UNIT 2 BANKING, AFFORDABLE CREDIT AND INSURANCE

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2.1 INTRODUCTION

In this Unit, we will discuss the organizations like banks, credit institutions and insurance companies. We also look into the differences among these institutions. A bank is a financial institution that serves as a financial intermediary and India has a vibrant banking system that not only hassle free but its also able to meet new challenges posed by the technology and any other external and internal factors. We will also learn about the different phases in the history on banking institutions in India.

2.2 OBJECTIVES

After studying this Unit, you would be able to
- Know the banking institutions;
- Understand the history of banking institutions;
- Describe the affordable credits; and
- Explain the insurance model.

2.3 BANKING

A bank is defined as an organization, usually a corporation, chartered by a state or federal government, which does most or all of the following activities: receives demand deposits and time deposits, honours instruments drawn on them, pays interest on them; discounts notes, makes loans and invests in securities; collects cheques, drafts, and notes; certifies depositor’s cheques and issues drafts and cashier’s cheques.

The term "bank" may refer to any one of several related types of entities. For example:
- A Central Bank circulates money on behalf of the government and acts as its monetary authority by implementing monetary policy, which regulates the money supply.
- A Commercial Bank accepts deposits and pools those funds to provide credit, either directly by lending, or indirectly by investing through the capital markets. Within the global financial markets, these institutions connect market participants with capital deficits (borrowers) to market participants with capital surpluses (investors and lenders) by transferring funds from those parties who have surplus funds to invest (financial assets) to those parties who borrow funds to invest in real assets.
A Savings Bank is similar to a savings and loan association (S&L). They can either be stockholder owned or mutually owned, in which case they are permitted only to borrow from members of the financial cooperative. The asset structure of savings banks and savings and loan associations is similar, with residential mortgage loans providing the principal assets of the institution's portfolio.

Because of the important role played by the depository institutions in the financial system, the banking industry is highly regulated, and government restrictions on financial activities by banks have varied over time and by location. In some countries, such as Germany, banks have historically owned major stakes in industrial companies, while in other countries, such as the United States, banks have traditionally been prohibited from owning non-financial companies. In Japan, banks are usually the nexus of a cross-share holding entity known as the "keiretsu". In Iceland, banks followed international standards of regulation prior to the recent global financial crisis that began in 2007.

The oldest bank still in existence is Monte dei Paschi di Siena, headquartered in Siena, Italy, which has been operating continuously since 1472. A Bank's main source of income is interest. A bank pays out at a lower interest rate on deposits and receives a higher interest rate on loans. The difference between these rates represents the bank's net income.

2.4 HISTORY OF BANKING

The first banks were the banks of merchants of ancient world which made grain loans to farmers and traders who carried goods between cities. The records of such activity date back around 2000 B.C. – in Assyria and Babylonia. Later in ancient Greece and during the Roman Empire period lenders were based in temples. They would not only provide loans but also accepted deposits. They also carried out the activity of changing money. During this period there was similar evidence of the independent development of lending of money in ancient China and ancient India.

The word bank was borrowed in Middle English from Middle French banque, from Old Italian bonca, from Old High German banc, bank bench, and counter. Benches were used as desks or exchange counters during the Renaissance period by Florentine bankers, who used to make their transactions atop desks covered by green tablecloths.

One of the oldest items found showing money-changing activity is a silver Greek drachm coin from ancient Hellenic colony Trapezus on the Black Sea, modern Trabzon, c. 350–325 BC, present in the British Museum in London. The coin shows a banker's table (trapeza)
laden with coins, a pun on the name of the city. In fact, even today in Modern Greek the word Trapeza (Τράπεζα) means both a table and a bank.

2.5 ACTIVITIES OF A BANK

Banks act as payment agents by conducting checking of current accounts for customers, paying cheques drawn by customers on the bank, and collecting cheques deposited to customers’ current accounts. Banks are also enable customers payments via other payment methods such as telegraphic transfer, EFTPOS (Electronic Fund Transfer at a point of sale - electronic payment system), and automated teller machine (ATM).

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

Banks provide almost all payment services, and a bank account is considered indispensable by most businesses, individuals and governments. Non-banks that provide payment services such as remittance companies are not normally considered as an adequate substitute for having a bank account.

Banks borrow most funds from households and non-financial businesses, and lend most funds to households and non-financial businesses, but non-bank lenders provide a significant and in many cases adequate substitute for bank loans, and money market funds, cash management trusts and other non-bank financial institutions. In many cases, Non- Bank lenders provide an adequate substitute to banks for lending, savings too.

Banks offer many different channels to access their banking and other services:

- ATM is a machine that dispenses cash and sometimes takes deposits without the need for a human bank teller. Some ATMs provide additional services.
- A branch is a retail location.
- Mail: most banks accept check deposits via mail and use mail to communicate to their customers, e.g. Sending account statements to the customers.
- Mobile banking is a method of using one's own mobile phone to conduct banking transactions.
- Online banking is a term used for performing transactions, payments through Internet.
• Relationship Managers of the private bank or business bank often visit customers at their homes or business place to provide banking and other financial services.
• Telephone banking is a service which allows its customers to perform transactions over the telephone without speaking to a human.
• Video banking is a term used for performing banking transactions or professional banking consultations via a remote video and audio connection. Video banking can be performed via purpose built banking transaction machines (similar to an Automated teller machine), or via a videoconference enabled bank branch.

