Personal Financial Planning

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Chapter I

Financial Planning Process

After reading this chapter, you will be conversant with:

- Utilities of Personal Financial Planning Techniques
- The Personal Financial Planning Process
- The Financial Planning Environment
- Various Determinants of Personal Income

Introduction

Rohan, a software engineer, has two kids and a dependent wife. Rohan is thinking of securing his children's future. What should he do?

Riya, has just joined a marketing firm. She has to repay her education loan and support her family. How can she make it possible with her meager salary?

Siddharth received ten lakh rupees from his mother's estate, on his twenty sixth birthday. He has no idea what he should do with this money.

All these people are facing a common problem. They have uncertainty in their future financial plans.

That personal financial planning is a niche area meant for the affluent class and is not for the needy is a general feeling among people. Financial planning does not require heavy bank balances or real estate property. Whether one has enough money or very less, personal financial planning comes handy for everyone.

Personal financial planning refers to the proper planning and implementation of well-coordinated plans to achieve financial objectives. If a person has huge cash reserves, he can plan to invest and spend it wisely. Similarly, even for a person who has low or inadequate income, financial planning is the need of the day. Financial planning can help such a person to deploy the scarce available resources in a wise manner. In other words, whether the person is rich or poor, depending on his future goals, savings and investments become essential. The savings and investments made today have to match the future goals. To make sure that this happens, proper projection of the future needs and the evaluation of the future courses of actions becomes necessary.

Thus, Personal Financial Planning can be defined "*as taking conscientious and systematic steps towards fulfilling one's financial goals*".

REWARDS OF FINANCIAL PLANNING

Financial planning is an ongoing process for an individual. A person may start it at an early age and carry it forward through his life with changes to suit his changing goals and needs. Financial planning provides the following rewards in the long-term for an individual.

Improved Standard of Living

Financial planning helps in managing one's resources and controlling undue expenses. Standard of living represents the quality of life a person enjoys through various comforts, luxuries and necessities. A person can maintain his/her standard of living or even improve it by planning efficiently his/her income and expenses and then provide for investment to meet future contingencies.

In the recent past, the income of certain sections of the society has been increasing steadily, with most families having two incomes. This has resulted in the increase in the spending on various items of current consumption, and also the aspirations for future requirements. As the income increases, the need for planning also increases, so that it is not managed in an unwise manner.

Spending Money Wisely

An individual always has two options with him/her with respect to his/her hard earned money – spend it or save it for the future. Sometimes, it is important for an individual to forgo his/her current needs to save for the future. Thus, if money needs to be spent, it should be spent wisely. Put differently, one should think of what manner of spending – or what types of spending in what combination – give one the most satisfaction for each rupee spent.

CURRENT NEEDS

The current needs of a person are dependent on the level of expenses on the basic necessities of life such as food, clothing, shelter, etc., and his/her propensity to consume. Everybody spends money on these basic necessities of life, but the quantity and quality differs from person to person. People can easily get influenced by various attractive schemes for buying expensive consumer durables, clothes, large houses, etc., irrespective of their current income. Financial planning thus helps in making a person realize that he/she has to strike a balance between his/her current expenses and future requirements.

The average inclination of an individual to spend a rupee of income on the current needs than to save for future needs is referred to as the 'average propensity to consume'. People with higher inclination to consume are said to have a higher average propensity to consume. Some people tend to spend almost equally on all the current needs, while some others over spend on some needs and are extra cautious about the others. As the income of the person increases, the propensity to consume decreases. The proportion spent on current needs as a proportion to the total income falls. It is not uncommon to find some people with a lower income range spending more on current needs, even in absolute terms, compared to another class of persons in a higher income range. This is dependent purely on the individual attitudes of people.

FUTURE NEEDS

Future needs can be taken care of by allocating a part of the current income for saving or investment. This allocation of a part of the income for the future depends on the current income of the individual. If a person earns less, it may not be possible for him/her to allocate a sizeable portion for future requirements. But as the income of the person increases, he/she can devote a bigger chunk of his/her earned income for saving or investment purposes.

At the same time, it should be said that irrespective of the level of income, it is imperative for a person to save for the future, for any financial plan to succeed. Individuals, earning a high income or low, will need some savings for the later years of the life. There may also be other needs that call for a lump sum to be spent later, like for the college education of a child. As such it is necessary to plan ahead in order to meet these huge expenses. Saving for such needs may also require sacrificing some of the current needs in order to be able to meet these future needs comfortably.

Accumulating Wealth

There is a general tendency among people to accumulate wealth. Accumulation of wealth may be in the form of tangible or intangible assets. Financial planning can help a person to formulate a plan for investing in assets at the right time, without disturbing the current income. Assets can also be subdivided into earning assets and tangible assets. Buying a car is an investment for long-term, but the asset does not earn any income. On the other hand, investment in fixed deposits, bonds, and stocks earn income. They are known as earning assets. Thus, an individual has to decide whether he/she should invest in earning or tangible assets. Again, within tangible assets, he/she has to select between those that generate income, like a commercial real estate, and those that result in only capital appreciation, like land. His/her decision will help in chalking out his/her future strategy for investment planning.

Box 1: Financial Objectives
Every person has his or her own financial objectives in life with respect to career chosen, attitude, values and basic needs. But the objectives can be generally categorized as following: i. Protection against personal risk resulting from • Premature death • Disability losses • Unemployment • Property and liability losses. ii. Capital accumulation aimed at meeting • Family needs • Educational needs • Emergency needs. iii. Provision for retirement income. iv. Reducing tax burden • During one's lifetime • At death – when property passes on to others. v. Estate planning (investing for the heirs). vi. Investment and property management.

STEPS IN FINANCIAL PLANNING PROCESS

Financial planning goes through a full circle, starting from defining goals, and developing financial plans based on the goals, to redefining and revising the plans. The process can be better depicted in the following manner:

Step I : Self-assessing the financial position.

Step II : Defining financial goals.

Step III : Developing financial plans and strategies.

Step IV : Implementation of financial plans and strategies.

Step V : Evaluating results of plans and budgets.

Step VI : Revising and redefining goals.

Self-assessing the Financial Position

To plan the financial future, first he/she has to assess the present financial position. He/she has to know the assets and obligations presently owed. Before fixing the targets, he/she has to assess whether or not the targets are possible to achieve. This can be seen in the light of present financial position of the individual. For example, before preparing the financial plans of an employee who is drawing a salary of Rs.25,000 per month in the private sector, consider the present net worth which is as follows:

Obligations	Present Value (Rs.)	Assets	Present Value (Rs.)
Housing Loan	2,50,000	House Property	8,00,000
Personal Loan	50,000	Motorcycle	40,000
		Investments	1,60,000
Total	3,00,000	Total	10,00,000
EMI on home loan	2,600	Net Worth	7,00,000

After ensuring the current financial position, the next step is to define the financial goals.

Defining Financial Goals

Financial planning starts only when an individual defines his or her financial goals. Like professional and personal goals, an individual also needs to identify his/her financial goals too. He/she needs to list down his/her priorities with respect to his/her financial requirements in the future.

Financial goals are determined by financial desires. A person may have a financial desire to be financially secure after the age of 60, a housewife may have a desire to secure her 10 year old daughter's future. A software engineer would like to start his/her own company after five years. These are all desires, originating from human needs and wants. The following points may help an individual in setting his/her goal.

GOALS SHOULD BE SPECIFIC

Financial goals should specify the end result of the whole process. The individual should specify what amount he or she is ready to part with to start an investment program, the time period and the purpose for such an objective.

GOALS SHOULD BE REALISTIC

The financial goals should be realistic in nature. In other words, they should be attainable. A person earning Rs.8,000 and having living expenses of Rs.6,000 cannot save 50% of his/her salary.

GOALS FOR THE WHOLE FAMILY

For achieving the financial objectives for the family, each member should involve himself/herself in the process. It not only reduces future conflicts but also increases the probability of success of the investment plan for the whole family.

GOALS SHOULD HAVE TARGET DATES

Every goal should specify the target date, specifying when it is to be accomplished. The target date helps in reducing diversions from the objective and meeting the financial goal.

Types of Financial Goals

After the above discussion, the next most important element in financial planning is to understand the various types of financial goals and how to use them in practice.

Long-term Goals

Long-term financial goals represent the long-term requirements of an individual. Long-term goals may extend beyond a period of six years. The time period should not be so long that the goals become unrealistic to achieve. It is possible that goals change over a period of time and thus need to be revised on a regular basis. The following table describes an individual's long-term goals.

Goal	Priority	Target Date	Cost Estimate
Take a home loan	High	2008	Rs.5,00,000
Investment in real estate	Medium	2010	Varies
Take a vacation in Venice	Medium	2009	Rs.50,000

Short-term Goals

Short-term goals are for a period of one year or less. They are immediate goals in the form of expenses in the current period, such as education expenses for a child newly admitted in nursery school. To attain long-term goals, it is essential to attain current short-term goals. The short-term goals also provide for the surplus required for savings, which are crucial for long-term goals. The following table provides a description of a person's short-term goals.

Goal	Priority	Target Date	Estimate Rs.
Buy school uniform for children	High	Dec., 2008	1,500
Buy a new cooking gas	High	Nov., 2008	2,000
Buy new seat cover for the car	Medium	Jan., 2009	1,500
Buy a new crockery	Low	Jan., 2009	1,500

Intermediate Goals

Intermediate goals fill up the gap between the short-term and long-term goals. They are generally spread over a period of two to five years. The following table describes an individual's intermediate goals.

Goal	Priority	Target Date	Cost Estimate Rs.
Repaying education loans	High	Dec., 2008	1,00,000
Take a week long vacation	Medium	June, 2008	8,000

It is always advisable to prioritize these goals on the basis of the urgency in fulfilling them. By doing so, an individual will be able to identify the goals that he/she has to concentrate on immediately and which of them can be deferred for some time.

Developing Financial Plans and Strategies

PLANNING FOR A LIFE TIME

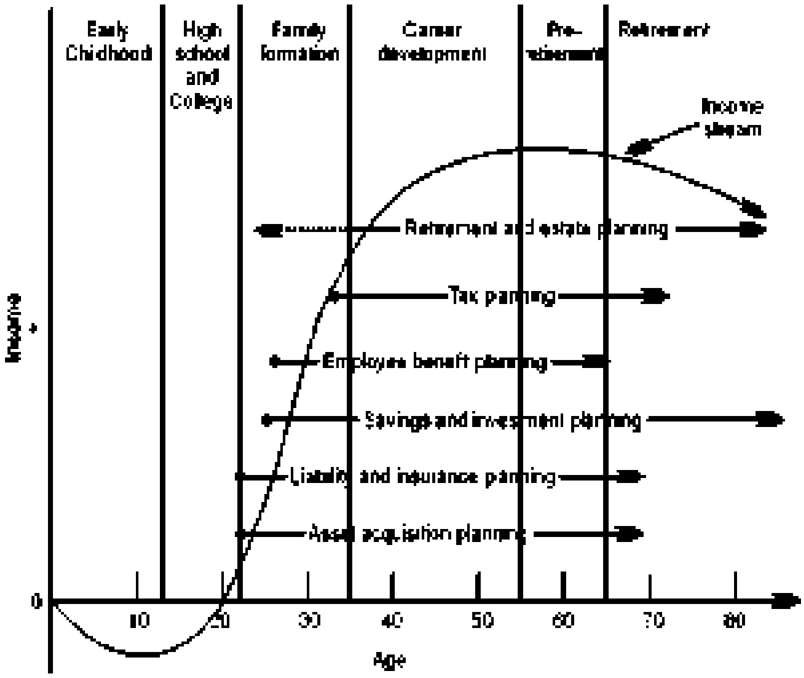
As one goes through the various stages of life, financial planning also goes hand in hand. Financial planning is a dynamic process. Financial goals and targets change with the changing environment and situations. They need to be updated and revised at the right time. A person may have to face contingencies such as unemployment, illness, disability, etc. Financial planning provides the requisite cushion for such contingencies.

An individual starts his/her life from being dependent on his/her parents, then begins his/her career and starts earning for himself/herself and his/her family. The income increases or stabilizes as the years pass on and he/she has responsibilities in the form of children and maintaining the requisite standard of living. After this stage, he/she has to take care of his/her retirement needs.

The financial plans given subsequently give a picture of what financial plans can be adopted in various stages of life. The asset acquisition plan will be in the initial years, insurance planning may begin when a person starts his/her family and retirement planning as one approaches middle age.

The following figure gives a brief summary of how financial goals of an individual change over a period of time.

Figure 1: Personal Financial Planning Life Cycle



Source: Personal Financial Planning, by Lawrence J. Gitman, and Michael D. Joehnk, Thomson Learning Publishers, Ninth Edition.

Asset Acquisition Planning

Asset planning is the first form of financial planning. A person in his/her lifetime decides to acquire certain assets, which may vary from acquiring a car to a house or investments in the form of buying stocks, bonds, etc. The assets acquired may range from liquid assets to real estate property to personal assets. Cash held and balances in savings accounts are examples of liquid assets, while assets such as automobiles, household furniture, appliances, and jewelry are personal assets. Land and structures fixed to it, like houses, etc., constitute real assets.

Liability and Insurance Planning

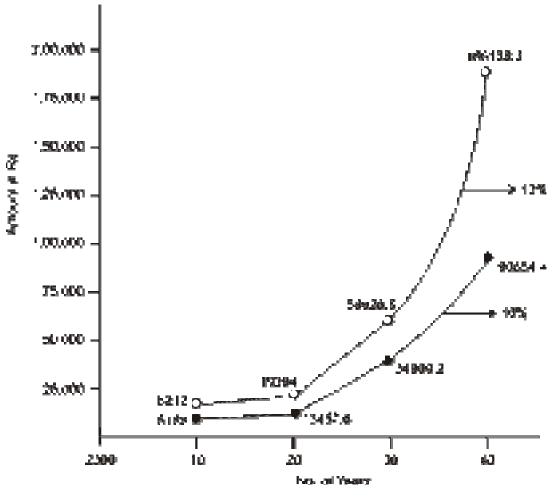
A person may have to manage his/her debt in the same way as managing his/her assets. Debt may be in the form of education loans or loan for an automobile or credit card payments. Apart from managing one’s debt, one also has to provide for his or her insurance. There is the risk that a critical illness may wipe out the entire earnings of a person or that an accident wipes out the savings accumulated through years of hard work. Thus, it is essential to have an adequate insurance cushion for a smooth living. Too much of insurance, too, is not desirable.

Savings and Investment Planning

As a person’s income increases, the importance of savings and investment will also increase. People generally start saving for meeting unexpected situations. At a later stage, it is essential to start investing in investment instruments such as bonds, saving schemes, bonds and personal property to accumulate wealth. The final wealth accumulated depends substantially on the return earned from the investments made initially.

The following figure shows how an amount of Rs.2,000 grows at the rate of 10% and 12% over a given period of time.

Figure 2: Savings Growth



Employee Benefit Planning

Generally, large firms provide employee benefits in the form of life and health insurance, disability insurance, reimbursement plans for education or it may be in the form of pension or retirement plans. Apart from these traditional plans, firms now-a-days also give benefits in the form of stock options, health and child care expenses, vacation leave, sick leave, etc. An individual should try to integrate his/her own personal plans with the benefit plans provided by the organization to achieve a better financial planning. Plans such as deferred retirement plans offer tax benefits. Similarly, there are certain retirement plans, which allow one to borrow loans. Insurance policies provided by the organization should also be duly supplemented by personal policies.

Employee benefits like group insurance and stock options offered by the employer should not be depended on too much. In today’s uncertain employment conditions, one should be prepared for eventualities like a loss of job – either through layoffs or dismissal – and having to run the family without a job for some time.

Tax Planning

Tax planning assumes importance for an individual, once he or she falls in the tax bracket. Taxation becomes a headache, as it is difficult to understand the intricacies of changing taxation laws and benefits. There are various exemptions and deductions available, under different sections of the Income Tax Act for different purposes and based on different criteria. Not considering the tax benefits available when planning the investments, can result in loss of a substantial portion of the return to taxes. Hence, tax planning and financial planning go hand in hand. A person should understand the implications of the taxation laws and make suitable arrangements for proper investment plans to minimize the costs of taxation.

Retirement and Estate Planning

One of the main long-term goals of financial planning is to make proper retirement plans. Apart from maintaining one’s standard of living and meeting all necessities in life, one has to take care of his/her retirement days. Old age brings with itself increased medical expenses and other requirements. Thus, investment in a retirement plan is of utmost importance for a person who is approaching middle age.

It is always advisable to start planning for retirement well in advance, rather than after one is into the late 40s or the 50s. This is because, investments made early in life multiply with accrual in interest and the final sum available will be much more. Apart from retirement plans, estate planning should also be done carefully for passing on the wealth to legal heirs. Estate planning is a complicated topic that calls for an understanding of wills, trusts, and their legal aspects. It will be covered in detail later.

Implementation of Financial Plans and Strategies

After preparing and analyzing financial plans and environment, the next important step is implementation of financial plans and strategies. This is the real and practical aspect in the personal financial planning process. Here, it is necessary to understand the volume of risk involved in the financial plans. A home loan may invite increased bank interest. To overcome this problem, an alternative course of action has to be developed at the preparation of financial plans. The plans also must be characterized by flexibility. Based on changes in the environment and time requirements, the plans have to be modified and implemented to reach the financial goals of the individuals.

Evaluating Results of Plans and Budgets

To review and evaluate the financial progress of the individual, the life period must be subdivided into specific intervals. Generally, programs should be evaluated yearly to assess the progress and results. At the end of each year, review the financial plan to see whether the individual has stuck to it or not. While evaluating the results of financial plans, find any deviations between the expected results and actual results and also the reasons for the deviations. Draw a course of action to reduce the deviations.

Revising and Redefining Goals

Static is not a symbol for development. Lastly, goals set-up are not static. Update the financial goals especially medium and long-term goals with significant changes in the financial environment. Innovations and technological changes bring change in the life style of an individual. The standard of living and income changes also fetch necessary changes to redefine the financial goals of the individual. The financial goals must be changed from time to time to suit the present environment. At the time of redefining the financial goals, the financial position of the individual and his/her present income must be clearly analyzed as defined in the first step. Hence, the process of personal financial planning is defined as a cyclical process which is never ending.

THE FINANCIAL PLANNING ENVIRONMENT

Financial and economic environment need to be properly understood by an individual before starting his/her financial plan. The economic environment of a country influences the individual financial decisions made by a person. Economic variables such as inflation, interest rates, retirement plans available by the government agencies, etc., influence the planning decisions. A bull run in the stock market may result in high returns from investment in the stock market, which attract higher investments into stocks and low investment in saving schemes. Similarly, in case of a depressed scenario in the economy, the investment might be low in the stock markets and high in saving schemes. The financial environment is influenced by various agencies, which are major players in the financial environment, integrating each other’s goals. There are three main such groups discussed below:

Government

The government is an overpowering influence in any business environment. It not only regulates the economic activity but also provides employment, and services in the form of public education, national defense, health care, etc. There are two main tools applied by the government, which impose restrictions – they are taxation policies and government regulations.

TAXATION

The government levies taxes on the income of the individual, sales, real estate and personal property. Taxes form one of the main sources of revenue for the government. By changing the taxation rates, the government can decide the amount of disposable income in the hands of the consumers and affect their financial planning.

REGULATIONS

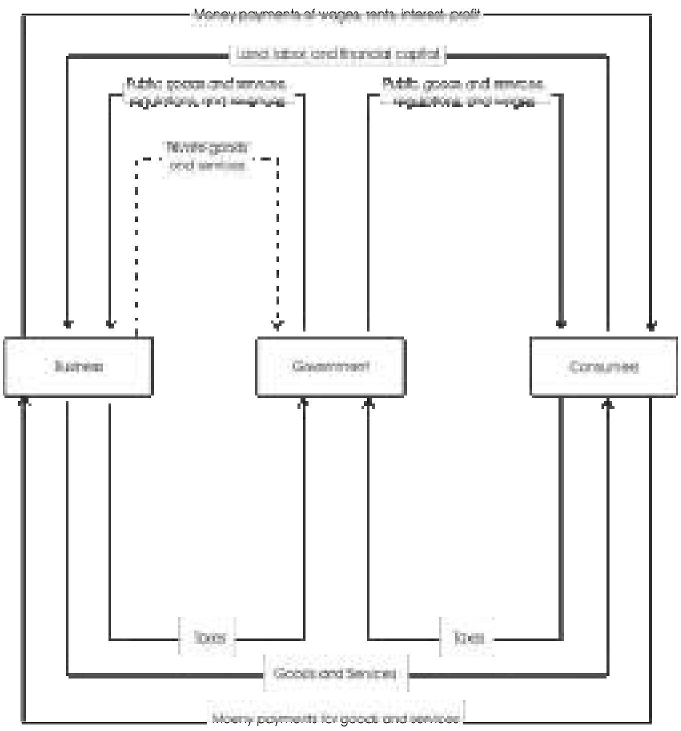
Governments impose various regulations to safeguard interests of the consumers, investors and general public as a whole. The government may impose restrictions on the undesirable activities of the sellers, producers, financial institutions, etc. It may also impose restrictions in the form of standards for food, medical assistance and other necessities and for prevention of pollution. The personal financial decisions of an individual are affected by the government laws, and regulations have to be made considering the legal requirements that are aimed at protecting the consumers and investors.

Business

Business enterprises produce goods and services by employing labor and utilizing land, capital and technology. Business firms need to pay wages, interest, and rent for the use of the factors of production and in turn earn profits. Thus, business enterprises facilitate the circular flow of income in the economy. Enterprises not only create healthy competition in the economy but also facilitate greater array of goods and services available to the customers.

The following figure shows the financial planning environment and interrelation between the government, consumers and the business enterprises.

Figure 3: Financial Planning Environment



Source: Personal Financial Planning, by Lawrence J. Gitman, and Michael D. Joehnk, Thomson Learning Publishers, Ninth Edition.

Consumers

Consumer is the 'king' in today's dynamic environment. Consumer's tastes and preferences determine the strategies of the business enterprises. In case the economy is depressed with low economic activity, the general public may cut its expenditure. Similarly, if the economy is going through a boom period, there is increase in the disposable income of the consumers leading to increase in consumer expenditure. These factors have to be considered while planning investments.

Economy

The economy is the result of interaction among various groups such as the government, business and the consumers. All these players have been discussed above in detail. The government is the most important player in the economy, maintaining the economic stability and high employment levels. The government through its monetary and fiscal policy is able to determine the requisite level of economic activity by influencing the interest rates, inflation and money supply. The government, by reducing and increasing taxes and interest rates, is able to regulate the fundamentals of the economy. Taxes and interest rates are generally lowered when the economy needs a stimulus and they are increased when the economy is getting overheated, during a boom.

ECONOMIC CYCLES

The level of economic activity changes constantly giving rise to various economic cycles also known as business cycles. An economic cycle goes through the following stages:

Expansion

Expansion in the economy occurs when the economy goes through high levels of employment and production. High levels of employment and production are indicators of high growth in the economy. The stronger the economy, the higher will be the level of employment and production.

Recession

Recession results, when the economic activity declines for a period of more than six months (often mentioned as two consecutive quarters).

Depression

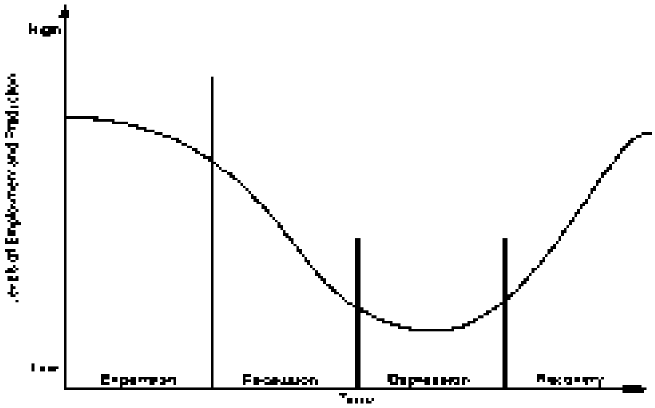
Depression in the economy is said to occur, when the economic activity comes to a standstill.

Economic Recovery

The recovery stage in the economy occurs when the production and employment levels start rising indicating a revival in the economic activity. Percentage changes in the Gross Domestic Product (GDP) are commonly used to measure the growth of an economy. An increase in the GDP means that the economy is growing and a fall in the GDP indicates poor economic conditions. Obviously, a higher GDP growth rate is more desirable than a lower rate. Unemployment rate is also used frequently to measure the health of an economy. Higher unemployment rates indicate that the industrial and other activities are not up to the full potential and increase in the unemployment rate points towards a deterioration of the economic conditions.

The following figure shows the various stages through which the economy of the country goes through.

Figure 4: Economic Cycles



Source: Personal Financial Planning, by Lawrence J. Gitman, and Michael D. Joehnk, Thomson Learning Publishers, Ninth Edition.

Inflation, Level of Prices and Interest Rates

Every economy is based on the exchange of goods and services among businesses and their customers. This exchange is facilitated by ‘money’ and the price of the product or service. Inflation occurs when the general level of prices increases. In this situation, the economy is said to be going through inflation. Inflation can be measured through various measures such as consumer price index or wholesale price index. These indices comprise of various products and services, which help in measuring the change in the general level of prices.

The level of inflation influences financial planning, as the disposable income in the hands of the individual may reduce. Inflation also affects interest rates - high rates of inflation increase the cost of borrowing, as the lenders demand a higher compensation as a price for parting with their money. Inflation also affects stock and debt market. Apart from all this, high level of inflation affects the retirement plans drastically. Thus, the economic scenario should be completely understood before formulation of any long-term financial plan by an individual.

VARIOUS DETERMINANTS OF PERSONAL INCOME

Personal income of an individual depends on various factors such as age, marital status, level of education; place of residence and last but not the least, the choice of career. Earning money is not difficult, but it is influenced by the above mentioned variables associated with the individual. A sixty year old man cannot have the same energy as that of a thirty year old. Similarly, a forty year old, executive director will earn more than a salesman in the same firm, at the same age. All these factors are discussed below:

Age

The age group in which an individual falls determines his/her earning capacity. The low level of income is generally for old people above 60 years or below the age group of 25. The highest earnings are in the age group of 35 and 55. In this age group, people develop their skills or are at the peak of their careers. Thus, one of the main determinants of the financial condition of a person is his/her age.

Marital Status

Family income also depends on the marital status of the individual. A single person will definitely earn less than a working couple. Where both the spouses are working, it is easier to plan financially for the future and also maintain the requisite lifestyle of the family.

Education

Education does make a difference, when it comes to personal income of an individual. A person having a PhD may earn more than a graduate. Although it is not necessary that the education of a person is the sole determinant of an individual's income but high education makes a difference in the long-run for the financial stability of a person.

Place of Residence

A person working in Kanpur will earn less than someone working in Delhi. This condition is again dependent on various factors such as the organization, designation, etc. But number of opportunities available in a bigger city or town gives a better exposure for finding a better job or changing a job than a smaller city for an individual. In addition, higher price levels is also a reason for wages being higher in bigger cities. Moreover, one has to generally travel long distances to reach his/her workplace.

Choice of Career

Earning capacity of a person depends on the type of career he or she chooses. A film star will definitely earn more than a normal sales executive. The career chosen by a person is again dependent on the education, standard of living, skills, and interests of a person, his/her preferences and personal values.

Career Plan

There is a close relationship between career and financial planning. Decisions made in one area affect the other. Career planning is similar to financial planning, as short and intermediate goals determine long-term goals of an individual. Proper career planning helps in determining the financial goals of an individual. The following points will help in proper financial planning for an individual:

- Identify skills, interests, values, etc.
- Identify long-term and short-term career goals.
- Develop a career plan and implement it to achieve the targets set.
- Keep reviewing the plan to adjust to the changing situations.

SUMMARY

- Personal financial planning involves proper planning and implementation of well-coordinated plans to achieve financial objectives. There is generally a misconception among people that personal financial planning is a niche area that is meant only for the affluent class. But it is not the case. Irrespective of the amount of income of a person it is always essential to plan in order to achieve the goals.
- Personal financial planning helps in proper projection of the future needs and evaluation of the future course of actions. Financial planning process involves defining goals, developing and implementation of plans, monitoring and control and evaluation of results. It involves identifying both long-term and short-term goals. Thus, the planning process goes on throughout the whole life process of an individual.
- An individual should analyze the whole financial environment before making any financial decision. The financial environment comprises of the business enterprises, consumers and the government. In addition to this, there are other factors, which also need to be taken into consideration for financial planning, such as age, marital status, choice of career, place of residence of the individual. Thus, the first chapter of this book provides the basic foundation of the subject, which would be discussed in detail in the forthcoming chapters.

Chapter II

Financial Statements and Plans

After reading this chapter, you will be conversant with:

- The Role of Financial Statements in Financial Planning
- Time Value of Money
- Preparing a Personal Balance Sheet
- Preparing the Income and Expense Statement
- Developing a Good Record-keeping System
- Ratio Analysis: Tracking Performance
- Preparing a Cash Budgets

Introduction

'Where is the money for a holiday?' replied Nita. Nita and Ramesh are a working couple with two kids. They have been planning for a vacation for quite some time. Their major household expenses go for their basic necessities, kid's expenditure and other household requirements. They have no idea where both their salaries drown.

What they need is to maintain their personal financial statements. The following chapter deals with the significance of financial statements and budgeting.

THE ROLE OF FINANCIAL STATEMENTS IN FINANCIAL PLANNING

Financial goals can be achieved only after thoroughly understanding one's current financial condition and developing financial plans accordingly. Although it is easier to assume and formulate financial plans, sound decisions to achieve long-term objectives can only be taken after thoroughly analyzing one's financial position through well-recorded statements. Financial statements are thus not only important to an enterprise but also for individuals and families to survive in today's dynamic competitive environment. Preparing and interpreting personal financial statements form the basics of personal financial planning.

The financial statements used for the personal finance are the same as those used by a firm. The two commonly used personal financial statements are:

a. Balance Sheet.

b. Income and Expense Statement.

Balance Sheet

Balance sheet gives information about the financial position of an individual at a given point of time. It helps to assess the value of the assets owned and the amount of debt owed by a person.

Income Statement

The income statement measures the financial condition of a person over a specific period of time. The statement includes both the income earned and the expenses incurred over a period of time. The income and expense statement forms the basis for preparing the budgets.

BUDGETS

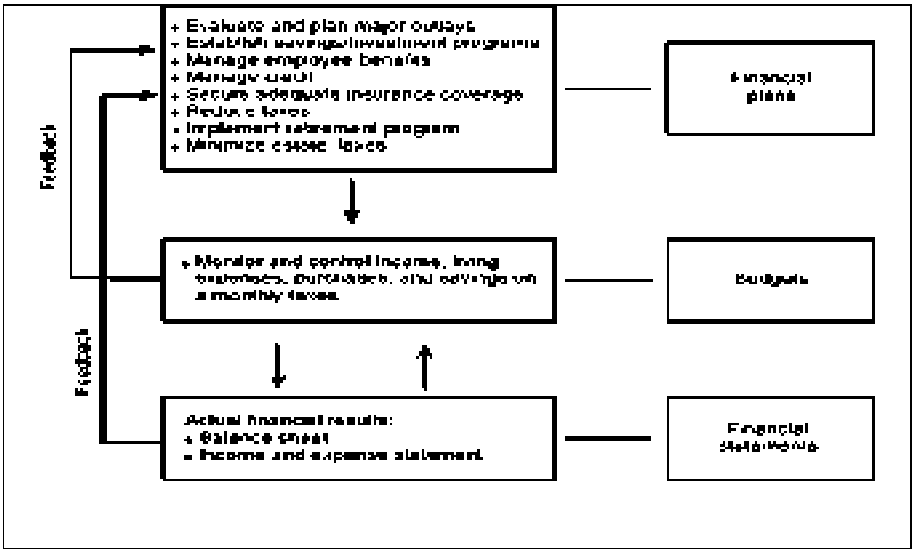
As mentioned earlier, budgets are forecasts made by analyzing the previous periods' financial statements. Budgets affect the financial statements, as provisions made in the budgets are taken directly in the financial statements. Comparison of the budgets with the actual expenses incurred enables an individual to monitor and control spending.

Special Planning Concerns

An individual goes through various ups and downs in life. He/she may go through financial prosperity in the form of a promotion or a major hike in salary. He/she may also have to face financially stressful periods occurring through death, divorce or retirement. It is however important that during such periods, the individual should keep his/her cool and not take any wrong financial decisions. For instance, at the time of the birth of the child itself, hasty decision with regard to the policy for the child's education should not be taken. Every decision should always be taken after proper analysis, since the effects of such financial plans extend over a long-term period.

The figure below shows the network of financial planning and how financial reports link future goals with actual results.

Figure 1: The Interlocking Network of Financial Plans and Statements



Source: Personal Financial Planning, by Lawrence J. Gitman, and Michael D. Joehnk, Thomson Learning Publishers, Ninth Edition.

Managing Employee Benefits

A number of people depend on employee benefits for their financial security. Employee benefits may be in the form of health insurance, life insurance and pension plans. An employee benefit plan generally contains the following:

- Health and life insurance.
- Long-term insurance.
- Disability insurance.
- Dental and vision care.
- Subsidized food services.
- Retirement programs.
- Educational assistance programs.

Different companies may have different employee plans. Some have attractive comprehensive plans, whereas other may not provide sufficient benefits. If an employee gets adequate benefits, his/her compensation will increase. While the employer pays for some of the above benefits in full, the employees usually pay for a part of the cost of certain benefits such as group health insurance, life insurance and VRS programs.

In case of two income couples, it is essential to investigate the benefits provided thoroughly so that both of them do not end up paying for the same benefit.

Increasingly, the traditional employee benefit plans are being replaced by the flexible benefit plans, also known as the cafeteria plans. In the flexible plans, the employer allocates certain amount of money to each employee who is then free to allocate the money for the benefits that he/she thinks are fit for his/her age, marital status, family size and other requirements. These plans also cover health, life insurance and other benefits. Although there is a greater choice in these plans, the benefits need to be managed properly. The benefit package so chosen should also be periodically reviewed with the changing needs of the individual.

Adapting to Major Changes in Life

There are certain situations in life, which need to be given special consideration as they affect the financial condition of the person and call for a revision of the financial plans and financial management strategies. Instances of such situations are marriage, divorce, death of spouse, birth of a child and taking care of dependent parents.

There is usually a change in the financial plans of a person once he/she gets married. He/she may start an investment plan, or begin to save more. In case of a two income couple, both of them need to decide about how to jointly manage their financial plans. In case of a divorce, income of the husband may decrease, as he may have to provide for alimony and child support. Death of the husband may affect the financial condition of the wife drastically, if he was the sole earner in the family. In case of a two-income family, the surviving parent has to take care of the needs of the family and invest wisely the life insurance proceeds and other assets.

TIME VALUE OF MONEY

Time value of money is one of the most important concepts of finance. According to this concept, a unit of money received today is worth more than the same unit of money received at some future point of time. On the basis of this concept, the value of money at different points of time can be calculated. The two main concepts to understand the time value of money are: future value and present value.

Future Value

Future value is the value to which an amount will grow if it earns a specific rate of interest over a given period. For instance, if a person makes an annual deposit of Rs.5,000 into a savings account, which pays 8% per year, after fifteen years, the total amount should be equal to Rs.75,000 (5,000 x 15). In case there are no withdrawals, the value of total deposit will be equal to Rs.1,35,760. The increase in the deposit in the latter case is because the interest earned in each of the years forms a part of the principal in the subsequent year leading to compounding.

Thus, the simple formula for calculating the future value of investment is:

Future value = Amount invested x Future value factor

The future value tables give the future values, which simplify the calculations. If the future value of a uniform investment made every year for 6 years at a rate of 12% is to be estimated, it can be easily found out from the future tables, as 1.974.

Future value concept is also used for determining an annuity. An annuity is a fixed sum of money that occurs annually. The annuity concept can be used to determine the amount of money to be saved annually in order to accumulate a given amount at the end of a certain period. The equation to be used in the above case is:

Annual Savings = Amount of money desired/ Future value annuity factor.

Illustration 1

Reema accumulated an amount of Rs.4,000, which she wants to invest for a period of 6 years. What would be the future value, in case the rate of interest is 6%.

Future value = Rs.4,000 x 1.419 = Rs.5,676.

THE RULE OF 72

The Rule of 72 can be applied to find out how long it takes for a specific amount of money to double. This can be done without using the time value tables or a financial calculator. The Rule of 72, is an approximation method that can be applied in the following manner:

$$\text{Number of Years to Double a Given Amount of Money} = \frac{72}{\text{Annual Compound Interest Rate}}$$

For instance, a savings account with the balance of Rs.5,000 has been opened, which earns a compound rate of interest of 6%. The number of years it would take for the amount to double, according to this rule, would be:

$\frac{72}{6}$ = 12 years.

Present Value

Present value can be defined as the value of an amount in the present, to be received in the future. Present value is therefore the amount to be invested today at a specific rate for accumulating a specific future amount. This process of finding the present value is known as 'discounting'. Discounting is the inverse of 'compounding', which is used to find the future value. The present value of an investment is calculated as follows:

Present Value = Future value x Present value factor

The present value techniques can also be used to determine the amount of funds that an individual can withdraw each year over a specified time period. This annual withdrawal can be calculated as follows:

Annual withdrawal = Initial deposit / Present value annuity factor

Illustration 2

Mina deposits Rs.5,000 every year for 6 years in a SBI savings scheme. At the end of six years, she will receive Rs.35,000. What will be the present value of the amount received after 6 years? Assume the interest rate to be 6%.

Present value (6%, 6) = 35,000

= 35,000/4.917

= 7,118.16

The present value factors can be obtained from the present value tables to estimate the present values of investments. Similarly, the present value of an annuity factor can also be found out.

PREPARING A PERSONAL BALANCE SHEET

After understanding the concept of time value of money, let us revert back to the main theme of the chapter namely, preparing and analyzing the personal financial statements. As mentioned earlier, the balance sheet is the statement indicating the financial position of an individual on a certain given date. In other words, it is a snapshot of a person's financial position on a particular day and presents a picture of the assets and liabilities of the individual and thereby his/her net worth. The balance sheet can be explained in the form of an equation as given below:

Total assets = Total liabilities + Net worth

Or

Net worth = Total assets – Total liabilities

The personal balance sheet of a person or a family should be prepared at least once a year. But it is better if the financial condition is monitored over a three-month or a six-month period. For calculating the fair value of the assets, investment statements and saving accounts should be taken into consideration. There are certain assets, which may have appreciation in their value, such as jewelry, artwork, land, etc., whereas there are other assets, whose value may depreciate. The value of vehicles and homes can be estimated from published sources or comparable properties.

The balance sheet statement should always balance. That is, the total assets should be equal to the sum of the total liabilities and the net worth. While preparing the balance sheet, it must be noted that the assets are to be listed on the left-hand side of the statement beginning with the most liquid assets first. The liabilities occupy the right-hand side of the statement and the net worth is also indicated on the right-hand side just below the liabilities. A format of the balance sheet is indicated in Table 1.

Table 1: Balance sheet as on date…

Liabilities	Assets
Current liabilities: • Utilities • Rent • Medical bills • Bank credit • Credit card balance Long-term liabilities: • Mortgage • Loans • Education loans • Real estate mortgage • Net worth: Assets – liabilities	Liquid assets: • Cash on hand • Savings account • Certificate of deposits • Mutual funds Investments: • Real estate • Bonds • Stocks Real property: • Owned house • House given on rent Personal Property: • Vehicles • Jewelry • Artwork

After going through the balance sheet format, let us have a look at the balance sheet of a family, showing the assets and liabilities in the format as indicated in Table 2. The utilities and rent are calculated per month. The rest of the amounts are calculated yearly. Net worth is calculated by deducting the liabilities from the assets.

Table 2: Balance Sheet as on 31st December of Arvind and Surekha

(in Rs.)

Liabilities	Year			Assets	Year		
	2002	2001	2000		2002	2001	2000
Utilities	60,000	50,000	45,000	Cash on hand	30000	30,000	50,000
Rent	85,000	80,000	75,000	Savings Account	40,000	50,000	50,000
Medical bills	25,000	18,000	15,000	Certificates of deposits	1,00,000	–	–
Bank credit	50,000	–	–	Real estate	2,00,000	3,00,000	3,00,000
Educational loans	1,20,000	1,50,000	1,80,000	Mutual funds	10,000	5,000	–
Mortgage	50,000	70,000	90,000	Stocks	10,000	5,000	–
Net worth	2,10,000	1,22,000	2,57,000	Jewelry	50,000	50,000	50,000
				Vehicles	50,000	50,000	50,000
Total Liabilities	6,00,000	4,90,000	5,00,000	**Total Assets**	6,00,000	4,90,000	5,00,000

After going through the above format, we now try to understand each of the items indicated in the balance sheet.

Assets

Assets are the items one owns. An asset can be in the form of cash or an item financed by debt. Even if the asset has not been fully paidup, it has to be represented in the balance sheet. Assets are generally grouped into various categories such as liquid assets, investments, real property and personal property. It has generally been observed that one-third of any household's assets are generally in the form of liquid assets and investments (financial assets), half of it is in the form of real assets and the remaining in the form of non-financial assets.

All the assets are recorded at their current fair market value in the personal financial statements. This value may be different from the original purchase price of the asset. The actual value of the asset or the price at which the asset is expected to sell in the open market is known as the fair market value of the asset. The assets are recorded differently in the personal balance sheet as compared to that recorded in the balance sheet of a firm. The total assets in 2002 are Rs.6,00,000, which depicts an increase of 20% from that is the year 2000 in Table 1.

TYPES OF ASSETS

The various types of assets include the following:

Liquid Assets

Liquid assets are low-risk financial assets such as cash, or assets that can be readily converted into cash. These liquid assets are generally needed to meet the day-to-day expenses and provide for unexpected events. The liquid assets are generally in the form of:

- Cash on hand.
- Demand deposit.

As given in the balance sheet (Table 1), the liquid assets are Rs.1,70,000. We observe that there has been an increase in the liquid assets as compared to that in 2000 primarily because of the investment in certificate of deposits.

Investments

Investments are those assets, which earn a return for the individual. These assets are held by an individual so as to earn a profit. Investment assets are generally in the form of:

- Common Stock.
- Government Bonds.
- Mutual Funds.
- Cash value of insurance and pensions.

Such assets also help an individual in achieving his/her long-term goals.

Real and Personal Property

Real and personal property is in the form of tangible assets, which one uses in everyday life. Real property includes the immovable property like a house or land. Real property has a high value and a long life. The value of these assets will always increase or appreciate.

Personal property is generally in the form of furnishings, vehicles, jewelry, home electronics, clothing, etc. The value of the personal property depreciates, once they are put to use. As given in the balance sheet above, the real estate investment has reduced by Rs.1,00,000 in 2002 as compared to the previous years.

Liabilities

Liability indicates the debt owed by a person or a family. The debt can be in the form of loans, bank credit card charges, mortgage on housing, etc. Liabilities can be broadly categorized into short-term and long-term liabilities. The liability that is due within one year is known as short-term liability while long-term liability refers to an amount due for a period of more than one year.

The different types of liabilities are as follows:

Current Liability

Current liability generally arises from expenditure on consumable goods and services, by bills such as electricity, water charges, rent, insurance premium that are due, medical and repair bill, etc. There is another type of current liability known as open-account credit obligation. These are the balances, which are owed while using a credit card. In a credit card, an individual can make purchases and by paying a minimum amount, can carry forward the rest of the amount to be paid later.

Line of credit is another form of current liability, which is offered by banking institutions, which provide a specified authorized amount of credit. Instead of using a credit card, a person can also use the line of credit by writing a cheque against the special credit line created by the bank. The liability on the open credit account is the total balance outstanding and not the monthly payments. As given in the balance sheet, the current liabilities have increased by a little more than 25% over the years from 2000 to 2002. Thus, with the increase in income, the expenditure has also increased.

Long-term Liability

The liabilities, which are due for more than a period of one year, are known as long-term liabilities. They are generally in the form of:

- Real estate mortgage.
- Consumer installment loans.
- Educational loans.
- Loans taken for buying stocks.

Real Estate Mortgage

These loans are associated with the purchase of real assets such as a house or a piece of land. These loans are generally paid in the form of installments for a long-term extending up to 10-15 years or even more. These mortgage payments are generally paid on an annual basis. As shown in the balance sheet, the couple pays a mortgage loan of Rs. 30,000 every year.

Consumer Installment Loans

These loans include payments in the form of installments paid for a specified period of time. These loans are generally taken for the purchase of automobiles, appliances or furniture.

In the balance sheet, the amount that is outstanding currently should be shown and not the total amount of the asset due in the initial period. In case of a mortgage loan, the principal amount and not the interest payments should be included in the balance sheet.

Educational Loans

As the education expenses have increased, most of the middle and lower middle income people face a tough challenge in sending their youth to higher studies. Deserving students from these families who may not be able to pursue higher education for lack of financial support usually find educational loan as a means to self development and prosperity.

Net Worth

Net worth can be defined as the actual amount of wealth owned by an individual or the family in assets. In other words, net worth is the amount available with the family after selling all the owned assets at their fair market value and payingoff all the liabilities. Thus, net worth is equal to total assets less total liabilities. After calculating the fair market value of the assets and estimating the liabilities, the net worth of an individual can be easily calculated. If the liabilities are more than the assets of a family then it technically means that the family is insolvent and that there is no proper financial planning.

The net worth of an individual increases as the individual moves from one phase of his/her life cycle to another. A student usually has a very low or sometimes even a zero net worth. This is because the assets that he/she has are usually in the form of cash and savings account while the liabilities, which include educational loans, or utility bills are usually greater. But it would be a different case for an employed person above 25 years. An employed person will have more liquid assets than a student and also personal property such as a vehicle, house, etc. Thus, his/her net worth will be higher and as he/she begins to advance in his/her career, his/her net worth increases. Net worth is an important indicator in long-term financial planning. The progress of an individual, with respect to his/her wealth can be monitored through the knowledge and analysis of his/her net worth. The balance sheet given in the table 1 shows that the net worth has reduced over the period of three years.

PREPARING THE INCOME AND EXPENSE STATEMENT

Income statement gives information about the financial activities over a certain period of time. It is generally prepared on an annual basis, but can also be prepared on a quarterly or monthly basis. The income statement evaluates the saving and investment done during a specific period. The statement has three main parts: income, expense and cash surplus. A cash surplus is nothing but the difference between the income and the expenses. The income statement takes into account only the cash transactions, that is, only those transactions, which involve cash, would be recorded.

The income and expense trends change as an individual or the family goes through various phases of the life cycle or as the needs of the family change. Generally, the income and savings are usually high for an individual above 40 to 50 years. Similarly, for individuals between the age group of 30 to 40, the income and savings are low, thereby leading to a low cash surplus too.

Format of the Income and Expense Statement

The income and expense statement is dated to define a specific period that is being covered. While preparing this statement an individual has to consider the gross payment, bonus and commission that he receives. Similarly, the securities bought and sold, and the interest earned on various securities should also be taken into consideration. On the expenditure front, all the monthly fixed payments have to be aggregated and then estimated for the whole year. The fixed and the variable expenses have to be estimated separately. This account of the expenses can be easily obtained from the chequebook, passbook, debit or the credit card statement. A format of the income and expense statement is indicated in table 2 which shows the income and expenditure of a family for the whole year.

As shown in table 2 the yearly income of the family is at Rs.2,00,000 in 2000, which has increased to Rs.2,80,000 over a period of three years. As the income increases so does the expenditure. The total income of the family increased by 40% whereas expenditure jumped by about 55%. Thus, although the income increased substantially, the rise in expenditure with respect to food, utilities, recreation, insurance premium, etc., reduced the cash surplus by 18.5%.

Table 3: Income and Expense Statement

(in Rs.)

Income		Year		
		2002	2001	2000
Salary		2,50,000	2,25,000	2,00,000
Bonus		20,000		
Commission				
Pension and annuity				
Investment income	Interest, dividend received, rent received, sale of securities	10,000	5,000	
Total Income		2,80,000	2,30,000	2,00,000
Expense				
Housing	Rent/mortgage	85,000	80,000	75,000
Utilities	Gas, electricity, water, phone	60,000	50,000	45,000
Food	Groceries	30,000	25,000	20,000
Transportation	Loan installments, repairs, and maintenance	6,000	4,000	2,000
Medical	Health and disability insurance	4,000	3,000	1,000
Clothing	Clothes, accessories	6000	3,000	2,000
Insurance	Life insurance, health insurance, motor insurance	8,000	8,000	8,000
Taxes	Provision for taxes	3,000	2,500	2,500
Recreation	Vacations	5,000	4,000	1,000
Personal Care		5000	4500	3000
Educational Loans		30,000	30,000	
Total Expenses		2,47,000	2,14,000	1,59,500
Cash surplus		33,000	5,500	40,500

The format given above would help in proper understanding of the income statement items given below:

Sources of Income

The sources of income fall in the following categories:

- Wages.
- Salaries.
- Interest from investments.
- Dividends.
- Pension or annuity.
- Rent received from house property or leases.
- Tax refunds.
- Proceeds from the sale of assets.
- Scholarships, grants, etc.

As shown in the income and expenditure statement, the income of the family comprises of salary and commission. The income has increased by 26% over the years.

Expenses

The common expenses include:

- Living expenses incurred for food, housing, medical expenses and transportation. The living expenses given in the statement have increased by 54%, which is higher than the increase in income.
- Asset purchase.
- Tax payments.
- Debt payments in the form of installments, loans, credit card payments.

The expenses incurred vary according to the age group and the place of residence of a person. The expenses can be categorized as fixed and variable for households. The fixed expenses can be in the form of installment payments or monthly insurance premia. The variable expenses however vary from period to period, and include expenses for food, clothing and other utilities.

Cash Surplus or Deficit

The net result of the income statement is the cash surplus or deficit. By deducting the total expenses from the total income, a person can easily have a full picture of his/her financial condition. A cash surplus occurs when the income is more than the expenses and deficit occurs when the expenses are more than the income.

In case of cash surplus, such surpluses can be used for appropriate investment purposes or for acquiring assets. A surplus can also be used for reducing the debt payments, which will affect the future income flows favorably. On the other hand, a deficit will force an individual to cover the same through savings and investments. Thus, while a cash surplus will add to the net worth of a person, a cash deficit will reduce the same. The income and expense statement given in table 3 depicts that there was a cash surplus in all the three years.

DEVELOPING A GOOD RECORD-RECORD KEEPING SYSTEM

Financial statements provide information not only about the financial condition of an individual but also help in monitoring the impact of various financial decisions and in tracking the financial activities of the individual. Financial statements can be analyzed only when the records pertaining to the financial statements are properly organized and maintained.

The following aspects should be considered in this regard.

Keeping Good Records

A good recording system should be instilled in order to facilitate a better control of the financial affairs of an individual. Such a recording system will help to prepare accurate financial statements. Recording involves keeping all the financial bills and documents safely, in order and up to date, which would later ease the process of preparing the financial statements. A journal or ledger book should be maintained in order to keep a record of all the daily financial transactions. Separate sections for various transactions should also be maintained. In this way, it would be easier to maintain a proper check on all the major items of the household.

Organizing Records

Records have to be organized in order to simplify the financial planning procedures. A ledger or journal book would be needed in order to record the various transactions. Separate files would also be needed to file credit card statements, insurance and taxation statements, etc. Monthly bills of electricity, water, rent and groceries should be filed separately. A list of the assets and liabilities should also be made to ascertain the value of the assets as on a particular date and the liabilities owed. A separate file should also be maintained for the income tax payments. Apart from this, proper filing of the investment certificates, purchase and sale documents, birth and marriage certificates, etc., are also necessary.

Types of Records

The following are the main records that should be maintained by an individual or a family:

BANK ACCOUNTS AND CREDIT CARD PAYMENTS

A list should be maintained of all the bank accounts and bank statements. The credit card statements should be maintained and filed. Credit card numbers should be noted down separately, which may be helpful in case the cards are lost.

TAXES

It is essential to file the income and expenditure statements properly so as to prepare the tax returns easily. Tax returns, if properly maintained, would help in a proper auditing also.

HOME

The documents relating to home, namely the purchase and sale documents and the related expenses incurred in the form of repairs should also be maintained.

INSURANCE

The current policies should be properly filed and expired ones should be discarded to avoid any confusion.

INVESTMENT AND RETIREMENT ACCOUNTS

The investment statements such as those of mutual fund, certificate of deposits, savings account and brokerage accounts should be properly maintained.

TRUSTS AND WILLS

Trust documents should be maintained in the form of photocopies at home and the original copy should be kept with an attorney.

RATIO ANALYSIS: TRACKING PERFORMANCE

Once the financial statements are prepared, the next task is to analyze them. One can analyze these statements by performing a ratio analysis. Ratio analysis helps in comparing the previous statements with the current financial statements. The four important ratios in this context are the solvency ratio, liquidity ratio, savings ratio and the debt service ratio. While the former two ratios relate to the balance sheet the latter two relate to the income and expense statement.

Balance Sheet Ratios

The following are the main ratios, which can be used by an individual to check out his/her financial position. The ratios are explained through the balance sheet figures given earlier.

SOLVENCY RATIO

Solvency ratio reflects the degree of exposure to insolvency. In other words, it indicates how much 'cushion' an individual has as a protection against insolvency. This ratio is calculated as follows:

Solvency Ratio = Total net worth / Total assets

We shall calculate the solvency ratio of Arvind and Surekha from the Balance Sheet given in table 1 2002.

The total net worth as indicated in the balance sheet is Rs. 2,10,000 while the total assets for the same year are Rs. 6,00,000. As such the solvency ratio is:

= Rs.2,10,000/6,00,000

= 0.35

LIQUIDITY RATIO

Liquidity ratio reflects how long an individual can continue paying for his/her current debts with his/her existing liquid assets in case of an income loss. It is calculated as follows:

Liquidity Ratio = Liquid Assets/Total Current Debts

Illustration 3

Calculate the liquidity ratio of Arvind and Surekha from the balance sheet in table 1.

Liquid assets include cash on hand, savings account and certificate of deposits. Therefore, total liquid assets are Rs.1,70,000. Now, the total current debts include the amount payable for utilities, medical bills and for rent. Therefore, total current debt is also Rs.1,70,000.

As such the liquidity ratio is:

Liquidity Ratio = Liquid Assets/Total Current Debts

For 2002, the liquidity ratio is calculated as

= Rs.1,70,000/Rs.1,70,000

= 1

The liquidity ratio should preferably be 2:1. The couple may thus face a liquidity problem with respect to level of cash available with the family.

Income and Expense Statement Ratios

The income and expenditure can also be interpreted and understood through ratios. The ratios are explained by using the data of 2002 in the income and expense statement as given earlier in table 2.

SAVINGS RATIO

Savings ratio is one of the ratios used for analyzing the income statements. This ratio indicates the cash surplus or deficit resulting from a specified period's activities. The savings ratio is calculated as follows:

Savings Ratio = Cash surplus/Income after taxes

We see that the cash surplus in 2002 is Rs.33,000 and the income after taxes is Rs.2,77,000. Therefore, calculating the savings ratio from the income and expense statement, we get,

= Rs.33,000 /Rs.2,77,000

= 0.12

DEBT SERVICE RATIO

Debt service ratio reflects whether an individual's financial condition is comfortable so as to meet his/her debt obligations. It is calculated as follows:

Debt service ratio = Total monthly loan payments/Monthly gross (before-tax) income

Monthly loan payments = Rs.30,000/12= Rs.2,500

Monthly gross (before-tax) income = Rs.23,333.33

Therefore,

debt service ratio = Rs.2,500/Rs.23,333

= 0.10

PREPARING A CASH BUDGETS

A budget is a short-term financial planning report, which helps in achieving the short-term financial goals. A cash budget should be prepared with respect to the lifestyle, family structure and values of an individual. A cash budget helps in:

- Monitoring finances.
- Allocation of income for investment.
- Disciplined spending.
- Attaining long-term goals.

As the goals of a person change over time, the cash budget also commensurately changes. Similarly, as one moves through the various stages of the life cycle, the financial position becomes more complex. The number of income and expenditure categories due to the increase in the number of assets and liabilities and also due to the increasing family responsibilities.

The Budgeting Process

A budget is similar to an income statement as it is also prepared on a cash basis. A cash budget includes both cash receipts and cash expenditure that are expected to occur in the future. In other words, a cash budget is an annual estimate of income, expenses, savings and investments. The cash budget can be prepared on a monthly, quarterly or annual basis.

There are three stages in the preparing the cash budget, estimating the income, estimating the expenses and finalizing the cash budget. Anticipated changes in the cost of living should also be taken into account while preparing the budget along with the changes in the level of income.

Estimating Income

The cash budget starts with the estimation of the income. Income in the form of salary or wages is usually received on a monthly basis. Therefore, care should be taken to calculate the annual income on the basis of the expected monthly income. Care should also be taken to ensure that an item, for which repayment has to be made, should not be taken as an income in the income statement. For instance, loan received, which has to be repaid, is not a source of income and should not be included in the sources of income. Similarly, the ‘take home’ salary is another item that has to be given importance. Certain deductions are made in the salary such as income tax, professional tax, etc., by the employer. Thus, the ‘take home’ salary will be less than the gross salary. The ‘take home’ salary should be taken into consideration for budgeting purposes.

Estimating Expenses

Estimating the expenses is more difficult than estimating the income for the forthcoming period. It would be easy to estimate the future expenses only when there are proper past records of bills, credit card and bank account statements. Otherwise, it is difficult to forecast the forthcoming monthly, quarterly or annual expenditure. Expenses can be easily budgeted by analyzing the expenditures usually incurred and then following the past trend to forecast the future.

Finalizing the Cash Budget

After estimating the income and the expenditure, the next step is to compare the expected income and expenses. This would also help to estimate the expected budget deficit or surplus. In case there is a surplus, certain investments can be planned out. On the other hand, in case there is deficit, steps should be taken to reduce expenses. A number of calculations and adjustments will have to be made for streamlining the budget.

Dealing with Deficits

It is usually seen that in some months of the year there is a heavy expenditure while in other months the expenditure is relatively lower and there is a surplus. Thus, to reduce the deficit in the former months, it is essential that certain expenses should be transferred to the months where surplus cash is available. The deficit can also be covered through savings and ‘investments’ income or by borrowings. The loans and borrowings can be repaid in the months when surplus funds are available.

The table below shows the cash budget of a family for the quarter. The cumulative balances indicate whether the income was sufficient to cover the expenses and basic necessities of the family.

Table 4: Cash Budget for the First Quarter of 2003

(in Rs.)

Income	January	February	March
Salary	22,000	22,000	22,000
Investment income	–	–	1,000
Other income	500	500	500
Total Income	22,500	22,500	23,500
Expenses			
Housing	6,000	6,000	6,000
Utilities	2,000	2,000	2,500
Food	3,000	2,500	3,200
Transportation	2,000	2,000	2,000
Personal care	500	400	400
Recreation	300	250	350
Savings and investments	3,000	3,000	3,000
Other expenses	1,000	1,200	800
Total Expenses	17,800	17,350	18,250
Cash surplus	4,700	5,150	5,250
Cumulative cash surplus	4,700	9,850	15,100

Budget deficits can be broadly dealt in the following manner:

- Cut expenses of low priority, such as clothing, entertainment, etc.
- Increase income by finding other high paying job.

Comparing Actual Results with Budgeted Figures

A cash budget is useful only if it is properly prepared and analyzed. This can be done by comparing the records of the actual income and expenditure with the budgeted statements so as to know the actual financial condition of the individual. The budgets show whether an individual is within his/her financial limits or not. An individual can take care of his/her budget by recording it in the beginning of every month and then comparing it with the actual budgets at the end of the month. This monthly comparison helps in identifying, those budget categories where the income falls short. Once these areas are identified corrective action can be taken easily. It is also essential to find out the reason for the deviations in the actual budget from the projected figures.

SUMMARY

- Financial statements play an important role in financial planning. Financial goals can be achieved only after a thorough understanding of one's current financial condition. Although it is easier to assume and formulate financial plans, sound decisions to achieve long-term objectives can only be taken after thoroughly analyzing one's financial position through well-recorded statements.

- Balance sheet, income and expense statement, and cash budget are the main statements used for financial planning by an individual. Balance sheet gives information about the financial position of an individual at a given point of time, whereas the income statement measures the financial condition of a person over a specific period of time. The next important statement used is the cash budget.
- A budget is similar to an income statement and includes both cash receipts and cash expenditure that are expected to occur in the future. In other words, a cash budget is an annual estimate of income, expenses, savings and investments and it can be prepared on a monthly, quarterly or annual basis.
- After preparing these statements, financial ratios can be applied to interpret the financial results. Thus, financial statements lay down the foundation of long-term financial planning.

Chapter III

Managing Taxes

After reading this chapter, you will be conversant with:

- Basic Concepts of Income Tax
- Personal Taxation
- Income Tax Benefits on Certain Investments
- Wealth Tax
- Filing Returns
- Permanent Account Number
- Tax Planning

Introduction

Manohar owns a textile factory. The business has been churning profits continuously over the past few years enabling Manohar to accumulate various assets such as land, three houses, two cars and jewelry. Despite paying taxes regularly, Manohar panics at the end of each financial year while filing his return. He seems very uncomfortable with the idea of filing returns. His wife then suggested him to approach a consultant for tax planning. He is in a dilemma, what should he do?

This is the normal point of view of most of the people who think that taxes are to be evaded and not to be paid, as tax rules take away their hard earned money. However, this viewpoint is incorrect. It is thus very essential to understand the concept of personal taxation. The following sections in the chapter deal with personal taxation laws such as Income Tax and Wealth Tax, Filing returns and tax planning.

BASIC CONCEPTS OF INCOME TAX

In personal financial planning, the incidence of tax plays a very important role. An individual should have a thorough knowledge of various aspects of taxes and tax policies, which would help him/her to understand how much he/she has to pay to the government and how much he/she can save even after paying taxes. To understand the concept of income tax, the following definitions need to be taken into consideration.

a. **Assessment Year (A.Y.)**

According to Section 2(9) of the Income Tax Act (Income Tax Act), assessment year means the period of 12 months starting from April 1 of every year and ending on March 31st, of the next year. An assessment year is the financial year immediately succeeding the relevant previous year. For example, the assessment period of 2008-09, starts on April 1st, 2008 and will end on March 31st, 2009.

b. **Previous Year (P.Y.)**

Income earned in a year is taxable in the subsequent year. The year in which income is earned is known as previous year and the subsequent year in which the income is taxable is known as the “assessment year”.

Section 3 of the Income Tax Act defines “previous year” as the financial year immediately preceding the assessment year. In case of a newly set up business, profession or source of income, the first previous year will be the period commencing from the date of setting up of business/profession or the date on which the new source of income comes into existence and ending on the immediately following March 31.

Certain incomes are however exempted from following the previous year rule. They are as follows:

- Income of persons leaving India either permanently or for a long period of time.
- Income of a person trying to alienate his/her assets with a view to avoiding tax.
- Income of a discontinued business.
- Income of non-resident shipping companies having no representatives in India.

These incomes are taxed as the incomes of the assessment year immediately preceding the normal assessment year at the rates applicable to the former.

For example, if a person plans to leave India permanently and his/her date of departure is 21.5.2008, then the income earned by the individual from 1.4.2008 up to the date of departure may be assessed in the assessment year 2008-09 at the rates applicable for the assessment year 2008-2009. Under other circumstances, this income would have been charged to tax in the assessment year 2009-2010.

c. **Person**

According to Section 2(31), the term 'person' includes:

a. An individual,
b. A Hindu Undivided Family,
c. A company,
d. A firm,
e. An association of persons or a body of individuals whether incorporated or not,
f. Local authority,
g. Every person, not falling within any of the preceding categories.

Individual means human being, group of individuals and also includes a minor or unsound person. In personal financial planning we would be dealing only with the individual. Thus, all the provisions relating to an individual would be given in detail in the following sections.

d. **Assessee**

According to Section 2(7) of the Income Tax Act, assessee means and includes:

- A person by whom any tax or any other sum of money is payable under the Act.
- Every person in respect of whom any proceeding under the Act has been taken for the assessment of his/her income or loss or the amount of refund due to him.
- A person who is assessable in respect of income or loss of another person or who is deemed to be an assessee, or an assessee in default under any provisions of the Act.

e. **Charge of Income Tax**

According to Section 4, income tax is an annual tax on income of a 'person', charged in the assessment year at the rates fixed by the Annual Finance Act as applicable to the relevant assessment year. The tax is levied on the 'total income' of every assessee computed in accordance with the provisions of the Income Tax Act.

f. **Income**

According to Section 2(24) of the Income Tax Act, the term 'income' is inclusive and not exhaustive. Therefore, the term 'income' not only includes those things, which are included in Section 2(24) but also includes such things, which the term signifies according to its general and natural meaning. The following are examples of income – profits, dividends, capital gains, value of perquisites, profits in lieu of salary, voluntary contributions received by a charitable or religious trust or institution, etc., sum received under a Keyman insurance policy, etc.

g. **Gross Total Income**

According to Section 14, income of a person is computed under the following five heads: income from salaries, income from house property, profits and gains of business or profession, capital gains and income from other sources.

h. **Total Income**

According to Section 2(45), total income of an assessee is gross total income received under the heads: Salaries, House Property, Business Profits, Capital Gains and Other Sources as reduced by the amount deductible under Sections 80C to 80U.

i. **Submission of Return**

Filing of income tax return is compulsory for all individuals whose gross annual income exceed the maximum amount which is not chargeable to income tax i.e. Rs.1,45,000 for Resident Women, Rs.1,95,000 for Senior Citizens and Rs.1,10,000 for other individuals and HUFs. A company or firm has to file the return of income irrespective of the whether there is a any income or loss.

j. **Assessment**

The word 'assessment' is defined to include re-assessment. In the general context, the word 'assessment' means computation of tax and procedure for imposing tax liability. Under the Income Tax Act, there are seven kinds of assessments namely self-assessment, provisional assessment, regular assessment, best judgment assessment, reassessment, jeopardy assessment, and precautionary assessment.

k. **Distinction between Capital Receipts and Revenue Receipts**

Understanding the difference between capital and revenue receipts is essential for identifying receipts, which are expressly taxable and those exempt from tax. Revenue receipts are charged to tax except in cases where they are expressly exempted. For example, incomes exempt from tax under Section 10. On the other hand, capital receipts are not chargeable to tax, unless specifically provided for. For example, the amount of compensation received by an employee from his/her employer in connection with the termination of his/her employment, though capital in nature is taxable under Section 17(3). The following points explain the differences between capital receipts and revenue receipts.

- Capital means accumulated wealth employed productively and the word 'revenue' means the return, yield or profit on any land, property or other important source of income. In other words, capital is a fund while revenue is a flow.
- A receipt on account of fixed capital is capital receipt while a receipt on account of circulating capital is revenue receipt.
- A receipt in lieu of source of income e.g., compensation for loss of employment is a capital receipt. A receipt in lieu of income e.g., compensation for loss for temporary disablement is revenue receipt.
- In order to determine whether a receipt is capital or revenue in nature, one has to go by its nature in the hands of the recipient ignoring the following:
  - Source of payment.
  - Motive of the payer.
  - Classification of such receipt in the books of the assessee.
  - Whether received in lump sum/installments.

l. **Distinction between Capital Expenditure and Revenue Expenditure**

The following table identifies the differences between capital and revenue expenditure:

Capital Expenditure	Revenue Expenditure
Incurred for acquisition or upgradation of a fixed asset.	Incurred for meeting routine expenses.
Benefit derived for several years.	Consumed within a previous year.
Incurred for improving earning capacity of business.	Incurred for maintaining profit-making capacity of business.
One time expenditure.	Recurring expenditure.

m. **Residential Status and Tax Incidence**

According to Section 5, the taxability of income of a person depends on his/her residential status and also on the place and time of accrual or receipt of income.

According to Section 5(1), a resident and ordinarily resident in India is assessable to tax in respect of (i) income, which is received or deemed to be received in India in the previous year by him/her or on his/her behalf; (ii) in respect of income, which accrues or arises or is deemed to accrue or arise to him/her during the previous year; and (iii) in respect of income, which accrues or arises to him/her outside India during the relevant previous year.

A resident but not ordinarily resident will be liable to tax if (i) income is received or deemed to be received in India or (ii) income is accrued or deemed to accrue in India or (iii) income is received and accrued outside India from a business controlled in or a profession set up in India.

With regard to a Non-resident Indian, tax liability arises on income received or deemed to be received in India by or on his/her behalf, and income accrued or deemed to be accrued in India during the previous year.

There are a few norms that have to be taken into consideration for determining the residential status of an assessee. These include:

	Basic Conditions at a Glance	
In the case of an individual [other than that mentioned in columns (2) and (3)]	In the case of an Indian citizen who leaves India during the previous year for the purpose of employment or, in the case of an Indian citizen who leaves India during the previous year as a member of the crew of an Indian ship.	In the case of an Indian citizen or a person of Indian origin (who is abroad) who comes to India on a visit during the previous year.
a. Presence for at least 182 days in India during the previous year. b. Presence in India for at least 60 days during the previous year and 365 days during 4 years preceding the previous year.	a. Presence for at least 182 days in India during the previous year. b. Non-functional.	a. Presence for at least 182 days in India during the previous year. b. Non-functional.

Additional Conditions

i. Resident in India in at least 2 out of 10 years preceding the previous year [or must satisfy at least one of the basic conditions, in 9 out of 10 preceding previous years].

ii. Presence of at least 730 days in India during 7 years preceding the previous year.

Rules of Incidence at a Glance

Resident and ordinarily resident	Resident and not ordinarily resident	Non-resident
Must satisfy at least one of the basic conditions and both of the additional conditions [i.e., one of (a) and (b) and both of (i) and (ii)].	Must satisfy at least one of the basic conditions and one or none of the additional conditions [i.e., one of (a) and (b) and one or none of (i) or (ii)].	Should not satisfy any of the basic conditions.

The period of 60 days is relaxed to 182 days for the following cases:

- When an Indian citizen leaves India during the previous year either for employment or as a member of a crew of an Indian ship;
- When an Indian citizen or a person of Indian origin comes on a visit to India.

Residential Status of the Firm and Association of Persons

According to Section 6(4), a partnership firm and an association of persons are said to be resident in India if control and management of their affairs are wholly or partly situated within India during the relevant previous year. They are treated as non-resident in India if control and management of their affairs are situated wholly outside India.

PERSONAL TAXATION

Personal taxation involves two main taxation laws:

a. Income Tax Act, 1961 and

b. Wealth Tax, 1957.

For proper tax planning, it is essential to have a proper understanding of both these laws. Let us first begin with the Income Tax Act, 1961.

The Income Tax Act, 1961, taxes the income of a person if it is above the exemption limit of Rs.1,10,000. On the other hand, the Wealth Tax Act taxes the net assets of an individual if they are above Rs.15 lakh.

The following sections discuss some of the key features and important tax exemptions available under each of the above two laws from the view of personal investment and tax planning.

Income Tax Rates

The income tax rates for the assessment year 2008-09 (Previous Year 1 April 2007 to 31 March 2008) are as follows:

For Individuals and Hindu Undivided Families other than Women and Senior Citizens (who are 65 Years or More).

Income	Tax Rates
Up to Rs.1,10,000	Nil
Above Rs.1,10,000 Up to Rs.1,50,000	10% over Rs.1,10,000
Above Rs.1,50,000 Up to Rs.2,50,000	Rs.4,000 +20% over Rs.1,50,000
Above Rs.2,50,000	Rs.24,000 + 30% over Rs.2,50,000

For Resident Women below 65 years

Income	Tax Rates
Up to Rs.1,45,000	Nil
Above Rs.1,45,000 Up to Rs.1,50,000	10% over Rs.1,45,000
Above Rs.1,50,000 Up to Rs.2,50,000	Rs.500 +20% over Rs.1,50,000
Above Rs.2,50,000	Rs.20,500 + 30% over Rs.2,50,000

For Senior Citizens (who are 65 years or more)

Income	Tax Rates
Up to Rs.1,95,000	Nil
Above Rs.1,95,000 Up to Rs.2,50,000	20% over Rs.1,95,000
Above Rs.2,50,000	Rs.11,000 + 30% over Rs.2,50,000

Surcharge

No Surcharge if the total income does not exceed Rs.10,00,000.

Where the total income exceeds Rs.10,00,000, surcharge will be levied @ 10% of the income tax payable.

Marginal Relief

In cases where the total income exceeds Rs.10,00,000, the total amount payable as income-tax and surcharge on such income shall not exceed the amount by which the income exceeds Rs.10,00,000.

Education Cess

Education cess of 3% is to be levied on the total tax (including surcharge) payable by all the assessees (whether resident or non-resident).

The applicability of rates can be explained by the following illustration:

Illustration 1

Ram, a male resident individual has a gross total income of Rs.3,00,000 for the assessment year 2008-09, and can claim a deduction of Rs.25,000 under Section 80C in respect of contribution to PPF. His income tax liability will then be as follows:

Particulars	Rs.
Income	3,00,000
Less: Deduction u/s 80C	25,000
Taxable Income	2,75,000
Income tax payable Rs.24,000 + 30% of Rs.25,000	31,500
Add: education cess @ 3%	945
Total Tax payable	32,445

Illustration 2

Rohini, a female resident individual has a gross total income of Rs.3,00,000 for the assessment year 2008-09, and can claim a deduction of Rs.25,000 under Section 80C in respect of contribution to PPF. Her income tax liability will then be as follows:

Particulars	Rs.
Income	3,00,000
Less: Deduction u/s 80C	25,000
Taxable Income	2,75,000
Income tax payable Rs.20,500 + 30% of Rs.25,000	28,000
Add: education cess @ 3%	840
Total Tax payable	28,840

Illustration 3

Rakesh a resident individual and a senior citizen has a gross total income of Rs.3,00,000 for the assessment year 2008-09, and can claim a deduction of Rs.25,000 under Section 80C in respect of contribution to PPF . His income tax liability will then be as follows:

Particulars	Rs.
Income	3,00,000
Less: Deduction u/s 80C	25,000
Taxable Income	2,75,000
Income tax payable Rs.11,000 + 30% of Rs.25,000	18,500
Add education cess @ 3%	555
Total Tax payable	19,055

Incomes Exempt from Tax

Under Section 10 of the Income Tax Act, the following types of income do not form part of an assessee's taxable income and hence by implication are exempt from income tax:

- Agricultural income, in case the agricultural income is below the taxable limit, otherwise the agricultural and non-agricultural incomes are added to determine the income tax.
- Receipts by a member of Hindu Undivided Family (HUF) out of family income.
- Interest income from a non-resident account in case of a non-resident Indian.
- Interest on deposits in 15-year Public Provident Fund.
- Share of profit from partnership firm.
- Interest received by a non-resident from prescribed securities.
- Leave travel concession provided by an employer to his/her Indian citizen employee.
- Foreign allowance granted by the Government of India to its employees posted abroad.
- Death-cum-retirement gratuity subject to some limits.
- Commuted value of pension subject to some limits.
- Any payment received by way of commutation of pension by an individual out of annuity plan of LIC.
- Leave salary of an employee subject to some limits.
- Retrenchment compensation of an employee subject to some limits.
- Educational scholarships.
- Awards for literary, scientific and artistic work, or proficiency in sports and games.
- Compensation received by the victims of the Bhopal gas accident.
- Any amount from provident fund paid to a retiring employee.
- Amount from an approved superannuation fund to legal heirs of the employee.
- Any income of an approved scientific research association.
- Income of certain national funds, educational institutions and hospitals on fulfillment of certain conditions.
- Any income of pension fund set up by LIC or any other insurer approved by the IRDA.

- Income by way of dividends and long-term capital gains of venture capital companies.
- Any amount received by an employee by public sector company or any other company at the time of his/her voluntary retirement. The exempted amount shall not exceed:
  a. Three months' salary for each completed year of service, or
  b. Monthly emoluments at the time of retirement multiplied by the balance months of service left before the date of retirement or superannuation.

In any case, the amount shall not exceed Rs.5 lakh. Where exemption has been allowed to an employee under Section 10(10C) for any assessment year, no exemption shall be allowed to him/her there under in relation to any other assessment year.

The benefit is also available to the employees of co-operative societies, universities, Indian institutes of technology and institutes of management as may be specified by the central government, or under its authority. From the assessment year 2004-05, payment received under voluntary retirement schemes from the following sources even if received in installments is exempted:

- The income of mutual funds authorized by Securities and Exchange Board of India or the Reserve Bank of India.
- Interest from notified securities and certificates, etc., issued by the Central Government, or under its authority, as also certain deposits in Post Office Savings Banks are excluded from the total taxable income of the recipient.

  The securities and deposits, and the particular items of income exempted are listed below:

  i. Monthly payment on 12-year annuity certificates issued by the Government.
  ii. Annual payment of National Defence Gold Bonds, 1980.
  iii. Interest from 10-year Treasury Savings Deposit Certificates.
  iv. Interest from 5-year Post Office Cash Certificates.
  v. Interest from 10-year National Plan Certificates.
  vi. Interest from 12-year National Plan Savings Certificates.
  vii. Interest from deposits in Post Office Savings Bank.
  viii. Bonus in respect of deposits under the Post Office Savings Bank Rules, 1959.
  ix. Interest on any scheme of fixed deposits governed by the Government Savings Certificate (Fixed Deposits) Rules, 1968, any scheme of fixed deposits governed by the Post Office (Fixed Deposit) Rules, 1968, and interest on Special Deposit Scheme, 1981, interest on 7% Capital Investment Bonds in the case of individual and Hindu undivided families.
  x. Interest on notified debentures of public sector companies.
- Income received by an approved fund for the welfare of employees or their dependents of which such employees are the members and which applies its income or accumulates it for application wholly its funds in the forms or modes specified under Section 11(5).
- Dividends received from shares issued by a domestic company are exempt in the hands of shareholders from the assessment year 2004-2005.
- Any sum received under a life insurance policy including any bonus allocated on such policy (excluding sums included under Section 80DDA).
- Family pension received by widows, children and nominated heirs of members of the armed forces and the paramilitary forces killed in the course of operational duties is exempt.

- Capital gains arising from transfer of agricultural land by way of compulsory acquisition where the compensation or enhanced compensation is received on or after April 01, 2004 subject to the condition that the land was used for agricultural purpose during the preceding two years.
- Long-term capital gains arising out of securities sold on the stock exchange are exempt under Section 10(38). In view of this new exemption, a tax at the rate of 0.125% on the value of all the transactions of purchase of securities in a recognized stock exchange in India is to be levied.
- Gifts from unrelated persons in cash or by way of a cheque or draft or by any other mode or by way or credit and otherwise than by way of consideration for goods and services is exempt to the extent of Rs.50,000.

INCOME TAX BENEFITS ON CERTAIN INVESTMENTS

The following are the major income tax benefits available on certain investments.

Section 80C Deductions in Respect of Life Insurance Premia, Deferred Annuity etc.

Deduction from GTI in respect of life insurance premia, deferred annuity, contributions to provident fund, subscription to certain equity share or debentures etc., is available under Section 80C.

Eligible Assessee: Individual or HUF.

Amount of Deduction:

a. 100% of the "qualifying investment" or

b. Rs.1 lakh whichever is lower.

QUALIFYING INVESTMENT

The investment eligible for deduction u/s 80C is same as those entitled for rebate u/s 88 irrespective the fact whether such investment is made out of income chargeable to tax. Some of them are given below:

a. Any amount paid towards LIC policy premium irrespective of the sum assured (subject to a maximum of 20% of sum assured).

b. Amount contributed towards a contract for a deferred annuity.

c. Amount contributed to provident fund (Maximum contribution is Rs.70,000).

d. Contribution by an employee to a recognized provident fund/approved superannuation fund.

e. Contribution to 10 year/15 year amount under Post Office Savings Bank Rules, 1959.

f. Subscription to any notified security of the Central Government.

g. Investments in National Saving Certificates VI, VII and VIII series.

h. Subscription to any notified saving certificate.

i. Contribution to Unit Linked Insurance Plan, 1971.

j. Contribution to Unit Linked Insurance Plan of the LIC, Mutual fund notified u/s 10(23D).

k. Contribution to notified annuity plan of the LIC of India or any other insurer.

l. Payment of tuition fee.

m. Repayment of principle amount of housing loans, etc.

n. Investment in a term deposit for a fixed period of not less than 5 years with any scheduled bank (From the assessment year 2007-08).

o. Investment in rural bonds of NABARD, as notified by the Central Government (Applicable from the assessment year 2008-09).

Note: Aggregate deduction under Sections 80C, 80CCC and 80CCD cannot exceed Rs.1,00,000.

Expenses/Contributions Deductible from Income

i. *Deduction in Respect of Contribution to Pension Fund* (*Section 80CCC*).

This Section provides a deduction to an individual for any amount paid by him/her in any annuity plan of LIC for receiving pension. The deduction shall be restricted to amount deposited or Rs.1,00,000 whichever is lower.

ii. *Deduction in Respect of Contribution to Pension Scheme of the Central Government* (*Section 80CCD*).

This deduction is available to an individual who is a central government employee or any other employee (w.e.f.) assessment year 2008-09 on or after January 1 2004.

