Chapter - 1

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1.1 MEANING OF FINANCIAL SYSTEM:

The financial system is much broader than a payments system in that way, it covers both cash and credit transaction but payment system concerned with payment in cash. The financial system is a set of institutional arrangements through which financial surpluses (or commands over real resources) in the economy are mobilised from surplus units and transferred to deficit spenders. The institutional arrangement includes all conditions and mechanisms governing the production, distribution, exchange and holding of financial assets or instruments of all kinds and the organisation as well as the manner of operation of financial markets and institutions of all descriptions. In concrete terms, financial assets, financial markets, and financial institutions are the three main constituents of any financial system.¹

Financial assets or claims are generally subdivided under the two heads of primary (or direct) securities and secondary (or indirect) securities. The former are financial claims against real sector units. The example are bills, bonds, equities, book debts, etc. They are created by real sector units as ultimate borrowers for raising funds to finance their deficit spending. The secondary securities are financial claims issued by financial institutions or intermediaries against themselves to raise funds from the public.

In the present day Indian economy important financial assets are currency, bank deposits (current, saving and fixed), post office savings deposits, life insurance policies, provident fund contributions, bonds (government and corporate), bills, hundies, corporate shares (ordinary and preference), units of the UTI, company deposits, nidhis, chit funds and similar other organization. The list is not meant to be exhaustive. Nor is any asset listed above homogeneous. Thus currency includes both coins and paper currency notes. Which are further of different denominations ordinary shares or bonds of no two corporations are identical, nor are any two insurance policies. The products of the financial industry are truly heterogeneous.
1.2 FUNCTIONS AND IMPORTANCE OF FINANCIAL SYSTEM:

The financial system helps productions, capital-accumulation and growth by (a) inducement savings (b) mobilising them and (c) allocating them among alternative uses and users. Each of these functions is important and the efficiency of a given financial system depends on how well it performs each of these functions.

(a) Inducement to save-

Savers require stores of value to hold their savings in. The financial system promotes savings by providing a wide array of financial assets as stores of value, aided by the services of financial markets and intermediaries of various kinds. For wealth holder, all this offer sample choice of portfolios with attractive combinations of income, safety and yield. With financial progress and innovations in financial technology, the scope of portfolio choice has also improved. Therefore, it is widely held that the savings-income ratio is positively elastic with respect to both financial assets and financial institutions. That is financial
progress generally induces larger savings out of the same level of real income.²

As stores of value, financial assets command certain advantages over tangible assets. They are convenient to hold or easily storable, more liquid, that is, more easily encashable, more easily divisible, and less risky. The Pecuniary yield from money is zero. But, as a generalized means of payment, it gives convenience yield to its holders and users. Non-money financial assets yield money returns to their holders. In addition, life insurance render other specific services as well. E.g. life insurance policies also provide cover against risk of loss of life cover the currency of the policy.

(b) Mobilisation of savings-

Finance assets separate the act of savings from the act of real investment. Savings are done by millions of individual households and firms. The may be in large or small amounts, long term of short term. All these individual savings need to be collected or mobilised before they can be spent by deficit

spenders. A financial system is a highly efficient mechanism for mobilising savings. In a fully-monetised economy this is done automatically when, in the first instant, the public holds its savings in the form of money. However, this is not the only way of instantaneous mobilisation of savings. Other finance methods used are deductions at source of the contributions to provident fund and other savings schemes. More generally, mobilisation of savings takes place when savers move into financial assets, whether currency, bank deposits, post office savings deposits, life insurance policies, bills, bonds, equity shares etc.

(c) Allocation of funds-

Another important function of a financial system is to arrange smooth, efficient, and socially equitable allocation of credit. Money-lenders and indigenous bankers have been providing finance to their borrowers since long. Modern financial development, new financial institutions, assets and markets have come to be organised, which are playing an increasingly important role in the provision of credit. Besides, there are banks, insurance companies and other financial institutions. They serve as financial intermediaries between the ultimate lender and the ultimate
borrower. They mobilise savings of the former by selling their own liabilities and make these funds available to deficit spenders at their own risk. So, many savers find the secondary securities of financial institutions much more acceptable than the primary securities of all sorts of borrowers.

