note.
5. The parties to a promissory note, i.e. the maker and the payee must be certain.
6. A promissory note may be payable on demand or after a certain date. For example, if it is written 'three months after date I promise to pay Satinder or order a sum of rupees Five Thousand only' it is a promissory note.
7. The sum payable mentioned must be certain or capable of being made certain. It means that the sum payable may be in figures or may be such that it can be calculated. (See specimen below).

Rs. 10,000/- New Delhi

September 14, 2002

I, Ramesh, s/o Sadanand of Surat, Gujarat promise to pay Sashikant, s/o Sunil Kumar of Ahmedabad, Gujarat or order, on demand, the sum of Rs 10,000/- (Rupees Ten Thousand only) with interest at the rate of 10 percent per annum, for value received.

Sd/-Ramesh

Stamp

To
Sashikant
Ahmedabad, Gujarat

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8.2.2 Bill of Exchange

Suppose Rajiv has given a loan of Rupees Ten Thousand to Sameer, which Sameer has to return. Now, Rajiv also has to give some money to Tarun. In this case, Rajiv can make a document directing Sameer to make payment up to Rupees Ten Thousand to Tarun on demand or after expiry of a specified period. This document is called a Bill of Exchange, which can be transferred to some other person's name by Tarun.

Section 5 of the Negotiable Instruments Act, 1881 defines a bill of exchange as 'an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a certain person, or to the bearer of the instrument'.

Specimen of a Bill of Exchange

Rs. 10,000/-		New Delhi
		May 2, 2001
Five months after date pay Tarun or (to his) order to sum of Rupees Ten Thousand only for value received.		
To Sameer Address	Accepted Sameer	Stamp S/d

Parties to a Bill of Exchange

There are three parties involved in a bill of exchange. They are:.

1. ***The Drawer:*** The person who makes the order for making payment. In the above specimen, Rajiv is the drawer.
2. ***The Drawee:*** The person to whom the order to pay is made. He is generally a debtor of the drawer. It is Sameer in this case.
3. ***The Payee:*** The person to whom the payment is to be made. In this case it is Tarun.

The drawer can also draw a bill in his own name thereby he himself becomes the payee. Here the words in the bill would be Pay to us or order. In a bill where a time period is mentioned, just like the above specimen, is called a Time Bill. But a bill may be made payable on demand also. This is called a Demand Bill.

Features of a Bill of Exchange

Let us know the various features of a bill of exchange:

1. A bill must be in writing, duly signed by its drawer, accepted by its drawee and properly stamped as per Indian Stamp Act.
2. It must contain an order to pay. Words like 'please pay Rs 5,000/- on demand and oblige' are not used.
3. The order must be unconditional.
4. The order must be to pay money and money alone.

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5. The sum payable mentioned must be certain or capable of being made certain.
6. The parties to a bill must be certain.

Caution Words like 'please pay Rs 5,000/- on demand and oblige' should not be used in Bill of Exchange.

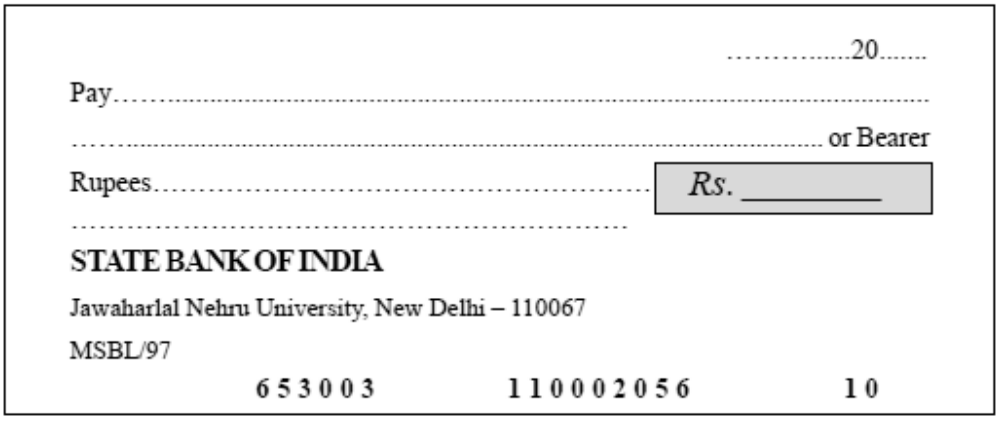
8.2.3 Cheques

Cheque is a very common form of negotiable instrument. If you have a savings bank account or current account in a bank, you can issue a cheque in your own name or in favour of others, thereby directing the bank to pay the specified amount to the person named in the cheque.

Therefore, a cheque may be regarded as a bill of exchange; the only difference is that the bank is always the drawee in case of a cheque.

The Negotiable Instruments Act, 1881 defines a cheque as a bill of exchange drawn on a specified banker and not expressed to be payable otherwise than on demand. Actually, a cheque is an order by the account holder of the bank directing his banker to pay on demand, the specified amount, to or to the order of the person named therein or to the bearer.

Specimen of a Cheque



Features of a Cheque

Let us look into some important features of a cheque:

1. A cheque must be in writing and duly signed by the drawer.
2. It contains an unconditional order.
3. It is issued on a specified banker only.
4. The amount specified is always certain and must be clearly mentioned both in figures and words.
5. The payee is always certain.
6. It is always payable on demand.
7. The cheque must bear a date otherwise it is invalid and shall not be honoured by the bank.

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Types of Cheque

Broadly speaking, cheques are of four types.

(a) Open cheque, (b) Crossed cheque (c) Bearer cheque, and (d) Order cheque

Let us know details about these cheques:

1. ***Open cheque:*** A cheque is called 'Open' when it is possible to get cash over the counter at the bank. The holder of an open cheque can do the following:
   (a) Receive its payment over the counter at the bank,
   (b) Deposit the cheque in his own account
   (c) Pass it to some one else by signing on the back of a cheque.
2. ***Crossed cheque:*** Since open cheque is subject to risk of theft, it is dangerous to issue such cheques. This risk can be avoided by issuing another types of cheque called 'Crossed cheque'. The payment of such cheque is not made over the counter at the bank. It is only credited to the bank account of the payee. A cheque can be crossed by drawing two transverse parallel lines across the cheque, with or without the writing 'Account payee' or 'Not Negotiable'.
3. ***Bearer cheque:*** A cheque which is payable to any person who presents it for payment at the bank counter is called 'Bearer cheque'. A bearer cheque can be transferred by mere delivery and requires no endorsement.
4. ***Order cheque:*** An order cheque is one which is payable to a particular person. In such a cheque the word 'bearer' may be cut out or cancelled and the word 'order' may be written. The payee can transfer an order cheque to someone else by signing his or her name on the back of it.

There is another categorization of cheques which is discussed below:

Ante-dated cheques: Cheque in which the drawer mentions the date earlier to the date of presenting if for payment. For example, a cheque issued on 20th May 2003 may bear a date 5th May 2003.

Stale Cheque: A cheque which is issued today must be presented before at bank for payment within a stipulated period. After expiry of that period, no payment will be made and it is then called 'stale cheque'. Find out from your nearest bank about the validity period of a cheque.

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

Post-dated Cheque: Cheque on which drawer mentions a date which is subsequent to the date on which it is presented, is called post-dated cheque. For example, if a cheque presented on 8th May 2003 bears a date of 25th May 2003, it is a post-dated cheque. The bank will make payment only on or after 25th May 2003.

Notes Since open cheque is subject to risk of theft, it is dangerous to issue such cheques. This risk can be avoided by issuing another types of cheque called 'Crossed cheque'.

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8.3 Features of Negotiable Instruments

Basis of Features	Promissory Notes	Bill of Exchange	Cheques	Hundis
Meaning	This is an instrument containing unconditional order to pay a certain sum of money to a certain person.	This is an instrument containing unconditional order to pay a certain sum of money to a certain person.	It is an order by the account holder of the bank directing his banker to pay on demand, the specified amount, to or to the order of the person named therein or to the bearer.	It is an instrument used for the purpose of transfer of money without its actual physical movement
Parties involved	Maker and the Payee	Drawer and drawee	Drawee Bank and Account holder	Holder or purchaser, drawer or indigenous banker, drawee and payee
Certainty of parties	Certain	Certain	Certain	Certain
Order	unconditional order	unconditional order	unconditional order	unconditional order
Certainty to pay	The time of payment must be certain	The time of payment must be certain	The time of payment must be certain	The time of payment must be certain in hundis.
Physical form	A promissory note must be in writing, duly signed by its maker	A bill must be in writing, duly signed by its drawer, accepted by its drawee	A cheque must be in writing and duly signed by the drawer	There is no actual physical movement of hundis
Transferability	Easily Transferable	Easily Transferable	Easily Transferable	Easily Transferable

Task Visit your nearby bank and try to see the negotiable instruments.

Self Assessment

Fill in the blanks with suitable word(s)

1. The person to whom the amount mentioned in the promissory note is payable is known as .....

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2. Transfer of a negotiable instrument to another person by signing on it, is known as .....
3. In a promissory note, the person who makes the promise to pay is called .....
4. The person who endorses the promissory note in favour of another is known as .....
5. A promissory note must be signed as per ..... Act.

8.4 Endorsement of Cheque

Negotiable instruments may be endorsed in various ways, and some negotiable instruments do not require any endorsement. If a negotiable instrument is a bearer instrument, then it may be negotiated by simply delivering it from one person to another with no endorsement required. Such negotiable instruments typically have a blank endorsement consisting of a person's name only. If the negotiable instrument is an order instrument, then the payee must first endorse it and deliver it before negotiation is complete. For example, if the instrument says, "Pay to the order of Jane Smith," then it is an order instrument and Jane Smith must endorse it and then deliver it to the payer or drawee.

Endorsements such as "Pay to the order of Jane Smith" are known as special endorsements and have the effect of making the instrument an order instrument rather than a bearer instrument. Restrictive endorsements ("Pay to Jane Smith only") and qualified endorsements ("Pay without recourse to the order of Jane Smith") also have the effect of requiring the payee to endorse the negotiable instrument. Qualified endorsements also affect the nature of implied warranties associated with endorsement.

Under the UCC, an unqualified endorser who receives payment or consideration for a negotiable instrument provides a series of implied warranties to the transferee and any subsequent holder in due course. An unqualified endorser warranties that he or she has good title to the instrument or represents a person with title, and that the transfer is otherwise rightful. The endorser also warranties that all signatures are genuine or authorized, that the instrument has not been materially altered, that no defense of any prior party is good against the endorser, and that the endorser has no knowledge of any insolvency proceeding involving the payer.

Other issues concerning negotiable instruments are also covered in Article 3 of the UCC. In the case of a forgery, the negotiable instrument becomes inoperative. Antedated or past-dated instruments are not invalid, provided the dating was not done for fraudulent or illegal purposes. Negotiable instruments that have been materially altered without the permission of all parties involved are void. But a holder in due course who is not party to the material alteration can enforce payment according to the instrument's original terms. Also covered in Article 3 are interpretations of contradictions that may appear from time to time in negotiable instruments.

8.5 Payment and Collection

8.5.1 Endorsement

The word 'endorsement' in its literal sense means, writing on the back of an instrument. But under the Negotiable Instruments Act it means, the writing of one's name on the back of the instrument or any paper attached to it with the intention of transferring the rights therein. Thus, endorsement is signing a negotiable instrument for the purpose of negotiation. The person who effects an endorsement is called an 'endorser', and the person to whom negotiable instrument is transferred by endorsement is called the 'endorsee'.

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Essentials of a Valid Endorsement

The following are the essentials of a valid endorsement:

1. It must be on the instrument. The endorsement may be on the back or face of the instrument and if no space is left on the instrument, it may be made on a separate paper attached to it called allonage. It should usually be in ink.
2. It must be made by the maker or holder of the instrument. A stranger cannot endorse it.
3. It must be signed by the endorser. Full name is not essential. Initials may suffice. Thumb-impression should be attested. Signature may be made on any part of the instrument. A rubber stamp is not accepted but the designation of the holder can be done by a rubber stamp.
4. It may be made either by the endorser merely signing his name on the instrument (it is a blank endorsement) or by any words showing an intention to endorse or transfer the instrument to a specified person (it is an endorsement in full). No specific form of words is prescribed for an endorsement. But intention to transfer must be present. When in a bill or note payable to order the endorsee's name is wrongly spelt, he should when he endorses it, sign the name as spelt in the instrument and write the correct spelling within brackets after his endorsement.
5. It must be completed by delivery of the instrument. The delivery must be made by the endorser himself or by somebody on his behalf with the intention of passing property therein. Thus, where a person endorses an instrument to another and keeps it in his papers where it is found after his death and then delivered to the endorsee, the latter gets no right on the instrument.
6. It must be an endorsement of the entire bill. A partial endorsement i.e. which purports to transfer to the endorse a part only of the amount payable does not operate as a valid endorsement.

If delivery is conditional, endorsement is not complete until the condition is fulfilled.

Who may endorse?

The payee of an instrument is the rightful person to make the first endorsement. Thereafter the instrument may be endorsed by any person who has become the holder of the instrument. The maker or the drawer cannot endorse the instrument but if any of them has become the holder thereof he may endorse the instrument. (Sec. 51). The maker or drawer cannot endorse or negotiate an instrument unless he is in lawful possession of instrument or is the holder there of. A payee or indorsee cannot endorse or negotiate unless he is the holder there of.

8.5.2 Classes of Endorsement

An endorsement may be:

1. Blank or general.
2. Speical or full.
3. Partial.
4. Restrictive.
5. Conditional.

Notes

Blank or General Endorsement (Sections 16 and 54)

It is an endorsement when the endorser merely signs on the instrument without mentioning the name of the person in whose favour the endorsement is made. Endorsement in blank specifies no endorsee. It simply consists of the signature of the endorser on the endorsement. A negotiable instrument even though payable to order becomes a bearer instrument if endorsed in blank. Then it is transferable by mere delivery. An endorsement in blank may be followed by an endorsement in full.

Example: A bill is payable to X. X endorses the bill by simply affixing his signature. This is an endorsement in blank by X. In this case the bill becomes payable to bearer.

There is no difference between a bill or note indorsed in blank and one payable to bearer. They can both be negotiated by delivery.

Special or Full Endorsement (Section 16)

When the endorsement contains not only the signature of the endorser but also the name of the person in whose favour the endorsement is made, then it is an endorsement in full. Thus, when endorsement is made by writing the words "Pay to A or A's order," followed by the signature of the endorser, it is an endorsement in full. In such an endorsement, it is only the endorsee who can transfer the instrument.

Conversion of endorsement in blank into endorsement in full: When a person receives a negotiable instrument in blank, he may without signing his own name, convert the blank endorsement into an endorsement in full by writing above the endorser's signature a direction to pay to or to the order of himself or some other person. In such a case the person is not liable as the endorser on the bill. In other words, the person transferring such an instrument does not incur all the liabilities of an endorser. (Section 49).

Example: A is the holder of a bill endorsed by B in blank. A writes over B's signature the words "Pay to C or order." A is not liable as endorser but the writing operates as an endorsement in full from B to C. Where a bill is endorsed in blank, or is payable to bearer and is afterwards endorsed by another in full, the bill remains transferable by delivery with regard to all parties prior to such endorser in full. But such endorser in full cannot be sued by any one except the person in whose favour the endorsement in full is made. (Section 55).

Example: C the payee of a bill endorses it in blank and delivers it to D, who specially endorses it to E or order. E without endorsement transfers the bill to F. F as the bearer is entitled to receive payment or to sue the drawer, the acceptor, or C who endorsed the bill in blank but he cannot sue D or E.

Partial Endorsement (Section 56)

A partial endorsement is one which purports to transfer to the endorsee a part only of the amount payable on the instrument. Such an endorsement does not operate as a negotiation of the instrument.

Example: A is the holder of a bill for Rs.1000. He endorses it "pay to B or order Rs.500." This is a partial endorsement and invalid for the purpose of negotiation.

Notes

Restrictive Endorsement (Section 50)

The endorsement of an instrument may contain terms making it restrictive. Restrictive endorsement is one which either by express words restricts or prohibits the further negotiation of a bill or which expresses that it is not a complete and unconditional transfer of the instrument but is a mere authority to the endorsee to deal with bill as directed by such endorsement.

"Pay C," "Pay C for my use," "Pay C for the account of B" are instances of restrictive endorsement. The endorsee under a restrictive endorsement acquires all the rights of the endorser except the right of negotiation.

Conditional or Qualified Endorsement

It is open to the endorser to annex some condition to his owner liability on the endorsement. An endorsement where the endorsee limits or negatives his liability by putting some condition in the instrument is called a conditional endorsement. A condition imposed by the endorser may be a condition precedent or a condition subsequent. An endorsement which says that the amount will become payable if the endorsee attains majority embodies a condition precedent. A conditional endorsement unlike the restrictive endorsement does not affect the negotiability of the instrument. It is also some times called qualified endorsement. An endorsement may be made conditional or qualified in any of the following forms:

1. ***'Sans recourse' endorsement:*** An endorser may be express word exclude his own liability thereon to the endorser or any subsequent holder in case of dishonour of the instrument. Such an endorsement is called an endorsement sans recourse (without recourse). Thus 'Pay to A or order sans recourse, 'pay to A or order without recourse to me,' are instances of this type of endorsement. Here if the instrument is dishonoured, the subsequent holder or the indorsee cannot look to the indorser for payment of the same. An agent signing a negotiable instrument may exclude his personal liability by using words to indicate that he is signing as agent only. The same rule applies to directors of a company signing instruments on behalf of a company. The intention to exclude personal liability must be clear.

   Where an endorser so excludes his liability and afterwards becomes the holder of the instrument, all intermediate endorsers are liable to him.

Example: A is the holder of a negotiable instrument. Excluding personal liability by an endorsement without recourse, he transfers the instrument to B, and B endorses it to C, who endorses it to A. A can recover the amount of the bill from B and C.

2. ***Facultative endorsement:*** An endorsement where the endorser extends his liability or abandons some right under a negotiable instrument, is called a facultative endorsement. "Pay A or order, Notice of dishonour waived" is an example of facultative endorsement.

3. ***'Sans frais' endorsement:*** Where the endorser does not want the endorsee or any subsequent holder, to incur any expense on his account on the instrument, the endorsement is 'sans frais'.

4. ***Liability dependent upon a contingency:*** Where an endorser makes his liability depend upon the happening of a contingent event, or makes the rights of the endorsee to receive the amount depend upon any contingent event, in such a case the liability of the endorser will arise only on the happening of that contingent event. Thus, an endorser may write 'Pay A or order on his marriage with B'. In such a case, the endorser will not be liable until the marriage takes place and if the marriage becomes impossible, the liability of the endorser comes to an end.

Notes

Effects of Endorsement

The legal effect of negotiation by endorsement and delivery is:

(i) to transfer property in the instrument from the endorser to the endorsee.

(ii) to vest in the latter the right of further negotiation, and

(iii) a right to sue on the instrument in his own name against all the other parties (Section 50).

Cancellation of Endorsement

When the holder of a negotiable instrument, without the consent of the endorser destroys or impairs the endorser's remedy against prior party, the endorser is discharged from liability to the holder to the same extent as if the instrument had been paid at maturity (Section 40).

Negotiation Back

'Negotiation back' is a process under which an endorsee comes again into possession of the instrument in his own right. Where a bill is re-endorsed to a previous endorser, he has no remedy against the intermediate parties to whom he was previously liable though he may further negotiate the bill.

A negotiable instrument is a piece of paper which entitles a person to a sum of money and which is transferable from one person to another by mere delivery or by endorsement and delivery. The characteristics of a negotiable instrument are easy negotiability, transferee gets good title, transferee gets a right to sue in his own name and certain presumptions which apply to all negotiable instruments. There are two types of negotiable instruments:

(a) ***Recognised by statute:*** Promissory notes, Bill of exchange and cheques; and

(b) ***Recognised by usage:*** Hundis, Bill of lading, Share warrant, Dividend warrant, Railway receipts, Delivery orders etc. The parties to bill of exchange are drawer, drawee, acceptor, payee, indorser, indorsee, holder, drawee in case of need and acceptor for honour. The parties to a promissory note are maker, payee, holder, indorser and indorsee while parties to cheque are drawer, drawee, payee, holder, indorser and indorsee.

Negotiation of an instrument is a process by which the ownership of the instrument is transferred by one person to another. There are two methods of negotiation: by mere delivery and by endorsement. In its literal sense, the term 'indorsement' means writing on an instrument but in its technical sense, under the Negotiable Instrument Act, it means the writing of a person's name on the face or back of a negotiable instrument or on a slip of paper annexed thereto, for the purpose of negotiation. A bill may be dishonoured by non-acceptance (since only bills require acceptance) or by non-payment, while a promissory note and cheque may be dishonoured by non-payment only. Noting means recording of the fact of dishonour by a notary public on the bill or paper or both partly. Protest is a formal notarial certificate attesting the dishonour of the bill. The term 'discharge' in relation to negotiable instrument is used in two senses, viz.,

(a) discharge of one or more parties from liability thereon, and

(b) discharge of the instrument.

Self Assessment

State whether the following statements are true or false:

6. A negotiable instrument does not require the signature of its maker.

Notes

7. The hundi which is payable after a specified period of time is called 'Darshani Hundi'.
8. A negotiable insrument is not freely transferable.
9. Stamping of promissory note is not mandatory.
10. The time of payment of a negotiable instrument need not be certain.

8.6 Loans and Advances

Efficient management of Loans and Advances portfolio has assumed greater significance as it is the largest asset of the bank having direct impact on its profitability. In the wake of the continued tightening of norms of income recognition, asset classification and provisioning, increased competition and emergence of new types of risks in the financial sector, it has become imperative that the credit functions are strengthened. RBI has also been emphasizing banks to evolve suitable guidelines for effective management and control of credit risks.

With a view to ensuring a healthy loan portfolio, public sector banks have taken various steps to bring their policies and procedures in line with changing scenario which also aim at effective management and dispersal of credit risks, strengthening of pre-sanction appraisal and post-sanction monitoring systems. Concurrent steps are being initiated by the banks to strengthen their organizational set-up by opening specialized branches to meet the credit requirements of specific types of borrowers, imparting intensive credit management training to staff and deployment of the trained staff at branches/offices having potential for credit growth. Banks have laid down detailed guidelines to be followed while considering credit proposals, some of the important ones are listed as under:

- All loan facilities are to be considered by the sanctioning authority after obtaining loan application(s) from the borrower(s) and compilation of Confidential Report(s) on him/them and the guarantor(s). The borrowers should have the desired background, experience/expertise to run their business successfully.
- The project for which the finance is granted should be technically feasible and economically/commercially viable i.e. it should be able to generate enough surplus so as to service the debts within a reasonable period of time.
- The cost of the project and means of financing the same should be properly assessed and tied up. Both under-financing and over-financing can have an adverse impact on the successful implementation of the project.
- Borrowers should be financially sound, enjoy good market reputation and must have their stake in the business i.e., they should possess adequate liquid resources to contribute to the margin requirements.
- Loans should be sanctioned by the competent sanctioning authority as per the delegated loaning powers and should be disbursed only after execution of all the required documents.
- Projects financed must be closely monitored during implementation stage to avoid time and cost overruns and thereafter till the adjustment of the bank's loan.

Banks extend loan facilities by way of fund-based facilities and/or non-fund based facilities. The fund-based facilities are usually allowed by way of term loans, cash credit, bills discounted/purchased, demand loans, overdrafts, etc. Further, the banks also provide non fund-based facilities by way of issuance of inland and foreign letters of credit, issuance of guarantees, deferred payment guarantees, bills acceptance facility under IDBI Rediscounting Scheme etc.

Notes

The usual types of facilities sanctioned by banks to the borrowers, as also other aspects like project appraisal, post-sanction follow up, management of NPAs, documentation, limitation etc. are discussed individually in the book. These are briefly explained hereunder:

Overdrafts

All overdraft accounts are treated as current accounts. Normally, overdrafts are allowed against the bank's own deposits, government securities, approved shares and/or debentures of companies, life insurance policies, government supply bills, cash incentive and duty drawbacks, personal security, etc.

Overdraft accounts are kept in the ordinary current account head of the bank branches. Temporary clean overdrafts in current accounts are maintained in the ordinary current account ledgers, today in an electronic form.

Demand Loans

A demand loan account is an advance for a fixed amount and no debits to the account are made subsequent to the initial advance except for interest, insurance premia and other sundry charges. As an amount credited to a demand loan account has the effect of permanently reducing the original advance, any further drawings permitted in the account will not be secured by the demand promissory note taken to cover the original loan. A fresh loan account must, therefore, is opened for every new advance granted and a new demand promissory note taken as security.

Demand loan would be a loan, which is repayable on demand in one shot i.e. bullet repayment.

Normally, demand loans are allowed against the bank's own deposits, government securities, approved shares and/or debentures of companies, life insurance policies, pledge of gold/silver ornaments, mortgage of immovable property. A separate account for each demand loan is kept in the appropriate demand loan ledger of the banks.

Term Loans

Term loans are sanctioned for acquisition of fixed assets like land, building, plant/machinery, office equipment, furniture-fixture, etc., for purchase of transport vehicles and other vehicles, for purchase of agricultural equipment, machinery and other movable assets e.g. tractors, pump sets, cattle etc. under various schemes of agricultural advances introduced from time to time, for purchase of house, consumer durables, etc. under special schemes introduced from time to time.

The term loan would be a loan, which is not a demand loan and is repayable in terms i.e. in instalments irrespective of period or the security cover.

Term loans are normally granted for periods varying from 3 to 7 years and in exceptional cases beyond 7 years. Term loans for infrastructure projects are allowed even with longer repayment period. The exact period for which a particular loan is sanctioned depends on the circumstances of the case.

Cash Credit Advances

Cash credit account is a drawing account against credit granted by the bank and is operated in exactly the same way as a current account on which an overdraft has been sanctioned. The various types of securities against which cash credits are allowed are pledge/hypothecation of goods or produce, pledge of documents of title to goods, mortgage of immovable property, book debts, trust securities, etc. In cash credit accounts the borrower is allowed to draw an account within the prescribed limit, as and when required.

Notes

Caution Term loans are normally granted for periods varying from 3 to 7 years and in exceptional cases beyond 7 years.

Bill Finance

Advances against Inland Bills are sanctioned in the form of limits for purchase of bills (Bills Purchase Limit) or discount of bills (Bills Discounting Limit) or bills sent for collection advance against bills sent for collection (ABC Limit), to borrowers for their genuine trade transactions. Bills are either payable on demand or after usance period.

Demand Bills which are payable on demand or at sight, are purchased from the parties who are sanctioned Bills Purchase limits and Usance Bills which are payable on maturity after a certain period of time as per terms of contract are discounted for parties who are sanctioned Bills Discounting limits.

Packing Credit

Packing credit is an advance given to an exporter who holds a Code Number assigned to him by the Directorate General of Foreign Trade (DGFT), for financing the purchase, processing, manufacturing or packing of goods prior to shipment, on the basis of letter of credit opened in his favour or in favour of some other person, by an overseas buyer or a confirmed and irrevocable order for the export of goods from India or any other evidence of an order for export from India having been placed on the exporter or some other person, unless lodgement of export orders or Letter of Credit with the bank has been waived.

Packing credit advances are generally allowed separately for each Letter of Credit/Firm Order to comply with the guidelines issued by corporate divisions of the concerned banks/Reserve Bank of India.

Inland Letters of Credit

Letter of credit (LC) is issued by the bank at the request of its customer in favour of a third party informing him that the Bank undertakes to accept the bills drawn on its customers up to the amount stated in the LC subject to the fulfilment of the conditions stipulated therein. Therefore, when the bank issues LC, it assumes responsibility to pay its beneficiary on production of bills drawn in accordance with the terms and conditions of the LC.

Guarantees

Guarantee is a contract to execute the promise, or discharge the liability of a third person in case of his default. In the ordinary course of business, the bank often issues guarantees on behalf of its customers in favour of third parties. When the bank issues such a guarantee, it assumes a responsibility to pay the beneficiary, in the event of a default made by the customer.

Notes When the bank issues LC, it assumes responsibility to pay its beneficiary on production of bills drawn in accordance with the terms and conditions of the LC.

Did u know? Temporary clean overdrafts in current accounts are maintained in the ordinary current account ledgers, today in an electronic form.

Notes

Self Assessment

Fill in the blanks:

11. Efficient ..... of Loans and Advances portfolio has assumed greater significance as it is the largest asset of the bank having direct impact on its profitability.
12. ..... is a contract to execute the promise, or discharge the liability of a third person in case of his default.
13. ..... accounts are kept in the ordinary current account head of the bank branches.
14. The exact period for which a particular ..... is sanctioned depends on the circumstances of the case.
15. Projects financed must be closely monitored during ..... stage to avoid time and cost overruns.

Notes The more frequently affirm must refinance debt, the greater is the risk of its not being able to obtain the necessary financing.

Task Draw specimens of different types of cheque that you have learnt from this lesson.

Case Study

Enforceability of lost or destroyed Negotiable Instruments/Commercial Paper

Posted on November 23, 2008 by pklawyers

An interesting case that shows the how lost or destroyed Negotiable Instruments/ Commercial Paper can remain enforceable is Atlantic National Trust, LLC v. McNamee, 2007.

The High court in Alabama held that a destroyed promissory note is still enforceable both the maker of the note, or an assignee could enforce it so long as its existence could be proven.

In this case a bank (Wachovia) made a loan in 2003 to the debtor, McNamee, in the amount of $150,000. For this he signed a promissory note. At some point, Wachovia inadvertently misplaced, lost or destroyed the original note. The note matured in 2005 and after the loan matured Wachovia assigned its rights in and to the note to the plaintiff Atlantic National Trust., which then sued for recovery. Atlantic demanded McNamee repay the remaining principal balance of $138,620 plus interest. The plaintiff moved for summary judgment based on an affidavit affirming that the instrument had been lost by the assignor.

Now Atlantic could not produce the original note, but had a copy, so the debtor defended on the grounds that the plaintiff assignee had no right to enforce the note since it was never in possession of the original document, and that the assignee of a lost note has no standing to sue the maker. Thus McNamee contended that because the original note was

Contd....

Notes

destroyed, the note could not be enforced. The federal court certified a question to the Alabama high court to clarify Alabama common law on that issue.

It was concluded that an assignee has all of the same rights, benefits, and remedies that the assignor has to enforce contracts to the extent the assignor was able to do so, hence the plaintiff assignee was entitled to enforce the note whether it was lost, destroyed, or stolen. Ultimately the evidence was clear that the note was genuine, the fact of the destruction of the original did not make it unenforceable either by the maker of the note, Wachovia, or by the assignee, Atlantic .

Source: http://pklawyers.wordpress.com/2008/11/23/enforceability-of-lost-or-destroyed-negotiable-instrumentscommercial-paper/

8.7 Summary

A negotiable instrument is a document guaranteeing the payment of a specific amount of money, either on demand, or at a set time. Negotiable instruments are often defined in legislation. For example, according to the Section 13 of the Negotiable Instruments Act, 1881 in India, a negotiable instrument means a promissory note, bill of exchange or cheque payable either to order or to bearer. So, in India, there are just three types of negotiable instruments such as promissory note, bill of exchange and cheque as explained below. Cheque also includes Demand Draft [Section 85A].

- Negotiable instruments are particular type of documents used for making payment in business transactions, the ownership of which can be freely transferred from one person to another.
- Types of Negotiable Instruments - Promissory note - Bill of exchange - Cheque - Hundi.
- ***Promissory note*** - An instrument in writing containing an unconditional undertaking, signed by the maker, to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.
- ***Bill of exchange*** - An instrument in writing containing an unconditional order, signed by the maker, directing a certian person to pay a certain sum of money only to or to the order of a certain person or to the bearer of the instrument.
- ***Cheque*** - It is an order by the account holder of the bank directing his banker to pay on demand the specified amount, to or to the order of the person named therein or to the bearer.
- ***Hundi*** - It is a form of bill of exchange drawn in any local language in accordance with the custom of the place.
- Features of negotiable instruments are-free transferability, good title, always in written form, unconditional order or promise, certainty of payment, payee, time, etc.

As a negotiable instrument is a promise of a payment of money, the instrument itself can be used by the holder in due course as a store of value; although, instruments can be transferred for amounts in contractual exchange that are less than the instrument's face value (known as "discounting").

Notes

8.8 Keywords

Accommodation bills: Those bills, which are drawn without any actual consideration, merely, to help out friends and relatives are known as accommodation bills.

Assignment: Assignment of any object means the transfer of its tile to another person through a written and registered deed under the Transfer of Property Act.

Banker's draft: It is a bill of exchange in which a bank orders its branch or another bank, as the case may be, to pay a specified amount to a specified person or to the order of the specified person.

Bills of exchange: A bill of exchange is an instrument in writing containing an unconditional order signed by the maker directing a certain person to pay a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument.

Cheque: Cheque is a kind of bill of exchange, which is always drawn upon a specific bank and is payable on demand.

Crossing of a cheque: When two angular parallel lines are drawn on the face of the cheque, then the cheque said to be crossed.

Negotiable instrument: A negotiable instrument is one, the property and the title in which is acquired by anyone who takes it as bonafide and for value notwithstanding any defect in the title of the person from whom he/she took it.

Payment in due course: Payment in due course means payment of the instrument after the expiry of the duration of the instrument, in good faith and without any negligence, to the possessor thereof and without the existence of any circumstances that may lead one to believe that the person receiving the payment is not entitled to it.

Promissory note: A promissory note is an instrument in writing (not being a bank note or currency note) containing an unconditional undertaking, signed by the maker, to pay a certain sum of money to, or to the order of a certain person.

Usances: The time fixed by the custom of countries for payment of bills drawn in one country but are payable in another country is known as a usance.

8.9 Review Questions

1. Name any two types of commonly used negotiable instruments.
2. Write two points of distinction between a promissory note and a cheque.
3. "The drawer can only draw a Time Bill". Do you agree with this statement? Give reason.
4. "A cheque need not bear a date." Do you agree? Give reason.
5. Explain 'Darshani Hundi' in about 20 words.
6. State any four essential features of a bill of exchange.
7. Write any four points of distinction between a promissory note and a bill of exchange.
8. Explain briefly "certainty of person" and "time of payment" as features of negotiable instruments.
9. "A bill of exchange must contain an unconditional promise to pay." Do you agree with this statement? Justify your answer.

Notes

10. State the three parties involved in a bill of exchange.
11. Define Promissory note and state its any four important features.
12. State the important features of a bill of exchange.
13. Give the definition of a 'cheque'. How does it differ from a bill of exchange?
14. "There are different types of Hundis used in our country". Do you agree? State any two important varieties of Hundis.
15. "Negotiable means transferable and instrument means documents. Thus, negotiable instrument means a transferable document." But apart from these, there are other essential features of a negotiable instrument. State any six.
16. What are the different types of cheques? Distinguish between open cheque and crossed cheque.
17. What is meant by negotiation? How is it effected and how does it differ from an assignment?
18. Define endorsement. What are the various classes of endorsement?
19. Explain the privileges granted to a holder in due course.
20. In what different ways may a negotiable instrument be dishonoured? What are the duties of a holder of a dishonoured bill?
21. How and when should a notice be served on a bill being dishonoured by either non-acceptance or non-payment? Under what circumstances is notice of dishonour unnecessary?
22. What are the various ways in which one or more parties to a negotiable instrument is/are discharged for liability? Discuss.
23. Define the term 'negotiable instrument'. What are its essential characteristics?
24. Discuss the presumptions in respect of a negotiable instrument.
25. What is a bill of exchange? How does it differ from a promissory note?
26. Who are the parties to a negotiable instrument? Discuss.

Answers: Self Assessment

1.	Payee	2.	Endorsement
3.	Drawer/Maker	4.	Endorser
5.	Indian Stamp	6.	False
7.	False	8.	False
9.	False	10.	False
11.	Management	12.	Guarantee
13.	Overdraft	14.	Loan
15.	Implementation		

Notes

8.10 Further Readings

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Unit 9: Priority Sector Lending

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Objectives

After studying this unit, you should be able to:

- Define what is Priority Sector, its classification, targets and guidelines of Reserve Bank of India.
- Understand exclusive Reserve Bank of India's guidelines on Small Scale Industries, Tiny enterprises, Small Scale Service and Business Enterprises and Key Sectoral Finances
- Know Self Help Groups and Micro Credit Financing

Introduction

The term priority sector itself suggests that certain sectors of the economy are need to be taken up on a priority basis for rapid economic development.

Notes

In pursuance of the same, the Government of India at a meeting of the National Credit Council held in July 1968 emphasised that commercial banks should increase their involvement in the financing of priority sector namely agriculture and small scale industries. The description of the priority sector was later formalised in 1972 on the basis of report submitted by the informal study group on statistics relating to advances to the priority sectors constituted by the Reserve Bank in may 1971.

9.1 Priority Sector Lending

The broad guidelines relating to priority sector leading in their current form are discussed below as basic queries and answers:

1. What are the targets under priority sector lending?

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

Category	Domestic Banks (both public sector and private sector banks)	Foreign Banks operating in India
Total priority sector advances	40 per cent of NBC	32 per cent of NBC
Total agricultural advances	18 per cent of NBC	No target
SSI advances	No target	10 per cent of NBC
Export credit	Export credit does not form part of priority sector	12 per cent of NBC
Advances to weaker sections	10 per cent of NBC	No target
DRI advances	1% of previous year's total advances	No target

Note: NBC denotes net bank credit.

2. What constitutes net bank credit?

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

3. What does the priority sector comprise?

Ans. Broadly, the priority sector comprises the following:

1. Agriculture
2. Small scale industries (including setting up of industrial estates).
3. Small road and water transport operators (owning up to 10 vehicles).
4. Small business (Original cost of equipment used for business not to exceed Rs. 20 lakh).
5. Retail trade (advances to private retail traders up to Rs.10 lakh).
6. Up to Rs. 1 lakh and Rs. 2 lakh for repairing of houses in rural/semi-urban and urban areas respectively].
7. Consumption loans (under the consumption credit scheme for weaker sections).
8. Micro-credit provided by banks either directly or through any intermediary; loans to self help groups (SHGs)/Non-Governmental Organisations (NGOs) for onlending to SHGs.

Notes

9. Loans to the software industry (having credit limit not exceeding Rs. 1 crore from the banking system).

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

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

4. What constitutes 'Direct Finance' for Agricultural Purposes?

Ans. Direct Agricultural advances denote advances given by banks directly to farmers for agricultural purposes. These include short-term loans for raising crops i.e. for crop loans. In addition, advances up to Rs. 5 lakh to farmers against pledge/hypothecation of agricultural produce (including warehouse receipts) for a period not exceeding 12 months, where the farmers were given crop loans for raising the produce, provided the borrowers draw credit from one bank. The sub-target for direct agriculture advances is 13.5% of the NBC.

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

5. What constitutes 'Indirect Finance' to Agriculture?

Ans. Indirect finance denotes to finance provided by banks to farmers indirectly, i.e., through other agencies. Sub-target for indirect agriculture advances is 4.5% of NBC. Important items included under indirect finance to agriculture are as under:

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

(ii) Loans up to Rs. 40 lakhs granted for financing distribution of inputs for the allied activities such as cattle feed, poultry feed, etc.

(iii) Loans to Electricity Boards for reimbursing the expenditure already incurred by them for providing low tension connection from step-down point to individual farmers for energizing their wells.

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

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

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

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

(viii) Loans to farmers through PACS, FSS and LAMPS.

Notes

Notes Indirect finance denotes to finance provided by banks to farmers indirectly, i.e., through other agencies. Sub-target for indirect agriculture advances is 4.5% of NBC.