2.6 BUSINESS MODEL
A bank can generate revenue in a variety of different ways including interest, transaction fees and financial advice. The main method is to charge interest on the capital it lends out to customers. The bank profits is from the differential between the level of interest it pays for deposits and other sources of funds, and the level of interest it charges in its lending activities. This difference is referred to as the spread between the cost of funds and the loan interest rate. Historically, profitability from lending activities has been cyclical and dependent on the needs and strengths of loan customers and the stage of the economic cycle. Fees and financial advice constitute a more stable revenue stream, and banks have therefore placed more emphasis on these revenue lines to smooth their financial performance.

In the past 20 years American banks have taken many measures to ensure that they remain profitable while responding to increasingly changing market conditions. First, this includes the Gramm-Leach-Bliley Act, which allows banks to merge with investment and insurance houses. Merging banking, investment, and insurance functions allows traditional banks to respond to increasing consumer demands for "one-stop shopping" by enabling cross-selling of products (which, the banks hope, will also increase profitability).

Second, they have expanded the use of risk-based pricing from business lending to consumer lending, which means charging higher interest rates to those customers that are considered to be a higher credit risk and thus increased chance of default on loans. This helps to offset the losses from bad loans, lowers the price of loans to those who have better credit histories, and offers credit products to high risk customers who would otherwise be denied credit.

Third, they have sought to increase the methods of payment processing available to the general public and business clients. These products include debit cards, prepaid cards, smart cards, and credit cards. They make it easier for consumers to conveniently make transactions
and smooth their consumption over time (in some countries with underdeveloped financial systems, it is still common to deal strictly in cash, including carrying suitcases filled with cash to purchase a home).

However, with convenience of easy credit, there is also increased risk that consumers will mismanage their financial resources and accumulate excessive debt. Banks make money from card products through interest payments and fees charged to consumers and transaction fees to companies that accept the credit-debit cards. This helps in making profit and facilitates economic development as a whole.

2.7 PRODUCTS OF A BANK
The following section will explain you the products of the bank. The banks in general offer the following products. Products of banks are divided into retail and wholesale. With regard to retail, the following products are offered by the banks.

Retail

- Business loan; Cheque account; Credit card; Home loan; Insurance advisor; Mutual fund; Personal loan and Savings account.

The wholesale products are dealt by the bank.

Wholesale

- Capital raising (Equity / Debt / Hybrids); Mezzanine finance; Project finance; Revolving credit; Risk management (FX, interest rates, commodities, derivatives) and Term loan

2.8 RISKS FACED BY BANKS
Banks face a number of risks in order to conduct their business. We will also explain in this Unit, how well these risks are managed and understood which serves as a key driver behind profitability, and how much capital a bank is required to hold. Some of the main risks faced by banks include:

- Credit risk: risk of loss arising from a borrower who does not make payments as promised.

- Liquidity risk: risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss (or make the required profit).

- Market risk: risk that the value of a portfolio, either an investment portfolio or a trading portfolio, will decrease due to the change in value of the market risk factors.
Operational risk: risk arising from execution of a company's business functions.

The capital requirement is a bank regulation, which sets a framework on how banks and depository institutions must handle their capital. The categorization of assets and capital is highly standardized so that it can be risk weighted.

2.9 ECONOMIC FUNCTIONS OF BANKS

The economic functions of banks include the following:

- Issue of money, in the form of banknotes and current accounts subject to cheque or payment at the customer's order. These claims on banks can act as money because they are negotiable or repayable on demand, and hence valued at par. They are effectively transferable by mere delivery, in the case of banknotes, or by drawing a cheque that the payee may bank or cash.

- Netting and settlement of payments – banks act as both collection and paying agents for customers, participating in interbank clearing and settlement systems to collect, present, be presented with, and pay payment instruments. This enables banks to economize on reserves held for settlement of payments, since inward and outward payments offset each other. It also enables the offsetting of payment flows between geographical areas, reducing the cost of settlement between them.

- Credit intermediation – banks borrow and lend back-to-back on their own account as middle men.

- Credit quality improvement – banks lend money to ordinary commercial and personal borrowers (ordinary credit quality), but are high quality borrowers. The improvement comes from diversification of the bank's assets and capital which provides a buffer to absorb losses without defaulting on its obligations. However, banknotes and deposits are generally unsecured; if the bank gets into difficulty and pledges assets as security to raise funding to continue to operate, this puts the account holders and depositors in an economically subordinated position.

- Maturity transformation – banks borrow more on demand debt and short term debt, but provide more long term loans. In other words, they borrow short and lend long. With a stronger credit quality than most other borrowers, banks can do this by aggregating issues (e.g. accepting deposits and issuing banknotes) and redemptions (e.g. withdrawals and redemptions of banknotes), maintaining reserves of cash, investing in marketable securities that can be readily converted to cash if needed, and
raising replacement funding as needed from various sources (e.g. wholesale cash markets and securities markets).

- Money creation – whenever a bank gives out a loan in a fractional-reserve banking system, a new sum of virtual money is created.