The allocative role of financial institutions is very important. Only corporations can go to the stock market for raising funds through public issue of equity shares and bonds. Even there the support of financial institutions as buyers of securities is important. But non-corporate borrowers cannot issue marketable liabilities. Therefore, they depend on bank finance or private finance. In the market for funds there is generally credit rationing. This makes the availability of credit important to all potential borrowers. Financial institution determine how institutional finance will get allocated among various sectors of the economy and among competing borrowers.

Therefore finance and money about them can not contribute to the growth process. Thus, finance is the life blood of business. It is rightly termed as the science of money.
1.3 NEED OF FINANCIAL INTERMEDIARIES:

In a modern market economy, the financial units are not necessarily balanced budget units in the sense that their saving out of current income is equal to their planned investment. On the other hand, economic units can be categorized as surplus units and deficit units. While in the case of the former, desired or planned investment is less than their saving out of income, resulting in surplus saving available for investment by other economic units. The latter have plans of investment which involve an outlay greater than their savings, the deficit being made up by borrowing from surplus units in the economy. Therefore, surplus units may also be called, "Ultimate lenders", while the deficit units are referred to as "Ultimate borrowers".

An economic unit, whenever, has a surplus saving, i.e., saving in excess of desired investment, it has the option of liquidating a part or whole of its outstanding liabilities or it may add to the stock of its financial assets or do both. If the economic units chooses to accumulate financial assets, it has many options such as increase its money holdings, advance loans, buy securities of government or of the corporations or of the co-operative, buy
life insurance policies etc. This may be treated either as supplying loanable funds or looking at in another way, as demanding financial assets.

In a similar manner, when there are economic units whose planned investment exceeds their saving they have two options open for bridging the gap:

(i) Decreasing their stock of financial assets, e.g., by drawing down the money holdings or reducing of other financial assets; or

(ii) By borrowing from other economic units. Such borrowing by the deficit units may be viewed as supplying securities by deficit units to procure loanable funds, or, alternatively, as demanding loanable funds.

The difference between savings and planned investment of different economic units, thus, is the main source of credit and debt in an economy. This variation between planned saving and investment within economic units required transfer of excess saving of surplus units to the deficit units to their planned investment requirements. In an economy, this is normally done by credit or financial markets. The main role of financial markets is
to bring together the surplus and the deficit units in an economy. This is possible either through external financing or, indirectly, through the process of financial intermediation.

Whenever the surplus economic units or ultimate lenders directly acquire the primary securities issued by ultimate borrowers, such as central and state government securities, the process may be described as direct financing of ultimate borrowers by ultimate lenders. On the other hand, indirect financing is possible only when there exist in the economy, financial intermediaries which intermediate between the ultimate lenders and ultimate borrowers. The process of intermediation is performed by purchasing the primary securities of the deficit units (ultimate borrowers) and supplying indirect securities (issue of claims against themselves) to the surplus units (ultimate lenders). For example, Life Insurance Companies issue claims against themselves in the form of Life Insurance policies, which are purchased by the public with a part of their saving. The amount thus accumulated is employed by the Life Insurance Companies in acquiring Government securities or by granting loans on mortgage. Thus, financial intermediaries play an important role in
transferring saving from surplus units to deficit units and, in the process, channelise saving into investment.

There is no doubt that the rate of growth in an economy is not determined solely by the proposition of income saved and invested, it is also dependent upon the efficient allocation of the available saving resources among alternative investment opportunities. It is the function of the financial intermediaries to help in allocating funds to investment projects with highest expected rates to return.

Financial intermediaries increase the types of financial instruments available both to borrowers and lenders, and thus widen the asset choices available to both of them. In addition, they are expected to lower the transaction costs by reducing imperfections in the market for loanable funds. Further because of the scale of operations, they are able to attract and mobilize the small amounts of saving of a large number of economic units and makes these funds available at a lesser cost to borrowers who have planned large capital outlays. In this way, they improve the organization and structure of financial markets and helps in transformation of saving into investment which results in
acceleration of economic growth in a country. The increase in the financial intermediation is expected to lead to a higher rate of return to the ultimate lenders and a reduction in the cost of capital to the ultimate borrowers, i.e., the spread between the rates paid by financial institution to surplus economic units and the rates paid by the deficit units to financial institutions is narrowed by financial intermediation. The smaller the spread between the two, the greater is the "operational efficiency of financial intermediation."

