Chapter - 1

INTRODUCTION

Building a sound financial system is an immense necessity for the economic development of a country. The main task of the financial system is to mobilize funds from the surplus budget unit to deficit budget unit. Financial system provides a strong mechanism for collection and allocation of financial resources among the various alternatives. However, in a developing country like India it is very hard to reach in a sound financial system due to the lack of requisite institutions, expertise and resources. Many legal and regulatory frameworks are needed to ensure discipline in the financial system. For these reasons, careful assessment of the financial system is necessary to determine about, which features of the financial system are basic and which features are secondary, and the types of institutions that are essential in the process.

Actually, financial system is decomposed of into two basic types of institutions. One is the banking financial institutions (BFIs) and the other is the non-banking financial institutions (NBFIs). These two financial institutions are different in respect of their activities and treatment of the assets and liabilities in the financial market. For a well functioning financial market along with the BFIs, NBFIs have an important role to uplift the
economic activity. These two financial sectors can simultaneously build up and strengthen the financial system of the country.

The necessity for the development of NBFIs could be best judged with the following issues. Firstly, the NBFIs are marked different from the banking institutions and with different phenomena. These two kinds of financial institutions are complementary rather than substitute organs in the financial system. Existence of banking and non banking financial institutions, money market and capital market keep the financial sector complete and enhance the overall growth of the economy. Secondly, there is a maturity mismatch in the sources and uses of funds in our financial system, which leads inefficiency in the financial system. Commercial banks by their definition are unsuited for long term lending. Inefficiency of BFIs in long-term loan management has already leaded an enormous volume of outstanding loan in our economy. However, with the present status, expertise and efficiency, the NCBs are barely able to serve the future investment demand of the country. Private commercial banks are less experienced and less equipped in this regard and they would not take the load or be able to take future challenges of term lending of the country. At this backdrop, in order to ensure flow of term loans and to meet the credit gap, development of NBFIs is a compelling necessity for the economy. Thirdly, sophisticated and well-developed capital market is considered as the hallmark for a market economy worldwide. Although our country is moving
toward a full market based economy, capital markets are still in infancy. This is due to lack of requisite institutions those are needed in the system. In the last twenty years there has been a tremendous growth worldwide of non-bank financial institutions to provide support services to the capital market. These range from broker dealer to investment banker. The health of the capital market is largely relied upon the health of the banking and non-banking financial institutions. The key players are the non-bank financial institutions in the development of the capital market.

Although NBFIs have immense necessity and greater importance in the financial system of India they are severly suffering from some problems including the fund problem in terms of both availability and cost. Initiatives from all concerns are necessary to eradicate the fund constraints to ensure easy flow of fund. The existing regulatory and legal framework for NBFIs is not adequate in a greater extent as compared to BFIs. In some cases the types of regulation for the NBFIs are analogous with the BFIs that create some problems. It should be framed separately for NBFIs in terms of deposit and non-deposit takers and on the basis of their activities. Again, judicial and legal reforms are also necessary to build up such organizations. However, RBI has taken several initiatives in recent years to improve the suitability of the regulatory framework.

Another important feature is that deposit mobilization and credit participation by NBFIs are not taken into account while formulating the
monetary and credit policy of the country. The term deposits mobilized by the NBFI are not yet included in the money supply of the country which have eventually impact on the monetary policy.

On the other hand, NBFI are being confined with short-term finance because of the fear that the loan will be bad. In this situation, some unsolved questions arise in this area, which include how much the economy should rely on bank versus non-bank financing ?.

In a conference on “building sound Finance in Emerging Market Economies” held at IMF headquarter in Washington D.C on June 10-11, 1993, a group of participants viewed that bank lending would be unprofitable and misguided in the transitional (Caprio et.al. 1994) period because of the risk of the environment and absence of skilled manpower. They also argued that development of the capital market would get preference if privatization were thought as the key part of the economic development. The participants also added fuel to the debate by proposing a technologically sophisticated and expensive payment network to facilitate the non-bank finance.