9.2 Other types of Indirect Finance to Agriculture

1. Finance for hire-purchase schemes for distribution of agriculture machinery and implements.
2. Loans for constructions and running of storage facilities (warehouse, market yards, godowns and silos) including cold storage units designed to store agriculture produce/ products, irrespective of their location. If the storage unit are registered as SSI unit, the loans granted to such units may be classified under advances to SSI, provided the investment in P&M is within the stipulated ceiling.
3. Advances to custom-service units managed by individuals, institutions, or organizations who maintain a fleet of tractors, bulldozers, well-boring equipments, thrashers, combines, etc., and undertake work from farmers on contract basis.
4. Loan to individuals, institutions that undertake spraying operations.
5. Loans to cooperative marketing societies, cooperative banks for re-lending to cooperative marketing societies (provided a certificate from the State Cooperative Bank in favour of such loans is produced) for disposing the produce of the members.
6. Loans to cooperative banks of produces (e.g. Aarey Milk Colony Cooperative Bank, consisting of licensed cattle owners).
7. Financing of farmers indirectly through cooperative system (otherwise by subscription to bonds and debenture issues), provided a certificate from the State Cooperative Bank in favour of such loans is produced.
8. Advances to State Sponsored Corporations advancing to weaker sections.
9. Finance extended to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, irrespective of their location, subject to the following conditions:
   (a) The dealer should be dealing exclusively in such items or if dealing in other products, should be maintaining separate and distinct records in respect of such items.
   (b) A ceiling of up to Rs. 30 lakhs per dealer should be observed.
10. Loans to National Cooperative Department Corporation (NCDC) for lending to the cooperative sector for purposes coming under the priority Sector.
11. For loans to farmers for purchase of shares in Cooperative Sugar Mills and Sugar Mills set up as joint stock companies and other agro based processing units (Maximum 6 shares of Rs. 1000 each or 3 shares of Rs. 2000 each, i.e., Rs. 6000/- per eligible borrower irrespective of their land holding).
12. Loans to Arthias (commission agents in rural/semi-urban areas) for meeting their working capital requirements on account of credit extended to farmers for supply of inputs.
13. Lending to Non Banking Financial Companies (NBFCs) for on-lending to agriculture.
14. Investments by banks in securitised assets, which represent indirect advances to agriculture.

Notes

6. What is the definition of 'Small Scale Industries' (SSI)?

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

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

7. What is the definition of 'Tiny Enterprises' ?

Ans. The status of 'Tiny Enterprises' is given to all small scale units whose investment in plant & machinery is up to Rs. 25 lakhs, irrespective of the location of the unit.

8. What are 'Small Scale Service & Business Enterprises' (SSSBE's)?

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

9. What does indirect finance in the small-scale industrial sector include?

Ans. Indirect finance to SSI includes the following important items:

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

(ii) Finance extended to Government sponsored corporation/organisations providing funds to the weaker sections in the priority sector.

(iii) Advances to handloom cooperatives.

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

(v) Credit provided by commercial banks to KVIC under the scheme for provision of credit to KVIC by consortium of banks for lending to viable khadi and Village Industrial Units.

(vi) Funds provided by banks to SIDBI/SFCs by way of rediscounting of bills of SSIs which are originally discounted by a commercial bank and rediscounted by SIDBI/ SFCs.

(vii) Subscription to bonds floated by SIDBI, SFCs, SIDCS and NSIC exclusively for financing SSI units.

(viii) Subscription to bonds issued by NABARD with the objective of financing exclusively non-farm sector.

(ix) Financing of NBFCs or other intermediaries for on-lending to the tiny sector. More so, all new loans granted by banks to NBFCs and other intermediaries for on-lending to SSI sector w.e.f. November 11, 2003.

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

Notes

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

(xii) Loans for setting up Industrial Estates.

(xiii) KVI Sector.

All KVI sector advances, irrespective of their size, location and investment in plant and machinery and will be eligible for consideration under the sub-target of 60% of the SSI segment within priority sector.

(xiv) Manufacturing of common salt through any process including manual operation which satisfy the norms under SSI.

(xv) Unit engaged in ship breaking/dismantling which satisfy SSI norms.

(xvi) Banks loan to bought leaf factories manufacturing tea provided original cost in P&M does not exceed the prescribed limit.

Did u know? The investment limit of Rs.1 crore for classification as SSI has been enhanced to Rs.5 crore in respect of certain specified items under hosiery, hand tools, drugs and pharmaceutical and stationery items by the Government of India.

10. What type of investments made by banks are reckoned under priority sector ?

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

(i) *State Financial Corporations (SFCs)/State Industrial Development Corporations (SIDCs)*

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

(ii) *Rural Electrification Corporation (REC)*

Subscription to special bonds issued by REC exclusively for financing pump-set energisation programme in rural and semi-urban areas and the System Improvement Programme under its Special Projects Agriculture (SI-SPA) will be eligible for inclusion under priority sector lending as indirect finance to agriculture.

(iii) *NABARD*

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

(iv) *Small Industries Development Bank of India (SIDBI)*

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

(v) *The National Small Industries Corporation Ltd. (NSIC)*

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

(vi) *National Housing Bank (NHB)*

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

Notes

(vii) *Housing & Urban Development Corporation (HUDCO)*

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

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

(viii) *Other investments*

Investments by the banks in venture capital will be eligible for inclusion in Priority Sector lending. This is subject to the condition that the venture capital funds/ companies are registered with SEBI.

(ix) *Lines of credit*

Banks may consider on merit proposals received from SIDCs and SFCs for sanction of term loan in the form of lines of credit.

(x) *Bills rediscounting*

Funds provided by commercial banks to SIDBI byway of rediscounting of bills of SSIs.

(xi) *Deposits in Rural Infrastructure Development Fund (RIDF)*

Outstanding balances of the deposits placed by Banks in RIDF of NABARD would be reckoned as Indirect finance to agriculture.

(xii) *Leasing & Hire Purchase*

Para-banking activities such as leasing and hire purchase financing undertaken departmentally by banks will be classified as priority sector advances, provided the ultimate beneficiary satisfies the criteria laid down by RBI for treating such advances to PS.

11. What are the weaker sections within the priority sector?

Ans. The weaker sections under priority sector include the following:

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

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

(iii) Beneficiaries of Swarnjayanti Gram Swarojgar Yojana (SGSY)

(iv) Scheduled Castes and Scheduled Tribes

(v) Beneficiaries of Differential Rate of Interest (DRI) scheme

(vi) Beneficiaries under Swarna Jayanti Shahari Rojgar Yojana (SJSRY)

(vii) Beneficiaries under the Scheme for Liberation and Rehabilitation of Scavengers (SLRS).

(viii) Self Help Groups (SHGs)

Notes

12. What action is taken in the case of non-achievement of priority sector lending target by a bank ?

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

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

13. Whether there is any time limit for disposal of loan applications?

Ans.

    (i) All loan applications up to a credit limit of Rs. 25,000 should be disposed of within a fortnight and those for over Rs. 25,000 within 8 to 9 weeks.

    (ii) All loan applications for SSI up to a credit limit of Rs. 25000 should be disposed off within 2 weeks and those up to Rs. 5 lakh within 4 weeks provided the loan applications are complete in all respects and accompanied by a check list.

14. What is the rate of interest for loans under priority sector?

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

15. What are the guidelines for charging of penal interest on PS advances?

Ans. The issue of charging of penal interest that should be levied for reasons such as defaults in repayment, non-submission of financial statements etc. has been left to the board of each bank. However, no penal interest is to be levied on PS advances up to Rs. 25000/-.

16. Apprise the guidelines about the service charges and insurance in PS advances.

Ans. No service charges/inspection charges to be levied on PS advances up to Rs. 25000 & for loans above Rs. 25000 banks are free to levy service charges.

Regarding insurance, banks may waive insurance of assets financed in:

(a) All type of PS advances up to and inclusive of Rs. 10000 for fire and other risks.

(b) Advances to SSI sector up to and inclusive of Rs. 25000 by way of:

    (i) Composite loans to artisans, village and cottage industries,

    (ii) All term loans,

    (iii) Working capital where these are against non-hazardous goods.

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

Notes

17. How is priority sector lending monitored by the Reserve Bank?

Ans.

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

(ii) All loan applications for SSI up to a credit limit of Rs. 25000 should be disposed off within 2 weeks and those up to Rs. 5 lakh within 4 weeks provided the loan applications are complete in all respects and accompanied by a check list.

18. What is the rate of interest for loans under priority sector?

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20. Apprise the guidelines about the service charges and insurance in PS advances.

Ans. No service charges/inspection charges to be levied on PS advances up to Rs. 25000 and for loans above Rs. 25000 banks are free to levy service charges.

Regarding insurance, banks may waive insurance of assets financed in:

(a) All type of PS advances up to and inclusive of Rs. 10000 for fire and other risks.

(b) Advances to SSI sector up to and inclusive of Rs. 25000 by way of:

(i) Composite loans to artisans, village and cottage industries,

(ii) All term loans,

(iii) Working capital where these are against non-hazardous goods.

21. How is priority sector lending monitored by the Reserve Bank?

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

9.3 Small Scale and Ancillary Industries – RBI Guidlines

Small scale industrial units are those engaged in the manufacture, processing or preservation of goods and whose investment in plant and machinery (original cost) does not exceed Rs. 1 crore. These would, inter alia, include units engaged in mining or quarrying, servicing and repairing of machinery. In the case of ancillary units, the investment in plant and machinery (Original cost) should also not exceed Rs. 1 crore to be classified under small-scale industry. The investment limit of Rs. 1 crore for classification as SSI has been enhanced to Rs. 5 crore in respect of certain specified items under hosiery, hand tools, drugs pharmaceuticals and stationery items and sports goods by the Government of India.

Notes

Tiny Enterprises

The status of 'Tiny Enterprises' may be given to all small scale units whose investment in plant and machinery is up to Rs. 25 lakhs, irrespective of the location of the unit.

9.3.1 Illustrative List of Small Scale Service Business (Industry Related) Enterprises (SSSBEs)

[*As per circular issued by the Ministry of Industries, Government of India*]

1. Advertising Agencies
2. Marketing Consultancy (All Marketing, Industrial Consultancy and Advertising Agencies)
3. Industrial Consultancy
4. Equipment Rental and Leasing
5. Typing Centres
6. Xeroxing
7. Industrial Photography
8. Industrial R&D Labs
9. Industrial Testing Labs
10. Computerised Design and Drafting
11. Creation of databases suitable for foreign/Indian markets
12. Software Development
13. Auto Repair, Services and Garages
14. Documentary Films on themes like family planning, social forestry, energy conservation and commercial advertising
15. Laboratories engaged in testing of raw materials, finished products
16. 'Servicing Industry' undertakings engaged in maintenance, repair, testing or servicing of all types of vehicles and machinery of any description including electronic/electrical equipment/instruments, i.e., measuring/control instruments, televisions, tape recorders, VCRs, radios, transformers, motors, watches, etc.
17. Laundry and Dry-cleaning
18. X-Ray Clinic
19. Tailoring
20. Servicing of Agricultural Farm equipment, e.g., Tractor, Pump, Rig, Boring Machines, etc.
21. Weigh Bridge
22. Photographic Lab
23. Blue printing and enlargement of drawing/designs facilities
24. ISD/STD booths for industries (extended to all ISD/STD booths)
25. Teleprinter/FAX services
26. Sub-contracting Exchanges (SEXs) established by Non-Government Industry Associations
27. EDP Institutes established by Voluntary Associations/Non-Government Organisations

Notes

28. Coloured, and Black and White Studios equipped with processing laboratory
29. Ropeways in hilly areas
30. Installation and operation of Cable TV Network
31. Operating EPABX under franchises
32. Beauty Parlours and Creches

[Software servicing and Data Processing (including computer graphics) and Printing Press, which were earlier registerable as SSSBEs have since been recognised as industrial activity registerable as Small Scale Industry (SSI)]

9.3.2 Illustrative List of Activities which are not Recognised as SSSBEs [Annexure-II]

[*As per circular issued by the Ministry of Industries, Government of India*]

Illustrative List of Activities which are not recognised as Small Scale Industry/Business (Industry Related) Enterprises i.e. SSSBE's

1. Transportation
2. Storage (except cold storage which is recognised as SSI)
3. Retail/Wholesale Trade Establishments
4. General Merchandise Stores
5. Sale Outlets for Industrial Components
6. Health Services including Pathological Laboratories
7. Legal Services
8. Educational Services
9. Social Services
10. Hotels

Industrial Estates

Loans for setting up industrial estates.

Task Discuss the rules and prudential norms of RBI in priority sector lending.

Self Assessment

Fill in the blanks:

1. _____ lending by commercial banks is monitored by Reserve Bank of India through periodical Returns received from them.
2. The status of '_____may be given to all small scale units whose investment in plant and machinery is up to Rs. 25 lakhs, irrespective of the location of the unit.
3. Small scale industrial units are those engaged in the manufacture, processing or preservation of goods and whose investment in plant and machinery (original cost) does not exceed Rs. 1 crore.

Notes

4. No service charges/inspection charges to be levied on PS advances up to Rs. 25000 and for loans above Rs. _____ banks are free to levy service charges.

5. _____ activities such as leasing and hire purchase financing undertaken departmentally by banks will be classified as priority sector advances, provided the ultimate beneficiary satisfies the criteria laid down by RBI for treating such advances to PS.

9.4 KVI Sector

All advances to KVI sector, irrespective of their size of operations, location and investment in plant and machinery, will be covered under priority sector advances and will also be eligible for consideration under the sub-target (60 percent) of the SSI segment within the priority sector.

Other units recognized as SSIs:

- Manufacture of common salt through any process including manual operation (involving solar evaporation) may be considered as an industrial activity and credit provided by banks to units engaged in the manufacture of common salt which satisfy the norms of SSI unit may be classified under advances to SSI.
- Units engaged in ship breaking/dismantling are composite ones which also undertake the processing of scrap thus obtained and hence the entire activity can be covered under processing. Therefore, all small scale industrial units with original cost of plant and machinery not exceeding Rs. 1 crore and engaged in ship breaking/dismantling activity may be considered as small scale industrial undertaking and bank advances to such units reckoned as priority sector advances.
- Bank loans to bought leaf factories manufacturing tea are to be reckoned as priority sector lending to small scale industry, provided the investment in plant and machinery (original cost) does not exceed the prescribed limits.
- Water mills (Gharat) have been recognized as an industrial activity and shall be eligible for registration as small scale industry.

9.5 Lines of Credit

Banks may consider on merit, proposals received from State Industrial Development Corporations (SIDCs) and State Financial Corporations (SFCs) for sanction of term finance/ loans in the form of lines of credit.

Such term finance/loans to the extent granted for/to the Small Scale Industrial (SSI) units, will be treated as priority sector lending, subject to the observance of following conditions:

1. SFC/SIDC should maintain separate and distinct accounts of fresh disbursements made to SSI units and outstanding amounts there against.
2. Periodical statements to be obtained from SFC/SIDC to monitor the position.
3. Annually, a certificate issued by SFC/SIDC statutory auditors certifying that the outstanding borrowings from banks were fully covered by the non-overdue loans outstanding in respect of fresh disbursements made to SSI units from out of term finance/lines of credit granted by banks.
4. The rate of interest to be charged by banks on such term finance/loans/lines of credit will be in conformity with the directives on interest rates issued by the Reserve Bank from time to time.

Notes

9.6 Bills Rediscounting

- Funds provided by commercial banks to SIDBI by way of rediscounting of bills which are originally discounted by a commercial bank and rediscounted by SIDBI will be eligible for inclusion under the priority sector as indirect finance to SSI.
- Funds provided by commercial banks to State Financial Corporations (SFCs) by way of rediscounting of bills of SSIs earlier discounted by the SFCs will be eligible for inclusion under the priority sector as indirect finance to SSIs.

Sub-targets for all scheduled commercial banks excluding foreign banks

Small Scale Industries

In order to ensure that credit is available to all segments of the SSI sector, banks should ensure that:

(a) 40 per cent of the total credit to small scale industry goes to the cottage industries, khadi & village industries, artisans and tiny industries with investment in plant and machinery up to Rs. 5 lakh;

(b) 20 per cent of the total credit to small scale industry goes to SSI units with investment in plant and machinery between Rs. 5 lakh and Rs. 25 lakh; and

(c) the remaining 40 percent goes to other SSI units with investment exceeding Rs. 25 lakh.

Processing of Applications

Completion of Application Forms: In areas covered by special schemes such as SGSY, the concerned project authorities like DRDAs, DICs etc. should arrange for completion of application forms received from borrowers. In other areas, the bank staff should help the borrowers for this purpose.

Issue of Acknowledgement of Loan Applications: Banks should give acknowledgement for loan applications received from weaker sections. Towards this purpose, while getting fresh stocks of application forms printed, it may be ensured that these forms have perforated portion for acknowledgement to be completed and issued by the receiving branch. Each branch may affix on the main application form as well as the corresponding portion for acknowledgement, a running serial number. While using the existing stock of application forms till then, an acknowledgement (separately prepared) should be given for each application, care being taken to ensure that the serial number given on the acknowledgement is also recorded on the main application.

Disposal of Applications: All loan applications up to a credit limit of Rs. 25,000 should be disposed of within a fortnight and those for over Rs. 25,000 up to Rs. 5 lakh, within 8 to 9 weeks provided the loan applications are complete in all respects and accompanied by a 'check list'.

Rejection of Proposals: Branch Managers may reject applications (except in respect of SC/ST) provided the cases of rejection are verified subsequently by the Divisional/Regional Managers. In the case of proposals from SC/ST, rejection should be at a level higher than that of Branch Manager.

Register of Rejected Applications: A register should be maintained at branch wherein the date of receipt, sanction/rejection/disbursement with reasons therefore etc., should be recorded. The register should be made available to all inspecting agencies.

Notes

(i) Rejection of applications for fresh limits/enhancement of existing limits should not be done without the approval of the next higher authority.

(ii) Sanction of reduced limits should be reported to the next higher authority immediately with full details for review and confirmation.

Collaterals: The limit for all SSI borrowal accounts for obtention of collateral security is Rs. 5 lakh. Banks may on the basis of good track record and financial position of the SSI units, increase the limit of dispensation of collateral requirement for loans up to Rs. 25 lakh (with the approval of the appropriate authority).

Caution All loan applications up to a credit limit of Rs. 25,000 should be disposed of within a fortnight and those for over Rs. 25,000 up to Rs. 5 lakh, within 8 to 9 weeks provided the loan applications are complete in all respects and accompanied by a 'check list'.

Composite loan: A composite loan limit of Rs. 1 crore can be sanctioned by banks to enable the SSI entrepreneurs to avail of their working capital and term loan requirement through Single Window.

Specialised SSI branches: Banks have been advised to open at least one Specialised SSI branch in each district. Further, banks have been permitted to categorise their general banking branches having 60% or more of their advances to SSI sector as specialised SSI branches in order to encourage them to open more specialised SSI branches for providing better service to this sector as a whole.

Delayed Payment: Under the Amendment Act, 1998 of Interest on Delayed Payment to Small Scale and Ancillary Industrial Undertakings, penal provisions have been incorporated to take care of delayed payments to SSI units which inter-alia stipulates a) agreement between seller and buyer shall not exceed more than 120 days, (b) payment of interest by the buyers at the rate of one and a half times the prime lending rate (PLR) of SBI for any delay beyond the agreed period not exceeding 120 days. Further, banks have been advised to fix sub-limits within the overall working capital limits to the large borrowers specifically for meeting the payment obligation in respect of purchases from SSI.

9.7 Revised Guidelines on Rehabilitation of Sick SSI Units (based on Kohli Working Group Recommendations)

As per the revised definition, a unit is considered as sick when any of the borrowal account of the unit remains substandard for more than 6 months or there is erosion in the net worth due to accumulated cash losses to the extent of 50% of its net worth during the previous accounting year and the unit has been in commercial production for at least two years. The revised criteria will enable banks to detect sickness at an early stage and facilitate corrective action for revival of the unit. As per the revised guidelines the rehabilitation package should be fully implemented within six months from the date the unit is declared as potentially viable/viable. During this six months period of identifying and implementing rehabilitation package banks/FIs are required to do "holding operation" which will allow the sick unit to draw funds from the cash credit account at least to the extent of deposit of sale proceeds.

Following are broad parameters for grant of relief and concessions for revival of potentially viable sick SSI units:

(i) Interest on Working Capital Interest 1.5% below the prevailing fixed/prime lending rate, wherever applicable.

Notes

(ii) Funded Interest Term Loan Interest Free.

(iii) Working Capital Term Loan Interest to be charged 1.5% below the prevailing fixed/ prime lending rate, wherever applicable.

(iv) Term Loan Concessions in the interest to be given not more than 2% (not more than 3% in the case of tiny/decentralized sector units) below the document rate.

(v) Contingency Loan Assistance the Concessional rate allowed for Working Capital Assistance.

Notes As per the revised definition, a unit is considered as sick when any of the borrowal account of the unit remains substandard for more than 6 months or there is erosion in the net worth due to accumulated cash losses to the extent of 50% of its net worth during the previous accounting year and the unit has been in commercial production for at least two years.

Did u know? Broad parameters for grant of relief and concessions is Interest on Working Capital Interest 1.5% below the prevailing fixed/prime lending rate, wherever applicable.

Self Assessment

State whether the following statements are true or false:

6. Funds provided by commercial banks to SIDBI by way of rediscounting of bills which are originally discounted by a commercial bank and rediscounted by SIDBI will not be eligible for inclusion under the priority sector as indirect finance to SSI.

7. Banks have been advised not to fix sub-limits within the overall working capital limits to the large borrowers specifically for meeting the payment obligation in respect of purchases from SSI.

8. A register should be maintained at branch wherein the date of receipt, sanction/rejection/ disbursement with reasons therefore etc., should be recorded.

9. A composite loan limit of Rs.1 crore can be sanctioned by banks to enable the SSI entrepreneurs to avail of their working capital and term loan requirement through Single Window.

10. Rejection of applications for fresh limits/enhancement of existing limits should be done without the approval of the next higher authority.

9.8 State Level Inter Institutional Committee (SLIIC)

In order to deal with the problems of coordination for rehabilitation of sick small scale units, State Level Inter-Institutional Committees (SLIICs) have been set up in all the States. The meetings of these Committees are convened by Regional Offices of RBI and presided over by the Secretary, Industry of the concerned State Government. It provides a useful forum for adequate interfacing between the State Government Officials and State Level Institutions on the one side and the term lending institutions and banks on the other. It closely monitors timely sanction of working capital to units which have been provided term loans by SFCs, implementation of special schemes such as Margin Money Scheme of State Government, National Equity Fund Scheme of SIDBI, and reviews general problems faced by industries and sickness in SSI sector based on the

Notes

data furnished by banks. Among others, the representatives of the local state level SSI associations are invited to the meetings of SLIIC which are held quarterly. A subcommittee of SLIIC looks into the problems of individual sick SSI unit and submits its recommendations to the forum of SLIIC for consideration.

Technology Upgradation

Banks have been advised to develop schemes to encourage investment by SSI units in technology upgradation. Government of India has also introduced the scheme of Credit Linked Capital Subsidy for the upgradation of the Small Scale Industries.

Cluster Approach

60 clusters have been identified by the Ministry of SSI, Government of India for focused development of SSIs. All SLBC Convener banks have been advised to incorporate in their Annual Credit Plans, the credit requirement in the clusters identified by the Ministry of SSI, Government of India.

As per Ganguly Committee recommendations banks have been advised that a full-service approach to cater to the diverse needs of the SSI sector may be achieved through extending banking services to recognized SME clusters by adopting a 4-C approach namely. Customer focus, Cost control, Cross sell and Contain risk. A cluster based approach to lending may be more beneficial:

(i) in dealing with well-defined and recognized groups;

(ii) availability of appropriate information for risk assessment; and

(iii) monitoring by the lending institutions.

Clusters may be identified based on factors such as trade record, competitiveness and growth prospects and/or other cluster specific data.

9.9 Mode of Disbursement of Loan

As far as possible, disbursement of loan amounts sanctioned should be made directly to the suppliers of inputs such as seeds, fertilisers, raw materials, implements, trucks, machinery, etc.

Repayment Schedule

- Repayment programme should be fixed taking into account the sustenance requirements, surplus generating capacity, the break-even point, the life of the asset, etc., and not in an "ad hoc" manner. In respect of composite loan up to Rs. 50,000 to artisans, village and cottage industries, repayment schedule may be fixed for term loan component only (subject to SIDBI's requirements being fulfilled).
- In the case of other borrowers affected by natural calamities, banks may convert drawings in excess of the value of security into a term loan repayable over a reasonable period of time and provide further working capital and extend/re-phase the installments due under term loans.

Rates of Interest

As per extant guidelines the banks are required to fix their own prime lending rates (PLRs) and the maximum band over the PLR. The interest rates on loans up to Rs.2 lakh should not exceed

Notes

the PLR and that beyond Rs.2 lakh is left to the discretion of the banks subject to PLR and the maximum bands. The banks have been advised to accord SSI units with a good track record the benefit of lower spreads over the PLR. Banks have been advised to set the interest rate on advances keeping in view prevailing general southward movement in interest rates. The banks have been further advised to fix at least 3 slabs for advances to SSI sector.

Penal Interest

- The issue of charging penal interests that should be levied for reasons such as default in repayment, non-submission of financial statements etc. has been left to the Board of each bank. Banks have been advised to formulate policy for charging such penal interest with the approval of their Boards, to be governed by well accepted principles of transparency, fairness, incentive to service the debt and due regard to difficulties of customers.
- No penal interest should be charged for loans up to Rs. 25,000.
- For limits over Rs. 25,000 the aggregate penal/additional interest should not exceed 2 per cent over and above the rate of interest applicable/normally charged to the borrowers.

Caution The banks have been advised to accord SSI units with a good track record the benefit of lower spreads over the PLR.

9.10 Insurance against Fire and Other Risks

Banks may waive insurance of assets financed by bank credit in the following cases:

No.	Category	Type of Risk	Type of Assets
(a)	All categories of priority sector advances upto and inclusive of Rs. 10,000	Fire and other risks	Equipment and current assets
(b)	Advances to SSI sector upto and inclusive of Rs. 25,000 by way of -		
	• Composite loans to artisans, village and cottage industries	Fire	Equipment and current assets
	• All term loans	Fire	Equipment
	• Working capital where these are against non-hazardous goods	Fire	Current Assets

Where, however, insurance of vehicle or machinery or other equipment/assets is compulsory under the provisions of any law or where such a requirement is stipulated in the refinance scheme of any refinancing agency or as part of a Government-sponsored programmes such as, IRDP (since replaced by SGSY), insurance should not be waived even if the relative credit facility does not exceed Rs. 10,000 or Rs. 25,000, as the case may be.

Other Charges

Banks should not levy any other service charges except by way of reimbursement of reasonable out of pocket expenses.

9.11 Self Help Groups

Rural indebtedness is one of the serious deficiencies which any developing economy suffers. Money lenders exploit, the rural masses, lend money at unbelievable rate of interest and assure

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that rural poverty continues to assure their prosperity. Indian economy being a developing are is no exception to this event. It is where the role of all concerned arises to inculcate savings habit among villagers for self sustenance. Formation of self help group is one such effort.

Self help groups refer to a homogeneous group of 10-20 members formed with intent to save a small amount regularly to help each other in times of need. Homogeneous group imply common characteristics they share amongst themselves. Pooled savings one kept in Savings Back account in the name of SHG.

Given below one some possible queries and their answers on SHG:

1. How many members can be there in a Self Help Group (SHG)?

Ans. 10-20. In case of common water user group, members, can be 5.

2. Can more than one persons of a family be the members of a SHG?

Ans. No, only one person of a family can be the member of an SHG. Here, minor cannot become the member of the group. NGO also cannot become the office bearer of the SHG.

3. Can persons of different social, cultural & financial background constitute an SHG?

Ans. The group formed by the members of heterogeneous background cannot depict a strong group dynamics, hence can't be sustainable. Therefore, the group should have persons from homogeneous social, cultural and financial background.

4. Generally it is said that members should save something to create a group corpus/fund corpus, but what is really saving means?

Ans. Concept of SHG is based on thrift, which means cutting their expenditure and sparing for the purpose, Whereas saving means to save something from the existing income.

5. Can savings mobilized by Self help Groups (SHGs) be deposited in a Saving Fund Account?

Ans. Yes. The group can open the saving account with the bank branch with the initial deposit of Rs. 100/-. Branch should not insist upon depositing entire group corpus while opening their SF a/c and bringing all the members to them for opening of SF account, only office bearers like president, secretary and treasurer can approach the branch for opening of account. Hence, photograph of all the members may not be insisted upon, but the same be obtained of the authorized persons by the members. For this purpose, resolution passed by the group should be kept on record.

6. What is meant by group corpus/fund corpus?

Ans. Amount held in SF account + amount internally lent amongst the members + cash in hand with the authorized persons + amount received as interest on the loans + any other contributions received by the group like grants, donations etc. However, for working out the loan eligibility the fund corpus will include the amount outstanding under the inter-loaning, cash balance with the group and balance with the bank.

7. What are other activities of the SHGs for strengthening group dynamics?

Ans. Regular periodical meetings, regular periodical saving, maintenance of books like cash book (summary of receipts and payments), register of individual account of members both for deposit and loans, minutes register and issue of passbooks to individual members.

8. It is generally considered that transparency in working of the group renders more cohesive group, what is the transparency?

Ans. Group should not revolve one or two members, but all the members should be aware of the happenings of the group like savings, inter-loaning amongst members (to inculcate

Notes

the ability to manage, utilize and repay their loan i.e. financial discipline), availing bank loan etc. Hence it is suggested that the collection of saving amount, imparting of loans, recovering installments of loans etc. should be in the meetings at a common place and in the presence of all the members.

9. Can branch finance to individual members of SHG?

Ans. No branch will finance to group and not to individual members.

10. What are the criteria for assessing the SHG for financing by the bank?

Ans. Group should be in existence for at least for period of six months, should have under taken savings and credits from its own resources and should be maintaining proper accounts/ record, meeting registers etc. The factors like regular conduct of meetings, regular savings, minimum absence of the members, utilizing of saving amount amongst majority of members through inter-lending, loan recoveries, maintenance of books, knowledge of the rules of SHGs to all the members, education level etc., are the basis for grading the group. If the branch is satisfied about the working of the group, then loan can be given prior to 6 months also.

11. If NGO which promoted SHG approaches the bank for advance for onward lending to SHG; can bank finance such NGO?

Ans. NGO having good track record, in existence for at least 3 years and having audited balance sheets can be financed.

12. What is the quantum of finance which can be made to SHG?

Ans. It should be in proportion of saving to loan and could vary from 1:1 to 1:4 depending upon the assessment of group by the branch. With satisfactory repayment, the ratio may be increased after each cycle until absorptive capacity of the group and its members have been reached. In PNB, bank has allowed loan to the tune of 10 times of the savings provided the track record of SHG in terms of rating, managerial capabilities, risk taking capabilities etc. repayment and accounting has been satisfactory, detail of which is as under:

(a) At the First Stage (i.e. From date of Ist lending to up to 1 year) proportion of saving to loan @ 1:4,

(b) At Second Stage (From Ist lending to completion of 2 year period): 1: 7,

(c) At third stage (from Ist lending to Completion of 3 years): 1: 10.

13. What is the Margin requirement?

Ans. Saving of the group is to be treated as Margin.

14. What is the rate of interest to be charged from Self Help Group?

Ans. @ PLR/PTLR less 1%.

15. What is the rate of interest to be charged from voluntary agencies?

Ans. @ PLR/PTLR

16. What are the security norms?

Ans. SHGs would not be in a position to offer any security other than the group savings, as such, the advance may be treated as clean/unsecured advance. Where finance provided by the branch is a clean/unsecured advance. Incumbents in charge have been empowered to sanction loan to SHG up to a maximum limit of Rs. 1 lac. However, RMs have been empowered to finance SHGs beyond incumbents' powers up to Rs. 5 lac. ZM has been

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delegated with full powers. In Govt. sponsored programmes, as well as general scheme of SHGs where assets are created, the incumbent can utilize their powers as per extant guidelines in Power Chart circulated from time to time.

17. Should the SHG be registered under any Act.

Ans. No.

9.12 Micro Credit: A Lifeline for the Poor

1. What is Micro Credit?

Ans. Micro Credit is defined as provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards. Micro Credit Institutions are those which provide these facilities.

2. What are the interest rates applicable?

Ans. The reform of the interest rate regime has constituted an integral part of the financial sector reforms initiated in our country in 1991. In consonance with this reform process, interest rates applicable to loans given by banks to micro credit organizations or by the micro credit organizations to Self-Help Groups/member-beneficiaries has been left to their discretion. The interest rate ceiling applicable to direct small loans given by banks to individual borrowers, however, continues to remain in force.

3. What are the terms and conditions for accessing micro credit?

Ans. Banks have been given freedom to formulate their own lending norms keeping in view ground realities. They have been asked to devise appropriate loan and savings products and the related terms and conditions including size of the loan, unit cost, unit size, maturity period, grace period, margins, etc. Such credit covers not only consumption and production loans for various farm and non-farm activities of the poor but also include their other credit needs such as housing and shelter improvements.

4. What is a Self-Help Group (SHG)?

Ans. A Self-Help Group (SHG) is a registered or unregistered group of micro entrepreneurs having homogenous social and economic background voluntarily, coming together to save small amounts regularly, to mutually agree to contribute to a common fund and to meet their emergency needs on mutual help basis. The group members use collective wisdom and peer pressure to ensure proper end-use of credit and timely repayment thereof. In fact, peer pressure has been recognized as an effective substitute for collaterals.

5. What are the advantages of financing through SHGs?

Ans. An economically poor individual gain strength as part of a group. Besides, financing through SHGs reduces transaction costs for both lenders and borrowers. While lenders have to handle only a single SHG account instead of a large number of small-sized individual accounts, borrowers as part of a SHG cut down expenses on travel (to and from the branch and other places) for completing paper work and on the loss of workdays in canvassing for loans.

6. What role does a Non-Governmental Organisation (NGO) play in provision of Micro Credit?

Ans. A Non-Governmental Organisation (NGO) is a voluntary organization established to undertake social intermediation like organizing SHGs of micro entrepreneurs and

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entrusting them to banks for credit linkage or financial intermediation like borrowing bulk funds from banks for on-lending to SHGs.

7. What are the latest Micro Credit disbursement indicators?

Ans. With a view to facilitating smoother and more meaningful banking with the poor, a pilot project for purveying micro credit by linking Self-Help Groups (SHGs) with banks was launched by NABARD in 1991-92 with a view to facilitating smoother and more meaningful banking with the poor. RBI had then advised commercial banks to actively participate in this linkage programme. The scheme has since been extended to RRBs and co-operative banks. The number of SHGs linked to banks aggregated 4,61,478 as on March 31, 2002. This translates into an estimated 7.87 million very poor families brought within the fold of formal banking services as on March 31, 2002. More than 90 per cent of the groups linked with banks are exclusive women groups. Cumulative disbursement of bank loans to these SHGs stood at Rs. 1026.34 crore as on March 31, 2002 with an average loan of Rs. 22,240 per SHG and Rs. 1,316 per family. As regards model-wise linkage, while Model I, viz. directly to SHGs without intervention/facilitation of any NGO now accounts for 16%, Model II, viz. directly to SHGs with facilitation by NGOs and other formal agencies amounts to 75% and Model III, viz. through NGO as facilitator and financing agency represents 09% of the total linkage. While 488 districts in all the states/UTs have been covered under this programme, 444 banks including 44 commercial banks (including 17 in the private sector), 191 RRBs and 209 co-operative banks along with 2,155 NGOs are now associated with the SHG-bank linkage programme.

Did u know? The number of SHGs linked to banks aggregated 4,61,478 as on March 31, 2002. This translates into an estimated 7.87 million very poor families brought within the fold of formal banking services as on March 31, 2002. More than 90 per cent of the groups linked with banks are exclusive women groups.

While the SHG-bank linkage programme has surely emerged as the dominant micro finance dispensation model in India, other models too have evolved as significant micro finance purveying channels.

The other successful models that have emerged are:

(a) An Intermediate Model that works on banking principles with focus on both savings and credit activities and where banking services are provided to the clients either directly or through SHGs;

(b) There is also a wholesale Banking Model where the clients comprise NGOs, MFIs and SHG Federations. This Model involves a unique package of providing both loans and capacity building support to its partners; and

(c) Further, there is an Individual Banking-based Model that has its clients as individuals or joint liability groups. While programme management and client appraisal in this model may be a challenge, it is best suited to lending to enterprises.

Keeping these validated models for delivery of credit to the poor and the unorganized sector in view, RBI is moving towards a system perspective for providing effective policy support not only because a number of different institutions, viz. banks, MFIs, NGOs and SHGs are involved, but also because these institutions have very different institutional goals. With this in view, a series of initiatives is being planned in the coming months for putting in place a more vibrant micro finance dispensation environment in the country where complementary and competitive models of micro finance delivery would be encouraged to co-exist.

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8. Is Foreign Investment allowed in Micro Credit projects?

Ans. Govt. of India vide their notification dated August 29, 2000 have included 'Micro Credit/ Rural Credit' in the list of permitted Non-Banking Financial Company (NBFC) activities for being considered for Foreign Direct Investment (FDI)/Overseas Corporate Bodies (OCB)/Non-Resident Indians (NRI) investment to encourage foreign participation in micro credit projects. This covers credit facility at micro level for providing finance to small producers and small micro enterprises in rural and urban areas.

9. What is the Micro Finance Development Fund?

Ans. There is an urgent need for micro credit providers to shift from a minimalist approach - that is offering only financial intermediation - to an integrated approach to poverty alleviation taking a more holistic view of the client including provision of enterprise development services like marketing infrastructure, introduction of technology and design development. In this context, the setting up of the Micro Finance Development Fund marks an important step. Pursuant to the announcement of Union Finance Minister in his budget speech for the year 2000-01, this Rs. 100 crore fund has been created in NABARD to support broadly the following activities: (a) giving training and exposure to self-help group (SHG) members, partner NGOs, banks and govt. agencies; (b) providing start-up funds to micro finance institutions and meeting their initial operational deficits; (c) meeting the cost of formation and nurturing of SHGs; (d) designing new delivery mechanisms; and (e) promoting research, action research, management information systems and dissemination of best practices in micro finance. This fund is thus expected to address institutional and delivery issues like institutional growth and transformation, governance, accessing new sources of funding, building institutional capacity and increasing volumes. RBI and NABARD have contributed Rs. 40 crore each to this fund. The balance of Rs. 20 crore was contributed by 11 public sector banks.

10. How many types of micro credit providers are there in India and what is the present legal framework governing them?

The position is as under:

Notes Govt. of India vide their notification dated August 29, 2000 have included 'Micro Credit/Rural Credit' in the list of permitted Non-Banking Financial Company (NBFC) activities for being considered for Foreign Direct Investment (FDI)/Overseas Corporate Bodies (OCB)/Non-Resident Indians (NRI) investment to encourage foreign participation in micro credit projects. This covers credit facility at micro level for providing finance to small producers and small micro enterprises in rural and urban areas.

Categories of Providers	Legal Framework governing their activities
(a) Domestic Commercial Banks: Public Sector Banks; Private Sector Banks; and Local Area Banks	(i) RBI Act 1934 (ii) BR Act 1949 (iii) SBI Act (iv) SBI Subsidiaries Act (v) Acquisition and Transfer of Undertakings Act 1970 and 1980
(b) Regional Rural Banks	(i) RRB Act 1976 (ii) RBI Act 1934 (iii) BR Act 1949
(c) Co-operative Banks	(i) Co-operative Societies Act (ii) BR Act 1949 (AACS) (iii) RBI Act 1934 (for sch. banks)
(d) Co-operative Societies	(i) State legislation like MACS

Contd....

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(e) Registered NBFCs	(i) RBI Act 1934 (ii) Companies Act 1956
(f) Unregistered NBFCs	(i) NBFCs carrying on the business of an FI prior to the coming into force of RBI Amendment Act 1997 whose application for CoR has not yet been rejected by the Bank (ii) Sec. 25 of Companies Act
(g) Other providers like Societies, Trusts, etc.	(i) Societies Registration Act '60 (ii) Indian Trusts Act (iii) Chapter IIIC of RBI Act '34 (iv) State Moneylenders Act

Notes The more frequently affirm must refinance debt, the greater is the risk of its not being able to obtain the necessary financing.

Self Assessment

Fill in the blanks:

11. Concept of _____ is based on thrift, which means cutting their expenditure and sparing for the purpose, Whereas saving means to save something from the existing income.
12. In order to deal with the problems of coordination for rehabilitation of sick _____, State Level Inter-Institutional Committees (SLIICs) have been set up in all the States.
13. _____ and _____ have contributed Rs. 40 crore each to this fund. The balance of Rs. 20 crore was contributed by 11 public sector banks.
14. _____ is defined as provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards.
15. _____ programme should be fixed taking into account the sustenance requirements, surplus generating capacity, the break-even point, the life of the asset, etc., and not in an "ad hoc" manner.

Case Study

Increased recovery on written off cases for one of the top NBFC of India.