To sum up, the growth and spread of financial intermediaries and the coming on the scene of new financial institutions lead to a reduction in the economic costs of financial intermediation.

1.4 TYPES OF FINANCIAL INTERMEDIARIES:

Financial intermediaries are a heterogeneous group of financial institutions other than commercial and co-operative banks. They include a wide variety of financial institutions, which raise funds from the public, directly or indirectly, to lend them to ultimate spenders. Three other all-India big term-lending institutions are the LIC, the GIC and its subsidiaries, and the UTI. Then, there are provident funds and post offices that mobilise
public savings in a big way for onward transmission to ultimate spenders. A large number of these institutions are public sector under takings. Besides them, there is a large number of small NBFI, such as investment companies, loan companies, hire purchase finance companies and the equipment leasing companies which are private sector companies, with only a few exceptions.

(i) **Life Insurance Corporation of India:**

In 1956, the life insurance business of all companies as mentioned was nationalised and a single monolithic organisation, the Life Insurance Corporation of India, was set up. Today, life insurance is almost entirely in the hands of the LIC. The post and telegraph department conducts same business in this area for its employees, but the volume of that business in relation to that of LIC, is negligible and declining.

The objectives of the LIC are (i) to spread life insurance and provide life insurance protection to the masses at reasonable cost; (ii) to mobilise people's savings through insurance-linked savings schemes; (iii) to invest the funds to serve the best interests of both the policy holders and the nation; (iv) to conduct business with maximum economy, always remembering that the money
belongs to the policy holders; (v) to act as trustees of the policy holders and protect their individual and collective interests; (vi) to innovate and adapt to meet the changing life insurance needs of the community, (vii) to involve all the people working in the corporation to ensure efficient and courteous service to the insured public.  

The LIC has diversified its activities considerably in the recent past by establishment (i) LIC Housing Finance Ltd. (LICHFL), (ii) LIC Mutual Fund (LIC MF) and (iii) Jeevan Bima Sahayog Asset Management Company Ltd.

(ii) General Insurance Corporation:

The general insurance business is also completely owned by the government, and it is controlled by a single organisation with four subsidiaries. Earlier, a number of Indian and many foreign companies did general insurance business in India and abroad. LIC and some mutual companies and co-operative societies also conducted general assurance. On the eve of nationalisation, 68 Indian insurers (including LIC) and 45 non-

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Indian insurers did business in this field. In November 1972, the business of these organisations was nationalised and vested in the hands of the General Insurance Company (GIC) and its four subsidiaries viz., National Insurance Co. Ltd., New India Assurance Co. Ltd., Oriental Fire and General Insurance Co. Ltd. and United India Insurance Co. Ltd. The GIC was given charge of the overall control, superintendence and policy making for smooth operation of general insurance business. At present the direct general insurance business is done mostly by the subsidiaries of the GIC. The premium income of the GIC itself is obtained mainly through the obligatory reinsurance premium on a quota share basis from subsidiaries on their direct business in India. Twenty percent of the business of subsidiaries is ceded to the GIC. GIC's direct business is only in the form of aviation insurance. The general insurance business is classified as marine, fire and miscellaneous. Fire insurance is a single major business, although its share in the total general insurance has been declining. Miscellaneous business has grown substantially while, marine insurance is relatively less important in India. The GIC was incorporated as a holding
company in 1992.\(^4\) The business of the GIC and its subsidiaries is transacted under the provisions of the insurance Act, 1938, and General Insurance Act 1972. The paid-up capital of the GIC is fully subscribed by the government, and that of its four subsidiaries, fully by the GIC.

The working of general insurance companies generally tends to get neglected in discussions of the financial sector in India; there has been an almost exclusive preoccupation with the working of the LIC. In view of the large amount of funds at the disposal of general insurance companies, more attention needs to be paid to the impact of their working on the financial system.