Contribution to the pension scheme by the employee up to ten percent of employee’s salary and contribution by the Central government/employer up to ten percent of employee’s salary is exempt from tax. The accruals will also be exempt from tax. The terminal benefits however will be taxable in the year of receipt.

iii. *Deduction in respect of Medical Insurance Premium* (*Section 80D*)

A deduction of Rs.15,000 is allowed under Section 80D in respect of any sum paid by cheque by an assessee to effect or keep in force the Mediclaim insurance policy. If the insurance policy is taken on a senior citizen, the deduction is allowed up to Rs.20,000.

iv. *Medical Treatment of Handicapped Dependents* (*Section 80DD*)

Section 80DD provides that if a person makes some expenditure on the maintenance or medical treatment of a handicapped dependent, or deposits money in an approved scheme for the maintenance of such dependent, a deduction of Rs.50,000 from taxable income will be allowed in respect of a person with disability and Rs.75,000 in case of a person with severe disability irrespective of the expenditure actually incurred, or the amount actually deposited.

v. *Deduction in Respect of Medical Treatment* (*Section 80DDB*)

An individual can claim a deduction of Rs.40,000 limited to the actual expenditure incurred towards expenditure for the medical treatment for individual himself/herself or for his/her relative or for any member of a Hindu Undivided Family in respect of selected serious diseases. The amount of deduction is irrespective of the amount actually incurred. If the amount is spent on a senior citizen, a deduction of Rs.60,000 limited to the actual expenditure is allowed.

vi. *Repayment of Loan for Higher Education* (*Section 80E*)

Where an individual takes a loan from any bank, financial institution or an approved charitable institution for the purpose of pursuing higher education, the entire amount paid by way of interest is deductible under Section 80E from the assessment year 2006-07. Such deduction is allowed in the initial assessment year (i.e. the assessment year relevant to the previous year in which the assessee starts paying the interest on loan) and 7 immediately succeeding assessment years. Such deduction is not available in respect of repayment of principal amount. However, such amount should have been paid out of his income chargeable to tax.

Note: From the assessment year 2008-09, the deduction is allowed for interest on loan taken by an individual for higher education of his relative also.

The term "relative" for the purposes of section 80E means spouse and children of the individual.

vii. *Deductions in Respect of Donations* (*Section 80G*)

Under this Section, certain specified donations are eligible for deductions from income. For some kind of donations, the amount deductible is 50% of the donation, while for some others; it is 100% of the donation. The total deduction under this Section is however limited to 10% of gross total income after being adjusted for certain items.

viii. *Donations for Scientific Research or Rural Development* (*Section 80GGA*)

Under this Section, certain donations to specific kinds of institutions are eligible for 100% deductions.

ix. *Deduction in the Case of a Permanent Physical Disability (including blindness) or Mental Retardation* (*Section 80U*).

The amount of deduction permitted under this Section is Rs.50,000. A higher deduction of Rs.75,000 shall be allowed in respect of a person with severe disability.

Income Tax on Salaries

For the purpose of income tax, the term 'salary' is defined to include:

- Wages, annuity, pension, gratuity, any fees, commission;
- Perquisites or profits in lieu of, or in addition to, salary or wages;
- Any advance of salary;
- Any payment received by an employee in respect of any period of leave not availed by him/her etc.
- Portion of the annual accretion in any previous year to the balance at the credit of an employee participating in recognized provident fund to the extent it is taxable.
- Transferred balance in a recognized provident fund to the extent it is taxable.
- The contribution made by the central government in the previous year, to the account of an employee under a pension scheme referred to in Section 80CCD.

Perquisites

A perquisite is defined as the value of any benefit or amenity granted or provided free of cost, or at a concessional rate. It represents a benefit, which has a tangible monetary value for a person. It does not, however, cover mere reimbursement of necessary expenditure. A perquisite may be divided into the following three categories:

a. **Perquisites Taxable in all Cases**

These include:

- Value of rent-free accommodation provided to the assessee by his/her employer.
- Value of concession in rent in respect of accommodation provided to the assessee by his/her employer.
- Any amount paid by an employer in respect of an obligation, which otherwise would have been payable by an employee.

- Any amount payable by an employer directly or indirectly to effect an assurance on the life of the assessee or to effect a contract for an annuity, etc.
- Value of any other fringe benefit or amenity such as interest free loan; traveling; touring; accommodation; free meals; gifts; credit cards; use of movable assets, etc.

b. **Tax-exempt Perquisites**

The major tax-exempt perquisites are as follows:

- The provision of medical facilities, including medical treatment abroad (subject to certain conditions u/s 17(2)).
- Refreshments during working hours.
- Subsidized lunch or dinner.
- Recreational facilities.
- Training expenditure.
- Goods sold by an employer to his employees at a concessional rate.
- Leave travel concession, subject to certain rules.
- Interest free loans to an employee if the interest free loan is Rs.20,000 or less.
- Perquisites allowed outside India by the government to a citizen of India for rendering service outside India.
- Employer’s contribution to provident fund.
- Conveyance facility provided for the journey between office and residence and back free of charge or at a concessional rate.
- Gift in kind up to an amount of Rs.5,000.
- Expenses of telephone/mobile phones.
- Periodicals and journals required for official work.
- Use of health club, sports facilities uniformly provided to all the employees by the employer.
- Sale or gift of movable assets (other than car and electronic items) to an employee after use of the same by the employers for ten years or more.
- Tax on perquisites in kind paid by the employer.

c. **Perquisites, which are Taxable only in the Hands of Specified Employees**

The value of any other benefit or amenity granted or provided free of cost or at a concessional rate is taxable in the case of following three ‘specified employees’:

- A director employee.
- An employee who has a substantial interest in the employer’s company, i.e., in case he/she owns equity shares carrying 20% or more voting power.
- An employee drawing in excess of Rs.50,000 p.a.

d. **Allowances**

An allowance is defined as a fixed quantity or other substance given regularly in addition to salary for the purpose or meeting some particular requirement connected with the services rendered by the employee or as compensation for unusual conditions of that service. The following is a list of tax-free allowances:

- Any allowance granted on tour or for period of journey in connection with transfer to meet the ordinary daily charges incurred by an employee.
- Any allowance granted to meet the expenditure incurred on conveyance in performance of duties on an office or employment of profit, provided free conveyance is not provided by the employers.
- Any allowance granted to meet the expenditure incurred on helper where such helper is engaged for the performance of duties of an office or employment of profit.
- Any allowance granted for encouraging academic research and training pursuits in educational and research institutions.
- Any allowance for purchase or maintenance of uniform for wear during the performance of the duties of an office of employment or profit.
- Allowance to government employees outside India.

The following allowances are partly exempted from tax, subject to certain conditions:

- House rent allowance.
- Children educational allowance.
- Allowance on the hostel expenditure on children.
- Transport allowance granted to an employee to meet his/her expenditure for the purpose of commuting between his/her residence and place of duty.

The following allowances are completely taxable:

- City compensatory allowance.
- Tiffin allowance.
- Fixed medical allowance.
- Servant allowance.

Tax on Income from House Property

A house property consists of buildings or lands appurtenant to building such as car parking spaces, courtyards, kitchen gardens etc. Typically, the legal owner in whose name the property stands is liable to pay the tax. However, under certain circumstances, tax is levied on deemed owners' as well.

ANNUAL VALUE

Income from house property is referred to as annual value. For the purpose of taxation, the annual value of house property is determined as follows:

- The annual value is taken as 'nil', if the house property is occupied by the owner.
- If the house cannot be occupied by the owner because of his/her employment, business or profession being at some other place forcing him/her to reside there, the annual value is taken as 'nil'.

However, these two clauses are applicable only for one house, and that too only if the owner does not let-out the house during any part of the year, nor does he/she derive any other benefit from such house.

In other cases, the annual value of any property is taken as:

- The sum for which the house may reasonably be expected to be let from year to year; or
- Where the house is let-out for a sum higher than one mentioned in above, the actual rent; or
- Where the house is let-out for a part of the year, and the rent received is lower than the sum of the actual rent received. This is due to the house being vacant for a part of the year.

DEDUCTION FROM ANNUAL VALUE

The following deductions are allowed from the annual value of a house property:

- Municipal taxes and rates.
- A flat deduction of 30% of the annual value is allowed, irrespective of the actual expenditure incurred.
- Where the property has been acquired, constructed, repaired, removed or reconstructed with borrowed capital, the amount of interest payable on such borrowings, subject to a maximum of Rs.1,50,000 in respect of self-occupied house property.
- Unrealized rent from the tenant.

TAX TREATMENT OF LOSS FROM HOUSE PROPERTIES

If the assessee incurs a loss under the head ‘income from house property’, the loss can be set-off against any other head of income. Any unadjusted loss can be carried forward for a period of 8 years for being set-off against any future income under the same head.

Income Tax on Capital Gain

Capital gains arise when a profit is made on transfer of a capital asset. Capital assets include all movable and immovable properties other than the following:

- Stock-in-trade, consumable stores or raw materials held for the purpose of one’s business or profession;
- Personal effects, such as wearing apparel – other than jewelry, furniture for personal use; However, archaeological collections, drawings, paintings, sculptures, any work of art are not considered as personal effects. In other words, there are considered as capital assets.
- 6.5% Gold Bonds – 1977;
- 7% Gold Bonds – 1980;
- National Defense Gold Bonds – 1980;
- Agricultural land in India situated outside the jurisdiction of a municipality or a cantonment board;
- Special Bearer Bonds, 1991;
- Gold Deposit Bonds issued under the Gold Deposit Scheme, 1999.

TRANSACTIONS NOT REGARDED AS TRANSFER

For the purpose of capital gain tax, certain transactions are not regarded as transfer. Hence, for these transactions, there is no liability towards capital gains:

- Any distribution of capital assets on the total or partial partition of a Hindu Undivided Family.
- Any transfer of a capital asset under a gift, or a will or an irrevocable trust.
- Any transfer by way of conversion of bonds or debentures, debenture-stock or deposit certificates in any form, of a company into shares or debentures of that company.

- Transfer of shares in certain schemes of amalgamations, etc.
- Transfer of a capital asset being any work of art, archeological scientific or art collection, book, drawing, painting, etc., to the government or any university or museum notified by the Central Government.
- Any transfer involved in a scheme entered into by the assessee with the borrower or arrangement subject to guidelines issued by SEBI.

The tax treatment is different for short-term capital gains and long-term capital gains.

Short-term Capital Gains

A short-term capital asset is one, which is held for 36 months or less, 12 months, or less in the case of equity shares, units of mutual funds/UTI and listed securities- immediately preceding the date of transfer. Short-term capital gains i.e., gains arising from the transfer of short-term capital assets, are treated as a part of total income in the year in which the transfer is effected, and taxed at the normal rates of tax.

Prior to amendment made in Finance Act 2004 the short-term capital gains are taxed at applicable tax rates (i.e. slab rates). This treatment continues to apply to all short-term capital asset except short-term capital gains from sale of securities. A new Section 111A has been introduced, to tax the short-term capital gains arising from the sale of securities to investors @ 10%.

COST OF ACQUISITION

To determine capital gains arising out of the transfer of a long-term capital asset, the cost of acquisition and the cost of improvement are allowed as a deduction from the sales proceeds. The cost of acquisition and cost of improvement of asset are linked to the Cost Inflation Index (CII). Long-term capital gains are therefore computed by deducting from the full value of the consideration the expenditure incurred in connection with the transfer, the indexed cost of acquisition, and the indexed cost of improvement.

"Cost Inflation Index" (CII) for any year means such index as the Central Government may, having regard to seventy-five percent of average rise in the Consumer Price Index (CPI) for urban non-manual employees for that year, notify in the Official Gazette.

Financial Year	Cost Inflation Index	Financial Year	Cost Inflation Index
1981-82	100	1995-96	281
1982-83	109	1996-97	305
1983-84	116	1997-98	331
1984-85	125	1998-99	351
1985-86	133	1999-2000	389
1986-87	140	2000-01	406
1987-88	150	2001-02	426
1988-89	161	2002-03	447
1989-90	172	2003-04	463
1990-91	182	2004-05	480
1991-92	199	2005-06	497
1992-93	223	2006-07	519
1993-94	244	2007-08	551
1994-95	259	–	–

Indexed cost of acquisition means an amount, which bears to the cost of acquisition the same proportion, as the Cost Inflation Index (CII) for the year in which the asset is transferred bears to the Cost Inflation Index for the first year in which the asset was held by the assessee or for the year beginning on 1st April, 1981, whichever is later.

In other words, indexed cost of acquisition for financial year 2007-08 would be:

$$\text{Indexed cost of Acquisition} = \frac{\text{Cost of Inflation for 2007-08}}{\text{Cost of Inflation Index for 1981-82 or later}} \text{ x Cost of Acquisition}$$

Long-term Capital Gains

Under Section 112, individual assessee and HUFs will pay a flat rate of tax @ 20% on long-term capital gains (except on securities). The long-term capital gains on sale of securities are fully exempt. Instead a security transaction tax of 0.125% on the value of all the transactions of purchase of securities that take place in recognized stock exchange in India has been imposed.

The threshold exemption of Rs.1,10,000 is fully available in cases where there is no income other than long-term capital gains and partially to the extent of unabsorbed threshold after set-off of any other income if it falls below Rs.1,10,000. A Education cess of 3% is applicable in case of all assessees and Surcharge of 10% on income tax is applicable only if the assessee has a total income exceeding Rs.10,00,000 and education cess of 3% is applicable on tax and surcharge.

Exemption under the Long-term Capital Gains (Section 54)

Under Section 54, exemption from long-term capital gains tax on transfer of residential house property is available if the whole or part of the gains are used to purchase another residential house within a period of one year before the date of such transfer or within two years of the date of transfer. In case of construction of residential property, the construction must be completed before three years of the date of transfer.

The condition is that the new residential house should be held for a minimum period of three years from the date of its acquisition.

In case the individual is unable to utilize the amount for the aforesaid purpose before the date for furnishing the return of income, it shall be deposited in a deposit account notified in accordance with the Capital Gains Account Scheme, 1988.

Exemption from Long-term Capital Gains (Section 54 EC & 54 F)

Under Section 54EC, exemption from long-term capital gains tax is available if the whole or part of the capital gains are invested in bonds issued by National Highways Authority of India (NHAI) or Rural Electrification Corporation (REC) within six months of the date of transfer of the asset.

From the assessment year 2008-09, Investments in such specified assets to avail exemption under Section 54EC, on or after 1 April 2007, should not exceed Rs.50,00,000 in a financial year.

The condition is that such investments should be held for a minimum period of three years and should not be used as security for taking loans during this lock-in period.

In the case of individuals and HUFs, long-term capital gains arising out of transfer of capital assets other than a residential house are protected from tax under Section 54F provided the sales proceed are invested to either purchase a residential house within two years or construct one within three years, subject to other conditions.

Adjustment of Capital Losses

Losses due to transfer of short-term or long-term capital assets cannot be set-off against any other income. From the assessment year 2003-2004, long-term capital losses can be set-off only against long-term capital gains. However, short-term capital losses can be set-off against both short-term capital gains and long-term capital gains. Any unadjusted capital loss may be carried forward and set-off against income under the head, "capital gains" of the subsequent years. However, such loss cannot be carried forward for more than eight assessment years.

Capital Gains on Bonus and Rights Issue

Bonus Shares

When a company distributes bonus shares by capitalizing its reserve it does not involve the release of any assets belonging to the company. The issue of bonus shares to an investor is therefore not deemed to be dividend. Consequently, a shareholder who receives bonus shares is not liable to pay any tax on their receipt. When the shareholder subsequently sells the bonus shares, the cost of acquisition is taken as nil.

Hence, the entire sale price after deducting transfer expenses is taxable as capital gain. The date of acquisition of bonus shares is the date of allotment of such shares.

Illustration 4

Prerna purchased 100 shares of ABC Ltd., in June, 1999 for Rs.3,000. In April, 2,000 the company issued bonus shares in the proportion of 3:5 and Prerna received 60 bonus shares, which she subsequently sold for Rs.12,000 in May, 2007. The long-term capital gains in this transaction are:

Sale proceeds of 60 shares	Rs.12,000
Less: cost of acquisition	Nil
Long-term capital gains	Rs.12,000

If the 600 shares are transferred in a recognized stock exchange in India, securities transaction tax of Rs.15 is applicable [12,000 x 0.125% = Rs.15]. Long-term capital gains on the sale of securities is exempt under section 10(38).

In other case, a Long-term capital gain @ 10% is chargeable on Rs.12,000 = Rs.1,200 + 3% (cess) of Rs.1,200 = Rs.1,236.

Illustration 5

Ramesh purchased 100 shares of XYZ Ltd., for Rs.5,200 in March, 1998. In April, 1999, the company issued bonus shares in the proportion of 1:1. Accordingly, B received 100 bonus shares, which he sold in June, 2007 for Rs.2,000. The transfer fee was Rs.300. The long-term capital gains made in this transaction are:

Particulars	Rs.
Sale proceeds of 100 shares	2,000
Less: Cost of acquisition	Nil
Long-term capital gains	300
Less: Transfer fee	1,700
Long-term capital gain	–

Since long-term capital gains on the sale of securities is exempt under section 10(38), the above sum of Rs.1,700 is exempt and is chargeable to securities transaction tax.

The Central Board of Direct Taxes (CBDT) has issued a circular specifying that when securities are purchased in several lots at different points of time, the First In First Out (FIFO) method will be adopted to calculate the period of holding of the security.

The circular adds that the assets acquired last will be considered remaining with the assessee while assets acquired first will be treated as sold. The assessee cannot therefore show that shares purchased at the highest price had been sold, thus increasing the cost of acquisition and reducing the tax liability. The cost of acquisition of bonus shares being nil, the assessee could end up paying a high capital gains tax.

Rights Shares

When a shareholder subscribes to a rights issue of shares, there is no income tax implication even though the shareholder may benefit to some extent.

Illustration 6

ABCL Ltd., issued rights shares in October, 2000, in proportion of 1:4 at a premium of Rs.12 per share. Meera, who holds 100 shares can get 25 shares by paying Rs.22 per share (Rs.10 face value + Rs.12 premium). Suppose the market price of the share is Rs.30, there is a positive benefit to Meera, but there are no tax implications. On the other hand, should a shareholder who is offered rights shares, decides not to subscribe the rights but sells his rights in the open market; he may be liable to capital gains tax.

Illustration 7

Deena received rights to subscribe for 50 shares of DEF Ltd., which he sold in the market at Rs.5 per share. Deena continues to hold the original shares. Then:

Particulars	Rs.
Sales proceeds 50 rights (50 x Rs.5)	250
Cost of rights	Nil
Capital gains (Short-term)	250

The Supreme Court has held that there is no taxable event when the assessee chooses neither to subscribe to the rights nor to renounce them. Hence, there is no tax liability for capital gains or gift tax. [CIT vs. Rasiklal Meneklal (HUF) (1989) 177 ITR 198].

Let us now turn to a comprehensive illustration covering both bonus and rights shares in order to make these points clearer.

Illustration 8

E purchased 300 shares of KLM on 1st October, 1995 for Rs.200 per share and incurred Rs.500 on brokerage and transfer fees. On 31st March, 1997, he received 150 bonus shares. On 1st May, 2007, he was allotted 150 rights shares for Rs.130 each. On 1st July, 2007, he sold 300 shares for Rs.400 per share and incurred an expenditure of Rs.1,000 on brokerage. Hence:

(in Rs.)

Particulars	No. of shares	Rs.	Indexed cost
Cost of acquisition on 1st October, 1995	300	60,000	1,17,651 *
Brokerage and transfer fees	–	500	980
Bonus shares on 31st March, 1997	150	–	–
Rights shares on 1st May, 2007	150	**19,500	–
Sales proceeds of 300 shares on 1st July, 2007 (300 x 400)	–	–	1,20,000
Less: Indexed cost of acquisition (1,17,651 + 980)			1,18,631
Less: Brokerage			1,000
			369

To arrive at the indexed cost of acquisition we use the following method:

60,000 x (551/281) = 1,17,651

Where 551 is the Cost of Inflation Index for 2007-08

While 281 is the Cost of Inflation Index for 1995-96

Similarly, 500 x (551/281) = 980

**Indexed cost has not been calculated, as it is a short-term capital asset.

Income Tax on Speculation in Shares

The Income Tax Act provides that loss from speculation cannot be adjusted against profits from any source other than speculation. The matter is quite simple when there are no past or current losses of speculation to be adjusted against the profits of speculation. In such a case, the profits are to be included in the total income and assessed.

A speculative transaction is defined in Section 43(5) of the Income Tax Act as a transaction in which a contract for the purchase or sale of any commodity, including stocks and shares, is periodically or ultimately settled otherwise than by the actual delivery or transfer of the commodity or scrips. It is however, clarified that the following two types of transactions pertaining to shares are not deemed to be speculative transactions:

- A contract in respect of stocks and shares entered into by a dealer or investor therein to guard against loss in his holding of stocks and shares through price fluctuations.
- A contract entered into by a member of a forward market or a stock exchange in the course of any transaction in the nature of jobbing or arbitrage to guard against loss, which may arise in the ordinary course of his/her business as such a member.

Section 73 of the Income Tax Act provides that any loss, computed in respect of a speculation business carried on by the assessee, shall not be set-off except against profits and gains, if any, of another speculation business. If at the end of the year, there is a loss from speculation business remaining unabsorbed, it can be carried forward for a maximum period of eight years immediately following the year in which loss originally occurred, for absorption only by profits from speculative transactions of such later years.

Inclusion of Other Persons' Income in Assessee's Income

There may be instances where some assessees try to avoid payment of income tax by transferring some of their incomes or properties to other people. To inhibit such attempts, Sections 60 to 65 were incorporated in the Income Tax Act. As a result, inspite of the fact that a certain income may be earned by one person, it qualifies for inclusion in the total income of another person.

The following is a brief summary of the relevant tax provisions:

- If any person transfers income without transferring the asset, which produces such income, the income will be taxed in the hands of the transferor (Section 60).

- If a person transfers an asset on revocable basis, the income from that asset is included in his/her income for the purpose of income tax (Section 61). This rule is subject to some exceptions given by Section 62, which specifies that the income is not included in the transferor's income when the transfer:

  i. Is by way of trust and is not revocable during the life of the beneficiary.

  ii. Is not revocable during the life of the transferee.

  iii. Was made before 1st April, 1961, and is not revocable for at least six years.

- In the following cases also, the income of a transferred asset is included in the income of the transferor:

  i. Transfer of assets by one spouse to another, other than for adequate consideration or in connection with an agreement to live apart.

  ii. Transfer by an individual to any person or association of persons, otherwise than for adequate consideration for the benefit of his or her spouse.

- In computing the total income of any person, there shall be included all such income as arises directly or indirectly, to the spouse of such an individual by way of salary, commission fees or any other form of remuneration, whether in cash or in kind from a concern in which such an individual has substantial interest, except where the spouse is technically or professionally qualified for the job.

- Income arising from the assets transferred directly or indirectly on or after 1st June, 1973, by an individual to his/her son's wife, otherwise than for adequate consideration, will be included in the total income for such an individual.

- Under a new Section 64(1A), all income, which arises or accrues to a minor, is to be clubbed with the income of the parent. However, the income derived by the minor from manual work or from any activity involving application of his/her skill, talent or specialized knowledge/experience will not be included in the income of his/her parent. Where such minor's income is clubbed, the parent is entitled to an exemption of Rs.1,500 for each minor child, or the income so included, whichever is lower.

However, with a view to provide appropriate relief to the handicapped minors, a provision has been made to keep the entire income of the handicapped minor out of the purview of the clubbing provisions contained under Section 64 (1)(a).

NO CLUBBING IN RESPECT OF LOANS

An interesting question arises as to what happens where a gift is not made, but a genuine loan is given to the spouse, which is repaid within a reasonable period of time. In such circumstances, courts have taken the view that the provisions for clubbing of income (and wealth) would not be applicable.

It should be noted that the clubbing provisions also do not apply to the second stage income. For instance, consider a case when Mr. A gifts Rs.10,000 to Mrs. A, who invests the money in a bank deposit. Mrs. A receives Rs.1,300 (the first stage income) as interest, which she again reinvests. If the reinvested amount earns an interest of Rs.130 (the second stage income) then this income is not to be clubbed with the income of Mr. A. Instead, this becomes the income of Mrs. A.

WEALTH TAX

Wealth tax is charged for every assessment year in respect of net wealth on the corresponding valuation date of every individual, a Hindu Undivided Family and Companies at specified rates.

Basic Exemption

There is a basic exemption of Rs.15 lakh in the case of wealth tax. In other words, if the net wealth of an individual does not exceed Rs.15 lakh, then he/she does not have to pay any wealth tax.

Wealth Tax Rates

Wealth tax is payable @ 1% of the amount of the net wealth exceeding Rs.15 lakh. There is no surcharge on wealth tax.

Assets that Attract Wealth Tax

Only the following six types of assets are chargeable to wealth tax:

- Guesthouses and residential houses, (However, one residential house or part of a residential house belonging to an assessee is eligible for exemption in the case of individuals and HUFs);
- Motor cars;
- Jewelry, bullion and any furniture or utensils, etc., made of any precious metals;
- Yatchs, boats, aircrafts;
- Cash in hand in excess of Rs.50,000;
- Certain types of urban land. (However, urban land held as stock-in-trade is not liable to wealth tax for a period of 10 years from the date of its acquisition).

Assets Exempted from Wealth Tax

The following assets are exempted from wealth tax:

- Property held under a trust.
- Interest of a coparcener in HUF property.
- Residential building of a former ruler.
- Jewelry in possession of a former ruler.
- Assets belonging to Indian repatriates.
- One residential house or part of a residential house belonging to an individual or HUF.
- Urban land held as stock-in-trade is not liable to wealth tax for a period of 10 years from the date of its acquisition.
- All financial assets such as shares, bonds, debentures, deposits, etc.

Deemed Assets

For the purpose of wealth tax, certain assets, which do not belong to an assessee under the general law, are also included in the net wealth of the individual. Some of these are:

- Assets transferred to spouse without adequate consideration, or not in connection with an agreement to live apart.
- Assets transferred without adequate consideration to son’s wife.
- Assets transferred without adequate consideration to a person or persons for the immediate or future benefit of oneself, or one’s spouse or son’s wife.
- Assets transferred otherwise than under an irrevocable transfer.
- Money gifted by mere book entries without actual payment taking place.

Clubbing of Minor's Net Wealth

The net wealth of a minor is clubbed with that of his/her parent. However, that of handicapped children are excluded from the clubbing provisions.

Valuation of Assets

Elaborate rules have been framed to value assets like such as jewelry, interest in partnerships, etc., and embodied in Schedule III of the Wealth Tax Act.

FILING RETURNS

Every person, if total income or the total income of any other person in respect of which it is assessable under this Act during the previous year exceeds the maximum amount which is not chargeable to income tax, is required to file a return of income within the due dates.

Note: A company or firm has to file the return of income irrespective of the whether there is a any income or loss.

Section 139(1) makes filing of return mandatory in the following cases:

Income tax	Due Date
Assessee:	
Company	31st October of the relevant assessment year.
Non-corporate Assessee:	
Where accounts are to be audited under any law	31st October of relevant assessment year.
Where the assessee is a co-operative society	31st October of relevant assessment year.
Where the assessee is a 'working partner' in a firm whose accounts are required to be audited under the Income Tax Act or any other law	31st October of relevant assessment year.
In any other case	31st July of the relevant assessment year.
Wealth tax	
In the case of an individual whose net worth exceeds Rs.15 lakh	31st July of the relevant assessment year.

The Finance Act, 2003, has provided that the above-mentioned returns can be filed in such form (including floppy, diskette, magnetic cartridge tape, CD-ROM or any other computer readable media) subject to the conditions mentioned in the scheme notified by the Board. [Section 139(1B)]

The other types of returns include the following:

Loss Return [Section 139(3)]

If the assessee has to carry forward losses under the heads of "Profits & Gains of Business or Profession" or "Capital Gains" during the year in question, he/she must furnish a return of income in the prescribed form and verified in the prescribed manner giving the prescribed details on or before the due date for such furnishing.

Belated Return [Section 139(4)]

Any person, who has not filed a return of income within the due date specified under Section 139(1) or within the time allowed under a notice issued u/s 142(1), can file his/her return of income within the extended time allowed under the law. These returns are termed as 'Belated Return' and can be filed within one year from the end of the relevant assessment year or before completion of the assessment, whichever is earlier.

To illustrate, in respect of the previous ended on 31.03.2008, the assessment year ends on 31.03.2009, therefore the belated return becomes time barred one year after 31.03.2009 i.e., on 31.03.2010. However, if the assessment is completed before 31.03.2010, then such return should be filed before completion of the assessment.

Revised Return [Section 139(5)]

If any person who has already submitted his/her Return of Income (R.O.I) u/s 139(1) or in pursuance to a notice u/s 142(1), subsequently discovers any omission or wrong statement therein, he/she may furnish a revised return for any previous year at any time before the expiry of one year from the end of the relevant assessment year or before the completion of the assessment, whichever is earlier. Omission or wrong statement has not been defined in the Act. Readings of the decided case suggest that 'omission' means unintentional act and 'wrong statement' means, which is not false to the knowledge of the taxpayer.

Other points are as follows:

- Only R.O.I filed under Section 139(1) or 142(1) can be revised. In other words, belated return filed by the assessee cannot be revised.
- A revised R.O.I filed by the assessee can again be revised.
- Once the revised return is filed, the original return loses its relevance and is deemed to have been substituted by the revised return.

Further Requirements [Section 139(6)]

Under further requirements, the assessee may be required to furnish the particulars of income exempt from tax, assets of the prescribed nature and value belonging to him/her, his/her bank account and credit card held by him/her, etc.

Further Requirements in the Case of an Assessee Engaged in Business or Profession [Section 139(6A)]

If the assessee is engaged in any business or profession he/she is required to furnish the following information:

- The names and addresses of his/her partners.
- The report of audit obtained under Section 44AB.
- Particulars of the location and style of the principal place wherein he/she carries on the business or profession and all the branches thereof.

Defective or Incomplete Return [Section 139(9)]

If the assessing officer is of the opinion that the return of income furnished by the assessee is defective, he/she has the discretion to intimate the defect to the assessee and give him/her an opportunity to rectify the defect within 15 days from the date of intimation or such time as may be extended by the assessing officer. If the return is not rectified by the assessee within such time, it will be treated as an invalid return and it will be deemed that the assessee had not filed any return. The provision specifies that if the assessee rectifies the return after such time, the assessing officer may condone the delay and treat the return as a valid return.

Explanation to the Section pronounces that a return will be deemed to be defective unless all the following conditions are satisfied:

Circumstances when a return can be treated as defective.

The assessing officer may regard a return as defective in any of the following cases:

a. Where the annexures, statements, columns in the return of income have not been duly filled in.

b. Where the return is not accompanied by –

   i. Statement showing computation of tax on returned income.

   ii. Proof of tax deducted or collected at source up to 31-3-2008, advance tax paid and self assessment tax paid.

   iii. Tax audit report u/s 44AB or copy of such report together with proof of furnishing the report on earlier date.

c. Where regular books of accounts are maintained, but the copies of manufacturing account or trading account or profit and loss account or income and expenditure account or any other similar account and balance sheet has not been furnished. Similarly, where no copies of personal account of the proprietor, partner or member has been filed.

d. Where copies of audited statement of accounts and auditor's report have not been filed.

e. Where regular books are not maintained, a statement indicating the amount of turnover or gross receipts, gross profit, expenses and net profit and the basis thereof together with the amount of total sundry debtors, sundry creditors, stock-in-trade and cash balance at the end of the previous year have not been filed.

RECTIFICATION OF DEFECT

In case there is a defect in the return, the assessing officer will inform the assessee about this fact and the assessee may be called upon to rectify the defect within 15 days or within such extended time as permitted. In case the defect is not so rectified, the Assessing Officer will treat the return of income as an invalid return. However, if rectification is done after the time granted, but before the assessment is made, then the assessing officer is authorised to treat the return as valid.

Note: Where the return is not accompanied by the proof of tax, if any claimed to have been deducted or collected at source (i.e. Form No.16 or 16A or 16AA or 27D), *on or after April 1, 2008*, the return of income shall not be regarded as defective.

E-filing of Returns

ELIGIBILITY

- Individuals deriving salary income but not having income from business and profession;
- Who are assessed or assessable at specified cities; and
- Who have been allotted a valid PAN.

PROCEDURE

The eligible assessee can approach an authorized "e-return intermediary" either with details of its income and its supporting documents or with a prepared return of income. The intermediary then prepares his/her return of income and obtains his/her signature on the same.

- The intermediary will transcribe the data on the return of income, and transmit the same online to the server of the Department in a predefined format.
- Department will send a provisional receipt online to the intermediary indicating date of receipt and the office of the Assessing Officer, where the paper return is to be furnished by the intermediary.
- The intermediary will submit the paper return along with the provisional receipt at the Income Tax office and will get an acknowledgement, which he/she will handover to the taxpayer.
- The department will process the electronically received returns on priority basis and issue refunds, if any.

RETURN FORMS

Prescribed Forms:

Form No.	Applicability
ITR 1	Income Tax Return Form for Individuals having Income from Salary/ Pension/ Family pension and Interest.
ITR 2	Income Tax Return forms for Individuals and HUFs not having Income from Business or Profession.
ITR 3	IT Return Forms for Individuals/HUFs being partners in firms and not carrying out business or profession under any proprietorship.
ITR 4	Income Tax Forms for Individuals and HUFs having income from a proprietary business or profession.
ITR 5	New Tax Returns Form for firms, AOPs and BOIs.
ITR 6	IT Forms for the purpose of filing returns for Companies other than companies claiming exemption under Section 11.
ITR 7	Form for persons including companies required to furnish return under Section 139(4A) or Section 139(4B) or Section 139(4C) or Section 139(4D).
ITR 8	IT Forms for Return for Fringe Benefits.
ITR V	Where the data of the Return of Income/Fringe Benefits in Form ITR-1, ITR-2, ITR-3, ITR-4, ITR-5, ITR-6 and ITR-8 transmitted electronically without digital signature.

PERMANENT ACCOUNT NUMBER

Permanent Account Number or PAN is required to be obtained by every person as explained hereunder:

- The total income under the Act exceeds maximum amount (Rs.50,000) but not chargeable to tax.
- The total sales, turnover or gross receipts is likely to exceed Rs.5,00,000.
- A person is required to furnish return of income on account of receipt of income under trust or other legal obligation for charitable or religious trust.
- An exporter or importer under the Customs Act, 1962.
- An assessee under the Central Excise Act, 1944.
- A person who issues invoices and requires registration under the Central Excise Rules or an assessee under the Service Tax.

Who can Apply for PAN?

The following can apply for a permanent account number:

- Individuals.
- Hindu undivided families.
- Companies.
- Partnership firms.
- Association of persons.
- Body of individuals.
- Trusts.
- Artificial judicial persons.
- Representative assesses.

Permanent Account Number under the New Series

Permanent Account Number or PAN under the new series has the following characteristics:

- PAN or Permanent Account Number is an all India, unique number of 10 characters allotted by the Income Tax Department.
- PAN under the new series is for life and will not change with change of your address or station or change of your Assessing Officer, etc.
- The new PAN series is undertaken to replace the old PAN or General Index Register (GIR) number.

In case of individuals, the PAN card will have the following information:

- Name;
- Date of Birth;
- Father's Name;
- Photograph; and
- Signature of PAN Holder.

How to Apply for a Permanent Account Number?

The application for obtaining a Permanent Account Number is applied in Form No. 49A by every person who is liable to obtain the said number. The following details need to be furnished:

- Name of the assessee and all other personal details.
- Residential address in case of individual.
- Office address along with the address of branches, if there is income from business or profession.
- Name of the person whose income is included in the income of the assessee.
- Old GIR/PAN already allotted.
- Sources of Income.
- Details of businesses, if there is income from business or profession.

An individual needs to quote his/her PAN in the following cases:

- All returns to, and/or correspondence with, any Income Tax Authority;
- All challans for payment of direct taxes;
- Application for opening an account with a bank;

- Documents pertaining to sale or purchase of immovable property valued at Rs.5 lakh or more;
- Documents relating to a time deposit exceeding Rs.50,000 with a bank;
- Documents relating to deposits exceeding Rs.50,000 in any account with a Post Office Savings Bank;
- Documents pertaining to a contract of a value exceeding Rs.10 lakh for sale or purchase of securities (shares, debentures, etc.);
- Person receiving any sum or income or amount from which tax has been deducted under the provisions of chapter XVII-B shall intimate his/her PAN to the person responsible for deducting such tax;
- Buyer referred in Section 206C shall intimate his/her PAN to the seller referred to in that seller.

Allotment of PAN (suo-moto) [Section 139A(1B)]

Section 139A(1B) has been inserted from assessment year 2007-08, which states that the Central Government may, for the purpose of collecting any information which may be useful for or relevant to the purposes of this Act, by notification in the Official Gazette, specify, any class or classes of persons who shall apply to the Assessing Officer for the allotment of the Permanent Account Number and such persons shall, which such time as mentioned in that notification, apply to the Assessing Officer for the allotment of a Permanent Account Number.

New Scheme for Submission of Tax Return through Tax Return Preparers [Section 139B]

This section has been inserted from June, 1 2006. It provides that –

- The Central Board of Direct Taxes has been empowered to frame and notify a scheme for facilitating specified class of persons in preparing and furnishing their returns of income through authorised Tax Return Preparers (TRP).
- This facility is available to any person except a company or a person who is required to undergo a tax audit or an audit under any other law for the time being in force.
- The authorized TRP will, in the specified manner, assist such person in furnishing the return of income and will affix his signature on such return of income.

Return by Whom to be Signed [Section 140]

The following provisions apply in case of an individual:

- In case the individual is absent from India by individual himself/herself or by a person authorized by him/her.
- In case, he/she is mentally incapable, by his/her guardians or any other person on his/her behalf.
- In case, it is not possible to for the individual to sign due to some reason, then by any person duly authorized by him/her or on his/her behalf.

TAX PLANNING

Every individual who falls in the taxable bracket has a tax liability. There was a time when, personal income tax was as high as 97.5% and wealth tax was 12%. But now the taxation scenario has changed. People are more willing to pay taxes. They are ready to follow the regulation as the tax rates have also gone down drastically. The maximum income tax rate is 30% and wealth tax is 1%. By appropriate tax planning, an individual can avail various rebates and concessions thereby reducing his/her tax liability. The following section gives a detailed view of the tax planning techniques that can be beneficial to one and all.

Introduction to Tax Planning

It is said that there are only two certainties in life – death and taxes. Both are inevitable. We meet both unwillingly. Unfortunately, the comparison ends there. Death relieves the person from all earthly worries. Taxation, on the other hand, neither fully kills the person nor lets him/her live in peace. There is one more thing in favor of death over taxes – death does not get worse every time the budget is presented by the Finance Minister! In the last 20 years, the Income Tax Act was amended more than three thousand times! For all his progressive views, Dr. Manmohan Singh could not help introducing 438 amendments within a period of two years. It is only very appropriate that Mr. N.A. Palkhivala pointed out a need to have “a separate Minister for Simplicity and Stability, whose exclusive task should be to ensure that the bureaucrats do not trivialize the fiscal law”.

There are three methods by which you can reduce your tax burden: tax evasion, tax avoidance and tax planning.

TAX EVASION

Some people reduce the tax burden by deliberately suppressing their income, or by inflating the expenditure and resorting to various types of accounting manipulation. Such underestimation of income seems to be a worldwide phenomenon. Tax-evaded money as a percentage of gross national product is estimated to be 18% in India, 6% in US, 2% in UK, 10% each in Denmark, Italy, Belgium and the former USSR. In Japan, it is reported that the accounts of 2,206 companies reviewed by the income tax department revealed underestimation of income in all companies except one.

The total amount of Income-Tax evasion reported in India in 2001-02 was Rs.1,717.17 crore (Rs.17.17 billion). In 2002-03 was Rs.1,546.40 crore (Rs.15.46 billion) and Rs.5,041.71 crore (Rs.50.42 billion) in 2003-04. Out of sheer desperation, the Government of India has been encouraging tax evaders, though indirectly, by announcing amnesty schemes from time to time. Under the previous schemes, you could deposit all your unaccounted money in a special deposit with National Housing Bank and live peacefully thereafter. Then you had the Gold Bonds Scheme.

Then came the voluntary disclosure of income scheme. This was a simple scheme where, irrespective of the year or the nature of the source of the funds, the amount disclosed either as cash, securities or assets, whether held in India or abroad was charged at a tax rate of 30%. Interest and penalty was waived. Immunity was granted from any action under the Income Tax, Wealth Tax and FEMA. All you had to do was to disclose your income, pay 30% tax on it and you got 100% peace of mind.

In an interesting article in The Hindu by P. Sadagopan (Retired CIT), recalcitrance was described as a technique of tax evasion. It is the calculated dodge of law’s processes at a procedural level. The first step is to avoid service of statutory notices or at least deferring them, for as long as can be managed. At the next stage, non-compliance with statutory obligations such as filing of returns, responding to the directives, backed by seemingly acceptable justification is the strategy. An apt quotation from Parkinson is cited: “If you receive a tax demand, raise an inconsequential query; your file goes to the bottom of the officer’s pile. And it would be months before he gets back to you”.

TAX AVOIDANCE

Some people save on taxes by exploiting the loopholes in the taxation laws, until they get plugged by the legislature. When MAT was first introduced for taxing book profits, many companies took advantage of loopholes in the legislation and provided additional depreciation to avoid the minimum tax. However, subsequently the loophole was suitably plugged through an amendment.

Similarly, under Section 80HHC of the Income Tax Act, exporters are given certain tax benefits. Many non-exporters just acquire ‘export performance’ from genuine exporters at a nominal price. There are several brokers who arrange these ‘export entries’.

According to a report in the Times of India, Sikkim has emerged as a tax haven for income tax dodgers. Though income tax law was introduced in Sikkim in 1989-90, it was kept in abeyance. Consequently, there emerged in Sikkim a well-organized racket for laundering hundreds of crores of rupees worth of unaccounted money. Even a couple of big industrial groups were reportedly involved in this laundering operation.

TAX PLANNING

You can reduce your tax liability by arranging your financial incomes and investments in such a way as to enjoy the maximum tax benefits by making use of all the beneficial provisions and tax incentives, which are incorporated in the tax laws that entitle you to rebates and concessions. Most of the tax incentives are investment oriented, and not only saves your tax but also boost the economy of the country in the long run. Tax planning is both perfectly legal and encouraged by tax authorities.

We have come a long way from the time when the maximum personal income tax rate used to be 97.5% and the maximum wealth tax rate around 12%. That was not taxation; but confiscation and legalized robbery. Fortunately, we are now talking of a maximum income tax rate of 30% and a surcharge of 10%, Cess of 3% and a wealth tax rate of 1%. What a change!

The first method, namely tax evasion, is unquestionably deplorable and deserves to be condemned without any hesitation. But there is considerable controversy about the second one – namely, tax avoidance. Even judicial opinion is sharply divided on this issue. However, it is being realized that exploiting legal lacunae and loopholes is not an act of good citizenship. Tax avoidance is, therefore, not being discussed in this book. The third method, namely tax planning, is dignified and worthy of universal adoption. This is what we shall discuss in detail in this chapter.

A Simple Example of Tax Planning

Harish Mehta has an income of Rs.1,86,000. Mehta gets a salary of Rs.12,000 p.m., long-term capital gains on account of shares of Rs.20,000, and interest from bank deposits of Rs.22,000.

Thus, Mehta’s gross income for assessment year 2008-09 will be as under:

Particulars	Rs.
Salary Rs.12,000 x 12	1,44,000
Interest on Bank Deposits	22,000
Long-term Capital gains on shares	20,000
	1,86,000

To reduce his tax liability, he contributes Rs.55,000 towards PF, LIC policies, National Savings Certificates, etc., eligible for deduction under Section 80C.

His taxable income (assessment year 2008-09) is given in the table below. As shown in the table he needs to pay a tax of only Rs.103 on a gross income of Rs.1,86,000.

The other side of the picture is that in order to save income tax, he has to commit a cash outflow of Rs.55,000 for Section 80C schemes.

Having done so, and paid a tax of Rs.103 Harish is left with only Rs.1,30,897 in cash, i.e. Rs.1,86,000 minus Rs.55,103.

Without such tax planning, Harish would have had to pay a much higher tax.

Table 1: Taxable Income of Harish Mehta for the Assessment Year 2008-09

	Particulars	Rs.
a.	Salary	1,44,000
b.	Interest on Bank Deposits	22,000
	Gross Total Income	1,66,000
	Less: Deduction u/s 80C	55,000
	Net Income	1,11,000
	Tax on Rs.1,11,000	100
	Add: education cess @ 3% on Rs. 100	3
	Total Tax (A)	103
c.	Long-term Capital Gains on securities for assessment year 2008-09 is exempt	–
	Total Tax (A) + (B)	103
	Surcharge	Nil
	Total Tax Payable	103

* Assuming that the benefits of indexation have not been utilized.

Typically, while tax planning will indeed save you from tax, it will also reduce the funds immediately available to you for expenditure. This is so because you have to lock up your funds in various stipulated tax-savings investment schemes. Thus, due to tax planning, the cash immediately available to Harish is reduced to only Rs.1,30,897 out of his income of Rs.1,86,000.

On the other hand, if he would not have done tax planning he would have to pay a tax of Rs.15,800 and be left with available cash of Rs.1,70,200. The following table gives the two options.

S. No.	Particulars	1 Gross Income	2 Total Taxes Payable	3 Income After Tax	4 Funds Locked up in Savings Schemes	5 Funds Available for Immediate Use (3-4)
		Rs.	Rs.	Rs.	Rs.	Rs.
1.	With Tax Planning	1,86,000	103	1,85,897	55,000	1,30,897
2.	No Tax Planning	1,86,000	7,200	1,78,800	–	1,78,800

With tax planning, Harish has funds (after tax) of Rs.1,85,897 i.e., Rs.1,30,897 immediately and Rs.55,000 locked up for several years.

Without any tax planning, his total funds (after tax) would be Rs.1,78,800 – all of it available immediately.

Which is the preferred alternative? Harish is the best person to answer that. It depends on his needs, what stage of his life he is in, and his investment options. For instance, after the age of fifty or fifty-five, he would probably have little need to save for the family and so it may be advisable to pay the tax and not lock up his funds in long-term investments simply to save taxes. If his children are on their way to being well-settled, the only investment he needs to consider may be those offering him relatively assured income in his retired life, rather than those which are predominantly geared to saving him taxes.

Basic Assumptions of Tax Planning

There are two basic assumptions of dignified and honorable tax planning:

i. All relevant facts are clearly presented to the tax authorities, and no material information is deliberately concealed with an intent to defraud.

ii. There are no bogus transactions or make-believe devices resorted to in order to circumvent any legal provisions.

How to Maintain a Zero-tax Status through Fixed Income Investments?

It is quite possible to pay none or very little tax by selecting a careful mix of fixed income investments. Earlier Finance Act, contained a Section 80L. Under Section 80L, interest income from some specified investments was eligible for deduction to an amount of Rs.12,000 general deduction and Rs.3,000 additional benefit in respect of interest from government securities. It may be noted that, with the deletion of this section the interest on deposits at Banks is no more lucrative since the interest on bank deposits become taxable with no tax relief. 8.5% tax free SLR power bonds, interest from Savings Certificates issued by the Central Government, interest on securities or deposits Central Government, Provident Fund, Post Office Savings Bank account etc. is few fixed income earning investments. In this section, we broadly outline such a plan, which you may like to refine and improve upon to suit your specific needs, in consultation with your tax consultant.

THE BROAD PLAN

- You will only invest in the following fixed income securities:
  - 8.5% tax-free SLR power bonds.
  - Public Provident Fund (8% p.a.).
  - 7% Capital investment bonds.
  - Post office savings bank account.
- A portion of the income will also be reinvested to save on taxes.
- The following incomes are exempt from income tax:
  - Basic exemption of income (assessment year 2008-09) –Rs.1,10,000.
  - Under Section 10: Income from certain sources like PPF, tax free public sector bonds – No Limit.

Hence, full advantage will be taken of all these benefits in planning the investments. Let us now look at two cases – one with an investment of Rs.17 lakh and the other with Rs.20 lakh.

Case A: Total Investment of Rs.17 lakh

Particulars	Investment	Income
	Rs.	Rs.
Non-convertible debentures (8% p.a.)	15,00,000	1,20,000
Post Office Saving Bank Account (6% p.a.)	2,00,000	12,000
Total	17,00,000	1,32,000

Of the total income of Rs.1,32,000 the interest of Rs.12,000 from Post Office Savings Bank Account are exempt under Section 10(15). Hence, the taxable income is Rs.1,20,000, the tax on which works out to Rs.1,030.

Thus,

	Rs.
Gross total income	Rs.1,32,000
Less: Tax	Rs.1,030
Income after tax	Rs.1,30,970
Post-tax return on investment of Rs.17 lakh	7.7%

In case you do not need the interest income immediately, you can achieve a zero tax status by investing Rs.10,000 in Public Provident Fund (PPF). You will then be eligible for deduction under 80C on deposits made in PPF, and there will be a no tax liability. The interest on PPF of Rs.800 is tax-free under Section 10.

Thus,

		Rs.
Gross income		1,32,000
Less: Invested in PPF		10,000
Income in hand		1,22,000
Tax		Nil
Post-tax income		1,32,000
Post-tax Return on Investment of Rs.17 lakh	7.76% (this year)	
	7.81% (next year considering tax-free PPF interest of Rs.800)	

Case B: Total Investment of Rs.20 lakh

Particulars	Investment	Income
	Rs.	Rs.
Non-Convertible Debentures (8%)	16,00,000	1,28,000
Post Office Saving Bank Account (6% p.a.)	2,00,000	12,000
8.5% Tax free SLR power Bonds	2,00,000	16,000
	20,00,000	1,56,000

Out of the total income of Rs.1,56,000 you can exclude the income from Post Office Saving Bank Account up to Rs.12,000 and from 8% tax-free Relief Bonds (under Section 10). Thus, on the balance of Rs.1,28,000, the tax works out to Rs.1,854. You can reduce that to nil by investing Rs.18,000 in PPF account under Section 80C. Thus, the post-tax return works out to 7.8% this year.

Tax Planning through Long-term Capital Gains from Equity Shares

Equity shares of well managed companies afford excellent opportunities for tax planning through long-term capital gains.

Shares held for more than 12 months are treated as long-term capital assets. Long-term capital gains arising out of securities sold on the stock exchange are exempt u/s 10(38).

As far as possible you should sell your shares only after holding them for 12 months or more. Otherwise, your gains will be taxed as short-term capital gains. With the insertion of a new Section 111A, short-term capital gains arising from the sale of securities are taxable at the rate of 10%.

However, it should be noted that in view of the above changes made, a tax at the rate of 0.125% is to be levied on the value of all transactions of purchase of securities that take place in a recognized stock exchange in India.

Illustration 9

Mr. Kapoor or purchased 100 equity shares of ABC Ltd. On 1st July, 2006 at Rs.600 and sold them in May, 2007 at Rs.3,000 per share.

Particulars	Rs.
May, 2007 Sale Value	3,00,000
July, 2006 Cost of Acquisition	60,000
Short-term Capital Gains	2,40,000
Capital Gains Tax @ 10%	24,000
Education cess @3% (for assessment year 2008-09)	720
Total Tax Payable	24,720

If the above shares would have been held for four more months and sold in the month of August 2007 or thereafter, he would not have paid any capital gains tax as long-term capital gains are tax exempt.

From the perspective of tax planning it is better to invest in shares based on their potential for capital appreciation over a period of at least 13 months rather than selling within 12 months. It is even better if you can hold the shares for a longer period, because you can avail the benefit of indexation.

Long-term capital gains are tax-exempt if the capital gains are invested within six months in specified equity shares such as in equity of public companies formed and registered in India and that investment is retained for more than one year by virtue of Section 54ED.

The Budget 2003 has provided further incentive to invest in equity shares of companies listed on recognized stock exchanges in India. The Finance Act, 2003 provides that the capital gains realized from sale of listed securities purchased on or after 1st March, 2003 but before 1-3-2004 will be tax exempt. An added benefit is the dividends received are also tax exempt in the hands of the investors.

Tax Planning through Established Growth Stocks

Investing in established growth stock is more beneficial because of the arithmetic of compounding. An established growth oriented company ploughs back its profits to earn more profits. This implies that the return is not only on the amount invested but also the return on the principal, i.e., return on return. The longer the time horizon of the investment, the more the investment appreciates.

Since one invariably invests in established growth stocks more for long-term growth and less for current income, there is scope for considerable tax planning through such growth stocks. Thus, if you can hold them for a longer period, you are exempt from the tax on any long-term capital gains. However, it should be noted that in view of the above changes made, a tax at the rate of 0.125% is to be levied on the value of all transactions of purchase of securities that take place in a recognized stock exchange in India. The longer you hold these assets, the higher will be the indexation benefits. Let us see how with the help of a simple illustration.

Illustration 10

Mr. Q has Rs.1,00,000 available for investment in established growth stocks in 2006, and would like to invest his money in such a way that it yields an annual compounded return of 30% per year over the next 10 years. Mr. Wizard, an investment consultant, assures him that this is possible through established growth stocks.

His family includes Mrs. Q (wife), Master Q (minor son aged 10) and Ms. Q (minor daughter, aged 8). As of now, his wife, son and daughter are not assessees.

Mr. Q should loan Rs.50,000 to his wife, Rs.25,000 to his son and Rs.25,000 to his daughter, the loans carrying a simple interest @ 10% p.a. As far as possible, the portfolios should not be shuffled during the 10-year period to get maximum advantage of tax-deferment. Unless you will share and realize your profits, there is no liability towards capital gains.

Thus, at the end of 10 years, the portfolios of wife, son and daughter will be shown below:

Particulars	Wife	Son	Daughter
	Rs.	Rs.	Rs.
2006 – Value	50,000	25,000	25,000
2016 – Value with compounded growth rate of 30% p.a.	6,89,000	3,44,500	3,44,500
Less: Loan and Interest @ 10% p.a. (simple)	1,00,000	50,000	50,000
Net Value in 2016	5,89,000	2,94,500	2,94,500

In 2016, a part of their portfolios will be sold by Mr. Q's wife, son and daughter to Mr. Q to settle his loan with interest.

With the help of such a plan, in 2016, Mr. Q's wife will own a portfolio of Rs.5,89,000, his son and daughter (by then, majors) portfolios of Rs.2,94,500 each.

The exact value of these portfolios may vary, depending upon specific tax planning to be done from year to year, the growth rate of portfolios and the future tax structure, etc.

Let us ignore the specific numbers because they have been indicated more by way of an example. Let us, instead, understand the key points, which emerge in relation to tax planning through growth stocks:

1. Lend money to non-assessees (or assessees with lower income levels) in your family at around 10% p.a. simple interest.
2. The family members should invest the funds in selected growth stocks, which can generate impressive growth in value in the next 10 years.
3. Do not sell the shares during the 10 years.
4. At the end of 10 years, repay the loan and interest by transfer of shares.
5. After a year or so, the shares obtained by way of repayment of loans can be gifted to son and daughter (who would be majors by that time) without attracting the clubbing provisions.

Please note that the 10-year period is only indicative, it could be 5, 7, or 12 years.

It may be possible to improve upon this plan depending on the specific issues involved in each case. You would be well advised to seek expert advice on this.

Tax Planning for the Family

Every individual would like to explore various possibilities of sharing income and wealth within the members of the family in order to lower the overall tax liability. Some of them are explained hereunder:

- Create a HUF (Hindu Undivided Family) so that the family property and family income is assessed separately from that of the individual members of the family. Tax practitioners can help you in creating an HUF in a perfectly legal manner.
- Open as many assessment files as possible for the members of your family, including minor children.
- Keep separate accounts for all the gifts received on birthdays and social functions so that they can form the sources of future income through suitable investments.
- To avoid problems of the clubbing provisions, you may consider making a gift to your would-be spouse or your son's would-be-spouse. Such pre-marital gifts do not attract the clubbing provisions.
- If you are the Karta of your HUF, you may make gifts within reasonable limits to the members of your family out of the HUF properties and build their separate assets.
- Since the income-clubbing provisions apply only so long as your children are minors, you may gift them some assets where the income will be received by them only after they attain 'major' status, e.g. 10-year cash certificates, zero-coupon bonds, etc.

- Some smart assessees do not gift anything to their spouses. Instead, they organize exchange of assets to avoid clubbing provisions, e.g., a husband exchanges his 1,000 Colgate equity shares with the jewelry owned by his wife (since *Stridhan* is the absolute property of the lady).
- Since the accretions to income arising on the transfer of asset does not attract the clubbing provisions you can gift any amount, which can be invested by your wife or daughter-in-law in 9% fixed deposit, etc. It is only the interest on such amount gifted that is included in the income of the individual. The interest on interest does not attract the clubbing provision.
- Since a genuine loan of any amount to your spouse or children does not attract the clubbing provisions, loan any amount (create evidence to avoid hassles in future) to children and spouse, which they may invest in income earning assets.
- You can use the Public Provident Fund scheme for building up capital of your minor children. If you have two children you can open two PPF accounts and deposit Rs.15,000 in each account every year. You will get tax deduction under Section 80C. Moreover, interest on PPF is totally exempt from income tax. Thus, when children become majors, you would have created capital for them while enjoying the tax benefits in the interim.

After going through all the provisions of tax planning, let us test our fundamentals through the following illustration:

A COMPREHENSIVE EXAMPLE OF TAX PLANNING

Gupta's Gross Salary

A. N. Gupta is an executive working for a well-known company. His gross salary per month is Rs.16,000 made up as under:

Particulars	Rs.
Salary	11,000
House Rent Allowance	3,000
Conveyance Reimbursement	2,000
Total	16,000

Gupta lives in a flat owned by his wife and pays a monthly rental of Rs.5,000. Mrs. Gupta pays Rs.10,000 towards municipal taxes. Under the present rules, the entire house rent allowance received by Gupta is exempt from tax. Similar is the case with conveyance reimbursement, assuming that he spends the entire amount.

Gupta's Take-home Pay

Thus, his take-home pay is as under:

Particulars	Rs.
Salary	11,000
Less: PF contribution (10%)	1,100
	9,900
House Rent Allowance	3,000
	12,900

Gupta's Income from House Property

Gupta purchased a flat in his own name by taking a loan of Rs.5,00,000 from his employer @ 6% p.a. repayable over 20 years. The annual installment is Rs.18,000, and the interest paid during 2007-08 is Rs.30,000. Gupta gets a monthly rent of Rs.8,000 from this flat and pays Rs.17,000 towards municipal taxes.

Thus, the income from house property of Gupta will be calculated as under:

Particulars	Rs.
Annual value (Rs.8,000 x 12)	96,000
Less: Municipal taxes	17,000
Net annual value	79,000
Less: 30% standard deduction	(–)23,000
Interest on loan	(–)30,000
	25,300

Gupta's Family Expenses and Investments

Gupta's family expenses are about Rs.12,500 p.m. on various household expenses. Gupta's wife has deposits in banks to the tune of Rs.1,37,500 earning 8% p.a.

There is a Public Provident Fund account opened by Gupta in his minor son's name. Gupta deposits varying amounts in the PPF account every year to minimize the tax liability. This year, he invested Rs.48,200 in PPF account and contributed Rs. 6,200 in Unit linked insurance plan of UTI.

All the birthday gifts amounting to Rs.50,000 received by his son were pooled up by Gupta and invested in about 600 shares of Gamma Infotech Ltd. @ Rs.83 in May, 1999. The company gave a bonus issue of 1:1 in 2000. Thus, the number of shares increased to 1,200. In May, 2007, the son sold these shares @ Rs.251 per share. He is now 19 years old.

Particulars	Rs.
Sale Value (Rs.251 x 1,200)	3,01,200
Less: Cost of Acquisition (Rs.600 x Rs.83) (the acquisition cost of bonus shares is Nil) 551/ 389 x 49,800	70,539
Taxable capital gains	2,30,661
The long-term capital gain is exempt. However transaction tax @ 0.125% is payable	288
Post-tax proceeds (2,30,661 – 288)	2,30,373

Thus, by the time he became a major, Gupta's son had a capital of his own to the tune of Rs.2,30,373.

The Total Picture

Let us now look at the total picture:

i. Mr. Gupta's Income (assessment year 2008-09)

Particulars	Rs.	Rs.
Salary (Rs.11,000 x 12)	1,32,000	
Income from house property	25,300	
Taxable Income		1,57,300
Less: deductions u/s 80C		
PF (Rs.1,100 x 12)	13,200	
PPF	48,200	
ULIP	6,200	
Repayment of loan (principal)	18,000	85,600
Taxable income		71,700
Tax payable		Nil

ii. Mrs. Gupta's Income

Particulars	Rs.	Rs.
i. Income from house property Annual Value (Rs.5000 x 12)	60,000	
Less: Municipal Tax	10,000	
	50,000	
Less: 30% standard deduction	15,000	35,000
ii. Interest on Bank Deposits		11,000
Total income		46,000
Tax		Nil

iii. Master Gupta's Income

Out of his capital, he invests a sum of Rs.3,00,000 in 8.5% RBI Relief Bonds and earns a tax-free interest of Rs.25,500 p.a.

Particulars	Mr. Gupta	Mrs. Gupta	Master Gupta	Total
	Rs.	Rs.	Rs.	Rs.
Gross Income	71,700	46,000	25,500	1,43,200
Tax	Nil	Nil	Nil	Nil

Cash Flows

As Gupta needs about Rs.12,500 p.m. for household expenses, let us look at the family cash flows:

Particulars	Rs.	Rs.
Inflow:		
(Salary + House property income + HRA)		2,64,000
Outflow:		
PF	13,200	
Housing Loan	48,000	
Municipal Taxes	17,000	
ULIP	6,200	
PPF	48,200	1,32,600
Net Inflow		1,31,400
Mrs. Gupta		1,000
Master Gupta		25,500
Total inflow for the family		1,57,900

Thus, the cash flow position will be quite comfortable leaving a surplus of nearly Rs.8,000.

The above example of Gupta's family shows how any family can prosper by careful planning of investments and taxes. Let us repeat once again: do not give importance to the specific numbers in this example. Try to understand the broad principles, modify and use them in your specific context.

SUMMARY

- Since taxes have an impact on many of the individuals and families, it is essential to understand the various relevant concepts for effective personal financial planning and money management. In India, the tax regime is dominated by the Income Tax Act, 1961 and the Wealth Tax.
- This chapter is designed to provide the readers with the basic idea of the various provisions under these Acts. The chapter also provides a basic understanding of filing of returns by an individual. An in-depth understanding of these Acts would enable an individual to implement an effective tax planning strategy.
- The objectives of tax planning are to reduce, shift or defer taxes so that the taxpayer can maximize the total after-tax income. Some of the strategies that can be adopted for this include maximizing deductions, investing in tax shelters or tax-exempt securities or using pension, retirement plans and annuities in order to generate tax-deferred income.

Chapter IV

Managing Cash and Savings

After reading this chapter, you will be conversant with:

- The Role of Good Cash Management in the Personal Financial Planning Process
- The Indian Financial Services Industry: Major Players and their Roles
- The Various Cash Management Products
- Electronic Banking Services
- Developing a Savings Program
- Channels of Savings in the Indian Financial Services Market

Introduction

'How should I manage my cash?' This is the general problem among people who get their monthly salary directly credited in their bank accounts and for which they fail to keep a track of how and where they are spending. In addition to this such people also use various cash and credit instruments such as ATM card, credit and debit cards apart from the cheques written by them. The result of all this is financial chaos. This is where cash management comes into the picture. There can be no financial planning, without proper cash management. No long-term goals can be achieved if an individual is not able to manage his/her current finances.

THE ROLE OF GOOD CASH MANAGEMENT IN THE PERSONAL FINANCIAL PLANNING PROCESS

Cash management deals with the day-to-day managing of one's cash and near-cash resources in order to achieve one's long-term objectives and goals. In addition to cash, there are other liquid assets, which also have to be properly managed. These liquid assets are mainly in the form of current account, savings account, mutual funds, treasury bills and certificates of deposit. Proper cash management helps in making funds available not only for basic and daily expenditure, but also for an effective savings program.

An important tool that enables an individual to keep his spending in control is to maintain a checking account. A checking account helps in keeping check over the amount allocated for a specific activity and the actual amount spent on it. For keeping a tight control over one's expenditure, one can maintain a policy wherein one writes cheques only on a specific date or period. It would also be helpful if one does not carry the chequebook in order to avoid making any unplanned expenditure. Before incurring any expenditure, it is advisable to make a cash budget in order to avoid overspending. An individual can avoid impulsive expenditure and save money by doing so. This would help him/her in the long run.

Establishing a savings program is another aspect of cash management and personal financial planning. Savings are essential for meeting contingencies and to achieve future long-term goals. An individual may want to discontinue his/her job for studies or invest in a new home. These objectives can be easily achieved by proper financial planning. Before we begin to discuss about this it would be beneficial to gain an understanding about the financial services industry and the institutions in it that facilitate an individual in the process of cash management.

FINANCIAL SERVICES MARKET

The financial service industry includes all the institutions that market various kinds of financial products and the financial services. The financial services industry in India comprises of banks, insurance companies, mutual funds, credit rating agencies and non-banking financial services companies. The financial services industry began to emerge as a distinct and a competitive sector only after the last decade. Since the liberalization of the financial sector, there has been a revolution in this industry. The entry of private and foreign players has made the sector more competitive. Emergence of new product lines and universal banks that offer every conceivable financial product under one roof are the emerging trends in this sector. The subsequent sections deal with an explanation of the major players dominating the scene of the Indian financial services industry.

Financial Institutions in India

CENTRAL BANK

India's Central Bank, the Reserve Bank of India (RBI), was established on April 1st, 1935 and was nationalized on January 1st, 1949. The Preamble prescribes the objective of the Central Bank as:

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

The following are the main functions of Reserve Bank of India:

- **Monetary Authority:** As a monetary authority, the RBI formulates, implements and monitors the monetary policy of the country. Its main objectives in this role include maintaining price stability and ensuring adequate flow of credit to productive sectors.
- **Regulator and Supervisor of the Financial System:** Being a regulator, it prescribes broad parameters of banking operations within which the country's banking and financial system functions.
- **Manager of Exchange Control:** Through the Foreign Exchange Management Act, 1999, the Central Bank facilitates external trade and payment and also promotes the orderly development and maintenance of foreign exchange market in India.
- **Issuer of Currency:** RBI issues currency in order to give the public adequate quantity of supplies of currency notes and coins and in good quality. It also exchanges or destroys currency and coins not fit for circulation.
- **Developmental Role:** RBI performs a wide range of promotional functions to support national objectives.

COMMERCIAL BANKS

The banking system was introduced in India in the beginning of the 19th century. All the banks, at that time, were joint stock banks with many of them being small and weak. The Banking Companies Act was passed by the government in 1949, which led to the elimination of weak banks from the industry. To revive public confidence in the banking system, Section 45 was inserted in the Banking Regulation Act in September, 1960, empowering the Government of India to compulsorily amalgamate weak units with stronger ones on the recommendations of RBI. Currently, the banking system in India comprises of the Scheduled Banks and the Non-scheduled Banks.

SCHEDULED BANKS

Scheduled banks are those banks, which are included in the second schedule of the Reserve Bank of India Act, 1934. According to the Section 42(6)(a) of the Reserve Bank of India Act, a scheduled commercial bank should fulfill the following conditions:

i. It must have a paid-up capital and reserves of an aggregate value of not less than Rs. 5 lakh;

ii. It must satisfy RBI that its affairs are not conducted in a manner detrimental to the depositors;

iii. It must be a state co-operative bank or a company formed under the Companies Act, 1956, or an institution notified by the Central Government on this behalf or a corporation or a company incorporated by or under any law in force in any place outside India.

The scheduled banks enjoys certain privileges such as approaching RBI for financial assistance, refinance, etc., and commensurately they have certain obligations like maintaining cash reserves as prescribed by the RBI and submission of returns. The scheduled commercial banks in India comprise of the State Bank of India and its associates (8), the other nationalized banks (19), foreign banks, private sector banks, co-operative banks and regional rural banks. As on 2007, there were 88 commercial banks.

NON-SCHEDULED BANKS

Non-scheduled banks are those joint stock banks, which are not included in the second schedule of the RBI Act on account of their non-complying with the minimum requirements for being categorized as scheduled.

CREDIT RATING AGENCIES

Credit rating refers to the rating of a financial instrument on the basis of the issuer's capability to repay the interest and the principal. The credit rating agencies analyze various parameters of a company or entity seeking a rating of its financial instrument. Some of the parameters include management capabilities, financials, track record, technical capabilities and nature of business. Credit rating is specific to a debt/financial instrument and is intended to grade different and specific instruments in terms of the credit risk associated with that particular instrument. The rating is therefore an opinion expressed by an independent professional organization and does not directly contain any recommendations to buy/sell the financial instrument. The following are the main credit rating agencies operating in India:

Crisil

Credit Rating Information Services of India Limited (CRISIL) is one of the foremost and largest credit agencies in India. CRISIL has also diversified into information and advisory services business, which together account for around 20% of its revenues. It is the market leader in India and serves as a 'full service'-rating agency. It has the most comprehensive range of rating services. Combining its understanding of risk and the science of building risk frameworks, with its strong contextual understanding of the businesses, CRISIL ratings provide reliable opinions on risk.

CRISIL is the only rating agency to operate on the basis of a sectoral specialization coupled with sharpness of analysis, responsiveness of the process and large-scale dissemination of opinion pieces. CRISIL ratings continue to play a stellar role in the development of the debt markets in India.

Care

Credit Analysis and Research Ltd. (CARE) was incorporated in April, 1993, as a credit rating, information and advisory services company and was promoted by Industrial Development Bank of India (IDBI), Canara Bank, Unit Trust of India (UTI) and other leading banks and financial services companies. CARE is registered with the SEBI. CARE is well equipped to rate all types of debt instruments such as commercial papers, fixed deposits, bonds, debentures and structured obligations. CARE, as a rating agency, prepares credit reports on specific requests from banks or business partners, conducts sector studies and provides advisory services in the areas of financial restructuring, valuation and credit appraisal systems.

ICRA

Investment Information and Credit Rating Agency (ICRA), an independent credit rating agency established in 1991, has been promoted by a number of leading public sector banks and financial institutions, such as IFCI, State Bank of India, Unit Trust of India, General Insurance Company of India and Export-Import Bank of India. ICRA has its head office at New Delhi and its branches are at the major metros. Its team comprises of about 100 analysts spread across the country.

In 1998, Moody's Investors Service (Moody's) took a minority stake in the equity capital of ICRA. ICRA rating services include credit rating of debt instruments, sub-sovereign ratings, credit assessment, asset securitization, rating of claims paying ability of insurance companies, credit assessment for small/medium industry and rating of collective investment schemes.

The other services offered by ICRA can be classified into the following five broad areas:

- Studies for effective decision-making and policy formulation by business corporates and regulatory authorities;
- Issues focusing to improve the business competitiveness;
- Formulating entry/growth strategies;
- Risk assessment and mitigation strategies; and
- Risk management services.

Merchant Banks

A merchant banker plays a pivotal role in channelizing the financial surpluses of the society into productive investment avenues. A merchant banker has a fiduciary role in relation to the investors. He/she has to conduct a proper due-diligence to ensure that only quality issues emanate from the issuer firms to the investors. The merchant banker is the leader among all the intermediaries associated with a public issue. He/she is required to guide and co-ordinate the activities of the registrar to the issue, bankers to the issue, advertising agencies, printers, underwriters, co-managers and brokers. A merchant banker should also ensure that the issuer firm complies with all the laws and regulations governing the securities market. He/she may also be called upon to assist the statutory authorities in developing a regulatory framework for the orderly growth of the market. A merchant banker performs the following services:

i. Management of debt and equity issues.

ii. Placement and distribution of the securities.

iii. Corporate advisory services.

iv. Project advisory.

v. Loan syndication.

vi. Venture capital and Mezzanine financing.

The prominent institutions that offer merchant banking services in India include Kotak Mahindra, IL&FS, Bajaj Capital, SBI, ICICI Bank and DSP Merrill Lynch.

Mutual Funds

A mutual fund can be best described as an ideal investment vehicle for retail investors who are not highly acquainted with the capital markets but are interested in participating in the stock market activities. Through a mutual fund a number of small investors with a common investment goal pool their money, which is then invested by the fund manager in appropriate securities, bonds and money market instruments so as to achieve the funds objectives. Mutual funds are managed by their asset management companies, which are sponsored by financial institutions, banks, private companies or international firms. An investor should choose a scheme on the basis of his/her objectives. For instance, a risk-averse investor would prefer a fixed-income fund while an investor desirous of capital appreciation will usually opt for an equity fund.

The leading mutual fund players in India include Templeton, Prudential ICICI, Reliance Mutual Fund, Alliance Capital Mutual Fund, Birla Mutual Fund, SBI Mutual Fund and Kothari Pioneer.

Insurance Companies

Insurance is an agreement wherein the insurer agrees to make good a loss suffered by the insured against a specific risk, in consideration for some specified amount. The insurer is generally an insurance company that pools all the risks of many such insured entities and provides insurance on the basis of probability. By pooling many such risks, insurance companies convert the uncertainty of an individual loss into a predictable expense. The insured has to forgo a certain amount of money periodically in return for the assurance given by the insurer against any risk of loss. Insurance provides a sense of security for the insured that will allow him/her to perform normal business.

Insurance as a financial service can never be underemphasized. Insurance companies play an important role in the financial system all over the world and also in India. Insurance companies hold substantial amount of assets and are capable of transferring funds quickly from one sector of the economy to another.

The following are the key players in the insurance sector in India:

LIFE INSURANCE SECTOR

i. Life Insurance Corporation of India

ii. Birla Sunlife

iii. HDFC Standard Life

iv. Prudential ICICI

v. Max New York Life.

GENERAL INSURANCE SECTOR

i. Tata AIG

ii. New India Assurance

iii. National Insurance Company

iv. Royal Sundaram

v. Oriental Insurance.

Having dealt at length about the Indian financial services industry let us now discuss the various cash management products available to an investor.

CASH MANAGEMENT PRODUCTS

Cash management is generally related to short-term savings. There are a number of products available in the Indian market for proper cash management and savings program also. These include:

Savings Account

A savings account is a type of account that can be opened in any commercial bank. The deposits made in these accounts are known as time deposits since they are expected to remain on deposit for a longer period compared to a demand deposit. Savings accounts usually carry a higher rate of interest. The savings account is used for accumulating funds for the future and thus higher the balance amount in this account, the higher will be the interest given by the bank. In order to open a savings account, an investor will usually have to fulfill the following requirements:

- **Eligibility:** The account holder should be a resident Indian.
- **Documentation:** For this purpose, the proof of identity would be needed.
- **Interest Rates:** The interest rates on savings must be specified. For instance, State Bank of India provides an interest rate of 3.5% compounded half yearly on savings.
- **Other Terms and Conditions:** These terms and conditions include maintaining the minimum balance specified to the account holder.

Fixed Deposits

Fixed deposits are saving instruments, in which a specified amount is deposited in an account for a specified tenure and the bank pays the interest accordingly. Generally, fixed deposits carry a high rate of interest as the money is locked for a longer time period, such as one year, three years or five to ten years also. A fixed deposit is a very useful instrument for long-term planning. For instance, money can be deposited for five years for a child's education. A fixed deposit has the following features:

- Interest may be paid monthly, quarterly or yearly.
- Interest earned can also be reinvested.
- Minimum deposit has to be maintained.

RECURRING DEPOSIT

Recurring deposit is another important form of savings instrument. A recurring deposit can be opened by an individual, wherein a specified amount is deposited every month in the account. A recurring deposit provides the following advantages:

i. Encourages savings.
ii. Has a high rate of interest.
iii. Loans are available against the deposits.
iv. Non-applicability of tax deducted at source.

Mutual Funds

Mutual funds play a very important role in the field of financial services as an investment vehicle. They provide the opportunity to investors, especially the small investors, to invest their funds and earn a healthy rate of return. Mutual funds in turn invest the pool of money collected in various stocks and securities. Such funds are managed by qualified professionals who use this money to create an appropriate portfolio comprising stocks, shares, bonds or money-market instruments. Thus, a mutual fund diversifies its portfolio over a variety of investment vehicles.

A mutual fund offers various benefits such as high returns, liquidity, transparency, income growth, good post-tax return and reasonable safety. It is essential that before investing in a mutual fund, an individual should identify his/her needs, preferences and objectives for financial planning.

Mutual funds can be classified on the basis of various parameters. These include:

I. **Mutual Funds on the Basis of Structure**

   a. *Open-ended Funds:* An open-ended fund scheme is open for subscription all through the year. An investor can buy or sell the units at "NAV" (Net Asset Value) related price at any time.

   b. *Close-ended Funds:* A close-ended fund is open for subscription only during a specified period, generally at the time of initial public issue. The close-ended fund scheme is listed on the stock exchanges where an investor can buy or sell the units of this type of scheme.

II. **On the Basis of the Objectives of the Fund**

   a. *Growth Funds:* The objective of a growth fund scheme is to provide capital appreciation over the medium to long-term. This type of scheme is an ideal scheme for the investors seeking capital appreciation for a long period.

   b. *Income Funds:* The objective of an income fund is to provide regular and steady income to investors.

   c. *Balanced Funds:* The objective of balanced fund schemes is to provide both growth and regular income to investors.

d. *Money Market Funds:* Money market funds aim to provide easy liquidity, regular income and preserve the income.

e. *Tax Saving Schemes:* Tax saving schemes offer tax rebates to the investors under specific provisions of the Indian income tax laws. Investments made under some schemes are allowed as deduction u/s 88 of the Income Tax Act.

f. *Industry Specific Schemes:* Industry specific schemes invest only in the industries specified in the offer document of the schemes.

III. **On the Basis of Whether a Load is Charged or Not**

a. *Load Funds:* Load funds charge a commission each time a unit holder buys or sells units in the fund.

b. *No-load Funds:* No-load funds do not charge a commission on the purchase or sale of the units in the fund.

ELECTRONIC BANKING SERVICES

In today's dynamic financial world, electronic banking or e-banking is the buzzword. Electronic banking has revolutionized the banking services industry by providing new, convenient and easier ways for investors to manage their cash and accounts. The following are the main innovations in the arena of electronic banking.

i. **Automated Teller Machines:** ATMs are 24-hour banking services that have made banking very easy, accessible and error proof for the customers. A customer can deposit cash and withdraw cash at any time of the day. ATMs can be made use of by the ATM cards or debit cards provided by the bank. Banks have ATM centers near offices, hospitals, hotels and shopping malls.

ii. **Debit Cards:** This is another facility provided by the banks. A debit card can be used by the customer in lieu of cash. The customer can use a debit card to make purchases wherein the amount of expenditure is directly debited against the account of the holder.

iii. **Phone Banking:** Banks also offer phone banking services. A customer can find out the balance of his/her account by calling up his/her bank and giving the password. Phone banking also helps in opening accounts, checking the status of the accounts at the end of every month, reporting any lost documents or making requests such as issue of a cheque book.

iv. **Internet Banking:** Through the internet, a customer can avail the following services:

- ***Account Information:*** Information with respect to summary of all banking transactions can be availed through the internet. Transactions can also be retrieved with proper details of the cheque number, transaction amount, date and so on. The account statement and transaction reports can also be downloaded and printed.
- ***e-cheques:*** Funds can be transferred from one account to another and even across cities within the same bank through e-cheques.
- ***Bill Payment:*** Bills such as those of telephone, mobile, electricity, insurance premia, credit cards, etc., can be paid online.
- ***Requests and Intimations:*** Requests can be made for a new chequebook, checking the balance, or opening a recurring account or fixed account through the internet. Similarly, intimations can also be made with respect to stopping a payment or to register online for phone or mobile banking.

Having understood the major cash management products, let us now understand how a savings program can be designed by an individual in the subsequent sections.

SAVINGS PROGRAM

Financial planning dictates that a certain portion of the assets should be available for meeting the immediate liquidity needs. There is no specific percentage of maintaining a liquid reserve but generally, people maintain a three to four months after tax salary as a reserve to meet the contingency needs of the family. Therefore, a specific savings plan must be developed in order to accumulate funds. The first step in this process is to make savings a priority in the budget. This can be done either by transferring some amount directly to other bank accounts or withholding a part of the salary from the salary paycheck itself. Emphasis should also be given on the savings product that is being used. Some people prefer regular savings account, whereas others prefer money market accounts. It is also essential to take into consideration the interest rate at which the savings are being made. As the short-term rates fluctuate more than long-term rates, care should be taken to place the savings at the right rate of interest.

Interest Rate Earned

Interest is the reward earned for saving. By putting one's money in a savings account, the bank or the financial institution gives an interest to the saver. Thus, interest calculation forms an important part of the whole savings program. Interest is generally earned in the following manner:

- **Discount:** Short-term investments are sold at discount. In other words, the security is sold at a discount to the face value and later redeemed at the face value. The difference between the two is the interest earned. Treasury bills fall in this category.
- **Direct Payment:** Interest is directly credited to the savings account.

Interest Rate Calculations

- **Simple Interest:** In case of a simple interest, the interest is paid on the initial amount deposited. If a person deposit Rs.2,000 in a bank for a period of one year at the rate of 5%, the interest earned will be:

  Rs.2000 x 0.5 = 100

- **Effective Rate of Interest:** The effective rate of interest is the annual rate of return earned in the time period when the funds are held. It can be calculated as follows:

  $$\text{Effective Rate of Interest} = \frac{\text{Amount of Interest Earned}}{\text{Amount of Money Invested}}$$

  In the illustration given above, the effective rate of interest is calculated as follows: 100/2,000 = 5%

- **Rate of Interest Compounded Semi-annually:** In the case of rate of interest that is compounded semi-annually, the interest is calculated on the initial amount plus the interest earned in the previous time periods. In other words, the interest is compounded every six months.
- **Compound Interest is Equal to the Future Value:** Compound interest is similar to the future value concept. In other words, the future values can be used to calculate the rate of interest.

Illustration 1

An amount of Rs.3,000 is deposited at a rate of 6% in a bank. Calculate the amount after a time period of five years.

Rs.3,000 x 1.338 = Rs.4,014

Where 1.338 is the Future Value Interest Factor for 5 years and at 6%.

Similarly, interest is calculated at the rate of 6% for five years as given below:

3,000 $(.06)^5$ = 4,014.6

Thus, future value is equal to the compound interest.