However, anyone can envisage the need of both bank and non-bank financial institutions for economic development. Banks are the principal sources of working capital and provide highly liquid investment in which firms’ can stone receipts. On the other hand, NBF sector is necessary to increase the mobilization of term savings and enhance availability of equity
and term finance for the private sector as well as support services for the capital market. Bank funds provide liquidity, which ultimately facilitate trade in commodities and in financial assets. Moreover banks act as the lender of the first resort of other financial institutions, which ensures its importance in the financial system.

In recent years, the dominance of banks as financial intermediaries in some developed countries has been reduced somewhat with the emergence of the non bank financial intermediaries and with the development of the corporate debt market that gives firms direct access to individual savings. Development of the government securities promotes the development of the money market. Secondary market for equity maximizes the wealth of the capitalist system and individuals demand for liquidity satisfied. Given this situation the matter is that with the banks, how far the non banks could simultaneously build up to bring the efficiency of the financial system.

The history of the economic development of different countries of the world suggests that financial development of the country start from banking financial institutions followed by the non banking financial institutions. But in the later stage, the contribution of non-banking financial institutions becomes more eminent than the BFIs. Actually both types of institutions are needed and competitions within and between banks and non-banks could enhance economic development and improve their expertise.
The Phenomenon of Long Term Financing and the Analysis of NBFIs performance in Term Financing

One important arena of NBFIs is the deployment of funds in the long term financing. By definition, banking financial institutions should not involve in the long term financing and they are the institutions related to the money market instruments and allowed to make only fully collateral short term lending. Bank business is based on the depositors’ money. Lending long is risky because it creates least accountability to the borrowers. Borrowing short and lending long by the BFIs create a mismatch in the financial system and hamper the macroeconomic stability. Time lag between lending and borrowing of the commercial banks has leaded a maturity mismatch as there is about 10 months average maturity gap between the deposit fund and loan portfolio (BB, FID). Again the interest rate charged by banks does not cover the total cost of funds. Before 1990, there was direct monetary control and the central bank administered the interest rate for both deposit and credit. After that although interest rates were not controlled by the central bank, commercial banks did not have such professionally-expert personnel to assess the lending risk. Banking sector in Bangladesh felt a lack of basic expertise, which was needed for the market-oriented approaches. In the same way performance of the two public Development Financial Institutions (DFIs) namely BSB and BSRS are very unsatisfactory as their non-performing loan is over 50% for the last several years. These issue
demanded for a sustainable basis for long term financing which is a major part of the NBFIs business by nature.

**Development of the Capital Market and the NBFIs**

The essence of market based financial system is the well-organized and efficient capital market. The stock market is the first and foremost forum in which individuals can trade risk and return, firms can raise capital and stockholders can maximize the value of their shares. At present, the worldwide capital market provides an excellent mechanism for mobilizing savings for industrialization. Through the efficient pricing of the shares in the market, the wealth of the company is maximized and individuals get prize for their sacrifice of present consumption. On the other hand, primary market gives the opportunity to the firms to generate capital from the public and also provides individuals participation in the firms’ ownership. The development of the secondary market for equity does not contradict with the development of the banking sector. In many countries of the world especially the countries of the continental Europe and Japan have started their reforms based on bank-dominated system first. So a full reform program of financial sector includes the development of both bank and non-bank financial institutions in the financial system so that the overall savings and investment activities improve significantly on bank financial are permitted to work as merchant banker. In this situation, they have to take a separate license from the Securities and Exchange Commissions (SEC).
Merchant banking activities involves activities like a manager of the issue, underwriter, bridge financer and portfolio manager etc. NBFIs can venture in such types of risky business because of their particular types of sources of hand, bank’s money is the depositors money and so that they go for less risky short term financing. For this reason banks are subject to high regulations and NBFIs are little or no regulations around the world and thereby can go easily for risky investment such as merchant banking, venture capital etc.. NBFIs are not permitted to use ‘bank’ in their names and use companies. Their funding is not covered by the government protection. These distinct natures make the NBFIs separate from the BFIs and place a separate arena in the financial market place.