Check Your Progress Exercise 1

Note: i. Use this space given below to answer the question.

   ii. Compare your answer with the one given at the end of this unit

1. What is banking?

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2. What are the activities of a bank?

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3. What are the risks faced by banks?

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2.10 BANKING IN INDIA

Effective and sound banking system need to have a healthy economy. The banking system of India is not only hassle free but it is able to meet new challenges posed by the technology and any other external and internal factors.
For the past three decades India's banking system has several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to only metropolitans or cosmopolitans in India. In fact, Indian banking system has reached even to the remote corners of the country. This is one of the main reasons of India's growth process. The government's regular policy for Indian bank since 1969 has paid rich dividends with the nationalization of 14 major private banks of India.

Not long ago, an account holder had to wait for hours at the bank counters for getting a draft or for withdrawing his own money. Today, he has a choice. Gone are days when the most efficient bank transferred money from one branch to other in two days. Now it is simple as instant messaging or dialing for a pizza. Money has become the order of the day. The first bank in India, though conservative, was established in 1786. From 1786 till today, the journey of Indian Banking System can be segregated into three distinct phases. They are as mentioned below:

- Early phase from 1786 to 1969 of Indian Banks
- From nationalization of banks in India to 1991- This phase is prior to Indian banking sector Reforms.
- New phase of Indian Banking System with the advent of Indian Financial & Banking Sector Reforms after 1991.

This scenario may be elaborated as Phase I, Phase II and Phase III.

### 2.11 THREE PHASES OF BANKING

The following section describe different phases of banking in India

**PHASE I**

The General Bank of India was set up in the year 1786. After that Bank of Hindustan and Bengal Bank was setup. The East India Company established Bank of Bengal (1809), Bank of Bombay (1840) and Bank of Madras (1843) as independent units and called it Presidency Banks. These three banks were amalgamated in 1920 and Imperial Bank of India was established which started as private shareholders banks, mostly Europeans shareholders.

Allahabad Bank was established exclusively by Indians in 1865 and it is the first of kind exclusively set up by the by the Indians. Punjab National Bank Ltd. was set up in 1894 with headquarters at Lahore. Between 1906 and 1913, Bank of India, Central Bank of India, Bank
of Baroda, Canara Bank, Indian Bank, and Bank of Mysore were set up. Reserve Bank of India came into existence in 1935.

During the first phase, the growth was very slow and banks also experienced periodic failures in the period between 1913 and 1948. There were approximately 1100 banks during this period and most of them are small. To streamline the functioning of the commercial banks, the Government of India brought The Banking Companies Act, 1949 which was later changed to Banking Regulation Act 1949 as per amending Act of 1965 (Act No. 23 of 1965). Reserve Bank of India was vested with extensive powers for the supervision of banking in India as the Central Banking Authority.

Before Independence, general public had less confidence on the banks. As a result, deposit mobilization was slow. At the same time, savings bank facility provided by the Postal department was considered as comparatively safer. Moreover, funds were largely given to traders by the bank.

**PHASE II**

Government took number of major steps in the banking Sector after the independence as reform measures. Imperial Bank was nationalized in 1955 with extensive banking facilities to the rural and semi-urban areas. Imperial bank established State Bank of India to act as the principal agent of RBI and to handle banking transactions of the Union and State Governments all the country.

Seven subsidiary banks of State Bank of India were nationalized in 1960 on 19th July. In 1969, another major process of nationalization was carried out. It was the effort of the then Prime Minister of India, Mrs. Indira Gandhi, 14 major commercial banks in the country were nationalized.

Second phase of nationalization of banks with reforms in India was carried out in 1980 with seven more banks. This step brought 80% of the banking segment in India under Government ownership.

The following are the major steps taken by the Government of India to regulate banking institutions in the Country:

- 1949: Enactment of Banking Regulation Act.
- 1955: Nationalization of State Bank of India.
- 1959: Nationalization of SBI subsidiaries.
- 1961: Insurance cover extended to deposits.
- 1971: Creation of credit guarantee corporation.
- 1975: Creation of regional rural banks.
- 1980: Nationalization of seven banks with deposits over 200 crore.

After the nationalization of banks, the branches of the public sector banks in India rose to approximately 800% in deposits and advances took a huge jump by 11,000%. Banking in the sunshine of Government ownership gave the public implicit faith and immense confidence about the sustainability of these institutions.

**PHASE III**

This phase has introduced many more products and facilities in the banking sector reforms. In 1991, under the chairmanship of M Narasimham, a committee was set up in his name, which worked for the liberalization of banking practices. During this period, Country witnessed flooding of foreign banks and their ATM stations. Efforts are being made to give a satisfactory service to customers. Phone banking and net banking has been introduced. The entire system became more convenient and the major shift has happened. Timely transactions in the banking system gained priority.

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

With years, banks are also adding services to their customers. The Indian banking industry is passing through a phase of customers market. The customers have more choices in choosing their banks. A competition has been established within the banks operating in India. With stiff competition and advancement of technology, the services provided by banks have become more easy and convenient. Earlier, one had to wait an hour to withdraw cash from one’s account, and a cheque from the north of the country took a month to clear in the south. Due to
advance in technology and reforms in the banking sector, banking transactions made easy with less time.