The Client

Our client is one of the top non Deposit taking NBFC of India having its presence in multiple locations in India and actively involved in financing of vehicle loans

Industry

Banking & Finance

Challenges

Our client was burdened with a very high NPA (Non Performing Assets) in the post recession period, with new business acquisitions having taken a back seat due to conservative market sentiments it was of core importance for the client to reduce its NPA portfolio.

Contd....

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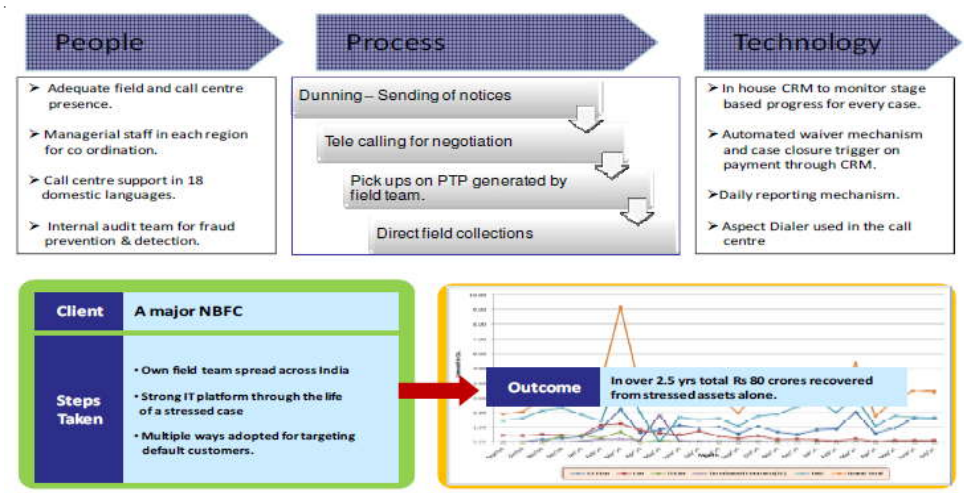
With limited focus on NPA in the initial period, the targeted volume of NPA was very substantial and spread out. Over a period of time, majority of NPA cases had become non-contactable which was a major concern for their successful resolution.

e-Nxt Solution

e-Nxt worked in complete co-ordination with the client in setting up of the entire Stressed Assets Recovery process which started with establishing contact with the default customer and concludes with receipt of full and final settlement amount.



Steps taken for recovery:

Dunning Process: Entire dunning process for the client which covered sending of payment reminder mailers to the client and its efficient tracking for delivered and non delivered mails was established; this enabled us to establish the availability of customer at the contact address which in turn was used for actual customer visits.

Within a very short span of time we were able to ramp up the dunning process by establishing an automated mail room which was able to handle more than 1.5 lakh mails per month.

Process robustness was subsequently built in by automating almost 70% of the labor intensive process.

Tele Conciliation: With our call centre facility having language expertise in 18 different Indian languages, we established the tele conciliation process supported by Aspect based dialers for making telephonic contact with the customers and ask for payments. In house IT team support was taken for automated removal of non-callable numbers in order to eliminate the manual effort of dialing a non callable number.

Field Support: Adequate field support was placed in major cities for visiting customer locations to convince them for making necessary payments for the default amount.

Field team in each region is managed by regional managers for operational parameters.

IT System: Entire stressed assets process is managed by internally created web based CRM which is accessed by the entire team as well as client from multiple locations.

Contd....

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Every stage of progress for each and every case is being tracked through the CRM there by ensuring transparency. All waivers generated are addressed to client as per the matrix which decides on the level of approval for particular case. This ensures that client is in charge for the waivers given to end customer.

Achievements

Total amount recovered - Rs. 80 crores over a period of 2.5 years.

Source: http://www.e-nxt.com/images/case_study_stressed_aassets.pdf

9.13 Summary

- The term priority sector itself suggests that certain sectors of the economy are need to be taken up on a priority basis for rapid economic development.
- An Intermediate Model that works on banking principles with focus on both savings and credit activities and where banking services are provided to the clients either directly or through SHGs.
- There is also a wholesale Banking Model where the clients comprise NGOs, MFIs and SHG Federations. This Model involves a unique package of providing both loans and capacity building support to its partners.
- Further, there is an Individual Banking-based Model that has its clients as individuals or joint liability groups. While programme management and client appraisal in this model may be a challenge, it is best suited to lending to enterprises.
- The reform of the interest rate regime has constituted an integral part of the financial sector reforms initiated in our country in 1991.
- Industry related service and business enterprises with investment up to Rs. 10 lakhs in fixed assets, excluding land and building will be given benefits of small scale sector.
- Domestic scheduled commercial banks having shortfall in lending to priority sector/ agriculture are allocated amounts for contribution to the Rural Infrastructure Development Fund (RIDF) established in NABARD.
- Priority sector lending by commercial banks is monitored by Reserve Bank of India through periodical Returns received from them. Performance of banks is also reviewed in the various set up under the Lead Bank Scheme (at State, District and Block levels).

9.14 Keywords

Direct Agricultural advances: This denote advances given by banks directly to farmers for agricultural purposes

Priority sector: The sector that certain sectors of the economy are need to be taken up on a priority basis for rapid economic development.

'Small Scale Service & Business Enterprises': Industry related service and business enterprises with investment up to Rs. 10 lakhs in fixed assets, excluding land and building will be given benefits of small scale sector. For computation of value of fixed assets, the original price paid by the original owner will be considered irrespective of the price paid by subsequent owners.

'Tiny Enterprises': It is given to all small scale units whose investment in plant and machinery is up to Rs. 25 lakhs, irrespective of the location of the unit.

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9.15 Review Questions

1. Discuss the concept of priority sector lending in India.
2. What are the types of Indirect Finance to Agriculture?
3. Small Scale and Ancillary Industries- RBI Guidelines.
4. Define the terms:
   (a) Tiny Enterprise
   (b) KVI Sector
5. What role does a Non-Governmental Organisation (NGO) play in provision of Micro Credit?
6. How is priority sector lending monitored by the Reserve Bank?
7. What are the guidelines for charging of penal interest on PS advances?

Answers: Self Assessment

1.	Priority sector	2.	Tiny enterprise
3.	Small scale units	4.	25,000
5.	Para-banking	6.	False
7.	False	8.	True
9.	True	10.	False
11.	SHG	12.	Small Scale Units
13.	RBI, NABARD	14.	Micro credit
15.	Repayment		

9.16 Further Readings

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Unit 10: Non-performing Assets

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10.9 Summary

10.10 Keywords

10.11 Review Questions

10.12 Further Readings

Objectives

After studying this unit, you will be able to:

- Know the concept of working capital
- Discuss the importance of working capital
- Identify the factors affecting working capital requirement
- Explain the levels of working capital investment
- Describe the overall working capital policy

Introduction

A Non-performing asset (NPA) is defined as a credit facility in respect of which the interest and/ or instalment of principal has remained 'past due' for a specified period of time.

With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days' overdue' norm for identification of NPAs, from the year ending March 31, 2004. Accordingly, with effect from March 31, 2004, a non-performing asset (NPA) shall be a loan or an advance where;

- Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,
- The account remains 'out of order' for a period of more than 90 days, in respect of an overdraft/Cash Credit (OD/CC),

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- The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
- Interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purposes, and
- Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

10.1 Non-Performing Assets (NPA)

Non-Performing Asset means an asset or an account of borrower, which has been classified by a bank or financial institution as substandard, doubtful or loss asset, in accordance to the directions or guidelines on asset classification issued by the RBI.

In order to move towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days overdue' norm for identification of NPAs, from the year ending March 31, 2004.

Accordingly, with effect from March 31, 2004, a loan or an advance shall be a non-performing asset (NPA) where;

1. Interest and/or instalment of principal remain overdue for a period of more than 90 days in respect of a term loan,
2. The account remains 'out of order' for a period of more than 90 days, in respect to an overdraft/Cash Credit (OD/CC),
3. The bill remains overdue for a period of more than 90 days in the case of bills purchased and discounted,
4. Interest and/or instalment of principal remains overdue for two harvest seasons but for a period not exceeding two half years in the case of an advance granted for agricultural purpose, and
5. Any amount to be received remains overdue for a period of more than 90 days in respect of other accounts.

Asset Classification (Guidelines by RBI)

As per RBI guidelines assets can be grouped into four categories:

1. ***Standard assets:*** These are loans that do not have any problem and are less risky.
2. ***Substandard assets:*** These are assets, which come under the category of NPA for a period of less then 12 months.
3. ***Doubtful assets:*** These are NPA exceeding 12 months.
4. ***Loss assets:*** These NPA are those that are identified as unreliable by internal inspector of bank or auditors or by the RBI. They may not get recovered.

10.2 Some Important Terms

1. ***'Out of order':*** An account will be treated as 'out of order' if:
   (i) The outstanding balance remains continuously in excess of the sanctioned limit/ drawing power.

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(ii) Where the outstanding balance in the principal operating account is less than the sanctioned limit/drawing power, but there are no credits (to this account) continuously for six months as on the date of balance sheet or credits (to this account) are not enough to cover the interest debited during the same period.

2. ***'Overdue':*** Any amount due to the bank under any credit facility is 'overdue' if:

(i) It is not paid on the due date fixed by the bank.

Notes In order to move towards international best practices and to ensure greater transparency, it has been decided to adopt the '90 days overdue' norm for identification of NPAs, from the year ending March 31, 2004.

10.3 Reasons for NPAs

Various studies have been conducted to analyse the reasons for NPA. The reasons may be widely grouped in two heads:

1. Over hang component (external)
2. Incremental component (internal)

Over hang component (portion) of NPA is due to environment reasons or business cycles etc. Incremental component (portion) may be due to internal bank management, credit policy, terms of credit etc. Some of the reasons can be detected and removed but some cannot as in the case of external causes. One has to wait for conditions to be positive. One thing is widely accepted that NPAs cannot altogether be eliminated.

10.4 Major factors contributing to high level of NPAs in India

1. Inadequate legal framework for collecting overdue loans.
2. Although loans are backed by additional/collateral security(s) but in practice, the value of the collateral security may not be matching (i.e. less) with the loans.
3. More importantly, timely execution of collateral is not done or is difficult.
4. Limited write-offs of NPAs by the public sector banks. As a consequence, NPAs tend to be carried in the account books and provisions against them are built up slowly.

10.5 Solution of NPA Problem in Indian Banks

The Indian financial sector has undergone significant transformation during the decades of financial liberalization.

Banking sector reforms, introduced in 1992-93, have been based on five fundamentals:

1. Strengthening of prudential norms and market discipline
2. Appropriate adoption of international benchmarks
3. Management of organizational change and consolidation
4. Technological up gradation
5. Human resource development

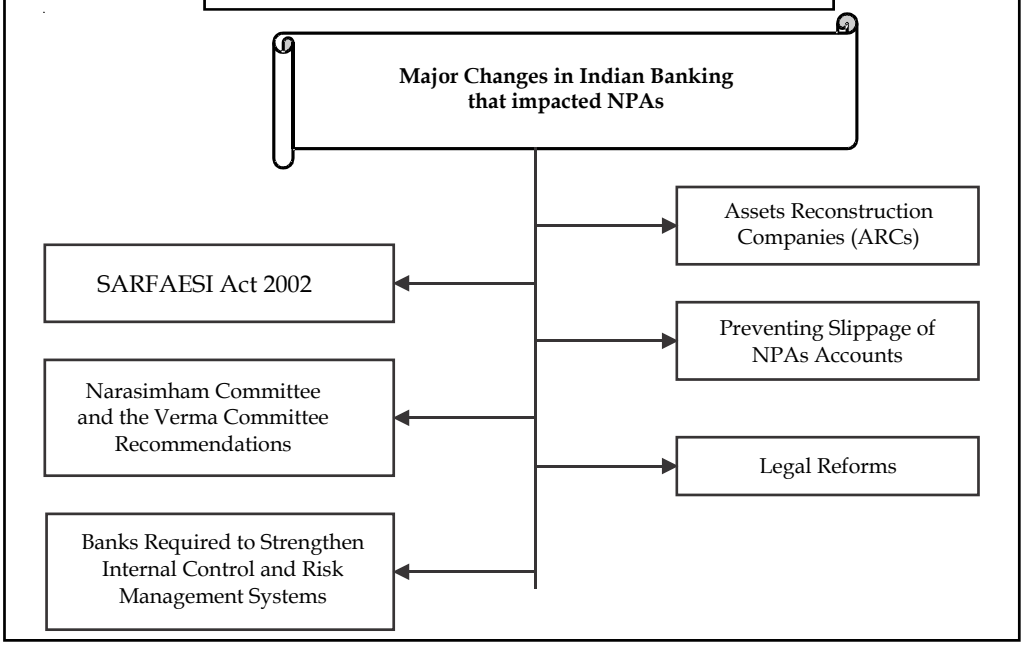
Notes

Deregulation, technological upgradation and increased market integration have been the key factors driving change in our financial sector.

After the reforms, the Indian banking system has become increasingly mature in terms of the transformation of business processes and the appetite for risk management.

The following points bring out some of the major changes in Indian banking scene and their impact thereof on NPAs:

Figure 10.1: Banking Changes that Influenced NPAs



1. ***Significant Amount of Non-Performing Assets (NPAs):*** The principal challenges of banking soundness are presence of significant amount of non-performing assets (NPAs) on bank balance sheets. A mix of upgradation, recoveries and write-offs has steadily reduced gross NPAs of scheduled commercial banks to 8.8 percent as at end March 2003 from 15.7 percent as at end-March 1997.

2. ***Assets Reconstruction Companies (ARCs):*** There is a large difference between bank's gross and net NPAs, typically equal to nearly one-half of gross NPAs, reflects both obligatory provisions against NPAs and the limited write-offs of NPAs by the public sector banks.

   NPAs tend to be carried on the books and provisions against them are gradually built up. The solution to this is the ARC:

   (i) After announcement in the union budget 2002-03, Assets Reconstruction Companies (ARCs) were established with the participation of public and private sector banks, financial institutions and multilateral agencies.

   (ii) ARC's are an extra avenue for banks to tackle their NPAs, and thus to take NPAs out of their balance sheets.

   (iii) ARCs are expected to recover bad loans at a faster pace, as they would be exclusively dedicated towards loan recovery.

3. ***SARFAESI Act 2002 (Given in Annexure):*** This Act increased the scope for the recovery of NPAs. The Act envisages relatively stricter legislations to provide comfort to banks in taking possession of the securities.

Notes

4. ***Preventing Slippage of NPAs Accounts:*** The Reserve Bank has recently issued guidelines on preventing slippage of NPAs accounts whereby banks are advised to introduce a new asset category: 'special mention accounts', in between 'standard' and 'substandard' categories for their internal monitoring and follow up. This enables banks to:

   (i) Look at accounts with potential problems in a focused manner right from the onset of the problem.

   (ii) Increase efficacy of monitoring

   (iii) Ensure Quicker remedial actions.

5. ***Narasimham Committee and The Verma Committee Recommendations:*** The Narasimham committee and the Verma committee looked into the problems of weak banks and made certain recommendations, which were considered by government and the Reserve bank in resolving NPA problem.

6. ***Legal reforms:*** The absence of quick and efficient system of legal redressal constitutes an important "moral hazard" in the financial sector as it encourages irresponsible borrowing. The problem of NPAs can also be tackled by suitable legal reforms. The problems in regard to legal system are:

   (i) Substantial delays in arriving at a legal solution of disputes

   (ii) Need of proper legal framework to ensure expeditious recovery of debt

   (iii) Need for adequate powers to banks to effect property transfers

   (iv) Need of more debt recovery tribunals and setting up of settlement Advisory Committees in banks.

7. ***Banks need to strengthen their internal control and risk management systems:*** Leaving aside the problem of weak banks, in profitable banks also, the NPA levels are still high. The resolution of the NPA problem would require:

   (i) A vigorous effort by banks to strengthen their internal control and risk management systems

   (ii) Setting up early warning signals for timely detection and action.

   (iii) Greater accountability on the part of corporate in terms of greater disclosures in the case of defaults

   (iv) An efficient credit information system

   (v) Stricter accounting and prudential standards.

The above steps can help effectively contain NPAs in future, if meticulously implemented.

The level of non-performing assets (NPAs) of the banking system in India has shown a decline in recent years, but it is still too high. Part of the problem in resolving this issue is the carry-over of old NPAs in certain declining sectors of industry. The problem has been further complicated by the fact that there are a few banks, which are fundamentally weak and where the potential for return to profitability, without substantial restructuring, is doubtful.

Caution The Reserve Bank has recently issued guidelines on preventing slippage of NPAs accounts whereby banks are advised to introduce a new asset category: 'special mention accounts', in between 'standard' and 'substandard' categories for their internal monitoring and follow up.

Notes

10.6 Converting NPAs to Performing Assets (PA) By Power of Business Intelligence (BI)

In simplest terms, BI integrates data from multiple data sources and provides analysis capabilities to better understand customers, markets and risk and gain greater visibility into business operations. The solution to most of the problems faced by banks lies in implementing business intelligence (BI) solution.

BI is the technology that unites uncommon corporate data into one resource, groups it as a single source of company truth, and leverages it to achieve the strategic goals of the organization.

BI does analysis and presents information in such a manner that supports tactical (routine) and strategic (special) decisions that ultimately affect revenues and profitability of a business.

BI will help the credit/banking industry to handle:

1. The loan origination process,
2. Handle increasing transaction volume,
3. Technology investments to enhance the operational processes,
4. Give timely reports on various categories of assets,
5. Suggest recovery mechanism and report its progress.

A BI solution provides:

1. A single point of access, thereby reducing the costs of identifying, gathering, and processing data.
2. It ensures that both operational managers and key executives make decisions based on data that is factual and as per rules.
3. BI can be used to analyse the geographic distribution of advances to better understand concentration of credit and prepayment risk, based on differences in regional economies, and to analyse loan portfolios.
4. BI can also be a critical tool to help bankers obtain high credit ratings from the rating agencies. (A rating agency assesses a banker's ability to meet its debt obligations in the future and thereof prevent and mitigate losses).
5. The analysis and reporting capability and level of transparency and control provided by a BI solution could be one of the qualitative factors in support of a higher rating.

According to Dr. K M Bhattacharya, Dean, Centre for Advanced Banking and Finance Studies, ICFAI Business School,

"The survival, growth and success of banks in today's fiercely competitive business environment depend on the quality of strategic decisions of the management, in which a robust BI solution can help".

Did u know? After announcement in the union budget 2002-03, Assets Reconstruction Companies (ARCs) were established with the participation of public and private sector banks, financial institutions and multilateral agencies.

Notes

Self Assessment

Fill in the blanks:

1. _____ means an asset or an account of borrower, which has been classified by a bank or financial institution as substandard, doubtful or loss asset, in accordance to the directions or guidelines on asset classification issued by the RBI.
2. The analysis and_____ capability and level of transparency and control provided by a BI solution could be one of the qualitative factors in support of a higher rating.
3. _____ is the technology that unites uncommon corporate data into one resource, groups it as a single source of company truth, and leverages it to achieve the strategic goals of the organization.
4. The solution to most of the _____ faced by banks lies in implementing business intelligence (BI) solution.
5. _____ 2002 (Given in Annexure): This Act increased the scope for the recovery of NPAs.

10.7 Management of Non-performing Assets

The three important tools of the recovery mechanism of NPAs are (1) Debt Recovery Tribunals (DRTs), (2) Corporate Debt Restructuring (CDR) Scheme and (3) Securitization and Reconstruction of Financial Assets through SCs/RCs.

The DRTs, as recovery mechanism for NPAs, comprise of DRTs, recovery officers and DRATs (Debt Recovery Appellate Tribunal).

The main elements of the DRT mechanism are: procedure of DRTs and modes of recovery of debts determined by the DRTs and DRATs.

A bank which has to recover any debt should approach the appropriate DRT which would issue a summon to the concerned borrower to explain within 30 days as to why the relief should not be granted to the bank. The DRT may make an interim order by way of injunction/stay/ attachment against the borrower to debar him from transferring, alienating or otherwise dealing with/disposing of any property/asset without its prior permission. It may also appoint a receiver of any property. The DRT would normally dispose of an application within 180 days. An appeal against an order of the DRT can be filed with a DRAT on depositing 75 per cent of the amount of debt due.

There are two modes of recovery of debt. The recovery officer can recover the debt by (1) attachment/sale of property, (2) arrest/detention in prison of the borrower and, (3) appointment of a receiver to manage the property. The recovery officer can also collect the amount from other parties who owe money to the borrower.

The objective of the CDR framework is to ensure timely and transparent mechanism for restructuring corporate debts of viable entities facing problems outside the purview of BIFR, DRT and other legal proceedings.

The CDR system has a 3-tier structure: CDR standing forum, CDR empowered groups, and CDR cell.

Notes The DRT would normally dispose of an application within 180 days.

Notes

The CDR mechanism covers only multiple banking accounts/syndication/consortium accounts with outstanding exposure of ₹ 20 crore and above. There are two categories of debt restructuring under the CDR system: Category 1 accounts classified as substandard and Category 2 accounts classified as doubtful.

The accounting treatment of the restructured accounts would be governed by the applicable prudential norms. The asset classification would continue to be bank-specific as per the existing prudential norms.

Banks should disclose in their annual accounts details about corporate debt restructuring.

The norms on income recognition, asset classification and provisioning relating to projects under implementation involving overrun would conform to the specified norms.

The main objective of the SARFAESI Act is to regulate securitization and reconstruction of financial assets and enforcement of security interest.

In terms of the regulation of the scheme of securitization and reconstruction of financial assets, the SC/RC should be registered with the RBI, with a minimum net owned fund of ` 2 crore or an amount up to 15 per cent of the financial assets acquired. Securitization means acquisition of financial assets (i.e., debt/receivables/any financial assistance) by the SC/RC from its owner, either by raising funds from a QIB by issue of security receipts representing undivided interest in the financial asset concerned or otherwise. Asset reconstruction means acquisition by an SC/RC, of any right/interest of any bank in any financial asset, for its realization.

Any SC/RC can acquire financial assets of any bank/FI. All rights in relation to the assets would vest in the SC/RC. The bank may give a notice of acquisition of the financial assets by an SC/RC to the obligor (i.e., the person liable to the owner of the financial asset) or the concerned registering authority in whose jurisdiction the mortgage/charge/hypothecation/assignment/other interest in the asset has been registered. Any payment to the SC/RC, pursuant to the notice, would be a full discharge from all liability in respect of such payment. After the acquisition of financial assets, an SC/RC may offer security receipts to QIBs for subscription.

The measures for asset reconstruction may be: takeover of management, sale/lease a part/whole of the business of the borrower, rescheduling of debts payable, enforcement of the security interest, settlement of dues payable by the borrower and taking possession of the secured assets.

Any SC/RC may act as (1) an agent for a bank for the recovery of their dues from the borrower, (2) a manager of the secured assets taken over by the secured creditor from the borrower.

Any security interest credited in favour of a secured creditor can be enforced without the intervention of courts/tribunal, by the concerned creditor. In case of failure of a borrower to pay to the secured creditor, he may take recourse to the following measures: (1) take possession/takeover the management of the secured assets, (2) takeover of the management, of the business of the borrower, (3) appointment of a manager to manage the assets, and (4) to require any person who has acquired any secured asset(s) from the borrower and from whom money is due to the borrower, to pay to the secured creditor, sufficient money to pay the secured debt. Payment made by such person would give him a valid discharge as if the payment were made to the borrower. All rights in the secured assets would be vested in the transferee as if transfer had been made by the borrower (owner of the asset).

Where dues of the secured creditor are not fully satisfied with the sale proceeds of the secured assets, he may approach the DRTs for recovery of the balance from the borrower.

The secured creditors would be entitled to proceed against the guarantors/sell the pledged assets without first taking any of the measures specified above.

Notes

The government may set up a central registry for registration of transactions of securitization/ reconstruction of financial assets and creation of security interest. It may also appoint a central registrar for registration of such transactions. The particulars of such transactions would be entered in the central register.

To carry out the provisions of the SARFAESI Act, the RBI has issued guidelines/directions, the main elements of which are: registration, asset reconstruction, functions of SCs/RCs, Securitization and prudential norms.

An SC/RC should have a minimum net owned fund of 15 per cent of the total financial assets acquired by it on an aggregate basis or ₹ 100 crore, whichever is less. In no case should it be less than ₹ 2 crore.

The elements relating to asset reconstruction are acquisition of financial assets, change/takeover of management/sale or lease of the business of the borrower, rescheduling of debts, enforcement of security interest, settlement of dues by the borrower and plan for realization.

The guidelines/directions relating to securitization include: issue of security receipts and disclosures relating to (1) issuers of security receipts, (2) terms of offer and (3) disclosures on quarterly basis.

The SCs/RCs should maintain a capital adequacy ratio of 15 per cent. The asset classification should be: (i) standard (ii) NP (i.e., substandard, doubtful and loss). The provisioning for NPAs are: sub-standard-10 per cent, doubtful-100 per cent on unsecured portion and 50 per cent on the remaining; loss assets-100 per cent written off/provided for. Income should be recognized on receipt basis.

The RBI's guidance notes for SCs/RCs relate to the acquisition of financial assets, engagement of outside agency and sales committee.

Guidelines on sale of financial assets to SCs/RCs and related issues fall into four groups:

1. Assets which can be sold,
2. Procedure for sale including pricing and valuation,
3. Prudential norms relating to provisioning/capital adequacy and exposures for banks, and
4. Disclosure requirements.

Caution An SC/RC should have a minimum net owned fund of 15 per cent of the total financial assets acquired by it on an aggregate basis or ₹ 100 crore, whichever is less. In no case should it be less than ₹ 2 crore.

Securitization (of standard assets) is a process by which performing assets are sold to a bankruptcy remote (i.e., the unlikelihood of the entity being subjected to voluntary/involuntary proceedings) special purpose vehicle (SPV) against immediate cash payment. It follows a two-stage process: (1) sale of performing assets to a bankruptcy remote SPV in return for immediate cash payment; (2) repackaging and selling the security interests representing claims on incoming cash flows from the asset(s) to third party investors by issuance of tradable debt securities. Exposures of banks/Fls/NBFCs (i.e., originators) to a securitization transaction/exposure include exposures to (1) securities issued by the SPV, (2) credit enhancement facility, (3) liquidity facility, and (4) underwriting facility.

The securitized asset is transferred from the balance sheet of the originator to the SPV as true sale so that the originator would not be required to maintain capital against the value of the transferred asset.

Notes

The beneficial interest in the securitized assets are sold/transferred to the SPV (i.e., a trust/ company/firm) on a without recourse basis.

An option to repurchase fully performing asset(s) at the end of the securitization scheme where the residual value of such assets has fallen below 10 per cent of the original amount sold to the SPV (i.e. clean up calls) could be retained by the originator.

Credit enhancement facilities include all arrangements provided to the SPV that could result in an originator absorbing losses of the SPV/its investors.

A liquidity facility is provided to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to the investors.

An originator/third party service provider may act as an underwriter for the issue of securities by the SPV and treat the facility as an underwriting facility for capital adequacy purposes.

Investment of banks in securities issued by the SPVs would attract all prudential norms applicable to non-SLR investments prescribed by the RBI. The maximum limit on investment by the originator in the securities issued by the SPVs is 10 per cent of the original amount of issue. The income on such securities may normally be recognized on accrual basis. However, if the income remains in arrears beyond 90 days, any future income should be recognized only on realization. Appropriate provisioning for the diminution in the value of securitization on account of over dues should be made as per the RBI norms for classification and valuation of investments by banks.

Banks can sell assets to an SPV only on cash basis. Any loss on sale should be reflected in the profit and loss account for the period during which the sales are affected out any profit/premium should be amortized over the life of the concerned securities.

Self Assessment

State whether the following statements are true or false:

6. Investment of banks in securities issued by the SPVs would not be able to attract all prudential norms applicable to non-SLR investments prescribed by the RBI.
7. Banks cannot sell assets to an SPV only on cash basis. Any loss on sale should be reflected in the profit and loss account for the period during which the sales are affected out any profit/premium should be amortized over the life of the concerned securities.
8. The securitized asset is transferred from the balance sheet of the originator to the SPV as true sale so that the originator would not be required to maintain capital against the value of the transferred asset.
9. To carry out the provisions of the SARFAESI Act, the RBI has issued guidelines/directions, the main elements of which are: registration, asset reconstruction, functions of SCs/RCs, Securitization and prudential norms.
10. A bank which has to recover any debt should approach the appropriate DRT which would issue a summon to the concerned borrower to explain within 30 days as to why the relief should not be granted to the bank.

In order to narrow down the divergences and ensure adequate provisioning by banks, it was suggested that a bank's statutory auditors, if they so desire, could have a dialogue with RBI's Regional Office/ inspectors who carried out the bank's inspection during the previous year with regard to the accounts contributing to the difference.

- Pursuant to this, regional offices were advised to forward a list of individual advances, where the variance in the provisioning requirements between the RBI and the bank is

Notes

above certain cut off levels so that the bank and the statutory auditors take into account the assessment of the RBI while making provisions for loan loss, etc.

- The primary responsibility for making adequate provisions for any diminution in the value of loan assets, investment or other assets is that of the bank managements and the statutory auditors. The assessment made by the inspecting officer of the RBI is furnished to the bank to assist the bank management and the statutory auditors in taking a decision in regard to making adequate and necessary provisions in terms of prudential guidelines.
- In conformity with the prudential norms, provisions should be made on the non-performing assets on the basis of classification of assets into prescribed categories as detailed in paragraphs 4 supra. Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realization of the security and the erosion over time in the value of security charged to the bank, the banks should make provision against substandard assets, doubtful assets and loss assets as below:

Loss Assets

The entire asset should be written off. If the assets are permitted to remain in the books for any reason, 100 percent of the outstanding should be provided for.

Doubtful Assets

- 100 percent of the extent to which the advance is not covered by the realizable value of the security to which the bank has a valid recourse and the realizable value is estimated on a realistic basis.
- In regard to the secured portion, provision may be made on the following basis, at the rates ranging from 20 percent to 50 percent of the secured portion depending upon the period for which the asset has remained doubtful:

Floating Provisions

Some of the banks make a 'floating provision' over and above the specific provisions made in respect of accounts identified as NPAs. The floating provisions, wherever available, could be set-off against provisions required to be made as per above stated provisioning guidelines. Considering that higher loan loss provisioning adds to the overall financial strength of the banks and the stability of the financial sector, banks are urged to voluntarily set apart provisions much above the minimum prudential levels as a desirable practice.

Provisions on Leased Assets

Leases are peculiar transactions where the assets are not recorded in the Leases are peculiar transactions where the assets are not recorded in the books of the user of such assets as Assets, whereas they are recorded in books of the user of such assets as Assets, whereas they are recorded in the books of the owner even though the physical existence of the asset is the books of the owner even though the physical existence of the asset is with the user (lessee). __(AS19 ICAI) with the user (lessee).

Did u know? The survival, growth and success of banks in today's fiercely competitive business environment depend on the quality of strategic decisions of the management, in which a robust BI solution can help.

Notes

Task Discuss RBI regulations and provisions related to securitization.

Self Assessment

Fill in the blanks:

11. Some of the banks make a '.....provision' over and above the specific provisions made in respect of accounts identified as NPAs.
12. A .....facility is provided to help smoothen the timing differences faced by the SPV between the receipt of cash flows from the underlying assets and the payments to be made to the investors.
13. An originator/third party service provider may act as an underwriter for the issue of securities by the ..... and treat the facility as an underwriting facility for capital adequacy purposes.
14. ..... (of standard assets) is a process by which performing assets are sold to a bankruptcy remote (i.e., the unlikelihood of the entity being subjected to voluntary/ involuntary proceedings) special purpose vehicle (SPV) against immediate cash payment.
15. Where dues of the secured creditor are not fully satisfied with the sale proceeds of the secured assets, he may approach the ..... for recovery of the balance from the borrower.

Case Study

VRS Troubles

In February 2001, India's largest public sector bank (PSB), the State Bank of India (SBI) faced severe opposition from its employees over a Voluntary Retirement Scheme (VRS). The VRS, which was approved by SBI board in December 2000, was in response to Federation of Indian Chambers of Commerce and Industry's (FICCI) report on the banking industry. The report stated that the Indian banking industry was overstaffed by 35%. In order to trim the workforce and reduce staff cost, the Government announced that it would be reducing its manpower. Following this, the Indian Banks Association (IBA) formulated a VRS package for the PSBs, which was approved by the Finance ministry.

Though SBI promoted the VRS as a 'Golden Handshake,' its employee unions perceived it to be a retrenchment scheme. They said that the VRS was completely unnecessary, and that the real problem, which plagued the bank were NPAs . The unions argued that the VRS might force the closure of rural branches due to acute manpower shortage.

This was expected to affect SBI's aim to improve economic conditions by providing necessary financial assistance to rural areas. The unions also alleged that the VRS decision was taken without proper manpower planning. In February 2001, the SBI issued a directive altering the eligibility criteria for VRS for the officers by stating that only those officers who had crossed the age of 55 would be granted VRS. Consequently, applications of around 12,000 officers were rejected. The officers who were denied the chance to opt for the VRS formed an association - SBIVRS optee Officers' Association to oppose this SBI directive. The association claimed that the management was adopting discriminatory policies in granting the VRS.

Contd....

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The average estimated cost per head for implementation of VRS for SBI and its seven associated banks worked out to Rs. 0.65 million and Rs 0.57 million respectively. As a result of the VRS, SBI's net profit decreased from Rs 25 billion in 1999-00 to Rs 16 billion in 2000-01.

1. The Federation of Indian Chambers of Commerce and Industry (FICCI) was founded in 1927. It is an apex business organization in India, with a membership of several thousand chambers of commerce, trade associations and industry bodies spread across the country. It represents over 2,50,000 business units.
2. Indian Banks Association is an apex body, of a voluntary nature for banks in India. It was started in 1926 and its members include Public Sector Banks, Private sector banks, Foreign banks having offices in India, Urban-Cooperative banks, Developmental Financial Institutions, etc. The main goal of IBA is to see implementation of efficient and progressive banking principles in the country.
3. Non performing Assets (NPAs) are loans on which interest payments have been due for more than one quarter (3 months) and in the case of monthly installments have been due for more than 3 instalments.

Source: http://www.icmrindia.org/free%20resources/casestudies/State%20Bank%20of%20India-VRS%20Story1.htm

10.8 BASEL I, II and III Banking Norms

The Basel Accords/ Norms

This refers to the banking supervision Accords (recommendations on banking regulations)- Basel I, Basel II and Basel III-issued by the Basel Committee on Banking Supervision (BCBS). They are called the Basel Accords as the BCBS maintains its secretariat at the Bank for International Settlements in Basel, Switzerland and the committee normally meets there.

Basel I

Basel I is the round of deliberations by central bankers from around the world, and in 1988, the Basel Committee (BCBS) in Basel, Switzerland, published a set of minimum capital requirements for banks. This is also known as the 1988 Basel Accord, and was enforced by law in the Group of Ten (G-10) countries in 1992 . Basel I is now widely viewed as outmoded. Indeed, the world has changed as financial conglomerates, financial innovation and risk management have developed. Therefore, a more comprehensive set of guidelines, known as Basel II are in the process of implementation by several countries and new updates in response to the financial crisis commonly described as Basel III.

Basel I, that is, the 1988 Basel Accord, primarily focused on credit risk. Assets of banks were classified and grouped in five categories according to credit risk, carrying risk weights of zero (for example home country sovereign debt), ten, twenty, fifty, and up to one hundred percent (this category has, as an example, most corporate debt). Banks with international presence are required to hold capital equal to 8% of the risk-weighted assets. The creation of the credit default swap after the Exxon Valdez incident helped large banks hedge lending risk and allowed banks to lower their own risk to lessen the burden of these onerous restrictions.

Since 1988, this framework has been progressively introduced in member countries of G-10, currently comprising 13 countries, namely, Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Spain, Sweden, Switzerland, United Kingdom and the United States of America.

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Most other countries, currently numbering over 100, have also adopted, at least in name, the principles prescribed under Basel I. The efficiency with which they are enforced varies, even within nations of the Group.

Basel II

Basel II is the second of the Basel Accords, (now extended and effectively superseded by Basel III), which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

Basel II, initially published in June 2004, was intended to create an international standard for banking regulators to control how much capital banks need to put aside to guard against the types of financial and operational risks banks (and the whole economy) face. One focus was to maintain sufficient consistency of regulations so that this does not become a source of competitive inequality amongst internationally active banks. Advocates of Basel II believed that such an international standard could help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In theory, Basel II attempted to accomplish this by setting up risk and capital management requirements designed to ensure that a bank has adequate capital for the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

Politically, it was difficult to implement Basel II in the regulatory environment prior to 2008, and progress was generally slow until that year's major banking crisis caused mostly by credit default swaps, mortgage-backed security markets and similar derivatives. As Basel III was negotiated, this was top of mind, and accordingly much more stringent standards were contemplated, and quickly adopted in some key countries including the USA.

The final version aims at:

- Ensuring that capital allocation is more risk sensitive;
- Enhance disclosure requirements which will allow market participants to assess the capital adequacy of an institution;
- Ensuring that credit risk, operational risk and market risk are quantified based on data and formal techniques;
- Attempting to align economic and regulatory capital more closely to reduce the scope for regulatory arbitrage.

While the final accord has largely addressed the regulatory arbitrage issue, there are still areas where regulatory capital requirements will diverge from the economic capital.

Basel II has largely left unchanged the question of how to actually define bank capital, which diverges from accounting equity in important respects. The Basel I definition, as modified up to the present, remains in place.

Basel III

BASEL III is a global regulatory standard on bank capital adequacy, stress testing and market liquidity risk agreed upon by the members of the Basel Committee on Banking Supervision in 2010-11.

The third installment of the Basel Accords (see Basel I, Basel II) was developed in response to the deficiencies in financial regulation revealed by the late-2000s financial crisis. Basel III strengthens

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bank capital requirements and introduces new regulatory requirements on bank liquidity and bank leverage. For instance, the change in the calculation of loan risk in Basel II which some consider a causal factor in the credit bubble prior to the 2007-8 collapse: in Basel II one of the principal factors of financial risk management was out-sourced to companies that were not subject to supervision, credit rating agencies. Ratings of creditworthiness and of bonds, financial bundles and various other financial instruments were conducted without supervision by official agencies, leading to AAA ratings on mortgage-backed securities, credit default swaps, and other instruments that proved in practice to be extremely bad credit risks. In Basel III, a more formal scenario analysis is applied (three official scenarios from regulators, with ratings agencies and firms urged to apply more extreme ones).

The OECD estimates that the implementation of Basel III will decrease annual GDP growth by 0.05-0.15%. Outside the banking industry itself, criticism was muted. Bank directors would be required to know market liquidity conditions for major asset holdings to strengthen accountability for any major losses.

Basel III will require banks to hold 4.5% of common equity (up from 2% in Basel II) and 6% of Tier I capital (up from 4% in Basel II) of risk-weighted assets (RWA). Basel III also introduces additional capital buffers, (i) a mandatory capital conservation buffer of 2.5% and (ii) a discretionary countercyclical buffer, which allows national regulators to require up to another 2.5% of capital during periods of high credit growth. In addition, Basel III introduces a minimum 3% leverage ratio and two required liquidity ratios. The Liquidity Coverage Ratio requires a bank to hold sufficient high-quality liquid assets to cover its total net cash outflows over 30 days; the Net Stable Funding Ratio requires the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress.

10.9 Summary

A commercial bank can serve society and help economy to develop only when it operates successfully. Generation of adequate operational surpluses by banks is necessary to provide cushion to support their credit risks and also to supplement the finances of the government.

Thus, a bank in order to survive successfully in the long run has to give due importance to profit as well as social goals. There should not be problem for a banker to strike satisfactory balance of the two goals if funds are properly managed and there is a conscious and deliberate planning of the bank's income, expenditure and overall productivity of human resources. Thus, profit constitutes the base of growth and contributes to inner strength.

Indian banking sector is having a serious problem of non-performing assets. The earning capacity and profitability of the banks are highly affected due to this.

The level of non-performing assets (NPAs) of the banking system in India has shown a decline in recent years, but it is still too high. Part of the problem is the carry-over of old NPAs in certain declining sectors of industry. The problem has been further complicated by the fact that there are a few banks, which are fundamentally weak and where the potential for return to profitability, without substantial restructuring, is doubtful.

Narasimham Committee was appointed to examine the effectiveness of the existing financial system of the country and suggest reforms.