(iii) **Unit Trust of India and Mutual Funds:**

Mutual funds are a very important form of financial intermediaries for promoting as well as mobilising financial savings. They also act as important investment institutes, especially for the corporate sector. It is a historical accident that when the first mutual fund of this kind was set up in India in 1964, it was named as the Unit Trust of India. Mutual funds are fast

becoming an important medium for mobilizing savings of the community, particularly of the middle-class and small investors, as they provide benefits of portfolio management of stock market securities to their share holders. A mutual fund does it by minimising risk and raising its rate of return through portfolio diversification, having an appropriate mix of securities, watching expertly market developments all the time and turning over the portfolio to benefit to the maximum from the ever-changing market scene. Other things being the same, the gains to the shareholders of a mutual fund generally depend upon the quality of its portfolio selection and management.  

In the mutual funds industry in India, the UTI occupies top-most and dominating position Established in 1964, it is a 50 percent subsidiary of the IDBI (Formerly of the RBI). The rest of the share capital has been subscribed by the LIC, the SBI, other schedule commercial bank, the IFCI and the ICICI. The tax concessions accorded by the Government of India to the UTI and its unit holders for about first 25 years of its operations have

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played an important role, among other things, in popularising the UTI among the saver-investors and providing it a firm footing in the market.

(iv) Provident/Pension Funds:

The provident/pension funds represent the most important form of long-term contractual saving of the household sector. The annual contribution to them is currently running at double the rate of annual contribution to life insurance, another major form of long-term contractual saving.

The provident funds are practically a post-independence phenomenon. Under the law, provident funds have been made compulsory in the organized sector of industry, coal mining, plantations, and services (such as government, banking, insurance, teaching). Separate provident fund legislation exists for coal mining, industries, and Assam tea plantations, with the growth of the organized sector of the economy and in wage employment, savings mobilisation through provident funds will grow further. The wage employees are encouraged to join provident fund schemes and make contributions to them, because thereby alone they earn employer's matching contribution to the fund. The
provident fund collections are made through deduction at source. This makes for convenience, regularity, and certainty of collection. The provident funds are required to invest at least 30% of their accruals in government and other approved securities, with a minimum of 15% in central government securities. The balance is mostly held in fixed deposits with banks.

(v) Post Offices:

Post offices serve as the vehicle for mobilising small savings of the public for the government. Their large number and wide geographical distribution throughout the country held in this mobilisation at very low additional cost. Small savings are mobilised under different schemes of small savings launched by the central government. The small savings instruments broadly comprise 'deposits' and 'certificates'.

The rate of interest offered on some of the small savings instruments is higher than the rates on other comparable instruments like bank deposits, furthermore, investments in 'small savings' carry many fiscal incentives (tax concessions), which go to raise the effective rate of interest to investors falling in high income taxable categories. Attractive effective interest rates have
helped greatly the mobilisation of savings under the 'small savings' schemes.

1.5 LIFE INSURANCE COMPANIES AS FINANCIAL INTERMEDIARIES:

Life Insurance Companies are an important constituent of the financial market in an economy. They collect savings from a large body of individual policy-holder and they utilize fund according to their benefit. Life Insurance Companies operate as long-term investors in capital markets. That is why they provide the long-term capital needs of investors in an economy.

The essence of life insurance is to motivate a large section of the society to save by offering to them protection against risk of loss due to death, old age and disability. It is, in fact a long-term contract between an individual and a company to pay a certain sum to the beneficiary of the insured or insured himself, upon his death or his survival after a certain stipulated number of years. The insured, on the other hand, binds himself to pay certain sums at stated intervals as premium according to the terms and condition of the policy. The nature of insurance can, therefore, be said to be social.
People of the upper class are keen to save in securities or durable assets. The less privileged or the small investors are the main contributors to life insurance. The desire of this class of people is stimulated by making plans superior to other forms of savings. In the case of death, the full assured sum is made available by the insurance companies irrespective of whether the life policy attains its maturity, whereas in other savings deposits, the total accumulated savings alone will be made available. The later will be considerably less than the sum assured and will not serve the purpose of life policy. Life insurance forces and encourages thrift by making saving habit through its long-term plans and easy premium installments. As this amount is not as easily withdrawable as a saving deposit and the installments are small and convenient, the continuation of the plan after its initial adjustment period becomes readily acceptable to the policy-holder.

Life Insurance Companies mobilize the public savings and channelize them in productive investments for the economic development of the country. It is an important institution for the mobilization and investment of small savings. Life Insurance
Life Insurance Company in Calcutta in 1818 followed by Bombay Life Assurance Company in 1823.