However, one may argue for the commercial banks involvement in the capital market as it follows the universal banking system, such as that of many continental European countries, Germany in particular. In the universal banking system, banks provide both commercial and investment banking services. The principal arguments are to lend from the equity and to provide economics of scale to the banking companies. But according to the some economists, the model might be practically inappropriate. Kundleberger, Blommestein Spencer, Sleelihere, Huvencr and Muldare are few of them. The weaknesses identified by them are first, it gives significant equity stake to the commercial bank and reach a certain proportion without approval from the central bank. Secondly, commercial banks feel lack of
expertise and experience to assess the potential risk and return of the investment in the market. Commercial banking activities are less risky than the security operation and risky security business may affect the commercial banking activities. Again Muldure (1992) got no evidence of economies of scale in the universal banking (Caprio et al. 1994).

So, capital market development needs the simultaneous development of associate institutions like NBFIs. NBFIs captures the second position in the world capital market in volume in the early 90s. NBFIs activities in this market involves investment and merchant banking, including the portfolio management, issue managing, underwriting and bridge financing, consultancy or advisory services, selling of financial data, corporate agents in merger and acquisition, investment counseling etc. NBFIs are required to take a separate licence from the SEC to do the activities related to the capital market. In our country, 7 NBFIs have got license from the SEC to do business. Among them, SABINCO is the largest portfolio investor and PFIL holds 46 investors accounts, the highest among all the merchant bankers working in the market. The NBFIs those are working as merchant banks, are also working as issue manager or underwriter of the issue. A careful analysis of the activities of 27 merchant bankers reveals that NBFIs are now in the leading position among the merchant banks (Roy, 2001).

There are a number of empirical studies of life-insurance demand that are related to this paper. Bernheim (1991) uses estimates of the demand for
life insurance to assess the strength of bequest motives. In particular, he finds that a significant fraction of total saving is motivated by the desire to leave bequests. Browne and Kim (1993) present evidence on life insurance demand across 45 countries. They find that the main determinants of cross-country variations in the demand for life insurance are the dependency ratio (i.e., the number of dependents per potential life insurance consumer), national income, government spending on social security, inflation, and the price of insurance. Finally, Brushbach and Lang (1998) analyze the rates of life insurance contracts generated by the German tax system. They conclude that the tax incentives afforded life insurance savings in Germany do not significantly increase savings. However, while their study carefully quantifies the tax advantage of life insurance saving, it assumes that the cross-sectional data are also capturing lifetime tax advantages and are thus closely related to the observable life insurance demand. That assumption could overstate the actual differences in tax advantages because income varies over the life cycle.

A Life-cycle model with whole life insurance

The model

A number of papers in the economics literature model the demand for term life insurance. Term insurance pays a benefit if the insured dies before a certain date. The first model for term life insurance in a continuous time setting is Yaari (1965). Fischer (1973) develops a life-cycle model of term life insurance demand
in discrete time and discusses the allocation of insurance purchases over the life cycle. Less common is the modeling of whole life insurance. In that case, the insurance company covers death for the whole life of the insured and thus faces a liability for sure at some point. Whole life insurance requires the build-up of insurance reserves because the insured typically pays premiums only during working life but may die at a later date. The premiums must therefore also finance the accumulation contracts enable the insured to take out those reserves (the cash value or surrender value) some time before death, and therefore resemble some combination of term life insurance with a savings plan.

Following the standard approach, this paper derives life insurance demand in a model with a “joy-of-giving” bequest motive (one exception is Lewis, 1989). The model has three periods and three types of assets, life insurance, bonds, and public pensions. Life insurance is modeled as a combination of term life insurance and savings plan, and the specification incorporates the salient features of the German tax and pension system.

GROWTH, IMPORTANCE AND FUNCTIONS OF L.I.C.

Insurance is essentially a co-operative endeavor. It is the function of insurance in its various forms to protect the few against the heavy financial impact of anticipated misfortunes. While it is not possible to predict which individuals amongst the many participants are likely to be the victims of misfortune, it is often possible forecast the quantum of the loss which the group as a whole may suffer. The sharing of the resultant expected loss
among all the participants ensure that the victims are compensated for the loss suffered by them. As a consequence the heavy and uncertain loss to some in neutralized by the definite contribution of moderate amounts which every participants is required to make.

The sense of insecurity faced by every member in the community is removed by the joint contributions. To neutralize the effect of possible losses, the people who are exposed to the possibility of the loss, have to pay definite contribution as the price of security. In many situations this possibility of a loss is small such contributions or ‘premiums’ for insurance cover relatively small compared to the losses incurred by the few.