Capital Adequacy relates to the firm's overall use of financial leverage. It also measures the relationship between firm's market value of assets and liabilities and the corresponding book value. Not all source of capital show up on the firm's balance sheet.

Notes

Capital Adequacy Ratio or CAR or CRAR is ratio of capital fund to risk weighted assets expressed in percentage terms.

The fundamental objective behind the capital adequacy calculation and fixing up the related norms is to strengthen the soundness and stability of the banking system.

10.10 Keywords

Capital-Assets Ratio: Ratio of capital employed to assets.

Credit Risk: Risk of non-recovery of loans.

Insolvency Risk: The risk of insolvency of debtor.

Narasimha Committee: A Special committee appointed by RBI to suggest banking sector reforms.

Shareholder Wealth: Owners' wealth i.e. capital, profits and reserves.

Social Banking: Banking done for social development and advancement of the masses.

Speculation in Shares: Buying and selling of shares in anticipation (rise/fall) in their prices.

10.11 Review Questions

1. Explain the rationale of banking sector reforms.
2. Critically appraise the important banking sector reforms that have been implemented till date.
3. Give a summary of the recommendations of the 2nd Narasimha Committee.
4. Classify NPAs according to their quality. Critically examine the measures taken to reduce such assets.
5. Explain briefly recent trends in the Indian banking system.
6. Explain the main features of Innovative banking in India.
7. What are the principal defects in the Indian banking system? Give suggestions to remove them.

Answers: Self Assessment

1	Non Performing Assets	2	Reporting
3	BI	4	Banks
5	SARFAESI Act	6	False
7	False	8	True
9	True	10	True
11	Floating	12	Liquidity
13	SPV	14	Securitization
15	DRTs		

Notes

10.12 Further Readings

Books

Magazines and Journals

The Professionals Banker, The ICFAI University Press, Hyderabad.

RBI Annual Report 2005-06.

Social Responsibility of Banks, By Philip J. Jennings.

Online links

www.asset.abnamro.com

Unit 11: Innovations in Banking

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Objectives

After studying this unit, you should be able to:

- Understand the ins and outs of E-banking and Electronic Clearing Service (ECS).
- Explain what is Electronic Funds Transfer (EFT)?
- Explain an analysis of various banking cards - Credit cards, Debit cards and other cards.
- Know Tele-banking

Introduction

Electronic banking, also known as electronic funds transfer (EFT), is simply the use of electronic means to transfer funds directly from one account to another, rather than by check or cash. You can use electronic funds transfer to:

- have your paycheck deposited directly into your bank or credit union checking account.
- withdraw money from your checking account from an ATM machine with a personal identification number (PIN), at your convenience, day or night.
- instruct your bank or credit union to automatically pay certain monthly bills from your account, such as your auto loan or your mortgage payment.
- have the bank or credit union transfer funds each month from your checking account to your mutual fund account.
- have your government social security benefits check or your tax refund deposited directly into your checking account.
- buy groceries, gasoline and other purchases at the point-of-sale, using a check card rather than cash, credit or a personal check.
- use a smart card with a prepaid amount of money embedded in it for use instead of cash at a pay phone, expressway road toll, or on college campuses at the library's photocopy machine or bookstores.
- use your computer and personal finance software to coordinate your total personal financial management process, integrating data and activities related to your income, spending, saving, investing, record keeping, bill-paying and taxes, along with basic financial analysis and decision making.

11.1 Electronic Banking or E-Banking

The following terms refer to one form or other of electronic banking: personal computer (PC) banking, Internet banking, virtual banking, online banking, home banking, remote electronic banking, and phone banking. Electronic banking is an umbrella term for the process by which

Notes

a customer may perform banking transactions electronically without visiting a brick-and-mortar institution.

E-banking is defined as the automated delivery of new and traditional banking products and services directly to customers through electronic, interactive communication channels.

E-banking includes the systems that enable banks' customers - individuals or businesses, to check accounts, do/transact business, or obtain information on financial products and services through a public or private network, including the Internet.

Customers can avail e-banking services by using an intelligent electronic device, such as a Personal Computer (PC), Personal Digital Assistant (PDA), Automated Teller Machine (ATM), Kiosk, or Touch Tone Telephone (TTT).

11.2 E-Banking Components

E-banking systems can vary significantly in their design depending on a number of factors. Financial institutions should choose their e-banking system design and configuration, including outsourcing relationships, based on four factors:

1. Strategic objectives for e-banking
2. Scope, scale, and complexity of equipment, systems, and activities
3. Technology expertise
4. Security and internal control requirements.

Financial institutions may choose to support their e-banking services internally. Alternatively, financial institutions can outsource any aspect(s) of their e-banking systems to third parties. The following entities could provide or host (i.e., allow applications to reside on their servers) e-banking-related services for financial institutions:

1. Another financial institution
2. Internet service provider
3. Internet banking software vendor or processor
4. Core banking vendor or processor
5. Managed security service provider
6. Bill payment provider
7. Credit bureau
8. Credit scoring company

E-banking systems rely on a number of common components or processes. The following list includes many of the potential components and processes seen in a typical institution:

1. Website design and hosting
2. Firewall configuration and management
3. Intrusion detection system or IDS (network and host-based)
4. Network administration
5. Security management
6. Internet banking server

Notes

7. E-commerce applications (e.g., bill payment, lending, brokerage)
8. Internal network servers
9. Core processing system
10. Programming support
11. Automated decision support systems

These components work together to deliver e-banking services. Each component represents a control point.

With cyber-cafes and kiosks springing up in different cities access to the Net has 'become easy. Internet banking (also referred as e- banking) is the latest in this series of technological wonders in the recent past involving use of Internet for delivery of banking products and services. Internet banking is changing the banking industry and is having the major effects on banking relationships.

Thus, banking is now no longer confined to the branches were one has to approach the branch in person, to withdraw cash or deposit a cheque or request a statement of accounts. In true Internet banking, any inquiry or transaction is processed online without any reference to the branch (anywhere banking) at any time. Providing Internet banking is increasingly becoming a "need to have" than a "nice to have" service.

11.3 Features of Online Banking Solutions

Online banking solutions have many features and capabilities in common, but traditionally also have some that are application specific.

The common features fall broadly into several categories:

1. ***Transactional:*** (e.g., performing a financial transaction such as an account to account transfer, paying a bill, wire transfer... and applications... apply for a loan, new account, etc.)
   (i) Electronic bill presentment and payment (EBPP)
   (ii) Funds transfer between a customer's own checking and savings accounts, or to another customer's account
   (iii) Investment purchase or sale
   (iv) Loan applications and transactions, such as repayments
2. ***Non-transactional:*** (e.g., online statements, check links, cobrowsing, chat)
   (i) Bank statements
   (ii) Financial Institution Administration - features allowing the financial institution to manage the online experience of their end users
   (iii) Hosting Administration - features allowing the hosting company to administer the solution across financial institutions.

Online banking platforms support account aggregation (combination) to allow the customers to monitor all of their accounts in one place whether they are with their main bank or with other institutions.

Security token devices are used to keep the information secure e.g. - passwords, security devices, encryption of data.

Notes

11.4 Automated Teller Machine

An automated teller machine (ATM) is a computerized telecommunications device that provides the customers of a financial institution with access (reach) to financial transactions in a public space without the need for a human clerk or bank teller.

On most modern ATMs, the customer is identified by inserting a plastic ATM card with a magnetic stripe or a plastic smartcard with a chip, that contains a unique card number and some security information, such as an expiration date or CVC (CVV). Security is provided by the customer entering a personal identification number (PIN).

By using an ATM, customers can access their bank accounts in order to make cash withdrawals (or credit card cash advances) and check their account balances. ATMs are known by various casual terms including automated banking machine, money machine, cash machine, hole-in-the-wall, cashpoint or bancomat.

1. ***Invention of ATM:*** Don Wetzel invented the Automated Teller Machine in the late 1960's, while working for a company in Dallas called Docutel.

ATM Type – I

A graduate of the University of Loyola in New Orleans (Class of 1951), Wetzel played professional minor-league baseball for three years after college before putting his bachelor's degree in foreign trade to work at IBM. He joined Docutel in 1968 and received the patent for the ATM in 1973.

2. ***Alternative Uses:*** Although ATMs were originally developed as just cash dispensers, they have evolved to include many other bank-related functions. In some countries, especially those which benefit from a fully integrated cross-bank ATM network (e.g.: Multibanco in Portugal), ATMs include many functions which are not directly related to the management of one's own bank account, such as:

   (i) Deposit currency recognition, acceptance, and recycling

   (ii) Paying routine bills, fees, and taxes (utilities, phone bills, social security, legal fees, taxes, etc.)

   (iii) Printing bank statements

   (iv) Updating passbooks

   (v) Loading monetary value into stored value cards

Notes

(vi) Purchasing-postage stamps, lottery tickets, train tickets, concert tickets, shopping mall gift certificates, Games and promotional features, Donating to charities, Cheque Processing Module, recharging pre-paid cell phones.

ATM Type – II

Increasingly, banks are seeking to use the ATM as a sales device to deliver pre-approved loans and targeted advertising using products such as ITM (the Intelligent Teller Machine) from CR2 or Aptra Relate from NCR.

3. ***Placement of ATM's:*** ATMs are placed not only near or inside the premises of banks, but also in locations such as shopping centers/malls, airports, grocery stores, petrol/gas stations, restaurants, or any place where large numbers of people may gather. These represent two types of ATM installations: on and off premise.

4. ***Transactional Secrecy and Integrity:*** The security of ATM transactions relies mostly on the integrity of the secure cryptoprocessor: the ATM often uses commodity components that are not considered to be "trusted systems".

   Encryption of personal information is used to prevent fraud. Sensitive data in ATM transactions are usually encrypted with data encryption standard (DES) but transaction processors now usually require the use of Triple DES. Remote Key Loading techniques may be used to ensure the secrecy of the initialization of the encryption keys in the ATM. Message Authentication Code (MAC) or Partial MAC may also be used to ensure messages that have not been tampered with while in transit between the ATM and the financial network.

5. ***Customer Identity Integrity - An ATM with a palm scanner:*** There have also been a number of incidents of fraud where criminals have attached false keypads or card readers to existing machines. These have then been used to record customers' PINs.

11.5 Electronic Clearing Service (ECS)

It is a mode of electronic funds transfer from one bank account to another bank account using the services of a clearing house. This is normally for bulk transfers from one account to many accounts or vice-versa.

This can be used both for making payments like:

1. Distribution of dividend, interest, salary, pension, etc. by institutions
2. For collection of amounts for purposes such as payments to utility companies like telephone, electricity, or charges such as house tax, water tax, etc.
3. For loan instalments of financial institutions/banks or regular investments of persons

Types of ECS

Notes

There are two types of ECS:

1. ***ECS (Credit):*** ECS (Credit) is used for affording credit to a large number of beneficiaries by raising a single debit to an account, such as dividend, interest or salary payment.
2. ***ECS (Debit):*** ECS (Debit) is used for raising debits to a number of accounts of consumers/ account holders for crediting a particular institution.

11.6 Electronic Funds Transfer (EFT)

Electronic funds transfer or EFT refers to the computer-based systems used to perform financial transactions electronically. Electronic Funds Transfer (EFT) is a system of transferring money from one bank account directly to another without any paper money changing hands. One of the most widely-used EFT programmes is Direct Deposit, in which pay roll is deposited straight into an employee's bank account, although EFT refers to any transfer of funds initiated through an electronic terminal, including credit card, ATM and point-of-sale (POS) transactions.

It is used for both credit transfers, such as payroll payments, and for debit transfers, such as mortgage payments. For payments, funds are transferred electronically from one bank account to the billing company's bank, usually less than a day after the scheduled payment date.

The growing popularity of EFT for online bill payment is paving the way for a paperless universe where checks, stamps, envelopes, and paper bills are obsolete. The benefits of EFT include reduced administrative costs, increased efficiency, simplified bookkeeping, and greater security.

The term EFT is used for a number of different concepts:

1. Cardholder-initiated transactions, where a cardholder makes use of a payment card
2. Electronic payments by businesses, including salary payments
3. Electronic check (or cheque) clearing

EFT may be initiated by a cardholder when a payment card such as a credit card or debit card is used. This may take place at an automated teller machine (ATM) or point of sale (EFTPOS), or when the card is not present, which covers cards used for mail order, telephone order and Internet purchases.

Caution Sensitive data in ATM transactions are usually encrypted with data encryption standard (DES)

11.7 Credit Cards

Cash in the form of notes and coins makes up just one form of payment system. A major development in banking brought i.e. through paper instruments namely cheques and credit transfers about a second phase in payment system. The requirement for greater flexibility and convenience and development of technology has given rise to electronic payments and this has further given way to invent plastic cards. The credit card can be defined as "a small plastic card that allows its holder to buy goods and services on credit and to pay at fixed intervals through the card issuing agency".

Notes

Operation of the Credit Card

Credit cards operate quite differently from cheque cards. A cheque card guarantees payment of a cheque, whereas a credit card guarantees against a sales voucher signed by the credit card holder.

Credit cards may also be used for the purpose of obtaining cash from the branches of issuing bank or branches of certain other banks with which arrangements have been made. Some institutions make a specific annual charge to their cardholders.

Notes Encryption of personal information is used to prevent fraud.

Mechanism of Credit Card Operation

1. Customer applied and got the credit card.
2. Arrangements are completed between the banker and seller.
3. The customer makes the actual purchases and signs on the sale vouchers.
4. The seller sends the detailed vouchers to the bank.
5. The bank settles the claims of the seller.
6. The customer receives the intimation from the bank in this regard.
7. The customer makes the payment for the purchases made by him.

11.8 Debit Card

A debit card is a plastic card which provides an alternative payment method to cash when making purchases. Physically, the card is like a credit card; however, its functionality is more similar to writing a cheque as the funds are withdrawn directly from either the cardholder's bank account (often referred to as a check card).

Depending on the store or merchant, the customer may swipe or insert their card into the terminal, or they may hand it to the merchant who will do so. The transaction is authorized and processed and the customer verifies the transaction either by entering a PIN or, occasionally, by signing a sales receipt.

The use of debit cards has become widespread in many countries and has overtaken the cheque and in some instances cash transactions by volume. Like credit cards, debit cards are used widely for telephone and Internet purchases.

Card-holders' accounts are immediately debited against purchase or services through the computer network. Hence, under debit card the card-holder must have adequate balance in his account. This system is intended to replace the cheque system of payment.

Did u know? A cheque card guarantees payment of a cheque, whereas a credit card guarantees against a sales voucher signed by the credit card holder.

A major development in banking brought i.e. through paper instruments namely cheques and credit transfers about a second phase in payment system.

Notes

Task Discuss various kinds of cards offered by Standard Chartered Bank.

Self Assessment

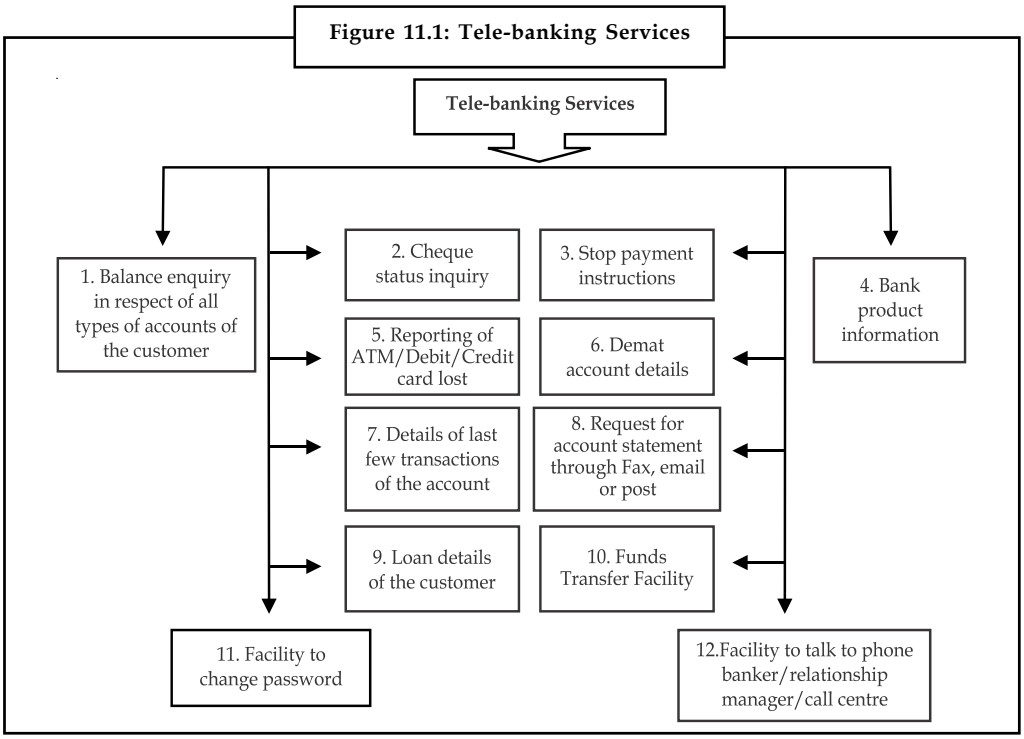
Fill in the blanks:

1. A ..... card is a plastic card which provides an alternative payment method to cash when making purchases.
2. EFT may be initiated by a cardholder when a .....card such as a credit card or debit card is used.
3. ECS (Debit) is used for raising ..... to a number of accounts of consumers/ account holders for crediting a particular institution.
4. With cyber-cafes and ..... springing up in different cities access to the Net has 'become easy.
5. Message Authentication Code (MAC) or ..... may also be used to ensure messages that have not been tampered with while in transit between the ATM and the financial network.

11.9 Tele-Banking/Mobile Banking

Tele-banking services help customers to avail banking services right from their home. By dialing the number allotted by the bank, customers can transact most of the banking transactions. Tele-banking facility may be available throughout the day. This facility is available only for the account holders. Tele-banking facilities are offered free of cost. Through tele-banking, customers can make following kind of enquiries and can avail facilities like:

Figure 11.1: Tele-banking Services



Notes

11.10 Terms in Tele-banking

Customer Identification Number (CIN): Unique 6 digit number allotted by Flex cube.

Telephone Personal Identification Number (TPIN): Password for query purpose.

Financial Telephone Personal Identification Number (FTPIN): Password for transaction purpose.

Eligibility

For telebanking facility, customers have to enter into an agreement with the bank by signing a declaration. The following are eligible for this service:

1. Individuals
2. Joint account holders with either or survivor operation condition.
3. Proprietorship concern
4. PA of NRIs.

Ineligibility

The following account holders are not eligible for the tele-banking services as per the bank's policy:

Illiterate persons, blind persons, minors, joint accounts with operation condition jointly, encumbered accounts, blocked accounts, inoperative accounts, Hindu Undivided Family account. However, the karta of HUF can avail this facility by providing an indemnity letter.

Procedure to avail Tele-banking Services

1. Submit the application forms in duplicate at bank branch for avail of tele-banking facility.
2. On receipt of the duly forwarded application from the branch, TPINs, FTPINs are generated centrally and dispatched to customer through courier.

Over view of Microfinance

There are a rich variety of financial institutions serving poor people. Microfinance refers to the provision of financial services to low-income clients, including consumers and the

self-employed. The term also refers to the practice of sustainably delivering those services. Microcredit (or loans to poor microenterprises) should not be confused with microfinance, which addresses a full range of banking needs for poor people.

More broadly, it refers to a movement that envisions "a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers." Those who promote microfinance generally believe that such access will help poor in getting out of poverty.

11.11 New Banking Products/Services

Products

Banking products are characterized under following heads:

Notes

1. ***Deposit Products:*** Savings Account - Current Account - Demand Deposits -Term Deposits - Certificate of Deposit
2. ***Remittance Products:*** Demand Draft - Travelers Cheques - Mail Transfer - Telegraphic Transfer - RTGS-SFMS
3. ***IT Products:*** MICR Cheques - Channel Banking - Core Banking - Internet Banking Mobile Banking - ATM's - Debit Card - Credit Card
4. ***Loan Products:*** Short Term Loans-Long Term Loans - Consumer Loans - Education Loans - Housing Loans - Business Loans - Farm Loans - Kisan Credit Cards - Corporate Loans - Syndication - Microfinance

Services

The growth of financial markets during the last 15 years has been phenomenal. This period has witnessed tremendous changes in the composition of markets. The share of banks in the total financial transactions recorded had fallen behind the security market transactions.

Financial markets, in the process, afforded efficient risk sharing mechanism among investors through an array of innovative financial instruments with very different risk-return relationship.

For example investors, who are extremely risk averse, may invest a large part of their wealth in risk-free securities such as treasury bills, whereas, more risk-tolerant investors may select risky stocks, while investors with moderate risk preference may choose a combination of bonds and stocks.

11.12 Factoring

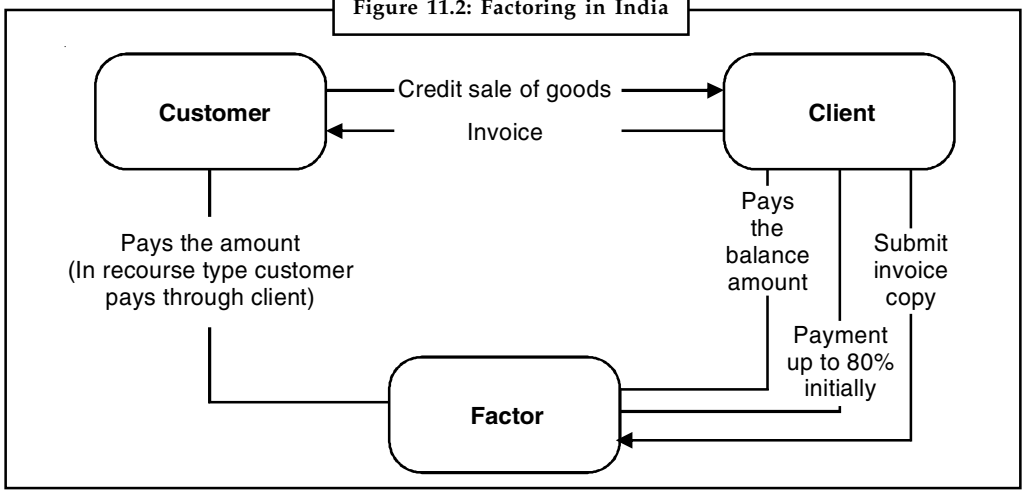
Features

- Buying the receivables of a company for a value.
- Enables better management of receivables.
- Involves outright sale of receivables of a manufacturing or trading firm to a financial institution called "factor".
- Could be with or without recourse to the client.
- A fee, as a percentage of the value of receivables, is collected by the factor.

Factoring is a financial option for the management of receivables. In simple definition it is the conversion of credit sales into cash. In factoring, a financial institution (factor) buys the accounts receivable of a company (Client) and pays up to 80% (rarely up to 90%) of the amount immediately on agreement. Factoring company pays the remaining amount (Balance 20% - finance cost-operating cost) to the client when the customer pays the debt. Collection of debt from the customer is done either by the factor or the client depending upon the type of factoring. We will see different types of factoring in this article. The account receivable in factoring can either be for a product or service. Examples are factoring against goods purchased, factoring for construction services (usually for government contracts where the government body is capable of paying back the debt in the stipulated period of factoring. Contractors submit invoices to get cash instantly), factoring against medical insurance etc. Let us see how factoring is done against an invoice of goods purchased.

Notes

Figure 11.2: Factoring in India



Source: http://www.languages.ind.in/factoring.htm

11.12.1 Types of Factoring

- ***Recourse factoring:*** Factor extends all the services to the client except debt protection i.e. in the event of non-payment by the debtor, the receivable is reassigned to the client.
- ***Maturity factoring:*** Factor provides all the services except for the pre-payment of debts i.e. the client is paid money upon maturity and realization of debt.
- ***Bulk factoring:*** Factor provides financial assistance against purchase of book debts but no administrative support in collecting the debt.
- ***Invoice discounting:*** Same as bulk factoring, but here the client himself collects the dues from the debtor on behalf of the factor and pass on the proceeds on realization to the factor.

11.12.2 Advantages

Freed from the hassles of managing receivables collection can stay focused on production and selling factors provides market intelligence to the manufacturer speeds up the collection.

11.13 Forfeiting

11.13.1 Introduction

Forfeiting and factoring are services in international market given to an exporter or seller. Its main objective is to provide smooth cash flow to the sellers. The basic difference between the forfeiting and factoring is that forfeiting is a long term receivables (over 90 days up to 5 years) while factoring is a short-termed receivable (within 90 days) and is more related to receivables against commodity sales.

11.13.2 Definition of Forfeiting

The terms forfeiting is originated from a old French word 'forfait', which means to surrender ones right on something to someone else. In international trade, forfeiting may be defined as

the purchasing of an exporter's receivables at a discount price by paying cash. By buying these receivables, the forfeiter frees the exporter from credit and the risk of not receiving the payment from the importer.

11.13.3 How forfeiting Works in International Trade

The exporter and importer negotiate according to the proposed export sales contract. Then the exporter approaches the forfeiter to ascertain the terms of forfeiting. After collecting the details about the importer, and other necessary documents, forfeiter estimates risk involved in it and then quotes the discount rate.

The exporter then quotes a contract price to the overseas buyer by loading the discount rate and commitment fee on the sales price of the goods to be exported and sign a contract with the forfeiter. Export takes place against documents guaranteed by the importer's bank and discounts the bill with the forfeiter and presents the same to the importer for payment on due date.

11.13.4 Documentary Requirements

In case of Indian exporters availing forfeiting facility, the forfeiting transaction is to be reflected in the following documents associated with an export transaction in the manner suggested below:

- ***Invoice:*** Forfeiting discount, commitment fees, etc. needs not be shown separately instead, these could be built into the FOB price, stated on the invoice.
- ***Shipping Bill and GR form:*** Details of the forfeiting costs are to be included along with the other details, such FOB price, commission insurance, normally included in the "Analysis of Export Value" on the shipping bill. The claim for duty drawback, if any is to be certified only with reference to the FOB value of the exports stated on the shipping bill.

11.13.5 Forfeiting Cost Elements

The forfeiting typically involves the following cost elements:

1. Commitment fee, payable by the exporter to the forfeiter 'for latter's' commitment to execute a specific forfeiting transaction at a firm discount rate with in a specified time.
2. Discount fee, interest payable by the exporter for the entire period of credit involved and deducted by the forfaiter from the amount paid to the exporter against the availed promissory notes or bills of exchange.

11.13.6 Benefits to Exporter

- ***100 per cent financing:*** Without recourse and not occupying exporter's credit line That is to say once the exporter obtains the financed fund, he will be exempted from the responsibility to repay the debt.
- ***Improved cash flow:*** Receivables become current cash in flow and its is beneficial to the exporters to improve financial status and liquidation ability so as to heighten further the funds raising capability.
- ***Reduced administration cost:*** By using forfeiting , the exporter will spare from the management of the receivables. The relative costs, as a result, are reduced greatly.
- ***Advance tax refund:*** Through forfeiting the exporter can make the verification of export and get tax refund in advance just after financing.

Notes

- ***Risk reduction:*** Forfeiting business enables the exporter to transfer various risk resulted from deferred payments, such as interest rate risk, currency risk, credit risk, and political risk to the forfeiting bank.
- ***Increased trade opportunity:*** With forfeiting, the export is able to grant credit to his buyers freely, and thus, be more competitive in the market.

11.13.7 Benefits to Banks

Forfeiting provides the banks following benefits:

- Banks can offer a novel product range to clients, which enable the client to gain 100% finance, as against 8085% in case of other discounting products.
- Bank gain fee based income.
- Lower credit administration and credit follow up.

Factoring	Forfeiting
Short Term	Medium Term
Buyer's Bank's guarantee not insisted	Normally insisted
Could be with or without recourse to the seller	Always without recourse
Collect as an agent	Collect as a sole owner

Self Assessment

State whether the following statements are true or false:

6. For telebanking facility, customers need not have to enter into an agreement with the bank by signing a declaration.
7. Tele-banking services do not help customers to avail banking services right from their home
8. Factor provides all the services except for the prepayment of debts i.e. the client is paid money upon maturity and realization of debt.
9. Microfinance refers to the provision of financial services to low-income clients, including consumers and the self-employed.

11.14 Securitisation

11.14.1 Features

- A structured process where under loans and other receivables are packaged, underwritten and sold in the form of asset-backed securities by commercial banks/financial institutions.
- Illiquid, non-negotiable and high valued financial asset is converted into securities of small value that are tradable and transferable.
- A lending institution called "originator" identifies the loans in its portfolio that are to be securitised.
- Such identified assets are passed through another institution called "special purpose vehicle (SPV)" usually an investment banker. On such transfer of assets for value to an investment banker, they stand removed from the balance sheet of the originator.

Notes

- SPV then splits the pool of transferred assets into individual securities of tradable size and reimburses itself by selling them in the debt secondary market to investors. These securities are known as "PTC" pay or pass through certificates.
- Repayments under the securitised loans keep on received by the originator and passed on to the SPV, who in turn makes use of them for redeeming the securities issued to the investors.
- The PTCs are tradable in the secondary market till their maturity date.

11.14.2 Advantages

- Diversifies the funding sources of lenders
- Lenders can augment their lendable resources
- Enables quick recycling of lent funds
- Enables increased volume of lending
- Helps in capital adequacy compliance

11.15 Hire Purchase

- It is like leasing except for the fact that ownership of the hired asset gets transfer to the name of the hiree and hence he is entitled for depreciation.
- Hiree pays hiring charges at stipulated intervals and quantum by the hirer.
- Hirer enjoys the right to take back the possession of the asset, once hiree defaults in payment of any instalment under hire purchase agreement.

11.16 Leasing

- Enables a person to acquire the right to make economic use of asset without owning it for a specified period of time.
- Agreement is signed by the owner of asset called lessor and the user called the lessee.
- Lessor permits the lessee to use the asset for a consideration known as lease rentals, payable at periodical intervals.
- Lease Agreement sets forth the period covered by the lease, provisions for payment of taxes, insurance, maintenance expenses, provisions for renewals, purchase of the asset on the expiry of the lease agreement, payment schedule of lease rentals, etc.
- Leasing could be of following types:

Financial lease/capital lease/full pay out lease

Lessor amortizes the full value of the asset, cost of capital plus administrative expenses within the period of the lease/asset life.

Lessor is normally responsible for maintenance, insurance and tax lease agreement is irrevocable.

Operating lease

Lease facility is offered for as short a period as desired by the lessee.

Notes

Leasing is extended on a period to period basis, hence the rentals are higher.

Lessor undertakes maintenance/repairs, insurance, tax and training of lessee's staff operating lease could be -

- dry lease - leaving the asset in the hands of lessee for his operation;
- wet lease - deputing the lessor's staff along with the asset to the lessee for its operation.

Leveraged lease

Lessor acquires the asset through borrowed funds and leases out.

Gearing on borrowed funds-obviously margins could be low/rentals could be high, usually resorted to by a group of lessors, while leasing out high cost assets.

Arranger bank helps the borrower in preparing information memorandum about the company and mails it to various banks, inviting participation in the loan.

Notes A lending institution called "originator" identifies the loans in its portfolio that are to be securitised.

11.17 Bancassurance

Bancassurance stands for distribution of financial products particularly the insurance policies (both the life and non-life), also called referral business, by banks as corporate agents, through their branches located in different parts of the country.

11.17.1 Licence for Bancassurance

Banks are required to obtain prior approval of the Insurance Regulatory and Development Authority (IRDA) for acting as 'composite corporate agent' or referral arrangement with insurance companies. Banks need not obtain prior approval of RBI to undertake bancassurance.

11.17.2 Benefits of Bancassurance

Bancassurance helps the banks to build synergies between the insurance business and bank branch network to sell insurance products through banking channels, as the bank branches have a ready customer in need of financial products/services. Since those customers are already having their dealings with the banking, they trust the branch staff, more than a private agent. Accordingly not only large commercial banks but stronger RRBs and Urban/Distt. Central Banks are also allowed to under taken bancassurance business now.

RBI guidelines on bancassurance (Sept 22, 2003)

1. Banks to comply with IRDA regulations for acting as 'composite corporate agent' or referral arrangement with insurance companies.
2. Banks not to adopt any restrictive practice of financing its customers to go in only for a particular insurance company in respect of assets financed by the bank.
3. Banks should also enter into an agreement with the insurance company.

Notes

4. The risks, if any, involved in insurance agency/referral arrangement should not get transferred to the business of the bank.

Caution Banks are required to obtain prior approval of the Insurance Regulatory and Development Authority (IRDA) for acting as 'composite corporate agent' or referral arrangement with insurance companies.

11.18 Money Market Mutual Funds

- A special genre of MF that pools savings of small investors for investment in short term money market instruments like CD, Call Money, Commercial Bills, Treasury Bills, Dated Government Securities, having an unexpired maturity up to 1 year, Rated Corporate Bonds/Debentures with a residual maturity up to 1 year, etc., and passes on the benefit of higher yield on these instruments to the unit holders.
- Can be established by commercial banks/public financial institutions/their existing mutual funds/subsidiaries/NBFCs etc.
- Can be either as money market deposit account or mutual fund. Individuals/NRI Individuals can subscribe.
- Minimum lock-in period 30 days.
- Investments are left to the commercial judgment of the fund managers.
- Maximum of 3% of total fund can be invested in CPs/Bonds and Debentures of any single company.
- MMFs of Commercial Banks would not be considered as part of demand and time liabilities for reserve requirement.
- Issue of units is subject to stamp duty.
- Prior authorization from RBI is necessary.

Did u know? Maximum of 3% of total mutual fund can be invested in CPs/Bonds and Debentures of any single company.

Self Assessment

Fill in the blanks:

10. ..... helps the banks to build synergies between the insurance business and bank branch network.
11. .....acquires the asset through borrowed funds and leases out.
12. A lending institution called "....." identifies the loans in its portfolio that are to be securitised.
13. A structured process where under loans and other receivables are packaged, underwritten and sold in the form of ..... securities by commercial banks/financial institutions.
14. ..... pays hiring charges at stipulated intervals and quantum by the hirer.

Notes

Task Find various Citibank online banking services.

Case Study **Federal Bank, Technology Driven Growth**

Bank Profile

Federal Bank is a fast growing premier private sector bank in India with business exceeding INR 3,600 million and INR 61.3 million. The bank has 565 branches, 16 administrative offices and 460 ATMs across India with a customer base of 4 million across the country. Technology has played a major part in the bank's aim to differentiate itself to its customers. ATMs, Internet, mobile banking and other channels have broken the barriers of location and time, and have expanded the reach of the bank's operations, earlier confined to the branches.

Across the globe, banks focus on IT investment protection, best use of available resources and reuse of developed components. Even though the objectives appear to be simple, putting these into practice has been a tough task and very few organizations have accomplished these objectives on a scale that is comparable with the global standards and demonstrated perceivable benefits. Federal Bank is one of the very few organizations that have accomplished these objectives.

Key Business Drivers

One of the main challenges on the way to growth for Federal Bank's management team was to choose between a packaged core banking solution or to continue leveraging its proprietary system. The bank envisaged aggressive plans for growth - both organic and inorganic, and the team ultimately felt that the existing proprietary system was not capable of meeting requirements due to its rigidity. The commitment to goals and an organization-wide attitude to welcome the change were most important for the final decision in this regard. As per the management at Federal Bank, to move to a new generation core banking solution, it was essential that:

- The new solution was capable of accommodating and building upon existing products that the bank offers and also help bank release futuristic products
- The new solution significantly improves the customer's banking experience
- The system is capable of interfacing with various delivery channels like ATM, Internet banking and so on
- The new solution helps the bank comply with regulatory requirements The next step was the selection of the packaged solution
- Federal Bank framed a well-defined and clear-cut plan for selection of appropriate system identifying the strength and weakness of the recourses and infrastructure available
- A strong pool of experts was identified to lead the mission
- A thorough selection process was initiated which resulted in three shortlisted solutions

Contd....

Notes

- Vertical and horizontal evaluation process was performed by experts taking inputs from all possible sources

The bank's team mapped the capabilities of each system against the business requirements and Finacle from Infosys was selected by the bank.

Solution Overview

Federal Bank decided to adopt a centralized architecture for better efficiency, more control and for meeting challenges of the future. After a rigorous selection process, Federal Bank decided to adopt innovative technology by procuring Finacle universal banking solution from Infosys to fuel its retail core banking transformation initiative.

The solution was fully equipped to accommodate and build upon existing products that the bank offered to its retail customers and empower the business to introduce futuristic products as well. It promised to significantly improve the customer's banking experience and support it through various delivery channels like the Internet etc. A significant reduction in time-to-compliance was another key solution differentiator.

The replacement exercise began with rigorous testing of the Finacle solution using a large number of test cases, representing various types of retail transactions typical of Federal Bank's operational scenario. The setting up of the data centre and disaster recovery site in accordance with international standards, in different seismic zones, was also planned and executed.

Federal bank started an aggressive roll out of the system in the last week of April 2007. Once the full-fledged implementation started, the bank surmounted the change management challenges in human capital. The most important factor was getting the staff to unlearn whatever they had learnt and the staff had to be motivated to assimilate the benefits of migrating to a new environment, explore more of the new solution and draw more from it.

Federal bank is an end-to-end solution provider for customers in a distributed system through various channels such as ATM, telebanking, mobile alerts, e-mail alerts, electronic bill payments, RTGS, NEFT and its flagship offering – anywhere banking. Federal Bank identified 36 channels, which enabled the bank to run a centralized system even though it was running on a distributed system; seamless integration of these entire channels was a major focus during CBS implementation. The solution is designed with Oracle RDBMS back-end; open architecture is developed and tuned on HP, Sun & IBM UNIX platforms.

Finacle solution came ready with almost all channel services. A major business challenge was the seamless integration of these channels providing customers with uninterrupted service even during the transition period. The technical team identified Finacle channel integrator Connect 24 as the starting point for channel integration. Most of the FedSoft legacy system was integrated with Financial Messaging Service (FMS) and an interface was internally developed for communicating between Fedsoft and Finacle. Every channel was integrated thought this interface. The scalability of internally developed interface was remarkable when it handled end-to end transactions between FedSoft and Finacle.

Some Federal Bank channel features integrated, are listed below:

- Anywhere banking
- Mobile banking
- FedNet (Finacle e-Banking)

Contd....

Notes

- E-mail alerts
- FedFast
- RTGS –FedFlash
- FedEpay
- Cash management system (CMS)

Source: http://www.infosys.com/finacle/customers/case-studies/Pages/federal-bank.aspx

11.19 Summary

Online banking (or Internet banking) allows customers to conduct financial transactions on a secure website operated by their retail or virtual bank, credit union or building society.

The system is updated immediately after every transaction automatically. In other words, it is said that it is updated 'on-line, real time'. Through net banking one can check the status of his/her account, place queries and also can be facilitated with a wide range of transactions simultaneously.

Debit cards allow for direct withdrawal of funds from a Customer's bank account. The spending limit is determined by the user's bank depending upon available balance in the account of user. It is a special plastic card connected with electromagnetic identification that one can use to pay for things purchased directly from his bank account.

Credit cards in India are gaining ground. A number of banks in India are encouraging people to use credit card. Diners Club and American Express used the concept of credit card in 1950 with the launch of charge cards in the USA. Credit card however became more popular with use of magnetic strip in 1970.

A major driving force behind the rapid spread of internet banking all over the world is its acceptance as an extremely cost effective delivery channel of banking services as compared to other existing channels. However, Internet is not an unmixed blessing to the banking sector.

11.20 Keywords

Credit Card: A card that entitles its holder to buy goods and services based on the holder's promise to pay for these goods and services.

Debit Card: A debit card (also known as a bank card or check card) is a plastic card which provides an alternative payment method to cash when making purchases. Functionally, it can be called an electronic check.

Online banking (or Internet banking): It allows customers to conduct financial transactions on a secure website operated by their retail or virtual bank, credit union or building society.

Operational Risk: An operational risk is a risk arising from execution of a company's business functions. As such, it is a very broad concept including fraud risks, legal risks, physical or environmental risks, etc.

Paper Money: Currency in the form of government notes and bank notes.

Plastic Money: Generic term for all types of bankcards, credit cards, debit cards, smart cards, etc.

Tele-Banking: Tele-banking services help customers to avail banking services right from their home.

Notes

11.21 Review Questions

1. Discuss the various e-banking services offered by a bank.
2. 'Plastic money has replaced paper money'. Critically analyze this statement. What are the limitations of credit cards?
3. What is e-banking? Discuss the advantages of ATMs.
4. Write short notes on:
   (i) Internet banking
   (ii) Tele-banking
   (iii) Debit card
   (iv) Smart card
5. Explain the various types of risks associated with Internet banking. How can they be overcome?