The same procedure can also be used to calculate the future value annuity factor:

Future value = Amount deposited yearly x Future value annuity factor

Assume that Rs.2,000 is deposited yearly at 5% for 6 years.

Future value = Rs.2,000 x 6.802

= Rs.13,604

Before depositing an amount, it is essential to take into consideration the following points, which affect the rate of interest earned:

- **Frequency of Interest Compounded:** The more number of times the interest is compounded, the higher will be the return earned.
- **Amount on which the Interest is Paid:** The return is also dependent on the initial deposit made in the savings account.

Once an investor develops a savings program, he/she would next be interested in knowing the other avenues available for saving.

CHANNELS OF SAVINGS

Savings should not only become a habit, but a priority in one's life. There are number of ways to save. Starting a piggybank at home, post office account, fixed deposit or a recurring deposit are different saving vehicles. In addition to these efforts made by a person, there are other instruments available in financial markets to make savings an easier task. The following are the main instruments that can be used for riskless investment and saving:

Treasury Bills

Treasury bills are issued in the form of promissory notes or finance bills by the government to tide over short-term liquidity shortfalls. These short-term instruments are highly liquid and free from default-risk as they represent the obligations of the government. Inflation, however, has an effect on the yield of these instruments.

Treasury bills are the most liquid instruments after cash and call money, as the repayment guarantee is given by the Central Government. Since treasury bills are virtually risk-free, the yield on these instruments is usually taken as a proxy for risk-free rate of return.

Treasury bills do not require any grading or further endorsement like ordinary bills. These instruments have distinct features such as zero default risk, assured yield, low transactions costs, negligible capital depreciation, eligible for inclusion in Statutory Liquid Ratio (SLR), and easy availability apart from high liquidity.

Types of treasury bills in vogue in India include:

- **14-day T-bill:** The maturity period of these bills is 14 days. The RBI holds auction for these bills on Friday of every week. The notified amount for this auction is Rs.100 crore.
- **91-day T-bill:** The auction of these bills is also on Friday of every week. The notified amount for this auction is Rs. 100 crore.
- **182-day T-bill:** The maturity period of these bills is 182 days. Its auction is on every alternate Wednesday (which is not a reporting week). The notified amount for this auction is Rs.100 crore.
- **364-Day T-bill:** The maturity period of these bills is 364 days. Its auction is on every alternate Wednesday (which is a reporting week). The notified amount for this auction is Rs.500 crore.

A major portion of the government's borrowings is through treasury bills of various maturities. The RBI decides the cut off yield, based on the bids received at the auctions, and accepts all bids below this yield.

Though various groups of investors, including individuals are eligible to invest in treasury bills, banks are the major investors in treasury bills. Investment is done in order to deploy their short-term surpluses and to fulfill their SLR obligations. The treasury bills are issued at a discount and can be traded in the secondary market. Treasury bills have a low yield due to the low risk attached to them. The minimum investment for treasury bills is Rs. 25,000.

The table below gives an illustration of the bid and ask rates of the treasury bills. The date is a as on 29th October, 2003.

Security	**BID**	**ASK**
7.40% GOI 2012	115.30	115.35
9.81% GOI 2013	134.65	134.70
7.46% GOI 2017	118.35	118.45
7.49% GOI 2017	118.15	118.20
8.07% GOI 2017	123.30	123.35
6.25% GOI 2018	106.21	106.25
6.05% GOI 2019	103.80	103.85
6.35% GOI 2020	107.40	107.45
8.35% GOI 2022	126.90	126.95
6.17% GOI 2023	103.40	103.45

Source: stcionline.com

YIELD ON TREASURY BILLS

The yield of the bill is calculated on the basis of 365 days a year. It is calculated as follows:

$$\text{Yield} = \left[\frac{F}{P} - 1\right] x \frac{365}{D}$$

Where,

F = Face Value

P = Price of the T-Bill

D = Number of Days to Maturity.

Illustration 2

The face value of a 364-day bill is Rs.100. If the purchase price is Rs.88.24, calculate the yield on the treasury bill.

$$\text{Yield} = \left(\frac{100}{88.24} - 4\right) \times \frac{365}{364} = 13.36\%$$

Trading on the National Stock Exchange in the treasury bills essentially takes place on the wholesale debt market segment. This segment provides trading facilities for a variety of debt instruments including government securities, treasury bills and bonds issued by public sector undertakings/corporates/banks, commercial papers, certificate of deposits, corporate debentures, state government loans, SLR and Non-SLR Bonds issued by financial institutions. Large investors and a high average trade value characterize this segment.

The exchange provides a facility for screen based trading with order matching facility. The members are connected from their respective offices at dispersed locations to the main system at the NSE premises through a high-speed, efficient satellite telecommunication network. The trading system is an order-driven, automated order matching system, which does not reveal the identity of parties to an order or a trade. This helps orders whether large or small to be placed without the members being disadvantaged by disclosure of their identity. The trading system operates on a price-time priority. Orders are matched automatically by the computer keeping the system transparent, objective and fair. Where an order does not find a match it remains in the system and is displayed to the whole market, till a fresh order, which matches, comes in or the earlier order is cancelled or modified.

With a view to encouraging wider participation of all classes of investors across the country (including retail investors) in government securities, the Government, RBI and SEBI have introduced trading in government securities for retail investors.

Trading in this Retail Debt Market segment (RDM), on NSE has been introduced from January 16, 2003. In the first phase, all outstanding and newly issued central government securities would be traded in the retail segment. Other securities such as state government securities, T-Bills, etc., would be added in subsequent phases.

Certificate of Deposits (CD)

The next lowest risk category investment option after treasury bills is the Certificate of Deposit (CD) issued by banks and financial institutions. Certificates of deposits were allowed in 1989, as one of the RBI's measure to deregulate the cost of funds for banks and FIs. A CD is a negotiable promissory note issued by banks and FIs for a period up to a year. It is issued at a discount to the face value, and the discount rate is negotiated between the issuer and the investor. Although RBI allows CDs of up to one-year maturity, the maturity usually quoted in the market is for 90 days.

The secondary market for the certificate of deposit does not have much depth but the instrument is highly secure. Banks and financial institutions issue certificate of deposits to raise funds by attracting deposits from corporates, high net worth individuals and trusts.

CDs are available for subscription for individuals, corporations, companies, trusts, associations, etc. NRIs can also invest but only on non-repatriable basis. A bank can issue a CD with a minimum denomination of Rs.5 lakh (face value) and thereafter in multiples of Rs. 1 lakh.

YIELD ON CERTIFICATE OF DEPOSIT

The return on the certificate of deposit can be calculated from the following formula:

$$\text{Discounted value DR} = \frac{F}{1+\left(\dfrac{I \text{ x } N}{365 \text{ x } 100}\right)}$$

Where,

F – Face Value

I – Discount rate

N – Days to Maturity.

Illustration 3

Let the face value be Rs.1,00,000 and the effective interest rate is 6%. The issuance period is for 90 days. Calculate the rate of return for the certificate of deposit.

= Rs.1,00,000/ 1 + (0.06 x 90/36,500)

= Rs.98,522.17

(Rs.1,00,000 – Rs.98,522.17)/Rs.1,00,000 = 1.47%

Commercial Paper

Commercial paper is an unsecured money market instrument issued in the form of a promissory note. Introduced in 1990 in India, commercial papers enable highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. It is issued by highly rated corporate borrowers, Primary Dealers (PDs) and Satellite Dealers (SDs) and all-India Financial Institutions (FIs), which have been permitted to raise resources through money market instruments under the umbrella limit fixed by Reserve Bank of India. For being eligible to issue a commercial paper, the company should fulfill the following criteria:

i. Tangible net worth of the company should not be less than Rs. 4 crore.

ii. The working capital (fund-based) limit of the company from the banking system should not be less than Rs.4 crore.

iii. The borrower account of the company should be classified as a standard asset by the financing bank/s.

iv. The corporate should obtain the requisite credit rating for issuance of commercial paper, from any of the rating agencies such as Credit Rating Information Services of India Ltd., (CRISIL) or the Investment Information and Credit Rating Agency of India Ltd. (ICRA) or the Credit Analysis and Research Ltd. (CARE) or the Duff & Phelps Credit Rating India Pvt. Ltd. (DCR India).

CPs can be issued for maturities between a minimum of 15 days and a maximum of up to one year from the date of issue. It can be issued in denominations of Rs.5 lakh or multiples thereof. CPs can be held by individuals, banking companies, other corporate bodies registered or incorporated in India and unincorporated bodies, Non-Resident Indians (NRIs) and Foreign Institutional Investors (FIIs). Commercial Papers can be issued only in a dematerialized form through any of the depositories approved by and registered with SEBI.

RETURN ON COMMERCIAL PAPER

The return on commercial paper can be calculated through the following formula:

$$\text{Return on Commercial Paper} = \frac{\text{Par Value} - \text{Purchase Price}}{\text{Par Value}} \times \frac{360}{\text{Days to Maturity}}$$

Illustration 4

Sushma purchased a commercial paper of XYZ Co. Ltd., issued for 3 months in the market for Rs. 4,76,500. The company issued the commercial paper with the face value of Rs. 5,00,000. Calculate the rate of return on the commercial paper.

$$= \left[\frac{(\text{Rs.}5{,}00{,}000 - \text{Rs.}4{,}76{,}500)}{\text{Rs.}5{,}00{,}000}\right] \times \left[\frac{\text{Rs.}360}{\text{Rs.}180}\right]$$

= 9.4%

Checking Account

Checking account is one of the most common cash management tools used in the US. It is considered as one of the safest, secure and most convenient tools for holding cash. While this instrument is not prevalent in India, it is worthwhile to gain an understanding about this instrument.

A checking account can be opened at a commercial bank, savings bank, credit union or even at brokerage houses through asset management companies. Since they are usually opened with commercial banks we offer an explanation of a checking account opened with a commercial bank.

OPENING THE CHECKING ACCOUNT

There are various factors affecting the opening of a checking account, such as location of the bank, costs involved, services available, etc. The bank should be easily accessible to the customer, either near his/her home or office. Similarly, the bank should also offer services such as ATM cards, debit cards, phone and net banking with the checking account. Last, but not the least, the cost of operating the account should be low.

Cost of Operating a Checking Account

As the services offered by the banks have increased, so have the costs. The customer has to maintain a minimum balance per month or quarterly, otherwise a service charge is imposed. Similarly, per cheque fees is also levied in certain cases. Some banks also charge the customer for using the ATM centers and phone banking facility.

INDIVIDUAL OR JOINT ACCOUNT

A joint account can be operated in either of the following ways:

- Individual checking accounts can be opened and one account holder cannot write a cheque on the other account.
- Joint account can be opened, where cheques have to be signed by both the account holders.
- Open a joint account, where either of the account holders can write the cheque.

Advantages of Joint Accounts:

- Low service charges.
- The right of survivorship is available for couples. If one spouse dies, the other spouse after fulfilling certain legal formalities can draw cheques on the account.

PROCEDURES OF CHECKING ACCOUNT

The checking account opening procedure is similar to that of any other bank account. The customer has to forward an application form with suitable documents such as birth certificate, proof of address, place of employment, etc. In addition to this, certain rules and regulations have to be followed such as providing proper identification documents and making an initial deposits. The bank will then provide the customer with the cheque book, ATM or debit card. Instructions will also be given with respect to writing of cheques, depositing, using ATM and debit cards and availing the internet banking services.

OVERDRAFTS

Overdraft facility is provided in checking accounts also. In India, overdraft facility is usually provided in current account only. Overdraft results, when a cheque is written for an amount more than that available in the account of the customer. In such cases, the bank provides the overdraft protection. It means that if the cheque deposited is more than the amount available in the account, the cheque will not be dishonored and will be paid by the bank. The bank generally extends a loan to cover the amount of overdrafts. Overdraft is also available in the form of automatic transfer program. In this arrangement, in case of overdraft, the funds are automatically transferred from the savings account to the checking account.

STOPPING PAYMENT

Payment may be stopped in the following cases:

i. Cheque books or cheques are lost.

ii. Cheque is found to be faulty.

iii. Cheque is issued for a service that has not been carried out.

The cheque can be stopped by intimating the bank. The account holder may have to fill up a form specifying the account holder, cheque number, amount of the cheque, etc. The payment can also be stopped by intimating the bank on phone.

MONTHLY STATEMENTS

The bank provides statements specifying all transactions related to the checking account including the service charge levied and interest earned. Monthly statements are important records needed for tax purposes also.

ACCOUNT RECONCILIATION

It is essential to reconcile the bank account as soon as one received the bank statements. A number of discrepancies or errors can be diagnosed by reconciling both the statements. Proper checking and reconciliation also helps to avoid unnecessary overdrafts.

SUMMARY

- Cash management involves day-to-day management of cash to achieve one's long-term objectives and goals. Cash management also involves management of liquid assets such as current account, savings account, mutual funds, treasury bills and certificates of deposit, etc. Proper cash management helps in making funds available not only for basic and daily expenditure, but also for an effective savings program.
- There are various tools available for cash management, which ultimately lead to proper savings programs such as savings account, fixed deposits, mutual funds and recurring deposits, etc. In addition to these tools, there are various saving channels available for an investor such as treasury bills, certificate of deposits and commercial papers.
- All these channels for savings are managed and facilitated by financial institutions such as commercial banks, mutual funds, insurance companies, etc. Proper cash management automatically lead to long-term savings which is the very essential in personal financial planning.

Chapter V

Making Decisions Regarding Houses and Automobiles

After reading this chapter, you will be conversant with:

- Parameters to be considered while Purchasing an Automobile
- Identifying the Various Housing Alternatives that Meet one's Needs
- Home Affordability Analysis
- Assessing the Rental Option and Performing a Rent-or-buy Analysis
- The Home Buying Process
- Financing the Housing Transaction
- Major Housing Finance Institutions in India
- Housing Schemes in India
- Real Estate Industry in India

Introduction

Arjun has just got a major promotion. With a good hike in his salary, he is thinking of buying a new car and also a nice, decent home. Being 28 years old he feels that this would be the right time to start working on these plans. How and where should he start?

Decisions regarding owning a house or an automobile are difficult to make as they usually involve huge amounts of money. The first section of the chapter deals with the issues involved with a car purchase and next section deals with the housing needs, the buying process and house financing. Let us first start with car financing.

AUTOMOBILE PURCHASE – PLANNING

Possessing an automobile such as a car has become a necessity for today's generation. Having a car could lessen the traveling time and also make the travel more comfortable. Certain others want to own a car as a status symbol or simply for pleasure. In any of the cases, certain criteria have to be considered before purchasing a car. These criteria would help to make the right decision about the type of car to be purchased.

Affordability

Before buying a car, it is essential to know what one can afford. Although a number of facilities are available for automobile financing, it is important to consider the availability of finance for buying an automobile such as a car. An individual should seriously analyze whether he/she has the capability to make the requisite down payment and the monthly installments. After considering all this, care should be taken to ensure that one's budgets and financials are not heavily disturbed as a result of opting a certain scheme. For instance, if an individual has a savings of Rs.1,00,000, he/she should not make a down payment of Rs.90,000. In such a situation, his/her savings will reduce drastically. In case his/her monthly income is Rs.8,000 and the monthly installment of a particular scheme is Rs. 3,500, he/she should analyze if it would be possible for him/her to meet other expenses, if he opts for the scheme and pays the installment.

Operating Costs

The operating costs of an automobile include:

- Installment costs.
- Insurance.
- License fee.
- Fuel and oil costs.
- Repairs and maintenance costs.

These costs can broadly be divided into two categories: fixed and variable. Fixed costs are in the form of installments and variable expenses include fuel costs and maintenance or repair costs. Depreciation is another expenditure that should be taken into consideration. It generally arises due to the difference between the purchase price and the sale price of the car.

Brand New or Second Hand

Before buying a car, a person also has to decide, whether he/she should go in for a brand new model or second hand one. Some people prefer to buy a second hand car than an original one. Buying a used car has the following advantages:

- Lower down payment to be made.
- Less expensive than the brand new car.
- There will not be a high depreciation.

On the other hand, the following are the main disadvantages of buying a used car:

- Maintenance costs may increase, as the car is a used one.
- Problems like low mileage may occur.
- Expenditure may have to be incurred for investigation of the vehicle.

Features of the Car

Before making a purchase, a thorough investigation has to be made with respect to the features of the car and whether it would meet one's needs or not. The following points have to be considered before buying a car (irrespective of whether a new car or a used one is bought):

- Performance of the car
- Handling and appearance
- Fuel economy
- Reliability and possibility of repairs
- Resale value of the car.

An individual should first understand what type of car would suit his/her requirements. A small car such as Maruti, would be suitable for a small family, whereas a Qualis is an appropriate one for a big family. There are certain accessories for a car such as air conditioning, music system, central lock system, gearbox lock, etc., which an individual may like to buy. These accessories are at the option of the buyer and depending on the choice made by the buyer the price of the car would also increase.

Reliability and Warranties

There are number of ways by which the reliability of a car can be checked or investigated. It can be done by contacting people who are using the particular brand of the car, or by browsing through magazines or consumer reports. In addition, it is essential to thoroughly check through the warranty booklets and understand the terms and conditions of the warranty. Generally, all manufacturers give a warranty period during which replacement is allowed and maintenance is also free. But certain schemes only provide for the maintenance of specific parts of the car such as the engine. It is therefore necessary to carefully scrutinize the documents pertaining to the warranty provided by the car manufacturers.

Purchase of the Car

Once the decision is made whether to buy a new car or a used one, the process of buying becomes easy. The first step is to visit all the dealers and have a look at all the cars, which may suit one's requirement and the available budget. After having a look at the cars, a person can easily get confused. Therefore, it is better to make a list of all the features required in the car one would like to own. Car dealers and manufacturers are now-a-days more focused on customer satisfaction, thus it is easy to choose and buy one if a person is clear of his or her requirements.

Price Negotiation

Price negotiation varies according to the dealer and the model chosen by a person. Generally, in case of a new car, there can be no bargaining, as the car is available at the showroom price. But the 'car on road' price is different as it includes cost of certain accessories and insurance. Thus, bargaining can be done in case of these cars. While purchasing a used car, it is essential to know what is the cost of the car to the dealer. In certain cases, the dealers may try to find out how much a person can afford, through the monthly salary of a person and accordingly adjust the price. Dealers may also give discounts on those models of cars, which are not much in demand. Thus, it is very essential to identify the right dealer before purchasing a car.

Financing Schemes on the Internet

There are a number of financing schemes available on websites of various companies providing financial services such as ICICI and HDFC bank. One of the websites, which is totally dedicated to auto loans, is 'auto.indiamart.com'. This website provides financing information with respect to vehicles ranging from a two-wheeler to a heavy commercial vehicle and also for second hand cars. Another website that gives information about second hand cars is 'bharatgroup.com'. The website gives information related to second hand cars, the model available and their prices. The following table below gives the EMI plan for cars available on the website: 'auto.indiamart.com'.

EMI Plan for New Cars

Types of Finance Schemes	Number of Months					
		12	24	36	48	60
Margin Money	EMI:(in Rs.)	9,033	4,919	3,562	2,894	2,502
Advance EMI	No. of Advance EMIs:	2	3	5	6	7
	EMI: (in Rs.)	8,911	4,785	3,373	2,703	2,305
Residual Value	EMI:(in Rs.)	7,403	4,157	3,151		
Step up Scheme	Last EMI:(in Rs.)	30525	4,785	30,525		
	EMI:(in Rs.)	Ist Year 2,746	2nd Year3,844	3rd Year 4,393		

EMI Plan for Used Cars

Types of Finance Schemes		Number of Months		
		12	24	36
Margin Money	EMI:(in Rs.)	9,271	5,184	3,847

Source: www.auto.indiamart.com

MEETING HOUSING NEEDS

Food, clothes and shelter are a man's basic necessities. Going by this, every man is on the lookout to own a home. People have different housing needs according to their tastes, preferences and financial condition. Some people may like to own a farmhouse; others may like to own an apartment on a busy street. A number of factors affect the choice of a house, such as its cost, distance from the working or shopping place, access to various factors or security.

Homes are available in various forms, varying from a condominium to an apartment. The different forms are described in the following sections:

Independent Houses

Independent houses are still the most popular form of housing. However, owning an independent house has become extremely expensive especially in the urban areas and metropolitan cities. They are however affordable in the semi-urban and rural areas. Independent houses can be small or huge in structure. Independent houses provide prestige and privacy to a family. They may be owned or taken on rent.

Condominiums

Condominium is a form of joint ownership. A condominium can be in the form of an apartment, townhouse or cluster houses. The buyer of the condominium has the ownership title of a particular unit, and joint ownership to swimming pools, lobbies, clubhouses etc. The buyers of these condominium units pay individual mortgage, taxes and building maintenance charges. There is generally an association made for the condominium owners and a board is elected to manage the whole building. The units are less expensive than the independent houses and make efficient use of resources such as land, water, etc.

Apartments

Apartments are generally the most common form of housing facility available today. Apartments are available for ownership and also on rent. In urban cities, people invest in apartments and give them on rent so as to have a source of income. Apartments are less expensive and affordable and can be easily maintained. A working family can easily afford an apartment. It is best suited for a small family, as it both affordable and secure.

Motives of Buying a House

Although a house is a basic necessity of life, people may have different reasons for buying it. Some people may buy a house for security and peace of mind, whereas others may do it for a source of income. In addition to this, individuals may also invest in a house for the following reasons:

- **Tax Shelter:** Tax shelter can be obtained by a person by investing in house property. The owner can obtain tax rebate on the installments and the interest. This has been explained in the previous chapter on managing taxes.
- **Inflation Hedge:** Investment in property is another way of hedging inflation. An inflation hedge occurs when the value of the property rises or appreciates equal to the rate of inflation or even greater than it. Thus, if a person would like to sell the property, he/she would get a higher price than what been had invested.

Cost of Home Ownership

A home has an emotional attachment for everyone, but certain financial criteria have to be fulfilled before taking a decision regarding the affordability of owning a house. The following points need to be taken into consideration:

DOWN PAYMENT

The first and most important aspect is the down payment. The majority of the buyers finance a major part of the cost of the house by borrowing from a finance company. However, lenders usually insist that buyers must invest certain money of their own. This is done through the down payment made by the buyers. The amount of down payment is determined by the ‘loan to value ratio’. This ratio specifies the maximum percentage of the value of a property that the lender is willing to finance. A property with a high loan to value ratio, will have a low percentage of equity contributed by the owner of the house. Similarly, a low loan to value ratio specifies that the contribution made by the financing company is low and the owner contributes the major part of the purchase price of the house. Some of the leading lending institutions are the commercial banks such as HDFC Bank, Standard Chartered Bank and ICICI Bank. The loan to value ratio specified by them is generally about 80-85% of the value of the property. Lending institutions also give housing loans on the basis of the earning capacity of the individual that may be around 48 or 36 times of the monthly income of the salary of the individual.

MORTGAGE FEES AND THE CLOSING COSTS

The lenders charge a mortgage fee at the time of granting the housing loan to the borrowers. It is in the form of interest and is the charge for the loan granted. It is related to the supply of loanable funds and demand for mortgage. Apart from mortgage fees, the closing costs also play an important role. Closing costs are the expenses that borrowers have to pay at the time the loan has been repaid and the title to the house property passes on to the buyer. The main closing costs include:

- Application fees.
- Loan origination fees.
- Mortgage points.
- Insurance fees.
- Attorney's fees.
- Appraisal fees.
- Mortgage taxes.

MORTGAGE PAYMENTS

The monthly mortgage payment is determined by using a complex formula. This payment comprises of the principal repayment and the interest. The lenders use various comprehensive tables to find the monthly payments. The tables that are used contain various combinations of the loan size, interest rate and the maturity period and are based on the principles of time and money.

Affordability

The most important issue with respect to mortgage payments is affordability. It is essential to determine the monthly installments to estimate whether the expenses are within one's budget limit or not. This calculation will also help in estimating how much one has to borrow finance for the purchase of the house. In order to obtain a mortgage, the borrower has to be qualified, that is, he/she should have a good credit record and he/she should also have sufficient income in order to pay the monthly installments. The borrowers should also fulfill the specific standards set by the banks and financial institutions in order to reduce the default risk.

In order to determine the affordability, banks usually compare the monthly mortgage payments and loan payments of the borrower to his/her monthly income. The rules of thumb adopted by the banks for a conventional mortgage loan are:

- The monthly mortgage payments should not exceed 25% to 30% of the borrower's gross income.
- The monthly loan payments should not exceed 33% to 38% of monthly gross income.

In order to own a house, a person may have to forgo certain luxuries in the initial stages so as to pay the monthly installments at the right time. In addition to making the installments, costs may also have to be incurred with respect to insurance and maintenance.

PROPERTY TAXES AND INSURANCE

The mortgage payments also include property tax and insurance payments. The monthly mortgage payments are composed of:

- Principal payment.
- Interest on loan.
- Property tax.
- Insurance.

The property taxes differ from country to country. The higher the cost of the home, the higher will be the property tax. The other important component is the insurance. The insurance cost depends on various factors such as location, age of the house, material used for construction and the geographical area. The insurance is basically done on the replacement value and the contents and not on the value of land.

MAINTENANCE AND OPERATING COSTS

Maintenance and operating costs need to be incurred, apart from making monthly payments. Maintenance costs are higher on new houses as it requires painting, repairs and certain other mechanical settings. In addition to all this, there are other expenses that need to be incurred, such as establishing water and electricity connections and a good sewage system. These expenses have increased considerably in the recent years and should also be taken into account before making the purchase decision.

Home Affordability Analysis

The following table shows the various points to be taken into consideration while making an analysis regarding the affordability of a home:

- **Amount of Annual Income:** An individual should take into account his/her total income or the income of the family, before taking any decision regarding taking a home loan. A person earning Rs.2,00,000 per annum cannot obtain a loan of Rs.50,00,000.
- **Monthly Income:** In case the borrower takes a loan for which he/she has to make monthly payments, it is essential to consider one’s monthly income or that of the family. If the income of the family is Rs.15,000 per month, they cannot afford to pay an installment of Rs.8,000, as there are other expenses of the family also.
- **Lender’s Affordability Ratio:** Lender’s affordability ratio is also important at the time of taking the decision.
- **Maximum Monthly Mortgage Payment:** The maximum monthly payment that an individual can afford.
- **Maximum Monthly Loan Payment:** The loan payment that an individual can afford. For instance, a family may decide that they would not be able to spare more than Rs.5,000 per month for monthly installments.
- **Average Interest on Loan:** The rate of interest available on the loan amount.
- **Planned Loan Maturity:** The time period for which the loan has to be taken. A person should decide for how many years he or she would like to repay the loan. A newly married couple should avail a ten-year loan only after taking into consideration the expenses that have to be met if a child is born.
- **Funds Available for making a Down Payment:** The amount of funds available for making the down payment under the loan scheme is the first obligation of the borrower in the home loan transaction. Thus, it is first necessary to check the available finances and then decide the amount that one can afford for a down payment under the housing scheme.
- **Maximum Purchase Price:** The purchase price should be the first consideration as it gives an indication to the borrower whether he/she would be able to repay the loan or not.

THE RENTAL OPTION

There are a number of reasons for renting a house or an apartment. These include:

- Lack of funds for making a down payment and meeting other closing costs;
- Job instability;
- Purchasing a house is an additional responsibility;
- Unable to find a suitable place for purchase.

Rental Contract

Rental contract should be in writing in order to make it a legal contract. The house can be taken on lease or on rent. In both the cases, it is essential that the contract be in writing in order to protect the rights of the tenant and the owner or the lessee and the lessor, in the case of a lease. The contract generally specifies the monthly payment to be made, the requisite initial deposit, and the various renewal options. In case of leases, the minimum term period may be 6 months or one year. The deposit is in the form of the rent of a certain number of months. This is taken as a security to cover any damage done to the property by the lessee. This applies to the rental property also. At the time of expiry of the contract, the initial deposit is returned or refunded back to the lessee or the tenant. In case there are certain repairs to be made, the expenses made by the owner or the lessor is deducted from the initial deposit and then refunded. It is essential to discuss the expenses to be paid by the tenant at the time of the expiry of the contract, at the time of entering into the contract itself. These expenses are generally in the form of water and electricity charges and other utility expenses.

Rent or Buy

Numerous factors have to be taken into consideration while deciding whether it is better to take an accommodation on rent or buy a property. The rent or buy analysis can be described as follows:

COST OF RENT

The cost of rent includes the following:

- Initial deposit to be made.
- Rental cost = Monthly payments x Number of months.
- Maintenance costs.

COST OF BUYING

The cost of buying includes the following:

- Mortgage Payments = Total Monthly Payments x Number of Months.
- Property tax to be paid.
- Maintenance costs.
- Closing costs.

Less:

- Principal reduction in loan balance
- Tax savings due to interest deductions
- Tax savings due to property tax deductions, such as deduction on repairs, which is 30%.

The decision whether to rent or to buy should broadly be only based on the cost of both these alternatives. Certain other factors such as job security, probability of changing the city, need for privacy and psychic satisfaction should also be considered while making this decision. These factors may outweigh the financial considerations. In addition, the future financial scenario also should be taken into consideration.

Illustration 1

The buy or rent decision can be analyzed through the following illustration given below:

Consider a situation where a person opts to live in a rented house the rent amount to be paid would be Rs.4,000 per month and maintenance cost would be Rs.500 per month. The tenant will have to make an initial deposit of three months' rent in advance. On the other hand if he goes in for the alternative of buying a house, the loan amount that would be available to him is Rs.3,00,000. In such a case, mortgage payments would be Rs.3,500 per month. The maintenance and operating expenses, in this case would be Rs.10,000 annually. In addition to this, property tax of Rs.24,000 will have to be paid. On the basis of this information, recommend which of the options is better.

(in Rs.)

	Cost of Rent			Cost of Buying	
1.	Initial deposit (3 Months)	12,000	1.	Mortgage Payments (3,500 x 12)	42,000
2.	Total rent paid (4,000 x 12)	48,000	2.	Maintenance and Operating cost	10,000
3.	Maintenance Costs (500 x12)	6,000	3.	Property tax	24,000
	Total cost	66,000		Total Cost	76,000

Cost of renting an accommodation is less expensive than buying a new house.

Common Home Buying Mistakes

Investment in buying a home is one of the major investments in life. Thus, it is essential that decisions with respect to buying a home be taken only after a thorough investigation is done. The following points, if taken into consideration will help in avoiding certain mistakes in home investment:

- Decision should be taken after giving thorough consideration to one's future needs, such as marriage, job shift, etc.
- It is necessary to choose an appropriate agent or property dealer who is well acquainted with the area.
- Thorough search should be done by examining various houses in the locality. A decision should be taken only after a thorough examination.
- The people living in the area or the neighborhood can also be consulted to know about the problems of the area or the building.
- The people staying nearby should be of good repute, similar age group etc.
- Resale value of the house should be taken into consideration.
- The property or the house should be thoroughly investigated or checked in order to find out whether it meets all the requirements.
- The contract relating to the purchase of the house should be thoroughly read and then signed. Doubts about the property or the agreement should be clarified at the beginning stages only.
- A house should not be rejected for the sole reason that it requires minor cosmetic changes.

THE HOME BUYING PROCESS

The decision of investing in a house property involves a lot of money, time and effort and has a long-term effect. It is therefore essential to conduct a thorough investigation before taking a decision in this issue. The following aspects should be taken into consideration before buying a home:

The Market

The market when it comes to the housing sector includes the real estate agents or the information in various sources like the newspapers. People willing to sell or give a house for rent, usually advertise the features of the property and their contact numbers in the newspapers. Interested buyers can contact them directly or through a broker. Now-a-days, information is available on the Internet also where, by specifying the preferences the buyer can get information about the house properties that meet the requisite criteria. In addition to this, an individual can even calculate his/her EMI, in case he/she would like to take a home loan. One of the EMI calculator format is given below. The Equal Monthly Installments (EMIs) to be paid can be calculated automatically by entering the loan amount, interest rate and tenure of the loan in the relevant fields.

LOAN DETAILS	
Interest Rate (%)	
Amount of loan required	
Tenure (in years)	
Reducing Balance based on	Annual Rests
RESULT	
EMI (Rs.)	

Source: indiaproperties.com

One of the websites where proper information with respect to housing information is available is *indiaproperties.com*. The website gives valuable information with respect to both residential and rented independent houses and apartments. The information is available with respect to all major cities of the country. Through the website it is easy to find out the property rates available in the various cities throughout the country. In addition to this, commercial banks providing home loan facility give information on the Internet. Some of these websites are hdfc.com, icicibank.com, etc.

Buying a house involves a number of factors: both emotional and financial. Thus, it is very essential that a person should be clear about what he/she actually requires. His/her requirements would include a combination of both necessary and optional features and also an affordability analysis. It is possible that at the start of the search, one would like to have an independent house with a lawn and a garage, but it is highly possible that he/she may settle for an apartment penthouse, if it fulfills all his/her requirements.

If a person already owns a house, but is not satisfied due to various reasons such as size, then it can be remodelled. The costs incurred on the remodelling can be recovered at the time of resale. It is quite difficult to find a house that perfectly suits one’s requirements. Thus, it is sometimes required to compromise on certain aspects while buying a house.

Agent

A real estate agent’s help can be taken for searching a house. A real estate agent has the requisite knowledge and the contacts to find the property that would suit the requirements of the buyer. The agent would also help in negotiating the price of the property or the rent. After gaining an understanding of the buyer’s needs, the agent tries to find a property that would suit these needs.

It should however be remembered that agents are actually employed by the sellers to sell or rent out their property at the highest possible price. Agents thus earn commission from both the seller and the buyer. The agents are, in many of the cases, under pressure to sell the property in order to earn a commission. Also, the agents may get a higher commission for selling the property at a higher price. Thus, care should be taken to select an agent who would work for the best interests of both the buyer and the seller.

Applying for Mortgage

Before beginning to search for a house, it is essential that the borrower applies for mortgage and arranges the loan in advance. After a buyer comes to know the amount of mortgage loan that he/she can avail, he/she should be on the lookout for a property accordingly. The prequalification process for the mortgage also helps to enhance one's bargaining power as the seller can be made aware of the limit of the loan. Prequalification also helps to estimate the required down payment and the closing costs of the different types of mortgages. The following information usually has to be furnished by the borrower to the lender at the time of applying for the loan:

- Proof of monthly income.
- Assets owned and debt owed.
- Amount in the savings accounts.
- Loans such as educational loan taken, if any.

Sales Contract

A sales contract, like all other contracts, should be in writing giving the following information:

- Names of the buyer and the seller.
- Description of the property.
- Price of the property.
- Signature of the buyer and the seller.

These are the minimum requirements that have to be fulfilled. In addition to these requirements, the contract may include certain provisions such as money deposits, a contingency clause and closing costs.

- **Earnest Deposit Money:** Money deposited when an offer is made by the buyer. The money is deposited in good faith and if the buyer withdraws the offer without stating any valid reason, the seller has the right to forfeit the amount.
- **Contingency Clause:** This clause lays down a condition that the property will be bought on the basis of the factors such as availability of finance, physical inspection of the property, or on the basis of the advice given by the lawyer or an expert.
- **Closing Cost:** Closing costs or expenses are paid at the time, when the mortgage loan is closed. They are generally in the form of loan application fees, loan origination fees, appraisal fees, etc.

Closing the Deal

As soon as the loan is approved, the closing process begins. Expenses related to closing costs such as insurance and financing have to be met at this stage. Apart from meeting the closing costs, it is essential that the title of the property be properly checked. It should be ensured that the title is free of all liens and encumbrances and the person selling the property has the legal right to do so. A title check can be made by seeking the help of an attorney or a lawyer who would scrutinize the requisite legal documents and records.

Closing Statement

The closing statement is provided to both the buyer and the seller, before closing the transaction. This statement reconciles the costs incurred by both the buyer and the seller and indicates how much the buyer owes and the seller received from the transaction. The closing statement should be reviewed by both the parties thoroughly in order to ensure that it is accurate and is as per the contractual terms of the transaction. Once this is done, the statement should be signed by both the parties in order to make sure that it is accurate.

FINANCING THE HOUSING TRANSACTION

The success of the housing transactions depends on the availability of the mortgage loans with favorable terms. A mortgage loan is secured by a property. In case there is default by the borrower, the lender has the right to liquidate the property and recover his/her funds. To understand the process involved in obtaining a mortgage loan, let us begin with identifying the sources and types of mortgage loans.

Sources of Mortgage Loans

The following institutions provide mortgage loans:

- Credit unions.
- Commercial banks.
- Savings banks.
- Mortgage bankers.
- Mortgage brokers.

Some credit unions make these loans available only to their members. The commercial banks have also become active in the mortgage loan market. They provide interim construction loans also, which are used for constructing or remodeling the house. Savings banks also provide mortgage loans. They provide loans from the amounts deposited with them by their customers. Their lending policies are specified by the mortgage market conditions and regulations specified by the authorities.

The mortgage banker and broker are other sources of mortgage loans. The mortgage bankers use their own money to fund the loans. On the other hand, mortgage brokers receive applications for the loans and then identify the lenders who are willing to provide the loans under the desired conditions. The mortgage bankers deal primarily with the government guaranteed loans, while the mortgage brokers provide conventional loans to the customers.

MORTGAGE BROKER

Using a mortgage broker can be highly beneficial for a buyer, especially when the buyer is not able to obtain a loan from a commercial bank or other conventional source of financing. Brokers have a huge database that contains details of the loans available at effective rates from various lenders. Brokers also have an ongoing relationship with the lenders and will therefore be able to negotiate the terms of the deal, obtain the finance at more favorable terms and also reduce the time taken to close a deal. The entire process of obtaining the requisite finance can thus be highly simplified by using a mortgage broker. It should however be borne in mind that not all the brokers are competent and some may recommend a loan that may not suit the requirements of the buyers. It is thus very essential to select a broker carefully and only after a thorough investigation.

Brokers earn their income from commission and fees paid by the lenders. The brokers also pass the costs of the seller on to the buyer. In addition to this, the borrowers have to pay the costs for the application, processing and document preparation to the lender at the time of closing the deal.

Information about mortgage rates is easily available through the Internet. Most of the housing companies give necessary information about the type of loan and the specific rates through their websites. The customers can easily access these websites and gain information on these aspects, without consulting a broker or a banker, dhfl.com (Dewan Housing Finance Corporation Ltd) is one such website, where information is available with respect to repayment period and types of loans. The processing fee charged by this company on the mortgage loans is 0.75% of the applied amount.

HOUSING FINANCE INSTITUTIONS IN INDIA

The following are the main housing finance institutions in India:

National Housing Bank

National Housing Bank was established in 1988 as a subsidiary of Reserve Bank of India. It is a principal agency promoting housing finance institutions both at local and regional levels. The bank guarantees financial obligations of housing finance institutions and underwrites the issue of stocks, shares, bonds, debentures and securities of these institutions. It undertakes research and surveys on construction techniques and other studies relating to or connected with shelter, housing and human settlement. It formulates schemes, for the purpose of mobilization of resources and extension of credit for housing. In addition to this, it is also responsible for coordinating with other institutions such as Life Insurance Corporation of India, the Unit Trust of India, the General Insurance Corporation of India and other financial institutions.

Housing Development Finance Corporation

HDFC was established in the year 1977 with the objective of promoting home ownership by providing long-term finance to households for meeting their housing needs. The institution was promoted with an initial share capital of Rs.100 million. The objective of HDFC is to enhance residential housing stock in the country through the provision of housing and promote home ownership. Another objective is to increase the flow of resources to the housing sector by integrating the housing finance sector with the overall domestic financial markets. HDFC has 130 offices spread all over the country. This extensive network helps HDFC in providing quality service to its large and extensive client base. HDFC established an office in Dubai in 1996. It has further enhanced its presence in the Middle East with service associates in Bahrain, Kuwait, Oman, Qatar and Saudi Arabia. HDFC has diversified itself into a financial conglomerate and has the following subsidiaries:

- HDFC Bank.
- HDFC Mutual Fund.
- HDFC Standard Life Insurance Company.
- HDFC Securities.
- Intelenet Global Services Ltd.
- Credit Information Bureau (India) Limited.
- Other Companies co-promoted by HDFC.
- HDFC Chubb General Insurance Company Ltd.
- HDFC Realty.

Types of Mortgage Loans

Mortgage loans can be classified broadly on the basis of two important criteria. These include:

i. Terms of payment.

ii. Whether the loans are conventional, insured or guaranteed.

I. Terms of Payment

Under this category, mortgage loans can be classified into fixed rate mortgage loans and adjustable rate mortgage loans.

Fixed Rate Mortgage

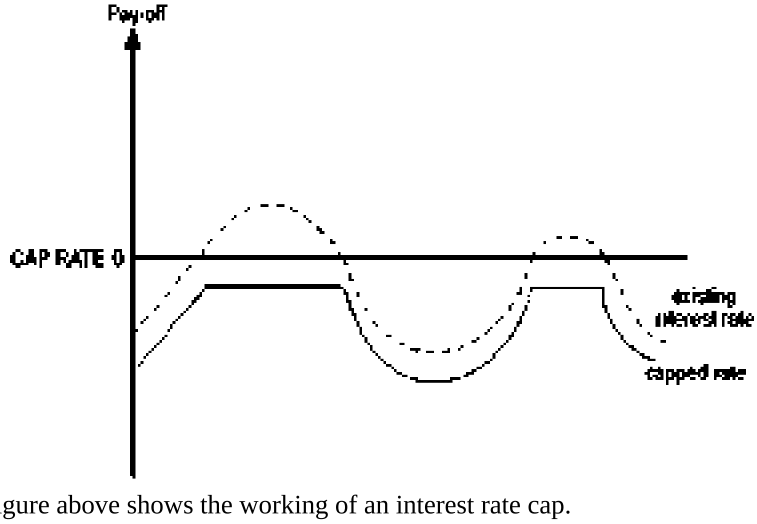
This type of mortgage accounts for a major portion of all the home mortgages written. Under this type of mortgage, both the interest rate and the monthly mortgage payments are fixed over the entire period of the loan. The most common type of this loan is for a period of 30 years. This is also the most expensive form of home financing due to the risks assumed by the lender. In addition to this type of loan there is another 15-year fixed rate loan. This loan is paid twice as fast as the 30-year period loan. Another variation of the fixed rate loan is the balloon payment mortgage loan. This mortgage is generally for a period of 5, 7 or 10 years. The interest rate of this loan is fixed at 0.25% to 0.5% below the 30-year fixed rate. The monthly payments in the balloon mortgage are same as that of the fixed rate mortgage. When the loan matures, the remaining principal balance becomes due and has to be refinanced. The low rate results in low monthly payments, but these loans have risk and it may be difficult to refinance them in the future.

Adjustable Rate Mortgage

Adjustable Rate Mortgage (ARM) is another form of housing loan. In this type of mortgage loan, the rate of interest and monthly payments are linked to a specific interest rate index and are adjusted at specific intervals in accordance to the changes in the index. The interest rate may be adjusted at various intervals, such as twice a year. As the index moves up, the interest rates and the monthly mortgage payments also move upward. This adjusted monthly mortgage payments remains fixed till the next adjustment period. The term for the adjustable rate mortgage is generally for 15 or 30 years. In the case of an ARM, it is not possible to predict the future monthly payments, as the size of the monthly payments varies according to the changing interest rates. The following are the basic features of an Adjustable Rate Mortgage (ARM) loan:

- **Adjustment Period:** Adjustment period is the time period between one rate or payment change and the next. Such a period may range from three months to five years.
- **Index Rate:** The baseline rate may be linked to treasury bills, certificates of deposits, savings account or other investments.
- **Margin:** Margin is the percentage points that a lender adds to the index to determine the interest on the adjusted rate mortgage.
- **Interest Rate Caps:** Interest rate cap is the limit on the amount of interest rate that would protect the borrower from extreme increases in the interest rates and the monthly payments. There are two types of interest rate caps: periodic caps and the interest rate caps. The periodic caps limit the interest rate rise from one adjustment period to another, whereas overall interest rate cap limit the interest rate increase throughout the life of the loan.

Figure 1: Interest Rest Cap



The figure above shows the working of an interest rate cap.

- **Payment Caps:** Payment caps limit the amount of mortgage payments made by the borrower. If the payment cap is 6%, the monthly payment will not increase more than 6%.

Negative Amortization

Some of the adjustable rate mortgages are subject to negative amortization, which occurs when there is an increasing principal balance resulting from monthly loan payments, which are lower than the amount of monthly interest being charged. This occurs when the initial payment is fixed lower than the interest charged or when the interest rates of the ARM adjust monthly although the actual payment can be adjusted only annually. Thus, as the interest rates rise, the current monthly payment would be less than the interest rate to be charged and this difference is added back to the principal thereby increasing the total size of the loan.

Fixed and Floating Rates for Home Loans

Some institutions in India provide loans both on the fixed and floating interest rates. In case of fixed interest rates, the interest rate remains unchanged for the entire duration of the loan period. Thus, if the interest rates fall, the borrower does not obtain any benefit. On the other hand, in case of floating interest rates, the rates fluctuate according to the market. If the interest rates increase, the borrower has to pay more and he/she may have to pay less at the time of falling of the interest rates. Thus, it is generally seen that the borrower purchases an interest cap to avoid loss at the time of rising interest rates.

The following table gives EMI on the basis of fixed and floating rates for a loan of Rs.1 lakh for various tenures by the leading lending institutions.

Table 1: EMI Plan for Home Loans

EMI per lakh (in Rs.)

	5 years		10 years		15 years		20 years	
	Fixed	Floating	Fixed	Floating	Fixed	Floating	Fixed	Floating
Bank of Baroda	2,076	2,016	1,294	1,240	1,075	1,015	965	900
CanFin Homes	2,101	2,170	1,299	1,327	1,065	1,065	962	946
Citibank	NA	2,040	NA	1,227	NA	999	NA	884
Corporation Bank	2,026	2,002	1,264	1,237	NA	1,011	NA	896
Dewan Housing Finance	2,076	2,064	1,293	1,280	1,059	1,044	965	948
HDFC	2,076	2,064	1,281	1,267	1,059	1,044	949	933
HSBC[1]	2,028	2,016	NA	1,281	NA	1,030	NA	916
Hudco	2,100	2,100	1,308	1,294	1,075	1,044	965	932
ICICI Bank	2,064	2,040	1,280	1,253	1,059	1,059	949	916
IDBI Bank	NA	2,040	NA	1,240	NA	999	NA	884
LIC Housing Finance	2,076	2,040	1,280	1,240	1,059	1,014	948	900
PNB Housing	2,101	2,088	1,299	1,285	1,081	1,065	963	946
State Bank of India	2,028	2,016	1,240	1,227	985	970	884	868
Standard Chartered	2,040	2,028	1,240	1,227	999	985	884	868
Tata Home Finance[2]	2,312	2,040	1,475	1,254	1,224	1,015	1,116	916
Union Bank of India	2,040	2,028	1,267	1,254	1,044	1,029	932	916

Source: Outlook Money 15th November, 2003.

1. Fixed rates for three years.
2. Fixed rates at annual rests.

Figures in bold represent lowest EMIs for that tenure.

Types of Adjustable Rate Mortgages (ARMs)

The following are the main types of ARMs:

- **Convertible ARM:** Convertible ARMs are those, which can be converted into fixed rate loans by the borrowers. The advantage in these kinds of loans is that in case the interest rates fall, the loan can be converted into a fixed rate loan by the borrower for a fee. For instance if the convertible rate is 12%, and in case the interest rates fall to 11.5%, the loan can be converted to this rate.

- **Two-step Mortgage:** This mortgage is also known as 5/25 and 7/35 mortgages. They are amortized over 30 years, but they have fixed rates for 5 or 7 years, and the rate may be adjusted in the later years. For instance, if the mortgage rate is 10% in the first phase of 5 to 7 years, in the remaining time period the rate will be adjusted. This is beneficial if the borrower sells the house before the adjustment period starts.

- **Growing Equity Mortgage:** These are fixed-rate mortgages where the payments increase for a specific number of years and then remain fixed or levels off. For instance, the mortgage amount will increase by Rs.3,000 every year and then level off. The loan period is shorter as the payments include more amount of principal.

- **Graduated Payment Mortgage:** The graduated payment mortgages have a low initial payment for the first few years and then increase gradually for a period of 5 to 10 years and then remain fixed. Graduated payments are useful for individuals who cannot pay high installments in the initial years. For instance, the installment amount may be as low as Rs.1,500 per month for the first two years and later increase to Rs.3,500 per month.

- **Shared Appreciation Mortgages:** In these kinds of mortgage loans, the lender agrees to charge a very low level of interest on the funds and in turn, the borrower agrees to share a part of the increase in the property value with the lender, when the loan matures or when the property is sold. For example, the interest rate will be as low as 8%, and when the property value increases by 50% after 5 years, it will be shared among the lender and borrower.

- **Biweekly Mortgages:** These are loans that have payments equal to half of the regular monthly payments that are made every two weeks rather than once every month. For instance the payment will be Rs.2,000 easier after every two weeks than paying Rs.3,000 per month.

- **Buy Downs:** This type of financing is offered on new homes. A seller or a builder may arrange for mortgage financing, which is subsidized for the buyer.

Choosing an Index

The index to which the adjustable rate mortgage is linked, significantly affects the level and the stability of the mortgage payments over the term period of the loan. The indices that are usually selected are the treasury bills, LIBOR – London Inter Bank Offering Rate or the Certificate of Deposit Rates.

The certificate of deposit rates and the LIBOR are volatile. They change according to the developments in the global financial markets. In order to choose an appropriate index, it is essential to consider the annual rate cap on the mortgage, level of interest rates and future interest rate expectations.

Monitoring Mortgage Payments

Mortgage payments made should be properly monitored over the whole term period of the loan. Calculation of the adjustment payments should also be properly verified. For this, it is essential to know the variations in the index rate, margin and the loan formula used.

II. CONVENTIONAL, INSURED AND GUARANTEED LOANS

Conventional mortgage is a mortgage wherein the lender assumes the entire risk of loss. Under this arrangement, the lender usually demands for a down payment. The higher the contribution of equity by the borrower, the lower is the chance of default. However, higher down payment makes home buying difficult.

Insured mortgage loans are common in the US. The most commonly seen loan in this category is the Federal Housing Administration (FHA) mortgage insurance program that helps people buy homes even when they have little money for paying the down payments and the closing costs. In these kinds of loans, the borrower has to pay a nominal insurance premium for which the FHA agrees to reimburse the lenders for the losses up to a specified amount if the buyer defaults. Guaranteed loans are similar to the insured loans. These loans are provided by the US Veterans Administration to the lenders who then provide the mortgage loans to the eligible veterans of the US Armed Forces. The veteran is not required to pay any closing costs or down payment in these loans.

Refinancing the Mortgage

In case the financing deal has been closed and interest rates fall, it is essential to think about refinancing the housing deal. However, the decision to refinance should be taken only after analyzing various factors. These include:

- Current monthly payments.
- New monthly payment.
- Monthly savings.
- Tax on monthly savings.
- Cost of refinance – prepayment penalty, closing costs and refinancing costs.
- Time taken to break even.

HOUSING SCHEMES IN INDIA

A number of banks and financial institutions provide housing finance. India with a growing middle-class has a huge untapped potential for the housing industry. Some of the housing schemes of various institutions are explained hereunder:

Standard Chartered Bank

The home loans provided by Standard Chartered Bank have the following features:

- Low interest rates, option of flat or reducing interest rates;
- Low EMI (Equated Monthly Installments);
- No hidden costs like processing charge – everything is done up front;
- Quick approval and realization;
- Tax benefits;
- No unfair collateral demands; and
- A simple mortgage process.

Standard Chartered Bank has also launched a home saver scheme, which has the following features:

i. It is a revolutionary new concept in home loans designed to save the interests thereby letting one pay off the loan faster.

ii. Every month, surplus funds are deposited, whether it is salary or in the form of any other savings. This surplus money deposited in the Homesaver account helps in reducing the interest payable as the deposits automatically reduce the balance outstanding on which the interest is calculated on a daily basis.

HDFC Bank

Home loans provided by HDFC offers various unique benefits. The loans are easy to arrange and repayable in easy monthly installments. The terms of the loan can be structured according to the customer's requirements.

The loan can be applied either individually or jointly. 85% of the cost of the property, including the cost of the land can be availed for loan. The maximum amount lent by HDFC is Rs.1,00,00,000 for home loan. The loan can be repaid over a maximum period of 20 years. HDFC has launched a new product known as home equity loan, which has the following features:

- Home Equity Loans can be applied either individually or jointly.
- Technical officers at the branch offices ascertain the market value of that unit.
- Loans can be availed up to a maximum of 40% of the market value of the property (including the cost of the land).
- HDFC lends up to a maximum of Rs. 50,00,000 and a minimum of Rs.1,00,000 on a Home Equity Loan to an individual.
- The market value of the dwelling unit should be at least Rs.10,00,000.
- The loan can be repaid over a maximum period of 15 years for a loan on an EMI basis and two years for a loan on a simple interest basis.

REAL ESTATE IN INDIA – OVERVIEW

Real estate has always been an avenue for investment for individuals looking at viable alternatives for investing money between stocks, bullion, property and other avenues. Money invested in real estate, provides stable and predictable income return, similar to bonds in addition to capital appreciation. But this investment scenario in real estate has changed considerably. This has been due to the corrective measures undertaken in the property markets in the mid 1990's. These measures increased the benchmark of quality and maturity in real estate markets.

During the 1990's, the Indian economy witnessed a huge influx of multinationals, who established their offices in metros such as Mumbai, Delhi or Bangalore. Thus, due to lack of suitable property and numerous restrictions on property development, there was an exponential rise in the rental and capital values for offices and prime residential property. In addition to this, rampant speculative and investment activity, lead to previously unseen increase in property values in cities across India. However, by 1997, the effects of an economic slowdown started to show and the fall in the commercial prices was the first casualty. As Indian companies faced a liquidity crunch in 1996, no fresh investment was made by them. By 1997, the new supply, triggered by the exponential demand of earlier periods, started flowing in the market, leading to oversupply in both the commercial and residential property markets.

By the end of 1999, much of the corrective measures had already occurred and the market began to be driven primarily by serious end user demand in both the commercial and residential sectors. Thus, from then onwards, there has been a serious sobering down of the markets with property valuations both in the sale and the rental markets. This phase of consolidation is expected to continue onward during the next few years. As a result of this correction, exposure to real estate, as a percentage of total assets, remained relatively low between 1998-2001. However, this situation has improved since then.

SUMMARY

- After going through the basic principles of personal financial planning, financial statements and their significance, tax and cash management, it would be easier for an individual to take any financial decision.
- This chapter deals with the financial decisions related to an automobile and purchasing a house. Both the decisions are difficult as they involve huge outlay of capital. Before buying a car, an individual should take into consideration various factors such as operating costs, affordability, features of the car, reliability and whether to buy a brand new car or a second-hand one, etc. Similarly, decisions relating to housing also should be taken after giving due consideration to the cost of ownership, rent or going for purchasing an accommodation, financing schemes, etc.
- There are a number of institutions which provide housing finance such as HDFC and various major banks such as ICICI bank, Standard Chartered bank, Citibank, etc. In India, the housing sector is flourishing and a number of financial institutions are providing various housing schemes at affordable rates.

Chapter VI

Managing Credit

After reading this chapter, you will be conversant with:

- The Basic Concepts of Credit
- Types of Credit
- Features of Credit
- Improper Uses of Credit
- Establishing Credit
- Types of Open Account Credit
- Different kinds of Credit Cards
- Advantages of a Credit Card over a Debit Card
- Obtaining and Managing an Open Account Credit
- Credit Scoring
- Managing Credit Card Accounts
- Disadvantages of a Credit Card

Introduction

Credit has become an integral part of everybody's life. It is an important source of cash flow for business concerns, industries and companies without which the activities almost come to a standstill. Credit, in simple terms, means 'the availability of money for an individual or a firm or a company to borrow.' It is a bond or a deal between the lender and the borrower, where the borrower receives something in value or cash or kind or service, with an agreement to pay back the same along with the borrowing capacity (interest) to the lender. In other words, it means obtaining immediate benefit of goods or services upon the promise of payment at a future date.

Earlier, banks were the main source of credit. Nowadays, Non-Banking Financial Institutions (NBFIs) such as mutual funds, pension funds, asset-backed security issuers, insurance companies, and the like, together issue far more credit than banks do. Indeed, deposits in banks by the customers have reduced, as they feel borrowing is a better option. Fear of bank robbery or closing down of banks, etc., is reduced.

THE BASIC CONCEPTS OF CREDIT

Demand for Credit

The demand for credit arises mainly to finance: (i) new enterprise, (ii) consumer spending, or (iii) speculative investment. Let's briefly examine how each of these demands affects the money supply and prices.

NEW ENTERPRISE

A new enterprise, or an existing enterprise expanding into production, requires funds. Credit is always used that has no effect on current prices. Economy cannot survive on its own. The amount of credit must grow in support as the economy grows. Liquid cash is scarce. If money supply was fixed, then the economy would come to a standstill due to lack of liquidity.

CONSUMER SPENDING

Money borrowed for purchasing of consumer products implies the availability of existing consumer products whose prices have already been set by the sellers. Such borrowing increases the money supply without affecting the prices.

However, where supply falls short of demand, prices on consumer goods will generally rise, at least temporarily. But those shortages tend to occur in isolated cases and are usually short-lived. They seldom have a lasting effect on the general price level.

SPECULATIVE INVESTMENT

Money borrowed for speculative purposes mainly affects asset prices, particularly equities and real estate. If the borrowing cost is set too low for an extended period, asset prices could become inflated. The resulting wealth effect may then lead to a relaxed attitude towards consumer prices and a general increase in the average price level.

Credit Assessment

The process of credit involves an important step – credit assessment. The objective of credit assessment is to decide the maximum limit that can be availed by the customer. Sanctioning of credit includes the following:

CUSTOMER'S CAPACITY TO PAY

The initial assessment of an individual or a company can be made from financial reports and statements, primary trading, profit and loss accounts, and balance sheets. In case of a company, the following issues should be examined carefully:

Is the company profitable? Are the profits supposedly made realistic? Is there an ever-strengthening position with regard to net worth? Is there any strengthening of assets that is paying particular attention to freeholds? Is there a running down of assets? Is there an ever-increasing reliance on loan capital? Do the shares, which are issued and fully paid, adequately capitalize the company or not?

In the case of an individual, his/her monthly salary, savings, investments in shares, securities, policies, etc., and overall financial status permit him/her to utilize the credit facility. In other words, the individual should have a sufficient cash flow during the repayment of credit. The risk and default ratio involved in the case of a company or business or firm is higher when compared to the individual. The chance of loss occurring due to financial obligation for repaying a debt is called credit risk.

CUSTOMER'S WILLINGNESS TO PAY

This is a very crucial area in credit. The credit manager should be very careful while sanctioning the credit to his/her customer. Because, anyone is ready to utilize the credit irrespective of their capacity. The repayment of the credit largely depends on the customer's willingness. The customer out of his/her own will should be prepared to repay the credit.

CUSTOMER'S NET WORTH

The customer's credit criterion depends on his/her net worth, i.e., total assets minus total liabilities of an individual or company. In case of a company, it is also called owner's equity or shareholders' equity or net assets. Net worth is of two types: deficit net worth and effective net worth. If the liabilities are more than assets and capital that results in a loss, then it is termed as a deficit net worth. If the company uses mezzanine financing (subordinate debt) other than the senior debts (banks, insurance, etc.) then it is considered as effective net worth of the company.

CUSTOMER'S COLLATERAL SECURITY

Collateral security is the assets pledged by an individual to secure a debt. It is a form of guarantee provided during a default. In such a case, the creditor can seize the collateral security from the borrower.

After the assessment process, the next step is to know how realistic the credit requirement for the customer is. Therefore, effective credit sanction is a synergy where sales, marketing and credit control make a significant contribution. Sometimes, certain creditors increase the credit of a particular borrower by just viewing a six-month or a year's trading level, especially in the case of a businessman. The creditor should always bear in mind that the credit limit sanctioned to a businessman is usually on the higher side say Rs.1,00,000-2,50,000. Therefore, increase in the credit limit should be sanctioned within six-month or one-year time period. This is because the trading levels of the businessman need not be the same every time. Fluctuations in profits and losses occur. Therefore, after proper evaluation of the borrower is done, the credit limit can be increased. This not only proves the reliability of the borrower but also the reveals the risk factor, to an extent, is less. Moreover, his/her performance on the existing limit on the card is known. This factor proves whether the credit limit should be increased or not.

Credit Rating

Credit rating is assessing the creditworthiness of the borrower by reviewing his/her credit report based on the history of borrowing and repayment. This is one of the most important steps in credit assessment. Based on the credit report, the credit officer finalizes whether the borrower should be granted credit or not. If his/her credit report is not positive then he/she is out rightly rejected. Sometimes, the credit officer may grant credit to a customer who is reliable, though his/her performance in any of the months may be bad because of late payment or non-payment of a minimal premium. This step is called deviation. The credit officer takes a deviation and sends the application to the branch for sanction along with the reasons. If the branch manager is satisfied, then the credit is sanctioned to the borrower.

Credit rating is done by granting points, as shown below:

Table 1: Credit Rating

Point	Credit Rating Criterion
0	A person new to the credit world.
1	A person paying the credit back in one month.
2	A person paying the credit back in two months.
3	A person paying the credit back in three months.
4	A person paying the credit back in four months.
5	A person who not repaid in four months but has not reached the ninth stage.
7	Debt payments are made under consolidation.
8	Repossession (debt cleared by selling the item).
9	Officially, a bad debt, which is usually uncollectible.

Source: http://investopedia.com/articles/00/091800.asp

To maintain a good credit rating, a borrower should adhere to the following norms:

- Prompt payments are a must. Timely and full payment of every month is important for building a good credit history.
- Extension of credit needs to be avoided. There may be a lot of credit card offers sent through mails and advertisements on websites that usually tempt people. They should be outrightly avoided, as they would be bad due to high rates of interest.
- The creditor must be duly informed when there is any problem during repayment. Overdue bills should never be ignored.
- His/her character and integrity should be good.
- He/she should always maintain a good track record in the books of creditors.

Sometimes, the credit history of a borrower is expunged after six or seven years. This is done in cases of those borrowers who have defaulted with the bank or any other company from where they were issued the loan. The reasons are: the borrower must have been irate and refused to pay the outstanding amount or the customer has become bankrupt because of loss in business or any other personal reason. In such cases, usually the bank or the creditor gives time to the borrower for repayment. If the borrower still refuses or unable to pay, then the bank can take legal action and claim for the amount. The legal action may be severe, which may lead to a poor credit rating. As a result, no bank or finance company will grant any loan to the borrower in the future.

Information generation about credit rating is no more a secret affair. If you want to know your credit rating or if there are any flaws in credit rating, always request a free copy from the credit bureau. Some serious flaws include an identity mistake, where a person’s credit history is actually that of someone else’s. Then immediately the credit bureau should be intimated and the flaw is corrected.

Credit Terms and Conditions

Credit limit approval should match the anticipated turnover and the financial status of the customer. The terms and conditions include certain eligibility criteria that should be satisfied by the customer. Credit limit provides flexibility for the customer to carry on his/her day-to-day activities, especially in case of a business or industry. The adequate credit limit required by the customer should be known so that the customer may not end up getting a low credit. If this happens, it may lead to unnecessary irritation between both the parties and hamper relations. Therefore, credit assessment plays a key role. It is very important to avoid bad and doubtful debts.

Credit Terms

A finance company or a bank grants credit to the following classes of borrowers:

i. Individuals and the household.

ii. Self-employed.

While the borrower's worth is assessed, it is important to take into account the limit to be allowed. Usually, the terms of repayment on the outstanding are within 30 days. Sometimes, due to unforeseen circumstances, the credit repayment period may be extended that involves a high risk. In such a situation, the lender should be very cautious, as there are chances of non-payment. In case of an individual, his/her personal income tax statement or payslip is verified along with his/her company's (in which he/she is working) current account statements. He/she should also have a satisfying savings account to avail a higher credit limit. In case of a company or business or firm, the income tax statement is verified along with the bank statements. If the bank statements have a constant balance of an amount satisfying the creditors, then a higher limit of credit is sanctioned.

In case of self-employed persons, the current account statements of his/her business or firm should be collected. The statement should not have any kind of cheque bounces or any late payment charges. The credit history report of the borrower should be collected from the bank manager, business clients, other banks or creditors. Information about the borrower's firm such as whether it is a well-established business, its existence, the stability of the profits, the goodwill of the business, etc., should also be collected. Adequate information whether the borrower has taken any other loan or credit card from any bank or finance company along with his/her performance, promptness in repaying the monthly installments, etc., should be collected. Sometimes, there may be circumstances when the borrower requires the repayment period to be extended due to unforeseen circumstances. These circumstances are more common in the self-employed sector and may be due to fewer profits earned in the business by the borrower. The risk in this sector is more when compared to the individuals or the household sector. Office and residence verifications of the borrower are done. Such a step helps to know whether the disclosed information by the borrower is/are true or not. The credit officer is very cautious when granting credit to a self-employed borrower, as the credit limit is high ranging from Rs.50,000 to Rs.3,50,000.

TYPES OF CREDIT

Credit is of two types, namely: commercial credit and consumer credit. Let us discuss these types of credit in detail.

Commercial Credit

The entire business world revolves around credit. A business also has to earn profits by using a credit. Attaining this objective, helps the business or company or the firm to grow, expand and meet commitments.

Sometimes, a credit is granted to the director of a company based on the company's income tax returns and bank statements. Such a situation arises when the customer refuses to disclose his/her personal income tax details, bank accounts, etc. Commercial credit includes a huge amount that is required by big businesses, firms and industries. Local, state and federal government also need credit for the construction of dams, roads, buildings, etc. Since the liquid cash flow of these corporate bodies keep fluctuating, the need for commercial credit is largely felt. The commercial credit facility is used for the purchase of those goods that are in need but cannot be afforded immediately. This investment is made for the future prosperity of the business. It also requires a short-term finance obtained from the suppliers. Credit assessment should be done very carefully depending upon the documents provided by the company. All the documents should be properly verified and a detailed analysis of the financials should be done. Major and minor errors should be examined carefully.

Consumer Credit

Consumer includes individuals or family. Extending the credit facility to individuals or family is consumer credit. A consumer credit is applicable to an open account that includes charge account, credit account and revolving account. Usually, a consumer credit is non-secured. Credit cards are the most unsecured loans. There is no security to be provided by the customer during the approval of a credit card. Nowadays, credit cards have increased among individuals, as the liquid cash flow with an individual is less. Almost all the financial institutions provide the credit card facility. The danger with a credit card is that if an individual fails to repay the credit amount, nothing can be seized, as credit card approval does not need any kind of collateral security. To avoid such a situation, financial status and position of the individual should be carefully assessed and the credit limit should be fixed accordingly.

Open Account

An open account includes a charge account, a credit account and a revolving credit facility provided to the customers. This topic will be dealt in detail later in this chapter.

WHY CREDIT?

Credit is widely prevalent due to the following reasons:

Avoid Cash Disbursement

Borrower’s avail credit because they avoid affording a huge cash payment. Credit on installment basis avoids an entire initial payment. For purchasing a house or an automobile, availing credit is a better option. Thus, an individual gets the satisfaction of owning an asset, without making the full payment. A consumer accessing credit willingly pays the excess amount involved (interest) for the ownership of the asset. Availing a credit facility helps the customer enjoy the most expensive asset in an affordable manner. The initial satisfaction that the customer enjoys, may decline over a period of time, but the payment of the loan remains for many years to come.

Financial Emergency

Emergency is something that is unexpected. During a financial emergency, people tend to borrow hand loans from their friends, relatives, etc. for short period. They borrow when the liquid cash flow with them is insufficient to meet their day-to-day expenses. For example, it may be in the form of medical expenditure or living expenses during unemployment. Usually, people prefer their savings to credit.

Convenience

Another word for credit is convenience. Today, people use credit cards as cash. There are a lot of merchants and banks that provide a variety of credit cards, charge cards, and debit cards. Consumers find such cards to be the most convenient way of purchase or dine or pay domestic bills. The transactions made on a credit card are recorded and a monthly statement is sent to the cardholder. Consumers feel safer carrying credit cards than huge cash. While traveling abroad, they find it more convenient because there is no additional interest rate for purchases or dining abroad. Also, the process of exchanging the rupee with the dollar is eliminated. The customer repays the amount of the transactions made abroad to the bank in rupees, which saves a lot of money. If a customer loses his/her card then the service department of the bank needs to be intimated. If there is any transaction made after intimation of lost card, then it is not the responsibility of the customer but the responsibility of the bank. In other words, the customer after intimation is not liable to pay for the transactions made on the card. This is one of the benefits, which the customer derives from the use of a credit card or a charge card.

Investment Purposes

It is more convenient to make a payment through a credit card than borrow the whole amount and pay a high interest. Margin loans have become popular where it is easy for the investor to make a partial payment for the purchase of different kinds of investment with borrowed funds. Credit gives the convenience of repaying the borrowed amount in installments. When a customer avails credit for the purchase of an asset, which he/she thought was impossible to afford, he/she gets an immense sense of satisfaction. The liquid cash of the person should be healthy while availing credit for paying the minimum monthly principal and interest.

IMPROPER USES OF CREDIT

The current reforms brought several freedoms into the lives of middle class Indian families. One of them is freedom of spending through credit which enables people to live beyond their means. 'Plastic cards' or 'credit cards' influence overspending. As cash is not paid and there is no immediate outflow of money, a person tends to spend beyond his/her line of limit. Earlier, people used to buy items or services whenever they felt necessary, but now they shop frequently irrespective of necessity using credit card. This habit is forcing many families into financial stalemate. The use of a credit card can be avoided during the following transactions:

Basic Expenses

The basic perspective of certain customers is that they tend to use credit cards even for basic domestic expenses. A sensible customer uses credit for purchasing long-term assets for a better future. This is because the credit used for the purchase of the asset is an amount, which cannot be afforded by him/her initially whereas basic domestic expenses are something that are affordable.

Expensive Impulse Purchases

Using credit for cosmetics or dresses or products, which may give a sense of satisfaction, but not an intelligent investment and needs to be avoided. Unfortunately, such spending leads to escalating bills. Since the customer has the facility to pay a minimum amount of the outstanding bill, they tend to go on a free ride. They are unaware of the fact that they end up paying a huge price in the long run.

Delinquency

Overspending and then over billing creates a lot of frustration among the customers. After the free ride is over, the high price in the bills comes as a reality. This may lead to unnecessary cut in food or clothing expenses or delinquent customers. This results in a lot of chaos and the image or prestige of the customer is at stake. If proved delinquent, then the collection agency threatens the customers. To avoid all these serious issues, customers should be more practical and intelligent.

ESTABLISHING CREDIT

Credit is provided to the borrowers only if the lenders are satisfied with the profile of the borrower. A profile includes the current debt position, credit history, credit assessment-capacity to repay, willingness to repay on the specified time and the credit rating of the borrower. If these criteria are found satisfactory only then can the credit facility be availed by the borrower. Some of the steps for establishing credit of a borrower are as follows:

Opening a Checking and Savings Account

This step holds the borrower to be a reliable credit customer. For a borrower, this step has the following advantages.

- Opening a checking and savings account creates an impression to the lender that 'You are a businessman to deal with.' In fact, this is the most important step as there is a saying "First impression is the best impression".

- Opening one or two charge accounts and using the credit and the charge cards for at least one or more monthly transactions.
- Prompt payments of interest on account balances, subscription charges and outstanding bills of the cards.
- Availing a loan, even if, not required.
- Making liquid investment in certificate of deposits, commercial papers, equity, debentures, shares, etc.
- Paying off loans immediately to an extent should be avoided, as lenders generally like them to be paid on an extended period of time. This is an important aspect as lenders learn how the borrower deals in a situation of crisis. As far as the lender's knowledge goes, a true borrower is one who repays the amount even during a crisis. In other words, he/she is a reliable borrower.

Building a Strong Credit History

Credit history is as important as an employment record. Prompt payment is the first step in maintaining a good credit history. This proves the creditworthiness of the borrower. When prompt payments are made, it helps to improve relations with the lender. In the consumer credit industry, there is a close check on the creditworthiness and past credit record of the borrower. This close check is called credit rating. The rating is given based on a detailed financial analysis that determines one's financial history. The creditors use this information before sanctioning a loan. Therefore, it is essential to be a prompt and a responsible payer. In certain cases, if the monthly payment of loans should be made and the borrower is tight, then the concerned credit officer should be intimated for the extension of the period of payment. The borrower should never be a delinquent. He/she should pay some amount, however late, rather than missing the payment. In certain cases, there is another alternative for the extension of a loan – explain the situation to the credit officer.

Once the problem is sorted out, regular payments can be resumed. By following this procedure, the loan official would be aware of the fact that the borrower wants to maintain his/her creditworthiness. This is a sensible way of dealing with the situation and the creditworthiness of the person is not questioned. To maintain one's creditworthiness, the following points should be taken into consideration:

- Use credit according to one's affordability.
- All the terms and conditions should be fulfilled.
- Make prompt payments.
- In case of difficulty of making payments, creditors should be duly informed.
- Never follow false practices as it leads to more serious problems.

A variety of people and businesses make decisions affecting the borrower's future. Such decisions are based on his/her credit history. For example, banks and other lenders consider his/her credit report when reviewing applications for mortgages, revolving lines of credit, or other loans. Landlords sometimes use credit reports to decide the reliability of the borrower before the house or flat is handed over. Also, a potential employer may even assess an applicant's credit report before extending a job offer.

Similarly, the borrower's credit report may also be reviewed when he/she applies for an auto insurance or a homeowner's insurance, or even a mobile phone. Therefore, it is important to establish a positive credit history of the borrower.

Credit Capacity

The consumer credit guidelines are based on the ability to repay. Using credit guideline and affordability as the criteria the amount of consumer credit that a borrower should have outstanding can be determined.

Table 2: Monthly Consumer Credit Payments (in US$)

Monthly Take-Home Pay	Low Debt Safety Ratio (10%)	Manageable Debt Safety Ratio (15%)	Maximum Debt Safety Ratio (20%)
1,000	100	150	200
1,250	125	188	250
1,500	150	225	300
2,000	200	300	400
2,500	250	375	500
3,000	300	450	600
3,500	350	525	700
4,000	400	600	800
5,000	500	750	1,000

Credit standing capacity depends on the affordability of the borrower. How much credit he/she can afford, is based on his/her monthly income, whether he/she has the capacity to repay the amount availed on credit or not. To measure this capacity, a credit guideline is used to ensure that the monthly repayment does not exceed 20% of the take-home income. Experts are of an opinion that 20% is the maximum repayment burden and recommend debt safety ratios (where the monthly repayment is close to 10-15% or less) if for an investment in the future. For example, if a person's take home salary is Rs.9,000, then the monthly consumer credit @20% would be Rs.1,800 (9000 x 0.20). This is the maximum amount that he/she can afford to pay monthly. The key factor is that with his/her income the payments should not exceed Rs.1,800.

The lower the debt safety ratio, the better the credit and easier repayment of the outstanding consumer debt.

To find one's own debt safety ratio, the following formula can be used:

$$\text{Debt safety ratio} = \frac{\text{Total monthly consumer credit payments}}{\text{Monthly take-home salary}}$$

Credit-related Problems Faced by Women

Credit-related problems are more common among the women in the US. Earlier, women were not entitled for credit in their own name and were considered as high-risk prone sector. To a creditor, even an employed woman with a good salary was susceptible to credit problems because after marriage she might get pregnancy and lose her job. Today, according to the Equal Credit Opportunity Act (ECOA) in US, it has relaxed certain rules against credit for women. Creditors should overlook the woman's marital status or childbearing plans and her salary should be considered equal to a man's salary. Even though the rules have been flexible, still certain women find it difficult to get credit in their name – especially the divorced and the widows. The following steps are solutions to the credit-related problems faced by women:

- A lady should use her own name while filling the credit application. Legal name should be used and not the social title. A married woman can choose from several legal names; for example, if her maiden name is Sherin Ali and her husband's name is Sohail Khan, then she can choose either from Sherin Ali or Sherin Ali Khan.
- Ensuring that the information reported to the credit bureau is in the wife's name as well as the husband's.
- Always, the wife should consider retaining a credit file separate from her husband's. If a married woman, has a good credit rating, then the creditors should be intimated of the name change but the file should be maintained in her own name.

TYPES OF OPEN ACCOUNT CREDIT

An open account credit is a type of account where a credit extension is given to the customer before any kind of transaction takes place. Credit extension is possible when the customer does not exceed the permitted credit limit and when prompt payments are made on the card. Both retail outlets and banks issue an open account. An open account of a retail outlet (departmental store, gas company, petrochemical industry, etc.) is applicable only to that particular concern or one of its locations. Retail outlets have started encouraging credit for sales promotion of their products. Open account by banks (such as Master or Visa or Diners card accounts, revolving credit facility, and overdraft protection facility) can be used for a variety of purchases or for dining or paying bills. In an open account credit, if the holder makes full and prompt payments, he/she can avoid paying interest charges. Suppose the interest charges are Rs.100 on the open account of a gas company and a credit statement is sent to the creditholder, which gives information about the recent transactions made. If there is no outstanding amount reflecting on the bill and the total account balance is only Rs.100, then these charges can be avoided by paying the full amount before the next billing.

Earlier, commercial banks were providing credit facilities to the customers, but after deregulation, many other financial institutions, brokers, and consumer finance companies provide credit. Retail outlet credit includes two kinds of accounts: charge accounts and credit accounts. Among the open accounts, the biggest are the bank credit cards and the retail charge cards. Other forms of an open account credit include entertainment cards, MTV cards, debit cards, pub cards, 30-day charge cards, travel cards, international cards, hotel cards, etc.

Bank Credit Cards

The most common among the open account credits are the bank credit cards or ‘plastic cards’. Bank credit cards are the cards issued by the bank or any other financial institution, which allows the customer to make purchases at any establishment that accepts it. It is widely used for the purchase of consumer goods and services. The two types of cards issued are the Visa Card and the Master Card. The credit card is used to pay for almost everything – groceries, cosmetics, assets, doctor bills, hotels, college fees, tuition fees, etc. In recent years, well-known credit card names such as American Express Blue Card, Citibank’s Taj Diners Club International, Bank of America’s Platinum, Centennial Visa or MasterCard, etc., have captured the customer’s imagination.

Interest Rates on Credit Card Loans

Interest rates on credit card loans are higher when compared to other consumer loans. This is due to the involvement of a high-credit risk. Credit cards don’t demand any kind of security unlike the personal loans, home loans, auto loans, etc. If a credit cardholder defaults, there is no security that can be seized. The consumer is inclined to use a full line of credit when he/she faces a financial emergency. Since it is the riskiest sector of loans, interest rates are very high. In case of home loans or two-wheeler loans, if a person defaults, at least his/her house and two-wheeler can be seized but it is not the same with credit cards.

Features of a Credit Card

Every individual, before using a credit card should be aware of its features. It can be used to either borrow money or for purchases of goods or products. The features of a credit card include the following:

LINE OF CREDIT

A line of credit signifies an agreement between a bank (and any other financial institution) and a customer for allowing the customer to maintain the maximum possible loan balance or the maximum amount of credit he/she is allowed to have outstanding at any point of time. Suppose a customer gets a maximum limit of, for example, Rs.2,00,000 on a credit card. He/she uses only Rs.1,50,000, and pays interest only on the amount used and not on the entire Rs.2,00,000. Therefore, the advantage of using the line of credit facility is that interest is not paid on the part of the unused amount. Usually, the customer can use 20% extra of his/her permissible limit on the card. This facility can be availed only if the bank believes that the customer is reliable.

CASH ADVANCES

A customer can withdraw cash from his/her credit card at any time from an Automated Teller Machine (ATM). There is a limit fixed for the withdrawal of cash. The usual limit is not beyond Rs.15,000. Suppose a person has a total credit limit of say Rs.16,000 and he/she has used only Rs.6,000, then he/she can take a cash advance up to Rs.10,000. The customer can take a cash advance from any participating bank. Cash advances are loans on which interest gets charged immediately. For obtaining a cash advance, the card is swiped in a commercial bank or any financial institution and the rest of the transaction occurs in the same fashion as the purchase of goods and services.

SURAKSHA INSURANCE

In the current banking scenario in India, almost all the banks have a tie-up with an insurance company. The most notable fact is that most of the people acquire credit cards for different insurance facilities provided by the card. One such facility is “Suraksha”, which is an additional insurance facility provided to the customer other than the normal insurance. It includes an additional coverage amount of Rs.25 lakh on an air accident. This facility is optional as it includes a monthly premium of Rs.88. This is one of the best features of the credit card. The total insurance coverage including “Suraksha” is Rs.45 lakh, which is an attractive offer to the customers. The premium coverage on “Suraksha” is minimal when compared to the insurance premium paid to other insurance companies.

PHOTO CARD

People look into the security part of a credit card rather than its benefits. A credit card with a photograph cannot be used by anybody. If the customer does not have a photo card then it can be used by anybody. Photo card is considered as security that reduces the chances of fraud. Therefore, most banks recommend their customers to use a photo card. This facility is advantageous for the bank too. If a customer turns delinquent then it will be easier for the bank to identify the customer. Otherwise, the bank may find it difficult to track such a customer.

MEDICAL EXPENSES

Insurance and medi-claim policies are a few important aspects that have become a part of everybody’s life. A bank, understanding this fact, provides the customers with more benefits like medical expenses. Therefore, a customer is provided with medical expenses by default. The customer gets 50% discount on the medical expenditure incurred. Suppose a person gets a bill of Rs.50,000 then he/she gets a 50% discount and ends up paying only Rs.25,000. The customer can then claim up to Rs.5 lakh.