Check Your Progress Exercise 2

Note: i. Use this space given below to answer the question.

ii. Compare your answer with the one given at the end of this unit

1. Briefly describe the process of banking in India?
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2. What are the achievements during the different phases of banking?
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3. What is the effect of liberalization on Indian banking?
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2.12 AFFORDABLE CREDIT

Credit is the trust which allows one party to provide resources to another party where the second party does not reimburse the first party immediately (thereby generating a debt),
instead arranges will be made either to repay or return those resources (or other materials of equal value) at a later date. The resources provided may be financial (e.g. granting a loan), or they may consist of goods or services (e.g. consumer credit). Credit encompasses any form of deferred payment. Credit is extended by a creditor, also known as a lender, to a debtor, also known as a borrower.

Credit does not necessarily require money. The credit concept can be applied in barter economies as well, based on the direct exchange of goods and services (Ingham 2004 p.12-19). However, in modern societies credit is usually denominated by a unit of account. Unlike money, credit itself cannot act as a unit of account.

Movements of financial capital are normally dependent on either credit or equity transfers. Credit is in turn dependent on the reputation or creditworthiness of the entity which takes responsibility for the funds. Credit is also traded in financial markets. The purest form is the credit default swap market, which is essentially a traded market in credit insurance. A credit default swap represents the price at which two parties exchange this risk – the protection "seller" takes the risk of default of the credit in return for a payment, commonly denoted in basis points (one basis point is 1/100 of a percent) of the notional amount to be referenced, while the protection "buyer" pays this premium and in the case of default of the underlying (a loan, bond or other receivable), delivers this receivable to the protection seller and receives from the seller the par amount (that is, is made whole).

The word credit is used in commercial trade in the term "trade credit" to refer to the approval for delayed payments for purchased goods. Companies frequently offer credit to their customers as part of the terms of a purchase agreement. Organizations that offer credit to their customers frequently employ a credit manager. On the other hand, credit is sometimes not granted to a person who has financial instability or difficulty.

Consumer debt can be defined as ‘money, goods or services provided to an individual in lieu of payment.’ Common forms of consumer credit include credit cards, store cards, motor (auto) finance, personal loans (installment loans), consumer lines of credit, retail loans (retail installment loans) and mortgages. This is a broad definition of consumer credit and corresponds with the Bank of England’s definition of "Lending to individuals". Given the size and nature of the mortgage market, many observers classify mortgage lending as a separate category of personal borrowing, and consequently residential mortgages are excluded from
some definitions of consumer credit - such as the one adopted by the Federal Reserve in the United States (US).

The cost of credit is the additional amount, over and above the amount borrowed, that the borrower has to pay. It includes interest, arrangement fees and any other charges. Some costs are mandatory, required by the lender as an integral part of the credit agreement. Other costs, such as those for credit insurance, may be optional. The borrower chooses whether or not they are included as part of the agreement.

Interest and other charges are presented in a variety of different ways, but under many legislative regimes lenders are required to quote all mandatory charges in the form of an annual percentage rate (APR). The goal of the APR calculation is to promote ‘truth in lending’, to give potential borrowers a clear measure of the true cost of borrowing and to allow a comparison to be made between competing products. The APR is derived from the pattern of advances and repayments made during the agreement. Optional charges are not included in the APR calculation. So if there is a tick box on an application form asking if the consumer would like to take out payment insurance, then insurance costs will not be included in the APR calculation (Finlay 2009).

2.13 AFFORDABLE CREDIT: WHAT IS IT, AND WHO HAS ACCESS?

There has been significant policy concern in recent years about the level of access of the lower income households to have affordable credit, which led the efforts by government and others to expand credit union and lending. More recently, the Office of Fair Trading’s in the United States issued irresponsible lending guidance due to recession in 2000 and 2010 has highlighted the need for lenders to make better use of affordability assessments in order to ensure that credit agreements are sustainable and do not risk causing people to become over-indebted.

However, the term ‘affordable’ has never been officially defined and is often simply used to mean ‘less expensive’ than forms of high cost credit such as home credit or payday lending. Although these lenders may be providing credit at prices which reflect high operating costs and default risks, these may not be affordable even at low levels of credit use for some households once the costs of other essential outgoings are taken into account.
Therefore, attempts are being made to determine levels of disposable household income which are available for credit repayments after taking account of essential expenditure, and to determine how much credit lower to middle income households can realistically afford to take on. Further to this, it is being explored how price rises in areas of the household budget including food and fuel will impact on the ability of households to make credit repayments.

This study will draw out the implications for future credit provision, including by looking at how credit could be used to help lower income households reduce future levels of expenditure or invest in activities which could increase disposable income levels over time.

**Check Your Progress Exercise 3**

**Note:** i. Use this space given below to answer the question.

   ii. Compare your answer with the one given at the end of this unit

1. What is credit?

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2. What is the difference between trade credit and consumer credit?

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3. What is affordable credit? Who has access to affordable credit?

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2.14 INSURANCE

Insurance is a risk management technique primarily used to hedge against the risk of a contingent, uncertain loss that may be suffered by those individuals by transferring the possibility of this loss from one interested person, persons, or entity to another. The scarce resources referred to here, fall into three divisions: human resources, financial resources, and capital, or tangible resources.