Answers: Self Assessment

1.	Debit	2.	Payment
3.	Debits	4.	Kiosks
5.	Partial MAC	6.	False
7.	False	8.	True
9.	True	10.	Bancassurance
11.	Lesser	12.	Originator
13.	Asset blocked	14.	Hiree

11.22 Further Readings

Books

Magazines and Reports

"*Mad rush to faulty ATM in France*" BBC report about a cash machine not being stocked correctly.

"*ATM turns $5s into $20s*" CNN/WAVY report, 9/14/06, about a hacked ATM at a gas station.

Australasian Legal Information Institute.

Fun with Automatic Tellers Phrack Magazine Volume One, Issue Eight.

"*Automatic Teller Machine Cards*" Phrack Magazine, Phrack Classic Volume Three, Issue 32.

Oxford Journals ITNOW.

Notes

Online links

PostalReporter.com news report.

www.atmmarketplace.com

www.atmdepot.com

www.wired.com/wired/archive/1.05/atm_pr.html

Notes

Unit 12: Insurance

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Objectives

After studying this unit, you should be able to:

- Define Methods of handling risks and how insurance works.
- Describe Rights and responsibilities of the insurer and insured and nature of insurance contract.
- Differentiate the difference between insurance contract and wagering contract; insurance and assurance.
- Differentiate the functions, characteristics and marketing of insurance and the classes of risk and their insurability.
- Define how risks affect well-being.

Notes

Introduction

Insurance is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment. An insurer is a company selling the insurance; the insured, or policyholder, is the person or entity buying the insurance policy. The amount to be charged for a certain amount of insurance coverage is called the premium. Risk management, the practice of appraising and controlling risk, has evolved as a discrete field of study and practice.

12.1 History and Meaning of Insurance

Man on earth always had an eye on the avoidance of ill-luck and has tried in all ages somehow to ensure himself and to take out a policy of some sort on which he paid a regular premium in some form of social denial and sacrifice.

– Summer and Keller

It existed in some form of mutual or communal protection in the Aryan tribes some 3000 years back.

– Stone and Cox

Transactions in the shape of Bottomry Bonds were done in Italy in 12th and 13th Century A.D.

The word "Bima" was derived from the Persian word "Bim" meaning "Fear" and "Bima" means "expense" incurred to get rid of fear.

– Persian Dictionary

From the beginning human societies have tried to find ways to soften the shocks of existence. Our ancestors were very much aware that no individual could do it alone, only by pooling the resources of the many, the unfortunate few could be helped.

This simple idea of mutual cooperation persists like a welcome footpath through the incredible tangle of human history. For example, in ancient times, enterprising merchants sent caravans and ships to trade with all parts of the known world: with Egypt, Phoenicia, India and China.

Traders in olden times devised a system of contracts in which the supplier of the capital of business would agree to cancel the loan if the trader was robbed of his goods. The trader who borrowed the capital paid an extra sum (a premium) for this kind of protection over and above the usual interest. As for the lender, collecting these premiums from many traders made it possible for him to absorb the losses of the unfortunate few, who really suffered the loss.

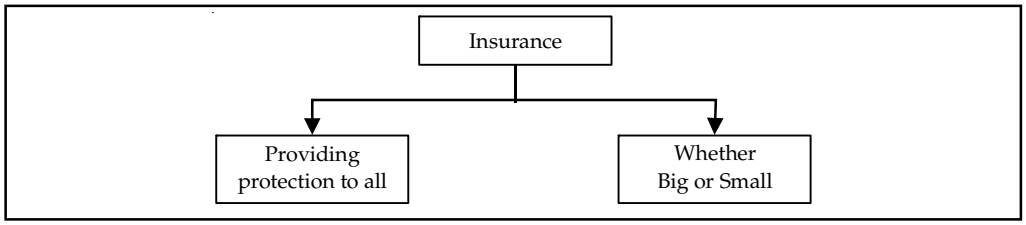
Above arrangement proved to be more sensible and appealing than the earlier one whereby the trader's ship and other tangible property as well as his life and those of his family as well was pledged (as a slave).

Accordingly, the practice was sensibly legalized in the code of Hummurabi in 2100 B.C. The Phoenicians and the Greeks applied a similar kind of system to their sea-born commerce. The Romans used burial clubs as a form of life insurance, providing funeral expenses for members and later on, for payments to the survivors for their future subsistence.

With the growth of towns and trade in Europe, the medieval guilds undertook to protect their guild members from losses by fire and shipwreck, provide ransom to get free from the captivity of pirates, and support in sickness and poverty and to provide decent burial. By the middle of the 14th centuries as evidenced by the earliest known insurance contract (Genoa, 1347), marine insurance was practically universal among the maritime nations of Europe.

Notes

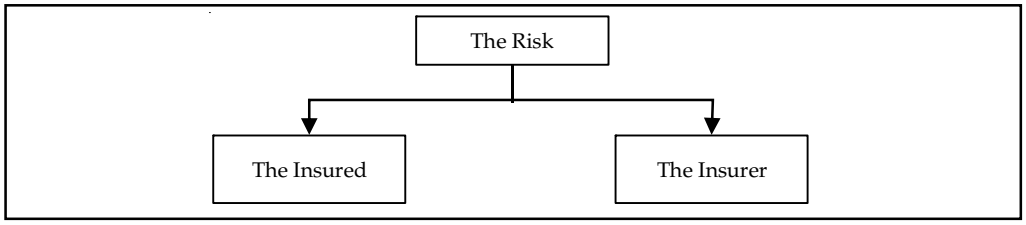
The first kind of formal insurance business was marine insurance. Traders who met in the Lloyd's coffee house in London agreed to share the losses of their goods carried by ships while on voyage to various countries. The losses normally occurred due to attack of pirates who robbed on the high seas or because of bad weather, which spoiled and destroyed the goods or sinking of the ship. The first insurance policy was issued in England in 1583.



Risk, as discussed in last chapter, is the uncertainty of a financial risk. Insurance primarily creates counter part of the risk, which is security.

1. Insurance is defined as a cooperative device to spread the loss caused by a particular risk over a number of persons who are exposed to it and
2. It does not reduce the risk,
3. It does not alter the probability of risk, but
4. It only reduces/spreads the financial losses.

Insurance may be defined in two ways:



Thus, insurance is a financial arrangement that spreads the costs of losses among the members of an insurance pool.

12.2 Indian Insurance Industry

India insurance is a flourishing industry, with several national and international players competing and growing at rapid rates. Thanks to reforms and the easing of policy regulations, the Indian insurance sector been allowed to flourish, and as Indians become more familiar with different insurance products, this growth can only increase, with the period from 2010 - 2015 projected to be the 'Golden Age' for the Indian insurance industry.

Indian Insurance Policies at a Glance

Indian insurance companies offer a comprehensive range of insurance plans, a range that is growing as the economy matures and the wealth of the middle classes increases. The most common types include: term life policies, endowment policies, joint life policies, whole life policies, loan cover term assurance policies, unit-linked insurance plans, group insurance policies, pension plans, and annuities. General insurance plans are also available to cover motor insurance, home insurance, travel insurance and health insurance.

Due to the growing demand for insurance, more and more insurance companies are now emerging in the Indian insurance sector. With the opening up of the economy, several

Notes

international leaders in the insurance sector are trying to venture into the India insurance industry.

Indian Insurance: History

The history of the Indian insurance sector dates back to 1818, when the Oriental Life Insurance Company was formed in Kolkata. A new era began in the India insurance sector, with the passing of the Life Insurance Act of 1912.

The Indian Insurance Companies Act was passed in 1928. This act empowered the government of India to gather necessary information about the life insurance and non-life insurance organizations operating in the Indian financial markets.

The Triton Insurance Company Ltd. formed in 1850 and was the first of its kind in the general insurance sector in India. Established in 1907, Indian Mercantile Insurance Limited was the first company to handle all forms of India insurance.

Indian Insurance: Sector Reform

The formation of the Malhotra Committee in 1993 initiated reforms in the Indian insurance sector. The aim of the Malhotra Committee was to assess the functionality of the Indian insurance sector. This committee was also in charge of recommending the future path of insurance in India.

The Malhotra Committee attempted to improve various aspects of the insurance sector, making them more appropriate and effective for the Indian market.

The recommendations of the committee put stress on offering operational autonomy to the insurance service providers and also suggested forming an independent regulatory body.

The Insurance Regulatory and Development Authority Act of 1999 brought about several crucial policy changes in the insurance sector of India. It led to the formation of the Insurance Regulatory and Development Authority (IRDA) in 2000.

The goals of the IRDA are to safeguard the interests of insurance policyholders, as well as to initiate different policy measures to help sustain growth in the Indian insurance sector.

The Authority has notified 27 Regulations on various issues which include Registration of Insurers, Regulation on insurance agents, Solvency Margin, Reinsurance, Obligation of Insurers to Rural and Social sector, Investment and Accounting Procedure, Protection of policy holders' interest etc. Applications were invited by the Authority with effect from 15th August, 2000 for issue of the Certificate of Registration to both life and non-life insurers. The Authority has its Head Quarter at Hyderabad. Detailed information on IRDA is available at their web-site www.irdaindia.org

Protection of the interest of policy holders

IRDA has the responsibility of protecting the interest of insurance policyholders. Towards achieving this objective, the Authority has taken the following steps:

IRDA has notified Protection of Policyholders Interest Regulations 2001 to provide for: policy proposal documents in easily understandable language; claims procedure in both life and non-life; setting up of grievance redressal machinery; speedy settlement of claims; and policyholders' servicing. The Regulation also provides for payment of interest by insurers for the delay in settlement of claim.

Notes

The insurers are required to maintain solvency margins so that they are in a position to meet their obligations towards policyholders with regard to payment of claims.

It is obligatory on the part of the insurance companies to disclose clearly the benefits, terms and conditions under the policy. The advertisements issued by the insurers should not mislead the insuring public.

All insurers are required to set up proper grievance redress machinery in their head office and at their other offices.

The Authority takes up with the insurers any complaint received from the policyholders in connection with services provided by them under the insurance contract.

12.3 Basic Terminology related to Contract of Insurance

Insurance Contract: Legally binding unilateral agreement between an insured and an insurance company to indemnify the buyer of a contract under specified circumstances. In exchange for premium payment(s) the company covers stipulated perils.

Capacity of parties: Legal capability of those involved in mutual assent of making a contract, including an insurance contract. Those who have been deemed to be incompetent to make a valid contract include intoxicated and insane persons, and enemy aliens, Minors can enter into a contract, but it is voidable at the option of the minor.

Legal plan: Group arrangement in which a network of attorneys provides legal services to the participants in the plan with the attorney fees being reimbursed by the provider. The attorneys who are members of the network provide their legal services at a reduced rate from their customary fee to the plan participants.

Indemnity: It is compensation for loss. In a property and casualty contract, the objective is to restore an insured to the same financial position after the loss that he or she was in prior to the loss. But the insured should not be able to profit by damage or destruction of property, nor should the insured be in a worse financial position after a loss.

Conditional: Terms specifying obligations of an insured to keep a policy in force. For example, an insured must pay the premiums due; in life insurance, if death occurs, the beneficiary or the insured's estate must submit proof of death; if there is a property loss, the insured must submit proof of loss.

Insurable interest: Relationship between an insured person or property and the potential beneficiary of the policy. For example, a wife has an insurable interest in her husband's life, because she would be financially harmed if he were to die. Therefore, she could receive the proceeds of the insurance policy if he were to die while the policy was in force. If there is no insurable interest, an insurance company will not issue a policy.

Mutual assent: Offer and acceptance upon which an agreement is based. For a contract to be legal (and thus enforceable in a court of law), an offer must be made by one party to another party, who accepts the offer. If properly negotiated, the insurance contract is deemed to be a contract of mutual assent.

Consideration: Something of value that one party gives to another in exchange for a promise or act. A consideration can be in the form of money, commodities, or personal services; in many industries the forms have become standardized.

12.4 Legal Definitions

According to **Chief Justice Tindal**, "Insurance is a contract in which sum of money is paid by the assured in consideration of the insurer's incurring the risk of paying a large sum upon a given contingency."

Notes

According to **Britannica Encyclopaedia**, "Insurance may be described as a social device whereby a large group of individuals through a system of equitable contributions may reduce or eliminate certain measurable risks of economic loss common to all members of the group."

In legal terms, insurance is a contractual agreement whereby one party agrees, for a consideration called premium, to compensate another party for losses. Thus, an insurance transaction involves the following:

Insurer: The party agreeing to pay for the losses of the insured.

Insured: The party who insured his risk with the insurer.

Premium: The payment to the insurer received from the insured for indemnifying the losses.

Policy: It is the contract between the insurer and insured that sets the contractual obligation between the two.

Exposure to loss: The insured's possibility of incurrence of loss is called the insured's exposure to loss.

12.5 How Insurance Works

The mechanism of insurance is very simple. People who are exposed to the same kind of risks come together and agree that, if any one of them suffers a loss, the others will share the loss and make good to the person who lost. All people who send goods by ship are exposed to the same risks, which are related to water damage, ship sinking, and piracy etc. Those owning factories are not exposed to these risks, but they are exposed to different kinds of risks like fire, hailstorms, earthquakes, lightning, burglary etc.

Like this, different kinds of risks can be identified and separate groups made. By insurance, the heavy loss that anyone or few of them may suffer is divided into bearable small losses by all. In other words, the risk is spread among the community and the likely big impact on one or few is reduced to smaller manageable impacts on all.

There are certain principles also, which make it possible for insurance to remain a fair arrangement. The first being sharing of risk as it is difficult for any one individual to bear the consequences of the risks that he is exposed to. It will become bearable when the community shares the burden.

The second is that the peril should occur in an accidental manner. Nobody should be in a position to make the risk event occur. In other words, none in the group should set fire to his assets and ask all others to share the costs of damage as this would be taking unfair advantage of an arrangement which is their to protect people from the risks they are exposed to. The occurrence of loss has to be random, accidental, and not the deliberate action of the insured person(s).

The manner in which the loss is to be shared can be determined beforehand. It may be proportional to the risk that each person is exposed to. This would be indicative of the benefit he would receive if the peril befell him. Insurance companies collect the share of people to the pool in advance and create a fund from which the losses can be paid.

The collection to be made from each person in advance is determined on some assumptions. While it may not be possible to tell beforehand, which person will suffer, it may be possible to tell on the basis of past experiences, how many persons, on an average, may suffer losses. The following illustrations make the concept of insurance clear.

Notes

Example 1: In a particular colony there are 600 houses each having a worth of Rs.. 30000. Every year there is a probability of 3 houses getting burnt. The resultant loss per house is Rs 30000 and total loss being Rs 90000. If all the 600 home owners pool Rs 150 each to the pool the unfortunate people whose houses were burnt can be easily paid.

Example 2: There are 10000 persons in a city who all are aged 40 and are healthy. It is expected that of these, 10 persons may die during the year. If the economic value of the loss suffered by the family of each dying person is taken to be Rs. 30000, the total loss would work out to Rs. 3,00,000/-. If each person in the group contributed Rs. 100/- a year, the common fund would be Rs.10,00,000/-. This would be enough to pay Rs. 30,000/- to the family of each of the ten persons who die. Thus, 10000 persons share the risk of 10 persons.

The surplus, if any, after payment of claims remains in the fund which is utilized to meet future excess losses or returned back to policyholders in one or the other form.

Human being - Are they Assets?

A human being is an income-generating asset. One's manual labour, professional skills are the assets. Human assets can also be lost like other assets due to causes like - early death, fatal sickness and death caused by accidents.

Accidents may or may not happen. Death will happen, sooner or later but the timing is uncertain.

Insurance is necessary to help those dependent on the income of a person.

Insurance - Is it a Business?

Insurance companies are called insurers. The business of insurance is to:

1. Bring together the persons with common insurance interests (sharing the same risks)
2. Collect the share or contribution (called premium) from all of them and
3. Pay out compensations (called claims) to those who suffer.

An Insurance policy, like all other contracts, creates rights and corresponding duties for the parties to the contract. Let us examine the rights and responsibilities of the insurer and the insured.

12.6 Rights and Responsibilities of the Insurer and Insured

12.6.1 Rights and Responsibilities of the Insurer

Rights and Responsibilities of the Insurer are listed below:

1. ***Right to collect premium from the insured:*** Insurer has a right to collect in advance a specified sum as premium for his taking obligation of reimbursing the loss to the insured as and when it occurs.

   An insurer pays the claims to the insured from the pool of funds so build up through collection of premiums. In fact, an insurer loads the premium with his administrative costs (management expenses and agents commission) as well.

Notes

2. ***Right to specify the rules and conditions that govern the promise made under the policy:*** Insurer explicitly states as to what risks the policy covers and the terms and conditions subject to which such losses will be reimbursed.

3. ***Responsibility to pay for the losses occurred and claimed by the insured:*** Once the insured suffers losses and lodges claim, the insurer is obliged to honour payments provided they are within the contractual terms.

12.6.2 Rights and Responsibilities of Insured

1. ***Obligation to pay premium to the insurer:*** The insured has to pay the prescribed premium to the insurer so as to create a contractual obligation on the part of insurer to reimburse the losses as and when they occur.

2. ***Right to collect payment from the insurer if a covered loss occurs:*** In the event of materialization of risk, the insured is entitled to claim reimbursement of losses from the insurer.

3. ***Obligation to comply with the terms and conditions prescribed by insurer:*** The insured has to comply with all the terms and conditions laid down in the policy and also agreed by him at time of creating the policy.

In an insurance contract, one should remember that a right created for one party represents a duty for the other party. In the event of default of premium or non-compliance of conditions by insured, an insurer may cancel the insurance or refuse to pay claims/payment of losses.

12.7 Nature of Insurance Contract

Insurance is a contract. A contract of insurance is a contingent contract. The general principles of law of contract must be complied with for a contract of insurance to be valid. Contract of insurance comes into existence where there is an offer (from the person facing the risk) and the underwriter or the insurer accepts it by issuing the policy. The contract of insurance (in order to be a valid contract) can be entered into only by person(s) competent to contract.

A contract of insurance other than life insurance contract is a contract of indemnity. The insurer undertakes to indemnify the insured for loss or damage arising as a result of risk specified. In case of life insurance, if a person dies the insurance company can only give a specified claim amount as compensation to the survivors; it cannot indemnify the loss of lost life as the person who is dead cannot be brought back.

12.8 Differences between Insurance Contract and Wagering Contract

1. People have sometimes said that the contract of insurance whether it is marine, fire or life insurance it is similar to a wagering contract.

Example: Once Mr. 'A' promised to pay Mr.' M' a sum of Rs, 50,000 if India won the cricket match against Australia that day. Payment of this sum depends on the future event, which at the time of contract is of uncertain nature. If the event does not happen no payment will be made. This is a wagering contract.

2. However, contract of insurance is different. The following are the points of distinction between the Insurance Contract and Wagering Contract:

Notes

Table 12.1: Distinction between the Insurance and Wagering Contract

Insurance Contract	Wagering Contract
1. Insurable interest is the subject matter in contract of insurance	1. In a Wagering Contract, the interest in the asset or event is limited. Parties are interested in knowing only for the purpose of winning or losing upon the future events.
2. Contract of insurance is essentially based on principles of indemnity.	2. In a Wagering Contract, there is no question of indemnity because no risk is covered.
3. Contract of insurance is legally enforceable.	3. A Wagering Contract is void because it is not recognized by law.
4. Contract of insurance is based upon the principles of good faith i.e., full disclosure of material facts required by both parties to contract.	4. There is no question of disclosure of material facts as it is not required by either party in Wagering Contract.
5. Risks and Premium are fixed on the basis of scientific methods.	5. No such calculations are made in the Wagering Contract.

Table 12.2: Differences between Insurance and Assurance

Insurance (Non-Life Insurance)	Assurance (Life Insurance)
1. The term 'Insurance' is used for non-life insurance contracts.	1. The term 'Assurance' is referred to life insurance business.
2. In the case of insurance, loss due to risk is not certain to happen i.e., loss is likely to happen or not.	2. Loss due to risk is certain to happen. Death is bound to happen sooner or later.
3. Generally, goods or property are the subject matter of non-life insurance.	3. Human life is the subject matter of life insurance contract.
4. Insurance contract is usually for one year.	4. Life insurance contract, is a continuing contract, i.e., long-term contract.
5. Fire, marine insurance and other contracts are contracts of indemnity.	5. It is not a contract of indemnity. Since life lost cannot be returned.
6. In fire insurance, insurable interest must be present both at the time of affecting the policy and also at the time of occurrence of loss too. In marine insurance it must be present only at the time of loss. It is not necessary at the time of affecting the policy.	6. Insurable interest must be present only at the time of taking out the policy, but need not be present at the time of maturity of the policy.
7. In the case of marine and fire insurance, policy cannot be surrendered by the assured before its maturity.	7. A life insurance policy can be surrendered by the assured before its maturity.
8. In the case of fire and marine insurance, insurance contain only the protection element.	8. Life insurance contains both the elements of security and investment.

Caution The general principles of law of contract must be complied with for a contract of insurance to be valid.

Notes In an insurance contract, one should remember that a right created for one party represents a duty for the other party.

Notes

Task Study the evolution of insurance in the world and in India.

Did u know? The contract of insurance (in order to be a valid contract) can be entered into only by person(s) competent to contract.

Self Assessment

Fill in the blanks:

1 Insurance companies are called .....

2. A ..... of insurance other than life insurance contract is a contract of indemnity.

3. Insurance is defined as a ..... device to spread the loss caused by a particular risk over a number of persons who are exposed to it

4. The first kind of ..... insurance business was marine insurance.

5. Insurance primarily creates counter part of the risk, which is .....

12.9 Role of Insurance in Financial System

Insurance is a part of financial system. Financial system may be defined as set of institutions, instruments and markets, which gather savings and channel them to their most efficient use.

The system consists of individuals (savers), intermediaries, markets and users of savings. Economic activity and growth are greatly facilitated by the existence of the market in mobilizing the saving and allocating them among competing users.

An economy needs institutions that impartially enforce property rights and contracts. Economic growth of a country depends on the existence of a well functioning financial infrastructure. It is essential that the financial infrastructure be developed sufficiently so that the market operates in an efficient manner.

Insurance as a part of the financial system provides valuable services to those affected by various risks or contingencies.

It takes care of the financial consequences of certain specific contingencies but in insurance terminology, such contingencies are called risks and they cause losses when they occur.

The effect of these losses on financial system is not only negative but may be disastrous and catastrophic also. It results in substantial burden on the financial well-being of those affected.

The insurance sector supports the financial system in several ways. A few have been enumerated below:

1. It accepts the risk from people and corporate bodies who are exposed to them.

2. It collects small amounts of premium, which are pooled together to be called an insurance fund. This fund is used for investment purpose.

3. It organizes compulsory insurance in certain areas as per the provisions of the law.

4. It sells voluntary insurance covers through its sales force.

5. It settles claims arising out of insured losses. Neither the insurance company nor the insured are allowed to make profits out of insurance. If insurance company gets a surplus

Notes

after meeting claims, it distributes it among policyholders in form of bonus or reduction in premium.

6. It follows the principles of Indian Contract Act, which help to prevent its misuse or abuse.

12.10 Functions and Characteristics of Insurance

Functions of Insurance

1. It helps capital formation
2. It provides certainty
3. It provides protection
4. It helps prevention of losses
5. It shares risk.

Characteristics of Insurance

An insurance contract has the following characteristics, which are generally, observed in case of all kinds of insurance contracts whether life, marine, fire, or miscellaneous insurance.

1. ***Risk Sharing and Risk Transfer:*** Insurance is a device to share the financial losses, which might occur to an individual or his family on the happening of a specified event. The event may be the death of earning member of the family in the case of life insurance, marine-perils in marine insurance, fire in fire insurance and other certain events in miscellaneous insurance,

   Example: Theft in burglary insurance, accidents in motor insurance, etc.

   The loss arising from these events if insured are shared by all the insured in the form of premium which they have already paid in advance. Hence, the risk is transferred from one individual to a group.

2. ***Cooperative Device:*** A group of persons who agree to share the financial loss may be brought together voluntarily or through publicity or through solicitations of the agents. An insurer, by insuring a large number of persons, is able to pay the amount of loss. Like all cooperative devices, there is no compulsion here on anybody to purchase the insurance policy (third party liability insurance in case of a vehicle owner is an exception).

3. ***Calculates risk in advance:*** The risk is evaluated on the basis of probability theory before insuring since the premium payable on a policy is to be determined. Probability theory is that body of knowledge, which is concerned with measuring the likelihood that something will happen and making estimates on the basis of this likelihood. The likelihood of an event is assigned a numerical value between 0 and 1. Those events that are impossible are assigned a value of 0 and those that are inevitable are assigned a value of 1. The higher values (between 0 and 1) are assigned to those events estimated to have a greater likelihood or probability of occurrence.

4. ***Payment of claim at the occurrence of contingency:*** The payment is made on happening of a certain contingency insured. It is true for all non-life insurances that payment will be made on happening of the specified contingency only.

   The life insurance claim is a certainty, because the contingency of death or the expiry of term, will certainly occur and the payment is certain.

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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 the 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 suffered due to the happening of 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. Moreover one cannot estimate the value of a human being. A person is no doubt precious to his/her family. The insurer promises to pay a fixed sum on the happening of an event i.e. death or permanent disability.

   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, are required to be proved.

6. ***Larger Number of insured persons:*** The price of insurance is basically linked to the cost of claims, which is only known subsequently. In the beginning, it is an unknown factor and an estimate is made on the basis of past claims experience or empirical data about the longevity of human beings, accidents and their financial consequences.

   Generally, the past claims experience is repeated with minor variations if a large number of risks are collected. This once again operates by the law of large numbers and is one reason why insurance companies want to do as much business as possible. The ultimate objective is to keep the insurance cost as low as possible.

7. ***Insurance must not be confused with charity or gambling:*** The uncertainty is changed into certainty by insuring property and life because the insurer promises to pay a definite sum at damage or death. In the absence of insurance, the property owners could at the best practice only some form of self-insurance, which may not give him absolute certainty.

   A family is protected against losses on death and damage with the help of insurance. From the point of view of an insurance company, the insurance contract is essentially non-speculative. In fact, no other business operates with greater certainties. From the insured's point of view, too, insurance is also not gambling. Failure to take insurance amounts to gambling because the uncertainty of loss is always looming on the head.

One could also say, the insurance is just the opposite of gambling. In gambling, by bidding the person exposes himself to risk of loosing, but the insured safeguards himself through insurance, and may suffer loss only if he is not insured.

12.11 Salient features of IRDA Act

The IRDA Authority has the duty to promote, regulate and ensure orderly growth of the insurance and reinsurance businesses across India, subject to the provisions of this Act and any other additional law that is being enforced.

Without prejudice to the generality of the provisions contained in sub-section (1) of IRDA Act, the powers and functions of the Authority shall include:

- Issuing a certificate of registration to the applicant as well as modify, renew, withdraw, suspend or cancel any such registration that is deemed unfit.
- Protecting the interests of the policyholders in matters concerning assigning of insurance policy, nomination by policyholders, settlement of insurance claim, insurable interest, surrender value of policy and other terms and conditions based on contracts of insurance.

Notes

- Specifying requisite qualifications, practical training and code of conduct for insurance intermediaries, insurance brokers and agents.
- Specifying the code of conduct for surveyors and loss assessors.
- Promotion of efficiency in the conduct of insurance business.
- Promoting and regulating professional organizations connected with the insurance and reinsurance business across India.
- Levying fees, commission and other charges for carrying out the purposes of this Act.
- Calling for data or information from, undertaking inspection of, conducting enquiries and investigations, conducting audit of the insurers, intermediaries, insurance intermediaries and other organizations connected with the insurance business.
- Under section 64U of the Insurance Act, 1938 (4 of 1938), controlling and regulation of the rates, advantages, terms and conditions etc. that may be offered by insurers (or Insurance Companies) in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee.
- Specifying the manner and form in which books of account shall be maintained and statement of accounts, financial statements etc shall be rendered by insurers and other insurance intermediaries.
- Keeping a tab, exercising control and regulating investment of funds by insurance companies.
- Regulating the maintenance of margin of solvency by the Insurers.
- Adjudication of disputes between insurers and intermediaries or insurance intermediaries, hospitals, healthcare organizations or with customers.
- To effectively supervise the functioning of the Tariff Advisory Committee.
- Specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organizations referred to in clause (f);
- Specifying the percentage of life insurance business and general (or non-life) insurance business to be undertaken by the insurance company in the rural or social sector.
- Exercising any such other powers that may be prescribed with passage of time.

Self Assessment

State whether the following statements are true or false:

6. One of the features of IRDA Act is to reduce the efficiency in the conduct of insurance business.
7. The uncertainty is changed into certainty by insuring property and life because the insurer promises to pay a definite sum at damage or death.
8. Insurance is not that device which shares the financial losses, which might occur to an individual or his family on the happening of a specified event.
9. The payment is made on happening of a certain contingency insured. It is true for all non-life insurances that payment will be made on happening of the specified contingency only.
10. In life insurance, the purpose is not to make good the financial loss suffered. Moreover one cannot estimate the value of a human being.

Notes

12.12 Meaning of Life Insurance

Many definitions of life insurance contract have been given from time to time by learned persons, scholars and in the insurance legislation as under:

"A contract of life insurance is that in which one party agrees to pay a given sum on the happening of a particular event contingent upon the duration of human life, in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another."

– Bunion

"Life Insurance contract may be defined whereby the insurer, in consideration of a premium paid either in lump sum or in periodical instalments, undertakes to pay an annuity of a certain sum of money either on the death of the insured or on the expiry of a certain number of years."

– R.S. Sharma

"A contract of Life Assurance is that in which one party agrees to pay a given sum on the happening of a particular event contingent upon the duration of human life in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another."

– Bunyon's Law of Life Insurance

"Life insurance business is the business of effecting contract upon human life."

– Insurance Acts

An untimely and premature death of the bread-earner brings economic disaster to the dependent family.

Three ways are suggested to remove problems of economic security viz.,

Social security schemes: The government can have some social security schemes for the socially and economically backward sections of the society i.e., for people below the poverty line. The Government of India has already introduced such schemes. But social security to all is an objective which is still very far. The few schemes already planned are also lacking in execution.

Group efforts: This can be made available through Group Life/Accident/Health Insurance Schemes. But these are mostly limited to a few groups in the organized sector and therefore not widely prevalent. Normally the big business houses provide such schemes and that too to the permanent staff.

Individual efforts: A person makes his own personal financial plan and decides where he would like to invest his savings. Several instruments are offered by the public sector and private sector. One instrument best suited to meet all kinds of risks and disasters is Life Insurance.

Miles M Dawson wrote in his book *The Business of Life Insurance*, "There is nothing more uncertain than life and nothing more certain than Life Insurance". Hence among all the above security measures life insurance is the best guard for an individual and his family. The importance of insurance must be made known to all. If this is done the distress of an individual and his family though inevitable will get minimized.

12.13 Salient Features of Life Insurance

Some of the features of Life Insurance are mentioned below:

1. Instrument of savings
2. Provides social security.

Notes

3. Risk coverage starts from the date of accepting of proposal.
4. Beneficiary nominee/legal heir stands to gain.
5. Policy can be assigned or mortgaged.
6. Policyholders can seek loans against the policy.
7. Certain policies cover up for treatment to serious ailments.
8. Ministry of Finance extends income-tax benefits on the amount of premiums paid.
9. Money can be set aside for children's marriage and education.
10. Provision for old age.

The Laws of Probability

The science of probabilities furnishes three principles of which practical use is made in life insurance. They may be called respectively

1. The law of certainty,
2. the law of simple probability, and
3. the law of compound probability.

Their use makes possible the description of risk in terms of mathematical values, and the statement of the three laws is as follows:

1. Certainty may be expressed by unity, or one;
2. Simple probability, or the probability or chance that an event will happen or that it will not happen may be expressed by a fraction; and
3. Compound probability, or the chance that two mutually independent events will happen is the product of the separate probabilities that the events, taken separately, will happen.

12.14 The Use of This Theory to Forecast Future Events

The value of these three laws of probability lies in the fact that they can be used to forecast future events. Future events can be foretold in one of two ways:

1. by a priori or deductive reasoning, and
2. From knowledge of what has happened in the past under similar conditions.

The validity of a prior reasoning depends on the completeness with which all the causes at work in the determination of any phenomenon are known; and the limitations of the human mind are such that a priori reasoning does not furnish a safe basis upon which to develop a superstructure guaranteeing that degree of certainty which is required in insurance. Reasoning inductively, or on the assumption that what has happened in the past will happen again in the future if the same conditions are present, does not require an analysis of the causes of phenomena in order to predict future events. There lies behind this statement the assumption that all things are governed by law. In the cases here used to illustrate the principles of probability this is the law of pure chance. It is an even chance one with another that any marble may be drawn from the box or that either side of the coin may be "up". Then if in a great number of trials it has been found that the coin falls "heads up" one-half of the time the conclusion follows that this result will follow approximately if the same number of trials is taken again.

Notes

This fact has important bearings upon life insurance. From data showing the length of life and ages at death in the past it is possible to predict probabilities of death and of survival in the future. This prediction is based on the assumption that, like the law of chance, there is a law of mortality by which human beings die; that certain causes are in operation which determine that out of a large group of persons at birth a definite number of lives will fail each year until all have died; and that the force of mortality could be measured if only the causes at work were known. But it is not necessary to analyze this law of mortality completely and to know all the operating causes in order to predict the possible rate of mortality in a group of persons. By studying the rate of death among any group and noting all the circumstances that might, according to our best knowledge, affect that rate, it is possible to surround any future group of persons with approximately the same set of circumstances and expect approximately the same rate of death. Thus without complete knowledge of the law of mortality a working basis is found for predicting future rates of death. It is necessary then to have mortality statistics in order to develop a scientific plan of life insurance.

The Measurement of Mortality - Mortality Tables

The establishment of any plan of insuring against premature death requires some means of giving mathematical values to the chances of death, and the considerations advanced in the first division of this chapter show that the laws of probability can be used for this purpose as soon as trustworthy data are secured showing the course of past mortality. Mortality tables, as such data are called, are records of past mortality put into such form as can be used in estimating the course of future deaths.

Sources of Mortality Tables

There are two sources from which the best-known mortality tables in existence today have been obtained: (1) population statistics obtained from census enumerations, and the returns of deaths from registration offices, and (2) the mortality statistics of insured lives. Well-known examples of the former are the English life tables of Drs. Farr, Ogle, and Tatham, successively in charge of the General Registry Office of England and Wales. Dr. Farr's life table, for instance, was based on the registered deaths in England and Wales during the years 1838-54, and on the two census enumerations of population for 1841 and 1851.

Description of a Mortality Table

A mortality table has been described as the picture of "a generation of individuals passing through time". It shows a group of individuals entering upon a certain age and traces the history of the entire group year by year until all have died. Since any description will best be understood by reference to an actual table, the American Experience table, used almost exclusively for the computation of premium rates by old line companies in the United States, is presented below.

The essential features of the table are the two columns of the number living and the number dying at designated ages. It is assumed that a group of 100,000 persons comes under observation at exactly the same moment as they enter upon the tenth year of life. Of this group 749 die during the year, leaving 99,251 to begin the eleventh year. The table proceeds in this manner to record the number of the original 100,000 dying during each year of life and the number living at the beginning of each succeeding year until but three persons of the original group are found to enter upon the ninety-fifth year of life, these three dying during that year.

Notes

American Experience Table of Mortality

Age	Number Living at Beginning of Designated Year	Number Dying * Designated Year	Yearly Probability of Dying	Yearly Probability of Surviner
10	100,000	749	.007490	.992510
11	99,251	746	.007516	.992484
12	98,505	743	.007543	.992457
13	97,762	740	.007569	.992421
14	97,022	737	.007598	.992404
15	96,285	735	.007634	.992366
16	95,550	732	.007081	.992339
17	94,818	729	.007688	.992312
18	94,089	727	.007727	.992273
19	93,362	725	.007765	.992235
20	92,637	729	.007805	.992195
21	91,914	722	.007855	.992145
22	91,192	721	.007906	.992094
23	90,471	720	.007958	.992042
24	89,751	719	.008011	.991989
25	89,032	718	.008065	.991935
26	88,314	718	.008130	.991870
27	87,598	718	.008197	.991803
28	86,878	718	.008264	.991736
29	86,160	719	.006345	.991655
30	85,441	720	.008427	.991573
31	84,721	721	.008510	.991490
32	84,000	723	.008607	.991393
33	83,277	726	.008718	.991282
34	82,551	729	.008831	.991169
35	81,822	732	.008946	.991054
36	81,090	737	.009089	.990911
37	80,353	742	.009234	.990766
38	79,611	749	.000408	.990592
39	78,862	758	.000586	.990414
40	78,108	765	.009794	.990206
41	77,341	774	.010008	.989992
42	76,567	785	.010252	.989748
43	75,782	797	.010517	.989483
44	74,985	812	.010829	.989171
45	74,173	828	.011168	.988837
46	73,345	848	.011562	.988438
47	72,497	870	.012000	.988000
48	71,627	898	.012509	.987491
49	70,731	927	.013106	.986894
50	69,804	962	.013781	.986219
51	68,842	1,001	.014541	.985459
52	67,841	1,044	.015389	.984611
53	66,797	1,091	.016333	.983667
54	65,706	1,143	.017396	.982604
55	64,563	1,199	.018571	.981429
56	63,364	1,260	.019885	.980115
57	62,104	1,325	.021335	.978665
58	60,779	1,394	.022936	.977064
59	59,385	1,468	.024720	.975280
60	57,917	1,546	.026693	.973307

Contd....

Notes

61	56,371	1,628	.028880	.971120
62	54,743	1,713	.031292	.968708
63	53,030	1,800	.033943	.966057
64	51,230	1,889	.36873	.963127
65	49,341	1,980	.040129	.959871
66	47,361	2,070	.043707	.956293
67	45,291	2,158	.047647	.952353
68	43,133	2,243	.052002	.947998
69	40,890	2,321	.056762	.943238
70	38,569	2,391	.061993	.938007
71	36,178	2,448	.067665	.932335
72	33,730	2,487	.073733	.926267
73	31,243	2,505	.080178	.919822
74	28,738	2,501	.087028	.912972
75	26,237	2,476	.094371	.905629
76	23,161	2,431	.094371	.905629
77	21,330	2,369	.111064	.888936
78	18,961	2,291	.120827	.879173
79	16,670	2,196	.131734	.868266
80	14,474	2,091	.144466	.855534
81	12,383	1,964	.158605	.841395
82	10,419	1,816	.174297	.825703
83	8,603	1,648	.191561	.808439
84	6,955	1,470	.211359	.788641
85	5.485	1,292	.235552	.764448
86	4,193	1.114	.265681	.734319
87	3,079	933	.303020	.696980
88	2,146	744	.346692	.653308
89	1,402	555	.395863	.604137
90	847	385	.454545	.545455
91	462	246	.532466	.467534
92	216	137	.634259	.365741
93	79	58	.734177	.265823
94	21	18	.857143	.142857
95	3	3	1.000000	.000000

12.15 Mortality rate

Mortality rate is a measure of the number of deaths (in general, or due to a specific cause) in a population, scaled to the size of that population, per unit of time. Mortality rate is typically expressed in units of deaths per 1000 individuals per year; thus, a mortality rate of 9.5 (out of 1000) in a population of 100,000 would mean 950 deaths per year in that entire population, or 0.95% out of the total. It is distinct from morbidity rate, which refers to the number of individuals in poor health during a given time period (the prevalence rate) or the number of newly appearing cases of the disease per unit of time (incidence rate). The term "mortality" is also sometimes inappropriately used to refer to the number of deaths among a set of diagnosed hospital cases for a disease or injury, rather than for the general population of a country or ethnic group. This disease mortality statistic is more precisely referred to as "case fatality".

One distinguishes:

1. The crude death rate, the total number of deaths per year per 1000 people. As of July 2009 the crude death rate for the whole world is about 8.37 per 1000 per year according to the current CIA World Factbook.