TRAVEL PRIVILEGES

Travel privileges constitute one of the most beneficial features especially for those who travel frequently. Most of the banks issuing credit cards have tie-ups with travel houses, which provide tickets at the doorstep. All that a customer needs to do is to call up the travel house and provide his/her credit card number. Thereafter, the ticket is sent to the customer’s house by the executive. The customer need not run around for the ticket at the airport. This saves a lot of time and money especially for those who have business trips. The customer is eligible for a 3.5% discount on domestic basic airfares and 7% discount on international basic airfares. There are special privileges in the airport lounges. If a flight is delayed, the customer is automatically directed to the lounge and given free complementary drinks, food and other refreshments. The banks may have lot of tie-ups even with hotels. If a customer is staying in the participating hotel, then the customers is given special discounts on lodging, food and travel.

Optional Beneficiary Features

Optional features of a credit card that are beneficial to a borrower include the following:

GOOD HEALTH POLICY

This policy covers persons whose average age ranges from 46-55 years. The coverage amount is Rs.2 lakh. The person can claim medical expenses for three members of his/her family.

MEDICLAIM POLICY

This policy covers persons whose average age ranges from 46-55 years. The coverage amount is Rs.2 lakh and the number of family members for whom the customer can claim medical expenses is three.

ACCIDENT INSURANCE POLICY

The average coverage of this policy is Rs.4 lakh.

RELATIONSHIP PRICING

If the borrower is already an account holder of a bank, then it is beneficial for him/her. This is because he/she can avail loans or any other products of the bank at low interest rates such as 1% off or sometimes 0% interest on car loan, home loan or personal loan.

Other Features

Credit cards provide a mix of all the contemporary benefits. It includes insurance coverage, buyer protection plan, loss or damage or theft coverage, etc. By availing all these benefits from the card, the customer need not separately apply for insurance, loss or theft or damage coverage, etc. With a credit card, he/she can get all the facilities easily. Since the banks have to survive in this competitive world, they provide the best facilities to attract customers. The buyer protection plan offered by a credit card protects the purchase of most merchandize items against theft, loss or damage up to 90 days. For example, if there is damage in any item during a 90-day tenure, then the cardholder gets the item replaced for free.

Other services and benefits include the following:

- Free accident insurance coverage against personal accident in India and abroad.
- Free protection of an array of eventualities for persons traveling in India or abroad including delayed baggage, lost passport, lost ticket and delayed flight.
- Full-value auto rental insurance coverage.
- 24-hour toll-free traveler's emergency message service.
- Free baggage insurance coverage against loss, damage or theft both in India and abroad.
- Lost card registration.
- Free household insurance only in India.
- Global purchase protection up to 180 days anywhere in the world.
- Free global calling card that allows the customer to make calls.
- Discounts on long distance calls.
- 24-hour toll-free customer service online.
- Delayed flight insurance.
- Air ticket loss insurance.

Interest Rates on Credit Cards

Interest rates are charged on the transactions made on the card. The normal interest rate every month is 2.95% and the service charges are 2.5%. For every new customer, the first 50 days is interest-free on the transactions made. If the customer is a reliable and prompt customer, then to a certain extent, he/she can avoid the interest and service charges. This will keep him/her in the good books of the bank.

Subscription Charges

Subscription charges are annual charges that the customer pays for using a credit card. Banks give discount on these annual charges. Suppose the annual charges are Rs.2,000 then the customer gets a discount of either 50% or 75% or sometimes free for the first year on the annual charges. This feature has become very important for the sales promotion of the bank's credit card. People enroll themselves more for credit cards if they don't have to pay for the annual charges. Sometimes, if according to the bank, the customer's profile is found satisfactory, then the customer is given the privilege of using the card absolutely free for his/her entire life. In other words, the customer need not pay the annual charges at all during his/her lifetime.

DIFFERENT KINDS OF CREDIT CARDS

Credit cards are available in plenty. Every company ranging from clothing to manufacturing or service companies are providing credit cards. Each credit card has different features and facilities such as insurance, discounts, etc.

Co-branded Credit Cards

One of the prestigious and fast growing sectors of the bank credit card market is the co-branded card. Co-branded cards are those bankcards that have a tie-up with a company of another sector. For example, the Jet Airways Card represents a tie-up between Jet Airways and the concerned bank. A person holding this card becomes a permanent member of Jet Airways and avails all its facilities such as free tickets if he/she earns the required bonus mile of 10,000 miles. (A bonus mile is like a point rewarded to the customer). Taj Diner's International Club Card signifies the tie-up between the Taj group of hotels and the concerned bank. The latest technology used in the Taj Diner's Club Card has made, it one of the most popular and preferred credit cards among the high-class sector. It has a smart chip technology, which by default, contains "reward points". Suppose a person dines at the Taj Hotel and uses his/her Taj Diner's Club card to pay a bill of Rs.800. The chip in the card may have 1000 reward points. The person redeems the amount of his/her bill for these "reward points". This means that the person ends up paying nothing. This is the unique feature of this card. Another co-branded card is the British Airways Card. This denotes a tie-up between British Airways and the concerned bank.

Retail Charge Cards

Retail charge cards are issued by department stores, oil companies, car rental agencies, etc. These cards are popular among the merchants; and so, their demand among the customers is more as they are widely accepted and convenient during shopping. These cards have a pre-set limit and are popular among the clothing stores, departmental stores, etc., as people tend to shop more in such outlets. Customers are supposed to make the full payment on the monthly bill. For sales promotion of the company's products, a revolving credit facility is provided by the card. These cards are more expensive than the bank credit cards.

30-day Charge Card

A 30-day charge card is a regular card that allows the customers to pay the monthly bill in full amount, which is billed within 10 or 20 days after the billing date. Interest can be avoided if the payment is made within the specified due date. However, an interest penalty is charged after the due date. Gas or electric or telephone companies, etc., offer such cards.

Silver Cards

Silver cards are internationally accepted cards offered to normal-profile sectors a low income consumers. The monthly income criteria of the customer should be a minimum of Rs.8,000 or above. It is not necessary for him/her to have an own house or a car. The insurance coverage on these cards is Rs.10,00,000. The air travel benefits include a 3.5% discount on domestic travel and 5% on international travel. Such cards have a limit of Rs.25,000 or less and their annual charges may be free or Rs.750 per year.

Corporate Credit Cards

Corporate credit cards are also called travel and entertainment cards. Such cards provide 30-40% of administrative expenses and require a lot of manpower application goes into it. Generally, a corporate person on an official tour, needs to provide bills for the expenses incurred during the travel. This process requires a lot of paper work and expenditure. The company usually sends these bills to the bank for verification and the entire process is time consuming. Therefore, banks provide corporate credit cards to the employees on behalf of the company. The expenses incurred are recorded in a monthly statement and the reimbursement of expenses for all the employees is done in one go. This not only benefits the bank but also the company, which is able to reduce its administrative as well as manpower expenditure.

Gold Cards

Gold cards are credit cards offered to persons in the high income category. The limit on the card starts from Rs.50,000-Rs.2,00,000. The eligibility criteria for a person using such a card include that he/she should possess a minimum balance of Rs.1,00,000 in his/her savings account. He/she should have an annual gross salary of Rs.1,50,000 or more in the income tax statement. He/she should have an own house and a premium car such as (Lancer, Accent, etc.). These internationally accepted cards have an interest rate of 2.95% and a service charge of 2.5%. A Gold card provides an insurance coverage of Rs.20,00,000 by default and Suraksha insurance (this is optional as it includes a minimum premium of Rs.88/month) that is additional of Rs.25,00,000. It covers baggage insurance, household insurance, air travel discounts (3.5% on domestic travel and 5% on international travel), revolving credit facility, which involves the minimum payment of the outstanding, i.e., 5%. The annual charges may be charged or may not be charged. Usually, Rs.2,000 is charged on the card.

Diner’s Club International Cards

The Diner’s Club International Card is an internationally accepted charge card and has a preset limit. It is an unlimited card offered only to the high-income segment. It also has similar features like the Gold card. The insurance coverage is Rs.30 lakh; air travel discounts are 3.5% domestic travel and 7% on the international travel. The annual charges are Rs.1,500 and for the first year it is only Rs.1,250. The minimum requirement to get a Diner’s Club Card is that the gross salary in the income tax statement should be Rs.1,56,000 or more. The rest of the eligibility criteria are same as of the Gold Card. The uniqueness about this card is that it does not offer a logo of either a MasterCard or a Visa Card. Therefore, its acceptance by the vendors and merchants is less and so, generally, people are reluctant to apply for the card.

Platinum Cards

Platinum cards are high-profile internationally accepted cards given usually to the abnormally high income people in the society. Such cards have a credit limit up to Rs.6,00,000 or more. Their annual charges are Rs.7,500 and insurance coverage is Rs.1,00,00,000. The person who holds a Platinum card should either be a Chairman or the Managing Director of a well-reputed company. It is a very prestigious card held by only a few individuals in the society.

Debit Cards

A debit card looks like a credit card and has a logo of either a MasterCard or a Visa Card. Debit cards provide direct access to a person’s checking or savings account. Buying through a debit card is similar to buying through a credit card. No finance charges are involved in a debit card. It may appear that a customer is charging it, but in effect, he/she is paying cash. Debit cards have become immensely popular especially among the sector that cannot afford to pay high interest credit card billing. Such cards are accessed through 24-hour teller machines. The accessibility is easier for cash advances through such cards. The disadvantage of a debit card is that it does not provide a line of credit. Some debit issuers charge an annual fee and some merchants charge a transaction fee for using a debit card. The biggest advantage of the debit card is that it does not burden you with credit card-like problems.

WHY A CREDIT CARD IS BETTER THAN A DEBIT CARD?

Both credit and debit cards have a logo of either a MasterCard or a Visa Card endorsed on them. They look similar but are very different in their nature and application. Debit card takes out the amount directly from the savings or the checking account whenever a purchase is made. Unlike a credit card, a debit card cannot be used if there is no balance in the savings account.

In a credit card, firstly, the transaction gets charged, which is added to all the charges made in that month and is sent to the cardholder at the end of the month for the payment. When a cheque is given in writing, only then the amount is deducted from the balance. If a partial payment is made then an interest is charged on the unpaid balance.

The advantage of debit cards is that problems with regard to overcharging of cost or interest can be eliminated. Unlike a credit card, protection facility is not provided for a debit card.

If the customer faces any problem with the credit card billing, the customer has every right to send notice to the company and it is the company’s obligation to respond to the customer’s problems within 60 days of notice.

Common problems usually faced by the customer are as follows:

- **Certain Items are not Advertised:** Certain allowances such as a delayed flight insurance or the transaction fee of 25% for using the card in petrol pumps are usually not advertised.
- **Double Billing:** There may be cases where the delivery of a particular item failed and a wrong amount was billed and so, the returned item was not credited. The credit card may verify such a problem with the merchant and if proper response is not delivered from the merchant, the company may remove the item from the bill until they get a satisfactory answer from the merchant. While the company investigates on the claim the customer is not required to pay the amount. No late fees and no interest is charged.

Secured Credit Cards

A secured credit card requires a deposit with the issuing bank. The amount required to secure a credit card, is usually only in hundreds of dollars. It is held as collateral while the bank issues credit of some percentage of the deposited amount, which is often 100%. In many cases, the card is reported to the credit bureaus as a normal (i.e., unsecured) credit card. This allows the cardholder to establish a positive credit history over the duration. Based on a good payment history over an extended duration, some banks will then issue the customer an unsecured credit card. Secured credit cards are often a tool for debt consolidation and credit repair programs. There are a number of such companies online.

Revolving Credit

Revolving lines of credit are open accounts that are offered by banks or other financial institutions or brokerage houses. They can be availed by writing cheques against demand deposit or specially designated credit line accounts. They do not involve the use of credit cards. They are considered more convenient than credit cards as they are not very expensive. They provide ready access to cash advance or borrowed money and all that is needed is writing a cheque. There are three forms of revolving credit, namely: overdraft protection, unsecured personal lines and home equity credit lines.

OVERDRAFT PROTECTION

This form of a line of credit is provided to the customer that allows him/her to overdraw to a specified limit from his/her savings account. If a customer wants to withdraw certain amount, all that he/she needs to do is to write a cheque and the overdraft protection line automatically advances the cash. Sometimes, an overdraft facility is availed through credit card. The bank automatically tracks the credit line and transfers the advance cash to the savings account. It is treated as a cash advance through a credit card.

It is very difficult to make a note of how much a given cheque withdraws the amount from the savings account. When the cheque book balance and the bank’s ledger books are referred, the balance may not be the same. Once an advance cash transaction takes place, a monthly repayment schedule is set up for the prompt repayment of the loan along with interest rates. A monthly statement is sent, other than the monthly cheque statement, which summarizes any activity on the overdraft protection line and indicates the monthly amount to be repaid.

There is a limit for overdraft. Therefore, using too many overdraft protection lines should be avoided. It should be used only when there is a financial emergency or when an emergency purchase is to be made. Overdrawing on a regular basis proves the mismanagement of cash and living more than the normal budget standards.

UNSECURED PERSONAL LINES

This is another form of revolving credit. In this type of credit, the customer need not face the troubles of applying for a new loan. The customer can borrow money from bank, or other financial institutions, or brokers, etc., any time.

Unlike the overdraft protection line, in an unsecured personal line, the amount taken in advance needs to be repaid over a period of two or five years. In order to keep the monthly payments low, large amounts of debt are given a longer duration for repayment. These are set with flexible interest rates so that the interest charged on cash advances vary with the determined interest rate. A monthly statement is sent to the customer and the minimum monthly payment is also stated. This kind of line of credit is less problematic and they are not very attractive. They include substantial credit limits and can have a combination of devastating effects on a family’s budget if it leads to profligacy or a higher reliance on credit. Therefore, such a line of credit should be used only in emergency situations in order to make a planned credit expenditure.

The overdraft protection works as follows: A loan application for a personal line of credit is submitted in the concerned bank. After approval, the credit line is established and cheques issued against which the amount is written. If there is any urgency of cash, then the amount is written on the cheque and deposited in the savings account. Suppose cash is required for the purchase of an expensive consumer item, for example, TV, then a credit cheque is issued to the dealer and it will be charged against the unsecured personal line of credit as advance.

HOME EQUITY CREDIT LINE

Home equity credit lines are similar to unsecured personal line of credit except that they are secured with a second mortgage of a person's house. This type of credit is acquired by writing a cheque. A line of credit is issued against the existing equity of a house. They are issued by most of the banks, other financial institutions, brokerages, etc. Home equity credit has become increasingly popular because of its numerous benefits. The period of repayment including interest of this type of credit is usually between 10-20 years. The amount of cash advance involved in this line of credit is huge and is about $1,00,000, which is why it should be used with caution. Payment of major expenditures through home equity line of credit can be done only if the customer can afford the purchase of the house and the required monthly payments fits comfortably within the budget.

OBTAINING AND MANAGING AN OPEN ACCOUNT CREDIT

Consumer credit has become very popular. Households use 30-day charge cards to pay their day-to-day bills, fees, etc. Most of the families use credit cards, one or two debit cards, etc., about 15-20 or more cards are held. Most families have the facility of line of credit that includes overdraft facility, unsecured personal line of credit, etc. When totaled most of families have a credit worth thousands of dollars or rupees. Even though these line of credits increase the budget of the household, they are maintained for convenience and to keep track of expenditure.

Opening any kind of account involves formal application procedures. Let's discuss these procedures in detail.

The Credit Application

Nowadays, we find several persons using more than one credit card. Some even possess around 20 credit cards. This may convey the wrong notion that it is easy to obtain a credit card. One method and probably the only way to obtain a credit card is to fill in an application. The application (refer Appendix I) includes the basic information about the customer such as his/her full name, address, official address, number of family members, date of birth, occupation, e-mail address, contact number, etc. This is to be filled by the customer who is applying for the credit card. This is the first step and the entire details of the customer are known. In other words, the lender ties to determine whether the applicant has the character and capacity to handle the debt in a prompt and timely manner. The credit card application is provided on the Internet too. Sometimes, certain customers may be too busy to visit the bank and fill in the application. Such customers have the facility to visit the concerned website and fill in the application. Along with the application, the person is asked to provide his/her personal income tax statement and bank statements. These are collected as a proof of his/her income mentioned on the application and to assess his/her creditworthiness. Suppose a customer holds any other bank's credit card, then he/she is asked to submit the credit statements of the last two months along with the application. This helps to judge the person better. This statement shows his/her credit limit, performance on the card, any late payment charges or any cheque bounces.

The Credit Investigation

Once the credit application process is complete then the application is sent to the investigation department. This department basically checks whether the information provided by the customer is true or not. An investigation that involves the credit bureau to check the information on the application including the amount of income, the current debt outstanding on other loans, or whether the person holds any other credit cards, and if so, then the performance on the card is evaluated. If the income is higher, the better is the credit history considered and greater the chances of the credit application getting approved. During the investigation process, the lender will attempt to verify the maximum possible information provided and any false or misleading information will lead to an outright rejection of the application. The information about office or residential address, current debt and debt history, etc., of the customer are collected either by one or two phone calls or through personal investigation. Executives visit both the office and the residence of the customer to know whether the address provided is true or not. If the person provides any bank statements, then the executives question the concerned bank manager to know more about the customer.

The Credit Bureau

A credit report contains some valuable information about the customer. It provides information about the residential address, the current employment, and the source for the payment of bills of the customer. It also provides information whether any legal action was earlier taken against the customer or has been sued or whether he/she arrested or had any problem of bankruptcy. Consumer Reporting Agencies (CRAs) or credit bureaus collect and send the customer's credit report to the banks or other financial institutions. Because they use this information to evaluate the applications for credit, insurance, employment allowed by the Fair Credit Reporting Act (FCRA). It is very important that every minute information should be entered accurately. Financial advisors suggest that the customer should view a credit report periodically for reporting any inaccuracies or omissions. This is very important; when a customer is considering a big purchase, say purchasing a house. Advance checking on the accuracy of credit-file could hasten the credit-granting process.

The credit report should be verified frequently to intimate whether any important information had been left out or whether any wrong information had been added in the borrower's profile, etc.:

A credit report should be verified carefully. The following measures need to be taken if the credit report contains any flaw:

- If the report contains any flawed information, the CRA must correct it.
- If an item is incomplete, the CRA must complete it. For example, if the file shows that the borrower was a late payer, but it failed to show that he/she was a delinquent, then the CRA must show that the borrower is still holding an account.
- In certain cases the borrower's account may contain another person's account, then the CRA should delete it.
- Name, address and security number of the borrower should be verified in order to know whether they were correctly entered or not.

The borrower's credit file may not reflect all his/her credit accounts. Although most national department stores and all-purpose bank credit card accounts will be included in his/her file, not all creditors supply information to the CRAs – certain travel, entertainment, gasoline card companies, local retailers, and credit unions are among those creditors, which don't disclose any information. If the borrower has been told that he/she was denied credit because of an "insufficient credit file" or "no credit file" and he has certain transactions made with creditors that did not appear in the credit file, then he/she should ask the CRA to add this information to future reports. Although they are not required to do so, many CRAs will add verifiable accounts for a fee. The borrower should, however, understand that if these creditors do not report to the CRA on a regular basis, these added items would not be updated in the borrower's file.

The Credit Decision

After the application has been filled and sent for investigation to the bureau, then the bank should decide whether to grant the credit or not. Credit scoring is issued for credit decision. Credit scoring is a method of evaluating the applicant's credit-worthiness by assigning scores to income, existing debt and credit references.

Scoring is also given if the customer has an own house, a premium car and income from other sources. There may be 10-15 different factors that are considered and each will receive a score based on some predetermined standard. Suppose a received application contains the following data: The age of the borrower is 45 years, his/her monthly income is Rs.50,000 (had been in the job for five years), owns a house and a premium car, is married, and has a child, then he/she would score:

Age (45 years)	:	18 points
Marital status (married)	:	9 points
Annual income	:	15 points
Length of employment	:	10 points
Rent or own a house	:	10 points
Total	**:**	**62 points**

Consider Another Example:

Age (under 25)	:	5 points
Marital status (single)	:	– 2 points
Annual income (30-35)	:	12 points
Length of employment (2yrs)	:	4 points
Rent or own home (rent)	:	0 points
Total	**:**	**19 points**

(**Note:** The points considered are fictitious; they may not be the real points as no credit scoring method has been published).

This shows that the stronger your personal traits are the higher your score. The idea is that the more stable the person is, the better the credit record will be. The whole credit scoring system is based on extensive statistical studies. It's purely mechanical procedures that assign score to each characteristic, add the scores, and based on the total score the creditworthiness of the borrower is determined. Generally, if the score equals or exceeds a predetermined score, then a minimum credit will be granted or else credit will be refused. Customers who are granted credit are notified and are sent a credit or a charge cards along with the material and a welcome kit describing the terms and conditions of credit.

This raises a question: On what basis does a creditor grant credit to the borrower? For many years, creditors have been using credit-scoring systems to determine the risk value of a customer for credit cards and auto loans. Most recently, credit scoring has been used to help creditors evaluate the ability of the borrower to repay home mortgage loans.

CREDIT SCORING

Credit scoring is a method that helps the creditors to decide whether or not to give credit to a particular customer. Significant data and information about the applicant along with his/her credit history including the bill-paying history, the number and type of accounts maintained, late payments, collection actions, outstanding debt, and the duration of maintaining the account, are collected from the credit application and credit report of the borrower. A statistical method credit scoring method is used to award points for each factor that helps in determining the repayment of the debt. A total number of points – a credit score – helps in predicting the creditworthiness of the customer. A credit report plays an important role in determining the creditworthiness of the customer. Therefore, it is necessary to make sure that the report is accurate before the submission of the credit application. There are agencies that provide this information. In the US, there are three well-known credit scoring agencies, namely:

- Equifax.
- Experian (formerly TRW).
- Trans Union.

These agencies charge $8 for a credit report.

Why is Credit Scoring Used?

Credit scoring is used to find out whether a particular customer would be reliable or not to the bank or company and how much could a company rely on him/her if he/she is granted a credit. The credit scoring process is done for the following two sectors:

SALARIED

In this segment, the pay slip or the income statement of employee is collected for credit scoring. If his/her salary is above Rs.50,000 it is considered as excellent. Other factors include his/her ownership of a house or a flat, or a premium car according to the bank. If he/she is holding any other credit cards or had borrowed a loan and his/her performance excellent then his/her credit scoring stands very good and becomes eligible for the credit card. It also takes into consideration what kind of an organization he/she is associated with.

SELF-EMPLOYED

In this sector, credit scoring is done on the basis of the following factors: The type of business of the borrower, the health of the business by determining the financial aspects including the company's bank statements, instances of cheque bounces or late payment charges, his/her performance on the loan(s) taken, and the card(s) he/she holds, whether he/she owns a house or flat and owns a car.

Credit Score Improvement

Credit scoring models are complex in nature and are of varying nature. If there is a change in one factor, the entire score may change, improvement depends if that factor affects the other factors considered in the model. Only the creditor can suggest improvements under a particular model that is used to evaluate the credit application.

Nevertheless, scoring models generally evaluate the following types of information in a customer's credit report:

TIMELY PAYMENT OF BILLS

Payment history typically is a significant factor. It is likely that the borrower's score will be affected negatively if he/she had paid bills late, an account referred to collections, or declared bankruptcy, are reflected on his/her credit report.

TOTAL OUTSTANDING DEBT

Many scoring models evaluate the amount of debt by comparing it to the borrower's credit limits. If the amount he/she owes is close to his/her credit limit, then it is likely to have a negative effect on his/her credit score.

CREDIT HISTORY

Generally, models consider the length of your credit track record. An insufficient credit history may have an effect on your score, but that can be offset by other factors, such as timely payments and low balances.

APPLIED FOR ANY OTHER NEW CREDIT RECENTLY

Many scoring models try to determine whether the borrower had applied for a credit recently by checking the "inquiries" on his/her credit report when he/she applies for a credit. Application for too many new accounts may negatively affect the borrower's score. However, not all inquiries are counted. Inquiries by creditors who monitor the customer's account or inspect the credit reports to make "prescreened" credit offers, are not counted.

NUMBER AND TYPE OF ACCOUNT MAINTAINED

Although it is generally good to have established credit accounts, too many credit card accounts may have a negative effect on his/her score. In addition, many models consider the type of credit accounts held by the customer. For example, under some scoring models, loans from finance companies may negatively affect the customer's credit score.

Scoring models may be based on more than just information in the customer's credit report. For example, the model may consider information from a borrower's credit application as well as his/her job or occupation, length of employment, or whether he/she owns a home.

To improve credit scores under most models, a borrower should concentrate on the timely payment of his/her bills, outstanding balances, and not acquire new debts. It's likely to take some time to improve a customer's credit score significantly.

Reliability of the Scoring System

Credit scoring systems enable creditors to assess millions of applicants constantly and neutrally on different characteristics. Credit-scoring systems must be based on a big sample for statistical validity. This system helps in taking decisions faster, more accurately and impartially than when it is assigned to individuals. In certain cases, when the scores are not high or the eligibility criteria is not met by the customer, then he/she is referred to the credit manager who decides whether or not the company or the lender should extend the credit facility.

Consequences of a Credit Denial

The consequences of a credit denial are more common in the US than in India. If a particular application has been denied of credit then according to the Equal Credit Opportunity Act, a creditor should provide valid reasons for the rejection. The creditor needs to be specific about his/her reasons, however, if his/her reasons are indefinite or vague, then the rejection is illegal. Acceptable reasons include: "Your income was low" or "You haven't been employed long enough", etc. Unacceptable reasons include: "You didn't meet our minimum standards" or "You didn't receive enough points on our credit scoring system", etc.

Sometimes, you can be denied credit because of information from a credit report. If so, the Fair Credit Reporting Act requires the creditor to give you the name, address and phone number of the credit-reporting agency that supplied the information. The borrower should contact that agency to find out what his/her report said. This information is free if he/she requests it within 60 days of being turned down for credit. The credit-reporting agency can tell you what's in your report, but only the creditor can tell you why your application was denied.

If a borrower has been denied credit, or he/she didn't get the rate on the required credit terms, then he/she should ask the creditor if a credit scoring system was used. If so, he/she should ask what characteristics or factors were used in that system, and the best ways to improve his/her application. If the borrower gets a credit, the creditor should be asked whether the best rate on the terms are available and, if not, the reasons for its absence. If the best rate available is not offered due to inaccuracies in his/her credit report, then the credit should be denied or rejected.

Computing Finance Charges

The card issuers are supposed to disclose the rate of interest they charge and their financial computation. This is called Annual Percentage Rate (APR). It is the actual or true rate of interest paid over the life of a loan. It is the right of the customer to know the interest charged and the obligation of the lender to tell the customer about the APR. Most of the bank and retail charge card issuers use one of the four variations of the Average Daily Balance method, which applies the interest rate to the average daily balance of the account over the billing period. Balance calculations under each method are as follows:

ADB INCLUDING NEW PURCHASES

For each day in the billing cycle, the outstanding balance should be added, including new purchases, and payments and credits should be subtracted. The resultant should then be divided by the number of days in the billing cycle.

ADB EXCLUDING NEW PURCHASES

This technique is the same as the first method, excluding the new purchases.

TWO-CYCLE ADB INCLUDING NEW PURCHASES

This method is calculated like the first method, but using the average daily balance for both the current and previous billing cycles.

TWO-CYCLE ADB EXCLUDING NEW PURCHASES

This method is the same as the two-cycle method, but excluding new purchases.

Therefore, it is very important for the customer to know the type of method the lender uses. Most of the banks compute finance charges monthly, but there are certain banks that use two-cycle computation. The carrying balance of the credit card may sometimes turn out to be very expensive.

(The example stated and the figures used are fictitious)

Assume that you have a Visa credit card that has a rate of interest of 2.5%. Your billing is dated November 10, 2003 – December 10, 2003, shows an opening balance of Rs.2,000. You made purchases of Rs.250 on November 15th and Rs.500 on November 22nd and a payment on December 6th of Rs.1,000. Therefore, the outstanding balance for the first 5 days (November 11-15) was Rs.2,000 for the next 5 days (November 16 – 22) it was Rs.250, for the next 15 days (November 23 – December 6) it was Rs.2,250 + Rs.500 = Rs.2,750 and the last 4 days it was Rs.2,750 – Rs.1,000 = Rs.1,750.

Finding the Average Daily Balance and Finance Charge

This kind of finance charges are followed both in India and the US. The finance charges can be determined as follows:

Number of Days	Balance (in Rs.)	No. of Days x Balance (in Rs.)
5	2,000	10,000
7	2,250	15,750
15	2,750	41,250
4	1,750	7,000
Total 31		Total 74,000

Average daily balance: $\frac{74,000}{31}$ = Rs.2,387

Finance charges: Rs.2,387 x 2.95% = Rs.70.42

Finance Charges for Various Balance Calculation Methods

These kinds of finance charges are applicable in the US. The interest is charged based on the different balances outstanding every month. There is a lot of difference on the amount of interest actually paid.

MANAGING CREDIT CARD ACCOUNTS

Suppose you have applied for a credit card in your favorite department store. The bank has granted the credit card. You have carefully reviewed the terms and conditions of the credit card and also studied about the finance charges in the application. After this, the most important step is managing the credit card accounts. Also, payments on time, tracking purchases and checking whether items returned are reflecting on the monthly statement or not, are important in managing credit card accounts.

The Statement

If a customer uses a credit card, then he/she receives a monthly statement from the bank. This statement is a record of transactions made in a particular month. It shows the period of billing, the payment date, the date of extension of the payment, the interest rate charged, the minimum payment that can be made and all the accounting activity during the current period. The statement also summarizes the account activity: The previous balance (the amount due at the beginning of the month), the new charges during the previous month, any interest charges on the unpaid balance, the preceding period's payments and any other credits (returns, etc.) and the new balance (previous balance + new purchases + finance charges – payments and credits).

Merchandize and cash transactions are not mentioned in the statements. The finance charges in each case is calculated @1.5% (US) and 2.95 % (India). The average balance method is used for computation of the finance charges. The monthly statement should be properly viewed every month. The acknowledgements during payments should be saved to review the monthly statement entries. If there is any discrepancy or error, then the service department should be informed so that arrangements can be made at the earliest.

Payments

Maintaining prompt payments always avoid problems and over billing. Carrying forward of the outstanding balance should be avoided. This helps in the avoidance of finance charges too. If the bill is paid on or before the due date, no additional finance charges will be incurred. If the cardholder finds it difficult to pay the new outstanding balance, then he/she can either pay an amount, which is equal to the old outstanding amount or which is greater than the minimum amount (a minimum percentage required to be paid by the cardholder to keep his/her account open. The minimum amount is as least 5% of the outstanding amount on the bill). However, he/she will incur financial charges in the following month. If a customer fails to pay the minimum amount, then he/she is considered as a defaulter and the concerned bank can take any legal action if it deems necessary.

RETURNING MERCHANDIZE

When merchandize is purchased with a credit card, then the merchant will issue it as a credit. It will appear as a deduction from the balance in the statement of the bill. If there occurs any problem after the purchase of an item from the merchant and the reason favors the customer, then he/she return the merchandize and shouldn't have to pay that part of the credit card bill. If the reason favors the merchant, then the customer has to pay that portion of the bill.

Using a Credit Card Wisely

A credit card can be used judiciously as follows:

GET THE BEST DEALS

Before applying to a credit card, the first important thing to be done by the customer is to assess him/herself by asking the following questions: What kind of a spender am I? How will I pay my bills? If I paid off my card balance promptly will I have a card that is different from others that can carry forward the monthly balance and pay minimum amount for it.

A customer generally examines the following features in a credit card:

- Annual fees.
- Rate of interest charged on the account.
- Method of calculating balances.

If you are a customer who pays the balance in full each month then you can demand for a card that has no annual subscription and has a long grace period. The rate of interest is ignored because you don't carry any balances next month. If you are a person who feels that you can pay your balance per month only partially then you may prefer a card, which has low rate of interest and where you can get a discount on the annual charges too. If you are a spender of a kind who gets a balance of not more than Rs.2,000, then you may prefer a card that has no annual fees and the rate of interest is as low as minimum. If you are a kind of spender who has large balances you may then prefer a card of annual fees so that the interest rates can be as low as possible.

All this assessment is done to pick up the credit card that suits your spending style and not any credit card, which comes your way. Therefore, before signing the application you should have complete knowledge about credit cards. Don't overlook all those charges and fees, which may lead you to a huge billing. All the terms and conditions should be properly understood and verified especially information such as the grace period, interest rates, annual fees, etc. If local deals don't impress you, there are deals available nationally. Also, looking into finance magazines or Internet is the best way to get the best deals.

Let us now discuss the advantages and disadvantages of credit cards.

Advantages of Credit Cards

In the present modern age of activities and high-risk in capital/money/cash, the transactions have become impossible without credit cards. The most significant fact about credit cards is that customers can delay payment until the end of the billing period. But this is not advantageous because this involves high interest rates that compensate the situation.

The major reasons for consumers choosing credit cards are interest-free loans, simplified record-keeping, emergency usage, security, etc.

INTEREST-FREE LOANS

Most of the credit and charge cards offer short-term or interest-free loans for the purchase of goods and services. The grace period ranges from 20-30 days within which the payment of the bill is expected to pay. As a rule, credit cards should be used only for purchasing merchandize and paying the monthly bill in full thereby avoiding the finance charges. If the creditor does not offer a grace period and includes only current purchases in the average daily balance then credit cards can be used only during financial emergencies because interest would be charged from the time the transaction has taken place.

SIMPLIFIED RECORD KEEPING

Monthly statements are sent to the credit card holder that provides a detailed record of transactions and a consolidated record of purchases.

Record keeping has the following advantages:

- **One Statement Only:** The customer gets only one statement irrespective of the number of transactions he/she has made. This makes easier the process of payment of the bill.
- **Banks Always have the Fear of Losing a Customer:** Since 'customer is considered as the king' it is very important to maintain customer satisfaction. He/she may stop the payment of the credit card account for unsatisfactory services.
- **Free Purchase Points and Merchandize:** These facilities are increasingly becoming popular. The credit card companies are providing the customers with the maximum incentive facility possible, which attracts the customers. The more he/she uses card, the more points he/she can get towards future purchases.

- **Establishing Credit History and Keeping a Good Credit Rating:** There are a number of key transactions that require a good credit rating. Which include obtaining a loan or dealing with a mortgage company. Applying for any kind of loan requires investigation about the customers' credit history. Therefore, credit cards are the best way to maintain a good credit history.
- **Re-establish Credit Rating after Bankruptcy or any Financial Mishap:** Those with a poor credit history or those undergoing debt consolidation or credit repair initiatives often use credit cards to repair the damage. Secured credit cards can be used in such cases where companies are reluctant to issue unsecured credit cards.
- **The Most Convenient Method of Shopping:** Credit cards provide the customer with the best comparison-shopping worldwide on the Internet. It is the most convenient way of paying the credit card bill. As e-commerce has become increasingly advanced, this comes closer and closer to a necessity. Some companies have created services that maximize Internet technology in this regard.
- **The Ability to Procure Cash Advances:** This eliminates the need to go to the bank as customers can simply get the cash they need from their grocery store or other merchant. Note that credit card companies do charge a percentage of the transaction as a fee for the cash advance.
- **For Emergency Purposes:** Financial emergency is uncertain. Therefore, a borrower uses a credit during a financial emergency. A credit can be in the form of availing a loan from a bank or from friends or relatives.
- **Security:** Credit cards are best used for security purposes. People find difficulty in carrying a huge amount of cash as there are chances of losing the money or it being stolen. Carrying a credit card is safer and is mostly preferred by the borrower as he/she would be free from the tension of carrying a large amount of cash. Moreover, he/she can also shop on an unlimited amount of money.

DISADVANTAGES OF CREDIT CARDS

The lure to acquire too many credit card accounts can lead to losing track of payment details and deadlines. This can be catastrophic, leading to a false sense of security where customers transfer accounts to new services with lower interest rates. This gyratory form of interest, if not properly controlled may lead to a huge billing amount. Difficulty with understanding the fine print that gives information to various fees and charges may not be obvious initially. It is important to understand how the interest rates on credit card charges are calculated. Such a step is particularly important to keep up with payments. It is possible that falling behind with payments will result in an interest charge on all future charges regardless of whether the bill settlement is done or not within the specified period. Possibility of fraudulent usage of card by others while shopping especially in the internet is very high.

Avoiding Credit Problems

As more and more vendors and merchants are increasingly accepting credit cards, the volume of credit card purchases have increased and grown incredibly, which in turn has increased the level of credit card debt. The demand for credit card is more during the holiday or festive seasons when more purchases are made. The real problem occurs when huge bills are received. If overspending is ignored then it would have a serious impact on the monthly household budget. By receiving mounting bills, it means that part of the future income should be kept aside only for the payment of these bills. The more the bills are, the less the amount spent on the necessities. The best way to avoid credit problems is to use a credit card in the most sensible way. If a person uses more cards then at least a few of them should be surrendered to reduce unnecessary payment. Carrying too many cards can lead to the following difficult situations:

- Tempts to overspend, which leads to a higher credit card debt.
- If the customer is applying for another loan then the creditor should check the amount of credit available and the outstanding balances on the credit cards. If there are any outstanding balances then the creditor may be reluctant to offer the loan due to fear of over extending its payment period. Financial advisors suggest that a person should not hold more than two credit cards.

In spite of reducing the number of credit cards, if a customer still receives a high billing amount, then he or she should stop making any new charges until the outstanding amount is paid in full. One sensible way to deal with this situation is to pay off the high interest rate cards or pay more than the minimum payment. As a result, the billing amount every month drops and outstanding balances decrease.

Another alternative would be to transfer all the balances to a card that has a low-introductory rate and pay off as much as possible before the rate increases. Another strategy would be to take up a home equity line of credit and pay off the credit card debt, but this is high-risk prone strategy because if it failed to pay the home line of credit then the chances of losing home is more!

Credit Card Fraud

Each year, the losses from credit and charge cards are estimated to be in millions of dollars. Such losses are due to fraudulent practices like theft that may take place without the cardholder's knowledge.

It's not always possible to prevent a credit card or a charge card fraud. Following are the steps to minimize the possibility of fraud:

- The card should be signed as soon as it is received.
- Credit or charge cards should always be carried separately from the wallet. They should be carried in a separate pouch.
- Always keep a track record of account numbers. Their expiration dates and phone number and address of each company in a safe place.
- Keep an eye on your card during the transaction, and get it back as quickly as possible.
- Cancel incorrect receipts.
- Destroy carbons received after the transactions.
- Receipts should be obtained for comparing them with the monthly billing statements.
- Check your bills promptly and reconcile accounts monthly, just as you would do with your checking account.
- Report any questionable charges promptly and in writing to the card issuer.
- The credit card companies should be informed in advance if there is a change of address.
- Should not lend card(s) or give card numbers to anyone.
- Should not leave cards or receipts lying around.
- Give out account number over the phone unless making the call to a reputed company.
- Never disclose the card number to any company's website on the Internet.

Reporting Losses and Fraud

If credit or charge card has been stolen or lost then it is the duty of the cardholder to call up the creditor or the lender and give information about the loss. Many companies have toll-free numbers or 24-hour online service centers to deal with such emergencies. By law, once a customer reports the loss or theft, she/he has no further responsibility for unauthorized charges.

Credit Card Blocking

While using a credit or charge card to check into a hotel or rent a car, the clerk usually contacts the company that issued your card to give an estimated total. If the transaction is approved, your available credit is reduced by this amount. That's termed as a "block".

Blocking is used to ensure that the customer does not exceed the pre-set limit of the credit card. If the customer has not reached anywhere near his/her credit limit blocking will never be an issue. However, if the customer is approaching the limit he/she needs to be very careful, as it would be very discomforting and inconvenient to have the card declined especially during an emergency purchase. When a credit card is issued, the customer should have complete details from the issuers with regard to the blocking of the credit line.

SUMMARY

- The credit market has come a long way. Without credit, there is no movement of activities. With the phenomenal growth of new companies and their frequent launch of new products on low introductory prices, credit fraud cases are escalating worldwide. The benefits of the investments in marketing technologies are now being realized, with companies finally learning how to use them to their potential.
- There has been a conversion from the magnetic-stripe to chip-based payment cards. Master Card International plans to use smart cards for a more secure Internet banking and shopping. The banking industry is continually adopting new measures to combat fraudulent behavior. One way is to educate consumers about the predominant types of credit card fraud taking place globally. Another way is to introduce new technology that reduces or eliminates such a type of fraud.

Appendix I
A Credit Card Application Form

Personal Information

First Name | MI | Last Name | Suffix
Select

Street Address (No periods, special characters, or P.O. Boxes) | Apt./Suite

City | State | ZIP Code
Please select

Home Phone Number
- -

Residential Status
Choose type

Time at Residence
Years Months

Name of Another Person in Household
(If the information does not apply to you, leave blank.)

First Name | Last Name

First Name on Home Phone Bill | Last Name on Home Phone Bill

Monthly Housing Payment
$

Date Of Birth (MM–DD–YYYY)
You must be 18 years of age or older to apply.

Social Security Number

Security Password/Mother's Maiden Name (Use letters only)
Remember this confidential password to ensure proper identification when you call.

Re-enter

Email (Example: jdoe@citi.net)*

**If you provide an email address, we may use it to contact you about your account. We may also use your email address to send you information about products and services you might find useful.*

Employment Information

Yearly Income*
$

Other Yearly Household Income*
$

**Alimony, child support or separate maintenance income need not be revealed if you do not wish it to be considered as a basis for repaying this obligation.*

Company Name

Business Phone Number

- -

Time at Company

Years Months

Employment Status

Please select

You are on a Citibank Website and subject to Citibank's privacy and security policies. If you leave this site and go to a third party site, you will then be subject to the privacy and security policies of that site.

Continue Cancel

Terms and Conditions for Opening a Credit Card Account

Please read these Terms and Conditions.

Please note that the Terms and Conditions for the Quicken® Platinum Select® MasterCard® and Quicken® Gold MasterCard® account, including the Initial Disclosure Statement, will be provided to you electronically. Before you receive an account number, if approved for credit, you will be asked to confirm that you agree to receive your Initial Disclosure Statement electronically and that you have the software and equipment necessary to view and retain a copy of the Initial Disclosure Statement.

CREDIT CARD DISCLOSURES	
Annual percentage rate (APR) for purchases	Quicken® Platinum Select® MasterCard® 0.00% for 6 months from date of account opening. After that, 9.99%. Quicken® Gold MasterCard® 0.00% for 6 months from date of account opening. After that, 13.99%.
Other APRs	Quicken® Platinum Select® MasterCard® Balance transfer APR: As long as first balance transfer is completed within 6 months from date of account opening, 1.99% for 6 months from date of first balance transfer. After that, 9.99%. Quicken® Gold MasterCard® Balance transfer APR: As long as first balance transfer is completed within 6 months from date of account opening, 1.99% for 6 months from date of first balance transfer. After that, 13.99%. Cash advance APR: 19.99%. Quicken® Platinum Select® MasterCard® Default rate: 23.99% See explanation below.* Quicken® Gold MasterCard® Default rate: 28.99% See explanation below.*
Variable rate information	Your APRs may vary. The Quicken® Platinum Select® MasterCard® rate for purchases and balance transfers is determined for each billing period by adding 5.99% to the Prime Rate.** The cash advance rate is determined for each billing period by adding 14.99% to the Prime Rate, but such cash advance rate will never be lower than 19.99%. The default rate is determined for each billing period by adding up to 19.99% to the Prime Rate.*** The Quicken® Gold MasterCard® rate for purchases and balance transfers is determined for each billing period by adding 9.99% to the Prime Rate.** The cash advance rate is determined for each billing period by adding 14.99% to the Prime Rate, but such cash advance rate will never be lower than 19.99%. The default rate is determined for each billing period by adding up to 24.99% to the Prime Rate.***

Grace period for repayment of balances for purchases	Not less than 20 days if you pay your total new balance in full each billing period by the due date.
Method of computing the balance for purchases	Average daily balance (including new purchases)
Annual fees	Quicken® Platinum Select® MasterCard® None Quicken® Gold MasterCard® None
Minimum finance charge	$0.50
Transaction fee for cash advances:	3.0% of the amount of each cash advance, but not less than $5.
Transaction fee for balance transfers:	3.0% of the amount of each balance transfer, but not less than $5 or more than $50.
Late fee:	$15 on balances up to $100; $25 on balances of $100 up to $1000; and $35 on balances of $1000 and over.
Over the credit-line fee:	Quicken® Platinum Select® MasterCard® $29 Quicken® Gold MasterCard® $29

* All your APRs may increase if you default under any Card Agreement that you have with us because you fail to make a payment to us or any other creditor when due, you exceed your credit limit, or you make a payment to us that is not honored.

** The Prime Rate used to determine your APRs for each billing period is the U.S. Prime Rate published in *The Wall Street Journal* two business days prior to the Statement/Closing Date for that billing period.

*** Factors considered in determining your default rate may include the length of time your account with us has been open, the existence, seriousness and timing of defaults under any Card Agreement that you have with us, and other indications of usage and performance.

All account rates, fees, and other cost information disclosed above are subject to change at any time in accordance with applicable law and the Card Agreement that will be sent with your card.

We allocate your payments to pay off low APR balances before paying off higher APR balances. That means your savings will be reduced by making transactions that are subject to higher APRs.

TERMS AND CONDITIONS OF OFFER

- This offer is only valid for new accounts. You must be at least 18 years of age. If you are married, you may apply for a separate account. Citibank (South Dakota), N.A. (“we” or “us”) is the issuer of your account.
- Federal law requires us to obtain, verify, and record information that identifies each person who opens an account, in order to help the government fight the funding of terrorism and money laundering activities. To process the application, we must have your name, street address, date of birth, and other identifying information, and we may ask for identifying documents from you as well.
- To process the application for a new account, it must be:
    1. Accurately completed
    2. Verifiably correct
    3. Some offers are for a limited time. If you are responding to a limited time offer, we must receive your application by the expiration date.
- Please allow four weeks from date of submission to process a completed application.

- We may gather information about you, including from your employer, your bank, credit bureaus, and others, to verify your identity and determine your eligibility for credit, renewal of credit, and future extensions of credit. If you ask us, we will tell you whether or not we requested a credit bureau report and the names and addresses of any credit bureaus that provided us with such reports.
- To receive a Quicken® Platinum Select® MasterCard®, you must have an annual income of at least $35000 and you must meet our credit qualification criteria for the Quicken® Platinum Select® MasterCard®. Otherwise, you may receive a Quicken® Gold MasterCard®, provided you meet our credit qualification criteria for the Quicken® Gold MasterCard®. The Quicken® Gold MasterCard® does not have as many benefits as the Quicken® Platinum Select® MasterCard®.
- Your credit limit will be determined by your yearly income and a review of your credit report. You will be informed of the amount of your credit line when you receive your card. Some credit lines may be as low as $500. Please note that cash advances may be limited to a portion of your credit line.
- If you are approved for credit, you will receive a Card Agreement (“Agreement”) with your card. Read it carefully for important information regarding your account. The Agreement will be binding on you unless you cancel your account within 30 days after receiving your card and you have not used or authorized use of your account. We may change the Agreement at any time in accordance with applicable law and the terms of the Agreement.
- By responding to this offer of credit, you agree to Intuit’s sharing with Citibank (South Dakota), N.A.: (i) Information regarding Intuit products and services you have purchased or received, should it be required in order for the Bank to serve your account, and (ii) Your name, company name (where applicable), address, telephone number and/or Email address, as provided to Intuit, to enable Citibank (South Dakota), N.A. to process your card application.

  By responding to this offer of credit, you authorize Citibank (South Dakota), N.A. (“Citibank” or “the Bank”) to share with Intuit, experiential and transactional information regarding your Quicken credit card account. Such information may include name, address, Email address, telephone, downloading activity with Quicken software, and purchase activity on your credit card account.

  Occasionally, Intuit may contact you with special offers that may interest you. You may request that Intuit not send you marketing offers by phone, mail and/or Email by going to http://privacy.intuit.com/. You may also call Intuit at 1-800-335-4651 from 8:00 a.m. to 5:00 p.m. PST or write Intuit at: Intuit Inc. Customer Communication, 2800 East Commerce Center Place, Tucson, AZ 85706.

DETAILS AND INSTRUCTIONS FOR BALANCE TRANSFERS

Just follow these simple steps to start saving money on your high-interest cards.

- About three weeks after you get your card, you’ll receive a complimentary balance transfer kit with everything you need to pay off your high–rate cards.
- You may transfer any amount as long as the total amount (including any balance transfer fee) does not exceed your available credit line. Be sure you do not transfer the amount of any disputed purchase or other charge, because you may lose your dispute rights. Also, continue to make payments on your other accounts until your balance transfer is processed.
- The available credit line for your new card will be reduced by the total amount of the transfers we approve. We may not approve future balance transfers if you default under any Card Agreement.
- Watch for payments to show up as credits on your other credit card statements. If the credited amount brings the balance down to zero, you may then cancel those accounts.
- Please note you cannot transfer balances from other accounts issued by Citibank (South Dakota), N.A. or its affiliates.
- Finance charges will be assessed on balance transfers from the date the transaction is posted to your account.

Close

Appendix II

Features of Various Credit Cards

Parameter	ABN AMRO Smart Gold	Citibank International Silver Visa	Citibank International Gold Master	Citibank International Silver Master	Citibank International Gold Visa	Citibank Jet Airways Master	HSBC Classic Visa	HSBC Gold Visa	HSBC Classic Master	HSBC Gold Master	HDFC Bank International Silver Card	HDFC Bank International Gold Credit Card
Minimum Credit Limit (Rs)	NA	15,000	30,000	12,000	30,000	30,000	15,000	50,000	15,000	50,000	15,000	40,000
Maximum Credit Limit (Upto Rs)	NA	75,000	2,00,000	75,000	2,00,000	2,00,000	45,000	Not specified	45,000	Not specified	75,000	3,00,000
No. of days of interest free credit	50	50	50	50	50	50	48	48	48	48	50	55
Accepted at	over 23 million merchant establishments all over the world	over 18 million Merchant Establishments	over 18 million Merchant Establishments	18 million Merchant Establishment	18 million Merchant Establishment	over 18 million Merchant Establishments	over 18 million Merchant Establishments	over 18 million Merchant Establishments	18 million Merchant Establishments	18 million Merchant Establishments	Over 18 Million Merchant Establishments	Over 18 Million Merchant Establishments
Cash advance limit	30% of available credit limit	Rs.5,000 for 1st yr and 60% of credit limit thereafter	Rs.10,000 for 1st yr and 60% of credit limit thereafter	Rs.5,000 for 1st yr & 60% of credit limit thereafter	Rs.10,000 for 1st yr and 60% of credit limit thereafter	Rs.10,000 for 1st yr and 60% of credit limit thereafter	40% of Credit Limit	40% of Credit Limit	40% of Credit Limit	40% of Credit Limit	30% of Credit Limit	40% of Credit Limit
Interest on roll over (% p.m.)	2.49	2.95	2.95	2.95	2.95	2.95	2.95	2.95	2.95	2.95	2.65	2.65
Transaction charges on cash advance (% p.m.)	2.50 or Rs.100 minimum	2.5	2.5	2.50	2.50	2.5 or minimum of Rs.75	2.50 or Rs.100 minimum	2.50 or Rs.100 minimum	2.50 or Rs.100 minimum	2.50 or Rs.100 minimum	2.5% or Rs.25 (HDFC Bank ATMs) OR Rs 150 (Other bank ATMs) whichever is higher	2.5% or Rs.25 (HDFC Bank ATMs) OR Rs 150 (Other bank ATMs) whichever is higher
Personal Accident - Road (Rs)	5,00,000	1,00,000	2,00,000	1,00,000	2,00,000	2,00,000	1,00,000	2,00,000	1,00,000	2,00,000	2,00,000	3,00,000
Personal Accident - Air (Rs)	15,00,000	10,00,000	20,00,000	10,00,000	20,00,000	20,00,000	10,00,000	20,00,000	10,00,000	20,00,000	4,00,000	25,00,000
Joining fee (Rs)	500	0	0	0	0	0	0	0	0	0	300	500

Parameter	ABN AMRO Smart Gold	Citibank International Silver Visa	Citibank International Gold Master	Citibank International Silver Master	Citibank International Gold Visa	Citibank Jet Airways Master	HSBC Classic Visa	HSBC Gold Visa	HSBC Classic Master	HSBC Gold Master	HDFC Bank International Silver Card	HDFC Bank International Gold Credit Card
Annual Fee (Rs)	2,000	750	2,000	750	2,000	2,000	350	1,000	350	1,000	700	2,000
No. Of Add-on cards	2	2	2	2	2	2	3	3	3	3	3	3
Rewards	1 pt for Rs.50 spent ; 50% extra on Intl. spends	1point for every Rs.100 spent.	1point per Rs.100 spent	1point for every Rs.100 spent.	1 point for every Rs.100 spent	1point per Rs.100 spent which is transferred to Jet Privilege scheme and is equivalent to 3 air miles.	1point per Rs.100 spent Free Easy Buy Music Gift voucher worth Rs.350	1point per Rs.100 spent	1 point for every Rs.100 spent Free Easy Buy Music Gift Voucher worth Rs.350	1 point for every Rs.100 spent	2 for every Rs.100 spent	2 for every Rs.100 spent
24hrs Helpline	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Photo Card	NA	Yes	Yes	Yes	Yes	Yes	NA	NA	NA	NA	NA	NA
Interest on Balance Transfer(% p.m)	0.99	0	NA	0	NA	NA	0	0	0	0	1.65	1.25
Balance Transfer Special Terms	100% of credit limit can be transferred	null	NA	null	NA	NA	null	null	NA	NA	6 Months	6 Months
Lost Card Liability before Reporting inRs.	Full	Full	Full	Full	Full	Full	Full	Full	Full	Full	Unlimited	Unlimited
Lost Card Liability after Reporting in Rs.	Nil	Nil	Nill	Nil	Nill	Nill	Nil	Nil	Nil	Nil	0	0
Credit Shield	Upto Rs.50,000	Not Available	Not Available	Not Available	Not Available	Not Available	Upto Rs.20,000	Upto Rs.40,000	Upto Rs.20,000	Upto Rs.40,000	NA	NA
Global Card	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	NA	NA
Balance Transfer	Yes	NA	NA	NA	NA	NA	NA	NA	NA	NA	Yes	Yes
Affiliates Of	Master	Visa	Master	Master	Visa	Master	Visa	Visa	Master	Master	Visa	Visa

Parameter	ICICI Bank Solid Gold Visa	ICICI Bank Sterling Silver Visa	ICICI Bank Sterling Silver Master	ICICI Bank Solid Gold Master	StanChart Gold Standard Visa	StanChart Classic Visa	StanChart Gold Standard Master	StanChart Classic Master	SBI International Card Visa
Minimum Credit Limit (Rs)	40,000	12,000	12,000	40,000	15,000	15,000	15,000	15,000	Not specified
Maximum Credit Limit (Upto Rs)	3,00,000	1,00,000	1,00,000	3,00,000	2,50,000	75,000	2,50,000	75,000	Not specified
No. of days of interest free credit	52	50	50	52	52	50	52	50	50
Accepted at	18 million Merchant Establishments	Over 18 million Merchant Establishments	Over 18 million Merchant Establishments	18 million Merchant Establishments	over 18 million Merchant Establishments	over 18 million Merchant Establishments	18 million Merchant Establishments	18 million Merchant Establishments	over 24 million merchant establishments worldwide
Cash advance limit	20% of Credit Limit	20% of Credit Limit	20% of Credit Limit	20% of Credit Limit	40% of Credit Limit	40% of Credit Limit	40% of credit limit	40% of credit limit	40% of the available limit
Interest on roll over (% p.m.)	2.75	2.95	2.95	2.75	2.95	2.95	2.95	2.95	2.75
Transaction charges on cash advance (% p.m.)	2.50 or Rs.250 minimum	2.50 or Rs.250 minimum	2.50 or Rs.250 minimum	2.50 or Rs.250 minimum	2.50 or Rs. 75 minimum	2.50 or Rs. 75 minimum	2.50 or Rs. 75 minimum	2.50 or Rs. 75 minimum	2.25% of cash transaction amount or Rs.75 minimum
Personal Accident - Road (Rs)	5,00,000	2,00,000	2,00,000	5,00,000	5,00,000	2,50,000	5,00,000	2,50,000	2,00,000
Personal Accident - Air (Rs)	15,00,000	6,00,000	6,00,000	15,00,000	15,00,000	4,00,000	15,00,000	4,00,000	6,00,000
Joining fee (Rs)	300	0	0	300	1000	100	1000	100	250
Annual Fee (Rs)	1,500	750	750	1500	2000	700	2000	700	750
No. Of Add-on cards	2	2	2	2	5	5	5	5	2
Rewards	1point per Rs.100 spent. 10% addl.points for spends > Rs.5000 in a cycle. 25 points for first time usage.	1 point per Rs.100 spent. 10% addl. points for spends > Rs.5000 in a cycle. 25 points for first time usage.	1 point per Rs.100 spent. 10% addl. points for spends > Rs.5000 in a cycle. 25 points for first time usage.	1point per Rs.100 spent. 10% addl.points for spends > Rs.5000 in a cycle. 25 points for first time usage.	1 point for every Rs. 125 spent locally and 1 point for every Rs.80 spent abroad.	1 point for every Rs. 125 spent locally and 1 point for every Rs.80 spent abroad.	1 points for every Rs. 125 spent locally and 1 point for every Rs.80 spent abroad.	1 point for every Rs. 125 spent locally and 1 point for every Rs.80 spent abroad.	1 Point on every Rs.125 spent
24hrs Helpline	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Photo Card	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	NA

Parameter	ICICI Bank Solid Gold Visa	ICICI Bank Sterling Silver Visa	ICICI Bank Sterling Silver Master	ICICI Bank Solid Gold Master	StanChart Gold Standard Visa	StanChart Classic Visa	StanChart Gold Standard Master	StanChart Classic Master	SBI International Card Visa
Interest on Balance Transfer(% p.m)	1.50	1.75	1.75	1.50	1.75	1.75	1.75	1.75	1.75
Balance Transfer Special Terms	For first six months	For first 6 months	For first 6 months	For first six months	For first six months	For first six months	For first six months	For first six months	null
Lost Card Liability before Reporting inRs.	Nil	2,500	2,500	Nil	Nil	Nil	Nil	Nil	Full
Lost Card Liability after Reporting in Rs.	Nil	Nil	Nil	Nil	Nil	Nil	Nil	Nil	1000
Credit Shield	Upto Rs.50,000	Upto Rs.25,000	Upto Rs.25,000	Upto Rs.50,000	Not Available	Not Available	Not Available	Not Available	Maximum Rs.1,00,000/-
Global Card	Yes	Yes	NA	Yes	Yes	Yes	Yes	Yes	Yes
Balance Transfer	Interest @ 1.5%p.m.	Yes	Yes	Interest @ 1.5%p.m.	Yes	Yes	Yes	Yes	Yes
Affiliates Of	Visa	Visa	Visa	Visa	Visa	Visa	Master	Master	Visa

SPECIMEN

HDFC BANK

We understand your world

SILVER CARD STATEMENT

All figures in INR

Cardmember's Name and Number	Statement Date	Payment Due Date
Sunil Kumar Roy	19/11/03	09/12/03

Credit Limit	Available Credit Limit*	Available Cash Limit*
33,000	17,140	9,900

THANK YOU FOR YOUR CARD MEMBERSHIP.WE ARE PLEASED TO INFORM YOU THAT YOUR CREDIT LIMIT HAS BEEN ENHANCED.

Date	Details	Merchant City	Transaction Ref. No	Amount
23/10/03	AGRAWALA SWEETS & REST	HYDERABAD	09999999998?	160.50
29/10/03	4TH SHI CASH ON CALL		09999999998?	1,076.55
08/11/03	AUTOPAY THANKYOU		19999999999D	640.00 Cr
12/11/03	BHARTI MOBILE LTD	HYDERABAD	VT033200046	1,100.00
15/11/03	ESEVA	HYDERABAD	09999999998?	552.00
18/11/03	PAYMENT-THANK YOU		00000000001	1,500.00 Cr
19/11/03	FINANCE CHARGES-RETAIL	INC SVC TAX	1999999999D	343.63

REWARD POINTS SUMMARY

Opening Balance	Earned	Adjusted	Closing Balance
1,037	36	0	1,073

Opening Balance	Payments/Credits	Purchases/Debits	Finance Charges	Total Dues
17,698.17	2,140.00	[illegible]	343.63	15,750.35

Overlimit	Past Dues, if any: 3 Months+	2 Months	1 Month	Current Dues	Minimum Amount Due
0.00	0.00	0.00	0.00	690.00	690.00

SWIPE YOUR HDFCBANK CARD,GET ASSURED GIFTS & DISCOUNTS UPTO 25%. YOU CAN ALSO WIN MEGA PRIZES WITH JUST ONE SWIPE.

Note: All contents of the statement will be deemed to be correct and accepted by you, unless you inform us of any discrepancies with 30 days from the date of this statement.

** The available credit / cash limit shown herein takes into account charges incurred but not billed. Please detach the coupon below and send it with the payment Please do not staple the cheque.*

Setting dues on your HDFC Bank International Silver Credit Card

1. For easy understanding of your monthly transactions, we have segregated them into International and Domestic. However, the total amount indicated on your statement refers to the sum total of your domestic and international transactions. In case you have availed of any of our EMI programs, the EMI will be included in your Minimum Amount Due.
2. You can avail of the Revolving Credit facility on your Credit Card by simply paying the Minimum Amount Due or any higher amount thereof, as shown on your statement before the payment due date and carry forward the balance to subsequent statements.
3. The Minimum Amount Due is calculated currently at 5% of your total current dues with a minimum payment criterion of Rs.200/-. In case you have availed any of our EMI programs, the EMI will have to be paid in addition to the Minimum Amount Due.
4. Any previous unpaid Minimum Amount Due will be added to your current Minimum Amount Due along with any outstanding exceeding your credit limit.
5. When you carry forward any outstanding or avail of Cash Advance, a finance charge, calculated by Average Daily Balance Method, will apply to balances carried forward and to fresh billings.
6. The Payment Due Date is the last date by which the payments should reach the bank, failing which your future transactions may not be honoured and you will be levied a late payment fee plus service tax as applicable.
7. "Statement Date" is the date on which your statement is generated every month. In the rare event of you not receiving your statement within 7 days of generation, please call your nearest call center to receive your billing information.
8. A purchase and subsequent cancellation are two separate transactions. Please do not withhold payment for reasons of non credit as delays in the credit process can cause your account to become irregular.
9. Payment made do you will be acknowledged in the subsequent statement.

Regular Information For International Usage

Usage of internationally valid cards outside India must be in accordance with the Exchange Control Regulation of RBI. In the event of any failure to do so, the Cardholder is liable for penal action under the Foreign Exchange Management Act, 1999. The onus of ensuring compliance with regulations is entirely on the cardholder.

Service Tax will be levied on fees, interest and other charges as per government guidelines. Please note that Service Tax is not applicable on your regular purchases.

Our 24 Hour Customer Call Center

For further details, call our 24-hour customer center numbers in your city. Ahmedabad/Baroda: 079-6424332 Bangalore: 080-5204332 Chandigarh/Ludhiana: 0172-2264332 Chennai:044-28604332 Cochin/Trivandrum: 0484-2344332 Coimbatore: 0422-5384322 Delhi: 011-51514322 Hyderabad: 040-55624332 Indore: 0731-5074332 Jaipur: 0141-5114332 Kolkatta: 033-22814332 Mumbai: 022-28564332 Pune: 020-6454332.

Visit us at www.hdfcbank.com or e-mail us at customerservices.cards@hdfcbank.com

Convenient Payment Options

In case you hold an HDFC Bank Account you can make:

- Payment through Netbanking, ATMs, Phonebanking and Branches.
- Payment through standing instructions on your banking account.
- Payment through local cheque/demand drafts at ATMs/Drop Boxes.

In case you do not hold an HDFC Bank Account you can make:

- Cash payment through branches and select ATMs.
- Payment through local cheques/demand drafts at ATMs/Drop Boxes.

Type of charge	Rates applicable
Cash Advance Fee	a) Cash withdrawn through HDFC Bank ATMs: 2% on advanced amount subject to a minimum of Rs.100/- b) Cash withdrawn through non-HDFC bank ATMs. 2.5% on advance amount subject to a minimum of Rs.200/-
Late Payment Fee	Rs.150/- p.m.
Charges on Over limit Account	2.5% of Over limit amount subject to a minimum of Rs.200/-
Fee on dishnoured instrument/payment	2% of Payment amount subject to a minimum of Rs.200/-
Surcharge on Transaction at Petrol Pumps	2.5% of transaction amount subject to a minimum of Rs.10.
Surcharge on purchase/cancellation of Railway tickets.	Rs.30 plus 2.5% of transaction amount.
Utility Payments	Rs.20/- per transaction + finance charges on Revolving Credit.
Foreign Currency transactions	Association Conversion Rate/Bank
Charge for reissue of Lost, stolen, or damaged card	Rs.100/-
Charge slip Retrieval Charges	Rs.125/- per charge slip.
Statement Request (Beyond 6 Months)	Rs.125/- per statement.

Some Dos & Don'ts

1. Ensure verification of your card is done in your presence. Also remember to get your card back after every transaction.
2. For Security reason, do not hand over your card or disclose your ATM-PIN to anyone, even if they claim to represent the Bank.
3. Drop cheques or drafts in the drop boxes. Please do not drop Cash/Post-dated cheques.
4. Do not forget to call our 24-hour Customer Call Center immediately, if your card is stolen/lost/misplaced.

All correspondence should be mailed to the Manger, HDFC Bank Cards Division, P.O Box 399, Anna Salai, Chennai-600-002.

Chapter VII

Using Consumer Loans

After reading this chapter, you will be conversant with:

- Home Loans
- Auto Loans
- Personal Loans
- Educational Loans
- Mortgage Loans
- Single Payment Loans
- Installment Loans
- Finance Charges and Monthly Payments and APR
- Sources of Consumer Loans

Introduction

Consumer loans play a key role in the personal financial planning process of an individual or a household. Financial goals are achieved through such loans. The significance of consumer loans is to successfully manage the credit borrowed, amount of credit to be used and managing the debt-repayment saddle. Consumer loans have become popular because of limited salaried individuals, household families, etc., who cannot afford to get expensive goods and services from their limited income. Therefore, they depend on loans. A consumer loan may be opted for buying a car or a stove or new clothes or for a vacation. Most of the consumer loans are treated as personal loans and are used for purchasing all major products and necessities. The interest paid on consumer loans is not deducted from the taxable income. While borrowing consumer loans, the approximate monthly budget should be determined. There should be control on the use of debts. If ignored, it may lead to the disturbance of the entire estimated budget, which in turn leads to serious problems. Before applying for the loan complete credit-counseling needs to be done to have a proper understanding about consumer loans. These loans must be borrowed from the lowest cost source i.e., at a low rate of interest. If all these aspects are not taken into serious consideration it may lead to bankruptcy.

Consumer loans are formal and negotiated contracts where, both the terms and conditions of borrowing and repayment are stated. They are one-shot transactions that are given for specified purposes. There is no revolving credit facility once a loan is borrowed. There are no cheques or any credit cards issued for this type of loans. Consumer loans have become a part of every household. The consumer should have a proper understanding about the type of loan suitable to his budget and repaying capacity. The consumer should be clear about the fact that, greater the maturity of the loan, the greater the cost of repayment. Business, people, companies, etc., lack liquid cash and therefore, prefer loans. These loans have now become a must for meeting the day-to-day expenses.

Different Kinds of Consumer Loans

Since the demand for consumer loans is always increasing, there are different kinds of loans offered by banks, other financial institutions, insurance companies, etc. The varieties of consumer loans include home loans, mortgage loans, educational loans, auto loans, two-wheeler loans, loans against shares, single-payment loans, installment loans, personal loans, quick cash in 24 hours, home improvement loans, line of credit or overdraft, any purpose loans, revolving loan, reverse mortgage, etc. Consumers in the current day market can make a choice of the type of loan that suits him/her best. He/she can go for the best interest rates i.e., since the consumer has a choice, he/she can take time to analyze and calculate the lowest rate of interest to be obtained. The different types of loans are hereunder discussed in detail.

HOME LOANS

One of the most widely preferred loans are the home loans. In India, most of people have a dream of having an “own house”. To fulfill such dreams, they need a huge capital that is not possible with their monthly income. Therefore, banks and other financial institutions recognized this need, and started to issue different kinds of loans to their customers. The advantage in obtaining a home loan is that the liquid cash or the savings is not used and the monthly loan installment is affordable. The loan is repaid over a period of time say 10 years or 15 years, etc. The asset is obtained without much expenditure and this in turn provides immense satisfaction to the customer. This initiates more and more individuals and households to opt for loans. The risk involved in these loans is very minimum. Since the target market is the household and the individuals, the default rate is generally very low. If there is a situation of default, then a period of extension is given to the customer. If the customer fails to repay the loan even then, the house or the land purchased or the construction for which the loan was applied can be seized. To eliminate this situation, the customer should learn the terms and conditions of availing a housing loan.

The appraisal officer states the entire terms and conditions and also attends to the queries of the prospective borrower. Various details such as the eligibility criteria, the period of repayment of loan, the interest rates on the loan, the documentation required from the borrower, etc., are discussed during this meeting. If the customer is satisfied and a proper study is done then filling of the application is done. The processing fee is paid, which is about 1% of the loan amount. This fee is non-refundable. The processing fee is paid only if the chances of getting the loan are really good from the appraisal officer. There is a personal interview with the borrower conducted by the appraisal officer. Next, the appraisal officer makes a report and then discusses it with the branch manager. The branch manager substantiates the recommendations of the appraisal officer and then sends the report to the competent authority for sanctioning the loan. The competent authority sanctions the loan after clarifying queries (if any) from the appraisal officer. After the loan is approved, the borrower collects the loan offer letter. The property details form and acceptance note are filled and signed. This implies that the borrower has agreed to the terms and conditions of the loan. The borrower is expected to collect the disbursement within a month of the offer letter, if not, then commitment charges of 1% of the loan are levied on the borrower. Generally, a 1% fee on legal and technical documents is charged, which the borrower pays. The legal documents are submitted to the legal officer. The loan agreement and other documents are signed. The legal officer prepares the legal report after studying the legal documents in detail. The technical officer visits the property and then makes a technical report. The technical officer recommends the amount for disbursement depending upon the stage of completion. The disbursement memo is then signed by the appraisal, technical and legal officer and then sent to the branch manager for his/her signature. The accounts department prepares the cheques to be sent to the borrower with authorized signatories. This disbursement memo is attached with important documents such as interview sheet, legal report, technical report, etc. Pre-EMI that the borrowers pays when the loan is partly discussed. When the loan is partly disbursed, the borrower cannot start paying the EMI instead pays a simple interest on the part amount drawn at the rate that is applicable to the borrower. This cheque is collected from the borrower before releasing the disbursement amount cheque. After the final disbursement, the EMI starts. This is the interest and the adjusted principal amount for the period allotted. The documents pledged by the borrower are released after the clearing of the loan.

Borrowers of home loans are divided between two sectors:

- Salaried.
- Self-employed.

List of Documents

SALARIED BORROWER

The following important documents are to be produced by the borrower at the time of submitting the application:

Loan application should be completely filled and duly signed. If there is a co-borrower applicable then he/she also need to sign. The latest salary slip should be produced along with the employment certificate on the company’s letterhead, which he/she is presently associated with. The employment certificate should be signed by the borrowers’ employer. Also, the two photo copies of the first pages of the ration card and the first and the last pages of the bank passbook which show the balance. If there are any rent or electricity bills, then the photo copies should be provided. If the borrower has applied for an LIC policy, then he/she should also produce the xerox copy of the policy, the latest premium receipt, the photo copies of receipts of various other investments by the borrower, proof of borrower’s educational qualification, proof of his/her age and previous work experience certificates. If there has been any property selected and an agreement has been entered into, then the photo copy of the agreement must be produced. If the borrower has given any amount as contribution or charity then the receipt should be produced. Form 16 of the borrower whose salary is taxable should be produced. This is to obtain information with regard to the tax deducted at source by the employer.

Computing of the Eligibility of a Borrower

Before calculating the borrower's eligibility, terms need to be understood.

IIR: IIR is the installment to the income ratio. It is derived as follows:

$$\text{IIR} = \frac{\text{Installment for the loan}}{\text{Net adjusted salary}} \times 100$$

According to National Housing Bank (NHB) rule, the IIR should not exceed 33.33%. For example, if a borrower's salary is Rs.10, 000 then he/she should not be asked to pay more than Rs.3,333. This is just an estimate and it is fixed. This reduces the default rate too.

LCR: LCR is loan to cost ratio. Cost means the agreement value of the property. It is derived as follows:

$$\text{LCR} = \frac{\text{Loan Amount}}{\text{Agreement Value of the Property}} \times 100$$

Earlier, the companies financed 100% of the cost of construction, but now it ranges from 70% – 90% of the cost of construction.

NET ADJUSTED SALARY

The loan of the borrower depends on the net adjusted salary. This salary needs to be calculated as one cannot compute eligibility based on the take-home salary. Some of the deductions need to be adjusted. Statutory deductions are eliminated. In case of non-statutory deductions, the following factors need to be considered.

Society Loan, Consumer Loan, Vehicle Loan, Provident Fund Loan: The limit and the number of installments on such loans should be verified. The number of installments already paid and the number of installments due should be taken into account. If the number of paid installments does not exceed 9, the amount of those installments should be added back to the net salary to calculate the net adjusted salary.

Festival Advance: It is considered as a short-term borrowing and is added back to the net salary.

Voluntary Contribution to Provident Fund (PF): Sometimes, people do contribute voluntarily to the PF other than statutory contribution for the purpose of saving. This is purely optional and can be discounted whenever required. This is added back to the net salary.

Life Insurance Premium: The borrower, for the purpose of savings also pays them; therefore, this is also added back to the net salary.

House Building Advance: Sometimes, borrowers would have already borrowed a loan from their employer. In such cases, the appraisal officer takes a cautionary step in deciding whether to grant a loan or not to the borrower. The officer has to identify whether it is a habit of the borrower to avail such loans. If the borrower has availed such loans then the outstanding amount should not be huge. There should be a check on the installment payment of the borrower. If the installment number is less than 9, then the amount of the loan is added to the net salary for the computation of the net adjusted salary.

Salary Advance: The borrower may sometimes take the salary in advance. In such a case, it should not be deducted but instead added to the net salary to derive the net adjusted salary.

Treatment of Overtime: Overtime is not fixed. It keeps fluctuating and depends on the period the borrower has worked. The overtime amount for the past six months should be taken into account and 50% of the average of the overtime must be added to the net salary to compute the net adjusted salary.

Treatment of Incentives: Borrowers sometimes receive performance-based incentives especially in the sales and marketing department. Therefore, average incentives for the last six months are considered and 50% of the average is added back to the net salary to compute the net adjusted salary. Quarterly and yearly incentives are ignored. The incentives are considered only if they are customary and unwavering every month.

The Total Net Adjusted Salary is computed as follows:

Gross salary – Deductions = Net salary

Net salary includes the following:

Gross Salary:

Less:

- Overtime
- Incentives
- Arrears
- Medical
- Leave Travel Allowance (if any)

Add:

- Voluntary contribution towards PF
- LIC premium
- Festival advance
- Other loans of a short-term duration that is less than 9 months.
- Average incentives
- Recurring deposit and other saving scheme contribution.

  = Net Adjusted Salary

Who can be a co-applicant?

Loan sometimes is taken jointly. It is not necessary that only one person should apply for a loan. Two or more persons can apply for a housing loan provided, they fulfill certain conditions. Co-applicant is not the main applicant. Therefore, the owner of the property should always be the main applicant. The borrower can jointly apply the loan with his/her spouse. The property may be in the name of any one of the two. The person whose income is considered need not necessarily be the owner of the property.

In the case of parents and their children the following rules apply:

The unmarried daughters can jointly apply with their father. The property should be in the name of the daughter and the income of the father is not taken into account. This is same with unmarried daughters and their mother applying for a loan. In the case of a father and a son, the son can jointly apply with his father and both their incomes are considered. The property should be in both their names and it does not matter who the main owner is. This is because the son is the legal heir.

If a person has two sons and he wants to apply for a loan, he can jointly apply for a loan with one of his sons, but he will not be considered as the owner of the property. This is to avoid any disagreement between his sons and after his death; both the sons should inherit the property. The father is considered as the only co-applicant and his income is considered for the loan. He may be the co-owner and not the owner of the property. He cannot be the owner of the property under any condition. In certain cases, the applicant may have a son and a daughter. In such a situation, an official declaration is collected from the daughter that she has no claim.

SELF-EMPLOYED BORROWER

A self-employed borrower is a person who has his/her own business or is a professional proprietor of a firm or a partner in a partnership firm or a director of a private limited company. The appraisal officer takes into account three aspects before granting a loan to the self-employed:

- Analyzing the financial statements.
- Proper understanding of the business of the borrower, the kind of business, the verification of the place of the business and identifying the implications of the business.
- Taking into account the aspects that are common between both the sectors: salaried and the self-employed.

All the three aspects are to be studied in detail.

Analyzing the Financial Statement

Verification of the balance sheets and Profit and Loss accounts of the past three years. Balance sheet verification gives an indication about the business profits and losses i.e., the stability of the profits and the frequency of losses. These documents are also studied in detail.

Profitability: Profits indicate the health of the firm. The net profit and gross profits are calculated. The profit margin in the case of a trading firm would be around 5-10% and in the case of manufacturing firm it should be more.

Expenses: The expenses of the firm should be known from the borrower for computing actual expenditure.

Turnover: The turnover of the firm is known by assessing the sales and the extent of the business activity of the individual. In case of a small business even though the sales and cash reserves are high they are not reflected on the paper.

Cost of Goods Sold: To arrive at the profit figure the officer should be able to obtain the actual cost of every item and then compare it with the selling price of the item.

Non-cash Expenditure: Non-recurring expenditure and non-cash expenditure like depreciation should be added to the net profit.

Operational Consistency: The trends for the last three years should be viewed carefully to see if there are any fluctuations. If fluctuations are noticed then the reasons for the fluctuations should be analyzed. However, evaluating the future trend is difficult based on the past records. Consistency in operations, analysis should be based on assets and liabilities of the firm. Usually, balance sheets give the idea about the assets and liabilities held by the firm. If the firm includes the borrower's personal assets then collateral security for the assets must be produced. For the liabilities of the company, contribution towards capital and borrowings should be analyzed. Suppose money on a long-term basis was taken by the borrower then the officer needs to know how he/she is planning to pay-off the loan, what was the purpose of availing a loan, whether or not he/she is paying the installments promptly, his/her performance on the loan, the reasons for opting another loan, etc.

After the officer is satisfied with the borrower's credentials, then he/she sends the recommendations to the branch manager for approval and signature. After this process, the following lists of documents are collected from the borrower:

- A prologue about the business.
- The balance sheets and the profit and loss accounts of past 3 years duly certified by a chartered accountant.
- The income tax returns of the past three years.
- The registration certificate of the business or the firm, which has been approved under the Shops and Establishment Act and the Factories Act.

- If the borrower is a member of any reputed club or association, he/she should produce a copy of the certificate of membership.
- The borrower should produce deduction of any professional tax certificate.
- Copy of the letter sent to the bank for obtaining the confidential credit report of the borrower.
- If the borrower has any loan approved from any bank, then the copy of the loan sanction letter should be produced.
- The photo copies of the income tax returns must be attested by a chartered accountant.

Generally, the appraisal officer finds that the books of accounts do not project the actual picture of the business of the borrower. This is very much true in the case of a borrower who has small business and avails for loan. Therefore, the officer should be very cautious in granting loans to this sector of borrowers.

Income tax returns should be properly scrutinized to find out whether they are filed regularly or not. This is an important aspect of consideration, as many of the small business borrowers tend to show income tax returns for availing loans.

The income of the borrower should be properly identified. The chartered accountant should certify the computation of the income. Interest income and dividend income should be considered as regular income. The other sources of income that the borrower can produce is the records of past 3 years agriculture income, income from house property etc. The bank statements should be checked carefully. The bank statements should not include any kind of cheque bounces or late payment charges, etc. If the bank statements include any cheque returns then the borrower may be outrightly rejected for the loan.

If there is any kind of credit facility available to the borrower then the documents should be produced. If his/her performance is excellent on the credit then it gives a confidence to the officer about the reliability of the borrower.

The loan should not be sanctioned to the borrower until the confidential credit report of the borrower is viewed. Usually, the report is received from the bank.

The formula for the Computation of Equated Monthly Income is as follows:

$$\text{EMI} = \frac{Lr(1+r)^n}{(l+r)^n - 1}$$

Where,

L = Loan amount

r = Rate of interest

n = Period of loan

Calculation of PEMI (Pre-equated Monthly Income): It is the interest amount paid on the amount given to the borrower. The computation of PEMI is as follows:

$$\text{PEMI} = \frac{\text{Amount disbursed x Rate of interest}}{365} \text{ x No. of days PEMI is due}$$

Calculation of the Loan Amount

- The net adjusted salary is calculated,
- 33.33% of the net adjusted salary should be computed. This shows the repayment capacity of the borrower,
- EMI table should be referred,
- The period of the loan should be stated. The monthly interest and principal amount should be stated.

Housing Finance Schemes

The following banks offer home loans:

CITIBANK

The amount of loan offered is from Rs.2,10,000 – Rs.10 million. The loan would fund up to a maximum of 80% of the value of the property. The tenure will be for a maximum period of 15 years subject to maximum age criteria.

Eligibility Criteria for a Borrower to Avail a Loan

For Salaried

- Minimum gross annual income should be Rs.1,20,000.
- Minimum of 25 years of age.
- Maximum of 60 years or your retirement age, whichever is earlier at the time of loan maturity.
- Must have at least two years of work experience.