In the context of insurance, scarce resources are also known as "exposures," because they are "exposed" to perils, those things, or forces, which cause destruction or reduction, in the usefulness, or value, of an exposed resource. Human resources are thus exposed to perils such as illness or death; financial resources to legal judgments that may result from negligent acts, and capital resources to physical perils such as fire, theft, windstorm, and vandalism, to name but a few.

A hazard is the cause of a peril. It is that thing or condition which increases the likelihood of a peril. Thus perils and hazards are identified by the exposure that they threaten. For example a slippery roadway could be viewed as a financial hazard, capital hazard, or human hazard by automobile owners, and rightly so, since this condition increases the likelihood of an automobile accident that might result in an unfavorable legal judgment, automobile damage, and bodily injury.

In the context of commercial trade, insurance is further defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for consideration or payment, in the form of a risk premium. The insurance premium develops at an actuarially-determined rate. This rate is a factor used to determine the amount of premium to charge for a certain limit, and type, of insurance on the scarce resource. The premium can further be viewed as a guaranteed, known, relatively small financial loss to the insured, paid to the insurer, in exchange for the insurer's promise to compensate (indemnify) the insured in the case of a loss to the insured resource(s). The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be indemnified.
Process of insurance: Insurance involves pooling funds from *many* insured entities (known as exposures) to pay for the losses that some may incur. The insured entities are therefore protected from risk for a fee, with the fee being dependent upon the frequency and severity of the event occurring. In order to be insurable, the risk insured against must meet certain characteristics in order to be an insurable risk. Insurance is a commercial enterprise and a major part of the financial services industry, but individual entities can also self-insure through saving money for possible future losses.

### 2.15 RISK AND INSURABILITY

Risks which can be insured by private companies typically share seven common characteristics:

1. **Large number of similar exposure units:** Since insurance operates through pooling resources, the majority of insurance policies are provided for individual members of large classes, allowing insurers to benefit from the law of large numbers in which predicted losses are similar to the actual losses. Exceptions include Lloyd's of London, which is famous for insuring the life or health of actors, sports figures and other famous individuals. However, all exposures will have particular differences, which may lead to different premium rates.

2. **Definite loss:** The loss takes place at a known time, in a known place, and from a known cause. The classic example is death of an insured person on a life insurance policy. Fire, automobile accidents, and worker injuries may all easily meet this criterion. Other types of losses may only be definite in theory. Occupational disease, for instance, may involve prolonged exposure to injurious conditions where no specific time, place or cause is identifiable. Ideally, the time, place and cause of a loss should be clear enough that a reasonable person, with sufficient information, could objectively verify all three elements.

3. **Accidental loss:** The event that constitutes the trigger of a claim should be fortuitous, or at least outside the control of the beneficiary of the insurance. The loss should be pure, in the sense that it results from an event for which there is only the opportunity for cost. Events that contain speculative elements, such as ordinary business risks or even purchasing a lottery ticket, are generally not considered insurable.
4. **Large loss:** The size of the loss must be meaningful from the perspective of the insured. Insurance premiums need to cover both the expected cost of losses, plus the cost of issuing and administering the policy, adjusting losses, and supplying the capital needed to reasonably assure that the insurer will be able to pay claims. For small losses these latter costs may be several times the size of the expected cost of losses. There is hardly any point in paying such costs unless the protection offered has real value to a buyer.

5. **Affordable premium:** If the likelihood of an insured event is so high, or the cost of the event is so large, that the resulting premium is large relative to the amount of protection offered, it is not likely that the insurance will be purchased, even if on offer. Further, as the accounting profession formally recognizes in financial accounting standards, the premium cannot be so large that there is not a reasonable chance of a significant loss to the insurer. If there is no such chance of loss, the transaction may have the form of insurance, but not the substance.

6. **Calculable loss:** There are two elements that must be at least estimable, if not formally calculable: the probability of loss, and the attendant cost. Probability of loss is generally an empirical exercise, while cost has more to do with the ability of a reasonable person in possession of a copy of the insurance policy and a proof of loss associated with a claim presented under that policy to make a reasonably definite and objective evaluation of the amount of the loss recoverable as a result of the claim.

7. **Limited risk of catastrophically large losses:** Insurable losses are ideally independent and non-catastrophic, meaning that the losses do not happen all at once and individual losses are not severe enough to bankrupt the insurer; insurers may prefer to limit their exposure to a loss from a single event to some small portion of their capital base. Capital constrains insurers’ ability to sell earthquake insurance as well as wind insurance in hurricane zones. In the U.S., flood risk is insured by the federal government. In commercial fire insurance it is possible to find single properties whose total exposed value is well in excess of any individual insurer’s capital constraint. Such properties are generally shared among several insurers, or are insured by a single insurer who syndicates the risk into the reinsurance market

**Legal requirement for insurance:** When a company insures an individual entity, there are basic legal requirements. Several commonly cited legal principles of insurance include:
1. **Indemnity** – the insurance company indemnifies, or compensates, the insured in the case of certain losses only up to the insured's interest.