Notes

2. The perinatal mortality rate, the sum of neonatal deaths and fetal deaths (stillbirths) per 1000 births.
3. The maternal mortality ratio, the number of maternal deaths per 100,000 live births in same time period.
4. The maternal mortality rate, the number of maternal deaths per 1,000 women of reproductive age in the population (generally defined as 15-44 years of age) .
5. The infant mortality rate, the number of deaths of children less than 1 year old per 1000 live births.
6. The child mortality rate, the number of deaths of children less than 5 years old per 1000 live births.
7. The standardised mortality ratio (SMR)- This represents a proportional comparison to the numbers of deaths that would have been expected if the population had been of a standard composition in terms of age, gender, etc.
8. The age-specific mortality rate (ASMR) - This refers to the total number of deaths per year per 1000 people of a given age (e.g. age 62 last birthday).

In regard to the success or failure of medical treatment or procedures, one would also distinguish:

1. The early mortality rate, the total number of deaths in the early stages of an ongoing treatment, or in the period immediately following an acute treatment.
2. The late mortality rate, the total number of deaths in the late stages of an ongoing treatment, or a significant length of time after an acute treatment.

Note that the crude death rate as defined above and applied to a whole population can give a misleading impression. The crude death rate depends on the age (and gender) specific mortality rates and the age (and gender) distribution of the population. The number of deaths per 1000 people can be higher for developed nations than in less-developed countries, despite life expectancy being higher in developed countries due to standards of health being better. This happens because developed countries typically have a completely different population age distribution, with a much higher proportion of older people, due to both lower recent birth rates and lower mortality rates. A more complete picture of mortality is given by a life table which shows the mortality rate separately for each age. A life table is necessary to give a good estimate of life expectancy.

12.16 Application of the Theory of Probabilities to the Mortality Table

The statement was made earlier in this chapter that risk in life insurance is measured by the application of the laws of probability to the mortality table. Now that these laws are understood and the mortality table has been explained, a few simple illustrations may be used to show this application. Suppose it is desired to insure a man aged 35 against death within one year, within two years, or within five years. It is necessary to know the probability of death within one, two, or five years from age 35. This probability, according to the laws heretofore explained, will be determined according to the mortality table and will be a fraction of which the denominator equals the number living at age 35 and the numerator will be the number who have died during the one, two, or five years, respectively, following that age. According to the table, 81,822 persons are living at age 35, and 732 die before the end of the year. Hence the probability of death in one year is 732/81822. During the two years following the stated age there are 732 + 737 deaths, or a total of 1,469. The probability of dying within two years is therefore 1469/85822.

Notes

Likewise the total number of deaths within five years is 732 + 737 + 743 + 749 + 756 or 3,716, and the probability of dying within five years is thus 3716/81822.

Probabilities of survival can also be expressed by the table. The chance of living one year following age 35 will be a fraction of which the denominator0 is 81,822 and the numerator will be the number who have lived one year following the specified age. This is the number who are living beginning age 36, or 81,090, and the probability of survival for one year is therefore 81090/81822. These illustrations furnish an opportunity for a proof of the law of certainty. The chance of living one year following age 35 is 81090/81822 and the chance of dying within the same period is 732/81822. The sum of these two fractions equals 81822/81822 or 1, which is certainty, and certainty represents the sum of all separate probabilities in this case two, the probability of death and the probability of survival. In like manner many more instructive examples of the application of these laws to the mortality table could be made, but they need not be carried further at this point, for the subject will be fully covered in the chapters on "Net Premiums".

Caution A life table is necessary to give a good estimate of life expectancy.

Notes Insurance is the best guard for an individual and his family.

Task What is a risk analyzer? Find out how a risk analyzer tool works.

Did u know? The crude death rate as defined above and applied to a whole population can give a misleading impression.

Self Assessment

Fill in the blanks:

11. ..... rate is a measure of the number of deaths (in general, or due to a specific cause) in a population, scaled to the size of that population, per unit of time.
12. Mortality rate is typically expressed in units of deaths per ..... individuals per year;
13. A mortality rate of ..... (out of 1000) in a population of 100,000 would mean 950 deaths per year in that entire population, or 0.95% out of the total.
14. A person makes his own personal financial plan and decides where he would like to invest his .....
15. The ..... can have some social security schemes for the socially and economically backward sections of the society i.e., for people below the poverty line.

Notes

Case Study

Customer Case Studies – Sahara India Life Insurance

A little about Sahara India Life Insurance

Sahara India Life is the first private sector company in the domestic Life Insurance sector to go solo without any foreign partner. SILICL is promoted by Sahara India, a USD 7,000 million diversified conglomerate having varied business interests in Public Deposit Mobilisation, Housing, Aviation, Media and Entertainment and new forthcoming projects like Consumer Products, Information Technology, Hospitals and Agricultural products.

Sahara India is a unique business organisation that takes pride in being not just a business enterprise but an emotionally integrated family, the world's largest family of over 600,000 members. Sahara India started 25 years ago with a small savings venture having assets of just USD 45 and only 3 members. Today, it is a major corporate entity having an asset base of over USD 7,000 million and 1707 establishments across the nation.

The company's growing pains

Sahara India was launching their Insurance division. As an Insurance company they had to have a ready and reliable back up for their customer data.

All in all, Sahara required an integrated solution that would provide them the following benefits:

1. Better manageability through server consolidation
2. Create redundancy to support criticality of their applications
3. Flexibility to scale up servers as and when required
4. Low total cost of ownership of IT infrastructure.

The IBM solution.

Sahara India Insurance chose IBM as its partner to help with its IT infrastructure. Computer Science Corporation's (CSC) applications span a wide spectrum of IBM platforms, including S/390, AS/400 (iSeries) and NetFinity, in addition to using a broad variety of IBM middleware technologies. Clients benefit from this alliance by virtue of CSC having early access to IBM's technologies and the subsequent ability to leverage these unique technologies into insurance applications by CSC.

It is no surprise that more than five of the top private life Insurance companies in India like ICICI Prudential, Tata AIG, ING Vysya, AMP Sanmar, IFFCO Tokio, etc. now run on

Contd....

Notes

IBM eServer iSeries. This makes iSeries the most preferred platform, in the Insurance Services Sector in India.

Details

Application	CSC application for insurance
O.S	i5
Platform	S/390, AS/400 (iSeries)
Netfinity	(xSeries)

The result - Life made easy

The benefits of server consolidation include - low total cost of ownership, increased availability, better manageability, enhanced scalability and freedom from redundancy.

The robust and secure IT infrastructure deployed by IBM enables Sahara to cut down the go-to-market time substantially and offer new customised products that they are planning to launch into their market soon.

Source: http://www-07.ibm.com/in/casestudies/case_sahara.html

12.17 Summary

Risk is one of those words, which are capable of a number of interpretations, and seems to fit in to various contexts. Risk is nothing but the uncertainty of loss. Almost everything that the businessman does, it is in an uncertain environment. The second thing that encompasses us in the study of risk is its quantification. In measuring risk we are really trying to place some value on our belief as to the likelihood that some event will or will not take place.

Can we substitute "chance" for "uncertainty"? No, chance is the expectation of a good or favourable result.

Risk may be defined in various ways and from various angles. It may be pure, fundamental, speculative, personal, business related, fidelity risk and so on. Whatever the kind of risk it should be identified, quantified and must be handled properly. This can be done through the formal technique of risk management. Risk management is concerned with direction of purposeful activities towards the achievement of individual or organizational goals. Risk management may be defined as "the identification, analysis and economic control of those risks which can threaten, the assets or earning capacity of an enterprise." A risk management organization shall be headed by a Director assisted by a risk management analyst(s). Risk management team may comprise of an insurance manager, safety, health and loss prevention manager, claims manager, and a security manager.

In legal terms, insurance is a contractual agreement whereby one party (insurer) agrees to compensate another party (insured) for losses. This document, popularly known as insurance policy, creates certain rights and responsibilities for both insurer and insured. The insurer has the right to collect premium and specify terms and conditions subject to which insurance coverage is available. The insurer is responsible to pay claims as and when lodged by the insured subject to terms of contract. Similarly, the insured is bound to pay the prescribed premiums and also comply with terms and conditions prescribed by the insurance company. He has a right to collect payment (claim) from the insurer, if covered loss occurs.

Insurance is a very beneficial financial and economic service. As a great financial intermediary, the insurance sector collects national household savings and invests them in productive avenues,

Notes

and thereby ensures safety and security for people and organizations. In every economy, there are a section of people who face many risks, but are unable to ensure themselves. This phenomenon has led to the emergence of concept of social insurance plans. Social insurance plans are mostly organized by government to give protection to the weak and the down trodden. Thus, insurance devise plays a significant role in maintaining the well being of individuals and the economy as a whole.

Insurance has been-defined as the institution which eliminates risk or which substitutes certainty for uncertainty. The occurrence of events insured against cannot wholly be prevented but the uncertainty of financial loss through such occurrences can be eliminated by distributing the loss over a group. Thus a man cannot be sure whether or not his house will burn even if he use all the preventive measures known. If the house burns the property is lost and gone forever that much material value has been actually destroyed. But it is not necessary that the owner should stand the entire loss. Before the fire occurred it was not known whether his house would burn or some one's else and he could agree with other owners of houses that they would all contribute to a common fund from which any unfortunate owner who lost his house by fire should be recompensed. Thus instead of the loss falling on one it can be divided equally among all. This is the essence of insurance and it illustrates the meaning of the statement that insurance is the elimination of uncertainty or the replacement of uncertainty by certainty. The common contribution to the fund above referred to constitutes the certain loss and is measured by the premium; the uncertain loss refers to the uncertainty that a particular house will burn. The same situation exists with respect to life insurance. It is not death itself that can be distributed, i.e. parcelled out among a number of insurers, but the financial consequences of death. Man has an earning power during a certain period of his life which is lost to his business or his family by premature death, but it is not known in advance upon whom death will fall prematurely, hence all men can contribute to a fund which will be used to satisfy the business and family needs of those who die early.

12.18 Keywords

Accident: An event definite in time and place and is unintended, unforeseen, unexpected and one time.

Agent: An insurance company representative licensed to solicit, negotiate or affect contracts of insurance, and provide service to the policyholder for the insurer.

Avoidance: A risk management technique whereby a situation or activity that may result in a loss for a firm is avoided or abandoned.

Chance: The unknown and unpredictable element that causes an event to result in a certain way.

Contingency: A happening dependent on something which may occur in future.

Fidelity Risk: Risk of loss due to dishonesty of a person.

Fire Insurance: Coverage for losses caused by fire and lightning, plus resultant damage caused by smoke and water.

Flood insurance: Coverage against loss resulting from the flood peril.

Fundamental Risk: Risk which arises due to the nature of the society and affect people at large e.g. inflation, unemployment.

Hazard: A condition that creates or increases the chance of loss.

Notes

Insurance: An instrument under which individuals, businesses, and other organizations or entities, in exchange for payment of a sum assured are guaranteed compensation for losses resulting from certain perils under specified conditions.

Insurable risk: A risk which can be insured by an insurer. The conditions that make a risk insurable may be probability of occurrence of loss, loss not in control of insured, capability of loss to be calculable etc.

Loss: The happening of the event for which insurance organization pays.

Occurrence: Happening of an accident that results in bodily injury or property damage during the period of an insurance policy.

Particular Risk: Risk which affects a particular person or a thing.

Personal Risk: Risk to a person in form of premature death, sickness, disability etc.

Property Risk: Risk of loss or damage to property.

Pure Risk: A risk which has a prospect of loss or no loss.

Risk: A circumstance, which may cause a damage or loss.

Risk Classification: The process of differentiating people on the basis of their risk exposure. It helps an insurer to decide premium rates for life insurance of different individuals.

Risk Control: Any voluntary action for reduction of frequency, unpredictability or severity of accident and loss.

Risk retention: An alternative form of insurance in which members of a simple profession or business come together to self-insure their risk.

Speculative Risk: A risk which has prospects of bringing profit or loss.

Uncertainty: A situation which cannot be accurately known or predicted.

12.19 Review Questions

1. Define risk. Explain how important it is to people?
2. What people mean to say when they use the word "risk"? Discuss the term insurance and its nature.
3. Describe various types of risks and their affect on human society.
4. Define risk management. Explain the process of risk management in detail.
5. Discuss various ways of handling risk in detail.
6. Write short notes on the following:
   (a) Risk identification
   (b) Risk management
   (c) Risk Manager
   (d) Fundamental risk
   (e) Transferring of risk
7. Differentiate between the following:
   (a) Fundamental and particular risk
   (b) Pure risk and speculative risk

Notes

Answers: Self Assessment

1.	Insurers	2.	Contract
3.	Cooperative	4.	Formal
5.	Security	6.	False
7.	True	8.	False
9.	True	10.	True
11.	Mortality	12.	1000
13.	9.5	14.	Savings
15.	Government		

12.20 Further Readings

Books

Risk management magazine

Actuarial news and risk management resource

Risk analysis: An international journal

Journal of risk research

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Edmond Halley, *An Estimate of the Degrees of the Mortality of Mankind* (1693)

Crude death rate (per 1,000 population) based on *World Population Prospects* The 2008 Revision, United Nations. Retrieved 22 June 2010

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www.swissre.com

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Unit 13: General Insurance

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Objectives

After studying this unit, you should be able to:

- Know principles of non-life insurance/general insurance and structure of the general insurance industry before and after liberalisation.
- Understand the classification of general insurance business and need of research and developments in general insurance sector.
- Define what is theory of rating?
- Define role of Tariff Advisory Committee (TAC) and claim settlement in non-life insurance.
- Explain the concept of fire insurance and essentials of fire insurance contract.
- Define the details of the risks covered under the fire insurance policy.
- Define various insurances like motor insurance/vehicle insurance/auto insurance/car insurance and medical insurance/mediclaim and personal accident/disability income insurance.

Introduction

General insurance or non-life insurance policies, including automobile and homeowners policies, provide payments depending on the loss from a particular financial event. General insurance

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typically comprises any insurance that is not determined to be life insurance. It is called property and casualty insurance in the U.S. and Non-Life Insurance in Continental Europe.

In the UK, General insurance is broadly divided into three areas: personal lines, commercial lines and London market.

13.1 Non-Life Insurance/General Insurance

When the insured pays the premium and the insurer accepts the risk, the contract of insurance is concluded. The policy issued by the insurer to the insured is the proof of the contract between them.

We know that no contract is valid without a consideration. In case of insurance contracts premium is the consideration from the side of the insured and the promise to indemnify is the consideration from the insurer.

Both the parties should be competent to contract and must give the consent for the insurance contract for covering the same risk for same peril in the same sense. Insurance contracts which are against the public policy are not valid contracts. Care should be taken by both sides that something which is illegal cannot be insured. If insurance is affected on say for example smuggled goods, and the insurer comes to know after some time of signing the contract, he may avoid the contract.

All insurance contracts are governed by the basic principles of insurable interest, indemnity, utmost good faith, subrogation and proximate cause. These are discussed below one by one:

Insurable Interest

A person who wants to insure should have insurable interest in the property to be insured. Insurable interest as discussed earlier is the interest of a person in a person or property such that he/she will stand to lose if something goes wrong with the person or property.

Presence of an Insurable property is a must.

The insured should have a legal relation to this subject matter. This insurable interest can arise in a number of ways like:

1. Ownership
2. Mortgage
3. Trustee
4. Bailer
5. Lessee

Now the question arises when should the insurable interest be present. Should it be there at time of contract or at the time of claim or both? Lets study this in context of various kinds of general insurance:

In fire and miscellaneous Insurance, the insurable interest must exist:

1. At the inception, i.e., while placing the property for insurance or we may say at time of entering into the contract.
2. During the currency of the policy, i.e., the insurable interest should not end/alter during the period of insurance.

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3. At the time of loss, i.e., in the event of loss the insured should have the interest in the property so that he can claim the insurance money.

In marine insurance, the insurable interest must exist, at the time of loss. It may not be there at the time of taking cover or during the currency of the policy.

In personal accident insurance, it is deemed that a person has unlimited financial interest on his own life. However, in practice there is monetary limit to the amount of insurance which matches the life of an individual. Insurable interest exists as between a husband and a wife, a parent and a dependent child. Employer is deemed to have Insurable interest in employee. A creditor has interest in his debtor.

Self Assessment

Fill in the blanks:

1. A person has unlimited ..... interest on his own life.
2. An ..... of the property (and joint owner) has insurable interest in the property.
3. A bank has insurable interest in the goods on the ..... of which it has advanced loans. The interest is limited to the amount of the loan. Usually, under such circumstances, the policies are issued in joint names of the insured and the bank.
4. The owner of a ..... has insurable interest in the vehicle as well as in a potential third party liability. If a third party is injured in the accident, the damages payable to the third party would be a financial loss to the insured. Hence, he can insure his third party liability too.
5. A ship owner has insurable interest in the ship owned by him. ..... owners, both sellers and buyers, have insurable interest in the goods owned by them. A ship owner has insurable interest in the freight he is going to get by carrying the cargo.

Indemnity

The objective of insurance is to indemnify i.e., to place the insured in the same financial position as he was just before the occurrence of loss. The principle prevents the insured from making a profit out of insurance. Insurance only makes good the loss and ensures public interest at large. The indemnity is the net loss suffered by the insured, and therefore, if there is any salvage/left over of the damaged property, the value of the salvage is deducted from the amount of loss subject to a maximum of the sum assured.

There are four methods of indemnification in general insurance, namely:

1. Cash Payment
2. Replacement
3. Repair
4. Reinstatement

Example: Explain the principle of indemnity

If a vehicle is insured and is destroyed by fire, the insurance company will make good the loss by taking into consideration the depreciation and the wear and tear of the vehicle, having been in use by the insured. The insurance company will not pay the price of new car. It will not be true

Notes

indemnity to pay the price of a new vehicle. If the insurance company's did so the insured will be tempted to destroy the insured assets.

In case a building is damaged by fire, the measure of indemnity is the cost of repairing it.

For machinery the measure of indemnity is the cost of repair, if the machinery is destroyed in fire, the market value of such machine after taking into consideration the wear and tear shall be paid by the insurer.

For manufactured stock, it is the cost of raw materials, plus cost of labour, fuel and overheads i.e. the value added will be indemnified.

It is so provided in the Marine Insurance Act, 1963 that for marine perils the indemnity is "in the manner and to the extent agreed", by the insurers and the insured.

In the case of personal accident policies, it is not possible to place a value on life as such. Hence Personal Policies are called benefit policies. Whatever is the sum assured as per the premium/ the type of policy taken the amount shall be paid.

Utmost Good Faith

In any insurance contract, the proposer is the only person who is supposed to know all the facts of the subject matter of the insurance and the insurer has to completely rely on what the proposer has disclosed. The proposer should, therefore, furnish all material facts concerning the property proposed for insurance.

The insured need not disclose the facts of the following nature:

1. Which would diminish the risk of insured, peril, e.g., appointing a driver or appointing a night watchman.
2. Which are presumed to have been known to the insurer, e.g., large scale rioting in the area.
3. Which could be understood from the information already, furnished, e.g., customary process in an industry.
4. Which should have been enquired but was omitted by the insurer? The insurer will construe this as warranty.

If the insured does not reveal the material facts related to the subject matter assured, then the contract is void or void able in the hands of the insurance company as the case may be.

Example: Material Facts

1. ***Marine Insurance:*** Method of packing, the nature of goods, the condition of vessel carrying the goods, the ports of shipment and destination etc.
2. ***Fire Insurance:*** Construction of the building, occupancy e.g., office, residence, shop, godown, workshop etc., the nature of goods, i.e. non-hazardous, hazardous, extra hazardous and so on.
3. ***Motor Insurance:*** Cubic capacity of engine (private car), the year of manufacture, carrying capacity of a truck (tonnage), the purpose for which the vehicle is used, the geographical area in which it is used, the owner's driver's convictions for traffic offences etc., age, height and weight, physical disabilities etc.
4. ***General:*** The fact that the previous insurers had rejected the proposal or charged extra premium, or cancelled or refused to renew the policy, previous losses suffered by the proposer.

Notes

If the insurance is placed through an agent, the agent has similar duty to disclose all material facts known to him in the agents report.

Subrogation

"Subrogation is the right which an insurer gets, after he has indemnified the loss, to step into the shoes of the insured and avail himself all the rights and remedies which the insured may have in respect of the loss indemnified".

Subrogation is the principle, which is applied to all contracts of indemnity. It means that after indemnifying the loss, the insurer gets the right of taking all steps to recover any money in compensation from the third party or by the sale of the asset against which claim has been paid.

Contribution

If a property has been insured with more than one insurer and the loss occurs the insured will get a proportionate part of the loss from each insurer. This principle of contribution is in support to the principle of indemnity which states that insurance must make good only the actual loss suffered by the insured. If a person insures his property with many insurers it does not mean that he can recover the claim from all the insurers. Insurance does not allow an insured to make a profit out of the loss. All the insurers will contribute the insured's loss in proportion of the sum assured with each of them.

Maybe the insured is able to recover the whole amount from one insurer, then as per the principle of contribution the insurer will attempt proportionate recoveries from other insurers concerned.

In order to avoid this inconvenience to the first insurer, fire policies and a majority of accident policies contain a contribution condition, which says, whenever contribution applies, the insured is obliged to raise claims against all the insurers, each of whom pays only his proportion of the loss.

This can be illustrated with an example.

Example:

X has insured his property with three insurers Aay, Bee and Cee. He incurs a loss of Rs. 12000

He will get claim from insurers as follows:

Sum insured with insurer Aay	Rs. 10000/-	Aay pays	Rs. 2000/-
Sum insured with insurer Bee	Rs. 20000/-	Bee pays	Rs. 4000/-
Sum insured with insurer Cee	Rs. 30000/-	Cee pays	Rs. 6000/-
Total Sum insured	Rs. 60000/-	Loss	Rs. 12000/-

The principle of contribution does not apply to personal accident policies as these are not contracts of indemnity.

Prerequisites to the application of the principle of contribution:

1. The subject matter of all policies must be common.
2. The peril insured for, must be common to all policies.
3. The policies must be affected in favour of a common insured.

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4. The policies must be in force at the time of loss.
5. The policies must be legally enforceable.

Proximate Cause/Causa Proxima

It is very important to state the perils against which the insurance cover is granted. The perils have to be specially mentioned in the insurance policy. When the actual loss takes place the insured has to prove that the loss has occurred due to the insured peril and against not expressly or impliedly excluded peril.

If stocks are stolen, the loss will not be indemnified under the fire policy, as burglary is not the insured peril. If a bomb dropped by an enemy in war burns stocks, then the loss is caused by war, which is an excluded peril under standard fire policy.

Hence the insurance company is not liable to pay a loss caused by an uninsured peril or an excluded peril.

In actual situations a loss may be caused by more than one cause. The difficulty arises in determining the loss which was the nearest to the loss. The insurance companies indemnify the proximate cause of loss and not the remote cause.

Example: To distinguish 'proximate cause' and 'remote cause'.

1. A person insured under a personal accident policy went out hunting and met with an accident. Due to shock and weakness, he was unable to walk, he fell down on the ground. Whilst lying on the wet ground he contracted cold which developed into pneumonia which caused his death. The court held that the proximate cause of death was the original accident and pneumonia (a disease which is not covered under the policy) only a remote cause. Hence the claim was paid.
2. An insured suffered accidental injuries and was taken to hospital. While undergoing treatment he contracted an infectious disease which caused his death. In this case, the court gave the ruling that the 'proximate cause' of death was the disease and the original accident only a 'remote cause'. Hence, the claim was not payable under a personal accident policy.

13.2 Origin and Growth of the General Insurance Industry before and after Liberalization

Prior to the nationalization, 107 insurance companies of which 63 were domestic companies and 44 foreign companies - transacted general insurance business in India, but the type of insurance covers were very limited. After nationalization of the general insurance sector, this business came to be transacted by GIC through its 4 subsidiaries and at present it has more than 160 products/policies available in the market. The four subsidiaries of GIC are: National Insurance Co. Ltd. (Kolkata), New India Assurance Co. Ltd. (Mumbai), Oriental Insurance Co. Ltd. (Delhi) and United India Insurance Co. Ltd. (Chennai).

With the opening up of the insurance sector in January 2000 to private insurers again, it is hoped that insurers will design more products on need basis. The coverage of general insurance will increase. The public at large has also welcomed this.

As the figure above shows GIC did general insurance business assisted by its four subsidiaries with the help of actuaries, surveyors and agents. Customers have been very much satisfied with the services of GIC and its subsidiaries.

Notes

1. In the new structure of non-life insurance sector one can see the four subsidiaries and new entrants.
2. New entrants would require an approval from the RBI if they are banks or finance companies.
3. GIC is now the reinsurer in the country.
4. Insurance Regulatory Development Authority (IRDA) is the regulator of Indian insurance industry.

Caution New entrants would require an approval from the RBI if they are banks or finance companies.

Did u know? All insurance contracts are governed by the basic principles of insurable interest, indemnity, utmost good faith, subrogation and proximate cause.

Insurance Regulatory Development Authority (IRDA) is the regulator of Indian insurance industry.

Tasks

1. "ONGC gets Rs. 1,700 cr insurance claim for Mumbai high fire" study the case and comment on claim settlement procedure in general insurance sector.
2. "Customer gets a policy instead of a cover note straight away. No follow up required for getting the original policy document". Discuss Maruti insurance in comparison to car insurance by other insurers.

Notes GIC is now the reinsurer in the country.

13.3 Classification of General Insurance Business

Let us have a look at the different products under the two segments.

Commercial line of insurance: Insurance for businesses, professionals and commercial establishments

1. ***Policies for cottage, tiny and small sector industries:*** Fire policy specifically for tiny sector, burglary policy, cash policy, motor policy and other miscellaneous policies are also available to trader and general traders.
2. ***Policies for traders:***
   (i) Dukan Mitra Policy
   (ii) Fire policy
   (iii) Marine cargo policy
   (iv) Cash policy

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(v) Fidelity guarantee

(vi) Plate glass and Neon Sign insurance

(vii) Motor Insurance

(viii) Office umbrella policy

(ix) Burglary policy

(x) Shopkeeper's policy

(xi) Traders policy

(xii) Other miscellaneous insurance.

3. ***Professional and Specific Professional/Properties Insurance:***

(i) Marine hull insurance

(ii) Bankers indemnity insurance

(iii) Stock exchange ad brokers insurance

(iv) LPG bottling plant and LPG dealers package insurance

(v) Satellite insurance

(vi) Jewellers block insurance

(vii) Medical establishment insurance

(viii) Professional indemnity

(ix) Carriers, legal liability insurance

(x) Aviation insurance

(xi) Sports insurance

(xii) Petrol attendants policy

(xiii) Adhikari Suraksha Kavach

(xiv) Oil and energy risk

(xv) Crop insurance

(xvi) Hut social security schemes.

4. ***Industries and commercial Organization:***

(i) *Project Covers:*

(a) Storage Cum Erection Insurance

(b) Workmen Compensation Insurance

(c) Marine Cum Erection Insurance

(d) Contractors Plant and Machinery Policy.

(ii) *Operational Covers:*

(a) Fire insurance

(b) Marine cargo insurance

(c) Workmen compensation insurance

(d) Boiler explosion insurance

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(e) Cash insurance

(f) Fidelity guarantee policy

(g) Motor insurance

(h) Special contingency insurance

(i) Neon sign insurance

(j) Plate glass insurance

(k) Electronic equipment policy

(l) Machinery break down policy

(m) Burglary insurance

(n) Third party life insurance

(o) Industrial all risks insurance policy

(p) Public liability insurance

(q) Group mediclaim insurance

(r) Product liability insurance

(s) Group personal accident insurance

(t) Other miscellaneous insurance.

5. ***Rural Industries and Rural Prospects:***

(i) Plantation insurance

(ii) Failed well insurance

(iii) Pisciculture insurance

(iv) Sericulture insurance

(v) Horticulture insurance

(vi) Fish in pond insurance

(vii) Prawn insurance

(viii) Elephant insurance

(ix) Dog insurance

(x) Bio gas plant insurance

(xi) Honey bee insurance

(xii) Tonga/animal driven cart insurance

(xiii) Agriculture pumpset insurance

(xiv) Cattle insurance

(xv) Pig insurance

(xvi) Poultry insurance

(xvii) Janta/Gramin Personal Accident Insurance

(xviii)Sheep and hog insurance

Notes

(xix) Horse, Mule, Pony, Donkey Insurance

(xx) Jan Arogya Policy

(xxi) Farmers package insurance

(xxii) Other Miscellaneous Insurance.

Personal Line of Insurance: Insurance for individuals and families, such as private-passenger auto and homeowners insurance

1. ***Property Insurance:***

   (i) Fire A+ B policies

   (ii) Pager/Cellular phone insurance

   (iii) Graha Raksha Policy

   (iv) Gun insurance

   (v) Motor insurance

   (vi) House holder policies

   (vii) Television/VCR policy

   (viii) All risks insurance

   (ix) Baggage insurance

   (x) Pedal cycle insurance.

2. ***Accident Insurance:***

   (i) Personal accident insurance

   (ii) Naado Lahri Insurance

   (iii) Wedding bells insurance

   (iv) Cradle care insurance

   (v) Passenger flight coupon insurance

   (vi) Margo Bandhu Insurance

   (vii) Raste-Apatti Kavach

   (viii) Suhana Safar Policy

   (ix) Destination of India

   (x) Kidnap and ransom insurance

   (xi) Raj Rajeshwari Policy

   (xii) Bhagya Shri Policy.

3. ***Health Insurance:***

   (i) Mediclaim Insurance

   (ii) Jan Arogya Insurance

   (iii) Overseas Mediclaim Insurance

   (iv) Videsh Yatra Mitra Policy

Notes

(v) Cancer Insurance

(vi) Sea Farers Health Insurance

(vii) Tertiary Care Policy

(viii) Bhavishya Arogya Insurance

(ix) Health quarter for non-resident Indian.

4. ***Liability Insurance Policy:***

(i) Professional Indemnity Policy, for Different Professions

(ii) Adhikari Suraksha Kavach

(iii) Doctors Indemnity Policy.

13.4 Definition of Fire Insurance

Section 2(6A) of the Insurance Act, 1938 defines Fire Insurance as 'the business of effecting, otherwise than incidental to some other class of insurances business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against in fire insurance policies.'

V. R. Bhushan and Prof. R.S. Sharma: Fire insurance is defined as an agreement whereby one party, in return for a consideration, undertakes to indemnify the other party against financial loss which the later may sustain by reason of certain defined subject matter being damaged or destroyed by fire or other defined perils to an agreed amount.'

T. R. Smith: Fire insurance may be defined as "a contract whereby the insurers in return for a consideration, known as premium, undertakes to indemnify the insured against financial loss which he may sustain, by reason of certain defined property, known as the property insured, being damaged or destroyed by fire or other perils within a stated period of the liability of insurer, being limited to a specified amount, called the sum insured". This definition is self-explanatory and includes all aspects of fire insurance.

Fire insurance contracts cover the risks of damage by fire. They insure the risk of loss caused whether by fire or incidental to fire. Thus fire insurance policies cover the insurance business in which the risk to the asset is from fire or incidental to fire. A fire insurance policy covers the fire and other occurrences as stated in the policy. The inclusion of various clauses to cover matters related to fire in the policy is essential to cover the loss caused due to various reasons.

The policy should mention clearly the subject matter/assets insured. The contract of fire insurance will not cover the assets, which are not mentioned in the policy document, though the loss is caused to the assets because of the fire. The policy document is the evidence of conclusion of the contract.

As such, presence of a physical asset is a must to have the risk of fire covered. The asset, which is insured, becomes the subject matter of the insurance contract. Occurrence of fire is essential and the damage should be caused to the asset due to fire. The damage has to be compensated and the assured has to be indemnified. The origin or cause of origin of fire damaging the asset is not of importance.

If the insurance company finds the malafide intentions of the assured, it can take it as a defense to avoid the fire insurance claim settlements. As such fire insurance contracts are a part of general insurance and are contracts of good faith.

The word fire should be construed in its simple meaning and sense without attributing any technical or scientific concepts or meanings to the term. The risk of fire is simply an unforeseen

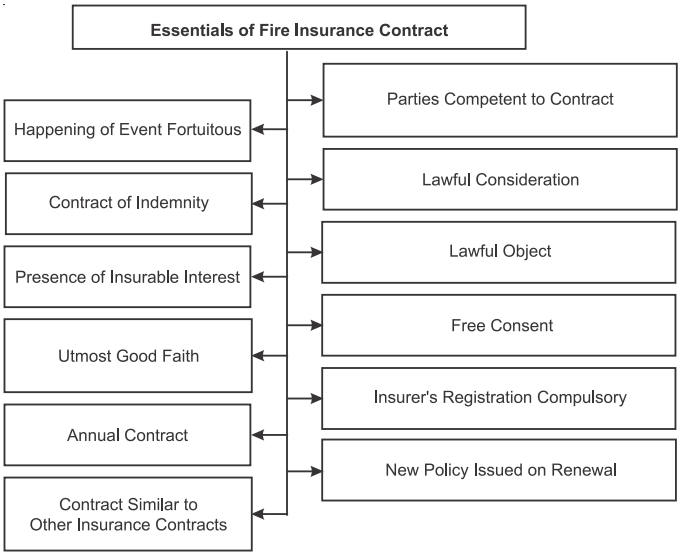
Notes

or unexpected event caused either by accident or incident that cannot be forecasted. The contract of fire insurance is valid as long as the assured has an insurable interest in the asset insured. In the absence of the insurable interest in the contract of insurance, the contract becomes a wagering contract and thus becomes void.

13.5 Nature of Fire Insurance Contract

All the essential elements of an insurance contract are present in a fire insurance contract. The essential elements are mentioned below:

Figure 13.1: Essentials of Fire Insurance Contract



1. The parties to the contract should have the capacity to contract. He should not be a minor, adjudged insolvent or insane.
2. The consideration of the contract should be lawful and not forbidden by the law.
3. The object of the contract should be lawful and not against the public policy or public interest.
4. The contract should have been concluded with the free consent i.e., without coercion, undue influence, fraud or misrepresentation.
5. The insurer and insured are the parties to the fire insurance contract. The provisions of Insurance Act, 1938, define the insurer's role. The Act defines the insurer and renders his registration compulsory.
6. The contract should be backed by the presence of consideration. The premium paid by the assured to cover the risk is the consideration by the assured and the promise made by the insurer to pay the compensation for the damage by fire is the consideration from the insurer.
7. The happening of event should be uncertain.
8. The presence of insurable interest is a must to validate the fire insurance contract.
9. The fire insurance contract, being a typical insurance contract, is a contract of uberrima fides i.e. utmost good faith must be there between the insurer and the insured.

Notes

10. The fire insurance contracts insure the property of the assured and are covered by the principles of general insurance. The contract of insurance cannot save the asset from the risk but it can provide the compensation or replacement in place of the asset that is lost/ damaged by fire.

11. The contract of fire insurance comes into existence just as any other type of an insurance contract. The assured, by filling up the proposal and providing the information of the asset insured submits the proposal of fire insurance contract to the insurer. The insurer, after verifying the facts and figures mentioned by the assured and satisfying himself accepts the premium and issues the cover note or the policy document to the assured as a token of the conclusion of the contract.

12. The fire insurance policies are of short duration. The period of the contract normally ranges up to one year. The policy has to be renewed after the expiry of the period of the insurance. Once the policy lapses, the cover also lapses. The renewals of the policy, by paying the premium, make the contract valid for another term on the original terms and conditions of the policy. The insurer issues a new policy document to the assured on renewal.

13.5.1 Subrogation

"Subrogation is the right which an insurer gets, after he has indemnified the loss, to step into the shoes of the insured and avail himself all the rights and remedies which the insured may have in respect of the loss indemnified".

Subrogation is the principle, which is applied to all contracts of indemnity. It means that after indemnifying the loss, the insurer gets the right of taking all steps to recover any money in compensation from the third party or by the sale of the asset against which claim has been paid.

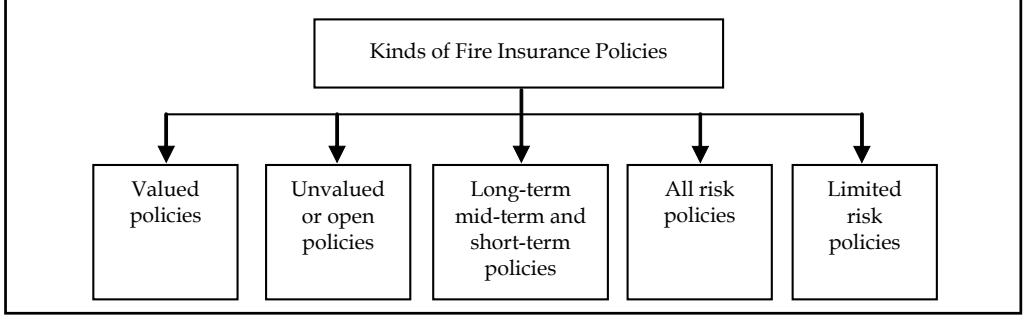
13.5.2 Reinsurance

Reinsurance is a form of an insurance cover for the insurance where several Insurance companies come together to issue one single risk. One entity (i.e., re-insurer) takes on all or part of the risk cover under a policy issued by an insurance company in consideration of a premium payment. It is similar to underwriting (on the party of reinsurer) as insurance companies go in for reinsurance so that they could protect themselves from the potential loss. It could be treaty reinsurance (blanket protection) or facultative reinsurance (specific).

13.6 Kinds of Fire Insurance Policies

The following are some of the fire insurance policies:

Figure 13.2: Classification of Fire Insurance Policies



Classification of Fire Insurance Policies

Notes

Standard Fire Policy

Fire insurance business in India is governed by the All India Fire Tariff that lays down the terms of coverage, the premium rates and the conditions of the fire policy. Fire insurance policy is suitable for the owner of the property, one who holds property in trust or in commission; individuals/financial institutions who have financial interest in the property. All movable and immovable property located at particular premises such as building, plant and machinery, furniture, fixtures, fittings and other contents, stocks and work-in-progress along with goods held in trust or in commission including stocks at suppliers/customer's premises, machinery temporarily removed from the premises for repairs can be insured.

The fire insurance policy has been renamed as standard fire and special perils policy. The risks covered are as follows:

Fire

Destruction or damage to the property insured by its own fermentation, natural heating or spontaneous combustion or its undergoing any heating or drying process can't be treated as damage due to fire. For example, paints or chemicals in a factory undergoing heat treatment and consequently damaged by fire are not covered. Further, property insured by order of any Public Authority is excluded from the scope of cover.

Lightning

Lightning may result in fire damage or other types of damage, such as a roof broken by a falling chimney struck by lightning or cracks in a building due to a lightning strike.

Explosion/Implosion

Explosion is defined as a sudden, violent burst with a loud rapport. An explosion is caused inside a vessel when the pressure within the vessel exceeds the atmospheric pressure acting externally on its surface.

An implosion means bursting inward or collapses. This takes place when the external pressure exceeds the internal pressure. This policy, however, does not cover destruction or damage caused to the boilers (other than domestic boilers), economizers or other vessels in which steam is generated and machinery or apparatus is subject to centrifugal force by its own explosion/ implosion.

These risks may be covered in separate and special boiler and pressure plant insurance policy.

Aircraft Damage

The loss or damage to the property (by fire or otherwise) directly caused by an aircraft or other aerial devices and/or articles dropped there from is covered under the fire policy. However, destruction or damage resulting from pressure waves caused by an aircraft traveling at supersonic speed is excluded from the scope of the policy.

Notes

Riot, Strike, Malicious and Terrorism Damage

1. The act of any person taking part along with others in any disturbance of public peace (other than war, invasion, mutiny, civil commotion etc.) is construed to be a riot, strike or a terrorist activity. Any loss or physical damage to the property insured directly caused by such activity. The action of any lawful authorities in suppressing such disturbance or minimizing its consequences is covered.
2. Further the wilful act of any striker or a lockout, or the action of any lawful authority in suppressing such act, resulting in visible physical damage by external means, is also covered.
3. Malicious act would mean an act with malicious intent but excluding omission of any kind by any person, resulting in visible physical damage to the insured property, whether or not the act is committed in the course of disturbance of public peace or not. Burglary, housebreaking, theft/larceny does not constitute a malicious act for the purpose of this cover.
4. Total or partial cessation of work or the retarding or interruption or cessation of any process or operations;
5. Permanent dispossession resulting from confiscation, commandeering, requisition or destruction by order of the government or any lawfully constituted authority; or permanent or temporary dispossession of any building or plant or unit or machinery resulting from the unlawful occupation by any person of the same or prevention of access to the same, are not covered.