The sharing of the risk as far as it relates to life insurance in our country is now arranged by the life Insurance corporation of India (L.I.C). The corporation which was set up by the L.I.C Act, 1956, is required to perform its functions in such a manner as to secure that life insurance business is developed to the best advantage of the community.

The determination of the “premium” or “price” for insurance cover involves statistical analysis and classification of risk and their measurement. Every member, who wants to have the benefit of insurance, it enters into a contract with the insurer. The members who obtain life insurance protection or agreeing to pay premiums are referred to as the policy holders: the insurer make administrative and financial arrangements for giving effect to the contract.
1. FUNCTIONS OF INSURANCE

Insurance provides certainty of payment at the uncertainty of loss. Better planning and administration can reduce the uncertainty of loss. But the insurance relieved the persons from difficult task. Insurance removes all the uncertainty and the assured is given certainty of compensation for loss.

2. INSURANCE PROVIDES PROTECTION

The main function of the insurance is to provide protection against the probable chances of loss. The time amounts of loss are uncertain and at the happening of risk the person will suffer loss in absence of insurance. The insurance guarantees the payment of compensation and thus protects the assured from sufferings.

3. THE RISK SHARING

The risk is uncertain and therefore the loss from the risk in also uncertain. So all the persons share the loss.

The risk-sharing is ancient time was done only at time of damage or death, but today on the basis of probability of risk and share is obtained from each and every insured in the shape of premium without which protection is not guaranteed by the issuer.

4. PREVENTION OF LOSS

Preventing the losses of the society because the reduction in loss causes lesser payment.
5. IT PROVIDES CAPITAL

The insurance eliminates worries and miseries of losses of damage destruction of property. The carefree person can devote his today and soul together for better achievements. It improves not only his efficiency. But the efficiencies of the masses are also advanced.

6. IT HELPS ECONOMIC PROGRESS

The insurance by protecting the society from huge losses of damage destruction reduces wastage of resources and help economic progress.

IMPORTANCE OF INSURANCE

The insurance comes to be more and more useful. The process of insurance has been evolved to safeguard the interests of people from uncertainty by providing certainty of payment at a given contingency. The importance of insurance here has been discussed in three phases.

1. Uses to individuals

2. Uses to business

3. Uses to the society

1. USES TO AN INDIVIDUAL

The insurance provide safety and security and against the loss on particular event. In case of life insurance payment is made when death occurs or the term of insurance is expired security against premature death
and old age sufferings are provided by life insurance. The insurance provide safety against the loss at a fire, against the loss at damage, destruction or disappearance of property, goods, furniture and machines.

2. INSURANCE AFFORDS PEACE OF MIND

The security wish is the prime motivating factor. This the wish which tends to stimulate to more work if this wish is unsatisfied it will create a tension which manifest itself to the individual in the form of an unpleasant reaction in work. The security banishes fear an uncertainty, fire windstorm, automobile, accident, damage, and death.

3. INSURANCE PROTECTS MORTGAGED

The insurance will provide adequate amount to the dependents at the early death of the property owner to pay of the unpaid loans. The mortgage gets adequate amount at to destruction of the property.

4. INSURANCE ELIMINATES DEPENDENCE

At the death of the husband or father the condition of family would suffer a lot. It brings similar at destruction of property and goods, the family would suffer a lot. It brings reduced standards of living and the suffering may go to my extent of begging form the relatives, neighbors of friends. The insurance is here to assist them and provide adequate amount at the time of suffering.
5. LIFE INSURANCE ENCOURAGES SERVICES

The elements of protection and investment are present only in case of life insurance. The property insurance only protection element in most of life policy elements of saving predominates. These policies combine the process of insurance and saving.

**Life Insurance Provides Profitable Investment**

Individual unwilling or unable to handle their own funds have been pleased to find an outlet for their investment in life insurance policies, endowment policies, multi propose policies, deferred annuities and certainly better from of investment. Life Insurance fulfills the needs of a person. The needs of a person are divided in (a) family needs (b) old age needs (c) readjustment needs (d) special needs (e) need for education (f) clean – up – funds.

**Family Needs**

Death is certain but the time is uncertain so there is uncertainly of the time when the sufferings and financial stringency may be fall on the family. Whole life policies are the better means of meeting such financial requirements.