2. **Insurable interest** – the insured typically must directly suffer from the loss. Insurable interest must exist whether property insurance or insurance on a person is involved. The concept requires that the insured have a "stake" in the loss or damage to the life or property insured. What that "stake" is will be determined by the kind of insurance involved and the nature of the property ownership or relationship between the persons.

3. **Utmost good faith** – the insured and the insurer are bound by a good faith bond of honesty and fairness. Material facts must be disclosed.

4. **Contribution** – insurers which have similar obligations to the insured contribute in the indemnification, according to some method.

5. **Subrogation** – the insurance company acquires legal rights to pursue recoveries on behalf of the insured; for example, the insurer may sue those liable for insured's loss.

6. **Causa proxima, or proximate cause** – the cause of loss (the peril) must be covered under the insuring agreement of the policy, and the dominant cause must not be excluded.

7. **Principle of loss minimization** - In case of any loss or casualty, the asset owner must attempt to keep the loss to a minimum, as if the asset was not insured.

### 2.16 INDEMNIFICATION

To "indemnify" means to make whole again, or to be reinstated to the position that one was in, to the extent possible, prior to the happening of a specified event or peril. Accordingly, life insurance is generally not considered to be indemnity insurance, but rather "contingent" insurance (i.e., a claim arises on the occurrence of a specified event). There are generally two types of insurance contracts that seek to indemnify an insured:

1. an "indemnity" policy, and
2. a "pay on behalf" or "on behalf of" policy.

The difference is significant on paper, but rarely material in practice. An "indemnity" policy will never pay claims until the insured has paid out of pocket to some third party; for example, a visitor to your home slips on a floor that you left wet and sues you for Rs 50,000 and wins. Under an "indemnity" policy the homeowner would have to come up with the Rs 50,000 to pay for the visitor's fall and then would be "indemnified" by the insurance carrier for the out of pocket costs Rs 50,000.
Under the same situation, a "pay on behalf" policy, the insurance carrier would pay the claim and the insured (the homeowner in the above example) would not be out of pocket for anything. Most modern liability insurance is written on the basis of "pay on behalf" language.

An entity seeking to transfer risk (an individual, corporation, or association of any type, etc.) becomes the 'insured' party once risk is assumed by an 'insurer', the insuring party, by means of a contract, called an insurance policy. Generally, an insurance contract includes, at a minimum, the following elements: identification of participating parties (the insurer, the insured, the beneficiaries), the premium, the period of coverage, the particular loss event covered, the amount of coverage (i.e., the amount to be paid to the insured or beneficiary in the event of a loss), and exclusions (events not covered). An insured is thus said to be "indemnified" against the loss covered in the policy.

When insured parties experience a loss for a specified peril, the coverage entitles the policyholder to make a claim against the insurer for the covered amount of loss as specified by the policy. The fee paid by the insured to the insurer for assuming the risk is called the premium. Insurance premiums from many of the insured are used to fund accounts reserved for later payment of claims — in theory for a relatively few claimants — and for overhead costs. So long as an insurer maintains adequate funds set aside for anticipated losses (called reserves), the remaining margin is an insurer's profit.

Effects

Insurance can have various effects on society through the way that it changes who bears the cost of losses and damage. On one hand it can increase fraud, on the other it can help societies and individuals prepare for catastrophes and mitigate the effects of catastrophes on both households and societies.

Insurance can influence the probability of losses through moral hazard, insurance fraud, and preventive steps by the insurance company. Insurance scholars have typically used moral hazard to refer to the increased loss due to unintentional carelessness and moral hazard to refer to increased risk due to intentional carelessness or indifference. Insurers attempt to address carelessness through inspections, policy provisions requiring certain types of maintenance, and possible discounts for loss mitigation efforts. While in theory insurers could encourage investment in loss reduction, some commentators have argued that in practice
insurers had historically not aggressively pursued loss control measures—particularly to prevent disaster losses such as hurricanes—because of concerns over rate reductions and legal battles. However, since about 1996 insurers began to take a more active role in loss mitigation, such as through building codes.

2.17 INSURERS’ BUSINESS MODEL: UNDERWRITING AND INVESTING

The business model is to collect more in premium and investment income than is paid out in losses, and to also offer a competitive price which consumers will accept. Profit can be reduced to a simple equation: Profit = earned premium + investment income - incurred loss - underwriting expenses.

Insurers make money in two ways:

1. Through underwriting, the process by which insurers select the risks to insure and decide how much in premiums to charge for accepting those risks;
2. By investing the premiums they collect from insured parties.

The most complicated aspect of the insurance business is the actuarial science of ratemaking (price-setting) of policies, which uses statistics and probability to approximate the rate of future claims based on a given risk. After producing rates, the insurer will use discretion to reject or accept risks through the underwriting process.

At the most basic level, initial ratemaking involves looking at the frequency and severity of insured perils and the expected average payout resulting from these perils. Thereafter an insurance company will collect historical loss data, bring the loss data to present value, and comparing these prior losses to the premium collected in order to assess rate adequacy.

Loss ratios and expense loads are also used. Rating for different risk characteristics involves at the most basic level comparing the losses with "loss relativities"—a policy with twice as much money policies would therefore be charged twice as much. However, more complex multivariate analyses through generalized linear modelling are sometimes used when multiple characteristics are involved and a univariate analysis could produce confounded results. Other statistical methods may be used in assessing the probability of future losses.