For Self-Employed

- Minimum net annual income should be Rs.1,50,000.
- Should be a minimum of 25 years of age and a maximum of 65 years at the time of loan maturity.
- Company should be in operation for the last three years.
- Company should be making profits.
- Should have filed IT returns for the last two years.

Documents Required for all Applicants/Co-applicants

- Loan application form duly signed by all the applicants,
- Two passport size photographs,
- Signature verification from your banker,
- Statement of a bank account for the last one year,
- Copy of two positive identifications (passport, driving license, ration card, credit card).
- Copy of Date of Birth.

For Salaried

- TDS certificate.
- Form 16 for last 2 years.
- Latest payslip.
- Letter from Employer stating all perks and benefits.

For Self-employed

- Copy of audited financial statements for the last two years.
- List including addresses and contact persons of top five clients.
- ITS 2 (Acknowledgments from IT dept.)

Interest Rate Structure

Loan Amount	Interest Rate	Document Fees
Rs. 2,10,000 – Rs.10,00,000	14%	2%
Rs. 10,00,000 – Rs.15,00,000	14%	2%
Rs. 15,00,000 and above	14%	2%

EMI Chart

EMI per Rs.1,00,000

Tenure	**Interest Rate 14%**	**Interest Rate 14.5%**
5 years	Rs.2,327	Rs.2,523
10 years	Rs.1,553	Rs.1,583
15 years	Rs.1,332	Rs.1,366

ICICI BANK

The loan amount is a maximum of 85% of the value of the property to be financed.

Minimum amount: Rs.1 lakh
Maximum amount: Rs.10 million.

The tenor of an ICICI Bank home loan ranges from a period of 1 year to 30 years depending on the type of loan availed.

The eligibility criteria are:

- The applicant should be at least 25 years of age. At the time of loan maturity, a maximum of 65 years age should be there.
- The applicant should have a regular source of income.

The documents required are:

- Passport size photograph of the applicant.
- Residence and age verification, may be established from the PAN card, Election ID, Passport, Driving License or Ration card.
- Bank statements for the last six months.
- Latest salary slip/statement showing all deductions in case of employed applicants.
- Certified copies of Balance Sheets and Profit and Loss accounts, IT acknowledgments, advance tax challans (for both company/firm and personal account) for the last three years in case of self-employed applicants.
- Memorandum/Articles of Associations for companies, partnership deeds for firms and a brief profile of your company/firm in case of self-employed applicants.

Interest Rate Structure

Tenure (years)	Interest Rate
1-5	11.25 %
6-20	12.75 %
21-30	12.85 %

EMI chart per Rs.1,00,000

Tenor	Interest: 11.25%	Interest: 12.75%	Interest: 12.85%
5 years	Rs.2,269	N.A.	N.A.
20 years	N.A.	Rs.1,168	N.A.
30 years	N.A.	N.A.	Rs.1,100

Other Charges:

Fees: 1.8% of the sanctioned loan amount.

Processing fee: Rs.500 (at the time of application).

AUTO LOANS

A car loan or an auto loan is obtained to purchase a new or a used car. The car is used as a collateral security for availing the loan. The loan period for new cars ranges from 3 to 7 years, while for used cars the loan periods are usually shorter in duration. The interest rate for auto loans depends on the duration of the car loan, and the credit rating of the buyer. Auto loan accounts constitute 35% of all consumer credit outstanding. Usually 80-90% of the auto loan is financed with credit and the rest is usually the down payment or the initial amount paid by the borrower.

Car has become a necessity in the household sector. At one point of time, it was treated as a luxury item. Later people started preferring traveling more in car than in bus or 3-wheeled autos or trains. This is because traveling by car saves a lot of time and money, therefore car is considered economical. Manufacturing of cars has increased over a period of time because of the increasing demand. Most people tend to purchase a car as it is regarded a status symbol and prestige in the society they live.

There are a number of banks and other financial institutions providing excellent loans those suits the needs of different classes of customers. The interest rates on the loans and the period of repayment of the loan are framed such that it is easily affordable by any class of household sector and individuals whoever satisfies the eligibility. Most of the banks and other financial institutions try their best to grant loans which fit into the normal budget criteria. Therefore, cars have become more preferable than two-wheelers as the latter are considered more accident prone compared to four-wheelers.

People have also become very safety-conscious due to fear of accidents. Moreover, a car can accommodate the entire family and since Indians are more family-oriented and move around more in groups, cars are always chosen as the best means of transport among them.

The risk in auto loans is less. If a person is not able to repay then the bank or any other institution from where the loan has been acquired, can seize the car. Therefore, the borrower should calculate his monthly budget carefully before applying for a loan. The borrower should also carefully study the terms and conditions of the interest rates, the monthly installments, the tenure of the loan, etc.

Budgeting is very important as the costs correlated with obtaining the car does not end when the car has been delivered or the loan is paid off. In fact, owing the car is one part of cost-cycle. Costs constituting repairs, maintenance, taxes, insurance, registration, etc., also add to the budget. Therefore, the affordable budget should be not only during purchase time but also over the life of the vehicle. The borrower should carefully decide on the kind of car he wants to go for, the price he can afford, the type he – petrol or diesel and the expected maintenance costs, etc. The borrower should also decide whether he wants to lease the car or go for hire purchase.

In case of lease, the financer or the lessor charges low rate of interest by transferring the depreciation benefits. The borrower gets tax benefits like, lease amount, cost of maintenance and insurance which can be claimed as expenses. In case of hire purchase, the borrower gets the benefit of tax shield on depreciation as the car is possessed by the borrower. The amount paid as road tax, interest on loan, insurance, repairs etc., are deductible from the income for income tax calculations. In case the borrower is an individual then he is not liable for the tax benefits. After deciding whether to go for leasing or for hire purchase the borrower should prefer a loan that suits his repaying capacity and monthly budget. Therefore, he needs to get the rates, terms and conditions of all the companies providing the auto loans. Comparison of the rates, the loan payment the tenure of the loan, the down payment or the initial payment to be made, the incentives or discounts that the companies offer must be identified. Before the loan agreement is signed the borrower should clear all his doubts by asking questions. He should try and get a copy of the agreement. Understanding the important clauses in the agreement or the contract will eliminate future troubles.

Most of the finance companies and banks market their loans through dealers or agents. Therefore, authentication of the dealer should be found out. Any ambiguity with regard to the dealer, in whose favor the post-dated cheques should be drawn for the repayment of the loan, should be cleared. Most lenders including foreign banks make the borrower sign 20-30 pages of documents. Even if one document is missed, then the loan will be rejected. If the borrower is not able to understand the terms and conditions of these documents then he should prefer any other lender or bank.

One important aspect that all borrowers follow is reading the loan application carefully. The following aspects should be noted:

- Check for any pre-payment penalty. If it is there, then go for the lowest possible rate for the penalty.
- Longest grace period should be known. The loans which give the maximum number of days for repayment without an interest charge are ideal.
- Whether interest rate is consistent throughout the contract.
- The terms and conditions may be printed finely and the borrower should make it a point to read the entire writing. The marketing person may intimate that the terms in writing must not be valued but actually it counts when a problem arises after the loan has been availed.
- The documents must be signed only after filling up the entire required blanks.
- The documents contained in the agreement booklet are as follows:
  - Hire-purchase agreement.
  - Schedule of charges, deposits and rates.
  - Irreversible power of attorney.
  - Promissory note.
  - Form 20 for the registration of the vehicle.
  - Certificate of inspection.
  - Form 26 for intimation of loss or destruction of certificate of registration and application of a duplicate certificate.
  - Form 27 for assignment of new registration mark on moving the vehicle to another state.
  - Form 28 for no-objection certificate and grant of certificate.
  - Form 29 notice to transfer the ownership of vehicle.
  - Form 30 report of transfer of ownership of the vehicle.
  - Form 34 applications for making an entry of an agreement of hire purchase/lease/hypothecation, subsequent to registration.
  - Form 35 notice of termination of an agreement of hire purchase/lease/hypothecation dealer authorization letter.
  - Signature verification.
  - Disbursement Memo.
- The cheque must be given for processing, insurance and the initial amount.
- The car delivery can be taken directly from the dealer.
- The loan installment must be paid regularly.
- A copy of computation of interest sheet or the loan statement at the end of every year should be collected to verify the interest rates charged.

- The borrower should ask the bank to release a lien on the car after the entire loan has been repaid.
- The borrower should ask the institution to give a 'Loan Clearance Certificate' after the entire loan has been repaid, to avoid any future controversies.
- There is no specific rule or regulation passed on how the interest rates must be charged. Therefore, the borrower should be very cautious as most of the lenders get chance to squeeze money. The loan could be very costly if exact charges are not known. Therefore written document about the charges must be taken by the borrower. Some lenders may not give the written document; if so, he is not a reliable lender. Some friends or relatives must be consulted to know about better lenders from whom they might have taken the loan and their experience. If the borrower is satisfied then the deal must be carried on.

Different Kinds of Auto Loans

Most of the financial companies and banks provide 90% of the finance depending upon the type of the car and the repayment period. Banks and other companies have become very competitive as there are different loans available in the market. Since customer is the ultimate choice maker it is the obligation of all the companies and banks to provide with the best facilities and alternatives; otherwise it would be very difficult to survive in such competitive environment. There are numerous auto loan schemes and some of them are as follows:

MARGIN MONEY SCHEME

Margin money is a payment to be made by the borrower. It is usually 10% of the total loan amount, along with EMI. Then post-dated cheques are issued for the remaining EMI. Not more than one installment should be made every month nor any charges should be paid that may increase the effective rate of interest on the loan. In certain cases the borrowers may overlook the terms of payment which are mentioned in the fine print and may end up paying more than required. Margin money scheme is most preferred if the repayment term is between one to five years.

ADVANCE EQUATED MONTHLY INSTALLMENT SCHEME

There is no need for down payment from the borrower. The loan is paid 100%. Five EMIs have to be given in advance and the rest is paid through post-dated cheques. The number of EMIs to be given depends on the tenure of the loan. Even though 100% financed 5-10 installments should be given in the beginning. The EMI goes on increasing because interest is charged on the entire loan amount.

SECURITY DEPOSIT SCHEME

According to this scheme certain amount must be deposited as security against the loan. It is refundable after the entire loan amount has been paid. Interest including compound interest will be received on the deposit amount but this amount is less than the rate charged on the loan. The EMI on this type of loan is higher when compared to the EMI of the other two schemes. The security deposit will be 10-30% of the total loan amount.

HIRE PURCHASE SCHEME

According to this scheme, a car is let on hire and also provides an option to purchase the car in accordance with the terms and conditions of the agreement. Usually non-banking financial institutions offer hire purchase. When the car is taken over by the hirer, an amount is charged which is less than one rupee and is called Option Money. This is charged by the non-banking financial institutions as they are not encouraged to offer loans because it has always been the privilege of the banks.

LEASE FINANCING PURCHASE

Lease contract is the contract between the lessee and the lessor for the hire of the asset. Lessor is the owner of the asset and the lessee is the user of the asset. The right to use the asset is with the lessee, but the ownership lies with the lessor.

The asset is hired for an agreed period of time and period-wise rent must be paid by the lessee to the lessor. Lease financing is issued by the non-banking financial institutions, corporates also avail this type of loan facility as it is tax saving. Lease Financing was very popular until few years back, but government exposed the loopholes involved in such financing and it lost its popularity.

Comparison of Loan, Lease and Hire Purchase Schemes:

	Loan	Hire Purchase	Lease
Ownership	The person to whom the loan has been issued.	The financier.	The financier.
Depreciation	The borrower claims for the depreciation.	The borrower.	The financier.
Interest Write-off	The interest is claimed against income.	The interest component of the hire rentals can be deducted from the income.	Entire rental and maintenance costs can be claimed against income.

Eligibility and Documentation

Eligibility for auto loans:

Since there are lots of companies providing auto loans, the requirement differs from company to company. But the general eligibility criterion is as follows:

- **Age of the Borrower:** There is a minimum and maximum age limit for a person to avail loan.
- The time period of the loan.
- **The Employment Period of the Borrower:** The number of years left for the service in the job.
- **Collateral Securities:** Usually, a car is taken as the collateral security when the loan is taken.
- **Any Deviation taken for Sanctioning the Loan to the Borrower by the Credit Assessing Officer:** Sometimes the borrower may be a reliable customer but due to certain reasons like performance on any other loan availed by him may give few points less. Then the credit officer takes a deviation and sanctions loan to such a customer.

Documentation for Auto Loans

There may be different classes of customers applying for loan. Therefore, different documentation papers are required for each class. The class may be salaried, self-employed, partnership firms, public/private limited companies. The documents required for each sector may be discussed in detail.

Documents Required for Salaried Sector

- **Proof of Income:** Two latest salary slips which should be attested with TDS certificate or Form 16.
- **Residence Proof:** Photo copies of insurance policy/ration card/driving license/ voter ID card/electricity bill/phone bill.
- **Credit History:** The borrower’s credit history must be verified with the bank manager. Photocopies of the bank statements showing the latest 3 months transactions should be attached. These transactions should not include any cheque bounces or late payment charges or wrong transactions.
- Photographs of the borrower must be provided.
- Identification proof like passport, office identity card, driving license.
- Signature verification from the bank should be collected.

Documents Required for the Self-employed Sector

- Balance sheet, the trading and profit and loss account for the last two years which has been certified by the auditor. The P&L statements for the last two years are checked in order to find out the stability of the business and its profits and losses.
- Copy of IT returns for the last 2 years.
- Residence proof which includes photocopies of the ration card, or electricity bill, or telephone bills, or driving license.
- Photographs of the borrower as this sector is considered most risky sector. The default rate in this sector is usually more.
- Signature verification from the bank.
- The declaration on the letterhead of the company should be collected stating that the concern is sole proprietorship.
- Latest documents with regard to any loan or credit card availed from any other company should be collected from the borrower. These documents are collected to find out the promptness about the borrower. Whether he is a reliable borrower, whether is making prompt payments, whether any cheques produced by him bounced or whether availing loans is a habit for the borrower, etc.

Documents Required for a Partnership Firm

- **Proof of Income:** Balance sheet and trading and profit and loss account which is certified by the chartered accountant.
- Copy of acknowledgement of IT returns of last 2 years.
- **Existence Proof:** Telephone bill/electricity bill/sales tax certificate/SSI registration certificate/shops and establishment Act.
- **Credit History:** The credit report of the firm must be verified. Not only must the verification of the report but also the credit assessment of the firm be made by collecting information about the firm from the bank manager.
- The firm and its reputation must be known from various sources like people, other offices who maintain relations with this firm, etc.
- The partnership deed should be verified. This is to know the number of partners in the firm. Entire information about the partners should be known. The profits and losses shared are also known from the partnership deed. The reliability of all the partners should be known.
- Letter of authority should be collected from all the partners authorizing one person to sign and execute all the confidential documents of the firm in the letterhead of the concern.
- Verification of the signature should be collected from the bank as also the account number and the number of years this account has been in operation. The verification from any other bank or finance company from where loan has been availed.

Documents Required for the Public/Private Limited Companies

The bank or finance companies may have to provide loans to private or public limited companies. Certain important documents need to be collected:

- **Proof of Income:** Balance sheet, trading and profit and loss statement of last two years that should be certified by a chartered accountant.
- The acknowledged copy of IT returns of last two years.
- Proof of existence that includes the telephone bill/electricity bill/sales tax certificate/SSI registration certificate/Shop and Establishment Act certificate.

- **Credit History Verification:** The credit history of the company should be verified from the bank. Only the report should be good when the loan is granted. The risk involved in this sector is high because lending a company or a business firm includes huge amount. Photocopies of bank statements showing the transactions of last three months should be collected.
- Memorandum and Articles of Association should be verified.
- The board of directors should give their authorized signature on the letterhead that states authorizing any other director to enter into agreement with the finance company.

Some of the Banks that Offering Auto Loans

ABN AMRO BANK

ABN Amro Bank offers car finance under the following three categories:

- Standard cars include Maruti Zen 800, Wagon R, Gypsy, Fiat Uno, Ambassador, etc.
- Premium cars include Esteem, Baleno, Opel Astra, Opel Corsa, Tata Sierra, Ford Ikon, Hyundai Accent, Mitsubishi Lancer, etc.
- Luxury cars include Mercedes Benz.

The car loans are offered to individuals as well as companies. The loans cover up to 90% of ex-showroom price for new cars and 75% of value (as determined by bank) on used cars. ABN Amro offers two payment plans. The details of which are as follows:

Arrears (Classic)

EMI starts from the first of the month following the disbursal month for loans booked between 1st and 15th of a month. EMI starts from the 16th of the month following the disbursal month for loans booked between 16th and 31st of a month.

Advanced EMI

Customer pays the 1st EMI in advance along with the loan application to the dealer. The advantage being EMI per lakh being less than the arrears scheme. Customer pays the 1st EMI in advance along with the loan application to the bank. In this case the EMI per lakh being the same as the arrears scheme.

The other schemes offered by ABN AMRO is as follows:

Pre-payment Options

Partial Prepayment: This facility allows the customer to pay-off the loan partially. There is no lock-in period for the loan amount. This option is allowed once in every calendar year. There are zero prepayment charges for payment up to 25% of the loan outstanding. This facility is allowed from the beginning of the loan.

Full Prepayment: This facility allows customers to fully prepay the loan on a minimal prepayment charges from day one. A charge of 4% is levied on 75% of the outstanding balance, provided 25% prepayment facility has not been availed in that calendar year. No charges are levied on complete prepayment after three years (provided all EMIs are paid satisfactorily).

Options are available where you can payback the loan by way of monthly installments spread over a period ranging from 1 year to 5 years.

Eligibility

Salaried Individual

Gross Annual Income should be above Rs.60,000 for standard cars and above Rs.1,00,000 for premium cars.

Self-employed

Individual: Individual may be a proprietor, a partner, a professional, or a director, with a Gross Annual Income of Rs.60,000 for standard cars and above Rs.1,00,000 for premium cars, is eligible to apply for an ABN Amro Car Loan.

Partnership Firm

Gross Annual Income should be above Rs.60,000 for standard cars and above Rs.1,00,000 for premium cars.

Private or Public Limited Company

Private Limited Companies should have been in existence for at least two years and have a minimum PAT of Rs.60,000 for a standard car or a minimum PAT of Rs.1,00,000 for a premium car.

Public Limited Companies should have been in existence for at least two years and have a minimum PAT of Rs.60,000 for a standard car or a minimum PAT of Rs.1,00,000 for a premium car.

Documentation

For Salaried Individuals/Self-employed/Sole proprietorship:

- Application form
- Photograph
- Bank signature verification
- Income Proof (Any one of the following)
  - ITR (Income Tax Returns)
  - Form 16
  - Salary slip
  - Appointment letters.
- Identity Proof (Any one of the following)
  - Laminated Driving License
  - Voters' Identity Card
  - Passport
  - PAN Card
  - Photo Credit Card
  - Photo Ration Card.

For Partnership Companies:

- **Identity Proof:** Certified true copy of partnership deed giving evidence three years of existence.
- **Income Proof:** Certified true copy of audited balance sheet and profit and loss statement for last two years or Chartered Accountant certified true copy of unaudited balance sheet and profit and loss statement along with IT returns.

For Limited Companies:

- **Identity Proof:** Certified true copy of Memorandum and Articles of Association and copy of certificate of incorporation.
- **Income Proof:** Audited balance sheet and profit and loss statements for the latest and previous financial year.

Interest Rates

Interest rates for standard cars varies from 17% to 18%

Interest rates for premium cars varies from 16.75% to 18%.

HDFC Bank

HDFC banks also give car loans based on three categories of cars as that of ABN Amro.

The car loans are offered to individuals as well as companies. The loans cover up to 90% of ex-showroom price for new cars as well as used cars (valuation based on bank recommendations). Options are available where you can payback the loan by way of monthly installments spread over a period ranging from 1 year to 5 years. The eligibility criterion includes:

Minimum Age: 21 years

Maximum Age: 65 years

Minimum household income: Rs.96,000

Documentation:

For Salaried Individuals/Self-employed/Sole proprietorship:

- Application form
- Photograph
- Bank signature verification
- Income proof (Any one of the following)
  - ITR (Income Tax Return)
  - Form 16
  - Salary slip
  - Appointment letter
- Identity Proof (Any one of the following)
  - Laminated Driving License
  - Voters' Identity Card
  - Passport
  - PAN Card
  - Photo Credit Card
  - Photo Ration Card.

For Partnership Companies:

- **Identity Proof:** Certified true copy of partnership deed evidencing three years of existence.
- **Income Proof:** Certified true copy of audited balance sheet and profit and loss statement for last two years or Chartered Accountant certified true copy of unaudited balance sheet and profit and loss statement along with IT returns.

For Limited Companies:

- **Identity Proof:** Certified true copy of Memorandum and Articles of Association and copy of certificate of incorporation.
- **Income Proof:** Audited balance sheet and profit and loss statements for the latest and previous financial year.

Interest rates vary from 16% for new cars to 21% for used cars.

ICICI BANK

ICICI offers car finance for new as well as used cars. The car loans are offered to individuals as well as companies. The loans cover up to 90% of value of the car. One can avail up to 90% of value of the car one wants to purchase through the loan. Options are available where you can payback the loan by way of monthly installments spread over a period ranging from 1 year to 5 years. The repayment due dates for every monthly installment are the 1st or the 7th of every month and payment would be collected through post-dated cheques.

Eligibility

Salaried Individual

Gross Annual Income should be above Rs.1,00,000.

Self-employed Individual

If an individual is a proprietor, a partner, a professional, or a director, with a Gross Annual Income of above Rs.60,000, then he is eligible to apply for an ICICI Car Loan.

Partnership Firm

The firm should have a minimum Profit After Tax (PAT) of Rs.60,000 for a standard car or minimum PAT of Rs.1,00,000 for a premium car.

Private or Public Limited Company

Private Limited Companies should have been in existence for at least two years and have a minimum PAT of Rs.60,000 for a standard car or a minimum PAT of Rs.1,00,000 for a premium car.

Public Limited Companies should have been in existence for at least two years and have a minimum PAT of Rs.1,00,000 for a standard or a premium car.

Documentation:

- Application form
- Photograph
- Bank signature verification
- Income proof (Any one of the following)
  - ITR (Income Tax Returns)
  - Form 16
  - Salaryslip
- Identity proof (Any one of the following)
  - Laminated Driving License
  - Voters' Identity Card
  - Passport
  - PAN Card
  - Photo Credit Card
  - Photo Ration Card
- Proof of Residence (Any one of the following)
  - Driving License
  - Voters' Identity Card
  - Photo Ration Card
  - Passport
  - Utility Bills for the last 3 months
  - Limited company or Govt. ID card/PAN card.

The following depicts the interest rate and EMI for different tenor for different brands of cars:

Ambassador, Tata Estate, Tata Sumo, Tata Sierra, Maruti Gypsy

Tenor (in months)					
	12	24	36	48	60
Interest rate (%)	16.5%	16.5%	16.5%	-	-
EMI (per Rs. Lakh)	8,973	4,853	3,492	-	-

Maruti Baleno, Opel Corsa, Ford Ikon, Mitsubishi Lancer, Opel Astra, Daewoo Cielo, Hyundai Accent, Mercedes Benz, Honda City

Tenor (in months)					
	12	24	36	48	60
Interest rate (%)	15.75%	15.75%	15.75%	15.75%	15.75%
EMI (per Rs.Lakh)	8,944	4,821	3,458	2,785	2,387

Tata Safari, Fiat Uno, Fiat Sienna

Tenor (in months)					
	12	24	36	48	60
Interest rate (%)	16.5%	16.5%	16.5%	16.5%	16.5%
EMI (per Rs.Lakh)	8973	4853	3492	2821	2425

Tata Indica, Daewoo Nexia, Daewoo Matiz, Maruti Zen, Maruti Esteem, Hyundai Santro, Toyota Qualis

Tenor (in months)					
	12	24	36	48	60
Interest rate (%)	16%	16%	16%	16%	16%
EMI (per Rs. Lakh)	8954	4832	3469	2797	2400

Maruti Omni, Maruti 800

Tenor (in months)					
	12	24	36	48	60
Interest rate (%)	16.25%	16.25%	16.25%	16.25%	16.25%
EMI (per Rs.Lakh)	8964	4843	3481	2809	2412

Source: www. indiainfoline.com

PERSONAL LOANS

It is a consumer credit. It is an unsecured loan that is granted for personal use based on the borrower's integrity and ability to pay. Some consumers need additional or extra cash for buying a new computer system or washing machine. The main features of personal loan are:

– The sanctuary required for the loan.

– The interest rate or the APR.

– The repayment tenure.

Personal loans are considered as a growing type of loan. It is also the product that the banks are finding a demand for in the market, according to Jane.C.Yao, Managing Director of American Bankers Association, a Banking Trade Group.

When the customer is planning to avail a personal loan then he needs to be cautious about the following:

Lower monthly payments are attractive, but, not always good. The customer should never feel keyed up with lower rates. The amount of credit available must be clearly known. The customer should also look into the hidden charges by interacting with the lender frequently. This also helps the customer to find out if there are any loopholes. Associated fees should be known, if any. Certain itemized charges information must be known like credit insurance, associated buying clubs and extra cash. The finely printed terms and conditions should be read and complete knowledge about the contract should be gathered. If there is any difference in, what the loan officer has communicated and what is written in the agreement, then the customer must outrightly reject the acceptance of the loan and the agreement. The customer should always bear in mind that what is in writing is important and that is what matters when any dispute arises between the customer and the lender. Bigger loans are not always better. Sometimes a loan officer tries to take money that was originally planned. The reason being if the officer convinces a customer for higher loan then he may get commission (more likely to take place in finance companies).

Types of Loans

There are two categories in personal loans. One is secured loans and the other is unsecured loans. The difference between these loans is that the secured loans need collateral security for availing the loan. The loan officer has the right to seize the collateral security if prompt payments are not made. High-rate collateral security reduces the risk for the lender and results in low rate of interest for the borrower. If individuals are declared bankrupt or credit history is poor and want to avail a personal loan, then they will have to pledge high-rate collateral security on the loan.

UNSECURED LOAN

Unsecured loans are loans that do not require any kind of collateral security for availing the loan. If the credit history of the customer is excellent and if he is financially sound then he is granted loan without any kind of security. Most of the unsecured loans limit is less say, Rs.50,000 or less.

Interest Rates

Interest is charged on this kind of loan. Since different lenders calculate interest rates differently, statutory regulations set out the calculation for the Annual Percentage Rate of charge (APR). APR is the true rate of interest charged on availing the loan that takes into account the total cost of interest and other charges like the broker’s fees, legal fees, etc. APR gives the customer a comparison between the loans.

Repayment Tenure

The repayment tenure on the loan states the time over which the loan will be repaid and the monthly payments. The size of the loan repayments together with the interest is known.

Credit Insurance

There are chances that the customer may become financially unsound to pay the monthly payments. In such a case credit insurance is useful. It is an insurance policy that continues the repayment of a particular debt. Most of the lenders offer credit insurance to the borrowers and a monthly premium is paid as a part of monthly repayments on the loan. Credit insurance is not included in the calculation of APR. Therefore a loan with or without credit insurance will have the same APR, but the monthly payments will be different.

Early Repayment Penalties

If a particular loan is repaid before its maturity period then some lenders impose penalty. Therefore these charges should be carefully understood if the customer wants to repay the loan early or before the maturity period.

Repayment Term

The customer should choose the period which he thinks best suits him. It can range from one year to seven years depending upon the capacity to repay.

Speedy Decision

Once the customer has applied for a loan then he usually receives a decision of granting the loan within 24 hours. If a loan has been applied through phone, usually an instant decision is given with regard to approval of the loan. If the loan has been approved then the customer receives an agreement for his signature and then returned. As soon as the lender receives the agreement, a cheque is sent to the customer or cash is credited to the customer's account.

Charges or Fees

There are no early repayment fees or additional charges levied on the customer. For unsecured loans the interest rebate will not be calculated on pro-rata basis. The table below shows the percentage of interest that will be deducted from the total amount if the loan is paid off early:

There may be circumstances when the customer may lose his job or he may meet with accident and may become disabled or may lose his life after an accident etc., questions arise on the loan repayment on who is responsible and whether anybody is liable on for repaying the loan. There are certain protective measures, which can be availed by the customer from the lender.

LOAN CARE COVER FOR THE UNSECURED LOANS

This cover is more popular and usually offered by banks in US. If the customer is unemployed continuously for 30 days the loan care cover manages to make the monthly repayments up to a maximum of $1500 per month until the customer finds a new job or up to a maximum of 12 months whichever is shorter. Suppose a customer dies before the period of loan then the loan care cover pays the entire amount. If the customer meets with an accident and is unable to work for more than 30 days or is down with illness for more than 30 days, then the loan care cover repays the loan amount for the remaining period or until the customer returns to work whichever is less. Cover can be added only at the beginning of the loan. The premium is included along with the monthly repayments.

The loan cover is available only if the following conditions are satisfied:

- The customer should be the first named person on the loan.
- He should be below 65 years.
- He should be a permanent resident of that country from where he is availing the loan facility.
- Continuously employed at least for 6 months from the time availing of the loan.

Like any other insurance policy, the loan care cover also excludes certain claims. These exclusions will not apply if the customer has been working with the same employer for more than two years:

- No claim will be paid for any self inflicted injuries.
- No claim for normal pregnancy unless there is any complication.
- No claim for unemployment which begins or which the customer is notified within 60 days of the start date of the loan.

- No claim will be paid for any kind of casual, temporary or occasional work.
- No claim will be paid for any misconduct or any actions which contribute to dismissal or removal from the job or voluntary unemployment.
- No claim will be provided which is beyond the termination of any contract or agreement.

Some of the banks that provide personal loans are as follows:

ABN AMRO

Money for any purpose. This is what personal loans are for. Use the loan amount for buying a favorite music system or take ones' family on a holiday or for a more long-term purpose like buy a computer for ones' child. And getting it is quite easy. A salary slip, proof of personal identity and signature will be enough. ABN Amro bank offers personal loans to salaried and self-employed. For salaried persons, ABN Amro bank has two categories of eligible employees on which a person is given a loan and they are: Category A and Category B. ABN Amro bank has the most comprehensive list of approved self-employed professionals. ABN Amro bank has certain special programs designed for the convenience of customers, for example, if a customer is a credit card owner, and would like to avail personal loan to offset his or her credit card liability, then ABN has such a program that suits his requirement. Also ABN has special programs for its existing customers wherein they can avail a lower rate of interest.

Bank	ABN Amro Bank
Eligibility:	Salaried: Minimum Gross Income p.a. Rs.1,00,000 Self employed Professional: Minimum Gross Income p.a. Rs.1,00,000/- & Gross Annual Turnover Rs.7,50,000/-
Minimum Loan Amount:	Rs.50,000/-
Maximum Loan Amount:	Rs.7,50,000/-
Maximum Tenure:	4 years
Interest Rate:	12%
Effective Interest Rates:	21% on monthly reducing balance
Frequency:	NA
Margin Required:	Nil
Security Required:	Nil
Documentation:	Proof of age
	Proof of residence
	Proof of identity
	Post dated cheques
	Last two months salary slips
	Last 6 months bank statements
	Proof of qualification
	IT returns for past 2 years
Remarks:	Loan available only to the bank's approved list of companies.

CITIBANK

For salaried persons, Citibank has two categories of eligible employees on which a person is given loan: Category A and Category B. There are over 6,500 companies that fall in Citibank's approved list of employers. Citibank has the most comprehensive list of approved self-employed professionals.

Bank	Citibank
Eligibility:	Minimum Annual Income: Self employed: Rs.85,000 Gross Others: Rs.96,000 Net
Minimum Loan Amount:	Rs.25,000
Maximum Loan Amount:	Rs.10,00,000
Maximum Tenure:	4 years
Interest Rate:	Category I – 11.5% Category II – 14%
Effective Interest Rates:	Category I – 20% Category II – 24%
Frequency:	Calculated on monthly reducing balance
Margin Required:	None
Security Required:	None
Documentation:	Proof of age
	Proof of residence
	IT returns for past 2 years
	Proof of qualification
	Post dated cheques
Remark:	The loan is provided only to people who are from a company that matches their list of companies.

HDFC BANK

For salaried persons, HDFC Bank has different categories of eligible employees to whom a loan can be given. There are over 6,500 companies that fall in HDFC Bank's approved list of employers. HDFC Bank has the most comprehensive list of approved self-employed professionals.

Bank	HDFC Bank
Eligibility:	Minimum Annual Income: Rs.96,000 Net
Minimum Loan Amount:	Rs.25,000
Maximum Loan Amount:	Rs.5,00,000
Maximum Tenure:	4 years
Interest Rate:	11.5%
Effective Interest Rates:	21%
Frequency:	Calculated on monthly reducing balance
Margin Required:	None
Security Required:	None
Documentation:	Proof of age
	Proof of residence
	IT returns for past 2 years
	Proof of qualification
	Post dated cheques
Remark:	The loan is provided only to people who are from a company that matches their list of companies.

ICICI BANK

ICICI Bank offers personal loans to both salaried and self-employed professionals. For salaried persons, ICICI Bank has a list of approved employers whose employees are eligible for an ICICI Personal Loan. ICICI Bank offers personal loan to Doctors and Architects in the self-employed professionals category.

Bank	ICICI Bank
Eligibility:	Minimum Annual Income: Self employed: Rs.80,000 Gross Others: Rs.1,20,000 Gross
Minimum Loan Amount:	Rs.20,000
Maximum Loan Amount:	Rs.3,00,000
Maximum Tenure:	3 years
Interest Rate:	11.9%
Effective Interest Rates:	21%
Frequency:	Yearly reducing balance
Margin Required:	None
Security Required:	None
Documentation:	Proof of age
	Proof of residence
	IT returns for past 2 years
	Proof of qualification
	Post dated cheques
Remark:	The loan is provided only to people who are from a listed company that matches their list of companies.

STANCHART BANK

Standard Chartered Bank offers Professional Loans better known as Professional Credit to only self-employed professionals. Standard Chartered Bank offers Professional Loans to:

- Doctors
- Chartered Accountants
- Architects
- Management Consultants
- Cost Accountants
- Company Secretary
- Engineers.

Bank:	Standard Chartered
Eligibility:	Professional residing within city limits and over 27 years of age
Minimum Loan Amount:	Rs.50,000
Maximum Loan Amount:	Rs.5,00,000
Maximum Tenure:	5 years
Interest Rate:	13%
Effective Interest Rates:	23%
Frequency:	Monthly
Margin Required:	None
Security Required:	None
Documentation:	Proof of age
	Proof of residence
	IT returns for past 2 years
	Proof of qualification
	Post dated cheques
Remarks:	The bank offers the loan for any purpose, i.e., for personal use or professional use. The loan is given only to people who are from their list of companies.

The following is the EMI table for loans of different tenures:

EMI per Rs.1,00,000	1yr	2yr	3yr	4yr	5yr
Countrywide	9,554	5,388	3,999	-	-
Stanchart	9,408	5,237	3,871	3,205	-
ANZ	9,312	5,139	3,768	3,097	2,706
Citibank	9,264	5,090	3,717	3,044	-
ABN Amro Bank	9,311	5,139	3,768	3,097	-
ICICI	9,311	5,139	3,768	-	

Source: www.indiainfoline.com

EDUCATIONAL LOANS

Education plays a very important role in India. People struggle to earn to give their children the best of education. Literacy rate in India stands at 53% of the population. Since most fields in education have become advanced a lot of people tend to give their children education in these advanced areas. To provide excellent education people require lot of investment. Understanding this problem of people, most banks and other financial institutions are now providing a variety of educational loans with reasonable interest rates. So people have a choice on the kind of educational loan that suits them and their repaying capacity. Few years back, educational loans were offered to students going to abroad for higher studies. But now because of the rapid advancement of technical educations in India itself, students have the facility for best higher education in India which saves a lot of money. People are ready to acquire education in spite of high fees as they can avail educational loans from banks. These loans are repayable in monthly installments, which are affordable.

The idea of selling educational loans was earlier tough in India as people did not generally take up loans. But now things are changing. As the expenses for education have increased, youth are not willing to let their parents pay-off and not willing to be a burden on their parents. They opt for the loan and work side by side and the amount earned is used for the repayment of the loans. This is an advantageous as the youth learns to struggle and have become more independent and responsible. Since educational loans have become primary sector lending, formalities involved are reduced and it is easier and cheaper to get educational loan for a child's bright future. The lower interest rates are actually the icing on the cake for those availing educational loan.

The best feature of such loans is that most banks provide a 'loan holiday' and start recovery one year after the course is completed and the individual gets into a suitable job. Other features are:

- Flexible repayment scheme
- Fast approval and turnaround time
- No collateral or Guarantor required (applies to specific banks only)
- Covers Tuition Fees and Insurance Premiums
- High Margin of Financing (approx. 80%)
- Peace of Mind – Insurance Benefits.

Eligibility

The customer availing for the loan should be an Indian citizen. He should have secured the admission to professional or technical courses through an entrance test or selection process.

There is no additional charge or processing fee. The outstanding interest for the moratorium period will be added to the loan amount at the time of commencement of the repayment. The EMI will be determined on this amount at the time the repayment is to commence. This installment comprises both principal and interest components. The EMI would be calculated depending on the tenor one chooses, to repay the loan. The EMI would be higher if the loan is to be repaid within a shorter period as against a longer term loan. A shorter repayment period, however, reduces the interest cost over the term of the loan. The repayment would begin one year after the course period or six months after the student gets a job, whichever is earlier. A minimum amount equivalent to the EMI on a monthly basis should be paid. However, one can choose to pay more than the EMI, and there is no prepayment penalty charged.

Here is an overview of some of the banks that offer educational loans:

BANK OF INDIA

Name of the Educational Loan: Vidya Vardhini Scheme

Purpose: Pursuit of studies in India and abroad

Eligibility: Should be a citizen of India. For vocational training courses and job oriented course age of the individual should be between 15-28 years, and 18-30 years in case of post-graduate courses and/or studies abroad. The applicant should have a good academic record. For studies abroad, the candidate should have secured admission in a particular university after having appeared in the specific entrance examinations. The applicant should have secured a minimum of 50% marks in the major subject. In case of SC/ST candidates eligibility norms may be relaxed.

Amount of Loan: The loan could vary depending on the specific subject requirement for studies abroad upto Rs.15 lakh. Loan for studies in India it is Rs.7.5 lakh.

Margin:

Up to Rs.4 lakh – nil

Over Rs.4 lakh

– for studies in India- 5%

– for studies abroad-15%

Repayment: Within 15 years from the first date of disbursement, including moratorium period.

CENTRAL BANK OF INDIA

Name of the Educational Loan: Cent Vidyarthi Scheme.

Purpose: Aims at bringing education within the reach of students and helps them improve their prospects in life.

Eligibility: Should have consistent good academic record in previous examinations with marks over 60% in 10th and 12th or first grade in other cases. (For SC /ST second class will be sufficient).

Amount of Loan:	India up to Rs.7.50 lakh	
	Abroad up to Rs.15 lakh	
Margin:	Up to Rs.4 lakh	
	Over Rs.4 lakh - In India	5%
	Studies Abroad	15%
Rate of Interest:	Up to Rs.4 lakh – PLR	
	Above Rs.4 lakh – PLR + 1%	

STATE BANK OF HYDERABAD

Purpose: For pursuing studies in recognized schools/colleges/institutions to meet:

– Tuition and other fees.

– Maintenance costs, books and equipment, etc.

– Cost of passage (for studies abroad).

Eligibility: For School/College education in India.

a. Minimum second division (Pass marks for SC/ST).

b. Parents/guardians (Including persons engaged in agriculture/allied activities, having independent regular source of income.

Loan Amount

i. ***School/College Education in India:*** (Up to 6 times the monthly net (take-home) income of the parents/guardian. Minimum loan is Rs.4,000 Maximum Rs.1 lakh.

ii. Technical/Professional higher studies in India and abroad 90% of the cost of study, subject to maximum of Rs.8 lakh. Margin is 10%.

iii. ***Interest Rates:*** At competitive rates on reducing balance only. Latest rates available at any SBH branch. Interest is compounded at quarterly basis.

Period of Loan

i. ***For School/College Education in India:*** Loans to be repaid in a period of 36 months, commencing immediately after disbursal, by the parents/guardian.

ii. ***For Technical/Professional Higher Studies in India and Abroad:*** The loan is to be repaid in 60 months after the completion of the course or securing a job, whichever is earlier. Regular periodic repayment as much as possible should be made during the period of study. Quarterly interest should be paid regularly.

iii. Prepayments permitted without any penalty.

STATE BANK OF INDIA

Purpose: You can take a loan for pursuing studies in recognized schools/colleges/ institutions to meet:

- Tuition and other fees,
- Maintenance costs, books and equipments, etc.,
- Cost of passage (for studies abroad),
- Caution fund/building fund/refundable deposit.

Eligibility

- Should be an Indian National.
- Secured admission to professional/technical courses through Entrance Test/ Selection process.
- Secured admission to Foreign University/Institution.

Loan Amount

- Studies in India - Maximum Rs.7.50 lakh.
- Studies Abroad - Maximum Rs.15 lakh.

Margin

Up to Rs.4 lakh: No margin

Above Rs.4 lakh

- Studies in India: 5%.
- Studies Abroad: 15%.

Interest

Lowest interest rates

Loan Amount	Interest Rate
Loans up to Rs.4 lakh	SBMTLR presently 12.00 % p.a.
Loans over Rs.4 lakh	1% above SBMTLR presently 13.00 % p.a.

While interest is not required to be paid during moratorium period, payment of the same before start of repayment would entitle you to concession in interest rate applied during the repayment holiday.

Repayment of Loan

- Repayment Holiday – Course period + 1 year or 6 months after getting job, whichever is earlier.
- The loan is to be repaid in 5-7 years after commencement of repayment.
- Prepayments permitted without any penalty.

The following is the revised interest rates with effect from 01-07-2003.

Education Loan Scheme Revised Interest Rate Structure (w.e.f. 01.07.2003)		
For loans up to Rs.4.00 lakh	SBMTLR	10.75%
For loans above Rs.4.00 lakh		11.75%

Source: www.statebankofindia.com/personalbanking/pm_int.asp#education

HDFC

Purpose: HDFC gives loans to students to partly meet their educational expenses/costs for pursuing specific higher educational courses at institutes approved by HDFC. Loans are given to students who are citizens of India. The student should have a consistent good academic record, and admission to an approved Educational Institute for pursuing a recognized course.

Eligibility: Students enrolled with an approved Educational Institute and desirous of availing the education loan can make an application, with the earning parent/guardian being the co-applicant to the loan. Currently, new entrants and existing students of only select leading national educational institutions are eligible to apply for education loans. Please check with HDFC Office for the list of approved institutions.

Amount of Loan: Loans can be availed up to a maximum of 90% of the total cost as determined by HDFC. The costs would generally cover expenses incurred towards the course fee, library charges, hostel and mess charges, cost of books and equipment. HDFC lends up to a maximum of Rs.2,00,000 on an educational loan.

The period of the loan is determined on the merits of each case but would not exceed 5 years. The repayment can be accelerated on completion of the course, considering the earning capacity of the student. HDFC's main concern is to help individuals to comfortably repay the borrowed amount.

Rate of Interest

Loan Amount (Rs.)	Rate of Interest - 12% p.a.
Up to 2,00,000	14.0

CITIBANK

Purpose: For Students of GNIIT program of NIIT.

Period of Loan: 84 months (max.)

Loan Amount: Rs.50,000 – Rs.2,00,000

Eligibility: Parent/Guardian Min. /Max 25/65.

Salaried Parent/Guardian must meet criteria Salary net take-home income should be above Rs.8,000 p.m.

Self-employed Salary of Parent/Guardian: Gross income for doctors should be above Rs.60,000; for others Gross income should be above Rs.85,000.

Mode of Payment: Post-Dated Cheques (PDCs) Guarantors required – None.

Security/Collateral: None.

Any Special Benefit/USP of the Scheme (not covered earlier)**:** Free international card with every loan sanctioned.

MORTGAGE LOANS

Many people feel mortgage lending process is very complicated and difficult to steer. Some mortgage sources are direct lenders such as mortgage banks with retail establishments. Mortgage loan is a secured collateral loan where the borrower is liable to predetermined set of payments for the repayment of the loan. The collateral security may be in the form of real estate property or an asset etc.

Indian mortgage finance industry has grown impressively in the last 5 years. The reason could be the decline in mortgage interest rates, credit accepted as a means of finance for the purchase of an asset and various tax incentives provided by the government. Increase in the income levels with stable/declined property prices, increased urbanization levels; increase in share in the mortgage finance sector also widened the growth in the mortgage finance industry. Since last three years there have been significant changes in the structure of mortgage industry. This may be due to growth in the mortgage loan disbursements when compared to the housing finance corporations. ICRA estimates that banks have surpassed the housing financial corporation in the mortgage market that is estimated to be Rs.700 billion at the end of 2003. Even though the industry has witnessed the entry of new players, the overall industry is dominated by large players such as HDFC Limited, ICICI bank, SBI and LIC Housing Finance. They account for 60% of the mortgage loans which are outstanding.

There are certain risk factors involved with mortgage lending. The insight about credit risk in the mortgage market is very low. The credit defaults have been moderate in India as housing financial corporations have targeted most of the prime borrowers. The credit default rate is expected to increase due to lack of foreclosure laws and uncertainty on the installment coverage on the loan. Lack of effective foreclosure laws would result in lower recovery of defaulted loans and higher loss. Uncertainty in installment coverage may occur due to sudden increase in interest rates which would burden some borrowers. Therefore, an effective implementation of the Securitization and Reconstruction Act is expected to have a favorable impact on the credit losses and hence profitability of the mortgage players.

A mortgage payment includes the principal amount, interest, taxes and insurance.

1. **Principal:** The repayment of the original amount borrowed on a monthly basis.
2. **Interest:** The cost of borrowing the principal amount, repaid on a monthly basis.
3. **Taxes:** Real Estate taxes paid to a local government agency.
4. **Insurance:** Homeowners insurance on the home. Also any mortgage insurance, which is paid to protect the mortgage company.

Types of Mortgages

Fixed: A fixed term (for example, 15 or 30 years) as well as a fixed interest rate. The interest rate and term are fixed at the start of the mortgage. The monthly amount for the payment of principal and interest will not change during the term of the mortgage.

Adjustable: Often referred to as an ARM (Adjustable Rate Mortgage). The interest rate on your mortgage will be adjusted up or down according to current interest rate levels. The monthly amount for your principal and interest payment will go up or down with these rate changes.

Fixed Rate Fixed Term Loans

Depending upon ones' plans, the banks offer conventional, fixed rate loans with convenient and flexible terms. These loans are fully amortizing, with a maximum loan amount of $322,700. For purchase transactions the Loan-to-Value (LTV) ratio shall not exceed 95%. For rate and term refinances the LTV shall not exceed 95%, for cash-back refinances the LTV shall not exceed 75%. Private Mortgage Insurance is required for loans with LTV in excess of 80%. Property must be owner-occupied. Late payments are subject to 5% late charge after 15 days.

Adjustable Rate Mortgage Loans

Premier Banks offer the following Adjustable Rate Mortgage (ARM) loans: 1 Yr; 3/1; 5/1; 7/1; and 10/1. Interest rates are tied to a benchmark adjusted to a constant maturity of one year with a margin of 2.75%. Interest rates and Interest rate caps vary by program. For purchase transactions the Loan to Value (LTV) ratio shall not exceed 95%. For rate and term refinances the LTV shall not exceed 95%, for cash-back refinances the LTV shall not exceed 75%. Private Mortgage Insurance is required for loans with LTV in excess of 80%. Property must be owner-occupied. Late payments are subject to 5% late charge after 15 days.

Jumbo Mortgage Loans

For Fixed Rate Fixed Term and Adjustable Rate Mortgage loans in excess of $322,700, Premier Banks offer Jumbo Mortgage Loans up to $1 million.

Down Payment or Initial Payment: One of the first questions that home buyers ask is "how much down payment are we going to pay". Unfortunately, there is no standard answer. Down payments will vary from 0% to upwards of 25% (with certain "non-conforming" loans). As an average, most home buyers make down payments in the 5%-15% range, although one's own personal situation may dictate more or less down payment. When factoring money for a down payment, one must also consider the closing costs, which will total in the 2-5% range, payable in cash at the time of closing.

Loan Against Shares: Sometimes borrowers may pledge their shares and take loan. This is providing a collateral security to the lender while availing a loan. If default occurs then the lender has every right to seize the shares and sell them to satisfy the unpaid loan amount. If there is still any deficiency then the borrower may or may not pay.

The following are the banks that offer mortgage loans:

ABN AMRO BANK

The loan amount is available by way of overdraft facility. For this the loan seeker will open a current account with ABN Amro Bank. The interest is charged upon the amount that is drawn from the account and not the amount of loan that is sanctioned. Say the amount of loan sanctioned to a particular customer would be Rs.7,00,000. Then he or she can draw from the current account to the extent of the amount of loan sanctioned i.e., Rs.7,00,000. But if he or she withdraws only Rs.3,00,000, then interest will be charged on Rs.3,00,000 only for the period the amount remains withdrawn. The interest is charged on average daily outstanding balance. The loan amount available under ABN Amro Bank loan against share program is as under:

Minimum Amount: Rs.1,00,000

Maximum Amount: Rs.20,00,000.

An Indian national above the age of 18 years and below the age of 65 years is eligible. The person has to be a resident of one of the following cities: Mumbai, Delhi, Chennai, and Kolkata. Documentation required is as follows:

- Application Form.
- Proof of Residence.
- Proof of Identity.
- Proof of signature of Borrower as well as the Guarantor.
- Overdraft Agreement-cum-Letter of Pledge-cum-Guarantee.
- Power of Attorney.
- Transfer Deeds for physical shares.
- Demat Pledge Forms.
- Pledge/Hypothecation form duly endorsed with the Pledge Order Number by the customer's DP physical securities.
- Proof of share ownership, like a dividend warrant photocopy, etc.

Interest Rates:

Loan Amount Rs.	Rate %	Annual Commitment Fees %
1,00,000 – 1000000	17.5	1.50
10,00,001 – 2000000	17.5	0.63

The other cost is the cost of Annual Commitment Fees. Annual commitment charges are debited to one's current account. This needs to be paid at the time of applying for the loan. In addition, there is an over limit fee of Rs.100 each time your outstanding amount exceed your limit. You will also be charged an additional 2% interest p.a. on the amount by which your outstanding exceeds the limit and for the period it is in excess.

CITIBANK

The loan amount available under Citibank loan against share program is as under:

Minimum Amount: Rs. 3,00,000

Maximum Amount: Rs.20,00,000.

Indian national above the age of 18 years and below the age of 65 years is eligible. The person has to be a resident of the following cities: Mumbai, Delhi, Chennai, Kolkata, Pune, Hyderabad, and Bangalore. Documentation required is as follows:

- Proof of residence
- Proof of identity
- Proof of signature of borrower as well as the guarantor

- Proof of share ownership, like a dividend warrant photocopy, etc.
- Transfer deeds for physical shares
- Demat pledge forms
- Account opening form to be signed by account holder
- Power of attorney.

Interest Rates:

Loan Amount Rs.	Rate %	Annual Commitment Fees %
3,00,000 – 5,00,000	17.5	1.5
5,00,001 – 10,00,000	17.0	1.0
10,00,001 – 20,00,000	16.5	0.5

Other Costs: The other cost is going to be the cost of Annual Commitment Fees. This needs to be paid at the time of applying for the loan. Annual commitment charges are debited to ones current account.

HDFC BANK

The loan amount available under HDFC bank loan against share program is as under:

Minimum Amount: Rs.10,00,000

Maximum Amount: Rs.10,00,000 to Rs.20,00,000

Documents required are as follows:

- Transfer deeds.
- Demat pledge forms.
- Xerox copy of dividend warrants of the shares/units pledged/covering letter from company received by shareholder at the time of transfer/allotment letter of rights/bonus issue/broker contract note.
- Xerox copy of valid Passport/driving license/ration card/recent telephone bill/recent rent receipt.
- Signed Photograph.
- Attestation of Borrowers and Guarantors signatures as per banks format.
- Account opening form to be signed by account holder.
- Overdraft agreement.

Interest Rates:

Loan Amount Rs.	Rate %
Rs.2,00,000	17.5
Above Rs.2,00,000	17.0
Rs.10,00,001 – Rs.20,00,000	16.5

The other costs involved are as follows:

Processing Charges: 1.00%

Penal Interest: 2%

Annual commitment charges are debited to one’s current account.

SINGLE PAYMENT LOANS

A loan that is granted to the borrower for a specified period of time is called a single payment loan. After the specified period of time or after the maturity of the loan the borrower is entitled to repay the entire amount. The entire amount includes the principal amount plus the interest. The maturity period ranges from 30 days to an year. They sometimes serve as interim financing which is used to pay bills or for purchase of consumer goods when the funds are unavailable but are expected to be forthcoming in future. Sometimes single payment loans are used by those customers who want to avoid the monthly installment payments and choose to make large payments at the end of the loan. Single payment loans are of two types secured and unsecured which are availed for any purpose like for a vacation or for purchasing a music system or for purchasing a television. Single payment loans help in rebuilding or establishing an individual's credit rating. The important loan features are as follows:

For availing a single-payment or any other loan, a customer should firstly submit a loan application. The loan application provides information to the lender about the purpose of the loan, whether it will be a secured loan or an unsecured loan, the financial condition of the borrower, etc. The loan officer verifies the customer's credit report and uses the loan application as a document to determine whether to grant the loan or not. As a part of the application process, three most important features are also considered:

Loan Collateral: Most of the single-payment loans are secured loans as collateral security is provided by the customer. Lenders prefer securities that are readily marketable like automobiles, jewelry or stocks or bonds. These items are sufficient enough to cover the principal portion of the loan in case the borrower defaults. In most of the cases, lenders file a lien and do not take the physical possession of the asset. Lien is a claim that permits the lender to seize the items served as collateral to satisfy the obligation in case the borrower defaults. Sometimes the lender can obtain Chattel mortgage from the borrower. Chattel mortgage is a mortgage instrument that gives title to the property of the borrower in the event of default. A collateral note is also collected from the borrower. Collateral note is a legal note which states that the lender has the right to sell the security in the event of borrower's default.

Loan Maturity: Usually the maturity period or tenure of single-payment loan ranges from one month to one year. Rarely may it extend to two years or more. When the customer avails a single-payment loan, he should be sure of the terms of repayment. He should choose the tenure which best suits him and his capacity. He should be sure that the maturity period is not extended too far as the finance charges payable increase. Since the loan is retired in single-payment the lender must be assured that the loan will be repaid even if uncertainty occurs in the future. Therefore, the borrower must be very careful while drawing a plan of his monthly budget.

Loan Repayment: The repayment of the single-payment loan is expected to take place on its maturity date. Usually the borrower repays the entire loan amount before the maturity date in order to reduce the finance charges. Occasionally funds required to repay this kind of loan is received prior to the maturity date. Commercial banks and other single payment lenders may not accept early repayment of the loan and may charge a prepayment penalty. It is an additional payment to be made by the borrower if he repays the loan before the maturity period. This is a charge paid over the remaining life of the loan. It is an amount to set a percentage of the interest. A borrower should always be sure about this penalty before he signs the agreement. Sometimes the customer may borrow a single-payment loan when there is shortage of money. Only when the loan matures, the customer realizes that making the payment of a big loan at one time affects the cash flow. The borrower should duly inform the lender that he can make only part payment or loan extension should be granted or some other arrangement can be made. In such a case the lender will agree for a loan rollover. It is a process of paying off the outstanding loan by taking another, with the guarantee that the interest and some of the principal amount is paid at time of rollover. The interest rate on the rollover may be high. Therefore the customer should be very careful on availing this kind of loan.

Rate of Interest	Loan Maturity						
	6Months	12Months	18Months	24Months	36Months	48Months	60Months
7.5%	Rs.170.33	Rs.86.76	Rs.58.92	Rs.45.00	Rs.31.11	Rs.24.18	Rs.20.05
8.0	170.58	86.99	59.15	45.23	31.34	24.42	20.28
8.5	170.82	87.22	59.37	45.46	31.57	24.65	20.52
9.0	171.07	87.46	59.60	45.69	31.80	24.89	20.76
9.5	171.32	87.69	59.83	45.92	32.04	25.13	21.01
10.0	171.56	87.92	60.06	46.15	32.27	25.37	21.25
10.5	171.81	88.15	60.29	46.38	32.51	25.61	21.50
11.0	172.05	88.50	60.64	46.73	32.86	25.97	21.87
11.5	173.30	88.62	60.76	46.85	32.98	26.09	22.00
12.0	172.50	88.85	60.99	47.08	33.22	26.34	22.25
12.5	172.80	89.09	61.22	47.31	33.46	26.58	22.50
13.0	173.04	89.32	61.45	47.55	33.70	26.83	22.76
14.0	173.54	89.79	61.92	48.02	34.18	27.33	23.27
15.0	174.03	90.26	62.39	48.49	34.67	27.84	23.79
16.0	174.53	90.74	62.86	48.97	35.16	28.35	24.32
17.0	175.03	91.21	63.34	49.45	35.66	28.86	24.86
18.0	175.53	91.68	63.81	49.93	36.16	29.38	25.40

Month	Outstanding Loan Balance (1)	Monthly Payment (2)	Interest Charges [(1)*0.01] = (3)	Principal [(2) – (3)] = (4)
1	Rs.1,000.00	Rs.88.85	Rs.10.00	Rs.78.85
2	921.15	88.85	9.21	79.64
3	841.51	88.85	8.42	80.43
4	761.08	88.85	7.61	81.24
5	679.84	88.85	6.80	82.05
6	597.79	88.85	5.98	82.87
7	514.92	88.85	5.15	83.70
8	431.22	88.85	4.31	84.54
9	346.68	88.85	3.47	85.38
10	261.30	88.85	2.61	86.24
11	175.06	88.85	1.75	87.10
12	87.96	88.85	0.89	87.96
Total		Rs.1,066.20	Rs.66.20	Rs.1,000.00

Finance Charges and the Annual Percentage Rate: There are two basic procedures for calculating the finance charges on the single-payment loan:

Simple Interest Method

Interest is charged on the actual loan balance outstanding. This method is used by commercial banks, credit unions on revolving credit lines. For example, Mr. Kumar borrows Rs.1,00,000 for 2 years at a rate of 12 percent per annum. On a single loan payment the actual loan outstanding for the 2 years will be Rs.1,00,000 because no other principal payments are made. Under the simple interest method the finance charges are obtained as follows:

$F_s = P \times R \times T$

Where,

F_s is the finance charge calculated using simple interest.

P is the principal amount of the loan.

R is the rate of interest.

T is the term of the loan in years.

Substituting the above in the formula:

P = Rs.1,00,000 R = 12% T = 2 years

$$Fs = Rs.1,00,000 \times \frac{12}{100} \times 2 = Rs.24,000$$

Therefore, the total loan repayment would be Rs.1,24,000.

To calculate the Actual Percentage Rate (APR) of interest of the loan, the average annual finance charge is divided by the average loan balance outstanding:

$$APR = \frac{\text{Average Annual finance charge}}{\text{Average loan balance outstanding}} = Rs.24,000/2 = Rs.12,000.$$

Since the loan balance outstanding is Rs.1,00,000 the average loan balance outstanding is also Rs.1,00,000. Dividing the average annual finance charge of Rs.12,000 by average loan balance outstanding Rs.1,00,000, APR is obtained which is 12%.

Discount Method

The discount method calculates the total finance charges on the full principal amount of the loan, which is then subtracted from the amount of the loan. The finance charges are paid in advance and represent a discount from the principal amount of the loan. The following formula is used for the discount method:

$$F_d = F_s = P \times R \times T$$

Thus for Rs.1,00,000 the borrower will receive Rs.76,000 – which is arrived by subtracting the interest charges from the loan principal. (Rs.1,00,000 – Rs.24,000). To find out the APR on this discount loan substitute the appropriate values into the APR equation. For this two year loan the average annual finance charge is Rs.12,000. Since this is a discount loan the borrower will receive only Rs.76,000. When these figures are used in the APR equation, it is found that the true interest rate for this 12% discount loan is more like 15.79% (12,000/76,000). The discount method yields a much higher APR on single-payment loans than does the simple interest method.

When money is borrowed through a discount loan, the borrower usually ends up paying more than the quoted:

Method	Stated rate of Loan	Finance charges	APR
Simple Interest	12%	Rs.24,000	12%
Discount	12%	Rs.24,000	15.79%

INSTALLMENT LOANS

Installment loans or installment purchase contract is an agreement that specifies the obligations of both the borrower and the lender drawn up when a purchase transaction is being financed on an installment basis. It contains four basic components.

Security Agreement

The security agreement or the interest indicates that the lender has control over the item purchased. In other words, in an installment purchase contract, the lender files a lien which states that in case the borrower defaults, the lender has complete right over the collateral security. If default occurs then the lender can sell the security to satisfy the unpaid balance by the borrower. If there are any excess funds obtained from the liquidation of the collateral security then the lender must pay it back to the borrower. If a deficiency occurs, i.e. if the proceeds from the liquidation are not sufficient to satisfy the loan then the borrower may or may not be liable for the payment of the unsatisfied portion of the loan.

The Note

The formal promise made by the borrower to the lender for the repayment of the loan is written down in a note. It states all legal obligations of both the borrower and the lender. It also states all details concerning the repayment terms, default conditions and disposition of the collateral security. It is a statement which is signed by both the borrower and the lender legally binding them to the terms and conditions therein. The entire agreement once signed is considered as a note.

Credit Life Insurance

Sometimes when a borrower avails an installment loan, he is required to buy credit life insurance and also credit disability insurance. It is a type of life insurance sold in conjunction with installment loans, in which the coverage decreases at the same rate as the loan balance. Credit life insurance provides assurance that the loan will be paid off if the borrower dies before the loan matures. In other words, these policies insure the borrower for an amount sufficient to repay the outstanding loan balance. This is the reason behind offering insurance coverage by credit card banks and institutions. From the borrower’s point of view the credit life insurance is not a very good deal as it is very costly and really does little more than provide lenders with a very lucrative source of income. Therefore the best choice for the borrower would be to avoid it!

Special Features

(These special features are more likely to be seen in the US scenario).

There are some special features of installment loans which would attract the borrowers. These special features are contained in the clauses to the sales contract or note that pertains to default, repossession and balloon payment. An acceleration clause is a clause which allows the lender to demand immediate repayment of the entire outstanding loan balance if the borrower defaults on loan payments. Although this is customary the lender allows the borrower for late payment or imposes a penalty instead of calling off the loan by exercising the accelerating clause. Most of the installment loan contains recourse clauses like the wage garnishment and repossession that lays down the actions a lender can take against the borrower. Wage garnishment is a court-ordered payment of a portion of defaulting borrower’s wages to a lender. The borrower must be in default and a court order must be issued enabling the employer to take such an action. The act of seizing collateral when the borrower default on a loan is termed as repossession. In some cases the ability to repose the collateral is limited and in some other cases collateral may be possessed without any notice and even stolen in effect from the borrower. The repossessed item is usually sold at an auction or by some other means and the amount due to the lender along with the legal and other expenses in connection with the repossession is taken from the sale proceeds. If this amount does not satisfy the loan amount then the customer may or may not be liable for the remaining portion. Sometimes installment purchase agreements are set up in such a fashion that the final payment is considerably larger than others. The lending act requires that any balloon payment which is defined as a payment more than twice the size of the normal installment payment should be clearly defined as such. It is always advisable for the lenders not to enter into an agreement which includes this kind of a clause because balloon payments can cause real financial strain when they are due. Only if there are adequate savings with the borrower or are expecting a sum of money sometime in near future then the use of balloon payment be justified.

FINANCE CHARGES AND MONTHLY PAYMENTS AND APR

Simple Interest

When simple interest is used the interest is charged only on the outstanding balance of the loan. Thus a loan principal declines with monthly payments; the amount of interest being charged decreases as well as the finance charges keeps changing every month. For example: Suppose the monthly payment required for $1,000, at 12% rate of interest which is a 12-month loan. Looking under 12-month column and across from the 12% rate of interest it turned that $88.85 is the monthly payment to pay-off the $1,000 loan in 12 months. When the monthly payments are multiplied by the term of the loan in 12 months the result will be $88.85 x 12 = $1,066.20 The difference between the total payments on the loan and the principal portion represents the finance charges on the loan in this case $1,066.20 – $1,000 = $66.20.

Add-on Method

Add-on method is a method of calculating interest by computing finance charges on the original loan balance and then adding the interest to that balance. Add-on loans are very expensive. With the add-on interest, the finance charges are calculated using the original balance of the loan; this amount is then added on to the original loan balance to determine the total amount to be repaid. The formula used for finding the amount of finance charges is as follows:

F = P x R x T

Substituting this with the previous example:

F = $1,000 x 0.12 x 1= $120

Compared with the finance charges for the same loan on a simple interest basis ($ 66.20) the add-on loan rate is more expensive. To find out the monthly payments on the add-on loan all that is needed is to add the finance charge ($120) to the original principal amount of the loan ($1,000) and then divide this sum by the number of monthly payments to be made. Therefore after substituting:

$$\frac{\$1,000 + \$120}{12} = \$93.33$$

As stated, these monthly payments are more than the rates paid according to the simple interest method.

Comparative Finance Charges

	Simple Interest	Add-on Interest
State rate on loan	12%	12%
Finance charges	$66.20	$120
Monthly payments	$ 88.25	$93.33
Total payments made	$1,066.20	$1,120.00

SOURCES OF CONSUMER LOANS

Consumer loans usually are obtained from commercial banks, consumer finance companies, credit unions, savings and loan associations etc., and more likely even from pawn houses, brokerages or friends or relatives. The major players are the commercial banks followed by the consumer finance companies and then by the credit unions. The choice of the lender is based on the interest rates fixed and the ease with which the loan is available and negotiated. Of course, it is easier than ever to obtain loans online. There are hundreds of websites which give information about installment loans. Some of these sites will actually accept applications online, and also offer brief listing of their services along with the toll-free service number.

Commercial Banks

Commercial banks are the most preferred and the popular source of consumer loans because they offer various types of loans at attractive interest rates. The advantage of availing loan from the commercial bank is that they charge lower rates than most lenders and they offer only to the best credit risk borrowers and are able to obtain relatively inexpensive funds from their depositors. The demand for these kinds of loans is generally high. Commercial banks usually lend only to customers with good credit ratings who can readily demonstrate an ability to make repayment in accordance with the specified terms. They also give preference to applicants who are account holders. If the applicant is a good customer of the bank the chances of approval of the loan are more. Although banks prefer to make loans secured by some type of collateral security, they also make unsecured loan to their best customers. The interest rates depend on the size of the loan acquired by the borrower.

Consumer Finance Companies

Sometimes consumer finance companies are known as small loan companies who provide secured and unsecured loans to individuals. These companies do not accept deposits but obtain funds from their stockholders and through open market borrowing as they do not have inexpensive sources of funds that banks and other institutions do, their interest rates are generally high. Loans provided by the consumer finance companies range less than Rs.2,50,000 and are secured with some kind of collateral security. Repayment is made on installment basis which usually is up to a period of 5 years or less. Consumer finance companies prefer to specialize in small loans to high-risk borrowers. These loans are very costly and the customers with poor credit ratings have no other choice but to avail such loans. Some borrowers prefer consumer finance companies as it is easy to get loans. If individuals are left with no other alternative then they should consider this as a last alternative.

Credit Unions

Only the members can obtain installment and single-payment loans from credit unions. They are non-profit organizations which have less operating costs and they charge low rates of interest on their loans. Depending upon the size of the loan requested, whether collateral security is required or not is decided. They offer both secured and unsecured loans. An added advantage of availing loan from the credit unions is that the loan payments can often be deducted directly from the payroll cheques.

Savings and Loan Associations

Savings and Loan Associations primarily deal with mortgage loans. They are not major players; they are not permitted to provide loans for consumer durables such as automobiles and other appliances. In addition, they are permitted to provide home improvement loans, personal and educational loans. The rates of interest charged by these associations are nearly equal to the commercial banks but sometimes they tend to be quite expensive. The rates charged on specific loans depend on certain factors like the type of loan issued, the purpose of the loan, the repayment tenure of the loan, the overall creditworthiness of the borrower.

Sales Finance Companies

Businesses that sell expensive items like automobiles, furniture etc., often provide installment financing to sell their products. Because the dealers cannot afford to tie up their funds in installment contracts, they sell them to a sales finance company for cash. It is a firm which purchases notes drawn by the sellers of certain types of merchandise usually big-ticket items. When the sales finance company purchases these notes customers are notified to make the payment directly to it. The cost of financing through a sales finance company is higher than the rates charged by the banks and other savings and loan associations particularly when the dealer is asked to do all the work in arranging the finance. Auto manufacturers use these loans to stimulate sales by keeping the cost of buying a new car which results in huge savings.

Life Insurance Companies

Life insurance policyholders obtain loans from their insurance companies. This is because certain type of policies not only provide death benefits but also have a savings function in which case they can be used as collateral security for the loans. The borrower should be very careful about these loans as they would include tax penalty when certain conditions are not met. The rate of interest in this type of loan is stated in the policy and it was usually set as low as 5-6%. The borrower will be charged interest rates as long as the loan is not repaid. These do not have any kind of repayment dates. In other words, the borrower does not have to repay it back. This is because when a loan is taken against the cash value of the borrowers' life insurance policy it actually means that the borrower is borrowing from himself. Therefore the amount of loan outstanding plus if there is any accrued interest; both will be deducted from the amount of coverage provided by the policy. The danger in life insurance loans is that they do not have a firm maturity date; consequently, borrowers may lack motivation to repay them.

In addition to life insurance companies, other financial service organizations are also entering the consumer loan field. It is now easier to get home equity loans as brokerage firms are also offering them. It is true that the commercial banks, finance companies dominate the consumer loan sector but other small players are also entering the market offering borrowers' options and choices, which they have never made before.

Friends and Relatives

Some borrowers instead of going to the bank or other financial institutions may prefer close friends who are ready to lend them. In some cases, these kinds of loans are very comfortable because either very less interest is charged or no interest is charged. The terms will however depend on the financial needs of the borrower but they need to specify in some type of loan agreement which states the repayment date, the interest rates if any, the obligations of the borrower and the lender. Not only does a written loan agreement reduces opportunities for disagreement and unhappiness but also protects the interests of both the borrower and the lender. Therefore, the borrower must remember that a loan to or from a friend or a relative is far more than a-run-of-the-mill banking transaction as the interest rate is emotional and the risk here is relationship.

Managing Credit

Borrowing money for major acquisitions and in general availing consumer loans is a good way to carry with the financial affairs. Meeting a major financial goal by buying on credit can be worked into the borrowers network of financial plans and repayment of the debt can be factored into the monthly cash budget. This is a better way than borrowing in a slap dash manner giving little or no consideration to debt repayment. Sound credit management is the result of when borrowing is well-thought of in advance and full consideration is given not only to the need of the asset or item but also to the repayment of the ensuing debt. Credit management is also the result of personal financial planning. Whatever route is chosen, the key point is to make sure that the borrowing will be fully compatible with the borrowers' financial plans and cash budget before the loan is taken out and the money spent.

SUMMARY

- Consumer loans are formal and negotiated contracts where, both the terms and conditions of borrowing and repayment are stated. They are one-shot transactions that are given for specified purposes.

- The advantage in obtaining a home loan is that the liquid cash or the savings is not used and the monthly loan installment is affordable.
- Sometimes, people do contribute voluntarily to the PF other than statutory contribution for the purpose of saving. This is purely optional and can be discounted whenever required.
- The interest rate for auto loans depends on the duration of the car loan, and the credit rating of the buyer. Auto loan accounts constitute 35% of all consumer credit outstanding. Usually 80-90% of the auto loan is financed with credit and the rest is usually the down payment or the initial amount paid by the borrower.
- Most of the finance companies and banks market their loans through dealers or agents.
- Since customer is the ultimate choice maker it is the obligation of all the companies and banks to provide with the best facilities and alternatives; otherwise it would be very difficult to survive in such competitive environment.
- Personal Loan is an unsecured loan that is granted for personal use based on the borrower’s integrity and ability to pay.
- If individuals are declared bankrupt or credit history is poor and want to avail a personal loan, then they will have to pledge high-rate collateral security on the loan.
- Most of the lenders offer credit insurance to the borrowers and a monthly premium is paid as a part of monthly repayments on the loan.
- Mortgage loan is a secured collateral loan where the borrower is liable to predetermined set of payments for the repayment of the loan. The collateral security may be in the form of real estate property or an asset etc.
- Single payment loans are of two types secured and unsecured which are availed for any purpose like for a vacation or for purchasing a music system or for purchasing a television.
- Most of the single-payment loans are secured loans as collateral security is provided by the customer. Lenders prefer securities that are readily marketable like automobiles, jewelry or stocks or bonds.
- Credit life insurance provides assurance that the loan will be paid off if the borrower dies before the loan matures. From the borrower’s point of view the credit life insurance is not a very good deal as it is very costly and really does little more than provide lenders with a very lucrative source of income.

Chapter VIII

Life Insurance

After reading this chapter, you will be conversant with:

- Insurance Planning
- Benefits of Life Insurance
- Calculating Insurance Needs
- What is Right for You?
- Buying a Life Insurance
- Life Insurance Products in India
- Personal Accident Insurance
- Travel Insurance

Introduction

Rajat, 45, software professional met with an accident and died on the spot. He was survived by two sons and his wife. After his death, his family realized that Rajat had not made any financial provisions for the family. There was very little cash in the savings account and a house. His wife regretted that had he taken a life insurance policy, their financial status would have been better.

A successful financial plan should include adequate life insurance coverage. A life insurance not only provides financial security to dependents in the event of untimely death but also provide investment benefits. Various life insurance policies possess attractive investment attributes. A life insurance policy provides sufficient security for fulfilling one's financial needs. It helps in maintaining available assets such as providing funds for paying off mortgage and also ensures fulfilling unfulfilled goals such as children education, daughter's marriage, and old age provision. An individual should be well informed about the need for a life insurance in financial planning. Being aware of life insurance is as important as being well versed with taxes and investments.

Life insurance should be bought wisely, otherwise, over a period of years it may lead to a huge payment out of income. Life insurance policies have various different features such as variation in cost structure, quality of the companies and agents. This chapter discusses how life insurance can be used in providing adequate protection to the family members in case of an untimely death. Although all the life insurance policies have various differentiating features, most of them cover all the basic features of life insurance.

INSURANCE PLANNING

It is difficult to think that one can lose everything; it is hard to predict unforeseen events that may cause loss to the family and near and dear ones. Unpredictable events such as accidents, serious illness, and untimely death of a family member may result in substantial financial burdens for the family. In addition to this, there may be disasters such as flood, earthquake or fire causing loss to personal property like your home or car.

This is where insurance comes into the picture. The basic aim of insurance is to protect the insured and his/her dependents from the loss of assets and earnings. Thus, insurance lends a degree of uncertainty to our financial plans. Insurance policies for home or automobile reimburse for damage or loss to the existing assets. Similarly, life insurance is meant to replace income that would have been earned had premature death not occurred. In other words, a life insurance provides funds to the family for maintaining an acceptable lifestyle, which includes education of children and other special needs. Disability insurance provides financial security if a person becomes disabled and covers hospitalization expenses. Health insurance, on the other hand, covers the medical costs arising from illness or accidents. Insurance planning, thus involves predicting or anticipating losses, which may occur to assets by weaving insurance into one's financial plans.

Concept of Risk

When a person has a financial interest in something – whether in one's own life, health, home, automobile, etc., he or she faces the risk of financial burden in case a loss or damage occurs reducing one's net worth. Because of the devastating effect such losses may have on a person's financial well being, steps should be taken to find ways to deal with such risks. Losses can be avoided through risk avoidance and loss prevention. But in case these methods are not providing proper coverage some economical method should be devised such as risk assumption and insurance.

In life insurance, the insurance concept revolves around, the uncertainty of death. The death of a person is certain, but the time is uncertain. An individual is exposed to risks such as accidents or may be disabled also. These risks have a direct impact on the financial condition of the family. If there is only one earner in the family, it is very essential that he/she should take up an insurance to secure his/her family's future.

Risk Avoidance

The most simple way to handle risk is to avoid the activity that creates it. For instance, if a person is afraid that he/she might lose everything from a lawsuit resulting from an automobile accident, he/she should quit driving. Similarly, with respect to life and health risks, skydivers or bungee jumpers should choose another activity.

Although it might seem that risk avoidance is an effective way to handle some risks, but the act of risk avoidance is also not without costs. For instance, people who avoid driving have to suffer considerable inconvenience. Similarly, the retired skydiver may find he/she suffers from more stress by avoiding sky diving, which may lead to different types of health risks. Risk avoidance is a useful method when the cost of handling risk through any other means is more expensive.

Loss Prevention and Control

Loss prevention is an activity that reduces the probability that a loss will occur. Loss control, on the other hand, lessens the severity of loss when it occurs. Both loss prevention and loss control are important aspects of risk management program for every individual and family. Insurance is one of the most fruitful method of handling risk.

Risk Assumption

In case of risk assumption, a person chooses to accept and bear the risk of loss. Risk assumption is an effective way to handle various small exposures to loss when insurance becomes too expensive. Risk assumption is also a reasonable approach in case of a very large exposure that cannot be prevented against which insurance cannot be secured.

Insurance

Insurance as a risk management tool permits the society to reduce financial risks and share losses. In the insurance parlance, an "insurer" represents a particular insurance company and an "insured" denotes the policyholder of a particular type of insurance. Insurers combine the loss experiences of large number of people, use statistical information through the acturial data, and thus are able to estimate the risk of loss faced by the whole insured population. Each insured person contributes a small amount known as the insurance premium in return for a promise from the insurer that he/she will be reimbursed for any covered losses. An insured gains, as he/she is able to transfer his/her risk to the insurer. On the other hand, insurance companies realize a gain, subject to the condition that they have accurately estimated the number of insured losses that will occur.

The insurance policy is a contract between the insured and the insurer. Under the insurance contract, the insurer promises to pay for losses according to specified terms of the policy. From the point of view of the insured, risk of loss is transferred to the insurance company. Similarly, the insurance company is willing to accept the risk as it hopes to make a profit by collecting premiums and investment earnings. The insurance company is able to do this, by combining a large number of insureds in a pool having predictable losses, than any of the insureds individually.

Premiums are paid for insurance from an individual's current income. The major decision is taken after making a comparison of the premiums to be paid from the current income and the protection that is obtained. This decision is difficult to make as the risk that a person suffers results from unforeseen events, and there is no certainty when these events will occur.

Underwriting

The insurer has to decide whom it should cover and whom it should not. This function of the insurer is known as 'underwriting'. Underwriting helps in guarding against adverse selection. Adverse selection occurs when only high-risk customers are given insurance coverage. Rate classification schedules are prepared to ensure that the policyholders pay premiums, which are equal to the probability of loss. The success of any insurance company depends on its underwriting standard. If the underwriting standards are too high, a large number of people will be denied insurance coverage. Similarly, if the underwriting standards are too low, the insurance company gets into solvency problems.

A major problem facing insurance companies is to select the criteria for classifying the insureds. A perfect relationship cannot exist between the available criteria and the loss experience. Thus, some customers may think they are charged more than the others. The first step in the underwriting process is for the insurance company to ask the potential insured to fill up an application form. This is done to gather information with respect to the risk potential of the individual. The application covers information regarding the potential insured's health, his/her height, weight, previous medical problems, family medical history, etc. The proposer may also have to go through various medical tests and furnish medical records. The information so gathered helps the underwriter to decide the extent of coverage to be provided and the premium to be charged.

All life insurance policies include incontestability clause. According to this clause, the insurer has the right to investigate information provided by the potential insured for a period ranging from one to two years. If a person has made a material false statement, the insurer has the right to rescind the contract within the specified time period. After the time period elapses, the insurer does not have the right to challenge the validity of the policy. The insurer can also adjust the premium of the policy any time, if it is found that the policyholder has made any material misstatement.

Underwriting is more of an art than a science. Insurance companies always try to improve their underwriting skills so that they are able to guard against their insolvency and provide better rates to their customers. Underwriting standards vary from company to company. Some insurers provide discount to non-smokers or people having low risk occupations.

BENEFITS OF LIFE INSURANCE

In addition to providing financial security to dependents, life insurance can be beneficial in many other ways. The benefits are discussed hereunder:

Protection from Creditors

When the insured dies, his/her assets and liabilities are transferred or given to the heir after all legitimate claims of the estate are deducted. A life insurance policy can also be structured in a way that death benefits are paid to the beneficiary under the policy and not to the estate. Even if the liabilities are more than the assets, the death proceeds will not be used to pay off the debts due to the creditors.

Vehicle for Savings

Life insurance policy can also be used as a saving and investment tool. Variable life policies, which are discussed later in the chapter are more of a saving and investment tool than a life insurance policy. But all insurance policies should not be construed as investment vehicles. In case of many policies, it may be found that the returns are less as compared to other investment tools. Thus, the main reason why insurance policies are sold is that it gives financial protection to the survivors in the event of the death of the insured. The savings feature of a life insurance is just a byproduct in an insurance policy.

Tax Benefits

From the assessment year 2004-2005, payment of premium in excess of 20% of the actual sum assured will not be eligible for deduction under section 80C. In case a person has more than one life insurance policy, the deduction will be allowed up to Rs.70,000 only. The value of any premiums agreed to be returned or the value of any benefit by way of bonus or otherwise, over and above the sum actually assured (which is to be or may be received under the policy by any person), will not be taken into account for the purpose of calculating the actual capital sum assured. The amount received on the maturity of the policy by the policyholder or the beneficiary is exempt from tax.

Who Needs Life Insurance?