Self Assessment

State whether the following statements are true or false:

6. The wilful act of any striker or a lockout, or the action of any lawful authority in suppressing such act, resulting in visible physical damage by external means, is not covered in terrorism damage policy.
7. Destruction or damage to the property insured by its own fermentation, natural heating or spontaneous combustion or its undergoing any heating or drying process can be treated as damage due to fire.
8. Fire insurance business in India is governed by the All India Fire Tariff.
9. Reinsurance is a form of an insurance cover for the insurance where several Insurance companies come together to issue one single risk.
10. If the insurance company finds the malafide intentions of the assured, it can take it as a defense to avoid the fire insurance claim settlements.

13.7 Storm, Cyclone, Typhoon, Tempest, Hurricane, Tornado, Flood and Inundation

These are all various types of violent natural disturbances that are accompanied by thunder or strong winds or heavy rainfall. Flood or inundation should not only be understood in the common sense of the terms, i.e., flood in the river or lakes, but also accumulation of water due to choked drains would be deemed to be flood.

Notes

Dictionary meaning of the terms are listed below:

1. ***Cyclone:*** Violent Hurricane
2. ***Hurricane:*** Violent Storm
3. ***Tempest:*** Furious Storm
4. ***Flood:*** Great flow of water
5. ***Inundation:*** Water rising to an abnormal level

Impact Damage

Impact by any rail/road vehicle or animal by direct contact with the insured property is covered. However, such vehicles or animals should not belong to or be owned by the insured or any occupier of the premises or their employees while acting in the course of their employment.

Impact: Collision

Subsidence and Landslide including Rockslide

Destruction or damage caused by subsidence of part of the site on which the property stands or landslide/ rockslide is covered. While subsidence means sinking of land or building to a lower level. Landslide means sliding down of land usually on a hill. However, normal cracking, settlement or bedding down of new structures; settlement or movement of made up ground; coastal or river erosion; defective design or workmanship or use of defective materials; and demolition, construction, structural alterations or repair of any property or ground - works or excavations, are not covered.

1. ***Subsidence:*** Sinking down
2. ***Landslide/landslip:*** The sliding down of a large mass of rock material, soil etc. Down the side of a mountain or cliff.

Bursting and/or Overflowing of Water Tanks, Apparatus and Pipes

Loss or damage to property by water or otherwise on account of bursting or accidental overflowing of water tanks, apparatus and pipes is covered.

Missile Testing Operation

Destruction or damage due to impact or otherwise from trajectory/projectiles in connection with missile testing operations by the insured or anyone else is also covered.

Leakage from Automatic Sprinkler Installation

Damage caused by water accidentally discharged or leaked out from automatic sprinkler installations in the insured's premises is covered. However, such destruction or damage caused by repairs or alterations to the buildings or premises; repairs removal or extension of the sprinkler installation; and defects in construction known to the insured, are not covered.

Bush Fire

This covers damage caused by burning, whether accidental or otherwise, of bush and jungles and the clearing of lands by fire, but excluding destruction or damage caused by forest fire.

Notes

The policy may also cover other than above risks of damage from earth quake, fire and shock; deterioration of stock in cold storages following power failure as a result of insured peril, additional expenditure involved in removal of debris, architect, consulting engineer's fee over and above the amount covered by the policy, forest fire, spontaneous combustion and impact damage due to own vehicles.

In case of a partial loss, the Insurance Company shall give payment for repairs and replacement. In case of policy with reinstatement subject to overall limit of the sum insured the Insurance company may at its option also repair or replace the affected property instead of paying for the cost of restoration.

Fixation of Premium

Premiums rating depends on the type of occupancy-whether industrial or otherwise. All property located in an industrial complex will be charged on rate depending on the product(s) made.

Facilities outside industrial complexes will be rated depending on the nature of occupancy at individual location.

Storage areas will be rated based on the hazardous nature of goods stored.

Additional premium is charged to include "add on" covers.

Discount in premium is given based on past claims history and fire protection facilities provided at the premises.

Exclusions

5% of each and every claim resulting from lightning/storm/tempest/flood.

Loss destruction or damage caused by war, invasion, act of foreign enemy hostilities or warlike operations (whether war is declared or not), civil war, mutiny, civil commotion assuming the proportions of or amounting to a popular rising, military rising, rebellion, revolution, insurrection, or military or usurped power.

Loss, destruction or damage directly or indirectly caused to the property insured by:

- Ionizing radiations or contamination by radioactivity from any nuclear waste from the combustion of nuclear fuel.
- The radioactive toxic, explosives or other hazardous properties of any explosive nuclear assembly or nuclear component thereof.

Loss, destruction or damage caused to the insured property by pollution or contamination excluding:

- Pollution or contamination which itself results from a peril hereby insured against.
- Any peril hereby insured against which itself results from pollution or contamination.
- Loss, destruction or damage directly to solution or unset precious stones curios, works of art for an amount exceeding Rs.10,000, manuscripts plans, drawings, securities, obligations or documents of any kind of stamps, coins or paper money, cheques, books of accounts or other business books, computer systems, records, explosives unless otherwise expressly stated in the policy.
- Loss, destruction or damage to the stocks in cold storage premises caused by change of temperature.

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- Loss, destruction or damage to any electrical and/or electronic machine, apparatus, fixtures or fitting (excluding fans and electrical wiring in dwellings) arising from or occasioned by over-running, excessive pressure, short circuiting, arcing, self-heating, or leakage of electricity, from whatever cause (lightning included).

Expenses necessarily incurred on:

(i) Architect's surveyor's and consulting engineer's fees and

(ii) Debris removal by the insured following a loss, destruction or damage to the property insured by an insured peril in excess of 3% and 1% of the claim amount respectively.

Loss of earnings, loss by delay, loss of market or other consequential or indirect loss or damage or any kind or description whatsoever.

The clauses covered above are subject to the normal general conditions of the insurance company.

Add-on Covers

The insurers can issue the standard fire policy as per the new Fire Tariff along with added benefits at the option of the policyholders by charging additional premium. These added benefits or add on covers are as follows:

1. Architect's surveyor's and consulting engineer's fees (in excess of 3% of the claim amount).
2. Debris removal (in excess of 1% of the claim amount).
3. Deterioration of stocks in cold storage premises due to power failure following damage due to an insured peril.
4. Forest fire.
5. Impact damage due to an insured's own vehicles, forklifts and the like and articles dropped there from.
6. Spontaneous combustion.
7. Omission to insure additions, alterations or extensions.
8. Earthquake (fire and shock) as per minimum rates and excess applicable as specified in the tariff.

Standard Policy Coverages

The tariff advisory committee has prescribed three types of fire coverages viz., Policy A, Policy B, and Policy C.

Policy A

Fire Policy A covers the following perils

1. Fire
2. Lightning
3. Explosion/Implosion
4. Impact damage
5. Aircraft damage
6. Riot, strike and malicious and terrorist damage

Notes

7. Storm, cyclone, tempest, hurricane, tornado, flood and inundation.
8. Earthquake
9. Subsidence and landslide (including rockslide)

Policy B/Policy C

Fire Policy B covers the following perils:

1. Fire
2. Lightning
3. Explosion/Implosion
4. Impact damage
5. Aircraft damage
6. Riot, strike and malicious and terrorist damage

The tariff permits exclusion of riot, strike and malicious and terrorist damage perils, with specified reduction in premium rate under policy.

13.8 Special Coverages

Apart from standard coverages, fire, policy may also be issued to meet the specific requirements of clients, some of these are:

1. Reinstatement Value Policies
2. Stock Policies
3. Consequential Policies

Reinstatement Value Policies

In this policy, the settlement of claims is on basis of reinstatement value. The claim amount will not be found adequate by the insured that desires to replace the property by a new one of the same kind, type or capacity.

Insurer will pay the value, which takes into account depreciation, wear and tear, but also the replacement cost. Thus, the losses will be settled on the basis of market value of the property on the date of fire.

The difference between the amount payable on the basis of market value and the new replacement value will become wider and wider, particularly when due to inflation, the cost of rebuilding and the prices of the machinery show a sharp increase.

Under the policy, the insurers pay, not the depreciated value but, the cost of replacement of the damaged property by new property of the same kind. The sum insured is required to reflect the new replacement value and not the market value as under the normal fire policy.

Policies for Stocks

There are three types of policies for stocks.

Floater Policies

1. Stocks at various locations can be covered under one sum insured through floater policies, since these policies take care of frequent changes in sum insured at various locations.

Notes

2. These cover stocks for one amount situated in a more than one specified building situated (1) within the limits of one city/town/village, (2) more than one city/town/village but maximum in 50 locations, (3) for more than 50 locations in various cities/towns/villages. The floating policies are not issued to transport contractors and cleaning and forwarding agents.
3. Floating policies for risks situated within the limits of one city/town/village may be issued by charging 25% loading over and above the highest rate applicable to anyone risk. 50% loading over and above the highest rate applicable to any one risk is charged under policies covering up to 50 locations in more than one city/town/village.
4. The maximum sum insured at any one location should not be more than 10% of the total sum insured.
5. The insured should essentially have a good internal audit and accounting procedure under which total amount of risk and location can, if required, be established. The condition of average is applied to the limit of sum insured at each location, and also to the total sum insured under the policy.

A policy issued to cover more than 50 locations in various cities/towns/villages in one amount is subject to the under noted regulations:

1. Total sum insured in respect of all locations should not be less than Rs. 3 crores.
2. The maximum sum insured at any one location should not be more than 10% of the total sum insured.
3. The address of the locations should be declared to the company, at the inception, and changes advised as and when they occur. However, when locations can be identified or change is very frequent, the requirements of specifying address of locations is released, but the number of unspecified locations should not exceed 105 the total number of locations or 20 locations whichever is lower.
4. The insured should have a good internal audit and accounting procedure to establish total amount at risk and locations at a particular time.
5. The pro-rata condition of average is applied to the limit of sum insured at each location and also to the total sum insured under the policy.

Declaration Policies

Declaration Policies are useful to businesses, which face frequent fluctuations in stock quantity or value. Insurance companies can issue these policies subject to the following conditions:

1. The minimum sum insured is Rs. 1 crore.
2. Monthly declarations based on the average of the highest value at risk on each day or highest value on any day of the month are to be submitted by the insured to the insurer.
3. Reduction in sum insured is not allowed under the policy.
4. The insured can't claim refund of premium on adjustment based on the declarations in excess of 50% of the total premiums.
5. The basis of value for declaration shall be the market value prior to the loss or as otherwise agreed to between the insurance company and the insured.

Exclusions: Declaration policies can't be issued in respect of insurance required for a short period stocks undergoing process and stocks at railway sidings.

Notes

Benefits: The premium is limited to the actual amount of risk irrespective of the sum insured. The liability of the insurer is concurrent under the policy. Provision for adjustment of premium is an incentive to the insured to effect cover for the maximum amount.

Floater Declaration Policies

These policies combine the features of both floater and declaration policies. All rules relating to floater policy and declaration policy apply in these kinds of policies except: the minimum premium retention of the insurance company shall be 80% of the annual premium.

Minimum sum insured is Rs. 2 crore.

13.8.1 Consequential Loss Policy

Coverage and Suitability: This policy is suitable for business establishments and corporate for whom business interruption would mean heavy monetary loss in view of huge fixed costs.

Fire consequential loss policy provides cover for:

1. Expenses and increased cost of working as a result of business interruption following a loss covered by the fire policy.
2. This cover can be taken for the maximum period of the anticipated interruption in the event of loss. In addition, the supplier's and the customer's premises on which the business is dependent, cost of auditors fee (required to submit the monetary claim) can also be insured.
3. It covers reduction in gross profit due to a reduction in turnover followed by interruption of business.

   The additional expenditure necessarily incurred for avoiding or reducing the fall in turnover during the interruption period is covered under this policy.
4. Also, there are overhead expenses of running the business such as salaries, wages, taxes, interest etc. which continue to be incurred in spite of the interruption of the production.

Premium: Premium chargeable depends on the type of industry/business, the anticipated gross profit, indemnity period chosen and additional covers required. Refund of premium (not exceeding 50%) can be claimed based on the actual gross profit figures as per the audited balance sheet after the expiry of the policy.

Basic fire policy to cover the asset at the business premises is a prerequisite. For claiming benefits under this policy the loss should be first admitted under the fire policy. Amount of gross profit required to be insured, the indemnity period, details of the business premises to be covered and additional covers required shall be provided in the proposal form.

This policy is of immense benefit especially in case of major fire loss, when the business operations get interrupted resulting in reduced turnover and eventually in loss of profits. It is a well known fact that fixed or standing charges have to be incurred immaterial whether there has been any production or not. All these are not covered by the normal fire policy. It is here that the consequential loss policy comes into force. Thus, for overall protection to the business and its profitability, consequential policy is necessary in addition to the fire policy.

Caution In floater policy the maximum sum insured at any one location should not be more than 10% of the total sum insured.

Self Assessment

Notes

Fill in the blanks:

11. ..... Policies are useful to businesses, which face frequent fluctuations in stock quantity or value.
12. The ..... advisory committee has prescribed three types of fire coverages viz., Policy A, Policy B, and Policy C.
13. Premiums rating depends on the type of .....-whether industrial or otherwise.
14. In Reinstatement Value Policies, the ..... of claims is on basis of reinstatement value.
15. ..... or inundation should not only be understood in the common sense of the terms, i.e., flood in the river or lakes, but also accumulation of water due to choked drains would be deemed to be flood.

Task Discuss the policies for stock.

Did u know? In declaration policy the minimum sum insured is Rs. 1 crore.

Notes For overall protection to the business and its profitability, consequential policy is necessary in addition to the fire policy.

Case Study

Customer Case Studies – Aviva Life Insurance

A little about Aviva.

Aviva Life Insurance is a joint venture between Dabur - one of India's oldest and largest groups of companies - and Aviva. Aviva Plc is UK's largest insurance group and the worlds oldest insurance group, with a history dating back to 1696. Today, it is the fifth largest insurer worldwide, with 30 million customers and ?40 billion assets under management.

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The company's growing pains.

Aviva India uses multiple applications like a custom-built policy administrator system, CRM and other financial applications. Most of these applications have been primarily running on the Windows Server platform. These applications coupled with infrastructure-based applications like File Serving; Mail Server Proxy Servers etc. were primarily running on multiple physical servers in their data centre. They had been procuring multiple of mid range and high-end servers for their data centre and branches from IBM.

The fundamental challenge was managing these multiple servers with multiple islands of storage physically and remotely. A huge recurring investment was being made on the purchase of additional infrastructural support to meet their expansion needs in India. Additionally, they were facing performance issues with the servers.

All in all, Aviva required an integrated solution that would provide them the following benefits:

1. Better manageability through server consolidation.
2. Create redundancy to support criticality of their applications.
3. Flexibility to scale up servers as and when required.
4. Low total cost of ownership of IT infrastructure.

The IBM solution.

Aviva Life Insurance, India chose IBM as its partner in its efforts to improve business performance and enable flexible business growth. IBM has consulted Aviva on the virtualisation of the computing environment. "Realising the value from storage consolidation, Aviva was geared up to introduce new and challenging concepts like server virtualisation and physical consolidation", says Abir Basak, Senior Manager, IT Infrastructure and Networking. This provided ease of operations in managing virtual machines and also creating new servers on the fly, whenever the business needs increased.

Aviva's disaster recovery initiative has also been setup using IBM technologies to ensure higher productivity and optimal capacity utilisation.

Details

Application Policy administration CRM, Financial application, File Server

O.S

Platform

The result - Life is simple.

The server consolidation has enabled the client to simplify their IT infrastructure and further their expansion plans in India by moving the existing servers to Aviva's new branches across the country. The benefits of server consolidation include - low total cost of ownership, increased availability, better manageability, enhanced scalability and freedom from redundancy.

The robust and secure IT infrastructure deployed by IBM enables Aviva to cut down the go to market time substantially and offer new customised products and services to the customers, as per changing market dynamics and demand.

Source: //www-07.ibm.com/in/casestudies/case_aviva.html

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13.9 Summary

All Insurance contracts are governed by the basic principles of insurable interest, indemnity, utmost good faith, subrogation and proximate cause.

In fire and miscellaneous insurances, insurable interest must be present both at the time of taking the policy and at the time of loss as well. For example, if the property insured under a fire insurance policy is sold and there is a loss after the sale, the insured cannot recover the loss as he has no more any insurable interest in the property.

In marine insurance, insurable interest is required to present only at the time of loss. It may or may not be present at the time of effecting insurance.

Ownership of the goods passes from the exporter to the importer when payment is made. If goods arrived damaged at the port of destination and if the importer had paid for goods, he can recover the loss as he has insurable interest at the time of the loss and also has a policy. In marine hull insurance, insurable interest must be present both at the time of the taking the policy and at time the loss.

Fire insurance policy covers the risk from fire and incidental to fire. All the essential elements specified in the Contract Act are also applicable to a fire insurance contract. The fire insurance policies are of short duration. Essential principles of fire insurance are - insurable interest and principle of indemnity. Ignition and combustion are important ingredients of fire, without which the fire policy is not operative.

The fire policy also covers the damage due to explosion and implosion of boilers, damage to aircraft or property dropped from aircrafts, damage from missile testing operations. A fire policy covers tangible, movable and immovable property of a person.

The warranties and important conditions of the fire policy concerning principle of good faith should be followed. The assured should inform the insurer of any alteration which affects the risk levels. Insurers can take custody of the property of the insured or happening of event and sell or dispose property and apply the rule of subrogation. The conditions and warranties can be implied or expressed. The claim is settled by the insurer after assessing the damage. The insurer has the right to reject the claim if it is not filed within the period of limitation mentioned in the policy. The loss assessment and payment of damages depends upon the type of policy taken. Fire insurance polices may be valued policies, unvalued or open policies, long, mid and short-term policies or limited risk policies.

13.10 Keywords

Accident Insurance: A form of health insurance against loss by accidental bodily injury.

Additional cover: An insurance policy extended to cover additional risk perils such as strikes, riots and civil commotion etc. on payment of extra premium.

Broker: Insurance salesperson that searches the marketplace in the interest of clients, not insurance companies.

Business Interruption Insurance: Insurance for a business owner against losses resulting from stoppage of business because of fire or other insured peril. The insurance provides reimbursement for lost net profits and necessary standing expenses.

Business Interruption: Stoppage of business after occurrence of a calamity e.g. fire. Due to interruption men, machinery and other resources may not be able to perform and there would be delay in supply of goods to customers.

Consequential Loss/Indirect Loss: A financial loss which occurs as the consequence of some other loss.

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Fire: A combustion accompanied by a flame or glow, which escapes its normal limits to cause damage.

General insurance: All kind of insurances other than life insurance.

Gross premium: Net premium plus expense loadings.

Indemnity: Restoring the victim of a loss by payment, repair or replacement.

Proposal Form: It is a form which is to be filled and deposited with the insurer/agent for securing an insurance policy.

Proximate Cause: The chief/main cause of loss or damage.

Unvalued or Open Policy: A policy in which the value of loss is not stated at the time of taking policy. Value of loss is determined at the time of actual loss.

Valued Policies: A policy in which the value of loss is stated at the time of taking policy itself.

13.11 Review Questions

1. Explain the principles of general insurance.
2. What have been the constituents of Indian general insurance industry before and after liberalization? Explain.
3. Explain the commercial lines of business in general insurance.
4. Explain the personal lines of business in general insurance.
5. Write short notes on the following:
   - (i) Causa Proxima
   - (ii) Insurable Interest
   - (iii) Remote Cause
   - (iv) Subrogation
   - (v) Contribution
   - (vi) Adhikari Suraksha Kavach
   - (vii) Mediclaim Insurance
   - (viii) Videsh Yatra Mitra
   - (ix) Industrial all risk Policy
   - (x) Claim Settlement
   - (xi) TAC operations
   - (xii) Methods of rating
6. Define fire insurance. What are the essentials of a fire insurance policy?
7. What kind of risks is covered by a fire insurance policy? Explain.
8. What is a standard fire policy? Explain in detail.
9. Explain various fire insurance policies in detail.

Notes

10. Write short notes on the following:
    (i) Mediclaim Policy Of GIC
    (ii) Consequential Fire Policy
    (iii) Declaration Policy
    (iv) Floater Policy
    (v) Risks Covered By Fire Insurance
    (vi) Reinstatement Policy

Answers: Self Assessment

1.	Insurable	2.	Owner
3.	Mortgage	4.	Motor Vehicle
5.	Cargo	6.	False
7.	False	8.	True
9.	True	10.	True
11.	Declaration	12.	Tariff
13.	Occupancy	14.	Settlement
15.	Flood		

13.12 Further Readings

Books

Ahmad, Khurshid, et al. "*Long Term care: An Insurance Industry Perspective,*" Journal of the American society of CLU/ChFC, 62 (March 1992).

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Unit 14: Marine and Motor Insurance

CONTENTS

Objectives
Introduction
14.1 Definition of Marine Insurance Business
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Objectives

After studying this unit, you should be able to:

- Define the concept of marine insurance business and types of risks covered by marine policy.
- Explain contents and principles of marine insurance policy.
- Define double insurance and reinsurance and clauses incorporated in a marine insurance policy.
- Know how to calculate rates of premium.
- Define meaning and types of marine losses, total losses and partial losses.
- Understand a detailed discussion on York-Antwerp Rules.
- Understand what are marine claims?

Introduction

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.

Cargo insurance - discussed here - is a subbranch of marine insurance, though Marine also includes Onshore and Offshore exposed property (container terminals, ports, oil platforms, pipelines); Hull; Marine Casualty; and Marine Liability.

Notes

14.1 Definition of Marine Insurance Business

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".

The identity with which insurance contract is entered into is called the "insurer" and the person entering into contract is the "insured".

Section 2 (C and F) of the Marine Insurance Act, 1963 defines marine insurance and includes the movables exposed to maritime perils. Movables mean movable tangible property, which includes money, valuable securities and documents, etc.

As per Arnold marine insurance is a "A contract whereby one party for an agreed consideration, undertakes to indemnify the other against loss arising from certain perils and sea risks to which a shipment and other interest in a marine adventure may be exposed during a certain age or a certain time."

Insurable Property

Insurable property means any ship, goods or other movables exposed to maritime perils. Insurable property is also called the subject matter of insurance. Insurable property must be stated in the policy with reasonable certainty.

Marine Adventure

There is a marine adventure, when:

1. Any insurable property is exposed to marine perils.
2. The earning of freight, passage money, commission, profit or other pecuniary benefit, or the security for any advances, loans or disbursement is endangered by the exposure of insurable property to maritime perils.
3. The owner of or other person interested in or responsible for, insurable property by reason of maritime perils may insure any liability to the third party.
4. ***Voyage:*** Voyage is the route of the sea through which the vessel undertakes the journey. The route of the ship is very important in the marine insurance business. The ship should carry on the voyage in the specified route, which is mentioned in the policy. Change of voyage is permitted only in a few specified circumstances.
5. ***Maritime Perils/Perils of the Sea:*** Maritime Perils are also called as "Perils of the Sea". It means the perils consequent on, or incidental to the navigation through the sea,

Example: Fire, war perils, rovers, thieves, captures, seizures, jettisons, barratry and any other perils.

6. The term "Perils of the Sea" refers only to fortuitous accidents or casualties of the sea, and does not include the ordinary action of winds and waves.

Notes

14.2 Contents of a Marine Policy

A marine policy will contain the following particulars:

1. Name of Insured
2. Policy Number
3. Sum Assured
4. The subject matter insured and the perils covered
5. Place where claims are payable
6. Premium
7. Steamer (or) Other Conveyance
8. Stamp Duty
9. Voyage or Journey
10. Number or date of bill of lading or Registered Post or Air Freight Receipt (as the case may be)
11. Place of issue of policy and date
12. Signature of the authorized person signing on behalf of the insurers.

Every marine policy must be stamped in accordance with provisions of the Indian Stamp Act, 1899.

14.3 Essential Elements or Principles of Marine Insurance

The marine insurance has the following essential features, which are also called fundamental principles of Marine Insurance.

Features of a General Contract

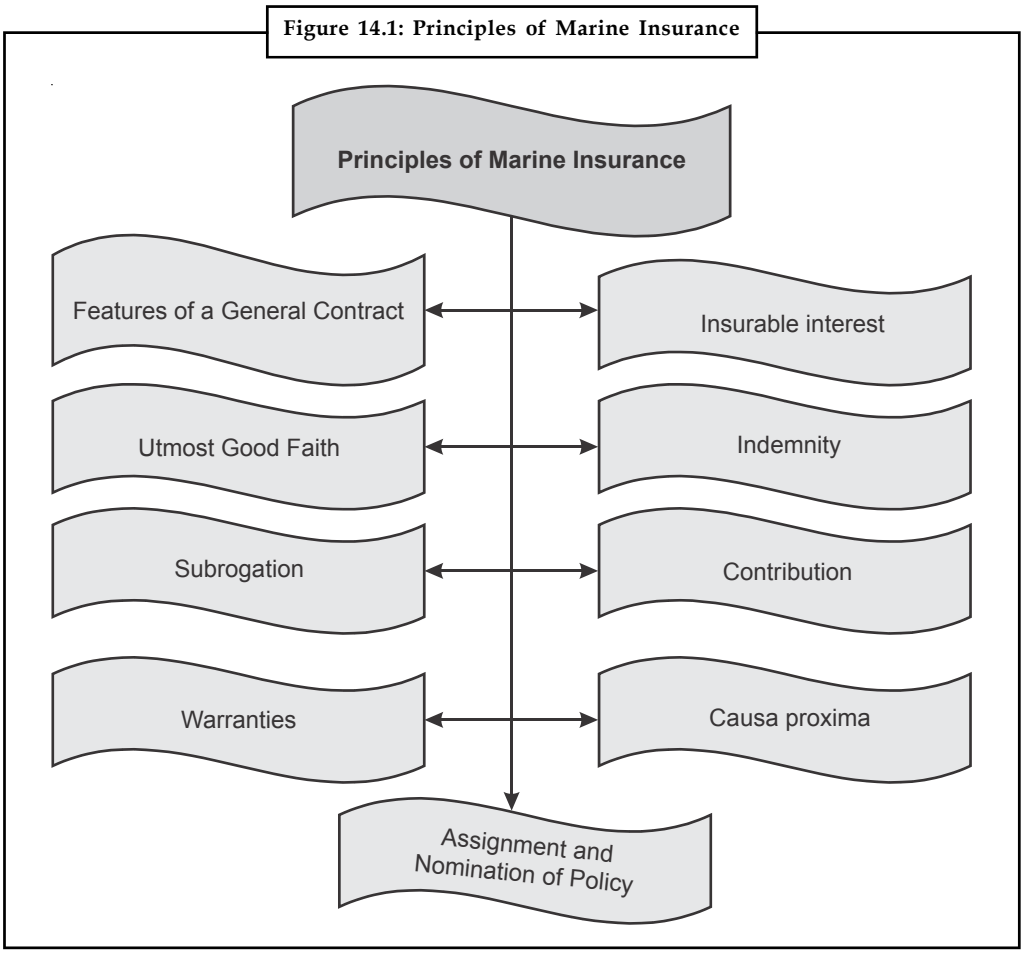
A marine insurance policy must fulfil all the essentials of a valid contract, namely offer, acceptance, agreement, lawful consideration, competent parties, free consent, and legal object. Here the proposal may be offered by a ship owner or a cargo owner or a freight receiver. When the insurer accepts the proposal, it becomes an agreement. The insurer is known as "Underwriter" and person taking insurance cover is called insured. The premium is determined on the basis of risk covered and is paid at the time of signing the contract.

Insurable Interest

It is not necessary that the insurable interest must exist at the time of affecting the insurance. The insured must have an insurable interest in the subject matter insured at the time when the loss actually occurs. According to Marine Insurance Act 1963, "every person has an insurable interest who is interested in a marine adventure".

Notes

Figure 14.1: Principles of Marine Insurance



The following persons have insurable interest in Marine Insurance:

1. Owner of Ship
2. Owner of Cargo
3. Creditor who has advanced money on a Ship or Cargo to the extend of his interest in such Ship or Cargo
4. Mortgager
5. Mortgagee
6. Master and crew - for wages
7. Bottomry bondholder
8. Person who pays advance freight is recoverable on loss
9. Shipper and their agents
10. Persons contingent interest such as the buyer, though the goods may be at seller's risk and though he may have the right to reject the goods, but has paid.
11. Trustee
12. Bailee

Notes

13. Insurer - he can reinsure
14. Assignee of the Bill of Lading.

Utmost Good Faith

Marine insurance is a contract of Uberrimae Fidei or Utmost Good Faith. The insured and insurer must observe utmost good faith in a contract of marine insurance. He must disclose all those relevant facts to the insurer which are likely to affect his willingness to undertake the risk.

If either party does not disclose full facts the other party can avoid the contract at any time.

Contract of Indemnity

The essence of a marine insurance contract is that it is a contract of indemnity. Under this contract the underwriter agrees to indemnify the insured against losses by sea risks to the extent of the amount insured. As a result, the insured can recover only the actual loss suffered and nothing more.

Principles of Subrogation

The principles of Subrogation and Contribution are applicable to the marine insurance contract. After meeting the loss agreed, the insurer steps into the shoes of the insured and becomes entitled to all the right and remedies available to the insured against the insured property or third persons.

Contribution

The doctrine of contribution also applies to marine insurance. Where the subject matter has been insured with more than one insurer, each insurer has to pay only the ratable proportion of loss. If he has paid more than his share of loss, he is entitled to recover the excess paid from his coinsurers. This principle again supports the concept that the insured cannot recover amounts on the same property for same peril from more than one insurer. If by chance he has taken cover from more than one insurer then all of them contribute in the ratio of the sum assured with them subject to the maximum loss.

Warranties

The principle of warranties applies to a Marine Insurance Contract. According to Marine Insurance Act, a warranty means a stipulation or term, the breach of which entitles the insurers to avoid the policy altogether and this is so even though the breach arises through circumstances beyond the control of the Warrantor. Warranties may be express or implied.

Express Warranties: Express warranty means a warranty, which is expressly stated. It is included in or written upon the policy or contained in some document referred to in the policy.

Express Warranties usually may be like:

1. The ship is safe on a particular day
2. The ship and goods are neutral and shall continue to be so
3. The ship will proceed to its destination without any deviation
4. The ship will sail on or before a certain day.

Notes

Implied Warranties: There are certain warranties, which are implied in every contract of marine insurance unless excluded expressly. These are:

1. ***Warranty of Seaworthiness:*** In a voyage policy the insured, at the time of affecting the insurance has to give a warranty of seaworthiness i.e., the ship concerned is in every respect fit for the voyage on which it is sailing.

   The warranty of seaworthiness includes particulars of ship like:

   (i) The ship must be sound as regards her hull.

   (ii) The gear must be sufficient and must be fully equipped, officered and manned.

   (iii) Ship must not be overloaded.

   (iv) If the voyage is to be performed in stages, the ship must be sea worthy at the commencement of each stage

   (v) Seaworthiness also includes cargo worthiness i.e. it must be fit to carry the cargo.

2. ***Warranty of Non-deviation from path:*** In the case of voyage policy where a voyage is contemplated between any two given ports there is an implied warranty of non-deviation on the part of the insured. The insured is supposed to give an undertaking, that he shall take the usual route taken by navigators, and shall not deviate except in cases where it is excusable by the law. If the ship, without lawful excuse, deviates from the voyage contemplated by the policy, the insurer is discharged from the liability as from the time of deviation. It is immaterial in such a case that the ship regained her route before any loss occurred. The intention to deviate is immaterial. There must be deviation in fact to discharge the insurer from his liability under the contract.

   What is a deviation?

   (i) Where the course of the voyage specially designated in the policy, is departed from or

   (ii) Where the course of the voyage was not specially designated by the policy, but the usual and customary course is departed from or

   (iii) Where several ports of discharge were specified by the policy, but the ship did not proceed to them in the order designated by the policy or

   (iv) Where the policy did not specify the ports of discharge but the ship (which should have) did not proceed to them in their geographical order.

   Can the deviation be excused?

   Deviation or delay is excused (justified) under the following circumstances:

   (i) It is authorized by the contract (or)

   (ii) It was caused by circumstances beyond the control of the master and his employer (or)

   (iii) It was caused by the barratrously conduct of the master or crew if barratry were one of the perils insured against

   (iv) It was necessary in order to comply with an express or implied warranty (or)

   (v) It was necessary to save life or to help a ship in distress (or)

   (vi) It was necessary to arrange medical or surgical aid for any person on board the ship (or)

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(vii) It was very necessary for the safety of the ship or subject matter insured (or)

(viii) It was necessary to avoid being captured or destroyed by the enemy of the government.

3. ***Warranty as to the Legality of Voyage:*** There is an implied warranty on the part of the insured that the adventure insured is a lawful one, and that, so far as the assured can control the matter, the adventure shall be carried out in a lawful manner.

   This warranty implies that the ship will not be used for undertaking any illegal voyage e.g., smuggling, trading with enemy etc.

4. ***Proper Documentation of the ship:*** Where there is an express warranty that the ship shall be neutral (especially in the case of a war time adventure) there is an implied warranty that the ship carries all the papers necessary to prove the neutrality.

Proximate Cause

According to Marine Insurance Act, the insurer is liable for any loss proximately caused by a peril insured against. He is not liable for any loss, which is not proximately caused by a peril insured against.

Assignments of Policy

A marine insurance policy is assignable unless it contains terms expressly prohibiting assignment. It may be assigned either before or after loss. A marine policy may be assigned by endorsement thereon or in any other customary manner.

Caution Insurable property must be stated in the policy with reasonable certainty. Otherwise at the time of loss, insurance company will not pay the damage.

Did u know? A marine insurance policy must fulfill all the essentials of a valid contract, namely offer, acceptance, agreement, lawful consideration, competent parties, free consent, and legal object.

Self Assessment

Fill in the blanks:

1. According to _____ Insurance Act, the insurer is liable for any loss proximately caused by a peril insured against.
2. _____ warranty means a warranty, which is expressly stated.
3. It is not necessary that the _____ must exist at the time of affecting the insurance.
4. The _____ of contribution also applies to marine insurance.
5. The insurer is known as "_____" and person taking insurance cover is called insured.

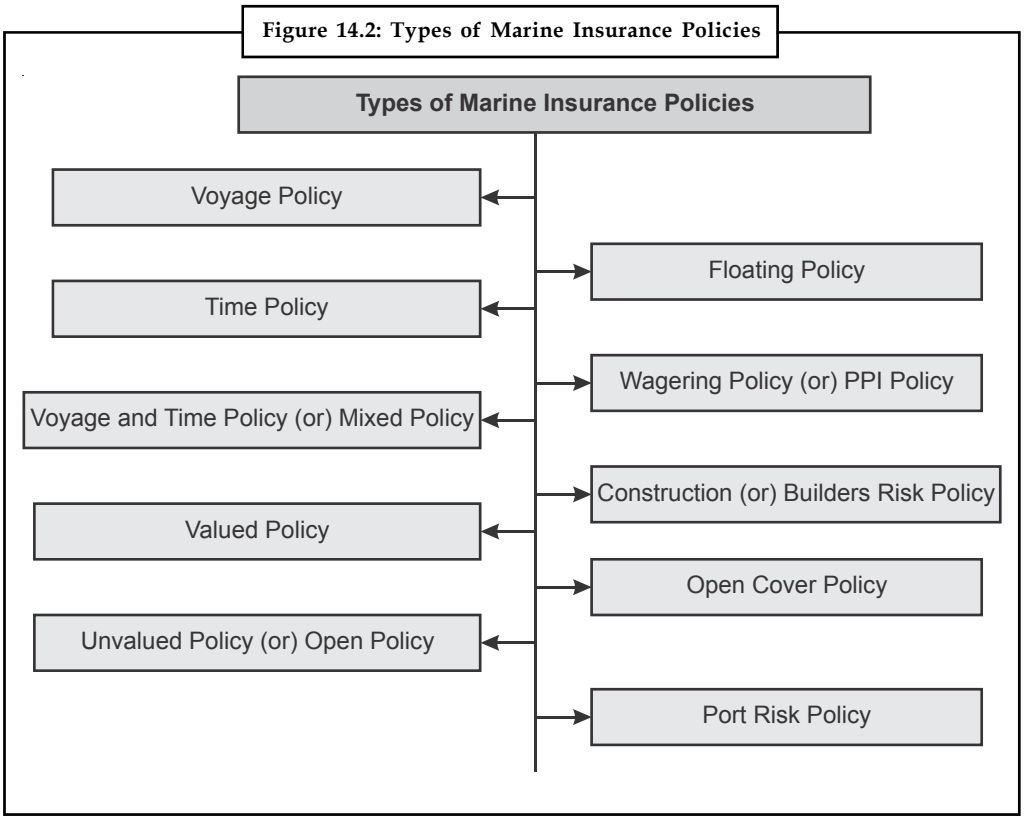
Notes

14.4 Kinds of Marine Insurance Policies

Though commonly in one form, marine policies are known by different names according to their manner of execution and the nature of risks covered. The following are the various kinds of marine insurance policies as contained in the Marine Insurance Act 1963.

1. ***Voyage Policy:*** As the name suggests this policy covers a voyage. This is a policy in which the limits of the risks are determined by place of particular voyage. For example, Madras to Singapore; Madras to London. Such policies are always used for goods insurance, sometimes for freight insurance, but only rarely nowadays for hull insurance.
2. ***Time Policy:*** This policy is designed to give cover for some specified period of time, say, for example 1st Jan, 2003 to noon, 1st Jan, 2004. Time policies are usual in the case of hull insurance, though there may be cases where an owner prefers to insure his vessel for each separate voyage under voyage policy.
3. ***Voyage and Time Policy or Mixed Policy:*** It is a combination of Voyage and Time Policy. It is a policy, which covers the risk during a particular voyage for a specified period. For example, a ship may be insured for voyages between Madras to London for a period of one year.
4. ***Valued Policy:*** This policy specifies the agreed value of the subject matter insured, which is not necessarily the actual value. Such agreed value is referred to as the insured value. A policy may be, say, for Rs. 10000 on Hull and Machinery etc.

Figure 14.2: Types of Marine Insurance Policies



5. ***Unvalued Policy/Open Policy:*** In the case of an Unvalued Policy, the value of the subject matter insured is not specified at the time of effecting insurance. It is taken for a specified amount and the insurable value is ascertained in the case of loss. Here the insurer is liable

Notes

to pay only up to actual loss incurred to the policy amount. It is also known as Open Policy.

6. ***Floating Policy:*** A floating policy describes the insurance in general terms, leaving the names of the ship or ships to be defined by subsequent declaration. Such policy has the advantage of being a valid marine policy, in all respects fully complying with the requirements of the Marine Insurance Act.

   The declaration may be made by endorsement on the policy or in any other customary manner. Unless the policy otherwise provides, declaration must be made in the order of shipment. They must comprise all the consignments within the terms of the policy and values must be honestly stated. Errors and omissions, however, may be rectified even after a loss has occurred, if made in good faith.

   When the total amount declared exhausts, the amount for which the policy was originally issued, it is said to be "run off" or "full declared". The assured may then arrange for a new policy to be issued to succeed the one about to lapse, otherwise the cover terminates when the policy is fully declared.

7. ***Wagering Policy:*** This policy is issued without there being any insurable interest, or a policy bearing evidence that the insured is willing to dispense with any proof of interest. If a policy contains such words as "Policy Proof of Interest" (PPI) or "Interest or No Interest" it is Wagering or Honor Policy. Under Section 4 of the Marine Insurance Act, such policies are void in law but such policies continue to be common.

8. ***Construction or Builders Risk Policy:*** This is designed to cover the risks incidental to the buildings of a vessel, usually giving cover from the time of laying the keel until completion of trails and handing over to owners. In the case of a very large vessel, the period may extend over several years.

9. ***Blanket/Open Cover Policy:*** In order to arrange their marine insurance in advance and to be assured to cover at all times, and also to avoid the effects of possible rapidly fluctuating rates, it is the practice of regular importers and exporters to avail "Blanket Insurance".

   One good way, and the most popular one of achieving this is by means of "Open Cover". An open cover is an agreement between the assured and his underwriters under which the former agrees to declare, and the latter to accept, all shipments coming within the scope of the open cover during some stipulated period of time.

10. ***Port Risk Policy:*** This is to cover a ship or cargo during a period in port against the risks peculiar to a port as distinguished from voyage risks. This kind of policy is probably very rarely used nowadays.