Upon termination of a given policy, the amount of premium collected and the investment gains thereon, minus the amount paid out in claims, is the insurer's underwriting profit on that policy. Underwriting performance is measured by something called the "combined ratio".
which is the ratio of expenses/losses to premiums. A combined ratio of less than 100 percent indicates an underwriting profit, while anything over 100 indicates an underwriting loss. A company with a combined ratio over 100% may nevertheless remain profitable due to investment earnings.

Insurance companies earn investment profits on "float". Float, or available reserve, is the amount of money on hand at any given moment that an insurer has collected in insurance premiums but has not paid out in claims. Insurers start investing insurance premiums as soon as they are collected and continue to earn interest or other income on them until claims are paid out.

Naturally, the float method is difficult to carry out in an economically depressed period. Bear markets do cause insurers to shift away from investments and to toughen up their underwriting standards, so a poor economy generally means high insurance premiums. This tendency to swing between profitable and unprofitable periods over time is commonly known as the underwriting, or insurance, cycle.

2.18 CLAIMS

Claims and loss handling is the materialized utility of insurance; it is the actual "product" paid for. Claims may be filed by insured’s directly with the insurer or through brokers or agents. The insurer may require that the claim be filed on its own proprietary forms, or may accept claims on a standard industry form, such as those produced by ACORD.

Insurance company claims departments employ a large number of claims adjusters supported by a staff of records management and data entry clerks. Incoming claims are classified based on severity and are assigned to adjusters whose settlement authority varies with their knowledge and experience. The adjuster undertakes an investigation of each claim, usually in close cooperation with the insured, determines if coverage is available under the terms of the insurance contract, and if so, the reasonable monetary value of the claim, and authorizes payment.

The policyholder may hire their own public adjuster to negotiate the settlement with the insurance company on their behalf. For policies that are complicated, where claims may be complex, the insured may take out a separate insurance policy add on, called loss recovery insurance, which covers the cost of a public adjuster in the case of a claim.
Adjusting liability insurance claims is particularly difficult because there is a third party involved, the plaintiff, who is under no contractual obligation to cooperate with the insurer and may in fact regard the insurer as a deep pocket. The adjuster must obtain legal counsel for the insured (either inside "house" counsel or outside "panel" counsel), monitor litigation that may take years to complete, and appear in person or over the telephone with settlement authority at a mandatory settlement conference when requested by the judge.

If a claims adjuster suspects under-insurance, the condition of average may come into play to limit the insurance company's exposure.

In managing the claims handling function, insurers seek to balance the elements of customer satisfaction, administrative handling expenses, and claims overpayment leakages. As part of this balancing act, fraudulent insurance practices are a major business risk that must be managed and overcome. Disputes between insurers and insured over the validity of claims or claims handling practices occasionally escalate into litigation.

Insurers will often use insurance agents to initially market or underwrite their customers. Agents can be captive, meaning they write only for one company, or independent, meaning that they can issue policies from several companies. Commissions to agents represent a significant portion of an insurance cost; therefore some insurers sell policies directly via mass marketing campaigns offering lower prices. The existence and success of companies using insurance agents (with higher prices) is likely due to improved and personalized service.

**Check Your Progress Exercise 4**

**Note:** i. Use this space given below to answer the question.

ii. Compare your answer with the one given at the end of this unit

1. What is insurance? Describe the process of insurance?

2. Describe the process of insurance?
2.19 SUMMING UP
In this Unit we learnt about the Banking and financial institutions. We also understood the
difference between credit and insurance and how Credit is the trust which allows one party to
provide resources to another party where that second party does not reimburse the first party
immediately, while Insurance is a risk management technique primarily used to hedge against
the risk of a contingent, uncertain loss that may be suffered by those individuals by
transferring the possibility of this loss from one interested person to another.

2.20 GLOSSARY

ATM: Automated Teller Machine. ATM is a machine that dispenses cash and sometimes
takes deposits without the need for a human bank teller.

Trade credit: The term trade credit is used to refer to the approval for delayed payments
for purchased goods.

2.21 ANSWERS TO CHECK YOUR PROGRESS EXERCISE

Check Your Progress Exercise 1

1. A bank is defined as an organization, usually a corporation, chartered by a state or federal
government, which does most or all of the following: receives demand deposits and time
deposits, honors instruments drawn on them, and pays interest on them; discounts notes,
makes loans, and invests in securities; collects cheques, drafts, and notes; certifies depositor’s
cheques and issues drafts and cashier's cheques.

2. Banks act as payment agents by conducting checking or current accounts for customers,
paying cheques drawn by customers on the bank, and collecting cheques deposited to
customers' current accounts. Banks also enable customer payments via other payment
methods such as telegraphic transfer, EFTPOS, and automated teller machine (ATM).
Banks borrow money by accepting funds deposited on current accounts, by accepting term deposits, and by issuing debt securities such as banknotes and bonds. Banks lend money by making advances to customers on current accounts, by making installment loans, and by investing in marketable debt securities and other forms of money lending.