It is a wrong assumption to say that everybody needs life insurance. The need of a life insurance depends on various factors such as the personal life situation and financial stability. An individual's life insurance needs change throughout life. When a person is single, he does not need life insurance at all unless there are dependent relatives. Children also do not need life insurance. The need for life insurance increases, once a person gets married and has children. The need for life insurance also depends on the earning capability of the spouse and various assets such as a house. As assets are built, the life insurance needs of the family also change, both in the terms of amount of insurance and type of insurance policies. There may also be changes in the life of a person such as divorce or death of a spouse. In the later years, the need of life insurance depends on the availability of the financial resources such as pension plans and other investments. Thus, life insurance planning should occur continuously throughout the life span of a person.

CALCULATING INSURANCE NEEDS

Insurance needs of an individual can be calculated through the following two techniques:

- Multiples Earnings Approach.
- Needs Approach.

Multiple Earnings Approach

The multiple earnings approach is a simple and popular approach. In this technique, to calculate the amount of life insurance to be bought, the annual gross earnings of a person are multiplied with an arbitrarily selected number. It can be in the form of multiples such as 5, 10 or 15 times earnings. A person who is earning Rs.1.2 lakh per annum, with a multiple of 3.5 will have life insurance coverage of Rs.4.2 lakh. Most of the life insurance agents have abandoned this approach. This method takes into consideration the financial obligations of a person and his/her financial resources in addition to his/her life insurance.

Needs Approach

The needs approach involves the following three steps:

- Estimating the total economic resources needed to meet obligations if he/she is to die.
- Determining financial resources that may be left over after death.
- Deducting the resources from the amount needed to find out the additional life insurance cover needed.

While assessing the economic needs of a family, various scenarios should be taken into consideration such as premature death, divorce, etc. In case of single parents, additional resources will have to be allocated for life insurance purposes. Two income families, which depend on the income of both the spouses, should also insure adequately. In case of families having children from prior marriages, a greater coverage is required for the dependent children.

ASSESSING ECONOMIC NEEDS

The needs approach analyses the basic question – 'What financial resources will be required by the family if the sole earner of the family dies?' Life insurance not only provides retirement benefits but also protects the family from financial distress in case of death of the sole earner.

Life insurance provides financial security for the following needs of the family:

Family Income

The main aim of people who have dependents is to protect the family's income. If a person is the sole earner of the family, he/she would make sure that his/her family lives comfortably, even if he/she dies. Individuals would like to provide for their dependent children or elderly parents. Thus, a monthly income is to be estimated for the family to live comfortably. For this, the first step is to develop a budget, covering all the necessary expenses such as food, clothing, utilities, insurance, recreation, travel, savings, etc.

Another important aspect is to decide what standard of living the family should maintain. Some people may think of reduced expenditure and consumption for the family, whereas others would like their family to maintain the same standard of living. Another significant aspect is to insure the income of the working mother. Generally, the income of the father is insured, though families who depend on the mother's income to meet their expenses, also face devastating consequences in case of her death.

- *Additional Expenses:* Additional expenses will have to be incurred if an adult member of the family, who performed certain important duties, dies. For instance, a mother may not be working, but she may be providing care, housekeeping and cooking. If she dies, additional expenses will have to be incurred to perform all these duties.
- *Pay off Debts:* The sole earner of the family would like to leave his family debt free, when he/she dies. So the needs to calculate, all the debts that is outstanding and need to be paid and insure enough to pay all of them. The debt may be in the form of credit card bills, installments loans, etc. Sufficient money has to be allocated to meet the mortgages and other debt obligations.
- *Surviving Spouse's Income:* As children become financially independent, the household expenses decrease. But the surviving spouse may need monthly support for the rest of her life. Thus, an estimate has to be made with respect to her life expectancy and the financial support needed by her.
- *Special Financial Needs:* Certain special needs of the family need to be accounted for. It can be either in the form of a child's higher education, disabled dependent, etc.
- *Liquidity:* There are people who have huge properties, but very low cash. Thus, a very high percentage of their wealth is in the form of non-liquid assets. Life insurance proceeds help in settling their mortgage payments and maintaining their assets.

AVAILABLE RESOURCES

After analyzing the financial needs of the family, the next step is to list all the current resources that are available. The savings, investments and social security benefits are the main funds available apart from life insurance benefits. In addition to that, there are benefits such as group insurance policies and pension funds. In case the surviving spouse is highly skilled and employed, it is another asset for the family. Apart from all this, families have assets in the form of jewelry, stocks, bonds and other liquid assets. A reasonable estimate should be made to determine the value of the assets.

NEEDLESS RESOURCES

The last step is to deduct the total resources required from the available resources. If the resources available exceed the required resources, there is no need of extra funds. But in case the available resources fall short of the required funds, additional life insurance will have to be taken to maintain the desired standard of living of the family. The insurance proceeds can be invested till the money is actually needed at an after tax return, which exceeds inflation.

WHAT IS RIGHT FOR YOU?

Life insurance coverage is available in various forms to suit the needs of the customers. The most common forms of life insurance are discussed in detail in the following sections:

Term Insurance

The first basic need of life insurance is to provide a lump sum amount to the family in the event of the untimely death of the breadwinner. This is called 'Term Insurance' or 'Temporary Insurance'. Here, the lump sum insurance amount is payable only if death of the insured occurs during a selected period. If the insured survives till the end of the selected period, nothing becomes payable.

Pure Endowment

Under pure endowment, there is accumulation of savings for a specific purpose. Here, the lump sum insurance amount is payable only if the insured survives till the end of the selected period. If the insured dies during the period of insurance, nothing becomes payable.

These two concepts 'Term Insurance' and 'Pure Endowment' are the basic elements of every life insurance product. By combining these two elements in different proportions, different products of life insurance have been developed. The proportions of these two elements in the mixture depend on the different needs of individuals, which can be met by life insurance. These two elements are, therefore, called the 'Basic Building Blocks' in all life insurance products.

A pure endowment or 'savings only' insurance is seldom issued by insurance companies as a separate policy. But Term Insurance has always been one of the major products used by every life insurance company.

Features of Term Insurance

- A Term Insurance policy in life insurance is a contract that furnishes life insurance protection for a limited number of years, the face value of the Policy being payable only if death occurs during the stipulated term, and nothing being paid in case of survival.
- Term Insurance policies can be issued for as short a period as one year or for fixed terms of 5, 10, 15 or 20 years or for protection up to a certain age, say 60 or 65 years.
- The most important advantage of a Term Insurance policy is its low cost.
- Term insurance policies are suitable where risk coverage is needed for a restricted period. For example, where a mortgage loan is availed for construction/purchase of a residence, a Term Insurance policy for a period equivalent to the period of repayment of the loan would be most suitable as a 'Collateral Security'.
- However, insurance companies underwrite proposals for Term Insurance policies very carefully. Various restrictions as to age at entry, size of the policy and period of insurance, etc., are imposed in view of the low cost – high risk nature of the policy.

Drawbacks

There are several other disadvantages in the Term Insurance policies. It is similar to property or liability insurance. The insurance money is payable only in case of death during the period of insurance. If death occurs later (i.e., after the expiry of the selected term) nothing becomes payable, irrespective of how long the original term might have been. Even where renewal of the contract is provided, if the insured neglects to renew the contract, the insurance company is absolved of all liability if the event happens.

The short-term life insurance provides risk coverage only for the term selected. At the end of the selected term, the risk coverage comes to an end. If there is no provision for automatic renewal at the end of the term, the insured will have to take a new term insurance policy. This will be subject to the condition of his/her health and payment of premium for attained age, which will naturally be higher. In addition to this disadvantage, there may be restrictions on the maximum age up to which term insurance can be allowed by the insurance companies.

Keeping these disadvantages in view, insurance companies introduced special features in Term Insurance contracts, by making them:

a. Renewable; and

b. Convertible.

Most of the Term Insurance Policies, issued for fixed terms of 5 years, 10 years, or more years, have a built-in automatic renewal feature. At the end of each fixed period, the policy can be renewed automatically by the policy owner without the necessity of a medical examination or irrespective of the status of his/her health, i.e., there is no necessity to prove continued insurability. Premiums will be on level for a given period depending on the age at the beginning of the period. But at the time of each renewal, premium will be the rate applicable to the age attained at the beginning of each such renewal. Hence, premium will be increasing with each renewal. Restrictions may be placed by insurance companies on the number of times of automatic renewal of a term insurance policy or the maximum age up to which such renewal can be allowed.

Renewable Term Insurance meets a valid need of policy owners by protecting their insurability. The price viz., the premium payable, however, will be increasing. At advanced ages, the premium will be very high and may be prohibitive. Therefore, there is a danger of healthy persons failing to renew the policies whereas most of those who are in poor health will renew without fail. The insurers will have to bear higher mortality costs and they take this possibility into account in their premium structure.

‘Convertible Feature’ also has become part of Term Insurance Contracts issued by several insurance companies. Here, the policy owner will have the option to exchange his/her term insurance policy for a permanent type of policy viz. ‘whole life’ or ‘Endowment’ without having to produce evidence of continued insurability. Such conversion is allowed during the period of insurance and effected for the ‘Attained Age’ *or* ‘Original Age’.

In the conversion at the ‘Attained Age’, the premium rate for the new policy (either Whole life or Endowment) will be for the age attained on the date of conversion. If the conversion method of adopted is at the ‘Original Age’, conversion will take effect from the date of commencement of the original Term Insurance policy. Premium for the converted policy, therefore, will be related to age at the original date of commencement. As a natural consequence, the premium in this method will be much less compared to the first method of conversion from the attained age. However, the difference in the premiums for the new policy and original policy with some interest, decided by the insurance company, will have to be paid by the policy owner to the insurance company.

The provision for conversion is advantageous to young people who are getting started in their career. While providing the much needed risk coverage at low cost during the initial years of one's career, the policy provides the advantage of conversion into a permanent plan at the end of the fixed term, say 5 years, when the insured will be sufficiently established to afford a higher premium.

It is also possible to provide for an 'Increasing or Decreasing Term Insurance'. The decreasing type is eminently suited to the specific need of mortgage protection. From an initial amount of insurance, the risk protection decreases year after year becoming zero at the end of the period of insurance. At any point of time during the period of insurance, the insurance sum will be equivalent to the outstanding mortgage loan, so that in case of the unfortunate death of the mortgagor, the insurance money will liquidate the mortgage loan.

Increasing Term Insurance is generally not issued as a separate policy. It is added as a rider to another policy contract. At the option of the insured, sum assured increases by fixed percentage or by fixed amount periodically under the contract. This amount will be available as death benefit.

Whole Life Insurance

As compared to the Term Insurance (which provides risk coverage during a specified period), whole life insurance covers the risk death of the insured, whenever it may happen. It means that there is no fixed term under whole life insurance. It is therefore aptly called 'Term Insurance For The Longest Term'.

There are two variations in the whole life insurance product. The first one is Pure Whole Life where under premiums are payable continuously throughout the life of the insured till death. Risk coverage is for the entire duration of life and the insured amount is paid on the happening of the death of the insured at any time. The second one is the Limited Payment Whole Life Insurance where under premiums are payable for a limited and shorter period at the option of the insured or till death if earlier. Risk coverage is however throughout the life of the insured.

Whole Life Insurance is a permanent type of plan of insurance. Premium rate is low but higher than that of the Term Insurance Plan. Whole Life Policy provides permanent protection at moderate cost. Unlike the Term Insurance Plan, there is no need to make special provisions here for renewal. The plan provides adequate and permanent protection to the family. It's moderate cost enables people with limited incomes also to have sufficient cover. Even if the premium payment is stopped, there will be cash value, subject to certain conditions. This cash value can be utilized to keep the policy in force for a limited period or in the alternative, the policy can be converted into a reduced paid-up policy.

Payment of premiums throughout the life of the insured, say up to age of 80 or 85 or even beyond, will be difficult as it extends beyond the active work life of the insured. Insurers, therefore, offer a limited payment as a whole life policy. The insured has the option here to limit the payment of premiums up to a certain age, say 60 or 70 years. Once premiums are paid up to the end of the selected (limited) period, further premiums need not be paid but the policy and risk coverage will continue till the death of the insured. Premium rate, under this policy, will be more than that of the Pure Whole Life Plan for obvious reasons.

It is also possible to have a conversion clause attached to a whole life insurance policy. After completion of a fixed number of years, say 5 years, a provision can be made to convert the policy into an Endowment Assurance. This is a good and convenient option for a young person who is at the beginning of his/her career. He/she can opt for a convertible whole life insurance policy, which is a permanent contract. During the first 5 years, he/she will be required to pay a low rate of premium applicable to a whole life plan. But at the end of 5 years, depending on his/her improved capacity to pay premiums, he/she has the option to convert the policy into an Endowment Assurance maturing at an age to be chosen by him/her. There will be no need to prove continued insurability at the time of conversion. If the policy owner does not opt for the conversion, the policy will continue as a whole life insurance.

Endowment Assurance

Another popular plan of life insurance is the Endowment Assurance. The insurer agrees here:

- To pay the insurance money in the event of the death of the insured during the endowment term, and
- To pay the insurance money in the event of the insured surviving till the end of the endowment term.

The first benefit has already been described earlier as Term Insurance. The second benefit is called Pure Endowment, which is a contract that promises payment of the face value of the policy only if the insured survives the period of insurance. In Pure Endowment, in case of death of the insured during the period of insurance, nothing becomes payable. Thus, an Endowment Assurance is a combination of the two elements viz., Term Insurance and Pure Endowment.

For understanding the economic concept of Endowment Assurance, this analysis divides Endowment Assurance into two parts, viz, a Decreasing Term Insurance and an Increasing Investment. The saving accumulation available under this policy is termed as investment part. This will be increasing and total accumulated value at any point of time during the period of insurance is called the Reserve Value. This Reserve Value is supplemented by Term Insurance. The two, when added, make up the face value of the policy. As the Reserve Value is of an increasing nature, the Term Insurance Value will be of a decreasing type. The table hereunder illustrates the point:

20-Year Endowment Assurance, male aged 35 years, Face Value $1,000

Table 1

End of Policy	Reserve Value (in $)	Net Amount at Risk (in $)
1	13.57	986.43
2	54.62	945.38
3	96.66	9.3.34
4	139.70	860.30
5	183.75	816.25
10	420.28	579.72
15	688.70	311.30
20	1000.00	NIL

Source: "Life Insurance" by S S Heubner and Kenneth Black Jr.

Premium rates under Endowment Assurance will be usually high compared to whole life insurance plan for the simple reason that the insurance company will have to pay a maturity benefit also at the end of the specified term. But if the period of insurance is very long, the rate is only slightly higher than the whole life insurance.

Endowment Assurance is a very sound plan for all types of customers. It provides an incentive to save, which we have already described earlier as thrift, or compulsory savings. It is an instrument to build up a corpus to provide for old age. Even if the period of saving is cut short by the untimely death of the insured, the policy provides a substantial lump sum money to the family. An Endowment Assurance can also be utilized to accumulate a fund for a specific purpose such as education of children, marriage of daughters, start-in-life for sons or for a donation to a 'philanthropic cause'.

Universal and Variable Life Insurance

Universal and Variable Life Insurance are types of permanent life insurance and both have the potential to accumulate cash value. How the cash value is invested by the insurance company is one of the key differences between the two. In respect of Universal Life Insurance, investment of the cash value will be done by the company as part of its own investment but with a guaranteed minimum return. On the other hand, in respect of Variable Life Insurance, the policy owner will have a choice to choose the way the cash value under his/her policy can be invested. One way to describe how both policies work is to think of them as a bucket, called the contract fund, into which net premiums are paid and from which most charges and fees are taken.

When premiums are paid, deductions are taken for such things as charges for premium taxes and, in some cases, sales fees. The balance of the premium, or net premium, is allocated to either the insurance company's general account (Universal) or separate account (Variable) and accumulate in the policy's contract fund.

Each month deductions are made from the contract fund to pay the cost of insurance, which increases over time, and other charges for administration and any additional benefits.

Continued timely premium payments, favorable investment results for "Variable Life" and current crediting rates for "Universal Life", and time can potentially result in the cash value of the policy growth to after a number of years.

Cash value may grow sufficiently so that it may exceed the monthly cost of insurance charges and other fees. If cash value is insufficient, the policy owner may need to make additional payments, which could be higher than the original premium. If cash value is more than sufficient, the policy owner may be able to access it through loans and withdrawals.

Policy loans and withdrawals will reduce the cash value and the death benefit payable to the beneficiaries. Both Universal Life and Variable Life Insurance policies can offer:

- Flexibility in the amount and timing of premium payments.
- Death benefit guarantees and options, depending on the type of policy.
- Potential for income tax deferred cash accumulation.

In addition, Universal Life offers the security of a minimum guaranteed crediting rate, and Variable Life offers a choice of investment options.

Universal Life Insurance

Universal Life Insurance is a variation of Whole Life. The difference between Whole Life and Universal Life is that with Universal Life, the pure insurance part of the policy (the Term portion) is separated from the investment (cash) portion of the policy. Whereas the Whole Life investment portion is invested in bonds and mortgages, the investment portion of Universal Life is invested in money market funds. The cash value portion of the policy is set up as an accumulation fund. Investment income is credited to the accumulation fund. The death benefit portion (Term Insurance) is paid out of the accumulation fund. The cost of the Term Insurance is paid on a mortality basis (age of the insured and amount of coverage). Unlike Whole Life Insurance, the cash value of Universal Life Insurance grows at a variable rate.

A particularly attractive feature of Universal Life Insurance is that the insured can vary his/her annual death benefit and the annual premium. Additionally, the insured may make partial surrenders of policy and take loans against the cash value of the policy. In subsequent years, when his/her earnings are good, he/she can put more money in the cash portion of the policy and get a faster buildup of the cash value. And if his/her earnings are not as good, he/she may skip paying the premium altogether or pay less than the total premium. All that happens is that the insurance company deducts the cost of maintaining the insurance portion and the administrative expenses from the accumulation fund.

Normally, there is a guaranteed minimum interest rate applied to the policy. No matter how badly the investments go by the insurance company, the policy owner is guaranteed a certain minimal return on the cash portion. If the insurance company does well with its investments, the interest return on the cash portion will go up. There are two different types of Universal Life Insurance. The first type is called Option A. Under Option A, there is a level death benefit, which stipulates that upon the death of the insured, no matter when it happens, the insurance company will pay the same amount. The second type of Universal Life Insurance is of course called Option B. Under this the death benefit is equal to a specified amount plus the policy's current cash value. With Option B, the death benefit increases under normal circumstances.

A very nice feature of Universal Life Insurance policies is that their annual statement breaks down the policy by components. The charges, credits, and insurance aspects are all detailed. It makes it much easier to compare different companies' policies. Also, under certain circumstances, if the Universal Life Insurance policy meets certain tax law criteria, it will be considered a life insurance policy for tax purposes and therefore, neither the cash value nor the death benefit will be considered as part of the taxable income.

Variable Life Insurance

Variable Life Insurance is a form of Whole Life Insurance. Just like Whole Life and Universal Life, a portion of the premium goes to the Term Life Insurance part of the policy; a part of the premium goes toward administrative expenses; and a portion of the premium goes toward the investment or cash value portion of the policy.

However, there is a major difference between the investment portion of Variable Life and the other forms of life insurance. With Variable Life Insurance, the insured may select how the funds in the investment portion of the policy are invested. The insured may choose to invest in a wide array of investment vehicles such as: stocks, bonds, or mutual funds. The catch is that he/she may only choose from investment vehicles from the insurance company's portfolio. That is, he/she may only choose from investment vehicles, which the insurance company offers to manage. Some insurance companies do now allow the insured to select investment vehicles managed by other companies. Usually, he/she may switch investment vehicles a few times each year. So, if the policy owner is a hands on type of person, he/she may want to give serious consideration to a Variable Life Insurance policy.

The downside to Variable Life Insurance is that it is expensive. Commissions and service fees can amount to a considerable sum. This does not leave much to invest. Second, value of the death benefits may fluctuate up or down depending on the performance of the investment portion of the policy. However, the death benefit can never fall below a defined level.

LIFE INSURANCE CONTRACT FEATURES

The following key features are found in most of the insurance contract features:

Beneficiary (Nominee) Clause

A beneficiary is the person who receives the death benefits of the policy on the insured's death. All life insurance policies have one or more beneficiaries. If there is no beneficiary, the death benefits are paid to the estate of the deceased and there is a lengthy, expensive legal procedure of going through the probate. Under life insurance, every policyholder needs to name a primary beneficiary and a contingent beneficiary. The death benefits will be paid to the primary beneficiary on the death of the insured. In case the primary beneficiary does not survive the insured, the death benefits will be distributed to the contingent beneficiaries. If both the primary and contingent beneficiaries do not survive the insured, the death proceeds will pass to the estate of the insured and distributed according to the will of the insured. If no will exists, the proceeds will be distributed according to the state law.

At the time of naming the beneficiary, care should be taken that the identification is very clear. There should be no confusion with respect to the identification of the beneficiary. For instance, if a person has named his wife as the beneficiary for his insurance proceeds, then there may be confusion, in case he divorces and remarries. There may be confusion with respect to the person to whom the death proceeds are entitled.

Survival Clause

In case both the insured and primary beneficiary lose their lives in a common disaster, then the death benefits will go to the contingent beneficiary. But if, the primary beneficiary survives the insured, even by few minutes, then the death proceeds will go the primary beneficiary's estate and not to the contingent beneficiaries. In other words, the death benefit will be entitled to the beneficiaries of the primary beneficiary. Thus, a 'survival clause' is included in the policy to ensure that in case both the insured and primary beneficiary die in a common disaster, and the primary beneficiary survives for a short time, still the contingent beneficiaries would be entitled to receive the death benefits.

Irrevocable Beneficiary

The beneficiaries named can be changed any time, until and unless, the person is not named as an "Irrevocable beneficiary". Thus, if a person desires to change the beneficiary, he can do so any time.

Settlement of the Insurance Proceeds

The insurance proceeds can be settled through various ways. It can either be settled according to the wishes of the insured or the policyholder before his/her death or it may be according to the beneficiary, at the time of the insured's death or when the policy matures.

Settlement Amount

The most common settlement procedure is to pay the death proceeds in the form of a lump sum amount, which can be used by the beneficiary to invest or use for any other purpose.

Interest

Under this arrangement, the insurance company will only pay interest to the beneficiary at some guaranteed specific rate. This method is useful when the beneficiary does not require the principal amount.

Fixed Period

The face value of the policy along with the interest will be paid to the beneficiary over a fixed time period.

Fixed Amount

In this arrangement, the policy proceeds are paid in the form of regular payments, till the total proceeds are fully paid.

Life Income

Under this arrangement, the insurer agrees to pay a specific amount for the rest of the life, based on the sex, age when the benefit starts, life expectancy, face value of the policy and the interest rate assumptions. This settlement option is suitable for the beneficiaries who do not want to outlive the benefit from the insurance proceeds.

Policy Loans

A policy loan is a loan made by the insurance company to the policyholder. The policy loans are available on all life insurance policies and secured by the cash value of the policy. These loans are repaid, but the balance amount and the interest at the time of death of the insured is deducted from the proceeds of the policy. Policy loans should be taken only in case of severe emergency as they reduce the death proceeds. If loans are taken without any urgent need, it defeats the ultimate aim of providing financial protection to the dependents. As these loans are less expensive than those offered by other institutions, people tend to borrow against their life insurance policies.

Payment of Premiums

Life insurance contracts specify how premiums ought to be paid. They are normally paid in advance. The policyholders may pay annually, quarterly, semiannually or even monthly. If premiums are paid more often than annually, the insurers may charge a fee. Premium may be paid directly to the agent or mailed to the insurer. In some cases, the insurer may deduct the premium amount directly from the bank account of the insured. If a person dies after paying premium more than one month in advance, the insurance company generally refunds the premium along with the death proceeds.

Grace Period

There is a grace period of one month, in case a person makes a late payment of the premium. This grace period is given so that the insured does not lose his/her insurance protection in case he/she makes a late payment of the premium. In case the insured dies during this grace period, the face amount of the policy after deducting the unpaid premiums will be paid.

Non-forfeiture Options

In case of non-forfeiture option, even when the policy is terminated prior to maturity, cash value of the policy along with some benefits is paid. There are generally two options discussed hereunder:

- Paid-up insurance: In this, the policyholder receives the policy proceeds as that of a terminated policy with a lower face value.
- Extended term insurance: The accumulated cash value is used by the insured to buy the term life policy for the same face value as that of the lapsed policy. The policy period is based on the amount of term protection and a single premium payment, which is equal to the total cash value.

Policy Reinstatement

Reinstatement revives the original contractual relationship between the insured and the insurer. The policyholder needs to reinstate the policy within a specified period after the lapse of the policy. Before going for a reinstatement, the policyholder should determine whether buying a new policy would be more beneficial.

Change of Policy

In many life insurance contracts, there is a provision for insureds to switch over from one policy to another. A policyholder may decide that he/she would like to have a paid-up policy at the age of 65, then the current whole life policy. If the policyholder makes such a change there may not be any penalty. In case the insured wants to change from higher to lower premium policies, he/she will need to prove insurability, which will reduce the possibility of adverse selection.

Multiple Indemnity Clauses

Multiple indemnity clauses provide double or triple of the face value if the insured dies in an accident. This benefit can be obtained by the insured by paying an extra premium. This clause is considered as irrational by many insurance companies as it provides no protection in the event of death due to illness.

Disability Clause

This clause contains a waiver of premium benefit or is coupled with disability income. Under the waiver of premium condition, the payment of premium on life insurance contracts is waived if the insured becomes permanently disabled before the age of 60. In case of disability income, the insured is granted not only the waiver of premium but also monthly income. The disability riders are available to the insured at a small cost and are added to the whole life policies, but are not available on term policies.

Guaranteed Purchase Clause

A policyholder, who has a guaranteed purchase option, can purchase additional coverage at stipulated intervals. There is no need for him/her to provide evidence of insurability. This option is generally offered to a whole life policyholder under the age of 40 years.

Suicide Clause

All life insurance contracts have a suicide clause, according to which the policy is void if the insured commits suicide within the specified time period. The time period is generally one year and if the insured takes his/her life after the lapse of this specified time period, the policy proceeds are paid.

Exclusions

As in the case of all insurance policies, a life insurance also provides various exclusions such as aviation and war exclusion. Aviation exclusion provides that no loss is covered if the insured is an inexperienced pilot or is using a military aircraft. This exclusion does not cover fare paying passengers of commercial airlines. War exclusions, on the other hand, provide that if the insured dies as a result of war, the insurance premium along with interest will be paid back. This exclusion is provided to guard against adverse selection. In addition to all this, if a person has a hazardous occupation or hobby, the insurer may not provide coverage or it may provide coverage at an additional cost.

Participation

Policy dividends reflect the difference between the premiums charged and the premiums paid, which are necessary to fund the mortality experience of the insurance company. In a participating policy, the policyholder receives these policy dividends. A base premium schedule is prepared by the insurance company for participating policies on the basis of its mortality or investment experience plus a margin. If the company’s loss experience is more favorable than expected, a return is made to the policyholder in the form of policy dividends.

Living Benefits

Many insurance companies provide living benefits, which allow the insured to receive a certain percentage of his/her death benefits prior to death. If the insured suffers from terminal illness and is expected to die within a specified period, the insurer may offer living benefits free of charge. Insurance companies are marketing living benefit riders, which allow advance of policy death benefit, such as 2 or 3 percent per month to pay for medical expenses. The rider may cost extra, in addition to the life insurance premium and benefits are capped as a percentage of death benefits.

BUYING A LIFE INSURANCE

One of the most important tasks is to select an appropriate life insurance policy. The first important thing in life insurance is to understand the features of the life insurance policy. The next step is to estimate the life insurance cover needed to cover the financial requirements of dependents. Proper understanding of the provisions of the life insurance policies should be undertaken followed by a search for the right insurance company.

The following sections unfold the various aspects of choosing a life insurance policy:

Review Needs and Coverages

Life insurance policies are used as savings vehicles to fill the gap in the financial resources that will be needed after death by the dependents. In case of young families, guaranteed renewable and convertible term insurance should form an important part of insurance protection. These policies provide insurance coverage at the least cost and help in preserving funds for other saving goals. In case of older people, term policies are more beneficial. Most families also obtain whole life policies, which provide continuous savings and permanent insurance. Similarly, whole life, variable life and single whole life policies should be purchased when the main aim is to save and not to obtain protection against financial loss resulting from death.

Compare Costs and Features

Various insurance companies will provide the same insurance coverage at different rates. Thus, polices provided by various insurers should be properly compared. The best way to go for insurance shopping is to use the Internet. With a click, a number of insurance quotes of various companies are available. An individual can know various discounts available regarding different policies and the physical examination that a person has to go through, on the web. If a person has a health problem, it would be better to examine all the available insurance policies and select the one that is most beneficial. It is also important to analyze the time period for which the rates will be locked in and the rates for the renewal of the policy. Comparison should be made among policies having the same provisions and amounts. For instance, a term life policy should not be compared with a whole life policy. In case of cash value policies, interest adjusted cost indices should be compared.

Selection of a Company

The important part is to select the insurance company. In addition to providing reasonably priced products, the insurer should also provide attractive contract features, good customer service and a sound financial track record. The insurance company should have the financial strength to survive and should have been in business for around 25 years. In other words, the insurance company should be there to pay death proceeds when the insured dies. There are certain other factors also, which should be considered such as the reputation of the firm, commission of the agent, etc. Choosing insurance companies has been made easy by credit rating agencies. The credit rating agencies assess the insurance companies on the basis of their debt structure, pricing practices, management strategies and claims paying ability.

Selecting an Agent

Life insurance agents play an important role in the life insurance business. Selection of an insurance agent is important, as one has to depend on him/her for various financial decisions. Before choosing an agent, his/her professional and formal education should be taken into consideration. His/her formal education also plays an important role. Before choosing an agent, various agents should be considered and evaluated.

LIFE INSURANCE PRODUCTS IN INDIA

Let us now examine some of the life insurance products of Life Insurance Corporation of India and other private life insurance companies, which have entered the market in our country. This discussion will enable the reader to appraise the different uses to which life insurance can be put.

The LIC of India, over a period of 45 years, introduced several innovative products. Quite a few of them are traditional products continued from pre-nationalization days. They are briefly discussed hereunder:

Term Insurance Plans

- **Two-year Temporary Insurance:** Risk is covered for a short period of two years.
- **Convertible Term Insurance:** This is a term insurance plan for a period of 5 or 7 years. The policy owner has the option to convert it into a limited payment Whole Life Insurance or an Endowment Assurance at the end of the term.
- **Bima Sandesh:** This is a term assurance with provision for return of premiums if the life assured survives the policy term.
- **Bima Kiran:** This is similar to Bima Sandesh. But at the end of the term, not only the premiums paid are refunded but a free insurance cover is allowed thereafter for a period of 10 years. This free insurance will be to the extent of 30% to 60% of the face value of the policy depending on the original period of insurance.
- **Mortgage Redemption Assurance:** This is issued to cover the outstanding loan under a house mortgage.

Whole Life Plans

These policies can be issued either on with-profit basis or without profit basis:

- **Pure Whole Life Policy:** Premiums are payable for a period of 35 years or 80 years of age of the life assured, whichever is later. Insurance money is payable on death, whenever that may occur. Once the policy owner reaches 85 years of age (provided at least 35 years' premiums have been paid), the policy will be treated as matured and insurance money will be paid to the life assured.
- **Limited Payment Whole Life Policy:** This is a variation of the pure whole life policy except that premiums are payable for a limited period at the choice of the insured.
- **Convertible Whole Life Policy:** This is a limited payment whole life policy where premiums are payable to policyholders aged upto 70 years. But the insured has an option to convert it, at the end of 5 years from commencement, into an Endowment Assurance for a selected period (not to mature beyond the age of 70 years of the insured). If the option is not exercised, the policy will continue as a limited payment whole life insurance policy.

Endowment Plans

- **Endowment Assurance Policy (with or without profits):** The face value of the policy will be paid either on death of the insured during the period of insurance or on maturity if the insured survives up to the end of the term.
- **Bhavishya Jeevan Policy (with profits):** This is an Endowment Assurance under which premiums during the first five years will be very high and from the sixth year it will be scaled down to almost 1/3rd of the original premium. This is suitable to professionals with a limited span of high income, or cine actors or those going to the Gulf for employment.
- **Jeevan Mitra (Double Cover or Triple Cover):** This is a with-profits Endowment Assurance with risk coverage to the extent of twice or thrice the face value of the policy. On maturity, the face value of the policy is paid.
- **Jeevan Griha (Double Cover or Triple Cover):** This is a low cost, without profit Endowment Assurance. Risk coverage will be twice or thrice the face value of the policy. The face value of the policy is paid on maturity. This plan is most suitable as collateral security for housing loans.

- **New Jana Raksha (with profits):** This is an Endowment Plan suitable for people in rural areas. After payment of at least two years' premiums, risk is covered for the next 3 years even if premiums are not paid. Agriculturists who are subject to the vagaries of nature find this policy very attractive.
- **Jeevan Shree (without profits but with guaranteed addition):** This is an Endowment Assurance, with a limited premium paying period, suitable to the top end of the society. The minimum sum assured under this policy is Rs.5 lakh. The LIC of India allows Key Man Insurance under this plan only.
- **Asha Deep II (with profits):** This is basically an Endowment Assurance plan with a rider to cover four serious illnesses viz., cancer, paralytic stroke leading to permanent disability, kidney failure (both kidneys) and cardiac bypass surgery. In case the insured is affected by any one of the above conditions in any year except the first year of the policy, LIC of India (a) pays 50% of the sum assured immediately (b) waives payment of all further premiums (c) pays an annuity of 10% of sum assured till date of maturity and (d) pays the balance of 50% of sum assured on death or on maturity with bonus.
- **Marriage Endowment or Education Annuity (with profits):** This is an Endowment Assurance. If death occurs during the period of insurance, no immediate payment is made. Payment in lump sum (in case of Marriage Endowment) and payment in half-yearly installments spread over a period of 5 years (in case of Education Annuity) are arranged on/from the date of maturity only. Several benefits are available on maturity.
- **Money Back Plans:** These are all basically Endowment Assurance policies. But the face value of the policy is paid in installments on survival of the insured at the end of fixed terms during the period of insurance, the balance of the face value of the policy being made available on maturity. In case of death during the period of insurance, the total sum assured (without deducting any survival benefits already paid) will be made available to the beneficiaries. For example, under a 20-year Money Back policy, on survival of the insured at the end of the 5th year, 10th year and 15th year of the policy, 20% of the sum assured is paid on each occasion. These are called survival benefits. The balance of 60% of sum assured along with bonus is paid on maturity. In case of death of the insured any time during the 20-year period, the full sum assured along with accrued bonus is paid without deducting any survival benefits already paid.

  Money Back (20 years, 25 years), Jeevan Surabhi, Jeevan Sanchay are different types of Money Back plan. Jeevan Sneha is a special type of Money Back Plan designed for females. For children also, LIC of India offers a separate Money Back policy.

Special Plans

LIC of India has designed several products for children. Children Deferred Assurance Plans, New Children Deferred Assurance Plan, Jeevan Balya, Jeevan Kishore, Children's Money Back Plan, etc. Jeevan Sukanya is offered especially for girls.

For the benefit of disabled children, parents can take either Jeevan Aadhar or Jeevan Vishwas policies. In respect of both the policies, exemption from Income Tax is available up to an annual premium of Rs.20,000 subject to certain conditions.

Jeevan Aadhar is a limited payment whole life policy on the life of the parent. On the death of the parent, 20% of the face value of the policy is immediately paid and the balance of 80% will be converted into an annuity payable monthly to the disabled child.

Jeevan Vishwas is an endowment policy. Either on the death of the parent or on maturity of the policy, benefits similar to the Jeevan Aadhar Policy are available to the disabled child.

MEDICAL BENEFITS

LIC has designed a policy by the name Jeevan Asha II.

This is an Endowment Assurance with a medical benefit rider. 2% of the face value of the policy is paid every two years (at the option of the insured) to enable the policy owner to have regular medical check-ups. The first such payment is made after three years. Twice during the period of insurance, LIC reimburses expenses ranging from 20% to 50% of face value of the policy, which encompasses minor or major surgeries.

Joint Life Policies

These policies can also be categorized under the following Endowment Insurance products:

- *Jeevan Saathi* is a Joint Life Assurance for both husband and wife. During the period of insurance, if any one (first life) of the married couple dies, the insurer pays the face value of the policy but subsequently the risk coverage continues on for the spouse (second life) till the date of maturity. Premiums payable from the date of death of the first life are waived. On maturity or on death of the second life, if earlier, the face value of the policy is paid.
- *Jeevan Saritha* is also a Joint Life Assurance for husband and wife but provides benefit of joint life and last survivorship annuity also, apart from lump sum payment on death or maturity.

Unit Linked Insurance Plans (ULIPs)

Unit Linked Insurance Plans (ULIPs) is the new best selling product in the insurance market. In simple terms, Unit Linked Products are innovative Capital Market Linked Insurance products where the premium payable by a consumer consists two parts viz., the risk premium and the investment premium. While risk premium takes care of providing security to the family in case of premature death of the policy owner, the second part i.e., investment premium will be invested in the capital market in the form of units by the insurer. Investment will be the sole concern of the insured, as he will decide on the type of fund in which the units should be invested. Thus, while getting the risk coverage one is able to fetch some money from capital market investment.

ULIPs and Traditional Insurance Plans

Traditionally, an insurance seeker preferred endowment plans to insure self against any eventuality and at the same time make some money to meet his financial objectives. Thus, endowment plans served the purpose of the insurance seekers who really wanted to make some money from the market in addition to having the insurance coverage. But, the arrival of ULIP on the scene has changed the entire definition of investment through insurance products.

One distinct aspect about ULIP is its flexibility. Insurance companies offer as many as six options within a ULIP with equity component differing from zero to a maximum of 100%; the options facilitate to whet one’s risk appetite. A person desirous of buying a ULIP product has the option to select one option that best fits his objective and his approach to risk. Even after selecting the option, he still has the choice to switch to another investment option. Another innovative feature in ULIPs is the Top-up facility. A Top-up is a one-time additional investment over and above the annual premium. In the traditional endowment plan, the concept of top-up facility is missing; also, skipping of the premium may lead to a lapse in the policy. ULIPs allow an insured to skip premium after regular payment in the initial years, when he/she is really in a financial trouble. For instance, if one has regularly paid the policy premium for three years, he/ she may skip the fourth year premium, though it is not recommended. This is unlike traditional endowment plan where one does not have the liberty to choose from among the investment options and therefore, keep oneself stuck to the option selected.

Characteristics of ULIPS

INVESTMENTS

Unit Linked Insurance Plans score in terms of investment avenues. Traditional endowment plans invest in government securities, money markets and corporate bonds. ULIPs, on the other hand, invest in various investment avenues with a few caps on each instrument such as stocks, bonds, etc.

TRANSPARENCY

The very essence of the ULIPs is in their transparency in terms of various disclosures. ULIPs are more transparent than the traditional endowment plans. As ULIPs are market-linked, they are visible in terms of price per unit. There is Net Asset Value (NAV), which is declared on a daily basis. The investors need to do simple calculations to know the status of their funds. Most ULIPs providers give their portfolio on a daily basis; and this gives an idea about how one's money is being managed.

As in the case of traditional endowment plans, insurers do send their annual statement of bonus declared during the year, which gives them an idea of how their insurance plan is faring. However, the very concept of NAV is missing, which would have made it more transparent.

LIQUIDITY

ULIPs are more liquid compared to the traditional endowment plans. As investments in ULIPs are NAV based, it is always possible to withdraw a portion of one's investment before maturity, however, with some provisions. The following table draws a comparison between ULIPS and Traditional Endowment Plans.

	ULIPs	Traditional Endowment Plans
Sum assured	As a multiple of the premium	Known upfront, premium is based on it
Investments	Allocation to equities, bonds, g-secs, money market depending on the option	Larger allocation to bonds, g-secs, money market smaller equity allocation
Expenses	Lower agent commissions, higher funds management charges	Higher agent commissions
Flexibility	High	Low
Transparency	High	Low
Liquidity	High	Low
Tax benefits	Available	Available

Source: www.personalfn.com

ULIPS and Mutual Funds

ULIPs as an investment avenue closely resemble mutual funds in terms of their functioning and structure. The insurance company also allots units to ULIPs and a NAV is declared for the same on daily basis like in the case of mutual funds.

The following table draws a comparison between ULIPS and Mutual Funds.

	ULIPs	Mutual Funds
Investment amounts	Determined by the investor and can be modified as well.	Minimum investment amounts are determined by the fund house.
Expenses	No upper limits, expenses determined by the insurance company.	Upper limits for expenses chargeable to investors have been set by the regulator.
Portfolio disclosure	Not mandatory.	Quarterly disclosures are mandatory™*.
Modifying Asset Allocation	Generally permitted for free or at a nominal cost.	Entry/exit loads have to borne by the investor.
Tax benefits	Section 80C benefits are available on all ULIP investments.	Section 80C benefits are available only on investments in tax-saving funds.
* There is lack of consensus on whether ULIPs are required to disclose their portfolios. While some insurers claim that disclosing portfolios basis is mandatory, others state that there is no legal obligation to do so.		

Source: www.personalfn.com

PERSONAL ACCIDENT INSURANCE

Personal Accident Insurance makes provision for payment of fixed compensation for accidental body injury resulting in death or disablement. The amount of claim payable is related to the amount insured under the policy. Disablement could mean permanent disablement such as loss of limbs, paralysis or temporary disablement, that is, inability to continue one's occupation or profession or business for a temporary period. In India accident insurance became a non-tariff class of business from 01.04.1994.

In Personal Accident Insurance, accident needs to be the sole and direct cause for death i.e. accident should be the proximate cause of disability or death. In case of partial and or temporary disability a part of amount is usually paid. Insurers also pay weekly compensation in case of disablement, which is a percentage of the capital sum insured.

Age Limit: The minimum age is 5 years and maximum age limit is 70 years. This is the basic age group which is provided cover at nominal rates. For those who have completed 70 of age and are existing policy holders, insurers may provide the insurance cover at an additional loading of 5% as renewal premium and for those who are fresh applicants, with an additional loading of 10%.

Disability may be of the following types:

- Permanent Total Disablement (PTD);
- Permanent Partial Disablement (PPD);
- Temporary Total Disablement (TTD); and
- Temporary Partial Disablement (TPD).

Permanent Total Disablement (PTD): In this case the disablement is total and permanent in nature. The assured is neither in a position to carry on his earlier vocation nor take up a new profession. The person will not be in a position to earn. He will lose his earning capacity as a result of disability which is permanent caused by accident. Permanent total disability includes, loss of both eyes, or both legs or both hands or one hand and one leg or one eye.

Permanent Partial Disablement (PPD): In this case, the disablement is permanent but not total. The assured may not continue his earlier profession but he may be in a position to take up a new vocation. The amount of benefit is computed according to a table and this amount may differ from insurer to insurer. A Medical Examiner's certificate is called for while paying weekly compensation.

Temporary Total Disablement (TTD): The disablement is total but temporary. It prevents a person from carrying his vocation for a short period. Sometimes the period may range from few days to few years also.

Temporary Partial Disablement (TPD): This is a temporary but partial disability. A person suffers minor injuries which are usually recovered in short period of time. The person can get back to his earlier profession.

Some of the insurance policies available for accidental cover are personal accident (Individual/group), Janat a personal accident and Gramch personal accident policies. Apart from this there are personal accident policies for specific groups:

- Students – Suraksha Policy
- Girl children – Bagyashree Child Welfare Policy
- Women – Raj Rajeshwari Mahila Kalyan Yojana Policy
- NRI – NRI Personal Accident Policy.

Scope of Cover under Personal Accident Insurance

Under the personal accident insurance the insurer undertakes to pay the insured or his legal personal representative, the following sums:

If at any time during the currency of the policy the insured sustains any body injury resulting solely and directly from accident caused by external violent and visible means:

a. If such injury, within 12 calendar months of its occurrence, be the sole and direct cause of the death of the insured, the capital sum insured as stated in the schedule of the policy document.

b. If such injury within 12 calendar months of its occurrence, be the sole and direct cause of the total and irrecoverable loss of:

   i. Sight of both eyes or of actual loss by physical separation of the two entire hands or two entire feet or one entire hand and one entire foot or loss of sight of one eye and loss of one entire foot or one entire hand – the capital sum insured, stated in the policy document.

   ii. Loss of two hands or two feet or one hand and one foot, or loss of sight of one eye and loss of use of one hand or one foot – the capital sum insured stated in schedule of policy document.

c. If such injury within 12 calendar months of its occurrence be the sole and direct cause of the total and irrecoverable loss of:

   i. Sight of one eye or actual loss by physical separation of one entire hand or one entire foot, 50% of the capital sum insured stated in the policy document.

   ii. Total and irrecoverable loss of use of a hand or a foot without physical separation, 50% of the capital sum insured.

d. If such injury shall as a direct consequence permanently, totally and absolutely disable the insured from engaging in any employment or occupation of any description whatsoever, then a lump-sum equal to capital sum insured.

   (The benefits under items b, c and d are known as permanent total disablement benefits).

e. If such injury shall within 12 calendar months of its occurrence be the sole and direct cause of the total and irrecoverable loss of use of or the actual loss by physical separation of the following, then a percentage of the capital sum insured shall be payable. This benefit is called permanent partial disablement benefit.

f. If such injury shall be the sole and direct cause of temporary total disablement, then so long as the insured is totally disabled from engaging in any employment or occupation of any description whatsoever, a sum at the rate of the capital sum insured per week is payable. This benefit is known as temporary total disablement benefit.

g. The compensation payable under the foregoing sub-clause (f) shall not be payable for more than specified number of weeks in respect of any one injury calculated from the date of commencement of disablement and shall not exceed the capital sum insured.

h. A clause called Education Fund has been incorporated under the Personal Accident tariff (Effective from 10.4.89).

The payment is made along with capital sum insured subject to a maximum limit prescribed in the policy document to the person/s. An undertaking from the person receiving the amount that the same will be spent solely for the education of the child/children of the deceased should be obtained before settlement.

The benefit under this extension is available on the basis of the original capital sum insured only and not on the cumulative bonus. The age limit of 23 years shall apply on the date of accident and not at the beginning of the policy year. The policy of insurance is extended to provide compensation towards Education Fund for the dependent children of the insured in the event of death or permanent, total disablement of the insured due to accident.

Exclusions:

The following are exclusions under the Personal Accident Insurance:

i. Compensation under more than one of foregoing sub-clauses in respect of the same period of disablement except under sub-clause (f).

ii. Any other payment after a claim under one of the sub-clauses (a), (b), (c) or (d) has been admitted and becomes payable.

iii. Any payment in case of more than one claim under the policy during any one period of insurance by which the maximum liability of the company in that period would exceed the sum payable under sub-clause (a) of this policy.

iv. Payment of weekly compensation until the total amount shall have been ascertained and agreed.

v. Payment of weekly compensation in respect of death, injury or disablement of the insured:

   a. From intentional self-injury, suicide or attempted suicide.

   b. Whilst engaging in aviation or ballooning or whilst mounting onto, dismounting from or traveling in any balloon or aircraft other than as a passenger (fare paying or otherwise) in any duly licensed type of aircraft anywhere in the world.

   c. Directly or indirectly caused by veneral diseases or insanity.

   d. Arising or resulting from the insured committing any breach of law with criminal intent.

vi. Payment of compensation in respect of death, injury or disablement of the insured due to or arising out of or directly or indirectly connected with or traceable to: war, invasion, act of foreign enemy, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, mutiny, military or usurped power, seizure, capture, arrests, restraints and detainments of all kings, princes and people of whatever nation, condition or quality.

vii. Payment of compensation in respect of death of or body injury or any disease or illness of the insured:

a. Directly or indirectly caused by or contributed by or arising from ionizing, radiations or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel. For the purpose of this exception, combustion shall include any self-sustaining process of nuclear fission.

b. Directly or indirectly caused by or contributed to or arising from nuclear weapons material.

Provided also that the due observance and fulfillment of the terms and conditions of this policy (conditions and all endorsements hereby are to be read as part of this policy) shall so far as they relate to anything to be done or not to be done by the insured be a condition precedent to any liability of the company under this policy.

viii. **Pregnancy Exclusion Clause:**

The insurance under this policy shall not extend to cover death or disablement resulting directly or indirectly caused by, contributed to or aggravated or prolonged by child birth or pregnancy or any consequence thereof.

The contingencies covered under a typical accident insurance policy, and the amount of compensation payable along with the cost is mentioned in (Table 2).

Table 2

	Accident Cover	Covered Available	Rates in Rs.per 1,000 of Capital Sum Insured
i.	Death – 100% of amount insured (CSI).	(1)	0.60
ii.	Loss of two limbs, two eyes or one limb and one eye – 100% of amount insured.	–	–
iii.	Loss of one limb or one eye – 50% of amount insured.	(1 to 3)	1.00
iv.	Permanent total disablement from injuries other than mentioned above – 100% of amount insured.	(1 to 4)	1.25
v.	Permanent partial disablement – varying percent of amount insured.	(1 to 5)	1.25
vi.	Temporary Total Disablement (TTD) – 1% of amount insured up to 104 weeks (Max. weekly benefits not exceeding Rs. 5,000).	–	–
vii.	Temporary Partial Disablement (TPD) 0.3% of amount insured up to 104 weeks (Maximum weekly benefits not exceeding Rs.500).	(1 to 7)	2.00

	Accident Cover	Covered Available	Rates in Rs.per 1,000 of Capital Sum Insured
viii.	Sickness & Disease cover – Temporary Total Disablement (TTD) up to:		
	a. 52 weeks at the rate of 0.5% of amount insured (Maximum weekly benefits not exceeding Rs.5,000) if confined to bed.	–	–
	b. 4 weeks in case of convalescence – 0.2% of amount insured (Maximum weekly benefits not exceeding Rs.300).	–	–
ix.	Reimbursement of Medical/Surgical/ Hospital/Nursing Home expenses necessarily incurred, subject to a limit of 2% of amount insured or 25% of valid claim, whichever is less.	(1 to 9)	5.00

Note: Maximum benefit under section 8(a)(b) is limited to 56 weeks in all during the entire policy period.

It is possible to arrange personal accident insurance cover on a selective basis also, at reduced premium costs. For example, insurance may be arranged for contingency of death only (cover 1) or death and loss of limbs (cover 1 to 3) and so on.

Extension of Coverage under Personal Accident Insurance

- **Medical Coverage:** At extra cost, sickness cover can be added to the policy, so also medical, surgical, hospital and nursing home expenses. Limits for medical coverage are as follows:

  i. Up to 25% of the claim amount or 10% of CSI on payment of additional premium of 10% or

  ii. Up to 50% of the claim amount or 10% of CSI on payment of additional premium of 25%.

  Exclusions: Not all diseases are covered, sickness insurance excludes diseases like – asthma, bronchitis, chronic nephritis and nephritic syndrome, diarrhoeas and all types of dysenteries including gastro enteritis; diabetes mellitus and insipidus, epilepsy, hypertension, influenza; all psychiatric or psychosomatic disorders; malaria, pyrexia of unknown origin; tonsillitis and upper respiratory tract infection including laryngitis and pharyngitis; and tuberculosis in any form.

  Reimbursement of medical expenses is subject to production of bills, vouchers, prescription, etc. If the insured person has other facilities for medical insurance either provided by his employers or arranged by him on his own, there is no need to purchase medical expenses extension under the personal accident policy.

- **War and Allied Risks:** War risk cover is granted to Indian personnel/experts working in foreign countries on civilian duties. In respect of both individual and group personal accident policies for Indian personnel/experts working in foreign countries on civilian duties, risk cover is permissible on payment of following additional premium:

– Personal accident policies issued during peace time/normal period – 50% extra over the tariff rate.

– For personal accident policies, during abnormal/apprehensive period – 150% extra over the tariff rate.

Additional Benefits under Personal Accident Insurance

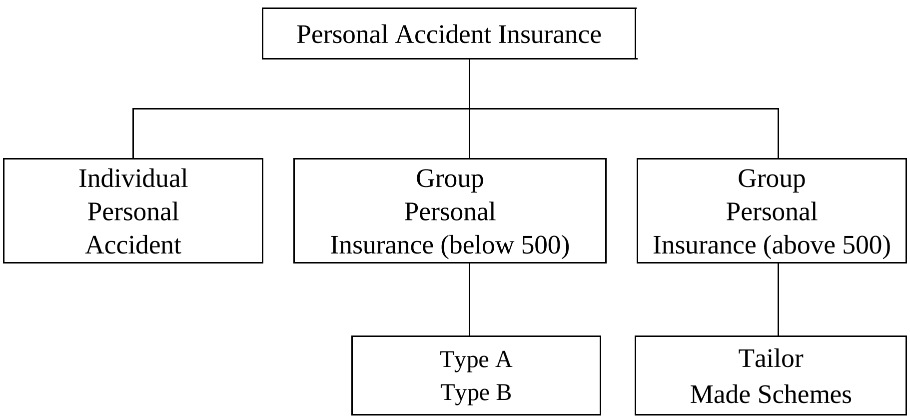
The amount of additional benefits payable on different contingencies, are usually indicated in the insurance policy document and may differ from insurer to insurer. Apart from the benefit of the capital sum insured, the following additional benefits are payable:

- **Expenses on Carriage of Dead Body:** The Personal Accident Insurance covers the actual expenses incurred for the carriage of the dead body of the insured to the place of residence subject to maximum of 2% of CSI or Rs.2,500, whichever is less.
- **On Duty Cover:** If Personal Accident cover is required only for the restricted hours of duty (and not for 24 hours) a reduced premium equivalent to 75% of the appropriate premium, should be charged. This restricted cover is intended for employees only under policies taken out by the employers for the employees meeting with accident arising out of, or in the course of employment only.
- **Off Duty Cover:** If cover is required only for the restricted hours when the insured employee is not at work and or not on official duty, a reduced premium of 50% of appropriate premium can be charged. A suitable clause shall be incorporated in the policy.
- **Education Expenses:** The education expenses of dependent children are taken care in case of death or Permanent Total Disability. This benefit may be in addition to the Capital sum insured. The benefit is payable as follows and does not include cumulative bonus:

  i. If the insured person has one dependent child, below age of 23 years, then amount payable is equal to 10% of CSI subject to a maximum of Rs.5,000.

  ii. If the insured person has more than one dependent child below the age of 23 years, then amount payable is equal to 10% of CSI subject to a maximum of Rs.10,000.

Figure 1



UNDERWRITING CONSIDERATIONS

Personal Accident insurance is a benefit policy and not strictly a contract of indemnity. The amount of insurance must be regulated by the financial position of the proposer. It is undesirable to grant cover for benefits, which will place the insured in a better financial position when he is disabled than, when he is following his normal profession or occupation. This may lead to a temptation to unduly prolong the incapacity. Hence, it is important to consider the proposer's net income and the resultant loss of earning capacity due to the accident. A reasonable margin may be allowed for extra expenses which may have to be incurred in the event of disablement. As a general rule, the compensation in respect of Temporary Total Disablement must be limited to his income per week.

FIXATION OF CAPITAL SUM INSURED

In order to fix a reasonable capital sum insured, insurers use Acceptance Limits Tables because of the simplicity and convenience in adopting them. Each table represents the maximum capital sum insured that can be offered to the proposer:

i. As different tables represent different capital sum insured it helps in fixing the appropriate amount according to the income of the proposer. This concept follows the Human Life Value principle of Dr. S.S. Huebner. In practice the operating officer has limits to underwrite the policy, and in higher sums the controlling office takes underwriting decisions.

ii. The insurer should satisfy itself that the capital sum insured is commensurate with the income of the insured person. The insured's reported income as incorporated in the proposal form is to be substantiated at the proposal stage itself by verification of Income Tax Returns and/or other records. If necessary, supporting documents have to be obtained.

iii. The acceptance limits are as follows:

    Table I – 48-60 months salary/income.

    Table II – 24-48 months salary/income.

    Table III – 24 months salary/income.

    If the capital sum insured for Table I or II is required, in exceptional cases, for a higher limit than mentioned above, the matter should be referred to the controlling office. Each such case should be examined by the controlling office on individual merits and the appropriate capital sum insured should be fixed between 60 and 100 months of the monthly income/salary after verification of the relevant records.

    Such a decision should be exercised only in deserving cases with the reasons recorded. In case the capital sum insured is required for more than 100 months under Tables I and II, the matter should be referred to the Head Office for approval well in advance.

iv. The insurer verifies even the existing personal accident policies so as to ensure that the maximum sum insured as mentioned above under different tables is not exceeded. If, however, for any valid reason, the capital sum insured has been fixed in excess are dealt by higher office of insurer.

v. The above limits will also apply to each individual who may avail of more than one policy.

The above limits are designed keeping in view the moral hazard involved in the insurance contracts. Moral hazard is very important in connection with this class of insurance. Acceptance must be limited to persons of good health, sound physical and mental condition. The duly completed proposal form must be carefully examined to ensure that the proposer is a healthy, sober and temperate person without any physical defect or infirmity. In particular, the proposer's weight must not be unduly light or heavy in relation to his height. In case the proposer has already lost or seriously impaired the sight of one eye or lost a limb or part of the limb or any other part of the body or is suffering from diabetes, defective hearing or deafness, fits, gout, heart problem, hernia, paralysis, rheumatic complaint, varicose veins etc., the consequences of accident tend to be more serious. Under these circumstances such proposals will have to be specially examined. In any event it is desirable that such proposals are approved by the controlling office.

Generally no proposal from persons below 12 years of age is considered. However, there is a provision in the tariff guidelines which allows insurers to use their discretion to cover persons below 12 years and above 70 years but the rate should be higher than which is applicable to persons between 12 and 70 years of age (the age group for which rates have been prescribed). However, insurance to persons below 12 years of age may be discouraged. The age limit has since been revised to 80 years. When proposals from persons above 70 are received, the premium should be loaded by 10%. This should be done once only between the age of 70-80 years. Medical examination should not be mandatory either for renewal or fresh cover.

Premium Rates

As mentioned earlier, the premium rates under Personal Accident Insurance, are non-tariff based, hence insurers can charge different premium rates. Following are the guidelines which prescribe premium rates for various covers indicated above, depending upon the category to which the insured person belongs.

CLASSIFICATION OF RISKS

Classification of risks helps the insurer in the underwriting process, whereby the rates are assigned to each category. The classification is done on the basis of occupation of the proposer. Personal accident risks are divided into three classes as detailed below:

Normal: This category covers the following professionals: Bureaucrats, doctors, lawyers, accountants, architects, bankers, consulting engineers, teachers, persons engaged in administrative functions and persons primarily engaged in occupations of similar hazard.

Medium: This category covers the following professionals: Builders, contractors, engineers engaged in superintending functions only, veterinary doctors, paid drivers and persons engaged in occupations of similar hazard and not engaged in manual labor. All persons engaged in manual labor include (except those falling under heavy risk), cash carrying employees, garage and motor mechanics, machine operators, drivers of heavy vehicles, professional athletes and sportsmen and wood working machinists and persons engaged in any occupations of similar hazard.

Heavy: Persons working in underground mines, explosives, magazines, works involved in electrical installations with high tension supply, jockeys, circus personnel, persons engaged in activities like racing on wheels or horse-back, big game hunting, mountaineering, winter sports, sking, ice hockey, ballooning, polo and persons engaged in occupations of similar hazards.

In case of any doubt regarding occupations not specified above, a reference is made by the issuing office to the controlling office of the insurer for a decision depending upon the merit of each case.

Accident Cover Rider

Accident cover rider is provided by way of add on cover in life insurance policies, on payment of additional premium of Re.1.00 per thousand sum assured. The maximum ceiling is Rs.10 lakh. It is popularly known as Double Accident cover in which additional sum assured is payable on accidental death. Premium waiver benefit is provided on permanent and total disability of the life assured, whereby the future payment of the premiums is waived. A fixed percentage of the sum assured is also payable to the life assured, which is known as disability benefit.

Under composite package policies such as House Holders, Shopkeepers, Golfer’s Policies, Gun Policies etc., where personal accident is covered, the cover is granted as per the tariff rate except where the scheme provides otherwise. The policy provides worldwide coverage. Payment of claim, however, can be made only in India in Indian Rupees.

Claims Procedure under Personal Accident Insurance

The following is the claim procedure to be followed for obtaining the claim payment:

a. Claim form duly filled, should be submitted to the insurer.

b. In the prescribed form, the doctor who treated the injured person should certify the nature of injury, duration of treatment and also duration of disablement.

c. Leave certificate from the employer wherever applicable.

d. Medical bills, diagnostic reports etc., should be obtained.

e. In case the insurer feels that the claim is exaggerated or is not a genuine claim, the dealing office should arrange to get the insured examined by a physician or surgeon on their panel.

f. In case, of fatal claim, the assignee or the insured's legal heir should submit death certificate and post-mortem report.

g. After satisfying itself about the assignee or the insured's legal heir, the insurer settles the claim.

PERSONAL ACCIDENT INSURANCE FOR INDIVIDUALS

As stated earlier, the personal accident insurance is intended to provide compensation in the event of either death or disability of the insured person, and the event must have resulted solely and directly from the accident, and caused by external, violent and visible means. Payment of medical expenses up to a certain percentage of the Capital Sum Insured or a percentage of the actual claim amount or the actual medical expenses incurred whichever is less are admissible only if incurred in connection with any accident which has given rise to a claim under the policy. Hazardous sports, activities or pursuits can also be covered by payment of extra premium. The provisions and conditions mentioned above are almost applicable to the individual personal accident insurance.

Family Cover: Some insurers provide option for self cover and family cover in accident insurance plans. In the latter the family members are also covered for the perils which cause the death or disablement.

Earning member	100% of capital sum insured
Spouse (If earning)	100% of capital sum insured
Spouse (If non earning)	50% of capital sum insured
Children (5 to 25 years)	25% of capital sum insured

Additional conditions for family cover:

1. A discount of 5% is allowed on gross premium.
2. While paying premium for husband and wife, the total sum insured is taken into account.
3. For children only death and permanent disability cover is provided.

TRAVEL INSURANCE

Travel insurance provides insurance cover when an individual is on tour. It can be considered a part of the holiday package. The travel may be undertaken for tourism, visit, business trip, health check-up etc.

The insurance cover is available to person below 70 years and who undertakes travel either within the country or abroad. The travel may be by sea, air or road. The normal travel insurance policy offers a wide range of options. These are grouped together for a special package arrangement.

The options are as follows:

- **Missed Departures:** It covers the losses incurred due to missed departures. Generally it is subject to limit, imposed by the insurers.
- **Personal Baggage:** This part is intended to take care of the baggage of the life assured, which may be damaged, stolen or lost while traveling.
- **Personal Liability:** It covers the liabilities incurred by the life insured while on tour. Limits are imposed by the insurer, for payment of liabilities.
- **Passport Indemnity:** It covers the losses suffered on losing passport while on tour.
- **Personal Money:** It takes care of the money lost while on tour.
- **Delayed Baggage:** Due to delayed baggage insured may have to incur additional expenses, which are covered under this section.
- **Travel Delay:** The losses suffered, by the life assured due to the delay in the traveling is covered under this section.
- **Personal Accident:** Any injury or loss of life caused to the assured while traveling are covered by way of personal accident.
- **Medical and Emergency Travel Expenses:** Medical and emergency travel expenses incurred on tour are covered under this head.
- **Hospitalization Benefits:** Any hospitalization expenses incurred by the life assured are covered.

Factors under Travel Insurance

a. Age of persons to be insured 14 to 70. (Children below 14 years usually are excluded).

b. Places being visited and risk exposure.

c. Period of the holiday.

d. Mode of travel.

e. Environment conditions and seasons etc.,

Plans of a public sector insurance company and private insurance company are discussed for the benefit of the student.

Air Travel Accident Insurance Cover

A special feature of the Personal Accident insurance scheme is that the risk of body injury during air travel, whether by scheduled flights or chartered flights, is automatically covered, irrespective of the number of flights during the year of insurance.

Flight Coupons

If annual personal accident insurance is not desired, persons undertaking air travel can purchase 'Flight Insurance Coupon' which is designed to cover a passenger against the risk of accidental body injury resulting in death or permanent disability caused whilst in or entering into or disembarking from any aircraft operated by a regular airline over a scheduled route.

Tariff Rate

As the duration of coverage is limited to the period of the flight, the premium cost of Rs.1 lakh policy is Rs.5. Therefore, if one travels say, 20 times in a year, flight insurance would cost Rs.100. One might as well buy an annual Personal Accident Insurance for, say Rs.1 lakh at a cost of Rs.60 for death risk and Rs.150 for death and disablement etc. Besides, this insurance provides coverage on a 24-hour basis for 365 days.

The premium rate is Rs.5 per Rs.50,000 sum insured, for a flight of not more than 24 hours' duration. However, the minimum premium would be Rs.5 in all cases.

The payment of compensation for air accidents, whether under Annual Personal Accident polices or Flight Insurance Coupons, is independent of the statutory liability of the airlines to pay compensation under the provisions of the Indian Carriage by Air Act, 1972.

Maximum Limits

The maximum limits of compensation provided for passengers in domestic flights are as follows:

i. *Death or Permanent Disablement* – Rs.2 lakh if over 12 years of age attending to usual business or occupation and Rs.1 lakh if below 12 years of age.

ii. *Temporary Total Disablement* – Rs.200 per day during the period of attending to usual business or occupation of disablement or Rs.40,000, whichever is less.

For 'international' flights the limits of compensation are provided in accordance with International Conventions such as the Warsaw Convention, the Hague Protocol, the Montreal Agreement (1966), etc. These limits apply in relation to passengers traveling by air between countries which have ratified all or any one of the other conventions. India has ratified all the conventions.

Coverage

The limit of compensation under Warsaw Convention is approximately Rs.80,000 per passenger. This limit is doubled under the Hague Protocol. The Montreal Agreement, 1966 applies to air travel and includes a point in the USA as a point of origin, point of destination, or agreed stopping place. And the limit of compensation for each passenger for death or body injury is fixed at Rs.6 lakh (approx.) inclusive of legal fees and costs or Rs.4.64 lakh (approx.) exclusive of legal fees and costs.

Passenger's Flight Insurance Coupon covers death and/or permanent disability and any body injury caused by violent, accidental, external or visible means whilst traveling in or entering into or descending from any aircraft owned and/or operated by a regular airline over a scheduled route by which the insured is traveling as a passenger during flights specified.

Benefits:

The following is the extent of compensation payable:

1. Should such injury, within three calendar months from the occurrence thereof, solely and directly:
   a. Cause the passing away of the Insured, or Result in the loss of
      i. Both hands or feet
      ii. One hand and one foot
      iii. One hand or foot and the complete and irrecoverable loss of sight in one eye.

      Compensation: The Capital Sum Insured

   b. Cause or result in the complete and irrecoverable loss of sight in both eyes.

      Compensation: The Capital Sum Insured

2. Should such injury, within three calendar months from the occurrence thereof, solely and directly cause or necessarily result in:
   a. The loss of the whole of one hand or one foot.
   b. The complete and irrecoverable loss of sight of one eye.

      Compensation: 50% of the Capital Sum Insured

3. Should such injury, solely directly and totally disable and prevent the Insured from attending to his business or occupation for the period of such total disablement with a maximum of 52 weeks from the date of the accident. Maximum weekly Benefit not to exceed 1% of the Capital Sum Insured subject to a maximum of Rs.3,000.

   Compensation: 1% of the Capital Sum Insured Per Week.

4. Should such injury, solely, directly and totally disable the insured and prevent him from attending to a substantial portion of his business or occupation, compensation for the period of such partial disablement with a maximum of 52 weeks from the date of the accident.

   Compensation: 0.15% Of The Capital Sum Insured Per Week.

Exclusions:

i. War and allied perils.

ii. Injury or death whilst under the influence of intoxicants, lunacy or insanity in case these are the direct/indirect causes.

iii. Injury or death arising from disobedience of instructions of air craft crew, owners, operators or their agents or servants.

iv. Accidental death of the insured shall not be presumed by reason of his disappearance.

SUMMARY

- Insurance as a risk management tool reduces financial risks and shares losses. Like any other insurance policy, a life insurance contract, provides financial security to the dependents of the insured. The policy not only provides financial security, but also acts as a savings tool.
- Before obtaining an insurance policy, an individual needs to calculate his life insurance needs.
- Life insurance coverage is available in various forms such as term insurance, endowment assurance, whole life policy, universal and variable life insurances. Selecting a life insurance is a difficult task. Thus it is very essential for the policyholder to understand the terms and conditions of the policy.
- Before selecting the policy, the proposer should review his needs; compare the variety of products available in the market and then opt go for the right kind of life insurances policy.

Chapter IX

Health Insurance

After reading this chapter, you will be conversant with:

- Health Insurance – it's Need
- Types and Sources of Health Care Plans
- Providers of Health Care
- Long-term Care Insurance
- Disability Income Insurance
- Critical Illness Insurance
- Health Insurance in India

Introduction

Rohan, 36, had a cardiac arrest. He is married and has two kids aged 10 and 6. His critical illness became a financial burden for the family. His medical expenses drained most of his savings. It was then he realized that he had no health insurance policy.

After obtaining a life insurance policy, the next step by an individual should be to obtain a health policy. As life insurance protects against death, similarly health insurance comes to rescue, when an individual faces financial crises due to his ill health or any form of disability. A person may have been saving for future needs in the form of various saving schemes. But all his savings may go down the drain if he falls ill or meets an accident. Thus the financial condition of the whole family would be in jeopardy, if he or she is the only breadwinner of the family. Thus in addition to investing in various savings tools, it is essential for an individual to obtain an appropriate health policy at the right time.

After understanding the significance of health insurance, let us clearly define what health insurance is. It can be defined as "any form of insurance whose payment is contingent on the insured incurring additional expenses or losing income because of incapacity or loss of good health". Health insurance can be classified into three main categories:

Medical Expense Insurance

The expenses of the insured, such as hospital, physician and other health care expenses are covered.

Long-term Care Insurance

Long-term insurance policies promise to pay expenses if the incapacity prohibits the insured's activities of daily life.

Disability Income Insurance

Disability income policies replace lost income when the insured is disabled as a result of sickness or injury. Payment is made because physical or mental incapacity prevents the insured from working.

HEALTH INSURANCE – IT'S NEED

Apart from providing protection to the insured, health insurance provides benefits as a long-term savings tool and reduces undue mental tension at the time of critical illness or disability. Taking this into consideration, the benefits of health insurance can be underlined as follows:

Savings Tool

People may prefer to save in various saving instruments than buying a health policy. But these savings involve a lot of time and may not be available at short notice and at the time of need. A saving program will yield very little in the beginning, while an insurance policy guarantees the full value and also various other benefits mentioned in the policy. Thus, if a person is unable to save sufficient amount in the early stages of his life, he should atleast obtain a health insurance policy to meet any contingency related to his health or disability.

Safe and Beneficial Instrument

A health insurance policy can be used as an accumulation plan. In addition to this, tax benefits are also available on the health polices, which increase its attractiveness as a saving tool.

Minimizes Worry

A health policyholder need not worry about the medical expenses incurred or loss of income incase of disability. The health policy takes care of all this and thus reduces undue tension on the part of the individual and his family.

Promotes Thrift

Health insurance policy may also lead to compulsory savings, if it is in the form of cash value policy. In case of cash value policy, if there is no claim made by the policyholder earlier, the whole sum insured is paid back. Thus, it leads to accumulation of savings through health insurance.

TYPES AND SOURCES OF HEALTH CARE PLANS

The health care industry is in its nascent stages in India. Although after independence, considerable progress has been made in the form of increased medical facilities, eradication of various diseases such as small pox, plague etc., and increase in the life expectancy rate, still major efforts have to be made. The demand for quality health care is rapidly increasing in the country owing to the increased awareness level among people and increase in the per capita income especially of the middle class. But the health care services sector is yet to develop to its full potential. On the other hand, in the US and the European countries, health services sector is one of the most developed sectors. There are number of products and services available provided by variety of suppliers. Thus to understand the nuances of the health care industry, let us first go through various health care providers and the services available in US and other western countries.

Health care coverage in the foreign markets can be obtained in the form of an indemnity plan or a managed care plan. Both these plans, provide financial help in case there is any loss arising from illness or accidents. A person may have a group plan obtained through his or her employer or in the form of an individual or group plan bought directly from the insurer or a government agency. Managed care plans are again categorized into Health Maintenance Organizations (HMOs), Preferred Provider Organizations (PPOs) and other similar groups. In US, 40% of the people are covered by HMOs and the remaining 60% by other forms of health insurances.

Indemnity Plans

Till 1988, indemnity plans were the most dominant health care plans and accounted for about 70% of the health insurance market. Under this plan, the organization from which insurance is purchased is separate from the insured. The insurance company either pays the provider or reimburses the insured for expenses incurred. The insured needs to submit claims for receiving payment. The reimbursement is around 80% of the costs after the deductible is paid. The deductible is the amount not covered under the policy and is paid by the insured himself.

Managed Care Plans

Managed care plans are the fastest growing segment of the health industry. Around 60% of the Americans are covered under these managed care plans. Under the managed care plan, the user needs to make monthly payments to the organization that provides the health services. Under this arrangement, the insurance companies may not be involved at all. At present there are many insurance companies, offering both managed care and indemnity plans. The following are the main features of the managed care plan:

- Managed care plans use various strategies to provide cost effective managed care.
- A small fee is paid by the user for office visits.
- No deductible is paid.

HEALTH MAINTENANCE ORGANIZATION (HMO)

HMO is an organization which consists of physicians, hospitals which provide health care services to its members. About 80 million people in the US are covered by HMOs. The HMO plan provides outpatient care, x-ray, laboratory services, maternity care, mental health care, minor surgery etc. A monthly fee is paid by the member, which varies according to the number of people in the family. The advantage of HMOs is that it reduces costs of health care and uses resources efficiently. It works on the principle of 'preventive medicine'. The members do not have to worry about deductibles, exclusions or filing insurance claims. The main disadvantage is that the members are not free to choose their own physician.

INDIVIDUAL PRACTICE ASSOCIATION (IPA)

In case of Individual Practice Association, the medical facilities are not provided from a central facility. The physicians of an IPA provide medical services to members and non members of an IPA alike. Although the service arrangements of an IPA are similar to an HMO, the physical facilities are different. Payment is made by the member monthly and large varieties of services are availed. Thus IPA's have more appeal as they allow the member some choice with respect to the physician.

PREFERRED PROVIDER ORGANIZATION (PPO)

The PPOs have both the characteristics of a HMO and an insurance plan. It provides greater flexibility than the HMO, with a network of doctors and hospitals. In addition to that it also provides insurance coverage for the medical services which are not provided by a HMO network. This organization is either administered by an insurance company or a service provider. It contracts services from a group of designated doctors and hospitals, who accept a negotiated fee schedule.

EXCLUSIVE PROVIDER ORGANIZATION (EPO) & POINT OF SERVICE PLANS (POS)

Under EPO arrangement, services are provided by the provider to the members at a reduced cost but reimbursement is made only when the affiliated providers are used. If the members use the provider that is not affiliated, then he needs to bear the whole cost. Point of services plan allows members to use the services of physicians outside the network. The payment is made similar to the indemnity plan. Under the plan, payment is made after deducting a deductible.

PROVIDERS OF HEALTH CARE

Major providers of health care are managed care organizations, Blue Cross and Blue Shield plans and health care insurance companies. In addition to this, services can also be obtained through group/individual plans and also from government agencies. The health care providers are discussed in detail hereunder:

Group Versus Individual Health Care

Group plans can be obtained either from the employer or any other professional association or directly from the provider. In case of group health insurance, the health care contract is written between a group and a health care provider, i.e., it can be a private insurance company, Blue cross / Blue shield or any other managed care organization. A group plan provides variety of services such as dental, vision care, medical expense coverage etc. The services provided under the plan are according to the negotiations between the insurer and the group.

If a person works in an organization having more than a few employees, then one would be easily covered under a group health care plan. With the high cost of health insurances, the employers generally require the employees to pay a portion of the cost. In some cases the group may also go for self insurance. In such cases, the employer may take the responsibility to make full or partial payment.

At a point of time, group health care was considered superior than the individual coverage. But now the differences between group and health coverages have narrowed and a number of advantages of group health have disappeared. This is due to the fact that many employers now do not guarantee universal coverage and are shifting a high premium cost to the employees. Individual coverage is more beneficial with the rise of downsizing, as the employees need to take individual coverage with the loss of group benefits. Individual coverage is also beneficial as the insured can tailor the coverage according to his needs. It is also possible that group insurance is taken up as a foundation or fundamental coverage and then supplemented with individual coverage.

Private Insurers

Private insurers sell a variety of indemnity and managed care plans. The most popular private insurers are Aetna, Prudential and Cigna in US. Managed care plans are offered by organizations which only provide managed care and also by other organizations which offer indemnity plans in addition to managed care plans such as blue cross/blue shield.

BLUE CROSS/BLUE SHIELD

Blue Cross and Blue Shield plans are medical plans and not insurance policies. In these medical plans, the member needs to pay the amount in advance. Under this type of arrangement, the blue cross enters into a contract with various hospitals to provide health care services to the members covered by it. On the other hand, blue shield plans provide surgical and medical services. Both these plans serve as an intermediary between the physicians and the members of the group. At present, Blue shield and Blue cross have combined to form as one single service provider, to compete with the private insurers. Around 77 million people in the US are covered by blue cross and blue shield plans.

Government Sponsored Health Care

The government also provides health care coverage. Coverage for illness, accidents and disability is provided by the government through social security administration programs. In addition to this, there is workers' compensation program which covers medical expenses, rehabilitation and disability.

SOCIAL SECURITY MEDICARE PROGRAM

The social security medicare program not only provides old age and survivor's benefit but also health insurance. The health care coverage is provided under two plans; Medicare and disability income. Medicare as a health care plan is designed to help people above the age of 65. But now it also includes individuals under the age of 65 who receive monthly social security disability benefits. Medicare can be sub-divided in two categories, basic hospital insurance and supplemental medical insurance.

Basic Hospital Insurance

Also commonly known as 'Part A', it provides inpatient hospital services for the first 90 days of illness, after applying a deductible for the first 60 days. It also covers post health services such as nursing care, rehabilitation, home health care etc.

Supplementary Medical Insurance (SMI)

It is a voluntary program, in which the members pay premiums, which are then matched with the government funds. The SMI program is for anyone above the age of 65. Also known as 'Part B', it covers the following:

- Physician's services
- Home health service
- Medical and health services
- Psychiatric care.

WORKERS' COMPENSATION INSURANCE

Workers' compensation programs are mandatory. The program has been designed to reduce the burden of job related illness or injury to the workers. Employers need to bear the entire cost and self employed employers need to make a contribution both for themselves and their employees. Workers compensation insurance covers the following basic areas:

- **Medical and Rehabilitation Expenses:** Hospital, surgical and other expenses incurred to help the employees to rejoin their jobs as quickly as possible.
- **Disability Income:** A specified percentage of pre-disability wages is paid. The amount paid is limited to maximum amount such as one and half times of the weekly wages.
- **Lump sum Payments:** Lump sum amount is paid to employees who suffer from dismemberment due to work related hazards. It may also be paid to beneficiaries in the event of death.
- **Second Injury Funds:** This is for the employers who may employ someone who is already handicapped and is further injured on the job.

Medical Expense Coverage and Policy Provisions

After going through the various health insurance plans and their providers, let us examine various types of medical expense coverage. Medical expense coverage is provided to pay for the following:

- Hospitalization.
- Prescription drugs.
- Laboratory and X- rays.
- Dental expenses.

These coverages are cost effective as they provide cover for the most important aspects of health care. Apart from this, if a person wants broader coverage, he or she can obtain major medical or comprehensive major medical coverage.

HOSPITALIZATION INSURANCE

Under hospitalization insurance, the cost of the hospital room and other incidental expenses are reimbursed. Hospitalization insurance pays for the following:

- Hospital room expenses which include meals, nursing and other services.
- Ancillary expenses in the form of laboratory tests, medicines etc.

Under some plans, a flat daily rate is given, without taking into consideration the actual expenses incurred. Some plans also provide outpatient services and out of hospital services such as pre admission testing, preventive treatment etc.

SURGICAL EXPENSE INSURANCE

It provides coverage for surgery in or out of hospital. Some plans pay a fixed amount according to the schedule of benefits where as others pay reasonable costs based on surgical costs or expenses in the previous year. The coverage pays for any type of surgery done to maintain the insured in good health. These policies cover cost of anesthetics and its administration and non-emergency treatment such as x-rays. The surgical expense coverage is provided as an integral part of the policy or as a rider. Cosmetic surgeries are excluded from the reimbursement, until and unless the surgery is done for a deformity due to an accident.

PHYSICIAN’S EXPENSE INSURANCE

It is also known as ‘regular medical expense’. It covers the cost of the physician’s fee for non-surgical care. In addition to this, it also covers x-rays and laboratory tests conducted outside the hospital. These plans are offered on a reasonable or customary basis or scheduled benefit basis. The first few visits to the physician are excluded and they serve as a deductible in the policy.

MAJOR MEDICAL INSURANCE

This insurance provides broad coverage for all types of medical expenses. The coverage is provided for a huge amount and in some policies, the coverage amount may be unlimited. These plans are used to cover expenses for catastrophic nature.

High deductibles are also used under the policies to protect against catastrophic illness. To avoid unnecessary payment of medical costs, certain provisions are included in the policy that limits payments.

COMPREHENSIVE MAJOR MEDICAL INSURANCE

The comprehensive plan combines basic hospitalization, surgical and physician expense coverage into one single policy with a low deductible. This plan is generally written in the form of a group contract.

DENTAL INSURANCE

Dental insurance covers dental health care and includes injuries sustained from accidents. Coverage is also provided for oral examination, filling, extractions, dentures, oral surgery, orthodontics etc. Dental plans also provide for provision which limit the reimbursement. Most of the dental covers are in the form of group insurance plans and in some cases companies may also offer individual and family policies.