**Old Age Needs**

The provision for old is required where the person is surviving more than his earning period. The reduction of income in old age is serious to the
person and his family. The life insurance provides old age funds along with the protection of the family by issuing various policies.

**Re – Adjustment Needs**

At the time of reduction in income whether by loss of un employment, disability or death adjustment in the standard of living of family is required. The family members will have to be satisfied with meager income and may have to settle down to lower income and social obligation. The life insurance helps to accumulate adequate funds endowment policy anticipated endowment policy and guarantied triple benefit policies are deemed to be a good substitute for old age needs policies are deemed to be a good substitute for old age needs.

**Social Needs**

If the members become disable to earn the income due to old age or death, those needs may unfill and the family will suffer.

**Need For Education**

Need for education, marriage, and insurance needs for settlement of children.

**Clean-Up-Funds**

After death, ritual ceremonies, payment of wealth taxes and income taxes are certain requirements, which decrease the amount of funds of the family members insurance come to help for meeting these requirements.
Multi purpose policy, education and marriage policies, capital redemption policies are the better policies for the special needs.

USES TO BUSINESS

**Un certainty of business losses is reduced**

In business, commerce, and industry a huge number of properties are employed with a slight slackness or negligence the property may be turned fatal not only to the individual or property. But to the third party also. New construction and new establishment. Are possible only with the help of business. So purchasing policy reduces the uncertainty of business losses.

**Business Efficiency Is Incurred With Insurance**

The carefree owner can work better for the maximization of the profit free from the botheration of losses. The new as well as old businessmen are guaranteed payment of certain amount with the insurance policies at the death of person. At the damage, destruction of disappearance of the property or goods. The uncertainly of loss may affect the mind of the business adversely. The insurance removing the uncertainty stimulates the businessmen to work hard.

**Key Man Indemnification**

Key man is that particular man whose capital, expertise experience energy, ability to control good-will and dutifulness make him the most valuable asset in the business and whose absence will reduce the
income of the employer tremendously and upto that time when such employee is not sub situated the death or disability such valuable lives will in many instance prove more serious loss than that by fire or any hazard. The potential loss to be suffered and the compensation to the dependents such employees require an adequate provision, which is met by purchasing adequate life policies. The term insurance policy is more suitable in this case.

**Enhancement of Credit**

The business can obtain loan by pledging the policy as collateral for loan. The amount of loan that can be obtained with such pledging of policy with interest there on will not exceed the cash value of the policy. In case of death this cash value can be utilized for setting of the loan with the interest. If the borrower in unwilling to repay the loan and interest, the lender can surrender there on repaid. The insurance properties are the lenders grant the best collateral adequate loans.

**Business Communication**

In any business particularly partnership business may close at the death of any partner although the surviving partners can restart the business. But in both the cases, the business the partners will suffer economically. The insurance policies provide adequate fund at the time death with the help of property insurance, the property of the business is protected against disasters
and the chance of disclosure of the business do to the tremendous waste or loss.

**Welfare of Employees**

The welfare or employees is the responsibility of the employer the employees are working for the employed. Therefore the employee has to look after welfare of the employee which can be provision for early death, provision for disability and provision for old age these requirement are easily met by the life insurance accident and sickness benefit and pension which are generally provided by group insurance. The employer generally pays the premium for group insurance.

**Uses to society**

**The wealth of the society is projects**

The loss of particular wealth can be protected with the insurance provided for compensation for loss of human wealth. The human material, if it is strong educated and carefree will generate more income. The loss of damage of property fire, and accident, can be well indemnified by the property insurance.

With the advancement of the society, the wealth or the property of the society attracts more hazardous, so new types of insurance are also invented to protect them against the possible losses. The happiness and propriety are observed everywhere with the help of insurance.
Economic Growth of the Country

For the economic growth of the country insurance provided strong hand and mind protection against loss of property and adequate capital to produce more wealth. In business to the property and human material and protected against certain losses. Capital and credit are expended with the help of insurance. Thus the insurance all the requirements of the economic growth of a country.

Reduction In Inflation

The insurance reduces the inflationary pressure in two ways first by extracting money in supply to the amount or premium collected and secondly by providing sufficient funds for production narrows down the inflationary gap. The two main cause of inflation namely increased money in supply and decreased production are property controlled by insurance business.