Self Assessment

State whether the following statements are true or false:

6. ***Wagering Policy:*** This policy is issued with there being any insurable interest, or a policy bearing evidence that the insured is willing to dispense with any proof of interest.

7. In the case of an Unvalued Policy, the value of the subject matter insured is not specified at the time of effecting insurance. It is taken for a specified amount and the insurable value is ascertained in the case of loss.

8. ***Valued Policy:*** This policy specifies the uncertain value of the subject matter insured, which is not necessarily the actual value.

Notes

9. ***Port Risk Policy:*** This is to cover a ship or cargo during a period in port against the risks peculiar to a port as distinguished from voyage risks.

Tasks

1. What is marine loss control engineering? What are its benefits?
2. E-marine is the user-friendly web tool. Is it available in India? Know about this tool and its advantages.

14.5 Motor Insurance/Vehicle Insurance/Auto Insurance/Car Insurance

Vehicle insurance is the insurance which consumers can purchase for cars, trucks, and other vehicles. Its primary use is to provide protection against losses incurred as a result of traffic accidents. Generally speaking, it is a cover in respect of motorized vehicles including fire, theft, impact, collision and third party liability cover.

Vehicle insurance can cover some or all of the following items:

1. The insured party
2. The inured vehicle
3. Third parties

What is a motor vehicle?

Motor vehicle includes private cars, motorized two-wheelers and commercial vehicles excluding vehicles running on rails.

Who can insure?

Owners of the vehicle, financiers or lessee, who have insurable interest in a motor vehicle, can insure the vehicle.

Public Policy

In many countries, it is compulsory to purchase auto insurance before driving on public roads. Even penalties for not purchasing auto insurance may be levied varying from state to state. Substantial fine may be charged, license and/or registration may be suspended, as well as possible jail time may be specified.

Usually the minimum requirement by law is third party insurance to protect third parties against the financial consequences of loss, damage or injury caused by a vehicle.

What does motor insurance cover?

Motor insurance policies provide cover against any loss or damage caused to the vehicle or its accessories due to the following natural and man made calamities:

Natural Calamities: Fire, explosion, self-ignition or lightning, earthquake, flood, typhoon, hurricane, storm, tempest, inundation, cyclone, hailstorm, frost, landslide, rockslide.

Notes

Man made Calamities: Burglary, theft, riot, strike, malicious act, accident by external means, terrorist activity, any damage in transit by road, rail, inland waterway, lift, elevator or air.

Motor insurance provides compulsory personal accident cover for individual owners of the vehicle while driving. One can also opt for a personal accident cover for passengers. The third party legal liability insurance is compulsory.

Third party legal liability protects against legal liability arising towards others due to accidental damages. It includes any permanent injury, death of a person and damage caused to his property.

Basis of Premium Charges

Depending on the regulations, the insurance premium can be either mandated by the government or determined by the insurance company in accordance to a framework of regulations (tariff) set by the government. Often, the insurer has more freedom to set the price on physical damage coverages than on mandatory liability coverages.

In case of non-mandated insurance-premium, the premium is calculated usually from the calculations of an actuary based on statistical data.

Various factors like the car characteristics, the coverage selected (deductible, limit, covered perils) and the usage of the car (commute to work or not, predicted annual distance driven).

Insured's Declared Value (IDV)

1. In case of vehicle not exceeding 5 years of age, the IDV has to be arrived at by applying the percentage of depreciation specified in the tariff on the showroom price of the particular make and model of the vehicle.
2. In case of vehicles exceeding 5 years of age and obsolete models, they have to be insured for the prevailing market value of the same as agreed to between the insurer and the insured.

What is not payable under the policy?

1. War perils, nuclear perils
2. Consequential loss, depreciation, wear and tear, mechanical or electrical breakdown
3. Damage suffered due to driving the vehicle under the influence of intoxicating liquor or drugs
4. Claims arising outside the specified geographical area
5. Claims arising when the vehicle is driven by a person without valid driving license
6. Contractual liability.

Special Points

1. ***Transfers:*** In case of change of ownership, one must ensure to affect the transfer of Insurance policy within 14 days from the date of transfer of ownership.
2. ***Change of Vehicles:*** A vehicle can be substituted by another vehicle for the same class, for the balance period of a policy subject to adjustment of premium, if any, on pro-rata basis from the date of substitution.

Notes

3. ***Detarrification:*** Uptil now the regulator was dictating the general insurance premium tariff rates. Recently, the Insurance Regulatory and Development Authority (IRDA) has notified that from 1st January 2007 all branches of Insurance except Motor third party would be de-tariffed.

14.6 Medical Insurance/Health Insurance/Mediclaim

It is a very fast and stressful life and one can meet different types of illnesses and diseases. With increasing living costs, the cost of medical treatment is also rising. A common man becomes sicker by paying the huge medical bills, than the disease itself.

Medical bills and money involved should be the last things to think about when a person or his relative comes across such an uncertainty of life. Here the answer to such worries about health problems is health or medical insurance.

Some Features of Health Insurance

1. Health insurance, also known as Mediclaim offers protection against unforeseen and unexpected medical emergencies. In situations like unexpected illness or accident the health insurance takes care of costs of treatment, hospitalization and other medical services.
2. Some medical insurances that also provide support for pre as well as post-hospitalization - like costs of medical tests or purchase of medicines.
3. Premium paid for Health Insurance Policies help us in getting tax saving benefits under Section 80D of Income Tax Act up to a maximum amount of Rs.10,000, while a senior citizen enjoys the maximum limit of Rs.15,000.
4. The contract may be renewable annually or monthly.
5. The type and amount of health care costs that will be covered by the health plan are specified in the beginning.
6. A Critical Illness rider option to cover medical expenses may be added whereby the amount insured in the policy will be given to the customer in case he/she encounters that critical illness during the time period of the policy.
7. Health insurance may be provided through a government-sponsored social insurance program, or by private insurance companies.
8. It may be purchased on a group basis (e.g., by a firm to cover its employees) or purchased by individual customers. The covered groups or individuals pay premiums for protection from huge or unexpected healthcare expenses.

Coverage

Today, most of the comprehensive private health insurance programmes cover:

1. The cost of routine and preventive checkups
2. Emergency health care procedures
3. Cost of most prescription drugs
4. Sometimes covers disability or long-term nursing or custodial care needs.

Notes

Exhibit 14.1: Some of the Factors Leading to Rising Healthcare

Factors Leading to Raising Healthcare Costs Expenditures

1. Rising hospital costs.
2. Greater emphasis and increased spending on drug/medicine therapy in the treatment of diseases.
3. Rise in fees of health care providers.
4. Better medical facilities due to arrival of new medical technology, especially for the treatment of conditions that were considered untreatable till now.
5. Increased consumer demand because of increases in life expectancy.

Comprehensive private health insurance must be based on:

1. Estimation of the total overall risk of healthcare expenses
2. Developing a routine finance structure (such as a monthly premium or annual amount)
3. Money is available (reimbursement) to pay for the healthcare benefits specified in the insurance agreement when ever required.
4. Policies are administered by a central organization/government agency or a private or not-for-profit entity operating a health plan.

14.7 Health Insurance Schemes (in India)

On the basis of ownership the existing health insurance schemes can be broadly divided into the following categories:

1. ***Government or State-based Systems:***

   Central Government Health Scheme

   Employees State Insurance Scheme (ESIS)

2. ***Market-based Systems (Private and Voluntary)***
3. ***GIC Mediclaim Coverage:***

   Mediclaim or Hospitalization Benefit Insurance Policy

   Domiciliary Hospitalization

   Bhavishya Arogya Insurance Policy

4. ***LIC Coverages:*** e.g.

   Jeevan Asha

   Asha Deep

5. ***Private Insurers:*** e.g.

   (i) Hospital Cash Daily Allowance Policy - Bajaj Allianz

   (ii) Health Guard - Bajaj Allianz

Notes

(iii) Critical Illness - Bajaj Allianz

(iv) Health Shield - Royal Sundaram

6. Employer provided Insurance Systems
7. Member Organisation (NGO or Cooperative)-based Systems

Health Insurance Issues in India

1. Focused and increased public spending on primary and health care services
2. Reform of ESIS and CGHS
3. Restructuring of premiums
4. Increase in visibility and awareness (advertisements)
5. Discourage specific exclusions for disease(s) in health care policies
6. Encouragement of health insurance for those especially vulnerable

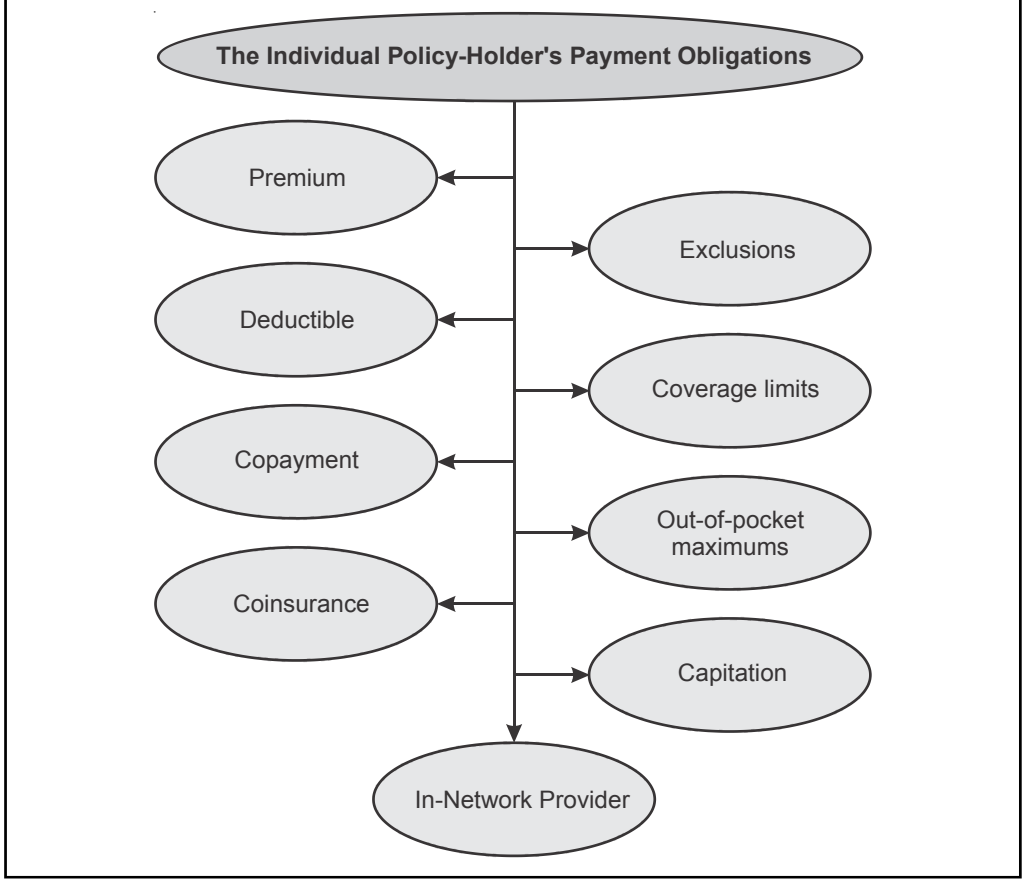
14.8 Payment Obligations

The individual policyholder's payment obligations may take several forms.

1. ***Premium:*** The amount policyholder pays to avail the health plan coverage each month/ year.
2. ***Deductible:*** The amount that the policyholder must pay out-of-pocket before the health plan pays its share.
3. ***Copayment:*** The amount that the policyholder must pay out of pocket before the health plan pays for a particular visit or service. For example, a policyholder might pay a Rs.500 copayment for a doctor's visit, or to obtain a prescription. It is paid each time a particular service is obtained.
4. ***Coinsurance:*** The policyholder must pay a percentage of the total cost. For example, the policyholder might have to pay 20% of the cost of a surgery, while the health plan pays the rest 80%.
5. ***Exclusions:*** Not all services are covered. Some medical services may be excluded.
6. ***Coverage limits:*** Some health plans only pay for health care up to a certain amount. The policyholder may be expected to pay any charges in excess of the health plan's maximum limit for a specific service. Some plans even have annual or lifetime coverage maximums whereby the health plan will stop payment when they reach the maximum, and the policyholder must pay all remaining costs rest of life.
7. ***Out-of-pocket maximums:*** Here the policyholder's payment obligation ends when they reach the out-of-pocket maximum, and the health plan pays all further covered costs.
8. ***Capitation:*** An amount paid by an insurer to a health care provider (a doctor/nursing home/hospital), in return of which the provider agrees to treat all members of the insurer.
9. ***In-Network Provider:*** A health care provider (a doctor/nursing home/hospital) on a list of providers preselected by the insurer. The insurer will offer discounted coinsurance or copayments, or additional benefits, to a plan member to deal within network provider.

Notes

Figure 14.3: Payment Obligations



Generally, providers in-network are those who have a contract with the insurer to accept further discounted rates from the "usual and Customary" fees /charges the insurer pays to out-of-network providers.

Eligibility for Taking Policy

Persons between the age of 5 years and 75 years can get this insurance. Children between the age of 3 months and 5 years of age can be covered provided one or both parents are covered currently. Persons of any nationality can take this policy.

Conditions for Reimbursement

Expenses on hospitalization for a minimum period of 24 hours are allowable except in case of specific treatments i.e. dialysis, chemotherapy, radiotherapy, eye surgery, dental surgery, lithography (kidney stone removal), tonsillectomy, D and C taken in the hospital/nursing home and the insured is discharged on the same day. In these cases, the treatment though less than 24 hours will be considered under hospitalization benefits.

The Heads of Reimbursable Expenses

1. Boarding expenses for room provided by the hospital/nursing home.
2. Nursing expenses.

Notes

3. Fees of attending doctors
4. Expenses incurred on anesthesia, blood, oxygen, operation charge, surgical appliances, medicines and drugs, diagnostic materials and X-Ray, dialysis and chemotherapy, radiotherapy, artificial limbs and cost of organs etc.

Exclusions Under a Normal Mediclaim/Health Plan Policy

The medical policy will not cover the following:

1. Any sickness or illness for first 30 days during the policy
2. Any medical expenses relating to pregnancy
3. Diseases caused by war, invasion or due to nuclear weapons etc.
4. Any expenses incurred for spectacles, cosmetic treatment etc.
5. Medical expenses done for purchasing tonics, vitamins unless incurred as part of a treatment.

Types of Coverages

The major types of coverages are: Comprehensive and Scheduled Plan.

Their meaning and main points of distinction are:

1. Scheduled health insurance plans are more of a basic policy providing access to day-to-day health care such as going to the doctor or getting a prescription drug. In recent years, these plans have got the name mini-med plans or association plans. Comprehensive health insurance cover a vast array of illnesses in the same plan.
2. Comprehensive health insurance pays a percentage (may be 100, 90, 80, 70, 60, 50, percent) of the cost of hospital.
3. These plans are generally costly because of the high potential benefit payout - Rs.10,000,000 to 50,000,000 is common - and because of the vast array of covered benefits.
4. Scheduled plans are not meant to be effective for catastrophic events. They cannot replace a comprehensive plan.
5. These plans cost much less then comprehensive health insurance.
6. They generally pay limited benefits amounts directly to the service provider, and payments are based upon the plan's "schedule of benefits".
7. Scheduled health scheme may also provide for - family package discount in premium, Cumulative bonus etc.
8. The renewal of insurance without break is essential here.

Special Points of a Long-term Care Insurance Policy

This policy is an extended version of the existing mediclaim/health policy. The period of insurance is fixed for 5 years and 10 years and premium rates are fixed as per sum insured and based on 5 years and 10 years. This policy covers the individual and group under this scheme for longer period with low premium rating comparatively.

Notes

Additional Benefits

1. Income tax benefits under section 80-D are available.
2. Family discount.

Exhibit 14.2: List of Diseases Covered Under Long Term Comprehensive Plan

List of Diseases covered under long term comprehensive plan

1. Cerebral or vascular stroke
2. Open and close heart surgery
3. Tuberculosis, which includes pulmonary T.B.
4. Encephalties (viral)
5. Neurosurgery
6. Total replacement of joints
7. Malignant diseases
8. Nephritis of any antilogy plus bacterial renal failure requiring kidney transplantation and dialysis
9. Liver disorder (Hepatitis B and C) associated with complications like cirrhosis of liver.
10. Serious injury including fracture of bones, head injury.
11. Vertebral column injury etc.

The medical expenses have become too high and injury or disease does not come with prior notice. The requirement of quality medical care has generated the market for health care insurance policies.

14.9 Personal Accident/Disability Income Insurance

The word 'accident' means an unforeseen or unexpected event. Accidents don't happen only on the roads. They can occur in office, while traveling or entertaining, or even at home while doing everyday chores.

In terms of finances, they make a double effect. On the one hand, healthcare spending increases due to the treatment taken. On the other, income is disrupted till one can work again. It is here that accident insurance plays the crucial role.

According to experts, for people below 45 years of age, the risk of accident is much higher than of health problems. Health risks and expenses increase with age and tend to typically surface when a person is 45 years or older. People between 25 and 55 years of age are two times as likely to get disabled than die. Thus, a large number of Disabilities occur through accidents and one cannot ignore the importance of accident insurance.

Accident insurance is a form of health insurance against loss by accidental bodily injury. This protects the insured against loss due to injury. It also covers the loss of earnings resulting from injury of the insured person.

In personal accident insurance, it is deemed that a person has unlimited financial interest on his own life but in practice there is a financial limit to the sum of insurance that matches the life of an individual.

Notes

In India, two major insurance options to cover the risk from accidents are available:

1. Stand-alone (separate) personal accident insurance policies sold by general insurance companies
2. Accident rider along with a life cover.

Disability

Accidents may result into disability and disability further results in loss of income and earning power, involving additional expenses and extra needs. Disability may be of two kinds:

Partial Disability

If a person becomes partially disabled to perform his tasks, it is called partial disability.

Disability income policies provide for the payment of reduced monthly income if insured can't work full time and/or is prevented from performing one or more important daily duties pertaining to his occupation.

Permanent Disability Benefit

Generally the policy defines the disability in physical terms viz. loss of sight of both the eyes, amputations of both the hands at or above the wrist, or amputation of both the legs at or above ankles etc.

The disability must be total and permanent and the life assured then or in future, would not be able to do any work, occupation or profession to earn or obtain any wages, compensation or profit.

The following benefits are provided for the insurance policy in case permanent disability arises out of an accident:

1. An additional sum equal to the sum assured will be paid in monthly instalments spread over 10 years.
2. The future premiums are waived off (are not payable).
3. In case of claim (Death or maturity) before 10 years the disability benefit instalments, which have not fallen due, will be paid along with the claim. The maximum limit is Rs 5.00 lakhs or Rs 10.00 lakhs depending upon the insurer and exclusion clauses are similar to accident benefit.

The basic pre conditions for granting the benefits are:

1. The disability should be solely and directly the result of accidental injury.
2. The disability must be total and permanent.
3. The accidental injury and the resultant permanent disability should take place before the assured attains the age of 65 years.

Immediately after the disability, the life assured must intimate the insurance company giving the full details within a specified time period.

Coverage

The policies cover a number of eventualities, including plane crashes, train accidents, murder, hit-and-run and even death due to snakebite.

Notes

Private Insurers: Personal accident insurance policies are offered by private players like Iffco Tokio General Insurance, Bajaj Allianz General Insurance, Royal Sundaram Alliance Insurance and ICICI Lombard.

National Insurers: National Insurance, New India Assurance, Oriental Insurance and United India Insurance - also offer personal accident insurance. The four general insurance companies offer the same policy and a person can buy it from any of the companies.

General Eligibility

Any person between the age group of 5 and 70 years can apply for a personal accident insurance policy. However, if one purchases the policy from Royal Sundaram, one needs to be between 18 years and 70 years, and in the case of Bajaj Allianz, the policy is only sold to persons in the age group of 18 years to 65 years.

Proof of Disability and Premium

Assured must provide a satisfactory proof of disability. If the claim is admitted the waiver of premium will be allowed from the due date of the premium following the date of accident, which brought about the disability.

If the decision is not taken before premium due time then the premium is to be paid till the final decision is taken. However, the insurer will refund premium, once the claim is admitted.

Disability Benefit

A feature added to some life insurance policies, which provides for the waiver of premiums upon the furnishing of proof that the insured has become totally and permanently disabled.

Sum Assured

Typically, the premium is around Rs 125-750 for a Personal Accident Insurance Plan (PAIP) with a Rs 250,000 cover.

Premiums

Premiums don't vary with age and insurers give discount of around 10 per cent when family members coverage is taken. PSU insurers charge premiums according to risk profile, whereas some private insurers charge a flat premium, irrespective of risk profile.

Types of Risks

People whose work is more static in nature, such as lawyers, accountants, teachers or the self-employed are regarded as normal risk by the insurers. Builders, contractors, engineers and veterinary doctors, whose job includes frequent site visits, are classified as medium risk. Those who work in high-risk industries, with chances of accidents, fall in the high-risk category.

Comprehensive Coverage

Comprehensive coverage is always beneficial as all coverage's together will be given at very less premium-comprehensive coverage of the four contingencies of death, permanent total disability, and permanent partial disability, temporary total disability must be taken even though companies offer the option of covering one, two or three of them.

Notes

Limitation to Accident Riders

Like other life insurance riders, the maximum accident cover under riders is 30 per cent of the sum assured. Since most life covers end at around age 65, the coverage from accident riders end with the base policy.

Another important point to remember is that once the claim is made, lump sum amount will be paid in case of death or staggered payments made in case of permanent total disability say 10 per cent of the rider cover annually over 10 years. In case one survive the accident, the coverage effectively ends from the time one makes the claim.

PAIP vs. Accident Riders

If we compare the two options, PAIP has an edge:

1. One gets a weekly payout in case of temporary total disability; a facility that riders don't give.
2. PAIP's coverage in terms of age limit is more and the coverage doesn't end after a claim is made, as is the case with accident riders.
3. A customer, who does not need a long-term commitment required in a life policy, can take a stand-alone (separate) personal accident cover.

Amount of Accident Insurance Cover

After fixing an option to buy accident insurance, the calculations as to the amount of cover need to be done on the same principle as computation of life insurance.

Example:

Table 14.1: Sample Calculation of Insurance

Cover Needs		
1.	Take-home salary	25,000
2.	Reduction in expenses	2,500
3.	Spouses' take home salary	12,000
4.	Income from investments	6,000
5.	Current disability income Needs [1 – 2 + 3 + 4)]	4,500
6.	Inflation adjusted disability income needs	31,680
7.	Disability income needed in future (5 + 6)/2	18,090

An Illustration ICICI Lombard: Personal Accident Policy Cover

Terrorism and acts of terrorism: In case of the death of the insured arising out of terrorism or acts of terrorism within the policy period, the nominee (mentioned in the policy) is compensated with the sum Insured. The company shall also pay compensation against permanent and total loss of limbs, sight etc. (of the insured) arising out of terrorism or acts of terrorism.

Accidental death: In case of death of the insured due to an accident within the policy period, the nominee (mentioned in the policy) is compensated with the sum insured.

Permanent total disablement (PTD): Personal Accident pays compensation against the permanent and total loss of limbs, sight etc. due to an accident.

Notes

Key Benefits

1. Covers claims arising out of Terrorism or acts of Terrorism
2. Covers against Accidental Death or Permanent Total Disablement (PTD)
3. Choose among Sum insured options of Rs. 3, 5, 10 and 20 Lakhs
4. Choice of cover period: 3, 4 or 5 years
5. No health checkup required
6. Easy Claim Process with minimal documentation

Eligibility

1. Age criteria at entry: Minimum 18 years, Maximum 70 years.
2. The applicant can buy the policy for his spouse aged between 18-70 years. Need for Personal Accident Insurance Covers

India continues to lose the maximum number of lives due to terrorism after Iraq. Terrorist activities are no longer limited to the sensitive border areas. The recent bomb blasts in Jaipur, Bangalore and Ahemdabad and 26/11/08 incident of Mumbai have put the entire nation under threat. Personal Accident Cover protects against terrorism related accidental losses and death. According to a report by IIT Delhi on traffic injuries and fatalities in India, road traffic accidents take a toll of almost 1.2 million deaths a year and additionally injure or disable between 20 million and 50 million annually.

Personal Accident Insurance protects the insured against Accidental Death and Permanent Total Disablement (PTD) and also protects against terrorism-related accidental losses.

Caution Comprehensive coverage is always beneficial as all coverage's together will be given at very less premium-comprehensive coverage of the four contingencies of death, permanent total disability, and permanent partial disability, temporary total disability must be taken even though companies offer the option of covering one, two or three of them.

Notes Like other life insurance riders, the maximum accident cover under riders is 30 per cent of the sum assured.

14.10 Catastrophe Insurance

Past decades have shown an increasing severity and frequency of losses arising from natural catastrophes: earthquakes, hurricanes, floods and large-scale fires. It is still controversial whether an increasing frequency of hurricanes and floods may be attributed to climate change (global warming), but it is clear that concentration of values in catastrophe-prone coastal areas has brought about an increase in the amount of damages. From 1970 to 1990, population in the Pacific and South Atlantic coastal states of the United States increased by 51% and 45% respectively, compared to a countrywide increase of 24% over the same period.

Notes

This evolution is a source of concern for the insurance industry, because the wealth elasticity of insurance demand is empirically larger than one. Thus, rapid increases in exposed wealth mean that insured losses represent an increasing proportion of total losses. For example, one of the most severe catastrophes over the past years was the Kobe earthquake in 1995, which caused losses to an amount of US$82.4 billion, but insured losses remained at a more modest $2.5 billion. This is relatively small compared to the series of losses which were inflicted upon the insurance industry since 1988. Insurers had to pay $12.5 billion for the Northridge earthquake (1994) and $16 billion for Hurricane Andrew (1992), more than 40 percent of the combined total cost for these two events, estimated at $65 billion.

Prior to Andrew, the industry had not anticipated such high damage values. Indeed, the financial press was saturated with stories of astonishment following Hurricane Hugo in 1989, which cost the industry over $5 billion. Ever since Hugo however, insured losses in excess of $1 billion have become the rule rather than the exception.

Catastrophic losses challenge the economic role of insurance as a private wealth redistribution mechanism. Insurance makes possible the transfer of numerous risks. It is a mechanism whereby insurers collect funds from many agents exposed to similar risks, to pay for losses that will randomly affect some of these agents. The reinsurance mechanism complements direct insurance by allowing a more world-wide diversification of risks. In general, the financial capacity of the insurance industry has been able to absorb intertemporal deviations of total losses from their expected value. However, financial capacity has been outpaced by potential losses in the catastrophe lines. The total capital of the US property-casualty insurance industry is estimated at $200 billion, of which $20 billion is provided by reinsurers (Kielholz and Durrer, 1997). The coverage capacity in the catastrophe line of business (direct insurance and reinsurance) is estimated at $25 billion. This is less than the reference loss, estimated by reinsurers, of $50 billion for a California earthquake or $45 billion for a single large east-coast storm; and it is well below the maximum probable losses from these two kinds of events, estimated at $100 billion for California earthquakes and $85 billion for east-coast storms.

The problem arises because the risk of natural catastrophes is not widely diversifiable in an insurance context, where insurers supply coverage in well-defined business lines. Natural catastrophes tend to occur in selected areas of the globe: seismic regions and ocean coasts. Moreover, only a subset of these regions expresses much demand for insurance coverage. Thus, reinsurers are not able to disseminate the risk easily across the world, and cross-subsidization among different lines of business is not feasible in a competitive environment.

Two types of solutions to the insurance capacity gap have been proposed and put into practice. Mandatory public provision of insurance is one alternative. It relies on the financial and fiscal ability of the government to spread losses across many citizens, as well as intertemporally. This was imposed in France, where all insureds pay an additional premium on their property-liability insurance contracts in exchange for coverage against natural catastrophes, with a reinsurance guarantee provided by the State.

Risk securitization represents a second alternative. It relies on the huge pool of financial capacity provided by asset markets. By increasing the capacity provided by reinsurance markets alone, securitization allows for a higher level of diversification for catastrophic risks (Cummins and Weiss, 2000). For example, total capitalization of the US financial market amounts to approximately $20 trillion, with a daily standard deviation of around $130 billion. Thus, typical daily fluctuations in total US asset market capitalization are able to cover the maximum probable loss from a California earthquake. Risk securitization is accomplished by issuing specific conditional claims and selling them directly to financial investors. Options on natural catastrophes (cat spreads) started trading at the Chicago Board of Trade in 1995, and catastrophe-linked bonds (cat bonds) have been issued since 1997.

Notes

Self Assessment

Fill in the blanks:

10. The recent bomb blasts in Jaipur, Bangalore and Ahemdabad and 26/11/08 incident of ..... have put the entire nation under threat.
11. People whose work is more ..... in nature, such as lawyers, accountants, teachers or the self-employed are regarded as normal risk by the insurers.
12. If a person becomes partially disabled to perform his tasks, it is called ..... disability.
13. Accident insurance is a form of ..... insurance against loss by accidental bodily injury.
14. According to experts, for people below ..... years of age, the risk of accident is much higher than of health problems.

Task Discuss the motor insurance coverage(s) provided by ICICI Lombard insurance company. What are the differences if any between motor cover of this company and motor cover provided by United India Insurance Company?

Case Study

Heungkuk Fire & Marine Insurance Company

Enterprise Data Platform Makes BI Tools Available to All Employees and Cuts Costs

Situation

Based in Korea, Heungkuk Fire & Marine Insurance Company offers fire, marine, automobile, health, and other types of insurance. Heungkuk also provides mortgage and other loans.

For several years, the company has been planning the development of its next-generation core banking system, a project that is set to begin in 2011. During this planning, Heungkuk decided that the project should not only strengthen and extend its existing systems and processes, but also help the company obtain new value from its data.

"In our industry, it is more common to develop and deploy core banking systems before improving enterprise information systems," says Dong-soo Woo, Head of IT Planning for Heungkuk. "We decided that we wanted to take the unusual step of first changing how we use information."

Woo continues, "Since the mid-2000s, we have noticed an increasing volume of data that underlines the need for data centralization and high-quality business intelligence information." For example, the proliferation of smartphones and tablet computers has resulted in a significant increase in the traffic of non-structured data that the Heungkuk IT environment must handle.

Contd....

Notes

In addition, not all Heungkuk departments could conduct data management and business intelligence (BI) activities. Only planning or finance employees could perform analysis, so managers and decision makers in other departments had to request reports and often waited several days before receiving them.

"We realized that if we spent two years developing our next-generation core banking system before taking steps to improve our enterprise data platform, we might fall behind our competitors," says Woo.

Heungkuk wanted a mission-critical enterprise solution that would centralize the company's data and provide self-service BI tools for all employees.

Solution

After reviewing technologies from Oracle, IBM, and SAP, Heungkuk decided to deploy a data warehouse and BI solution based on Microsoft SQL Server 2008 R2 data management software.

"Out of all the solutions we evaluated, the Microsoft proposal offered the most user-friendly approach," says Woo. "Also, with a Microsoft solution, we saw that we could comply with regulatory data-security requirements without having to purchase a third-party solution." Heungkuk worked with its IT infrastructure partner, INBREIN, to develop and deploy the new solution.

To speed deployment, Heungkuk used Microsoft SQL Server Fast Track Data Warehouse, a set of reference architectures based on best practices for data management and optimized for specific hardware components. To reduce systems-integration delays and further decrease the project's time-to-market, Heungkuk selected an enterprise data warehouse appliance from HP.

In addition to SQL Server 2008 R2, the new solution includes Microsoft SharePoint Server 2010. With the data compression capabilities of SQL Server 2008 R2, the solution can scale up to 48 terabytes. Transparent data encryption helps Heungkuk protect data and log files, easing compliance with regulations without requiring any changes to applications.

The solution loads data from the company's line-of-business applications into one central data warehouse. Employees in all departments can use familiar Microsoft Excel spreadsheet software to perform analysis on this data and create visual representations of the results. Users who need to perform more complex analysis have access to Microsoft SQL Server PowerPivot for Microsoft Excel, with which they can analyze hundreds of millions of rows of data on their desktops. Users can share the results of their analysis in a SharePoint Server 2010 portal, all without any assistance from the IT department.

Heungkuk is also planning to deploy Microsoft SQL Server 2008 R2 StreamInsight to support complex event-processing applications. With SQL Server 2008 R2 StreamInsight, Heungkuk can have almost real-time access to information from a variety of data streams, further reducing the cost and time needed for manual analysis.

Benefits

The Microsoft data warehouse and BI solution has helped Heungkuk Fire & Marine Insurance Company provide all employees with data-analysis capabilities and speed the delivery of key reports to decision makers. The IT department can now avoid the cost of developing and maintaining the custom dashboards that were part of the previous solution. Integrated security tools help the company protect its customers' privacy, and the innovative solution strengthens the reputation of Heungkuk as an industry leader in Korea.

Contd....

Notes

Because the new solution is intuitive and easy to learn, Heungkuk can extend self-service BI tools company-wide for the first time. "The Microsoft BI solution will be used by all of our employees," says Woo. "Everyone from information workers to branch managers to sales representatives will make use of this solution."

Woo expects that the value of the BI information available from the new solution will encourage widespread buy-in from users. "With the Microsoft solution, we can make information analysis part of everyone's job description," says Woo. "Our business users are always thirsty for more information, and as soon as they see that they can get it from the Microsoft BI solution, they will be eager to use the new tools."

New users will find those tools easy to learn and use. Woo explains, "With the Microsoft BI solution, users can drill down into the information as deeply as they want by using familiar Excel tools."

Once Heungkuk deploys StreamInsight, the company will realize additional value. "With the addition of SQL Server 2008 R2 StreamInsight, our Microsoft BI solution will help us provide even more robust protection for our clients," says Woo. "The insurance industry is increasingly emphasizing real-time information, and the Microsoft platform positions us well to respond to this emerging business need."

Speeds Information Availability

With the new solution, Heungkuk employees access vital data much faster than before. "Our analysts used to have to wait three to four days between requesting data and receiving the report," says Woo. "With the Microsoft solution, users have almost immediate access to the data they need, right at their desks."

Users also have higher confidence in the data's accuracy. "Because the previous data solution was not well integrated, users sometimes experienced inconsistencies," says Woo. "With a centralized Microsoft data warehouse solution, we are able to provide our employees with a single, authoritative version of company data."

Reduces Development and Maintenance Costs

Because of the solution's self-service BI tools, Heungkuk no longer needs to budget for IT projects to analyze, process, and share information. By using the solution's report-building tools, employees can easily create visualizations of the data they are analyzing, relieving the IT department of this task. "In the past, our IT department had to develop distinct systems for each different business unit to upload information and view analysis results," says Woo. "With the Microsoft solution, we can avoid custom analysis projects, saving 220 million won in development costs and about 2 million won in annual maintenance fees per project."

Expands Security Tools

Another advantage of the Microsoft data warehouse solution is its robust, integrated security tools. Woo explains, "With SQL Server 2008 R2 transparent data encryption, we can comply with government privacy regulations without needing to invest in an additional third-party solution."

Woo says that the new solution is also helping Heungkuk strengthen its reputation as an innovative and forward-thinking company. "Many of our competitors have completed their core banking system upgrades and are only now looking at how to improve their data management solutions. With a data warehouse and BI solution from Microsoft, Heungkuk has taken the lead."

Source: http://www.microsoft.com/india/casestudies/microsoft-sql-server-2008-r2-enterprise/heungkuk-fire-marine-insurance-company/enterprise-data-platform-makes-bi-tools-available-to-all-employees-and-cuts

Notes

14.11 Summary

In marine insurance contracts, the proposal is made to the insurance company by the owner of the ship to insure the vessel, crew and other cargo which is on board, to secure the same from the marine perils. The insurance company accepts the offer for a payment of consideration called the premium. The insurance company can demand for extra premium either to cover the extra risks or cover the marine insurance contracts meant for the areas, which are decided to be high-risk prone ports or routes.

The marine insurance contract, being a part of general/non-life insurance is a short-term contract for a period of the voyage or for a maximum period of one year or for such period till a specific purpose is complete. The premium is paid in lumpsum. Payment of insurance premium is must as a consideration for the insurance cover. The insurance company issues a policy on payment of insurance premium.

The insurable interest, principles of indemnity and proximate cause, contribution and subrogation play an important role in the marine insurance business. A contract of marine insurance is a contract based upon the utmost good faith and if the utmost good faith is not observed by either party, the contract may be avoided by the other party.

The marine insurance policy should contain the clauses as per the Marine Insurance Policy Act, 1963. The policies of marine insurance may be voyage policy and time policy.

Health insurance may be provided through a government-sponsored social insurance program, or by private insurance companies. The term health insurance is generally used to describe a form of insurance that pays for medical expenses. It is sometimes used more broadly to include insurance covering disability or long-term nursing or custodial care needs.

Accident insurance is a form of health insurance against loss by accidental bodily injury. This protects the insured against loss due to injury. It also covers the loss of earnings resulting from injury of the insured person.

In Personal Accident Insurance, it is deemed that a person has unlimited financial interest on his own life but in practice there is a financial limit to the sum of insurance that matches the life of an individual.

14.12 Keywords

Accidental Death: Death caused by accident. In case of death of the insured due to an accident within the policy period, the nominee (mentioned in the policy) is compensated with the Sum Insured.

Adventure: A risky undertaking of an uncertain outcome.

Bailee: A person to whom goods are entrusted by another, to hold and return after some time.

Bailer: A person entrusting goods to another, to hold and return after some time.

Barratry: It is a fraudulent practice/act committed by the master or crew of a ship to the prejudice of the owner of goods.

Cargo Insurance: Type of ocean marine insurance that protects the shipper of the goods against financial loss if the goods are damaged or lost.

Cargo: Goods being transported by rail, plane, truck, ship or other conveyance, excluding the equipment needed to operate the conveyor.

Notes

Catastrophe: An event that causes a loss of extraordinary magnitude e.g. a hurricane or tornado.

CGHS: Central Government Health Scheme.

Disability Benefit: A feature added to some life insurance policies which provides for the waiver of premiums upon the furnishing of proof that the insured has become totally and permanently disabled.

Health Insurance/Mediclaim: Health Insurance also known as Mediclaim. It offers protection against unforeseen medical emergencies.

Inchmaree Clause: Covers losses resulting from latent defect in hull and machinery of vessel and losses resulting from errors in navigation or management of the vessel by master or crew.

Letter of Credit: A document issued by the buyer's bank, through its foreign correspondent bank, establishing a credit against which the seller may draw after complying with specific instructions.

Marine Insurance: A contract whereby one party for an agreed consideration, undertakes to indemnify the other against loss arising from certain perils and sea risks to which a shipment and other interest in a marine adventure may be exposed during a certain age or a certain time.

Peril: The cause of a possible loss, such as fire, windstorm, theft, explosion, or riot.

Permanent Total Disablement (PTD): The permanent and total loss of limbs, sight etc. due to an accident. Personal Accident insurance pays compensation against PTD.

Vessel: A passenger or cargo carrying boat or ship.

Voyage: A journey through water.

14.13 Review Questions

1. Define the following terms:
   (i) Marine insurance
   (ii) Marine adventure
   (iii) Perils of sea
   (iv) Voyage
   (v) Marine policy
2. Explain the main features or essentials of a marine insurance contract.
3. Explain all the clauses related to a marine adventure in detail.
4. Define Contract of Marine Insurance. Explain briefly the various kinds of Marine Insurance Policies.
5. What are marine losses? Explain various kinds of marine losses in brief.
6. Discuss in detail:
   (i) General losses
   (ii) Particular losses
7. Write about the documents required for filing a marine insurance claim.
8. Define abandonment. How and when is it done?

Notes

9. Distinguish between general average loss and particular average loss.
10. Write short notes on the following:
    (i) Voyage Policy
    (ii) Floating Policy
    (iii) Wagering Policy
11. Explain various fire insurance policies in detail.
12. "Much of the increase in the cost of medical care can be attributed to unnecessary and undesirable over utilization of health services, often prompted by the existence of insurance." Do you agree or disagree? What policy provisions have been designed to control over-utilization of health services?
13. What is accident insurance? Explain the relevant provisions.
14. Define health insurance. Briefly trace the history of health insurance in India.

Answers: Self Assessment

1.	Marine	2.	Express
3.	Insurable Interest	4.	Doctrine
5.	Underwriter	6.	False
7.	True	8.	False
9.	True	10.	Mumbai
11.	Static	12.	Partial
13.	Health	14.	45

14.14 Further Readings

Books

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Online links

www.uiic.co.in

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