3. Banks face a number of risks in order to conduct their business, and how well these risks are managed and understood is a key driver behind profitability, and how much capital a bank is required to hold. Some of the main risks faced by banks include:

- Credit risk: risk of loss arising from a borrower who does not make payments as promised.
- Liquidity risk: risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss (or make the required profit).
- Market risk: risk that the value of a portfolio, either an investment portfolio or a trading portfolio, will decrease due to the change in value of the market risk factors.
- Operational risk: risk arising from execution of a company's business functions.

Check Your Progress Exercise 2

1. The banking system of India is not only hassle free but it is able to meet new challenges posed by the technology and any other external and internal factors. During past three decades India's banking system has several outstanding achievements to its credit. The most striking is its extensive reach. It is no longer confined to only metropolitans or cosmopolitans in India. In fact, Indian banking system has reached even to the remote corners of the country. This is one of the main reason of India's growth process.

With years, banks are also adding services to their customers. The Indian banking industry is today passing through a phase of customers market. The customers have more choices in choosing their banks. With stiff competition and advancement of technology, the services provided by banks have become more easy and convenient. The government's regular policy for Indian bank since 1969 has paid rich dividends with the nationalization of 14 major private banks of India.
2. The first bank in India, though conservative, was established in 1786. From 1786 till today, the journey of Indian Banking System can be segregated into three distinct phases. They are as mentioned below:

- Early phase from 1786 to 1969 of Indian Banks
- Nationalization of Indian Banks and up to 1991 prior to Indian banking sector Reforms.
- New phase of Indian Banking System with the advent of Indian Financial & Banking Sector Reforms after 1991.

During the first phase the growth was very slow and banks also experienced periodic failures between 1913 and 1948. There were approximately 1100 banks, mostly small. During the second phase, the Government took major steps in this Indian Banking Sector Reform after Independence. In 1955, it nationalized the Imperial Bank of India, with extensive banking facilities, on a large scale especially in rural and semi-urban areas. It formed State Bank of India to act as the principal agent of RBI, and to handle banking transactions of the Union and State Governments all over the country. Seven subsidiary banks of State Bank of India were nationalized in 1960 on 19th July. In 1969, another major process of nationalization was carried out. 14 major commercial banks in the country were nationalized. The third phase is known as the phase of liberalization where the many more products and facilities in the banking sector reforms. In 1991, under the chairmanship of M Narasimham, a committee was set up in his name, which worked for the liberalization of banking practices.

3. Since 1991, we have seen a tremendous growth in the banking industry. The country is flooded with foreign banks and their ATM stations. Efforts are being made to give a satisfactory service to customers. Phone banking and net banking has been introduced. The entire system became more convenient and swift. With years, banks are also adding services to their customers. The Indian banking industry is passing through a phase of customers market. The customers have more choices in choosing their banks.

With stiff competition and advancement of technology, the services provided by banks have become more easy and convenient. Earlier, one had to wait an hour wait before withdrawing cash from one’s account, and a cheque from north of the country took one month to be cleared in the south. Now, this happens within a matter of minutes.
Check Your Progress Exercise 3

1. **Credit** is the trust which allows one party to provide resources to another party where that second party does not reimburse the first party immediately (thereby generating a debt), but instead arranges either to repay or return those resources (or other materials of equal value) at a later date. The resources provided may be financial (e.g. granting a loan), or they may consist of goods or services.

2. The term "trade credit" refers to the approval for delayed payments for purchased goods. Companies frequently offer credit to their customers as part of the terms of a purchase agreement.

Consumer credit can be defined as ‘money, goods or services provided to an individual in lieu of payment.’ Common forms of consumer credit include credit cards, store cards, motor (auto) finance, personal loans (installment loans), consumer lines of credit, retail loans (retail installment loans) and mortgages.

3. Though the term ‘affordable’ credit has never been officially defined and is often simply used to mean ‘less expensive’ than forms of high cost credit such as home credit or payday lending. Although these lenders may be providing credit at prices which reflect high operating costs and default risks, these may not be affordable even at low levels of credit use for some households once the costs of other essential outgoings are taken into account.

Therefore, attempts are being made to determine levels of disposable household income which are available for credit repayments after taking account of essential expenditure, and to determine how much credit lower to middle income households can realistically afford to take on.

Check Your Progress Exercise 4

1. **Insurance** is a risk management technique primarily used to hedge against the risk of a contingent, uncertain loss that may be suffered by those individuals by transferring the possibility of this loss from one interested person, persons, or entity to another. The scarce resources referred to here, fall into three divisions: human resources, financial resources, and capital, or tangible resources.
2. The process of insurance involves pooling funds from many insured entities (known as exposures) to pay for the losses that some may incur. The insured entities are therefore protected from risk for a fee, with the fee being dependent upon the frequency and severity of the event occurring. In order to be insurable, the risk insured against must meet certain characteristics in order to be an insurable risk. Insurance is a commercial enterprise and a major part of the financial services industry, but individual entities can also self-insure through saving money for possible future losses.

2.2 REFERENCES


2.23 QUESTIONS FOR REFLECTION AND PRACTICE

1. What is a bank and what are the economic functions of a bank?
2. How has liberalization changed the face of banking in India?
3. Why is affordable credit not being offered to all individuals?
4. How does the process of Insurance work? What is the connection between underwriting and investing in the insurance business model?