Special Insurance Plans

These plans are generally not needed by people as appropriate coverage is generally provided by the plans already discussed above. Thus these plans in use due to the efforts of the marketing team of various insurers. These plans are discussed hereunder:

- **Accident Policies:** Under this policy, a specified sum is paid to the insured if he is injured in an accident. Such policies are sold in conjunction with an oil company or travel and entertainment cards etc. A fixed amount is paid irrespective of the actual amount of loss.
- **Sickness Policies:** Sickness policies are similar to accident policies with respect to the design of the policy and the shortcomings. The only difference is that, a disease is specified for payment or reimbursement.
- **Dreaded Disease Policy:** This policy is the popular version of the sickness insurance. Cancer policies are a popular form of dread disease policy.
- **Hospital Income Policies:** Under these policies a specific amount is guaranteed on the daily, weekly or monthly basis. Special care is taken that the policy does not cover pre-existing conditions or illness which may lead to extended hospitalization.

Policy Provisions of Medical Expense Plans

Health care plans can be compared only after evaluating various policy provisions. These provisions may be restrictive or liberal. The provisions can be categorized on the basis of terms of payment and terms of coverage.

TERMS OF PAYMENT

There are four main provisions relating to the payment made under the health care plans:

Deductible

Deductible is the amount not covered under the policy and is paid by the insured himself. Major medical plans supplement basic hospitalization, surgical and physician expense offered under indemnity plans and provide large for deductibles. On the other hand comprehensive major medical plans offer low deductibles. Most of the plans provide calendar year, all-inclusive deductible. This arrangement allows the insured to accumulate deductibles from more than one incident. That is, if a person is covered for accidents and also major illnesses, he can use the total amount of deductible available in any proportion for the different events that give rise to claims. Some plans also provide carry over provision, according to which, a part of the deductible that occurs in the last three months, can be applied to the following year’s deductible.

Co- insurance

The co-insurance provision stipulates that the insurer will pay a specific percentage of the loss covered in excess of a deductible. Co-insurance reduces the possibility of incurring unnecessary medical expenditure. This clause does not apply to expenses related to basic hospitalization, surgical and physician's expense coverage.

Internal limits

Internal limits are constraints placed on the payment of specified expenses, even if the overall policy limits are not exceeded. Internal limits are placed on the expenses such as surgical fees, hospital room expenses, nursing services etc. Thus the internal limit set by the insurer reduces the possibility of increased unnecessary medical expenditure. Thus if an insured, selects an expensive plan, he or she will have to bear the portion of charges over and above the reasonable level beyond a specified maximum amount.

Co-ordination of Benefits

The co-ordination of benefits provision prevents an insured to obtain multiple payments for the same illness or accident. Thus an insured cannot collect more than 100% of the insured amount through various insurance policies.

Terms of Coverage

The following are the main provisions affecting the value of the health care insurance plan:

PERSONS COVERED

Some health insurance policies cover only the person named in the policy and not the whole family, on the other hand; there are policies, which offer protection to all family members. In case of family protection, some policies may terminate benefits payable on behalf of children after they reach the age of 18 or 24 years.

CANCELLATION

There are certain policies, which have a provision of cancellation at the option of the insurer. Thus, it is very essential on the part of the insured to check that such a provision is not mentioned in the policy document and only those policies are bought by the insured which specifically mention that coverage will not be cancelled till the premium is paid.

PRE-EXISTING CONDITION

Most of the health insurance policies include a pre-existing clause. According to this clause, coverage is excluded in case a person has some physical or mental problems at the time the insurance policy is obtained. In some policies, the exclusion is permanent, where as in some policies this clause is applicable only for the first few years.

MENTAL ILLNESS

There are many health insurance plans, which exclude or provide reduced benefits for treatment of mental disorders. Mental illness and emotional disorders are the main health problems prevalent in western countries. Mental illness leads to extended hospitalization. Thus it is excluded from many health insurance policies.

REHABILITATION

Many health insurance policies include rehabilitation coverage for counseling, occupational therapy or job training programs. This kind of coverage not only provides for the medical expenses but also rehabilitation, incase a person becomes disabled due to an accident or any prolonged illness.

Cost Containment Provisions for Medical Expense Plans

In the past few years, various cost containment provisions are included in the health care plans to reduce rising medical costs. These provisions have been added in both the managed care and indemnity plans. These provisions are explained hereunder:

ADMISSION CERTIFICATION

In case of admission certification, the insured needs to get the approval from the insurer for going to the hospital for a scheduled stay. But in case of emergency, such approval is not needed.

CONTINUED STAY REVIEW

The insured needs to get approval of the insurer for any stay that exceeds the approved limits in the policy.

SECOND SURGICAL OPINIONS

In many health plans, second opinion is required for various non emergency procedures. In the absence of this, the surgical benefits may be reduced.

WAIVER OF CO-INSURANCE

As insurers save money by encouraging outpatient surgery, in many health insurance plans, the co-insurance clause is waived and payments are made 100% for the outpatient surgery procedures.

Types of Policy Offered by the Insurance Companies in India

Life Insurance Corporation of India

- Health Plus.

Tata Aig

- Health First
- Health Investor
- Life Health Protector.

Apollo DKV

- Easy Health Individual
- Easy Health Family Floater.

National Insurance Company

- Personal Accident Insurance
- Group Personal Accident Insurance
- Jan Arogya Bima Policy
- Mediclaim Policy
- Overseas Mediclaim Insurance (Employment & Study)
- Overseas Mediclaim Insurance (Corporate Frequent Traveller)
- Overseas Mediclaim Insurance (Business & Holiday).

Oriental Insurance Corporation

- Personal Accident Insurance
- Group Personal Accident Insurance
- Jan Arogya Bima Policy
- Mediclaim Policy
- Overseas Mediclaim Insurance (Employment & Study)
- Overseas Mediclaim Insurance (Corporate Frequent Traveller)
- Overseas Mediclaim Insurance (Business & Holiday).

United India Insurance Corporation

- Personal Accident Insurance
- Group Personal Accident Insurance
- Jan Arogya Bima Policy
- Mediclaim Policy
- Overseas Mediclaim Insurance (Employment & Study)
- Overseas Mediclaim Insurance (Corporate Frequent Traveller)
- Overseas Mediclaim Insurance (Business & Holiday).

New India Assurance Corporation

- Personal Accident Insurance
- Group Personal Accident Insurance
- Jan Arogya Bima Policy
- Mediclaim Policy
- Overseas Mediclaim Insurance (Employment & Study)
- Overseas Mediclaim Insurance (Corporate Frequent Traveller)
- Overseas Mediclaim Insurance (Business & Holiday).

Bajaj Allianz

- Hospital Cash Daily Allowance Policy
- Health Guard Policy.

Royal Sundaram

- Accident Shield
- Health Shield Insurance
- Group Personal Accident Policy
- Health Premium Platinum.

ICICI Lombard General Insurance

- Critical Care
- Family Floater Plan
- Personal Accident Insurance
- Health advantage Plus Insurance.

ICICI Prudential Life Insurance

- Hospital Care
- Crisis Cover
- Health Assure Plus
- Cancer Care
- Cancer Care Plus
- Diabetes Care
- Diabetes Care Plus
- Diabetes Assure.

Cholamandalam

- Chola Health Insurance
- Chola Family Health Insurance
- Travel Health Insurance.

Reliance

- Personal Accident Policy

LONG-TERM CARE INSURANCE

Long-term care is the delivery of medical and personal care other than the hospital care to people suffering from chronic diseases resulting from illness or frailty. Due to increasing health services, the mortality rates have reduced and people are living for a longer period than before. Elderly people after reaching certain age cannot take care of themselves and thus require long-term care. Thus long-term care is an area of financial planning which should not be neglected by an individual.

Long-Term Care Insurance Provisions and Costs

Long-term care is still evolving and its significance can be understood by going through the following provisions or features:

TYPE OF CARE

Long-term care provides benefits both for the nursing home services and also for the services provided in the insured's home. These services may be in the form of physical therapy, home health aides etc. Financial planners recommend, including both of these services. There are many policies which also cover adult day care, community care programs, etc.

ELIGIBILITY REQUIREMENTS

There are certain provisions which determine whether the insured would receive the payment or not. These provisions are known as gatekeeper provisions. For instance, one of the gatekeeper provisions is that the insured should be unable to perform his daily living activities such as bathing, dressing, eating etc.

SERVICES COVERED

Several levels of services are provided such as skilled, intermediate and custodial. Skilled care is required when a person needs constant attention from a physician. Intermediate care is provided when medical attention is required but not constant attention. In case of custodial care, assistance is required for daily activities but no medical attention is required.

DAILY BENEFITS

Long-term care benefits also provide reimbursement on a daily basis. The maximum amount given by the insurer depends on the amount of premium paid by the insured.

BENEFIT DURATION

The maximum duration varies from one year to the entire life time of an individual. The average stay in a nursing home is about two and a half years. The financial planners recommend for purchasing a policy for duration of 3 to 6 years so that care is provided for a longer period than an average period.

WAITING PERIOD

The insured needs to pay the premium during the waiting period or the elimination period. This period is generally for 90 or 100 days. Although, for the waiting period, the premium is lower, the insured should have the sufficient amount for meeting his expenses during his period.

RENEWABILITY

Long-term care policies include a guaranteed renewability to ensure continued coverage for lifetime. This clause does not provide for a level premium. The premiums may be raised in case the claim experience become unfavorable for a peer group.

PRE-EXISTING CONDITIONS

Many health insurance policies have pre-existing conditions clause for a period of 6 – 12 months. On the other hand, some policies do not include such clauses at all.

INFLATION PROTECTION

Many health insurance policies provide riders that increase benefits with the increase in the rising costs. Benefits can be increased by paying additional premium by the insured.

PREMIUM LEVELS

Premiums charged for the long-term insurance are expensive and vary according to the policies of the insurance companies. It is generally recommended by the financial planners to buy insurance policies at a young age.

Need for Long-Term Insurance

An individual needs to understand the significance of long-term care. The impact of prolonged stay in a nursing home can be great financial burden to the family. Before obtaining a long-term care policy, an individual needs to analyze the following aspects:

ASSETS

Substantial assets should be available with a person to avail the benefits of long-term care. A person should be able to afford to pay the premiums. In many cases, people having sufficient assets prefer self insurance.

PREMIUMS

Premiums of many policies can be around 5% to 7% of the annual income of a person. Thus people prefer investing the amount otherwise than spending on insurance, which would be available in the future.

FAMILY HISTORY

There may be adverse family history of various diseases requiring long-term care such as cancer.

AVAILABILITY OF FAMILY

Cost of long-term care can be reduced, if there are family members who are willing to take care of the insured in his later years.

Selecting a Long-Term Care Policy

In addition to the guidelines discussed above, the following aspects should also be taken into consideration before selecting a long-term care policy:

BUY THE POLICY WHILE YOU ARE HEALTHY

If a person contacts a disease, he becomes uninsurable. Thus, the best time to insure oneself is in the early 50s or 60s.

BUY THE RIGHT TYPE OF COVERAGE

The right kind of coverage should be bought. The coverage obtained should not be over and above the actual coverage required. The policy should cover skilled, intermediate and custodial care. Costs can be reduced by increasing the waiting period before the benefit starts. The longer the costs are covered, the lower will be the premium.

UNDERSTANDING THE POLICY

It is very essential that the policy is properly understood and only then obtained. One of the thumb rules used is that 80% to 90% of the nursing home costs should be covered.

DISABILITY INCOME INSURANCE

Disability income insurance provides weekly or monthly payments, when the insured is unable to work due to illness, injury or any other disease. Disability income insurance comes to rescue when the sole earning member of the family becomes sick for an extended period and there is an adverse impact on the financial condition of the family. Thus disability insurance should be obtained by every individual who is the sole earner for the family. Most of the employers provide disability insurance at advantageous rates. The coverage available is generally voluntary and the person may have to bear the whole cost. Social security programs also provide disability benefits, if the disability last for at least one year.

Disability Insurance Needs

The main aim of disability insurance is to provide income at the time the insured is unable to earn for the family. Disability insurance helps in maintaining the same standard of living at the time of financial crises or difficulty. An individual should take into consideration the following before obtaining disability insurance:

- Take home salary – Disability benefits are not always exempted from tax. Thus a person may be able to replace only his take home salary.
- Disability benefits from various sources – Disability benefits from the government programs may be available in the form of social security benefits.
- Other benefits – Benefits may also be available through employer sponsored disability plans or through group disability benefits. All these benefits should be added and deducted from the current monthly take home salary. The difference would be the estimated disability benefits required to maintain the current after tax income.

DISABILITY INSURANCE AND ITS PROVISIONS

Disability insurance policies have various standards and conditions, which must be satisfied before getting benefits. Some policies will have a residual benefit option for which partial benefit is paid if a person can work part time or at a lower salary. In case of individual disability policies, presumptive disability clause provides that when both the hands, eyes and hearing is lost, full benefits will be received even if the person is able to earn in some capacity or the other. In addition to this there are certain other provisions which need to be taken into consideration:

Benefit Amount and Duration

Disability insurance pays a flat monthly payment. The insurers rarely pay more than 60% to 70% of the insured's gross income. The monthly payments would be paid for a few months or for a lifetime. Disability policies may be for a short period of 2-5 years or even for lifetime.

Probationary Period

A probationary period of a week to a month is included in the policy starting from the day the policy is issued. If any diseases or illness occurs during this probationary period, it will not be covered. This helps in reducing the costs of the insurer.

Waiting Period

Also known as elimination period, it ranges for a period of one month to one year. Longer waiting period can be chosen if a person has enough funds to meet any contingency. This would help in reducing the premium cost.

Renewability

Most of the policies have renewable guarantee or are non-cancellable. Premiums are raised if the loss experience of the insureds in the same class worsens.

Other Provisions

In many disability policies, premium is waived. If a person is disabled for a period of 60 or 90 days, the insurer will waive the payment of future premiums that become due during the period of disability. Disability income insurance is part of the overall personal financial planning. Thus it is essential to strike a balance between the cost and the coverage available.

Buying Health Insurance Cover

Health insurance coverage needs to be managed and systematically planned. Study should be made about the resources that are available for use and identify gaps in protection available already. The following paras would help in purchase of a health policy:

MATCHING NEEDS AND RESOURCES

In case of a health policy, losses covered are against illness or accident. The health policy covers expenses of medical bills, rehabilitation, counseling and loss of income due to inability to work. Although it is not possible to estimate medical expenses, long-term care expenses can run into lakhs. Thus it is essential to estimate one's total insurance needs and the resources available. After this, the various sources of coverage should be identified, i.e., the various provisions of the policies and the extent of coverage provided. If any gaps are identified relating to the coverage available, then steps should taken to fill up the gaps by taking an appropriate policy.

COMPONENTS OF THE HEALTH CARE PLANS

The health insurance plan should not only cover costs of illness or accident but also provides for risk reduction. As in case of other insurances, the risk in health insurance can also be dealt in four ways or methods as discussed hereunder:

Risk Avoidance

Risk avoidance is the best way to avoid exposure, even in health insurance. A non-smoker does not have to worry about getting cancer due to smoking.

Loss Prevention and Control

A number of diseases and ailments can be avoided if one follows a healthy life style. People face health problems due to smoking, having alcohol, use of drugs, improper diet and lack of regular exercise etc. These routine habits lead to illnesses such as heart ailments, cancer, tuberculosis, mental disorders etc. In addition to the health problems, one should follow various safety rules such as driving safely on the highways and avoid driving under the influence of alcohol. Thus loss prevention should be a priority to avoid health hazards.

Risk Assumption

The next step in the health care plan is risk assumption. The risk assumption relates to the risk retained by an individual. There are certain risks which have small loss potential. Thus it is economical to pay a small loss than paying high premiums. Having insurance plans with deductibles is also a form of risk assumption, as the insured has to bear a part of the claim amount. Similarly in case of co-insurance, the insured needs to bear certain percentage of the claim amount. Thus, deductibles, co-insurance and internal limits are various forms of risk assumption.

Purchasing Health Insurance

After understanding the intricacies of various health care plans and the major providers, an individual needs to formulate a plan incorporating the basic principles of risk avoidance, risk assumption, prevention and control and then decide to shop for a health insurance policy. In addition to this, an individual needs to take into consideration the following points:

COST OF COVERAGE

Buying health insurance is similar to buying a car. In both the cases, payment will have to be made, whether in the form of installments or premiums. As in the case of a car, one needs to compare the features of the various models, similarly the features of the various policies will have to be compared before making the decision for buying a policy.

SELECTING HEALTH CARE INSURANCE AS AN EMPLOYEE BENEFIT

Many individuals obtain health insurance from their employers. In some cases, employers offer only one plan to the employees and pay for it. In this case, the employee should analyze the plan and decide whether he should be a part of it or not. The employers have also started offering cafeteria plans, which provide a menu of benefits which can be chosen by the employee. The menu should be chosen, taking into consideration one's family needs. If the spouse is also employed, then care should be taken that his or her benefit package is also analyzed before taking any decision.

QUALITY OF AGENT AND COMPANY

Health care plans should be obtained from an agent who is able to answer all queries about the policy. The health care insurer should be able to settle claims promptly. Apart from getting information from the agent, advice from friends who have gone through various claim experiences should also be obtained.

Choosing a Health Care Plan

After reviewing various health providers and health plans, a choice has to be made. An individual needs to review his needs and the coverage already available from the employers or any other government agency. Choice should be made after analyzing thoroughly the benefit plan available from the employer. Before choosing a plan, the benefit package of the spouse should also be analyzed to check that there is no clash or conflict in the benefits availed. A person generally has to decide whether to go for a managed care or an indemnity plan. Before choosing a health care plan, the following points should also be taken into consideration:

Freedom of Choice: A person needs to decide whether to continue the services of his current doctor or join a managed care arrangement.

Out of Network Provider: It should be checked whether reimbursement would be there, if services of out of network service provider is availed. For some people who visit their doctor once a year only, managed care is cheaper alternative.

Coverage: An individual needs to check whether, all the services needed by him are covered in the plan or not.

Managed Care: It is also essential to check the credentials of the participating doctors and physicians.

Age and Health Condition: Age and health should be taken into consideration before joining any health plan, whether it is a managed care or an indemnity plan.

CRITICAL ILLNESS INSURANCE

Quite often serious illness can mean exorbitant cost which is beyond the means of ordinary people. So, insurance companies have designed a benefit or contingency policy that pays on diagnosis of certain serious illnesses. The compensation is for the illness that strikes, not a reimbursement for expenses incurred. An afflicted insured, gets an across the board compensation as per the limits of indemnity.

The critical illness policy introduced by the public sector insurance companies has the following provisions:

The policy covers critical/major illnesses like:

- Stroke, and
- Cancer.

Major organ transplantation:

- Renal failure, and
- Multiple sclerosis,
- Coronary artery surgery (Coronary Artery Bypass Graft under which maximum limit is 20%).

Limits of Indemnity

The policy provides for various limits for indemnity as follows:

a. Rs.5 lakh

b. Rs.10 lakh

c. Rs.20 lakh

d. Rs.25 lakh.

There is a waiting period of 90 days after the inception of the policy after which claims can be entertained.

The proposer must have a personal income of Rs.2 lakh per annum.

Premium

The premium ranges from Rs.0.62 to Rs.15.25 for females and Rs.0.82 to Rs.21.86 for males.

Scope and Exclusions for Various Diseases and Ailments

CORONARY ARTERY SURGERY

Scope: Open chest surgery for connection of two or more coronary arteries by Coronary Artery Bypass Graft (CABG) which has been proved necessary by means of coronary angiography.

Exclusion: Angioplasty and/or any other intra-arterial procedures. In case of coronary artery surgery, compensation will be limited to 20% of the sum insured.

CANCER

Scope: Any malignant tumor, characterized by uncontrolled growth and spread of malignant cells and includes leukaemia and malignant disease of the lymphatic system.

Exclusion: Any non-invasive cancer in situ and all skin cancers except invasive melanoma.

RENAL FAILURE

Scope: Chronic, irreversible failure of both kidneys to function as a result of which regular renal dialysis must be administered.

STROKE

Scope: Any cerebrovascular incident producing neurological sequels lasting more than 24 hours.

Exclusion: Evidence of neurological deficit for at least 3 months has to be produced.

MULTIPLE SCLEROSIS

Scope: Neurological abnormalities that have existed for a continuous period of at least 3 months or a relapse of such abnormalities that have existed for a continuous period of at least 3 months.

Exclusion: This must be evidenced by the typical symptoms of demyelination and impairment of motor and sensory functions.

MAJOR ORGAN TRANSPLANT

Scope: The transplants of kidney, lung, pancreas or bone marrow from a donor to the insured person. The insured must undergo actual transplant in order to claim benefits.

Exclusion: Transplants of all other organs, parts of organs or any other tissue transplant.

This is a benefit policy, not a reimbursement policy.

The critical illnesses have to be diagnosed by a registered medical practitioner, supported by clinical, radiological, histological and laboratory evidence acceptable to the company and to be re-confirmed by a Registered Medical Practitioner appointed by the company.

Critical Illness Rider

Statistics suggest that one in every 300 Indians suffers from heart stroke and four million stroke victims continue to survive. Among the total population, about twenty per cent of the population has a tendency to develop cancer, and at least fifty per cent of them will suffer from this disease for at least five years thereafter. This means additional medical expenses that may not necessarily be sufficiently covered under a common health insurance policy. And these would be in addition to threat of losing the existing job. Hence there is an utmost need to provide for these circumstances, and critical illness riders could be used as an alternate to cover up these hazards.

Critical illness riders, under a life insurance policy offer payment equal to the sum assured, if the life assured suffers a serious illness, irrespective of amount of expenses incurred on treatment. Critical Illness Insurance pays on diagnosis of a specified illness and not on death of the life assured due to the critical illness.

One of the unique features of the policy is that it provides for a lump sum benefit irrespective of the actual medical or hospitalization expenses incurred by the life assured. Medical examination is not required up to the age of 65 years after which it is mandatory.

The major diseases which are covered through critical illness riders are:

- Cancer
- Coronary artery graft surgery
- Heart attack
- Stroke
- Major organ transplant
- Complete renal failure
- Paralysis
- Valve replacement surgery
- Major surgery of the aorta.

In reality the cost of buying a critical illness rider is not actually cheap and in turn it can amount to about 90 percent of the cost of the base insurance cover. For example, a 25-year old buying a 20-year term cover will pay Rs.4.29 per Rs.1,000 sum assured. If he opts for a critical illness cover for the same amount, he needs to pay an additional Rs.4 per Rs.1,000 sum assured.

Database

In the absence of centralized medical records, insurers face problems in providing life insurance covers, and it becomes even more critical when it comes to offering critical illness coverage. In most countries, they have vast databases of medical statistics that are used for pricing. But in India such information is limited which acts as a hindrance in developing plans and adequately pricing them.

The latest critical illness riders introduced in India are – HDFC’s Health Plus International credit card, LIC’s critical care rider and Tata AIG’s Health First. These products offer cashless hospitalization. Incidentally, the critical illness riders are value addition to life insurance policies, which also act as a marketing strategy for insurers to increase their sales.

Long-term Hospitalization/Domiciliary Hospitalization Insurance Policy

This policy is identical to the individual and group mediclaim policy of the public sector insurance companies with the following additional features:

1. Additional cover is introduced to cover boarding and lodging expenses for one of the family members or next of kin of the insured who accompany the insured during the hospitalization period subject to a payment of additional nominal premium.

2. Hospitalization and operation expenses towards the person donating the organ to the insured person during the course of an organ transplant operation are payable subject to limits available during the policy period.

3. Reasonable expenses incurred for ambulance within city limits at the time of admission and discharge are payable.

4. Registration and admission fees paid to the hospital have been included in the list of hospitalization expenses.

5. The condition of number of beds in the definition of hospitals has been deleted.

6. Pre-existing condition has been defined in the policy.

7. Since the policy is issued for a longer period than one year, the limits are operative for a period of 12 months only i.e., the policy period. The limits of policy period in which the disease is diagnosed are applicable for any one illness. There is no carry forward of limits. Hence, the sum insured is available a fresh after every period of 12 months. To make this point clear, two new definitions have been added to the policy.

    - **Period of Insurance:** The period continuing till five years or ten years only as the case may be.
    - **Policy Period:** A period of 12 months each continuing from date of inception from which the risk is assumed.

8. A new condition for deletion of pre-existing disease has been incorporated as under:

    – Pre-existing conditions at the time of inception of first coverage will be deleted after the policy has completed four continuous claim free policy periods and the insured is not under treatment for at least two preceding years for the pre-existing conditions.

    – Pre-medical health check-up is compulsory and the cost has to be borne by the insured. The insured has to submit the family physician's certificate along with the proposal form stating his health status.

9. For group policies the minimum number of persons would be 51, and only one group policy is to be issued covering all eligible members of the group. Unnamed policy cannot be issued.

A benefit of Rs.500 per week maximum up to 52 weeks during any one period of insurance is available.

Installment facility can be granted in case of group policies as under:

i. 2 installments in case of a five-year policy.

ii. 4 installments in case of a ten year policy period.

A 5% discount per year may be granted receiving premium in advance subject to a maximum 50% discount. While calculating this 5% discount, the first year's premium is not to be discounted i.e. if 3 years premium is received in advance, the discount to be granted is 10% of the 2 years premium. For the purpose of installment, the number of years premium may be calculated by utilizing annual premium chart and not the one-time premium chart.

Additional Features

i. Income Tax Benefit under Section 80D is not available.

ii. Service Tax @ 5% extra.

iii. A family discount of 10% is applicable as per item 6 of the prospectus (applicable to individual policy only).

Exclusions

Domiciliary hospitalization inter-alia would not include expenses for the following:

a. Asthma.

b. Bronchitis.

c. Chronic Nephritis and Nephrotic Syndrome.

d. Diarrhoea, all types of dysentries including gastro enterities.

e. Diabetes Mellitus and Insipids.

f. Epilepsy.

g. Hypertension.

h. Influenza, cough and cold.

i. All psychiatric or psychosomatic disorders.

j. Pyrexia of unknown origin for less than 10 days.

k. Tonsillitis and upper respiratory tract infection including laryngitis and pharingitis.

l. Arthritis, gout and rheumatism.

Treatment for periods exceeding 3 days only will be considered under domiciliary hospitalization claims.

HEALTH INSURANCE IN INDIA

The guiding principle enunciated in the Bhore Committee of 1946 which states that 'no individual should fail to secure adequate medical care because of inability to pay for it' looks unreachable even after 50 years of Indian independence. Hardly 3% of the Indian population is covered by some form of health insurance, either social or private. The total expenditure on health in India is 6% of the GDP and the government is spending less than 25% against the average spending of 30-40 percent in other developing countries. In India, health insurance mainly exists in the form of Mediclaim policy offered to the individuals or groups, association or corporate bodies. State owned insurance companies, covering only about 2.5 million people of the country's population, account for the penetration of Mediclaim policy. Social insurances like Employee State Insurance Scheme are available but they have restricted the coverage to a very small segment of the population that is around 3 percent.

The government has taken serious interest in the potential of insurance companies to provide and popularize health insurance coverage at a modest rate of premium. To achieve this goal the government has allowed income tax rebate for premium paid for health insurance policies. GIC made some headway under its various health care plans for different segments of policyholders, by covering more than 2 million persons. LIC and UTI also made attempts to offer some type of health insurance covers. However, health insurance could not pick up momentum in India due to the following reasons:

- Service costs are out of reach of many people,
- Lack of good and efficient physicians and less number of hospitals,
- High illiteracy rate,
- Poor medical equipment and,
- Poor budget allocation towards health care.

We shall now discuss in detail about the health insurance policies available in India:

Mediclaim Policy

Mediclaim policy provides for cashless hospitalization for the treatment of any illness or disease or accidental injury suffered during the policy period. Under the policy, the claim payment is made through Third Party Administrators (TPAs). The third party administrators are required to provide hassle-free admission and discharge from the Network hospital without making any payment. The reimbursement of domiciliary hospitalization claims is also made through the TPA.

The proposer needs to fill a proposal form and the requisite details and submit it along with the photographs of each family member to be insured. Family package cover can also be taken. It covers the proposer, spouse, dependent parents and two dependent children with a 10% discount in premium. Group mediclaim policies can also be issued and discount can be availed if the group size is of more than 100 members. Tax rebate is available under Section 80D of the Income Tax Act, incase premium upto Rs.10,000/- is paid by cheques.

ELIGIBILITY

The policy covers individual, up to the age of 80 years. Children between the age group of 3 months to 5 years can be covered provided one or both the parents opt for a Mediclaim cover.

SCOPE OF THE POLICY

Mediclaim policy becomes operative when treatment is taken as an in-patient in a hospital/nursing home in India. The nursing home or the hospital should satisfy certain criteria.

The institution where treatment is taken should be established for indoor care and treatment of sickness and injury and which either:

- Has been registered as a Hospital/Nursing Home with the local authorities and is under the supervision of a registered and qualified Medical Practitioner; Or
- It should comply with minimum criteria as under:
  - i. At least 15 in-patient beds (10 beds in class ‘C’ city).
  - ii. Fully equipped operation theatre.
  - iii. Fully qualified nursing staff employed round the clock.
  - iv. Fully qualified doctors should be in charge round the clock.

The policy provides for Domiciliary Hospitalization expenses when medical treatment is taken for a period exceeding 3 days for an illness/disease/injury which normally would require treatment as an in-patient in a hospital/nursing home but is actually taken whilst confined at home in India under the following circumstances:

- Either the condition of the patient is such that he/she cannot be removed to the hospital/nursing home.
- The patient cannot be removed to the hospital/nursing home for lack of the accommodation therein.

The mediclaim policy does not cover any disease/injury which the insured is suffering from, at the time of taking the first policy. In individual mediclaim policy expenses are reimbursed if incurred for a medical check-up, subject to certain limits, once every 4 years, provided the policy is renewed without break and no claim has been preferred during this period.

ADD ON COVERS

The mediclaim policy provides the facility of extending the cover for treatment taken in Nepal and/or Bhutan but with prior permission from the insurance company. The group mediclaim policy can also be extended, on payment of additional premium, to cover maternity benefit i.e. expenses incurred in delivery, provided the extension is taken for all the members covered in the group.

SUM INSURED

The policy provides various options ranging from Rs.15,000/- to Rs.5 lakh. Sum insured represents the maximum amount that would be reimbursed by the insurer. In individual mediclaim policy, a cumulative bonus of 5% is given on every claim, free renewal whereby the sum insured is increased by 5% on renewal provided there has been no claim in the previous policy period. Maximum cumulative bonus permissible is 50% which would be given after 10 years claim free renewal. In the event of a claim, the increased percentage will be reduced by 10% subject to minimum of the basic sum insured selected.

Overseas Mediclaim Policy[1]

The overseas medical policy covers expenses incurred by the insured outside India as a direct result of bodily injuries caused or sickness or disease contracted. The policy cover is available in the form of the following eight plans:

Plan A-1: Travel to countries excluding USA and Canada for business and holiday limited to USD 50,000.

Plan A-2: Same as above except that benefits stand increased to USD 2,50,000.

Plan B-1: Travel worldwide including USA and Canada for business and holiday limited to USD 1,00,000.

Plan B-2: Same as (B-1) above except that benefits stand increased to USD 5,00,000.

Plan C: For traveling to countries excluding USA and Canada for employment and studies limited to USD 1,50,000.

Plan D: For traveling worldwide including USA and Canada for employment and studies limited to USD 1,50,000.

Plan E-1: For traveling worldwide including USA and Canada for corporate frequent travelers limited to USD 1,00,000.

Plan E-2: Same as (E-1) above except that benefits stand increased to USD 5,00,000.

PREMIUM

The premium depends on the age of the insured and the country which is visited.

COVERAGE

Coverage is available initially for up to 180 days and extension is allowed on original policy for further period of 180 days subject to declaration of good health**.**

ELIGIBILITY

The policy provides coverage for the age of 6 months up to 70 years of age. Policy is to be taken prior to departure from India. For the travelers above the age of 60 years, traveling to USA and Canada the following medical reports need to be submitted along with the proposal form:

1. ECG.
2. Fasting Blood Sugar or Urine Strip test.

These reports are required if the travel period exceeds 60 days and above.

If the travelers are unable to submit the above Medical reports, the cover stands restricted to USD 10,000.

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1 Overseas mediclaim policy has been taken from 'niacl.com'.

SUMMARY

- Health insurance is a form of insurance whose payment is contingent on the insured incurring additional expenses or losing income because of incapacity or loss of good health. It is also known as disability insurance, or medical expense insurance.
- Health insurance is in nascent stage in India and is mainly available in the form of mediclaim policy offered by all the four public insurance companies. In developed markets such as the US, health insurance is provided by Blue Cross and Blue Shield and other government programs.
- The major health care plans available are in the form of indemnity and managed care plans. Disability income insurance on the other hand provides weekly or monthly payments, when the insured is unable to work due to illness, injury or any other disease. It comes to rescue when the sole earning member of the family becomes sick for an extended period and there is adverse impact on the financial condition of the family.
- Another form of health insurance is long-term care insurance. Long-term care is the delivery of medical and personal care other than the hospital care to people suffering from chronic diseases resulting from illness or frailty. Elderly people after reaching certain age, cannot take care of themselves and thus require long-term care.

Chapter X

Property and Liability Insurance

After reading this chapter, you would be conversant with:

- Principles of Property Insurance
- Property and Liability Insurance in India
- Motor Insurance Policy
- Buying Insurance and Settling Claims

Introduction

On a cold evening in December, a big building consisting of 20 flats went up in flames. Most of the flat owners stood outside the building watching helplessly. Although no lives were lost, the first two floors were severely damaged. Nothing could be recovered as no one had taken any form of property insurance.

In the insurance context, a trilogy can be written: 'life, health and property'. After insuring one's life and health, the next step for an individual is to go for property insurance. Property insurance in particular guards against catastrophic losses of real and personal property caused by perils such as fire, theft, vandalism and other calamities. Property of an individual includes his residence and its contents, vehicles owned etc. Although people spend a lot of money on insuring their assets, they are totally unaware, whether their property is over-insured or under-insured. Thus it is very essential to understand the principles of property and liability insurance, which would help in achieving one's long-term personal financial goals. The basic principles of property and liability insurance can be sub-divided into three categories; types of exposure, principle of indemnity and co-insurance. They are discussed in detail hereunder.

PRINCIPLES OF PROPERTY INSURANCE

Types of Exposure

In property insurance contract, the property owner is under an obligation to identify the property to be insured and the perils against which insurance is to be obtained. If the property owner performs both these obligations religiously, there would be no chance of under or over insurance.

PROPERTY INVENTORY

Before obtaining a policy, an individual should prepare a list of the assets he owns. The list is generally in the form of a property inventory schedule which covers all the assets such as house, furniture, clothing, accessories, house equipment, vehicles etc. In India, coverage to all these assets is provided under various package policies. Many insurance companies also provide property inventory forms which provide full information with respect to the assets to be covered, their purchase price and replacement value. These property inventory forms are kept in safe custody, both by the insurers and the policyholders as they are helpful at the time of settlement of claims.

IDENTIFYING PERILS

The property owner needs to identify the perils against which the property needs to be insured. Most of the household and auto policies may exclude loss or damage caused by earthquake, war, nuclear radiation. Most of the property insurance policies limit coverage on the basis of location of the property, types of hazards that the property is exposed to etc.

Principle of Indemnity

According to this principle of indemnity, the insured cannot be compensated by the insurer for an amount exceeding the insured's economic loss. This principle does not apply to life and health insurance. The indemnity principle encompasses the following concepts:

CASH VALUE VERSUS REPLACEMENT COST

According to the principle of indemnity, the insured will be entitled to the replacement cost less the amount of depreciation. In other words, if the property is damaged, the insurer will not pay more than the replacement value or what the asset would cost less depreciation. In some insurance policies, replacement cost is calculated without taking into consideration the amount of depreciation.

SUBROGATION

The principle of subrogation allows the insurer to collect any amount paid by the party at fault after the claim amount has been paid to the insured by the insurer. In other words, the insured cannot receive the claim amount from the insurer and also the compensation from the other party. Thus, the insured needs to transfer any benefit it receives from the other party to the insurer, in the same way as it transfers the right to sue the party at fault.

OTHER INSURANCE CLAUSE

According to this clause, if the insured obtains insurance coverage from more than one insurer, each insurer will be liable according to the pro rated amount of the loss based on the proportion of the total insurance covering the property.

Co-Insurance

The co-insurance provision is generally mentioned in most of the property contracts. According to this provision, if the property is not properly covered, the insured will be regarded as a co-insurer and bear a part of the loss. This provision is also applicable when the insurer covers a specific percentage of the value of the property, the balance amount will be treated as self-insured by the insured.

PROPERTY AND LIABILITY INSURANCE IN INDIA

As already discussed, property insurance provides coverage to an individual's residence, its contents and his conveyance etc. In India, insurance to an individual's house and its contents exposed to hazards, such as fire and other allied perils is covered under householder's policy. The householder's policy is in the form of a package policy which provides coverage to an individual and his family against personal accident, his baggage while traveling, home appliances etc. In addition to this, coverage is also provided to valuables like jewelry and fragile property like window glass and glass doors. The policy also covers liability to his servants like drivers and maidservants and liability towards general public.

Home Insurance – The Need

An individual saves and scrounges over a considerable part of his lifetime to own a house of his own. Yet his life time investment can be reduced to nothing by a fire or an earthquake. The house and its belongings can be lost in few moments and there would be a huge financial burden for an individual to face. Thus, this is where insurance comes to rescue. An insurance policy should be obtained for the house, the biggest material investment made by an individual, to ensure a sense of security.

WHAT IT COVERS

Householder's insurance policies are generally termed as the 'Householders' Package Policy'. The policy insures against loss of or damage to the house and its contents, including jewelry and domestic appliances, third party liability and even loss of baggage during travel within India. The householder policy given by various insurance companies provides coverage under 10 sections. These sections cover a contingency or a product at a nominal premium. Although the name and order of the sections may vary, scope of the cover under these policies is the same.

Section 1, also known as the base policy, is divided in two sub-sections; one sub-section covers the building and the other its contents against fire. If an individual owns a house, he should at least obtain cover under both the sub-sections of section 1 and under section 2. The householder policy of New India Assurance Company is explained later in the chapter.

In case of a rented house, a person can skip the building cover, unless it is specifically mentioned in the lease agreement, but the cover under sections 1(b) and 2 should be obtained. The cover available under section 3-10, is optional. The cover bought under these sections should be linked to the estimated value of the products or contingencies for which protection is obtained.

Sum insured is the amount for which the contents are covered, with sub limits under each of the various sections under the policy. Some insurance policies, on the basis of the premium charged and the service rendered, categorize the 10 sections into tariff and non-tariff. The first two sections are the tariff sections and the rest are non-tariff sections.

Box 1: Householder's Package Policy of New India Assurance Company Ltd.

The policy is designed to meet the insurance needs of a householder by combining a number of standard policies under a single policy. Discount in premium is offered under the policy depending upon the number of sections of the policy, opted for, by the proposer.

Scope of the Policy

The policy provides coverage under 10 sections as given hereunder:

Section I: Fire & Allied Perils – The policy provides coverage for the building and its contents belonging to the proposer and his/her family members permanently residing with him/her.

Allied Perils include the following:

- Fire, Lightening
- Explosion of gas in domestic appliances
- Bursting and overflowing of water tanks, apparatus or pipes
- Damage caused by Aircraft
- Riot, Strike, Malicious or Terrorist act
- Earthquake, Fire and/or Shock, Subsidence and Landslide (including Rockslide) damage
- Flood, Inundation, Storm, Tempest, Typhoon, Hurricane, Tornado or Cyclone
- Impact damage.

Section II: This section covers burglary and house breaking including larceny and theft. It also covers contents of the house against loss due to burglary, house breaking, larceny or theft.

Section III: Covers loss or damage to jewelry and valuables by accident or misfortune whilst kept, worn or carried anywhere in India subject to the value declared in the schedule.

Section IV: This section covers loss or damage to fixed plate glass in the insured premises by accidental breakage subject to limit of sum insured.

Section V: It covers domestic appliances against unforeseen and sudden physical damage due to mechanical or electrical breakdown.

Section VI: It covers loss or damage to TV sets including VCP/VCR/ACD/VCD players by fire and allied perils, burglary, house breaking or theft, breakage due to accidental external means, mechanical or electrical breakdown.

Section VII: It covers loss or damage to pedal cycles by fire and allied perils, burglary, housebreaking, theft, accidental external means.

Section VIII: It covers loss or damage to the insured's accompanied baggage by accident or misfortune whilst the insured is traveling on tour or holiday anywhere in India.

Section IX: This section covers death or bodily injury by accidental, violent, external and visible means to the insured person named in the schedule and subject to limits specified therein.

Section X: This section covers insured's legal liability for bodily injury or loss of or damage to property of third party limited to amount specified in the schedule and workmen's compensation liability to domestic servants engaged in insured's premises.

It is essential to opt for Section I B, which provides coverage to the contents of the house under the policy. At least three sections including Section I B should be taken under the policy.

Sum Insured

- Under the policy, the household items need to be grouped in categories such as furniture, clothing, linen, utensils, crockery etc., and a value equivalent to the market value i.e., the value for which the used item could be bought or sold in the market is mentioned.
- Sections I A and B, II, III, IV, VI, VII and VIII are insured on market value basis as described above.
- Under Section V i.e., breakdown of domestic appliances, the sum insured should represent the current replacement value of a similar item.
- Claim amount payable would be the amount required to bring the damaged item to the same condition as it was prior to the damage subject to the adequacy of the sum insured.
- Under Section IX relating to personal accident, the sum insured should not exceed 72 months salary from gainful employment.

Claims

In case of any incident leading to a valid claim under the policy, the following steps should be taken:

- Necessary steps should be taken to minimize the loss/damage.
- In case of fire, inform fire brigade immediately.
- In case of theft, larceny or burglary inform the police immediately along with a list of items stolen and their approximate value.
- Insurance company should be informed by phone or fax and in writing.
- The insured should extend full co-operation to the surveyor appointed by the insurer and provide necessary documents to substantiate the loss. A claim form issued by the company should also be submitted.

Source: www.niacl.com

Fine Print

After going through the above policy, you would be conversant with a householder's policy and its provisions. In addition, there are certain points which should be given due consideration by the insured:

- Although there is no limit on the amount of cover that can be bought under the householder's package policy, at the time of claim settlement, value of the property is considered and no gain should be made by changing the policy. For instance a house worth Rs.5 lakh is insured against fire for Rs.10 lakh. If a fire destroys the house, the amount paid will be Rs.5 lakh which is the fair value of the house and not Rs.10 lakh which is the insured value.
- The personal accident section under the policy covers only family members whose identity is specified at the time of obtaining the policy.

Exclusions

A householder policy does not cover loss or damage due to willful negligence. For instance, no compensation will be paid if goods or articles are stolen from an unlocked house. In addition to that, each section of the policy has its own claim limits and exclusions.

Special Tips for Buying a Householder's Policy

- If an individual owns a house in a seismic or flood zone, he or she must get a building cover under section 1(a). Section 1(a) provides coverage for the building against fire and allied perils. The foundation of any house is endangered primarily by floods and earthquakes. Similarly, if person owns a house in an area which is insulated from such natural calamities, he or she can consider skipping the building cover.

- Details of valuables should be properly specified at the time of buying the policy. For instance, in the case of gadgets, specifications such as name of the manufacturer, model name and number, date of purchase and price should be mentioned. Such specifications help in smooth claim settlement process.
- Details should also be mentioned in case of jewelry with respect to its description material and weight etc. Jewelry should also be valued by a certified valuer. Premium can be saved by keeping some jewelry at home at any point of time, and the rest in a locker. Thus, premium can be saved by covering only that part of jewelry that is kept at home.
- The sum insured of the gadgets should be pegged to its replacement value and not its depreciated value. This ensures that if the gadgets are damaged beyond repair, the policy replaces them without any requirement of using one’s own finances.
- Review your insurance cover with each gadget purchase. There is no need to wait till the renewal of the policy. This can be done at any time during the policy duration. Insurer can be approached with the gadget specifications and sum insured in the policy can be increased.
- Discounts can be availed on premium payments under the policy. Buying cover under four to six sections entitles the insured to a discount of 15% under the policy on the premium payable. The discount can be extended up to 20% if the cover is obtained for more than six sections. For instance, personal accident cover is available as a stand alone policy. If a person buys it along with the householder’s policy, he might avail a discount and reduce his premium.
- Under section 1(a), which provides coverage for the building, the fire cover is linked to the buildings cost and not to its market value. The market value of a house includes the land cost and the building cost. It is the building that is at risk due to various perils and not the land.
- Some insurance companies have started giving a no claim bonus to the policyholders. Under this provision, in case there is no claim under the policy in a specific year, the insurer gives a discount on the premium paid by the insured.
- The insurer needs to be intimated immediately, in the event of a burglary, fire or baggage loss. In addition to that a police complaint, preferably an FIR has to be filed. In the event of fire, fire report has to be obtained from the fire department.
- The surveyor appointed by the insurer will assess the damage and give his recommendations to the insurer. In case a person is not satisfied with the surveyor’s assessment, he or she can challenge it with the insurer. In such a case, the insurer will appoint another surveyor to give a fresh recommendation.

MOTOR INSURANCE POLICY

After insuring his house and its belongings, an individual would like to cover his vehicles also. Property and liability insurances comprises mainly of insurance of house property and vehicles. Vehicles covered may be in the form of a scooter or a car etc. In India, it is essential to obtain a motor third party insurance by anyone who owns or uses a motor vehicle.

The first Motor Policy was issued in 1895 in England. In India, the Motor Vehicles Act was legislated in 1939 and later in 1946 the Motor Insurance was made compulsory. The M.V. Act of 1939 was amended by the Act passed in 1988 and the Amended Act of 1988 was made effective from 1.7.1989. Important amendments were again made to the Motor Vehicle Act effective from 14.11.1994. Motor vehicle policies are designed in accordance with the provisions of Motor Vehicle Act, the motor business is governed by the tariff which provides minimum rates for insuring various types of vehicles. Motor vehicles are classified into four categories, viz. private cars, motor cycles, commercial vehicles and miscellaneous and special types of vehicles. Before obtaining an insurance policy, the proposer should go through the following provisions of motor insurance:

Motor Insurance Policies

Motor insurance policies are divided into two types of policies: Policy 'A' and Policy 'B' issued under the tariff. Policy 'A' covers the liability of the motor vehicle owner towards third parties as required by the Motor Vehicle Act, whereas Policy 'B' covers loss or damage to the vehicle and also the 'third party liability' as per Policy 'A'. In addition to this, the policy can also have extensions to third party risks such as third party liability to driver, cleaner and workers etc., by paying additional premium.

RATING

The premium rating of the vehicles is divided into two categories: own damage tariff and third party tariff. The vehicle should not be insured for less than its market value for the purpose of full indemnity in case of total loss. The tariff varies for private cars, motor cycles, commercial vehicles and other miscellaneous vehicles. The own damage premium rate depends on the insured's estimated value of the vehicle, the registered laden weight of the vehicle in case of commercial vehicles, and the seating capacity in case of passenger vehicles like taxies and buses etc. In addition to this, it also depends on the cubic capacity of the vehicles in case of two wheelers and private cars. The tariff is also different in case of private cars and four wheeler taxies divided into Zones 'A' and 'B' according to the geographical area in which the vehicle plies.

Own Damage Cover

Under own damage cover, coverage is provided according to the following provisions:

- Perils covered under the 'own damage cover':
  - i. Fire explosion, self-ignition or lightning
  - ii. Burglary, housebreaking or theft
  - iii. Riot and strike
  - iv. Earthquake (fire and shock damage)
  - v. Flood, typhoon, hurricane, storm, tempest, inundation, cyclone, hailstorm
  - vi. Accidental external means
  - vii. Malicious act
  - viii. Terrorist activity
  - ix. Whilst in transit by road, rail, inland waterway, lift or air.
- In all the classes of vehicles except in commercial vehicles, damage to tyres alone is not covered but if the vehicle is damaged at the same time, damage to tyres is covered restricting the cost of replacement up to 50% only.
- Loss or damage to accessories by burglary/theft is covered in private cars where as in motor cycles and commercial vehicles, it is not covered unless the vehicle is stolen at the same time.
- Loss or damage to lamps, tyres and mudguards and/or bonnet, side parts, bumpers and/or paint work are covered in private car and motor cycle, but the same are not covered in commercial vehicles.

- Cost of protection/removal to nearest repairer and redelivery charges are limited to Rs.1,000 for private cars and commercial vehicles but in case of motor cycles they are limited only to Rs.200.
- If losses are minor and are caused by the insured peril supported by necessary proof, payment up to Rs.500 can be considered against production of bills in private car and commercial vehicles and up to Rs.150 in case of motor cycles.
- In case of Japanese model (commercial) vehicles an additional sum of Rs.5,000 is to be imposed on the policy.

Motor Own Damage Claims

As soon as an accident takes place, the damages falling under the purview of the policy conditions, should be immediately intimated by the insured to the insurer in writing. The insurer on its part will arrange for spot survey of the damages and supply a claim form to the insured which is to be filled up and sent to the company along with an estimate of repairs and spot photos. The insured also needs to intimate the loss to the police station, in whose jurisdiction the place of accident falls and file an FIR. After the spot survey, the vehicle can be removed from the place of accident to the place of repair. After the claim form is received, the insurer arranges for a detailed survey of the losses in the repair shop by one of the surveyors in the company.

CLAIM SETTLEMENT

The losses can be settled in under the 'motor own damage' in the following four ways:

i. Repair basis

ii. Cash loss (Repair) basis

iii. Total loss basis

iv. Salvage loss basis.

Repair Losses

If the vehicle comes under the purview of Repair Basis, the surveyor insists upon dismantling the vehicle to verify all internal damages if any, due to the accident. After the survey, the surveyor prepares a report with respect to the parts to be replaced and their appropriate cost. The cost for replacement will be limited to the dealer's list price. If major parts to be replaced are chassis, main axle, rear axle, dash board, engine parts etc., they should be purchased from the dealer to maintain the quality of the vehicle. In case of aged vehicles, if the insured chooses to replace some parts with disposal parts, the cost of such parts should be restricted to the disposal rate only. Similarly, if important parts like front end structure, batteries, radiator etc., are purchased from local manufacturers, the price should be restricted to local market price only. In case of repair losses, bills are a must for all the replacements made, repairs carried out and labor charges also. In case of losses exceeding certain limits, re-inspection of the replacements/repairs made will have to be carried out by a surveyor.

Cash Loss (Repair) Basis

The cash loss (repair) basis settlement will arise in cases where the insured is not in a position to produce the repair bills of the vehicle. This type of settlement is subject to the consent of the Controlling Office. This settlement is almost similar to the repair basis settlement mentioned above. But while assessing the loss on account of spare parts, taxes are to be removed, and out of the amount arrived for repair, 25% is to be deducted. In case of cash loss settlements, the policy and the certificate of insurance is obtained and cancelled before the loss is settled.

Total Loss Basis

Total loss settlement and salvage loss arises, when the cost of repairs of the vehicle are more than 75% to 80% of its value. The sum insured or the market value of the vehicle, whichever is less, will be paid to the insured and the wreckage is taken over by the insurer. The policy is cancelled and intimation is given to the Road Transport Authority (RTA). The certificate of insurance is also obtained by the insurer and cancelled before the loss is settled.

After the loss is settled by the insurance company, the sale of wreckage is advertised in the newspaper. The wreckage is sold to the highest bidder provided the highest value quoted is reasonable as recommended by the surveyor. Proper care should be taken by the insured to preserve the wreckage in a good condition until it is disposed of and expeditious action regarding sale of wreckage should be taken so that its value does not deteriorate.

Salvage Loss Basis

Salvage loss settlement is similar to total loss, except that the estimated value of the wreckage is deducted from the claim amount with the consent of the insured. Thus the wreckage becomes the property of the insured. As in the case of total loss, the policy and the certificate of insurance is obtained and cancelled before the loss is settled. In this form of settlement, opinion of atleast two surveyors is necessary regarding the value of the wreckage.

Motor Third Party Claims

Motor Third Party Claims play an important role, as most of the insurance companies are facing huge losses in this segment. The loss ratio of a company in motor insurance depends on the judicious control and management of these losses. According to the Motor Vehicles Act, every victim of a motor accident is entitled for compensation for loss of life/body injury arising out of a road accident. In addition to that, workers like driver, cleaner and coolies engaged for the maintenance and movement of the vehicle are also entitled for compensation if they meet with death/injury arising out of the use of the motor vehicle.

Earlier, if the victim in an accident was at fault, no compensation was paid to him. Later this legislation was amended and it was required to pay a minimum amount of compensation for death/permanent disability to the victim irrespective of the fact, whether he is at fault or not. This is known as ‘No Fault Liability’. At present, the minimum amount of ‘No Fault Liability’ for death is Rs.50,000 and for grievous injury resulting in permanent disability it is Rs.25,000.

Dependents of the motor accident victim can make application in the tribunals set up by the government for the purpose of adjudicating accident cases. Once the petition is filed, in case of death and injury, notices are sent to the insurance company and the insured. The insurer needs to verify whether the vehicle was covered at the time of accident and vehicular documents like RC, Driving License, Permit, etc. were in order. The insured will also be asked to furnish a claim form, and the vehicular documents for verification.

In case, the judgement requires payment, it should be made immediately to avoid accumulation of interest. If the case is fit for appeal the detailed opinion of the panel advocate should be obtained and the matter should be referred to the High Court through the Controlling Office. An appeal should be based on firm grounds and previous similar cases should be noted down for deciding whether it would be fruitful.

LOK ADALATS

Lok Adalats handle third party Motor Insurance cases and settle losses so that speedy justice can be given to the victims and their families. Once Lok Adalat agreement is arrived at and signed, insurance company cannot appeal later. Thus, utmost care should be taken for reaching an agreement in the Lok Adalats.

Features of Motor Insurance Policies

The following are the main features of the motor policy offered by Oriental Insurance Company Ltd:

Motor Cycle 'B' Policy

The policy covers any two wheeled vehicle (inclusive of detachable side car) which is used only for social, domestic and pleasure purposes. The policy does not provide cover use for hire or reward, organized racing, speed testing and carriage of goods in connection with any trade or business or use for any purpose in connection with motor trade. The policy can be extended for personal accident cover by paying high premium.

RISKS COVERED UNDER THE POLICY

- Fire
- Explosion
- Lightening
- Burglary
- Theft, riot and strike, typhoon, hurricane, storm, tempest
- Malicious act
- Earthquake, flood, terrorist activity, landslide/rockslide
- It also covers damages by accidental, external means while in transit by rail/road, inland water, lift or air in addition to the legal liability required by law.

EXCLUSIONS

- Consequential loss
- Depreciation
- Wear and tear
- Mechanical/electrical breakdown
- Failures or breakages
- Damage to tyres unless the motor car is damaged at the same time and any accidental loss or damage suffered while the person driving is under the influence of liquor or drugs.

Private Car 'B' Policy

The policy covers a private car defined as any transport vehicle/car/omnibus whose unladen weight does not exceed 7,500 kgms and is used only for social, domestic and pleasure purpose and insured's own business also. The policy does not provide coverage for hire or reward, organized racing, speed testing and carriage of goods in connection with any trade or business or use for any purpose in connection with motor trade. On payment of extra premium the policy may be extended for personal accident cover as well.

RISKS COVERED UNDER THE POLICY

- Fire
- Explosion
- Lightening
- Burglary and Theft
- Riot and Strike
- Typhoon
- Hurricane, Storm, Tempest, Malicious Act

- Earthquake, Flood and Terrorist Activity
- Landslide /Rockslide.

It also covers damages by accidental, external means while in transit by rail/road, inland water, lift or air in addition to the legal liability required by law.

EXCLUSIONS

- Consequential loss
- Depreciation
- Wear and tear
- Mechanical/electrical breakdown, failures or breakages
- Damage to tyres unless the motor car is damaged at the same time and any accidental loss or damage suffered while the person driving is under the influence of liquor or drugs.

The following are the main features of the policy offered by Bajaj Allianz General Insurance Co. Ltd.

Scope of Cover

The policy undertakes to reimburse the expenses incurred for:

- Repair/replacement of the parts of the vehicle.
- Payment for the market value of the vehicle in case of a total loss, provided that the originating cause of such damage is an accident, theft, earthquake, flood, riot, strike and malicious acts.

The policy also provides cover against liability to third party including the liability under Motor Vehicles Act which is compulsory. It covers the legal liability of insured towards third party personal injury and property damage arising out of an accident involving the insured vehicle.

Other Salient Features

- Discount available if voluntary excess is utilized.
- Discount available for membership with approved automobile associations.
- Depreciation rates are defined in the policy, for the parts needing replacement in the event of an accident.

General Exclusions

- Any accidents outside the geographical area.
- Consequential loss, normal wear and tear.
- Driving without a valid license for that class of vehicle. Driving under the influence of liquor/drugs.
- Vehicle not being used as per the regulations of registration.

Automobile Insurance Premium

Automobile insurance premium paid depends on various factors such as the kind of automobile, two-wheeler or a car, model of the vehicle, type of coverage etc. Thus, to understand the premium rating of an automobile let us go through the following various factors:

- **Rating Territory:** Premium is higher for geographic areas having high claim probability. In India, for premium setting, the areas are divided into two zones, Zone A and Zone B. Zone A consists of ‘Madras Region’ and Mumbai region excluding ‘Mumbai’. Zone B includes rest of India and Mumbai.

- **Vehicle:** The type of vehicle also determines the amount of premium to be paid. The vehicles can be classified as private cars, motor cycles, scooters and commercial vehicles. The rating of a vehicle is done by taking into consideration the following points:
  - The year of manufacture of the vehicle.
  - Purchase price and insured's estimate value.
  - Age of the vehicle.
  - Private cars over the age of 15 years, are not accepted on comprehensive terms but only for third party risks.
  - Comprehensive coverage is given to taxis up to three years only.
  - Comprehensive coverage for private and public carriers is up to five years.
- **Use of the Vehicle:** The use of the vehicle is another rating factor. If, a car is used for private purpose, the risk is less than in case of taxis. Similarly, owner driven taxis represent a better risk than a taxi driven by a paid driver. In case of carriers, private carriers are considered as a better risk than the public carrier. A private carrier is used for the carriage of own goods and thus is expected to take more care than that of the pubic carrier.
- **Driver of the Vehicle:** Apart from the characteristic of the vehicle and its use, the driver or the person who uses the vehicle is also examined. The driver of the vehicle is examined on the following parameters:
  - Age of the driver plays an important role, as a young driver may not have the requisite experience. Similarly, an elderly driver is more prone to accidents, because of his advancing age.
  - A defect such as loss of vision in one eye needs to be evaluated by the underwriter. Similar is the case of a handicapped person, who is able to drive.
  - Profession of the driver also plays an important role. For instance, a person in entertainment industry who uses his vehicle for long journeys may present a hazardous risk.

BUYING INSURANCE AND SETTLING CLAIMS

Before buying property and liability insurance, an individual should develop an inventory of exposures and arrange them from the highest to lowest priority. It is also possible that losses covered by insurance seldom occur but such losses have the potential of huge financial crisis. In addition to that, such losses should be covered first which can cause serious disruption to the financial plans of the family. Although such losses may not lead to insolvency, they may still present serious financial burden for the family, in the form of loss of a house due to fire, theft of vehicle etc. Thus, a person needs to select an appropriate policy or coverage from the right kind of agent and the insurance company.

Property and liability insurance companies deal with insurance claims promptly. An individual should follow the following process in case a claim arises:

- **Steps Following an Accident:** After an accident, the first thing that insured should do is to record the names and addresses of all witnesses and the injured party also. In addition to that, he should record the license numbers of all the vehicles involved in the accident. The accident should be notified to the police and the insurance agent. The insured should not discuss or admit liability at the place of accident except with the insurer or the police.

- **Claims Settlement:** After the accident occurs, the first thing that the insured has to decide is whether he would like to file a claim or not. In case he takes a decision to file a claim the following process needs to be followed:
  - ***Notice to the Insurer:*** The first step is to intimate the insurer about the loss that has occurred.
  - ***Investigation:*** The insurance company needs to check whether the loss falls within the policy provisions. The insurer may also gather information from various sources, to find out the right amount of loss to be compensated. The insured should give timely notice to the insurer so as not to hinder the claim process.
  - ***Proof of Loss:*** The insured may be required to provide the appropriate proof of loss in the form of medical bills or statement of lost wages, physical evidence of damage etc. After evaluating the loss, the insurer, may compensate the full claim amount or pay a lesser amount. In some cases the insurer may also deny the liability to the insured, in which case, the insured may go for arbitration or any other legal alternative.

SUMMARY

- Property insurance provides coverage against catastrophic losses of real and personal property caused by perils such as fire, theft, vandalism and other calamities. Property of an individual includes his residence and its contents, vehicles owned etc.
- The basic principles of property and liability insurance are the principle of exposure, principle of indemnity and co-insurance. Insurance to an individual's house and its contents exposed to hazards, such as fire and other allied perils is covered under householder's policy. The householder's policy is in the form of a package policy which provides coverage to an individual and his family against personal accident, his baggage while traveling, home appliances etc. In addition to this, coverage is also provided to valuables like jewelry and fragile property like window glass and glass doors. In addition to covering one's house, an individual needs to insure his vehicles also.
- Property and liability insurances comprise mainly of insurance of house property and vehicles. Vehicles covered may be scooters or cars etc. Motor insurance policies are divided into two types of policies; Policy 'A' and Policy 'B' issued under the tariff. Policy 'A' covers the liability of the motor vehicle owner towards third parties as required by the Motor Vehicle Act, whereas Policy 'B' covers loss or damage to the vehicle and also the 'third party liability' as per Policy 'A'. In addition to this, the policy can also have extensions to third party risks such as third party liability to driver, cleaner and workers etc., by payment of additional premium.
- In property insurance contract, the property owner is under an obligation to identify the property to be insured and the perils against which insurance is to be obtained.
- Many insurance companies also provide property inventory forms which provide full information with respect to the assets to be covered, their purchase price and replacement value.
- Most of the property insurance policies limit coverage on the basis of location of the property, types of hazards that the property is exposed to etc.
- The householder policy given by various insurance companies provides coverage under 10 sections. These sections cover a contingency or a product at a nominal premium. Although the name and order of the sections may vary, scope of the cover under these policies is the same.

- A householder policy does not cover loss or damage due to willful negligence. For instance, no compensation will be paid if goods or articles are stolen from an unlocked house.
- The loss ratio of a company in motor insurance depends on the judicious control and management of these losses. According to the Motor Vehicles Act, every victim of a motor accident is entitled for compensation for loss of life/body injury arising out of a road accident.

Chapter XI

Planning for Investments

After reading this chapter, you will be conversant with:

- Meaning and Purpose of Investment
- Investment Constraints
- Various Investment Vehicles
- Factors Considered in the Choice of Investments
- Developing the Investment Strategy

Introduction

Raj, a software engineer, is one among the thousands of people who were hit badly by the tech crash. Having earned huge amounts during the Internet boom period, Raj is barely able to make his ends meet today. Had Raj planned his investments appropriately, things would not have been so difficult as they are today for him.

MEANING AND PURPOSE OF INVESTMENT

Throughout our life we earn and spend money but it rarely happens that our current income exactly matches our consumption desires. Sometimes, earnings are more than the consumption and sometimes consumption is more than the earnings. These imbalances in earnings and consumption lead us either to borrow or to save from the current income. The basic motive to save money is to use it as a backyard for future consumption. How to make these savings increase over a period of time is the essence of investment. The process of placing money in some medium such as stocks, bonds, real estate, etc., in expectation to receive some future benefits is known as investing. More specifically, an investment is the current commitment of money for a specific period in order to derive future payments that will compensate for (1) the time the funds are committed (2) the expected rate of inflation and (3) the uncertainty of the future payments.

Basics of Investing

To determine an investment program suitable to any investor, it is first necessary to lay down in clear terms two things – the return objectives and the risk tolerance. These two together form the goals of the investment, which have to be achieved, always, within the constraints and preferences of the investor. Investment constraints are generally in terms of predetermined levels of liquidity, tax savings, legal compliance, investment horizon, etc. Preferences, on the other hand, are generally imposed on the portfolio by the investor himself, such as a desire to invest at least 25% of the total funds in sectors such as information technology or in the other areas at the other extreme in government securities. The investment policy should be a fine blend of the goals with the constraints and preferences. Portfolio managers commonly put down the investment policy of an investor thus obtained on paper either in the form of a statement or a set of guidelines.

To put it differently, each investor has his/her own set of objectives and constraints. While most of these are known only in qualitative terms, they will eventually lead to form quantitative objectives and constraints by the investment manager, which, in turn, form the basis for the formulation of the optimal portfolio.

Morever, though investors may have highly diverse objectives, constraints and preferences, they do form homogeneous groups each of which distinctly differs from the other. Investors can be categorized into individual investors and institutional investors. While most of what we discussed above in principle applies to both, the following differences can be noticed:

- Individual investors generally treat risk as ‘the possibility of losing money’, or sometimes even as ‘losing money’. Institutions are more technical, sophisticated and define risk clearly as the standard deviation or in more general terms, as the variability of the return.
- Individual investors can be categorized based on their psychological characteristics such as being an introvert or extrovert, aggressive or conservative, confident or uncertain, etc. Institutions, on the other hand, fit more readily into a definition, based on the nature of their liabilities and the requirements of their owners or beneficiaries, into pension funds, provident funds, insurance companies, banks, etc.

- Investment policies of the investors can be laid down based on what the investors think is best for them while often, the investment policies of the institutions are determined to a significant extent based on various legal requirements. For example, in India, the government lays down the investment pattern of provident funds and also insurance companies and the freedom available to portfolio managers while handling the portfolios of these institutions is limited.
- Investment policies of the individuals generally become complex because they are subject to taxes. Allocation of a significant portion of the portfolio to tax saving investments makes the job of the portfolio manager much more difficult as the returns have to be brought up to the desired level with the remaining funds. Most of the major investment institutions are, on the other hand, exempt from tax.

Implementing Investment Strategies

Investment management process can be broken into two steps (i) information process, and (ii) implementation process. The former deals with the selection of the stocks, whereas the latter deals with the proper execution of investment ideas and maintaining the values of the stocks. The proper mix of these two processes leads to a well-defined investment process.

Portfolio management decisions result in equity trading. Trading strategies are to be handled with care; it has to be seen that the trading strategies adopted by an individual investor are not the same as those adopted by an institutional investor.

Achieving Goals through Investing in Portfolios

Ideally every investment targets a goal. The goal may be either tangible or intangible. It may vary from individual to individual and at different stages of life for the same individual. Some of the different types of goals are listed below.

SHORT-TERM HIGH PRIORITY GOALS

Goals such as saving for improvement of one’s own qualifications or saving enough to pay the margin for a housing loan are generally very short-term priorities. The individual generally has a high emotional involvement with the achievement of such goals. The emotional involvement generally arises from the fact that, for people with modest resources, the cost of non-achievement of these goals is very high. They generally tend to invest the funds in highly safe and liquid investments to achieve these goals.

LONG-TERM HIGH PRIORITY GOALS

The goals that fit into this category are generally like planning for the higher education of a child who is just born, planning to set-up a charitable institution after retirement, or achieving financial independence a certain number of years down the line. The goals being long-term, investments are generally made in risky assets of long maturity. It is also common to hold a reasonably diversified portfolio.

LOWER PRIORITY GOALS

In life, there are certain goals that one would like to achieve, but without much heart burn if they are not achieved. Consider, for example, goals like going on a tour to a foreign country, owning the trendiest color television in the world or owning a house in the wealthiest colony of the city. As these are likely to be beyond the reach of most people in the ordinary course of events, the funds that they save for these goals are generally invested in highly speculative investments. Investments such as these are often made for the fun and thrill of the process than for seriously achieving the goals. It is not uncommon to find investors who allocate a part of their savings to speculative investments.

MONEYMAKING GOALS

There are some individuals who are not satisfied with the attainment of goals that are suitable to their economic level. They are always in continuous pursuit of avenues to acquire substantial wealth. They are people with entrepreneurial bent of mind. Such individuals generally invest all they have into a single investment and monitor it carefully. Their risk-tolerance is often very high. Therefore, they invest in upcoming companies and wait till the companies grow and then harvest their profits and move on to another company.

Purpose of Investing

The purpose of investing may be different for different people. For example, people may invest to meet their down payment needs for their newly purchased flat or car, for some it may be the way to make additional income and for others it may be a retirement plan or to secure expenses for their children's education. The most frequent investment objectives may be:

a. **Higher Current Income:** Most people put their money into investment so that they can enhance their current income. The main motive behind such an investment is to receive benefit from the current income either in the form dividends or interest.

b. **Save Money for Major Purchases:** Some of the major expenditures in one's life are purchasing a home, meeting his/her child's educational need, investing capital in a business, making a world tour, purchasing an expensive car, etc. However, in many of the cases, this expenditure cannot materialize only through one's current income. Therefore, people often save money for several years in order to meet this expenditure.

c. **Planning for the Retirement:** Another important reason to save money by investing in appropriate avenues is to provide for one's needs after retirement. In order to maintain a decent lifestyle, even after retirement, people plan and make appropriate investments.

d. **Shelter from Taxes:** The tax treatment for all sources of income is not the same. For example, if a person owns a real estate property, he/she can avail certain deductions, thereby reducing his/her tax liability. Thus, real estate can serve as a very attractive investment vehicle for some people. Secondly, investment in real estate supports other investment objectives like retirement planning.

Investment Objectives

Before selecting appropriate objectives for any kind of investors, several preconditions must be met. The first requirement is to assess the current existing situations and needs of the portfolio beneficiary. Sudden and drastic alteration in the composition of the portfolio should always be avoided. It will be better to make stepwise changes in the portfolio. The next concern in setting up the investment objectives will be to consider the investment horizon for the institutional investors that suit earning capacity and investment behavior. If the portfolio is a part of pension funds assets, the investment horizon will be very long. Market volatility is not as much a concern to institutions like pension funds whose horizon is long, as to an individual investor saving for his children's college education. The frequent fluctuations in the market are not of much concern to pension funds as they are to any individual investor. Apart from the investment horizon issue, the other important issue in setting objectives includes liquidity needs and ethical considerations established by the fund manager. Fund managers may differ in their perceptions towards the set of portfolio objectives they would like to fix for a particular institution. However, many of them will find the following four distinct objectives to be optimal:

i. Stability of principal

ii. Income

iii. Growth of income

iv. Capital appreciation.

STABILITY OF PRINCIPAL

Any kind of investor cannot afford to lose his principal. If any investor insists in maintaining the stability of its principal and advises its fund manager accordingly, its portfolio objective will be regarded as conservative because its approach towards the main objective may result in less return compared to that of other investors. The emphasis on this approach is to preserve the principal value of the fund. Whenever stability of principal is the objective, the appropriate investment avenues include banks, certificates of deposit and other money market instruments. These instruments are not only safe but always ensure that principal value of the investment is recovered at the time of maturity.

INCOME

The income objective is in contrast to the stability principal because here emphasis is on getting a periodic income rather than safety of the principal amount. A slight decline in the principal value is of no major concern to the institutional investors. If a new issue of 5-year Treasury Bills with 6 percent coupon is floated in the market, a fund manager can buy 1,000,000 worth of these and earn 60,000 per year. But these securities will be interest rate sensitive and if the general rates of interests rise, the market value of these securities will fall. The fund manager can show a decline in the value of the investment on paper for the time being, but if the bills are held until maturity, they will yield the original par value and the paper loss will vanish. If they had been sold prior to the maturity, an actual loss would have been realized. The impact of the fluctuations in the market will vary depending on the nature of the fund. It is important to remember here that when income is chosen as an objective, suitable investments include corporate bonds, government bonds, government securities, preferred stock and probably some good common stocks.

GROWTH OF INCOME

Time value of money determines value expected to be received by investors in future. A rupee today is worth more than a rupee at any point of time in the future. Time value of money can be divided into two major components – the reward for foregoing current spending and compensation for inflation. If somebody receives a fixed income of Rs.60,000 per annum, the lifestyle he can maintain with that amount changes from year to year. Consider that over the next 6 years the average inflation rate turns out to be 5 percent. In today’s rupee value, Rs.60,000 to be received in 6 years is worth about $60,000/(1+1.05)^6$. Definitely the purchasing power of the sum has diminished considerably and to avoid this erosion in the value of money, the institutional investors sometimes adopt the strategy of growth of income. If in the institutional investor’s objective is to increase the growth of the income, it will initially plan for a fixed annual income of say, Rs.50 crore, but if he also desires an annual growth of 5 percent in the level of the income generated per year, then in ten years, the annual income from the fund will be $50(1 + 0.05)^{10}$ or Rs.81.44 crore. Similarly, in the next twenty years, the annual income will be $50(1 + 0.05)^{20}$ or Rs.132.66 crore.

As long as growth income of the portfolio is more than the inflation rate, the value of the portfolio will rise. Because of this reason, any investor would like to set the growth rate of his portfolio at least equal to the rate of inflation. Here, it is important to clearly understand the difference between the objective of income and growth of income. An income objective always requires as much current income as possible without going beyond the risk criteria prescribed by the investors. The income provided by the income fund will be greater in the initial period when compared to the fund seeking growth of income but in later periods the income generated by the growth of income fund can be much larger than that generated by the income fund. The growth of income objective insists upon the fund manager to achieve some kind of capital appreciation in the original investment as well as a smooth current income. This kind of earning pattern requires some kind of investment in the common stock. The common stock purchased will generate a continuous income in the form of dividend while the appreciation in value of common stock will provide the necessary appreciation in the portfolio. Funds having this objective will primarily invest in the fixed income securities such as long-term bonds.

CAPITAL APPRECIATION

Sometimes the objective of the investors is to get maximum capital appreciation from their portfolio. These investors are not interested in getting a smooth income over a long period of time but are willing to invest in those assets which may provide a substantial amount of increase in the original investment. Investors willing to set this objective for their portfolio will be preferably investing in growth-oriented common stocks. It is important to remember here that whether any investor is seeking capital appreciation or aspiring for the growth of his income, there is one ultimate goal of maximizing the expected utility of the investments. In simple terms, the concept of the utility is to satisfy oneself and avoid all the things that can cause risk of devaluation of one’s investment or decline in continuous income. Normally, any investor will be interested in his primary objectives but it may be possible to establish a secondary objective in addition to the primary objective. As its name refers, the secondary objective refers to the objective that is important after the primary objective. If the primary goal for the institutional investor is to get maximum capital appreciation, his portfolio manager will invest primarily in common stocks. The rest of the fund can go into debt, real estate and other class of assets. Suppose the primary goal of some investors is to get capital appreciation and also a smooth income every month. In this situation, we can say that the secondary goal of the investor is income.

DIFFERENCE BETWEEN INVESTMENT, SPECULATION AND ARBITRAGE

There are two terms – investment and speculation, which are often used interchangeably though there is a difference between these two terms. Lot of people invest in securities such as stocks, bonds and mutual funds while others speculate in commodities or options. Investment is generally considered for a long-term period, while speculation is a short-term activity that involves buying and selling of securities in which the future value and expected return are highly uncertain. Investors in securities usually get returns in the form of interest, dividend or capital gains in the long-term while speculators in securities are always on the look out for speculative gains that can arise either due to certain market sensitive information or through their forecasts of certain future market developments. Such forecasts may be about interest rate movements, security prices, government policies, etc. Speculation is riskier than investment and requires a close eye on the market movements. Another unifying factor of the financial markets is arbitrage. Arbitrageurs take advantage of the price differentials existing between the markets. When the prices of the securities in one market appear to be out of line with other markets, arbitrageurs switch over to the market that offers the best of prices. Thus, arbitraging involves transfer of funds from one market to another.

Direct Investment vs. Indirect Investment

An investor can either invest directly in securities in his/her own name or can invest through an investment company, also referred to as a mutual fund. An investment company is a financial intermediary that collects money from the investors and invests in various securities on their behalf. Financial intermediaries provide the advantages of professional management, diversification, relief from the burden of investment decision-making and convenience for investments of small amounts. The return from these investments is passed on to the investors either periodically or at the end of a specified time period. The investment company charges a fee for its services referred to as the management fee. For example, certain investment companies charge an annual percentage against the assets in the fund, which is known as the expense ratio.

In the case of direct investment, the responsibility of selection of appropriate investment avenues and their management falls on the individuals themselves. Thus, direct investment in stock, bonds and other financial instruments requires considerable expertise and constant supervision of the markets so as to take informed investment decisions. By direct investment, one can avoid paying management fee and administrative charges charged by financial intermediaries.

INVESTMENT CONSTRAINTS

An investor seeking fulfillment of one of the above goals operates under certain constraints like Liquidity, Age, Need for Regular Income, Time Horizon, Risk Tolerance, Tax Liability. The challenge in investment management, therefore, lies in choosing the appropriate investments and designing a unit that will meet the investment objectives of the investor subject to his constraints. To take on this challenge the first step will be to get acquainted with the different types of investments that are available in our financial market.

Formulation of investment policy for individual investors, as already mentioned, is more complex than formulating one for institutional investors, as the individuals have a lot of constraints, subject to which the goals are likely to be achieved. For example, an individual may want to fix a certain portion of his funds in tax saving investments, another part in real estate because he expects the real estate boom will continue, and also want to keep some liquid funds to invest in initial public offerings. The proportions of the funds fixed in various avenues and also the nature of avenues changes from investor to investor and from time to time for the same investor. The portfolio manager has to think of adjusting the overall risk level and the return required keeping in view all the constraints faced by the investor. Let us now discuss the different types of constraints that individuals generally face.

Liquidity refers to the degree to which the asset can be converted into cash at the prevailing market prices. The liquidity of assets may range from a single day to a number of years depending on the class of the asset.

The real needs for liquidity fall in five different categories:

i. **Emergency Cash:** This should be the most liquid of all assets. It may be required at any time when the need arises. So, it does not form a part of the investment portfolio, and is set aside in money market funds.

ii. **Goal Spending:** These are meant for short-term needs, say five years. So, the assets falling under this head should also have fair amount of liquidity.

iii. **Income Taxes:** Since the tax payment date would be known in advance, the amount to be paid is kept aside as cash and not in any other form.

iv. **Estate Transfer Taxes:** The real need for estate taxpayer comes from the estate’s assets, this is mainly because, they are wealthy enough and do not require life insurance for loss of income protection.

v. **Investment Flexibility:** The portfolio should be flexible enough to take advantage of the opportunities in the market. Therefore, at least 75 percent of the assets should be such that they can be liquidated within a couple of weeks.

Individuals need cash at different times for different reasons. Cash is required, for example, to get treated for a sudden and severe ailment or to recover from an accident. People, therefore, want to keep about three to four months' consumption as reserve to meet such unforeseen circumstances. Presence of aged persons or infants in the family accentuates the need for such cash. Funds for emergency use are generally invested in money market funds or other investments (such as bank savings deposits) which are highly liquid and are generally not considered as part of the portfolio. The proportion of liquid assets in the portfolio is also determined by the goals the individual wants to achieve. For example, a person planning to buy a house five years down the line should invest the required amount in assets that mature in about five years and are reasonably liquid. It is also necessary to have some liquid investments to take advantage of the emerging investment opportunities. If not, the individual may have to forgo attractive investment opportunities (in the form of undervalued shares, etc.) that may be available from time to time. Some suggest that about two-thirds of the portfolio should be in investments that can be liquidated with a notice of about two to three weeks.

The degree of liquidity required by institutional investors varies significantly. For example, the liquidity needs of a life assurance company are considerably less than those of a non-life insurance company transacting marine or fire insurance business. Even among companies transacting non-life insurance business, mature companies may be less concerned with liquidity than newly created companies. In the pension area, the liquidity needs of a pension fund will depend upon the current age distribution of future beneficiaries, with relatively young plans of growing firms having less need for liquidity than older firms where considerable benefits must be paid in the near future. In the mutual funds industry, open-ended schemes need to have more liquidity in their portfolios than close-ended schemes. A need for liquidity implies a need to tilt the portfolio to the most readily marketable and liquid types of bonds and money market instruments such as Treasury Bills and Commercial Paper.

Tax Considerations in Investing[1]

The primary concern for many investors has been tax on capital gains, which has been hovering around 34 percent since 1986 depending upon the domicile of the investor. Primarily, there are two misconceptions about taxes. The first is that, "taxes are simply another item of expense, and they should be considered to be always adding values" (Ellis). It is to be understood that capital gains taxes are not inevitable in any given period and they can be controlled in a better way than actually perceived. So, if one assumes that the taxable and the non-taxable portfolios can be managed the same way, it would be a mistake. The second misconception is that, "a very few people in the money management business understand that taxes are a very important item of expense".

Institutional investors like Pension Funds are basically tax-exempt entities; and would therefore; tilt their portfolios to high-yield stocks if the high-yield stocks offer higher pre-tax returns. In the Indian context, we are aware that approved mutual funds are exempt from taxes under Section 10(23-D) of the Income Tax Act. But there are other institutional investors such as banks and insurance companies which are subject to income taxes. Therefore, the investment policies of such investors must consider the tax factor and the nuances of the tax code applicable to them.

1 This section draws from "The Portable MBA in Investment", Peter L Bernstein, Edited by Robert H Jeffrey. Publisher: John Wiley and Sons.