KINDS OF POLICIES

Whole Life Policy

In a whole life insurance policy the specified sum becomes payable to the beneficiary only on the death of the assured. The rate of premiums has to be paid on this policy throughout the life of the assured. This type of insurance is the most suitable for family protection after the death of the earning member.
**Paid Up Policy**

If the policyholder is unable to pay further premiums, in lieu of surrendering a policy, he has the option of taking and paid-up policy. The effect of taking a paid-up policy is that no further premiums are payable. But the sum assured is reduced while other conditions remain as usual. The reduced sum is capsulated in such a way that it bears to the original sum assured the same ratio as the total number of premiums stipulated for the original policy. It becomes available when the original assured sum would have become payable. A paid up policy is allowed only after the policy has been in force for at least 2 or 3 years.

**ENDOWMENT LIFE POLICY**

This policy provided for the payment of a stated sum of money either on the attainment of a specified age or at death which ever occurs earlier. The premium has to be paid till the date of maturity. That is the time when the policy becomes payable. The rate of premium is generally higher than in whole life policy. The important advantages is that it combines savings for old age with that of protection for the assures person’s family in the event of his premature death.

**Joint Life Policy**

A policy may be effected upon the joint lives of 2 persons e.g husband and wife or 2 partners of a form in this case the assured sun
becomes payable after the expire of a certain period or on the death of any of the person's assured.

**Children's Deferred Insurance**

This policy is taken by the parents on the lives of their children with a view to provide funds for meeting the expenses of their education or marriage or for giving a start in life when they come of age.

**Double Accident Indemnity Policy**

According to this policy, if the insured dies because of an accident, this ill make his representative to get double the amount of the policy.

**Group Insurance Policy**

This policy is taken on the lives of the members of a family or by an employer to cover the lives of the employee of his concern.

**Annuity Policy**

In annuity policy the amount of the policy is paid up way of annuities for a specified number of years or till the death of the assured.

**Sinking Fund Policy**

Sinking Fund policy may be taken with a view to providing for the payment of liability or replacement of an asset.

**Partnership Assurance**

In case of partnership, if any partner dies the firm is dissolved and remaining partners who desire to continue the same business will have to pay the decreased partners capital to his heirs. To pay such a large amount at
once, the partners find it difficult and in order to provide for his contingency they may take out a suitable life assurance. This is referred to as partnership assurance. This is referred to as partnership assurance.

**Term Assurance**

In term assurance, the amount is made payable only when a person dies before ascertain date or age. In this policy generally the premium is low at the outset, but rises gradually with the passage of years. Sometimes in the terms of his policy a provision may be for its conversion into ‘whole life’ or Endowment policy’. It may then be called “commutable Term Assurance Policy”.

**Janata Policy Scheme**

Under this scheme only endowment policies are issued for terms of 10, 15 or 25 years. Provided that the policy should not mature beyond or after 60 years of age. It can be issued only the age of 45 years for a person and the maximum amount of the policy can be Rs. 1,000 on one’s life.

**With Profit an Without Profit Policies**

Insurance policies may also be divide into with profit and without profit policies. In the case of with-profit policy; the assured gets not only the sum assured but also share in the profits that are declared at intervals and credited to the policy holders as bonus. In the case of the without profit or nonprofit policy, the policyholders does not get any right to share in the
Comparison of Life Insurance With Other Forms Of Insurance

While the concept of insurance is of spreading the loss over many, the basic principles of insurable interest and utmost good faith apply equally to all classes of insurance, Life insurance differs from other forms of insurance in following way.

Risk is Certain Under Life Insurance

Each Person Has To Die Sooner Or Later. Risk of death is certain under the Life insurance. However under non-life insurance risk is not certain. Therefore, the mathematical value of risk under life insurance can be found out with more degree of accuracy.

Life Insurance is a Long Term Contract

Since life insurance contracts are long-term contracts service to the policyholders assures great importance. Investment of funds and interest yield are also, therefore, vital.

Difficulty in Determining Value of Human Life

It is not difficult to determine value of the subject matters of insurances, under non-life insurance like properties, machines etc., but is difficult to determine the value of human life, which is subject matter of insurance under life insurance contracts.