The Indian Life Assurance Companies Act, 1912 was the first statutory measure to regulate life insurance business. Later in 1938 with a view to protecting the interest of insuring public earlier legislation was consolidated and amended by the Insurance Act, 1938 with comprehensive provisions detailed and effective control over the activities of insurers.

By 1956, 226 Indian insurers, provident insurance societies, and 16 non-Indian insurers were carrying on life insurance business in India. But since January 19, 1956 the life business came under the control and ownership of government. In June 1956, a bill was passed for establishing Life Insurance Corporation of India, which started functioning since September 1, 1956. The corporation is a body corporate having perpetual succession and a common seal with powers to acquire, hold and dispose of property and may by its name sue and be sued. There will be not more than 15 members including a chairman thereof. The corporation is charged with the main duty to carry on life
insurance business. It has one central office in Mumbai 7 Zonal Offices and 101 Divisional and 2048 Branch Offices.6

The growth of life insurance business has been analyzed under new business inclusive of group insurance business, new business individual insurance excluding annuities, growth in sum assured and number of policies, average amount per policy, rural new business, annuities, business in force, lapses, number of offices, productivity of assets and process of new insurance plans.

The following table gives the detailed account regarding the growth of new business of life insurance in India and abroad:-

**Investments as at 31st March, 2005**

<table>
<thead>
<tr>
<th>No.</th>
<th>Investment in India</th>
<th>Rs. in Crores</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i)</td>
<td>Loan</td>
<td>54238.82</td>
</tr>
<tr>
<td>(ii)</td>
<td>Stock Exchange Securities</td>
<td>355635.70</td>
</tr>
<tr>
<td>(iii)</td>
<td>Special Deposits with Central Govt.</td>
<td>00.00</td>
</tr>
<tr>
<td>(iv)</td>
<td>Other investments</td>
<td>2982.64</td>
</tr>
<tr>
<td></td>
<td>Total (in India)</td>
<td>412857.16</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Investment out of India</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) Loan</td>
</tr>
<tr>
<td>(ii) Stock Exchange Securities</td>
</tr>
<tr>
<td>(iii) House property</td>
</tr>
<tr>
<td>(iv) Other investments</td>
</tr>
<tr>
<td><strong>Total (out of India)</strong></td>
</tr>
<tr>
<td><strong>Grand total (in India &amp; out of India)</strong></td>
</tr>
</tbody>
</table>

Source:- Annual Report of LIC.

It is on account of these characteristics that it is one of the ideal savings institutions especially in a developing country later India. Therefore, it can be said that life insurance corporation is a complete service by it self. It combines savings with protection of life and is in itself an investment institution.

1.7 OBJECTIVES OF THE STUDY:

The main objectives of the proposed study is to examine, study and analyse the functioning of LIC with special emphasis on its nature of investment and pattern, however the sub-objectives of the study are as following-

(i) To examine and analyse the horizontal and vertical spread of life insurance coverage in India.
(ii) To analyse the trends and patterns of the investment of LIC before and after the insurance sector reform period.

(iii) To examine the impact of opening of the insurance sector on the LIC of India.

(iv) To study and analyse the portfolio structure of the LIC of India and nature of the investment policy.

1.8 WORKING HYPOTHESIS:

(i) LIC invests its funds mainly in public sector enterprises and government securities but its term loans to the private sector are also increasing over the time, with till in favour of priority sector.

(ii) Lowering of interest regime has increased the selling of insurance policies in members and amounts.

(iii) With privatization of insurance sectors LIC has remained unaffected largely with respect to its number of policy holders and growth rate of its insurance premium.

1.9 METHODOLOGY AND DATA SOURCE:

A suitable approach will be developed for the present study in the context of the theoretical framework of investigations,
in terms of the objectives of the study to be expressed in the form of testable hypotheses.

The proposed study will be based mainly on the data to be collected from various secondary sources including various government publications such as Annual Reports of LIC, Regional Office of LIC, Journal of Business and Finance in India, Indian Economic Reviews, Indian Economic Journal, Business Times and Financial Times, Economic Times etc.

The data and information obtained thus shall be classified, tabulated and analysed by using appropriate statistical methods and techniques and in the last inferences shall be drawn.