Other Considerations: Often, there are assets which an individual inherits and which he does not want to sell. They may be illiquid as well, such as a partnership in a business. How to cope with the presence of such assets in the portfolio? One answer could be to reduce the weight age of that class of assets in the new investments made. But, consider a person holding a large number of stocks of his employer company, which are still subject to lock in. While the person is holding stocks of considerable value, his holding is highly undiversified. To make his stock portfolio diversified, additional investments in other stocks are required, and the proportion of stocks in the portfolio will increase if more investments are made in stocks. In such situations, it is unavoidable to make a compromise and the nature of compromise should depend on the preferences of the investor. The investor may feel that the existing assets should be held indefinitely either for sentimental reasons or as buffer assets to provide him financial independence. In such cases, the assets can be ignored completely. In other cases, where the assets currently being held are also necessary for the achievement of goals, but the holding of those assets cannot be reduced, the job of the portfolio manager becomes quite complicated. In such cases, the proportion of similar assets in the new portfolio should be reduced and it need not be zero. The new portfolio should be as diversified as possible to ensure that the investors get possible gains from holding other classes of assets as well.

It must be emphasized that the foregoing discussion is only an attempt to provide an overview of the complexities involved in the objectives and constraints of taxable individuals. The range of objectives and constraints that are found in reality are more complex and call for a person of intelligence, knowledge and experience to handle them. And, it must be borne in mind that the foregoing discussion may not be necessarily the most important objectives and constraints, though an individual may perceive them to be so. It is the duty of a portfolio manager to counsel the individual in identifying the most important objectives and constraints and help in formulation of an appropriate portfolio strategy. This should form an important part of the relationship between the individual and a portfolio manager.

Regulatory and Legal Considerations

The government mostly determines the regulatory and legal considerations for any bank. Banks are required to maintain the prescribed amount of capital adequacy ratio. They are also required to fulfill the statutory liquidity requirements prescribed by the respective Central Banks. In certain instances, the government may also determine their borrowing and lending rates. Banks are also the biggest investors in government securities due to the reserve requirements.

As per the RBI guidelines, banks can invest in shares, debentures and units of mutual funds. The total amount of exposure of any commercial bank to the capital market should not exceed 5 percent of the bank’s total outstanding advances (including commercial paper) as on March 31, of the previous financial year. The maximum limit of 5 percent prescribed for investment in stocks includes exposure to both fund based and non-fund based investment by a bank in a capital market. The maximum ceiling of 5 percent captures the following:

a. Direct investment by a bank in stocks, debentures, convertible bonds and units of mutual funds, which invest in equity stocks.

b. Advances paid to the individuals for investment in equity stocks (including IPOs), debentures, bonds and units of mutual funds investing in stocks.

c. Advances (secured and unsecured) and guarantee provided to the stockbrokers and market makers.

Within the maximum exposure limit of 5 percent, the total exposure of banks in common stocks, convertible bonds, debentures and equity-oriented mutual funds should not exceed 20 percent of their net worth.

Most institutional investors are regulated regarding the eligible class of assets, the minimum and/or maximum amount that can be placed in a particular asset class, and the maximum amount that can be invested in a given asset. Within an asset class, there can be restrictions on some particular assets on their eligibility for investment.

Regulatory restrictions on investment patterns and on the inclusion of certain types of investment vehicles obviously, reduce the institutional investor's ability to achieve a better risk-return trade-off. For example, strategies involving futures and options may allow the investor to achieve unique risk-return speculative by the regulators; these derivative instruments may not qualify as eligible investment vehicles. Fortunately, in the recent years, more and more regulators have become familiar with the economic role of these instruments, and they have broadened their position regarding the use of the new financial products by the institutions they regulate. In fact, there is a trend to replace traditional "laundry lists" of approved investments by the "Prudent Man Rule" which allows the institutional investor with the much needed flexibility to cope with the ever changing array of investment alternatives.

Unique Needs, Circumstances and Preferences

Portfolio construction would be sterile without provisions for the special requirements of each investor. For example, institutional investors may be concerned with social responsibility issues that may preclude investing in firms that make objectionable products or do business, in certain countries. The investment committee of the institution may have a predefined portfolio structure where the quality and/or the maturity range of the portfolio holdings are restricted. Such considerations must be taken into account while framing the investment policy.

Specific needs or circumstances and some required preferences of any bank are directly linked to its size, locality and the combination of uncontrollable liabilities and individual skills in matching assets and liabilities in the most efficient manner. A small bank may not have huge core deposits of any prominent sophisticated individual depositor and these banks may not have sufficient resources to purchase the liability from big banks.

TIME HORIZON

The time horizon for banks is generally of short-term. Even though some loans like mortgages are made over the long-term, increased fluctuation of interest rates over the past several years has changed the pattern of even this type of lending. Variable short-term mortgage instruments, floating rate notes, short-term renewable mortgages with long-term amortization period and other new instruments have provided the way to match the maturities or duration of assets and liabilities to lessen the interest rate risk.

Determination of Portfolio Policies

Efficient management of assets and liabilities in situations of highly volatile interest rates decides the profitability of the bank. The policy guidelines of a bank, project its ability to manage assets and liabilities. Generally, banks employ the technique of scenario forecasting as an important decision tool to manage the future assets and liabilities. Apart from using this technique, bank economists develop several different interest rate scenarios based on the forecasts of the general economy and other factors affecting the interest rates. They use these scenarios by assigning proper probabilities so that they can be used for developing the actual position of future assets and liabilities. The developed scenarios work as guidelines to the banks and accordingly they adjust their assets and liabilities position to avoid any big loss and to increase profits. It will be more convenient for banks to fix the required spread between the costs of funds borrowed and the interest inflow from loans so that they increase the stability of their future earnings.

VARIOUS INVESTMENT VEHICLES

After deciding the investment objectives, one has to decide about the investment vehicles. There are various investment vehicles available in the financial markets and investors can choose an appropriate one depending on their needs. Some of the most common investment vehicles are:

- Bonds
- Stocks
- Preferred Stock and Convertibles
- Mutual Funds
- Real Estate
- Commodities Futures and Options.

Bonds

A bond is the basic form of fixed income security. It is issued by a borrower (borrowing company) to the lender (the investor). The bondholder receives coupon payments at periodical intervals say annually, quarterly or semi-annually and the redemption amount on the maturity date. For example, when an individual invests Rs.1,000 in a bond that pays interest at the rate of 10% semi-annually, he/she can expect to receive Rs.50 semi-annually (i.e., 10% x 1000 x 0.50) and at the maturity he/she will recover Rs.1,000, if the bond is redeemed at par. Sometimes, bonds are issued as zero coupon bonds where no interest is paid to the investors. Instead, these bonds are issued at a discount to the face value and are redeemed at par. The difference between the two is the return to the investor. For example, a bond with a face value of Rs.10,000 may be issued at a discounted value of say Rs.8,500. The bond would be redeemed after, say, 10 years and at that time the investor would get Rs.10,000.

Stocks

Common stock may be defined as the residual ownership of a corporation that is entitled to all assets and earnings after other claims have been paid and that generally has voting control. The advantage of equity capital to the issuing firm is that it offers permanent capital with limited liability for repayment without any fixed obligation for the payment of dividends. The issue of common stock, however, results in the dilution of control of the issuing company. The shareholders enjoy voting rights in the firms. Common stock has no maturity date and as a result remains outstanding indefinitely.

Preferred Stock and Convertibles

Preferred stock in the strict sense is to be treated as equity. It is often included under fixed income securities as the dividend income is fixed for preference shares. At the time of liquidation of a company, preference shareholders have a lower priority compared to bondholders, but they have a higher priority compared to equity shareholders. Convertibles, in contrast, are a special type of fixed income obligation that carry a conversion feature and can be converted into a specified number of equity shares after a specified time period.

Mutual Funds

Investment in stocks, bonds and other financial instruments require considerable expertise and constant supervision so as to be able to take informed decisions. Small investors usually do not have the necessary expertise and the time to undertake any such monitoring that can facilitate informed decision-making. This is the predominant reason for the popularity of mutual funds. A mutual fund is a financial intermediary that collects money from the investors and invests in various securities on their behalf. The return from these investments is passed on to the investors either periodically or at the end of a specified time period. The mutual funds charge a fee for their services referred to as management fees. Mutual funds sell units of the funds to the investors. Most of the mutual funds issue and repurchase the shares at a price that reflects the underlying value of the portfolio at the time of transaction. This price is known as net asset value. Mutual finds are of two types namely close-ended mutual funds and open-ended mutual funds. Close-ended mutual fund schemes have a stipulated maturity period wherein the investor can invest directly in the scheme at the time of the initial issue and thereafter units of the scheme can be bought or sold on the stock exchanges where the scheme is listed. Open-ended schemes usually do not have a fixed maturity period and are available for subscription and redemption on an ongoing basis. The units can be bought and sold any time during the life of the scheme at NAV related prices.

Real Estate

Investors can invest in different forms of real estate such as land, flats, independent houses or commercial property. Real estate is not exchangeable and transferable easily. The return from real estate investment can be in the form of rent, capital gains and certain tax benefits. Investors have to consider various factors such as location, design and potential for appreciation while investing in real estate. Among these factors, location is an important parameter because it determines the value of the real estate. It is very difficult to predict the risk and return involved in the real estate market and therefore investors have to consider various factors while investing in real estate.

Commodities Futures and Options

Commodities are tangible goods that can be used for various purposes. They include all goods and articles except financial assets. In fact, commodities futures and options are contracts to buy and sell goods such as cotton, corn, wheat, coffee and cocoa, silver, oil, etc. The contracts are traded all around the world for various purposes and in various modes in both organized and unorganized markets.

Security Forms of Financial Investment

We know that the recipient of money in a financial investment issues a document or a piece of paper to the investor (supplier of money), evidencing the liability of the former to the latter to provide returns. This document also outlines the rights of the investor to certain prospects and/or property and sets the conditions under which the investor can exercise his/her rights. This document is variously called ‘Security Certificate’, ‘Note’ and so on.

The term ‘security’ is a generic term used generally for those documents evidencing liabilities that are negotiable – that can be bought and sold in the stock market. The security form of investment has received great impetus since 1980 following the Central Government’s liberal policy towards foreign investments – direct and portfolio, streamlining of licensing, capital issues, and other procedural formalities to facilitate faster capital formation; providing incentives for exports; and encouraging private sector to tap the primary market for meeting their long-term capital requirements.

There are different types of securities conferring different sets of rights on the investors and different sets of conditions under which these rights can be exercised. They are gilt-edged securities, corporate debentures, preference shares and equity shares.

The important characteristic features of these securities are described below.

GILT-EDGED SECURITIES

The debt securities issued by the government and semi-government bodies are called gilt-edged securities. They comprise the treasury bills and the dated securities (also called bonds or dated loans) of the central government, state government, and semi-government bodies like Port Trusts and State Electricity Boards. They are the acknowledgments of debt incurred by the issuing government or semi-government body. Gilt-edged securities thus represent the public borrowings of the issuing government or semi-government bodies. Over the years, the central and state governments and the semi-government bodies have made an extensive use of these securities for meeting their short and long-term resource requirements.

Treasury Bills

These short-term securities are issued by the RBI on behalf of the Central Government. Currently, the T-Bills having a maturity of 91 and 364 days only are being traded. No interest is paid on these bills. Instead they are sold at a discount. In other words, the buyer pays a price less than the face value of the bill and receives the full face value on the last day of maturity. The difference between the discount price and face value represents the interest income to the investor.

Since April 1st, 1996 the sale of treasury bills by Public Debt Office of the RBI had been stopped. Now it is carried out by the RBI by conducting auctions: Weekly for 91 days T-bills and fortnightly for 364 days T-bills.

The discount rate on treasury bills being very low, the return to the investor is meager. However, they are the safest and the most liquid securities you can find in the market. They are a safe investment because the central government will never default on making payment when the bills mature. They are liquid because the commercial banks are ready to buy them at any time due to the facility of rediscounting with the RBI. There is however little public interest in treasury bills because of the availability of equally safe investment opportunities providing a better return and also because they are sold in large denominations. Frequent buyers of treasury bills are the commercial banks, state governments, and semi-government bodies. Due to rediscounting facility, the RBI generally ends up holding nearly 80 percent of the outstanding treasury bills at any given time.

As against the periodic issue of the ad hoc treasury bills to the RBI in the past, the government is now raising funds through the Ways and Means financing.

Since the RBI has started selling treasury bills auction, through, the discount rate is now determined by market forces and on a competitive basis. The discount rates on treasury bills increase as the number of days to maturity increase. However, the discount rates on T-Bills are lower than the rates on the dated government securities.

Central Government Dated Securities

These securities of the central government have a maturity period longer than one year and carry a fixed rate of interest. The interest is payable semi-annually and the payment is usually made by issuing coupons which can be encashed at any bank. Though these securities are redeemed at par, their issue price can be higher or lower than the face value depending upon the prevailing market conditions.

These securities are held either in the form of promissory notes or stock certificates. The difference between a promissory note and a stock certificate is that while the former is negotiable and transferable by a simple endorsement, a stock certificate can be transferred only by executing a transfer deed and submitting a copy of the deed to the RBI. The RBI issues a new certificate to the transferee. A promissory note has to be presented to RBI every time the payment of interest is due, but no such presentation of the stock certificate is required because the RBI knows who the present owner is and mails the interest coupon to him on the due date. The public/recognized provident funds are required to hold these securities only in the form of stock certificates.

The coupon rate on the central government dated securities is higher than the discount rate on treasury bills, due to the fact that the maturity of dated securities is longer. Hence, there is a need for providing liquidity premium to the investor. These securities are the next best alternative from the stand point of safety. There is no default risk, but the real value of income and capital returned on maturity could be lower due to possible inflation. The market for central government securities is captive in the sense that certain institutions such as commercial banks, Life Insurance Corporation (LIC), General Insurance Corporation (GIC), development financial institutions like the Industrial Development Bank of India (IDBI), recognized/public provident funds, registered trusts, government and semi-government bodies are required by law to invest at least a certain percentage of their investible funds in the central government securities. Besides the central government, and the state governments also issue dated securities.

Recently, a number of innovations have been introduced in the gilt-edged securities market. The credit policy announced by the Bank on April 21, 1992, underlined the need for the center to reduce its dependence on the RBI and the banking system for its credit requirements. As a first step in this direction, treasury bills of varying maturities have been introduced by the RBI which would help to widen the market for treasury bills. Moreover, in order to develop dated securities as monetary instruments with flexible yields to suit investors' expectations, the Government of India also offered to sell dated securities of 5 years maturity in auctions. The Discount and Finance House of India (DFHI) started offering a two way quote in government securities with the intention of developing a secondary market.

Semi-Government Dated Securities

These are the promissory notes issued by the institutions and corporations set-up by the central/state governments. They also include the securities of municipal corporations. The semi-government bodies such as electricity boards, housing boards, port trusts, central and state financial institutions issue securities to meet the financial needs of their developmental activities. Semi-government securities are guaranteed by their respective governments and carry a higher coupon rate or lower issue price than for their counterpart state government dated securities.

The price quotations for gilt-edged dated securities are reported to stock exchange for inclusion in the official quotations list by the licensed dealers. While the issue of securities, payment of interest, and transfer of the central and state government securities are handled by the RBI, the issue, interest payment and transfer of semi-government securities are handled by the commercial banks for a fee. As mentioned earlier, the gilt-edged securities market is dominated by the institutional investors like the LIC, GIC, banks, and provident funds. There are a few members of the stock exchanges who specialize in gilt-edged securities. But they operate primarily as brokers and not as dealers.

CORPORATE DEBENTURES

Corporate debentures are the promissory notes issued by the joint stock companies in the private sector. They are thus the debt obligations of the issuing corporation. Like government securities, they have an issue price at which they are originally issued, a coupon interest rate, and a specified maturity date.

Debenture Trust Deed

When a debenture issue is sold to the investing public, the debenture trust deed calls for appointing a trustee. Banks, insurance companies and firms of attorneys usually act as trustees to corporate debenture issues. The main job of the trustee is to look after the interest of debenture holders by ensuring that the company adheres to the provisions of the indenture – the agreement entered into between the issuing company and the debenture holders. To perform their role effectively, the trustees are vested with adequate powers which include the right to appoint a nominee director on the board of the company in consultation with the institutional debenture holders.

The indenture is a legal document describing in considerable detail the contractual relationship between the issuing company and the debenture holders. This agreement specifies, among other things, the periodicity of interest payment; mode of redemption of debentures; collateral securities, if any; rights of the debenture holders in the event of default; rights, duties, and responsibilities of the trustee to the issue; and restrictive covenants such as limit on dividend payment, restriction on the company's capacity to create additional debt, etc. If corporate debentures are placed privately with one or more institutions like LIC, UTI and banks, then no trustee is appointed and no indenture is created. Instead, there is a loan agreement between the parties with similar provisions as in an indenture.

Special Features of Corporate Debentures

Corporate debentures are less liquid and more risky than government securities. They do not have a captive market; the success of an issue and the marketability of debentures subsequent to the issue depend largely on the reputation of issuing corporation, financial market conditions, and the interest shown by the institutional investors. Since prompt payment of interest and repayment of principal on the due dates depend upon the earnings prospects and the financial conditions of the issuing corporation (which tend to fluctuate over time), the investors will naturally demand a higher return on corporate debentures than on government securities. The prevailing market returns on these securities are generally consistent with this expectation.

In most cases, the interest on corporate debentures is payable semi-annually. There are, however, some issues with annual or quarterly interest payment. It is mandatory on the part of the company to pay interest irrespective of its financial conditions. In the event of a default, the debentureholders have the right to force the company to go into liquidation. If liquidated, they have a priority claim over shareholders in the sense that their accrued interest and principal amount are paid-off first before anything from the operating income and liquidation proceeds is distributed to shareholders.

The maximum rate of interest payable on debentures was fixed from time to time. All restrictions on interest rates on debentures and public sector undertakings, other than tax-free bonds of the public sector undertakings are now removed. The interest rate on such debt instruments will hereafter be governed by the market forces. The interest rate and period of redemption shall be approved by the government on a case-by-case basis.

Types of Debentures

Debentures can be classified into two or more categories along the following dimensions: Security, transferability, and convertibility.

Straight and Mortgage Debentures

Based on security dimension, debentures can be classified as unsecured (or straight) debentures and secured (or mortgage) debentures. Unsecured debentures have no charge on any specific asset(s) of the company while secured debentures carry a fixed or floating charge on the assets of the company. The usual practice is to create a charge on the immovable properties of the company both present and future by way of an equitable mortgage. The equitable mortgage is affected by depositing the title deeds relating to the mortgaged assets in favor of the trustees of the debenture holders. The public limited companies issuing debentures to the public are permitted to issue only secured debentures.

Registered and Bearer Debentures

As per dimension of transferability, debentures can be classified as registered and unregistered debentures. Unregistered debentures (or bearer debentures) are freely negotiable and can be transferred by a simple endorsement. On the other hand, registered debentures can be transferred only by executing a transfer deed and filing a copy of it with the company. The registered debenture holders receive interest cheques from the company whereas interest is paid on bearer debentures only upon presentation. According to the Companies Act, 1956, only registered debentures are to be issued to public.

Convertible and Non-convertible Debentures

Debentures can also be classified into convertible and non-convertible debentures depending upon whether they carry a conversion feature or not. Convertible debentures are the ones which can be converted into equity shares at the option of the debentureholders. In this case, the ratio of conversion (the number of shares exchanged for the converted portion) or alternatively the conversion price (the price at which equity shares are exchanged for the converted portion of the debentures), and the period during which the conversion can be effected are specified at the time of the issue. Convertible debentures can be either fully convertible or partly convertible. In the case of partly convertible debentures, the non-converted portion will carry interest until it is repaid as per the provisions in the indenture. Of late, non-convertible debentures have been issued with warrants which entitle the holder to buy a specified number of shares on a specified future date at a fixed price.

For example, Tata Metaliks Ltd. came out with a public issue in May, 1993 of 23,22,000, 14% secured redeemable Partly Convertible Debentures (PCDs) of Rs.125 each, the terms of which are as follows:

a. Each PCD will have a face value of Rs.125 and shall consist of two parts.

   Part A Convertible portion of Rs.40.

   Part B Non-Convertible portion of Rs.85.

b. Part A of each PCD will be automatically and compulsorily converted into 4 equity shares of Rs.10 each at par on allotment.

c. Part B of the PCD will be redeemed at par in three installments of Rs.28 and Rs.29 at the end of 7th, 8th and 9th years respectively from the date of allotment.

'Convertible' Zero-Coupon Bond

A zero-coupon bond is a loan instrument slightly different from a debenture. A debenture is usually offered at a face value (say Rs.100), earns a stream of interest (say, 14 percent p.a.) till redemption and is redeemed with or without premium. Unlike the above, a zero-coupon bond, say a five-year bond, may be offered at a discount (say, at Rs.50), fetches no periodic interest and is redeemed at the face value (say, Rs.100). The return on such a bond when subscribed to at Rs.50, is also about 14 percent. It is just that in this case the interest is reinvested in the company for a period of five years. A zero-coupon bond may also be redeemed by allocation of ordinary share(s). For want of better terminology, such a bond has been referred to as a 'Convertible' zero-coupon bond.

Redemption

Irredeemable corporate debentures are perhaps non-existent. In fact, all corporate debentures are redeemable and the redemption takes place in a pre-specified manner. Typically, debentures have a term-to-maturity of 7 to 10 years and are redeemed in installments over a period of time. Recently, companies have been permitted to issue debentures of shorter maturities like debentures with a maturity period of one year. Corporate debentures can be redeemed by creating a sinking fund. A sinking fund provision in the indenture requires the issuing company to make periodic payments to the trustees. The trustee can retire the debentures by purchasing them in the market or calling them in a manner acceptable to the debentureholders. In some cases, however, the company itself can handle the retirement with the sinking fund amount.

Debenture Redemption Reserve

The guidelines for protecting the interests of debentureholders requires, among other things, the issuing company to create a Debenture Redemption Reserve (DRR) out of its profits to the extent of 50% of the amount of debentures to be redeemed before the date of redemption. The company can utilize the DRR for redeeming debentures only after 10% of the debenture liability has been actually redeemed by the company.

Call Option

Some debenture issues have a call feature attached to them, which provides an option to the issuing company to redeem debentures at a specified price before the maturity date. In this case, there is, what is known as an effective call option period during which the option can be exercised. The call option period usually commences after 1 to 3 years from the date of allotment. When the debentures are redeemed by call, they are done so at the call price which can be 5% above the par value. The call price is maximum at the start of the effective call option period and declines step-wise towards the face value as the call date approaches the maturity date. The effective call option period and the time-series schedule of call price are announced at the time of issue.

PREFERENCE SHARES

These are a hybrid variety of securities which have some features of equity shares and some features of debentures. Preference shares carry a fixed rate of dividend. Preference dividend is payable only out of distributable profits. Generally, dividend on preference shares is cumulative. Hence, dividend not paid in one year has to be paid during the subsequent years before equity dividend is paid. All preference shares shall be redeemable within 20 years as per the Companies Act, 1956.

EQUITY SHARES

Investors' Classification of Equity Stocks

Unlike in the West where we find different classes of common stock with differing voting rights and rights to income and assets of the company, the equity stocks of all Indian joint stock companies belong to just one class. The rights and privileges conferred on the shareholders are all the same and they are enjoyable in proportion to one's shareholdings. With the commencement of the Companies Amendment Act, 2000, companies are allowed to issue shares with disproportionate voting rights.

The investment community in India, however, has its own categorization of equity stock, not on the basis of voting or any other right, but on the basis of behavior of prices (and returns) of equity stocks. These categories include Blue chips, Growth stocks, Income stocks, Cyclical stocks, Defensive stocks, Speculative stocks, Glamour stocks, and so on.

Non-security Forms of Financial Investment

There are a number of non-security forms of investment opportunities available to an investor in India. Unlike stocks and debentures discussed above, the certificates or notes evidencing these investments are neither transferable nor are they traded in any organized financial market. Hence, the nomenclature 'Non-security form', although, in the strict sense, is a misnomer.

Broadly, these financial investment media can be classified into (1) National Savings Schemes, (2) Post Office Savings Deposit Schemes, (3) Deposits with Commercial Banks, (4) Corporate Fixed Deposits, and (5) Unit Schemes of UTI.

As can be seen from the above classification, most of the non-security forms of investment are the schemes or the plans of the central government, and the bodies controlled by it. These schemes are meant to mobilize small private savings for public use. Excepting corporate deposits, the other non-security forms of investment provide adequate safety and a reasonable liquidity. Many of these investments also have significant tax advantages. Although nominal returns on these investments are low vis-a-vis security returns, the features of tax advantage and safety can swing many small investors into their fold, particularly the conservative investors. In fact, statistics indicate that nearly 80% of the household savings are in these forms of investment.

The knowledge of non-security forms of investment is important not only because they are popular among small investors, but also because they help in fulfilling an important task of an investor, money manager/investment counselor – to obtain a balanced portfolio that satisfies a given set of objectives. The financial investments in media – security and non-security types differ in their return, risk, liquidity, and tax characteristics. So, it would be possible to form a portfolio by spreading one's investment across these forms such that investment objectives are best served. In this section, we will discuss the salient features of the major non-security forms of investment media available in India.

NATIONAL SAVINGS SCHEMES

Over the years, the Government of India has floated several national savings schemes with a view to mobilize private savings for public use. These schemes are operated mainly through the Post Offices because of the familiarity of these places to the masses. Some series of National Savings Schemes are operated through the State Bank of India and other nationalized banks. These series are known as 'Bank Series'. Investment in the eighth series of this scheme qualifies for a tax rebate. At present, the rate of return on NSS is 9% p.a. credited annually on April 1. Interest income qualifies for a limited tax deduction.

POST OFFICE SAVINGS DEPOSITS SCHEMES

These include savings bank account, time, and recurring deposit accounts. These accounts can be operated in the post offices throughout the country. Interest so earned is totally tax-free under Section 10 of the Income Tax Act.

Interest on the time deposit schemes qualifies for deduction under Section 80L of Income Tax Act. Premature withdrawal of deposits are, however, allowed only after 6 months at a discount.

The Post Office 5-year Recurring Deposit Account carries a comparable compound interest rate (9.5%). The interest on recurring deposits is covered by Section 80L of the Income Tax Act.

Investment in post office/bank accounts also qualifies for exemption under the Wealth Tax Act subject to the overall exemption limit.

DEPOSITS WITH COMMERCIAL/CO-OPERATIVE BANKS

The major deposit schemes of the Commercial/Co-operative banks include the savings bank account, fixed deposits, recurring deposits, and annuity deposit schemes.

A savings bank account at a commercial bank carries a nominal interest of 4% per annum with some limit on the number of withdrawals (usually 25 times a quarter). If this account is opened with district or industrial co-operative bank, the interest rate is higher by about 1%. The interest is calculated on the monthly minimum balance, but credited to the account twice or four times a year. This is a very liquid interest earning account because frequent withdrawals are permitted.

Banks accept fixed (i.e., term) and recurring deposits. Such deposits for a period longer than 10 years are not accepted by the nationalized banks because of a directive issued by the RBI. Under the fixed deposit scheme, the deposit is made in lump sum initially for a set term, whereas, under recurring deposit scheme, the depositor deposits a certain amount periodically on a regular basis over a specified period of time.

The interest on fixed deposits can be on a compounding or non-compounding basis, but the interest on recurring deposits is always on a compounding basis. Those banks offering simple interest term-deposit schemes generally provide for reinvestment of interest at the rate allowed on term-deposits.

Banks also offer annuity deposit schemes. Under an annuity scheme, a lump sum deposit is made with the bank initially and the bank agrees to make payment of a certain uniform amount at regular intervals over the annuity period, either to the deposit holder or to his nominee. Each periodical payment under the annuity deposit scheme consists of two components – the principal repayment and interest. In the initial years the interest component of the annuity is higher and in the later years the principal component is higher.

Given the rate at which the bank pays interest on the outstanding balance of the principal amount, these periodical uniform payments can be figured out using the PVIFA tables. For example, if one buys a 5-year, 10% annuity deposit certificate for Rs.26,535.6, the annuity he is entitled to receive over the 5-year period can be determined as follows:

$$\text{Annuity} = \frac{26,535.6}{\text{PVIFA}_{(10,5)}}$$

$$= \frac{26,535.6}{3.791}$$

$$= \text{Rs.}7,000$$

It is to be noted that besides these deposit schemes, banks do have other schemes to attract small savings like cash certificate scheme, perennial income scheme, etc. The other points worth noting about bank deposits are (i) premature encashment is possible; (ii) the interest on these deposits is covered under Section 80L of the Income Tax Act; (iii) the Deposit Insurance Corporation offers a cover up to Rs.1,00,000 per account.

CORPORATE FIXED DEPOSITS

Investors can also consider depositing their money for a fixed term with companies. These fixed deposits which are considered as a part of the unsecured liabilities of the company, have a maximum maturity period of 3 years and carry a maximum rate of interest of 12.5% (earlier 14%). The public deposits accepted by the companies are governed by the provisions of the Companies (Acceptance of Deposits) Rules, 1975. The important features of this regulation are (a) Public Deposits cannot exceed 10% of the share capital plus free reserves; (b) The maximum maturity period cannot exceed 3 years and the minimum maturity period cannot be less than 6 months; (c) No company with a net owned fund of less than rupees one crore shall invite public deposits. (d) The company inviting public deposits must disclose the prescribed information relating to its financial performance and position. These guidelines apply with certain modifications to finance companies.

The interest on public deposits is paid semi-annually on a cumulative or non-cumulative basis. While the interest rates offered on company deposits are attractive vis-a-vis bank deposits, it should be noted that there is no tax benefit neither on the interest income, nor, does the investment in CFD qualify for any tax rebate.

Besides, company deposits have a higher degree of default risk than bank deposits. For one thing, these deposits do not enjoy any risk cover from the Deposit Insurance Corporation like bank deposits. Further, these deposits are serviced and finally repaid from the earnings of the company which by nature are uncertain and fluctuate over time. To add to this, these deposits are unsecured and rank *pari passu* with other unsecured liabilities for repayment in the event of liquidation. Therefore, the decision to invest in public deposits must be necessarily based on a thorough analysis of the financial stability and profitability of the company[2] or on the credit ratings provided by rating agencies like CRISIL and ICRA.

2 The company (Amendment) Bill, 1987 has proposed serious penalties for companies defaulting on payment of interest and repayment of these deposits.

UNITS OF UTI

The Unit Trust of India (UTI) in the public sector is the only units investment trust in the country. It was set-up in 1964 with a view to mobilize small savings by selling 'units' and invest the proceeds in the corporate stocks and debentures and gilt-edged securities. A unit represents a share in the income earned and in the assets (portfolio of securities) held by the trust under a given scheme. Some important unit schemes offered by UTI are discussed below.

Unit Scheme, 1964

One of the major unit schemes of UTI is the Unit Scheme, 1964. Under this scheme which is an open-ended one, units of the face value of Rs.10 each are sold on a continuous basis at a price quoted by the UTI from time to time. During the month of July, for about 3 – 6 weeks, these units are sold at a special price which normally is lower than the price quoted during the other periods of the year. A unit holder can avail himself of this facility, if so desired, for automatic reinvestment of dividend income in further units at the reduced price.

Unit Scheme, 1971

This unit scheme is a unit-linked insurance plan. Under this scheme, the units are not sold on tap. Instead, they are issued to the participants of the plan. It is a contractual savings plan for a target total contribution of Rs.6,000 at the minimum and Rs.75,000 at the maximum over a period of either 10 years or 15 years. A small amount of the contribution is paid to LIC for the insurance cover and the rest is invested. The total contribution to be made by a participant represents the insurance cover amount and this amount is paid to the nominee or legal heir in the event of the participant's death. The plan also provides for personal accident insurance cover up to Rs.15,000 free of cost to the participant.

Unit Scheme for Charitable and Religious Trusts and Societies

The units sold under the scheme have a face value of Rs.100 and a participating trust or society is required to buy at least a 100 units. A participant can opt for reinvestment of dividends. The investment, however, cannot be withdrawn for the first three years.

Children's Gift Growth Fund 1986

Under this scheme, an irrevocable gift can be given by any adult to any child under 15 years of age. This investment remains with UTI till the child attains the age of 21 years. As it is indicated by the name, its primary aim is to build-up a fund for children. Till the scheme matures, there is an assured dividend of 12.5% p.a. which is automatically reinvested in further units, so the investment grows at a compound rate. Units can be gifted in multiples of 10 subject to a minimum of 50. Units are sold at par at Rs.10 throughout the year.

Mutual Fund Unit Scheme 1986 (Mastershares)

This scheme provides an opportunity to the investors to participate in the growing equity market. The funds mobilized through Mastershares are invested in a basket of equities spread over a wide range of industries, thus giving the benefit of diversification and spread of risk to the common investor. Mastershares are quoted on the stock market and so can be bought or sold at any time.

Growing Monthly Income Scheme (GMIS'91)

This scheme is launched to satisfy the growing need of middle class investors for regular income schemes and to cope with the rising cost of living. The scheme offers two options. Option 'A' provides regular monthly income of 14.5% p.a. for the first 3 years and 15% p.a. for the last two years with a minimum 2% capital appreciation on maturity. Under Option 'B' invested amount more than doubles itself in 5 years.

The investment in units under the unit-linked insurance plan qualifies for deduction under Section 88 of the Income Tax Act. The investment in units is also eligible for exemption under the Wealth Tax Act subject to the overall exemption limit. Dividend income qualifies u/s 80L of the IT Act.

FACTORS CONSIDERED IN THE CHOICE OF INVESTMENTS

The following factors should be taken into consideration while choosing an investment:

Investment Risk

The primary consideration for all the investors will be the safety of the funds lent. Every investment option will have an element of risk involved in it. Risk and return go hand in hand in investments and finance. One cannot talk about return without considering risk because investment decisions always involve a trade-off between risk and return. Risk can be defined as the probability that the actual outcome from an investment will differ from the expected outcome. This means that the greater the variability of the actual outcome from the expected outcome, the greater is the risk involved in the investment. Although one cannot eliminate risk fully, one can however minimize the risk by using appropriate investment strategies. For minimizing risk, one must first know the methods of measuring it.

QUANTIFYING RISK

Generally, the risk associated with a security is measured by the volatility of total return. More the volatility of the returns, more will be the risk in the security. In fact, risk is associated with the dispersion in the likely outcomes. Dispersion refers to variability. If an asset's return has no variability it implies that the asset has no risk. An investor analyzing a series of returns on an investment over a certain number of years needs to know something about the variability of the returns. In other words, an investor must have an idea about the asset's total risk. There are different ways to measure the variability of returns. The first measure is the range of return, i.e. the difference between the highest possible rate of return and the lowest possible rate of return. Since the range is based on only two extreme values it does not give a very clear picture about the risk.

The variance of an asset's rate of return can be measured as the sum of the squared deviations of each possible rate of return from the expected rate of return multiplied by the probability that the rate of return occurs.

Mathematically, it can be represented as follows:

$$\text{VAR (k)} = \sum_{i=1}^{n} P_i (k_i - \bar{k})^2$$

Where,

VAR (k) = Variance of return

P_i = Probability associated with the ith possible outcome

k_i = Rate of return from the ith possible outcome

$\bar{k}$ = Expected rate of return

n = number of years.

A third and the most popular way of measuring variability of returns is through standard deviation. Standard deviation, denoted by σ, is simply the square root of the variance of the range of return explained as above.

$$\sigma = \sqrt{\text{VAR(k)}} = \left[\sum_{i=1}^{n} \text{Pi}\,(\text{ki} - \bar{k})^2 \right]^{1/2}$$

Standard deviation and variance are conceptually equivalent quantitative measures of total risk. Standard deviation is preferred to range because of the following advantages:

i. Unlike the range, standard deviation considers every possible event and assigns each event a weight equal to its probability.

ii. Standard deviation is a very familiar concept and many calculators and computers are programmed to calculate it.

iii. Standard deviation is a measure of dispersion around the expected (or average) value. This is in absolute consensus with the definition of risk as "variability of return".

iv. Standard deviation is obtained as the square root of the sum of squared differences multiplied by their probabilities. This facilitates the comparison of risk as measured by standard deviation and expected return 'k' as both are measured as percentages. This is why standard deviation is preferred to variance as a measure of risk.

Illustration 1

Mr. X has the stock of Alpha Company whose probability distribution and corresponding rates of return are as follows:

Possible Outcomes	Probability of Occurrence	Rate of Return
1	0.10	50
2	0.20	30
3	0.40	10
4	0.20	–10
5	0.10	–30

Calculate the risk of Mr. X's investment.

Solution

For calculating the standard deviation (risk), we have to first calculate the expected rate of return:

$$K = \sum_{t=1}^{n} Piki$$

$= (0.10)(0.50) + (0.20)\ (0.30) + (0.40)\ (0.10) + (0.20)\ (–0.10) + (0.10)\ (–0.30)$

$= 0.05 + 0.06 + 0.04 – 0.02 – 0.03 = 0.10$

$= 10\%$

Calculating the standard deviation of return:

Possible outcome	K_i(%)	$(K_i – K)$	$(K_i – K)^2$	P_i	$P_i(K_i – K)^2$
1	50	40	1600	0.10	160
2	30	20	400	0.20	80
3	10	0	0	0.40	0
4	–10	–20	400	0.20	80
5	–30	–40	1600	0.10	160
					480

$$\sigma = \sqrt{VAR(k)} = \left[\sum_{i=1}^{n} Pi(ki - \bar{k})^2\right]^{1/2}$$

$$= \sqrt{480} = 21.9\%$$

TYPES OF RISKS

In this section, we try to find out the various types of risk and factors, which make any financial asset risky. Let us first take a look at some of the general types of risk:

a. **Market Risk:** This is the most common type of risk. It refers to the day-to-day fluctuations in a stock's price caused due to various market developments. All securities are exposed to market risk but the exposure is greater in case of equity shares. Market risk affects mainly stocks and options. On the whole, stocks tend to perform well during a bull market and poorly during a bear market indicating that volatility is not so much a cause but an effect of certain market forces. Volatility is a measure of risk because it refers to the behavior, or "temperament," of the investment rather than the reason for this behavior. Because market movement is the reason why people can make money from stocks, volatility is essential for returns, and the more unstable the investment, the more the chance of it going either way.

b. **Interest Rate Risk:** This risk is the variability in a security's returns resulting from changes in the level of interest rates, other things being equal. Security prices move inversely to interest rates. Interest rate movements affect bondholders more as compared to the equity shareholders.

c. **Default Risk:** It arises when a company, that has issued bonds, defaults on its interest or principal obligations. In case the company goes bankrupt and is unable to pay its debts fully, a part of the money is completely lost. Although the remaining part may be paid after a long delay, it would still result in a loss of present value to the investors. As investors, we must always recognize that, even if no money is ultimately lost, the loss of present value can be very substantial if there is a long delay. Government bonds have the least amount of default risk and also provide the least return while corporate bonds tend to have a high value of default risk despite providing attractive returns. Bonds with lower chances of default are considered to be "investment grade," and bonds with higher chances of default are called junk bonds. Bond rating services, such as Moody's, enable investors to determine which bonds are investment-grade, and which bonds are "junk" by assigning ratings to the bonds.

d. **Purchasing Power Risk:** With a rise in inflation there is reduction in the purchasing power of the rupee. This is known as inflation risk and it affects all securities. This risk is directly related to the interest rate risk as interest rates move up with the inflation rates.

e. **Other Risks:** When investing in foreign countries one must consider the fact that currency exchange rates can also change the price of an asset. Foreign exchange risk applies to all financial instruments that are in a currency other than the domestic currency. As an example, if you are a resident of America and invest in some Canadian stocks in Canadian dollars, you may lose money if the Canadian dollar depreciates in relation to the American dollar, even if the share value appreciates. Political risk represents the financial risk that a country's government will suddenly change its policies. This is a major reason as to why second and third world countries do not attract adequate foreign investments.

Return

An investor primarily invests in order to earn a return. Investors generally expect to earn a return that can compensate for the risk exposure taken by investing in a particular security. The unorganized sector generally yields high returns but the associated risk is also too high. The importance of returns in any investment decision can be traced to the following factors:

- It enables investors to compare alternative investments in terms of what they have to offer the investor.
- Measurement of historical past returns enables the investors to assess how well they have done.
- Measurement of historical returns also helps in the estimation of future returns.

There are two types of returns: realized return and expected return. Realized return is the ex-post or after the fact return, return that was or could have been earned. The expected return is the return from an asset that investors anticipate or expect to earn over some future period.

Return is basically made up of two components. One is the periodic cash receipts or income on the investment in the form of interest, dividends, etc., and second is the appreciation (or depreciation) in the price of the asset, referred to as capital gain (or loss). The latter is the difference between the purchase price and the price at which the asset can be sold. Many investors have capital gains as their prime objective and this component expected to be larger than the income component. The yield can be measured in different terms. Some of the most commonly used terms while defining returns are as follows:

a. **Nominal Yield:** The yield or internal rate of return of an investment is the discount rate that equates the present value of the cash outflows with the present value of the expected inflows, where the discount rate is defined as the rate at which the present value equates the sum to be received within a given period of time.

   It can be represented mathematically as follows:

$$PV = \sum_{i=1}^{n} \frac{An}{(1+Kn)}$$

   Where,

   PV = Present Value

   An = Sum to be received at the end of the period

   Kn = Discount rate

   n = Number of years

   If future values are discounted more than once annually then the formula is

$$PV = \sum_{i=1}^{n} \frac{An}{(1+Kn/m)^{mn}}$$

   Where,

   m = Number of times discounted per year.

b. **Current Yield:** The current yield is different from the nominal yield. It is measured by comparing the coupon interest with the prevailing market price. Thus,

$$\text{Current Yield} = \frac{\text{Coupon interest}}{\text{Prevailing market price}}$$

   Normally, the current yield of an investment keeps on changing over a period of time because the market price may fluctuate. For example, a stock selling at Rs.50 per share with an annual dividend rate of Re.1 has a current yield of 2 percent. If the stock price rises to Rs.100 the current yield reduces to 1%.

c. **Yield to Maturity:** The correct way of computing the return on any asset involves considering the entire sequence of cash flows obtained from the investment and their timing. This is referred to as calculating the internal rate of return. In the case of bonds, there is a cash outflow when the bond is bought, which is followed by a series of cash inflows in the form of periodic interest coupon payments and there is a final cash inflow when the redemption value is received at maturity. Calculating the IRR on this stream of cash flows gives the true return on the bond, which is known as yield-to-maturity. Thus, the yield-to-maturity is the rate of return earned by an investor who purchases a bond and holds it till maturity. The yield-to-maturity is the discount rate, which equals the present value of the promised cash flow to the current market price/purchase price.

For example, consider a bond with Rs.1,000 as par value whose current market price is Rs.850. The bond carries a coupon rate of 8% and has a maturity period of 9 years. What would be the rate of return that an investor earns if he/she purchases the bond and holds it till maturity?

The rate of return earned, also referred to as yield to maturity, is the 'k_d' value in the following equation:

$$P_o = \sum_{t=1}^{n} \frac{I}{(1+k_d)^t} + \frac{F}{(1+k_d)^n}$$

$$\text{Rs.}850 = \sum_{t=0}^{9} \frac{80}{(1+k_d)^t} + \frac{1000}{(1+k_d)^9}$$

$$= 80(\text{PVIFA } k_d\%, 9 \text{ years}) + \text{Rs.}1{,}000\ (\text{PVIF } k_d, 9\text{yrs.})$$

To find out the value of 'k_d' in the above equation, several values of 'k_d' will have to be tried out in order to reach the input value. Therefore, to start, consider the discount value of 12% for 'k_d' in which case the expression becomes

$= 80 \times 5.328 + \text{Rs.}1{,}000 \times 0.361$

$= \text{Rs.}426.24 + \text{Rs.}361 = \text{Rs.}787.24$

Since the above value is less than Rs.850, we have to try a less value for 'k_d'. So, let k_d = 10%. Then the value will be

$= 80 \times 5.759 + \text{Rs.}1{,}000 \times 0.424$

$= \text{Rs.}460.24 + \text{Rs.}424 = \text{Rs.}884.72$

From the above calculations, it is clear that 'k_d' lies between 10% to 12%. Now we have to use linear interpolation to find out the exact value of 'k_d'. Finally, after further calculations, we get the value of 'k_d' as 10.71%.

Since this method is time-consuming, we can use the following formula to find out the approximate yield-to-maturity on a bond:

$$\text{Yield-to-Maturity} = \frac{I + (F - P)/n}{0.4F + 0.6P}$$

Where,

I = Annual interest payment

F = Par value or redemption value of the bond

P = Current market price of the bond

n = Years to maturity.

Marketability and Liquidity

Investors also give due consideration to the liquidity of the instrument while choosing an investment. A security that can be bought and sold quickly without a significant price concession is considered liquid. The greater the uncertainty about the time element and the price concession, the greater the liquidity risk. Securities, which have ready markets like treasury bills, have a lesser liquidity risk.

Diversification

Generally, investing in a single security is riskier than investing in a portfolio because the return to the investor is dependant on a single asset. Hence, in order to reduce the risk, investors usually prefer to hold a diversified portfolio, which might contain equity shares, bonds, real estate, saving accounts, bullion, and various other assets. In other words, we can say that by diversifying, an investor does not put all his/her eggs in one basket.

HOW TO DIVERSIFY?

Let us assume an investor invests his/her money equally in the stocks of two companies Banlight Limited, a manufacturer of sunglasses and Varsha Limited, a manufacturer of raincoats. If the monsoon turned out to be above average in a particular year, the earnings of Varsha Limited would increase leading to a rise in its share price. This would result in increasing returns to shareholders. On the other hand, the earnings of Banlight would be on a decline leading to the corresponding decline in the share prices and investors' returns. However, if there were a prolonged summer, the situation would be just the opposite. While the return on each individual stock might vary quite a bit depending on the weather, the return on the investor's portfolio (50% Banlight and 50% Varsha Limited) would be quite stable because the reduction in one would be offset by the increase in the other. Thus, the risk of the portfolio would be very low compared to the risk of investing in individual securities. The table 1 below gives the return on the two stocks on the assumption that rainy, normal and sunny weather are equally likely events (1/3) probability each. Let us calculate the expected return and standard deviation of the two stocks individually and of the portfolio of 50% Banlight and 50% Varsha Limited.

Table 1

Weather Conditions	Return on Banlight Stock	Return on Varsha Stocks	Return on Portfolio (50% Banlight and 50% Varsha)
Rainy	0	20	10
Normal	10	10	10
Sunny	20	0	10

Table 2

Possible Outcome	Probabilities	Return on Banlight Stock	Return on Varsha Stock	Return on Portfolio (50% Banlight and 50% Varsha)
Rainy	1/3	0	20	10
Normal	1/3	10	10	10
Sunny	1/3	20	0	10
Expected rate of return		10	10	0
Standard deviation		8.16	8.16	0

Note that the portfolio earns 10% returns, no matter what the weather condition is. Hence, by diversification two risky stocks can be combined to obtain a risk less portfolio as is evidenced by standard deviation of the portfolio.

While the example elucidates the benefits of diversification, in practice, one rarely ever finds stocks, whose returns are 'perfectly negatively correlated'. The returns on Banlight and Varsha are said to be perfectly negatively correlated since they always move in opposite direction in exactly the same manner. On the other hand, two stocks, which go up or down together in the same manner are said to be perfectly positively correlated. Both these types of correlations rarely happen in practice. In general, all stocks have some degree of positive correlation because certain variables such as economic factors, political climate, etc., tend to affect all stocks.

We need not have stocks, which are perfectly negatively correlated in a portfolio in order to achieve the benefits of risk reduction through diversification. As long as the assets in a portfolio are negatively correlated, diversification results, in risk reduction. The risk reduction effects of diversification are important for investors.

Tax

Tax consideration plays a major role in the choice of investments by an individual. The investor generally prefers to invest in those securities, which offer tax incentives, as the post-tax returns are significant to an investor. For example, in India, tax benefits are available on amounts invested in National Savings Certificate under Section 88, and exemption can be claimed under Section 80L for interest accrued on it. Interest accrued for any year can be treated as fresh investment in NSC for that year and tax benefits can be claimed under Section 88.

Denomination and Tenor

In some cases, investment can be made only in certain minimum amounts and for a particular maturity. For example, in case of Post Office Kisan Vikas Patra Scheme, the investment period is seven year and eight months. Premature encashment is permitted after 2.5 years from the date of investment. Lower interest is accrued, if prematurely withdrawn.

Use of Security as Collateral for Getting Loans

Some investments can be used as a collateral for obtaining loans. For example, one can avail a loan against the National Savings Certificates by pledging it to the bank. The bank will have the NSC assigned in its favor and advance a percentage of up to 75% of face value plus the amount of accrued interest till the date of taking the loan.

DEVELOPING THE INVESTMENT STRATEGY

Asset Allocation

Asset allocation is one of the crucial steps in the prices of portfolio building. An individual should decide the structure and contents of his/her portfolio only after considering various factors. Rather, it is possible to make reasonable decisions on this front only after spending considerable time to figure out what the future might have in store. Individuals having the resources to do so often seek professional guidance in this matter, considering the significance and complexity of various investments. Not that the professionals can play God but that better knowledge and experience may bring out better results. The process of asset allocation may take place afresh for a new investor or through a review for an existing investor. The review of the pattern of allocation may take place on a continuing basis or periodically. In the process of asset allocation or review of the current pattern of allocation, many steps are involved. The process involves two independent approaches to analysis, both of which ultimately merge into the process of optimization of the return and risk to the investors.

Let us now look at different approaches to asset allocation.

POPULAR APPROACHES

To a layman, asset allocation can be looked at as a decision on how to divide the income between current spending and investment, and how to distribute the investment among the various possible avenues to attain the targeted goals. The methods in this approach generally try to capture a part of the wisdom that professionals acquire through years of study and practice.

a. **100 Minus Your Age Method:** According to this method, the percentage of your total investment that can be invested in equities depends on your age and is based on the premise that you will live up to 100 years. The method suggests that the proportion of investment to be placed in equities is 100 minus your age. The rest may be placed in bonds and other safe investments.

Your Age	100 Minus Your Age	% Investment in Equities	% Investment in Bonds
30	70	70	30
40	60	60	40
50	50	50	50
60	40	40	60

Though life expectancy is increasing, the probability of a person living beyond 100 years is still low. As the age increases, the ability to take risk normally declines. This method essentially addresses this issue.

The person who uses this method reduces his/her allocation to equities, as he/she grows old. This method, while based on the general perceptions about the desirable exposure to equities over the life of a person, suffers from some obvious defects. It does not take into account the life expectancy of a person, the factor of inflation, the wealth to be accumulated or the current financial needs. Over the years, this method results in increase in the current income and decrease in growth, which can be harmful for the financial condition of the person, if factors such as inflation and increasing long life expectancies are taken into consideration.

b. **Financial Objectives Method:** This method is based more on common sense than anything else. It simply says, plan your financial needs in future and invest enough money so that you will be able to realize them. It does not talk anything about how and where and when to invest. If one's goals are short-term, one has to invest in short-term liquid investments and if they are long-term, one has to go in for long-term investments. All that one has to know is what one wants to achieve and how much one can save today for that.

c. **Cash Flow Needs Method:** This method, as the name suggests, involves projecting the cash flows of the future and estimating the deficit, if any. Investments will then be aimed at filling the deficit. The sources of income that a person may have, for example, may be wages and salary, pension payments, interest and dividend income on investments already made, rental income from properties, sale proceeds of properties, inheritance of property, sale of used vehicle, etc. The outflows expected in future should then be reduced from the inflows. If there is a surplus, then one may go in for conservative or safe investments. In case there is a deficit, investments will have to be aggressive and the degree of aggressiveness depends on the amount of deficit and the amount now available for investment.

d. **Risk Tolerance Method:** This method ignores the financials and focuses on the psychology of the individual. According to this method, a risk-averse person should invest all or most of the money available in low risk investments and a risk-lover may invest in high-risk instruments.

e. **100% Common Stocks for Long Run:** This strategy involves placing all the long-term investments entirely on equity stocks. This method generally gets popular when stock markets are on a high and falls in popularity along with the markets. There is no other basis, scientific or otherwise, for it.

Some investors try to decide on the asset allocation by themselves while others may try to take professionals' help. The individual or organization with which the investor entrusts his/her money specializes in the area of capital markets and also generally has a lot of experience. He/she will be able to devote a lot of attention on how best to handle the decision. When the investor depends on a single individual, it is necessary for the individual to fully understand the investor's goal, his/her risk tolerance and other characteristics. When the ultimate decision-making is with the individual, investment advisors generally show him/her the possible outcomes of different alternative asset mixes and let him/her choose. For example, an investor may be shown the range of likely annuity values beginning from the time he/she turns 60 years old to help him/her choose what he/she wants. A different way of making this decision is to take the services of an investment manager or institution that specializes in a category of investments and invest with that manager or institution. Mutual funds generally follow this method. They formulate a pattern of allocation and offer it to the investor. The investor whose requirements match with what is being offered may choose it. When faced with the question of allocation of assets among different investment funds or managers, one will have to look at the expected returns that they can provide, the standard deviations and the correlation between them.

Implementation of Investment Strategy: Theory vs. Reality

While asset allocation decision is difficult to make, even in theory, needless to add, it is much more difficult in practice. To make the decision effectively, many important aspects of the real world have to be considered.

Not only the theory of successful asset allocation is difficult to understand, it is more so in implementing the theory. There are several reality factors that have to be encountered if it has to be implemented efficiently. In conclusion, it must be emphasized that the asset allocation decision requires a lot of information, sophisticated analysis and careful implementation, keeping the costs and benefits in view. Proper asset allocation is of utmost importance for the success of the overall portfolio strategy. While the help of professionals is available and perhaps should be availed of in certain circumstances, the decision-making ultimately rests with those on whose shoulders the responsibility lies for ensuring that the required sums are accumulated or those who are directly affected by the targeted sums not being achieved. The various tools for asset allocation that are now available have evolved over the years. While the tools and techniques may have undergone some changes over the years, the importance of the asset allocation decision has not changed. It is still the most important part of the investment decision-making process.

SUMMARY

- The main objective of any investment policy is to maximize the returns based on the risk tolerance power of the investor. The investment policy also depends on other constraints like tax, legal complications, and liquidity, etc., that are to be pre-ascertained by the investor.
- Generally, the investment goals, constraints and expectations differ from an individual investor to an institutional investor. The individual investor is unsophisticated when it comes to evaluating the risk; he also harbors several misconceptions regarding the losses on investment, techniques of investments and quantification of risk. Evaluation of the psychology of the individual investor helps the portfolio manager to devise a specific strategy for himself.
- Several theories have been propounded, which help to classify the investors in different categories. Unlike the individual investors, the institutional investors like mutual funds, insurance companies, banks, etc., adopt various quantitative techniques and make investments in a judicious manner. Such investors match the assets with their liabilities and form suitable trading strategies so as to maximize their investment objective.

Chapter XII

Investing in Equities

After reading this chapter, you will be conversant with:

- The Structure of Capital Markets
- National Stock Exchange
- Bombay Stock Exchange
- Foreign Security Market
- Theories of Common Stock Valuation

Introduction

Equity markets, the world over, grew at a great speed in the decade of the nineties. After the bear markets of the late eighties, the world markets saw one of the largest ever bull markets of more than ten years. The market capitalization of all the listed companies in the world markets increased from US$9,399,659 million (9.399 trillion) in 1990 to US$32,222,750 million (32.222 trillion) in 2000; the market capitalization thus increased to more than 3.4 times in 10 years. The increase of the market capitalization in the developing countries was even more marked, with an increase to 4.3 times the market capitalization in 1990. The world market capitalization as a percentage of the world GDP also increased from 48 percent in 1990 to 105.1 percent in 2000. Thus, growth of equity markets has far outpaced the GDP growth of the world. However, due to the dotcom crash in 2000 and the subsequent recession in the world economy, the world market capitalization decreased to US$ 27,818,618 million (27.818 trillion) during 2001. The spectacular growth was partly due to increase in the number of listed companies, which grew from 25,424 in 1990 to 48,645 in 2001.

Stock is the share in the ownership of the company. Stock represents the claim on the company's assets and earnings. In other words, it means, the more the stock, the ownership stake in the company becomes greater. The stock is represented by a stock certificate which is a document that proves the ownership in the company. Few years ago when the person wanted to buy or sell shares, he or she physically took the certificates to the brokerage firm. But now information technology has increased, because of which this document is stored electronically. Now trading with a click of mouse or a phone call has made transaction easier. The stock certificate is considered worthless if there is no claim on the ownership of the company's assets and earnings. Another important feature of stock is its limited liability. It mea the owner of the stock, he or she is not responsible for the payments of the debts if the company is not able to. Owing stock means even if the company goes bankrupt, the owner of the stock will never lose his or her personal assets.

The reason why a company issues stock is that the company needs to raise money. For this the company can either sell part of its company or borrow from banks or any other financial institution which is called issuing stock. These methods of raising money are called as Debt Financing. Issuing stock is called as Equity Financing. Issuing stock is more advantageous as it does not require the company to repay or pay interest. All that the shareholders get in return for their money is the hope that the shares will be worth more some day.

It should be known that when it comes to individual stocks, there is no guarantee of safety of principal or a periodical return. Some companies may pay dividends but some may not. Without dividends an investor can make money only through its appreciation in the open market. Although risk might have negative aspects, it has its brighter side to. Greater risk is related to greater return on the investment. This is the reason why stocks can be expected to outperform other investments such as bonds, savings accounts, etc.

THE STRUCTURE OF CAPITAL MARKETS

Primary Market and Secondary Market

PRIMARY MARKET

It is a place where the investors have the first opportunity to subscribe to newly issued securities. It is the market where securities are created. Companies sell their new stocks or bonds for the first time to the public in this market. It is otherwise called as Initial Public Offering (IPO). An IPO comes into existence when a private company sells its stock to the public for the first time. The most important feature about the primary market is that the public buys securities directly from the issuing company.

SECONDARY MARKET

The secondary market is that segment of capital market where the outstanding securities are traded. From the investors' point of view, the secondary market imparts liquidity to the long-term securities held by them by providing an auction market for these securities. The secondary market operates through the medium of stock exchanges which regulate the trading activities in this market and ensure a measure of safety and fair dealing to the investors. The striking feature of the secondary market is that the investors trade among themselves. It does not include issuing companies and investors trade previously-traded securities. Secondary markets are of two types.

Auction Market

All individuals and institutions assemble to trade securities at one area and announce the prices at which they are willing to purchase or buy. The NYSE is the best example of an Auction Market. It is the largest stock exchange in the world.

Dealer Market

Individuals or companies will specialize in specific securities and buy or sell according to the demand of the market. Over-the-counter markets are grouped under dealer markets as the demand and supply for particular stocks is not enough to meet the requirements of different investors. Most bonds are traded in dealer market and NASDAQ is an example for dealer market. These dealers earn profits through differences in the posted bidding and asking prices for their specific securities.

Bull Market and Bear Market

BULL MARKET

A market where the prices of a certain group of securities rising or expected to rise. Bulls are optimistic investors who expect good things to happen in the market. A long-term upward price movement is characterized by a series of peats intermediate highs which are interrupted by higher consecutive intermediate lows.

BEAR MARKET

A market where the prices of a certain group of securities are falling or expected to fall. A less publicized and a sinister version of short selling takes place in bear market. This is called short and distort. These types of short sellers use often misinformation to manipulate stocks in the bear market by turning the sentiments of the investors negative.

Table 1: Stock Basics

YH	YL	Stock	Previous close	Open	Close	High	Low	Quantity	Value	P/E
187	92	Apollo Hosp.	175.80	177.30	178.30	181.00	176.05	484.89	867.51	22.5
64	18	Arvind Mills.	61.75	62.20	62.45	63.15	61.60	2378.00	1485.97	9.5
93	51	Balaji Telefilms	90.00	90.00	92.95	93.80	90.00	649.90	642.69	8.3

The terms used in the above are:

YH – Year high

YL – Year Low

Prev. close – Previous day's closing rate

Open – Next day's opening rate

Close – Next day's closing rate

High – The highest rate

Low – The lowest rate

Quantity – in 000s

Value – in lakh

P/E – The price earnings ratio.

Source: www.economicsfinances.com

Different Types of Stocks

COMMON STOCK

Generally when people talk about stocks they refer to common stock. Majority of the stock is referred to common stock. Common stock or shares represent the ownership in the company and their holders have the right to claim a portion of profits. Common stock yields higher returns when compared to any other investment. If a company goes bankrupt, the common shareholders will not receive money until the creditors, debtors and the preferred shareholders are paid.

PREFERRED STOCK

They represent some degree of preference of ownership in the company. With preferred shares investors are usually guaranteed a fixed dividend. The most advantageous feature of preferred stock is that in the event of liquidation the preferred shareholders are paid off before common shareholder. The company has the option to purchase shares from the shareholders at any time. In other words, the preferred stock is callable.

INCOME STOCK

Income stocks are those which have an elongated and prolonged record of paying high dividends. Usually a company whose common stock is classified under this stock is considered as a stable and matured industry. This type of companies normally pay a high percentage of corporate earnings as dividends to common shareholders. They are also more likely to be sensitive to interest rate fluctuations. Income stocks are more common with those who need current cash flow from their stock investments.

GROWTH STOCK

Growth stock are the stocks that can be expected to experience high rates of growth in operations or earnings. These growth rates are to a large extent higher than the market averages. These companies usually reinvest their earnings instead of distributing them as dividends to support their high growth rates. The price of growth stock as well as their return on their stock tends to be higher than the income stock. They do not fit well with a speculative approach calling for high current cash flow from investments and a high degree of investment principal stability.

VALUE STOCK

These are stock of companies which are considered undervalued because they may be in an industry that is out of favor, they may be experiencing management turmoil or they may be restructuring their business operations. These stocks tend to have lower price or earnings and price to book ratios than growth stocks do. Therefore their prices are cheap compared to the prices required to be paid for growth stocks.

CYCLICAL STOCK

They are the stocks of the companies whose earnings follow the business cycle. Examples of cyclical industries are oil and other natural resources, steel, cement and housing, etc. These are more risky than other stocks. They are subject to changes in business cycles. The objective to invest in cyclical stocks is to purchase these stocks during the economic upturn and sell them before the economic downturn.

DEFENSIVE STOCK

They are the stocks that are considered as counter cyclical. Prices of these stocks remain constant or may rise during the periods of economic downturn and show lacklustre results during economic upturn. These are used for balancing the investment portfolio of the investors. Defensive stocks are well established companies producing goods which are always in demand even during a downturn, such as food, beverages, etc.

BLUECHIP STOCK

Companies with highest overall quality are considered as Bluechips. Bluechips are financially stable with steady-dividend paying records during both good and bad years. They are usually the leaders within their industry. Many investors find bluechips attractive because of high-quality and relative stability.

Box 1: Stocks at a Glance
• Stock means possession or ownership. The owner has the right to claim on the assets and the earnings of the company as well as voting rights. • Stock is equity. Bonds are debt. Stocks are considered riskier investments and they require higher return, whereas bondholders are guaranteed a return on their investment. • Entire investment may be lost because of stocks. But if the stocks are invested in the right company then investor makes a lot of money. • Stock market is the place where the buyers and the sellers meet for trading in stocks. The most reputed stock exchanges include NYSE and the NASDAQ. • The stock prices change according to the change in the supply and demand. There are many factors which influence the price and one of the most important is the earnings. • Stocks can be bought either through brokerage firms or through Dividend Reinvestment Plan. (DRIP). • The stock prices and quotes are easy to understand once the terminology is known properly.

NATIONAL STOCK EXCHANGE

The High Powered Study Group on Establishment of new stock exchanges in its report submitted on 30.6.1991 has recommended the establishment of a National Stock Market System and a National Stock Exchange. The NSE was established in 1992 and was recognized as a stock exchange in 1993. The biggest attraction of the NSE was that it offered screen based trading. The trading screens were located in brokers' offices and the information regarding prices and volumes was available to those who wanted to place buy or sell orders. This has reduced the possibility of manipulation by brokers and the popularity of the exchange increased steadily. The NSE offered trading in equities called capital market segment as well as debt called the debt market segment. Both the segments became operational in 1994 within a gap of few months.

The National Stock Exchange is India's latest bourse, after the regional stock exchanges and the OTCEI. Like OTCEI it is computerized. However, it is not confined to scattered pockets and has a national reach through satellite linkage. Like the BSE only members conduct transactions but professionals who do not have a stake in the system run it. The idea of forming NSE was conceived by the late Mr M. J. Pherwani who was then the Chairman of National Housing Bank. The trading on NSE commenced with debt instruments from June 30, 1994. The NSE launched its equity market segment on the 3rd of November, 1994. The trade was for 100 shares of Reliance. On this day during the three hour session 1,498 trades were executed in 200 securities with value being put at Rs.9 crore. The main objectives of the NSE are to provide speedy transactions, fast settlements and to benefit the small investor who often finds it difficult to sell shares at BSE.

Trading System

Trading on all stock exchanges was being carried out by "public outcry" in the trading ring. This was an inefficient system and also resulted in lack of transparency in trade. The Over-the-Counter-Exchange of India (OTCEI) was the first exchange to introduce screen-based trading in India. Listing on OTCEI was restricted to small and midcap companies. Screen-based trading received a big boost with the setting up of the National Stock Exchange. NSE provided nation-wide access to investors by setting up trading terminals all over the country. These terminals were networked through satellite links.

The trading ring is divided into trading posts. A trading post is a designated place where buyers and sellers in specified securities get together and strike bargains. To execute the order of a client in respect of a particular trading post where the share is traded and enters into a bargain. The broker can get all the information about the movements in prices of different securities through the internal radio service of the exchange. A broker receives various kinds of orders from his clients in respect of the price at which he may transact business on their behalf. He may receive an ‘at best order’ which means that the security may be purchased at the lowest best possible price or sold at the highest price which may be realized. The client can place limit order which means a limit or boundary is put on the price at which a security may be bought or sold. There is another kind of order known as Stop Loss Order in which the client instructs his broker to sell a security if the price falls below a certain level. This kind of order is generally given in times of a falling market. The opening of trading on the floor of the exchange is preceded by a bell which is rung 15 minutes before the trading begins. Similarly another warning bell is rung 15 minutes before the closure of trading. Trading is usually done in multiples of trading lot of securities. The brokers record the details of the deals entered into by them in books which are known as Sauda books. The entries in the sauda books are very important because in the event of a dispute regarding any deals, it is these entries that are generally relied upon. Again it is on the basis of these entries that computer printouts are generated which give the official quotations of the exchange for the day. Completion of the transaction is marked by the issuance of contract note by the broker to the client for the executed transaction. Contract notes are drawn on the basis of transactions recorded in the pucca sauda books after the execution of the order.

The fully automated trading system enabled market participants to login orders execute deals and receive online market information. The competition from NSE forced the regional stock exchanges including BSE to switch over to screen based trading. The NSE trading system is order driven while the OTCEI system is quote driven. In an order driven environment, the system captures all the orders and matches them with each other to execute the transaction. A quote driven system is based on the market making concept (dealer giving two way quotes) and the order logged in is matched against the best quote given by the market maker. BSE Online Trading (BOLT) is a mixture of both quote driven and order driven system as the system permits both jobbing and direct matching of orders.

Depositors

One of the major drawbacks of Indian capital market was that securities were held in the form of certificates. This led to problems in physical storage and transfer of securities. There was also the risk of bad delivery for the buyer. The transaction costs were also higher due to physical movement of paper and the incidence of stamp duty. National Securities Depository Ltd. (NSDL) was set up in 1996 as India’s first depository. A depository is an entity, which holds the securities in electronic form on behalf of the investor. This is done through dematerialization of holdings at the request of the investor. Dematerialization is a process by which physical certificates of the investor are destroyed and an equivalent number of securities are credited to his account. This also enables transfer of securities by book entries. The risk of bad deliveries is also eliminated. The transaction costs are also reduced due to less flow of paper and transfer of securities through depository does not attract stamp duty. Further the depository also handles all the corporate actions like exercising for rights, collection of dividends, credit for bonus, exercising of warrants, conversion option, etc., on behalf of the investor.

Clearing Mechanism

The clearing houses attached to the stock exchanges functioned only as conduits to delivery of securities and money. The default risk by the counterparty in the transaction continued to remain. The NSE was the first stock exchange to set up a clearing corporation. The National Securities Clearing Corporation (NSCC) assumes the counterparty risk in all trading deals made on the exchange.

NSCC acts as the counterparty for all the trades and the default risk in the deal is borne by it. NSE has created a special Trade Guarantee Fund for this purpose and loss due to default will be met from its corpus.

Carry Forward System

Earlier, the Indian Stock Exchanges had been an amalgam of cash market and forward market. The prices of the scrips on the exchange did not reflect their 'true' price in the underlying cash market. Further there was indiscriminate and rampant speculation in the market. Defaults were common and other members were forced to "accommodate" the defaulting member. Often, the defaults had a snowballing effect and the entire market would be in the throes of a major payment crisis. This frequently resulted in the closure of the exchanges for a few days. In order to curb the prevailing malpractices, SEBI banned carry forward transactions on all stock exchanges in 1993. Later based on the recommendation of the committee chaired by G S Patel, which worked out the modalities to re-introduce the system, a modified carry forward system was introduced. The badla procedure was also streamlined. Again the system of carry forward of positions was banned from July 2, 2001. In order to give the market adequate time to orderly unwind the positions, the board recommended a transitional mechanism. As per the mechanism, all outstanding deferred positions in the current settlement should be compulsorily liquidated by September 3, 2001. The board also approved introduction of options on individual scrips from July 2. Introduction of other derivative products to introduce the rolling settlement in the additional 251 scrips from July 2 was reiterated, thereby bringing the total number of scrips to 441. Further it was decided that all scrips listed on all the stock exchanges should be traded only under rolling settlement mode, w.e.f January 2, 2002 and no scrip shall be traded on weekly settlement basis.

Box 2: Advantage Rolling
The rolling settlement has many virtues. One, it reduces speculation and arbitrage in scrips as settlement occurs on a daily basis. Thus, there would be increase in delivery-based transactions reducing the speculation currently existing by way of carry forward of position in various scrips. Apart from this, shifting position from one stock exchange to another will reduce which, in turn, will eliminate arbitrage opportunities in scrips. Two, it reduces pricing glitches and manipulation and explores a better price discovery process. With the rolling settlement in place, all open positions at the end of each day would come up for delivery thereby improving the quality of cash market transactions. Thus, price formation process on daily basis would be improved thereby resulting in improved price discovery process. Three, it reduces end of settlement period pressure as shares are delivered and cash is paid everyday instead of a week. Thus, the rolling settlement spreads the delivery and payment throughout the week. Four, it narrows the bid-ask spreads, reduces the settlement risk and eliminates the need to synchronize the settlement dates on NSE and BSE or for that matter across the exchanges. And, of course, with the implementation of a Rolling Settlement investors will be benefited, as settlement will not take long and the prices an investor pays or receives will be closer to the market price. Securities and money will be transmutable.

Settlement System at present Indian Stock Exchanges are working on T + 2 rolling settlement systems. Under T + 2 rolling settlement system all trades executed on a day are netted and only net obligation are to be settled by way of delivery or payment. In case of sale of shares the seller is required to give the delivery by

6 p.m. in electronic form and by 4 p.m. in physical form on T + 1 day to the depository participant. The depository participant's execute pay-in instruction by 10.30 a.m. on T + 2. The depository transfers the securities to the clearing house/exchange/clearing corporation by 11 a.m. on T + 2 day. The clearing house/exchange/clearing corporation executes the pay-out of securities and funds latest by 1.30 p.m. on T + 2 to the depositories and clearing banks and the depositories and the clearing banks in turn complete the process by 2.00 p.m. on T + 2.

The Settlement Procedure at NSE

The NSE has a computerized trading mechanism. The mechanism is hooked nationwide via satellite to increase the scope and depth of the market.

The automated environment moreover ensures that all the orders floating in the system whether they are best buy or best sell quotes are available on the system. Each trading member of NSE has a computer located in his office wherever that may be in India. The computer is connected to the central computer system at NSE, by a satellite link using VSAT (Very Small Aperture Terminals). During the trading time, the member can go on entering the buy or sell orders with the best price and the time-frame within which he wants his orders to be executed.

The computer will bear the various orders and within 30 seconds the transaction is executed and the unmatched orders are stored in the memory and executed when they are matched. Thus the role of jobbers is eliminated. The trading time on NSE is from 9.55 a.m to 3.30 p.m. NSE trading system allows flexibility while placing an order, allowing brokers to place limits on price or on the order or even on the time-frame. The trading member can break large lots into smaller lots or cancel the outstanding orders in one go.

The computer sorts out orders on the basis of price-time priority i.e., sorts out orders as and when they are received in terms of the price of each security and the time entered.

PROTECTION OF IDENTITY OF THE INVESTOR

Till the transaction is executed, the identity of brokers is not disclosed. As the participants' identity is protected, the trading member can even enter high volume transaction.

For NSE, the dealing room in the brokers' office is as exciting as a stock exchange trading floor.

SETTLEMENTS

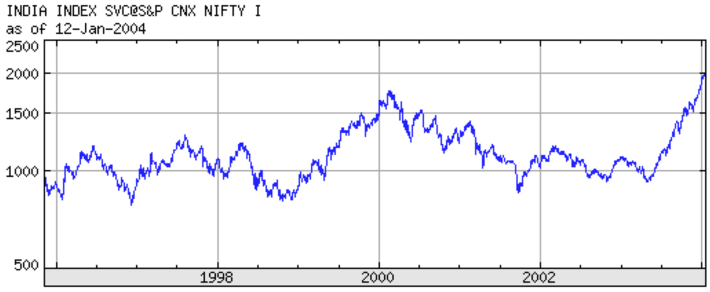
The settlement for debt is to take place via a book entry transfer in a depository. The book entry transfer system is to operate similar to a bank passbook. The accounts would be maintained against each member, detailing securities held in the members' name.

THE CENTRAL DEPOSITORY

In the Central Depository the funds and securities position would be debited/credited through electronic book entry transfers which are expected to speed up payments. Each member is to have a passbook account in the depository where the securities deposited in the members' name is recorded, by electronic book entry transfer.

At the end of each day's transaction, the computer generates a report of matched transactions and the net positions of each trading member.

Figure 1

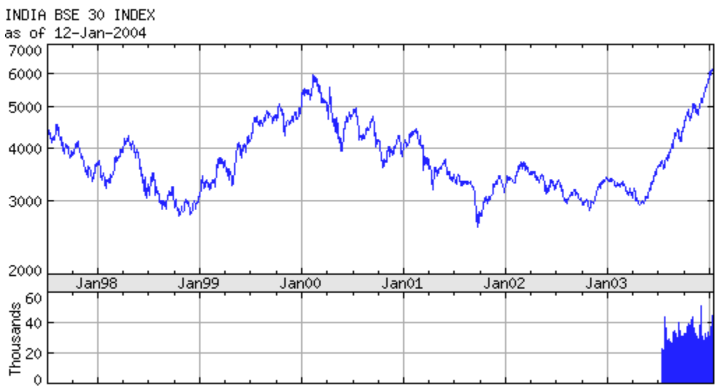


BOMBAY STOCK EXCHANGE

The roots of the Stock Exchange, Mumbai can be traced back to 1875, when the Share and Stockbrokers Association (non-profit organization) was established. BSE is the oldest stock exchange in Asia and is a very important stock exchange in Indian capital market. After liberalization, the stock exchange, Mumbai has witnessed a huge increase in trading and economic deregulation that prompted the stock exchange to improve its operations on par with the international standards. The Board of Governors of BSE comprises 9 elected directors (one third of them retire every year by rotation), an executive director, three government nominees, a Reserve Bank of India nominee and five public representatives. A president, vice-president and an honorary treasurer are annually elected from among the elected directors by the governing board following the election of directors. The executive director works as the chief executive officer and is responsible for day-to-day administration of the stock exchange.

In May 1995, the Bombay Stock Exchange took a major step when it started order-cum-quote driven electronic trading for all the listed securities. The BOLT, BSE Online Trading System increased market transparency, liquidity and elimination of mismatches. In addition, BOLT also provides flexibility in systems by handling growing volumes of trade and increases market activity. Since then, BSE is executing orders through computerized facility and orders are matched in less than one-tenth of a second. Trading hours have been increased from two hours under the open-outcry system to six hours. Processing speed coupled with extended trading hours has ensured that most orders get executed on daily basis. Beginning with screen-based trading in May 1995, the exchange has started providing direct online facility since September 1997. The BOLT network, based on Very Small Aperture Terminal (VSAT) Technology, provides connectivity between members/Trader Work Stations (TWS) and its trading and settlement system. The expansion of BOLT network was started by the exchange on August 30, 1997, with the prior approval granted by SEBI. Now, the members of stock exchanges are free to install their trading terminals to cities where there are no stock exchanges. The BOLT network covers over 227 centers having VSATs and TWS.

Figure 2: The movement of the Sensex from 1998 to 2003



Over-the-Counter Market

The success of OTC market and its efficiency over the traditional stock exchanges led to the desire to replicate the OTC system in India. At the same time, liberalization of the economy in India allowed foreign investors to invest substantially in India. In order to mobilize resources, cheaper and faster sources of finance were found necessary. This would not only help the companies establish their operations, but also help the country by generating employment opportunities and boosting the economic growth. In order to have faster transactions, greater liquidity in the market and a transparency in transactions, the OTCEI was established. It was incorporated under Section 25 of the Companies Act, 1956. The promoters of OTCEI are UTI, ICICI, IDBI, IFCI, LIC, GIC, SBI Capital markets and Can Bank Financial Services. OTCEI was set up to promote access of small and medium-sized companies to the capital markets. Companies with an issued capital ranging from Rs.30 lakh to less than Rs.3 crore are eligible to list their shares under OTCEI.

The OTCEI was the first exchange in India that offered transparency and screen-based trading. Some of the important characteristics of OTCEI are:

- A ringless trading mechanism
- Creation of liquidity
- Computerized and transparent trading
- Two way quotes, one for the sale and the other for purchase
- Exclusive list of companies
- Permit trading of equity and debentures.

The trades of all the dealers spread all over India are matched through a satellite communication network. The entire network of more than 50 centers dotted all over the country is through the OTCEI Automated Securities Integrated System (OASIS). There is no physical trading floor for trading in OTCEI, neither is there any physical delivery of shares. Therefore, OTCEI is capable of allowing nationwide listing and trading of shares. The listing requirements of OTCEI are different from that of the other stock exchanges. The method of public offer is different in OTCEI.

OTCEI provides the following benefits to the listed companies:

- A reasonable mode for closely held private companies to offer their shares to public.
- Listing for companies with market capitalization as low as Rs.3 crore.
- A single platform for the companies to be listed nationwide, removing the need for applying for listing in different exchanges.

Advantages of OTCEI to the Investors

- Investors need not go to the distant stock exchange but can trade through the counters of OTCEI setup at several centers.
- OTCEI removes illiquidity by introducing new players' namely compulsory market makers to help the small investors for sale of their securities.
- Investors will display security prices online and hence price blindness is removed.
- OTCEI helps to reduce the delay in settlements.
- OTCEI intends to provide the information relating to the companies to all its investors.

Securities Traded on the OTCEI

i. The shares/debentures of the companies listed with OTCEI can be bought or sold at any OTCEI counters.

ii. Certain shares/debentures listed with other stock exchanges and units of UTI and mutual funds are permitted to be traded on OTCEI.

FOREIGN SECURITIES MARKET

New York Stock Exchange

The origin of the New York Stock Exchange can be traced back to 1792, when 24 prominent brokers and merchants gather on Wall Street to sign an agreement for trading of securities on common commission basis. The first corporate stock traded was that of Bank of New York. In 1817, New York brokers established a formal organization named as the New York Stock and Exchange Board. After the collapse of Ohio Life Insurance Company in 1857, the market value of exchange crashed by 45%. In 1863, the New York Stock and Exchange Board were renamed as New York Stock Exchange. Membership in NYSE became exchangeable in 1868, as it enabled its members to sell their membership. On April 22, 1903, the NYSE moved to its current (location) at 18 Broad Street. The NYSE remained closed for 4½ months after the First World War broke out in 1914. After World War I, Wall Street replaced London as the world investment capital. October 24, 1929 was Black Thursday, when stock prices fell sharply and market crashed in huge volume. This crash was the beginning of the “Great Depression”. The Dow index crashed in 1932 by 89% from its highest level. NYSE developed rapidly during 1950s and 1960s. Trading hours were extended from 10 a.m. until 4 p.m. In 1979, NYSE expanded into futures trading and it formed the New York Futures Exchange (NYFE). NYSE experienced tremendous growth during 1990s and Dow Jones Industrial Average crossed 3,000 levels. In this period, exchange started two trading sessions which eventually assured 24-hour trading. In 1995, the three-day settlement period was started. In 1996, the Dow Jones Industrial Average reached 5,000 and average daily volume surpassed 350 million shares. The period 1996-97 witnessed heavy listing of non-US companies. On October 28, 1997, DJIA soared by 337.17 points, which was its biggest single-day gain and following this volume crossed 1 billion figures. The Dow Jones Industrial Average (DJIA) crossed the 10,000 figure in 1999.

When it was published for the first time in 1885. The Dow Jones Industrial Average Index comprised of 12 stocks that were most active and were highly capitalized at that time. Four years later, the number of stocks considered was increased to 20 and further to 30 in 1928. The 30 stocks included in DJIA are widely held by individuals and institutional investors. These 30 stocks represent about a fifth of the $8 trillion-plus market value of all US stocks and about a fourth of the value of stocks listed on the New York Stock Exchange. Today, all these stocks are regarded as good investment vehicles even by conservative investors. DJIA is considered as the main index for the movement of the New York Stock Exchange (NYSE). Other famous indices are S&P 500 and NYSE composite index.

NYSE trading process is a unique system. On the trading floor an auction takes place each day. Open bids and offers are provided by exchange members who act on behalf of their institution and investors buy and sell orders for each listed security by meeting directly on the trading floor. Prices are calculated on the basis of supply and demand. Stock buy and sell orders go through a single location, which ensures that any common investor is exposed to a wide range of orders from buyers and sellers. This process provides the investor the best available price.

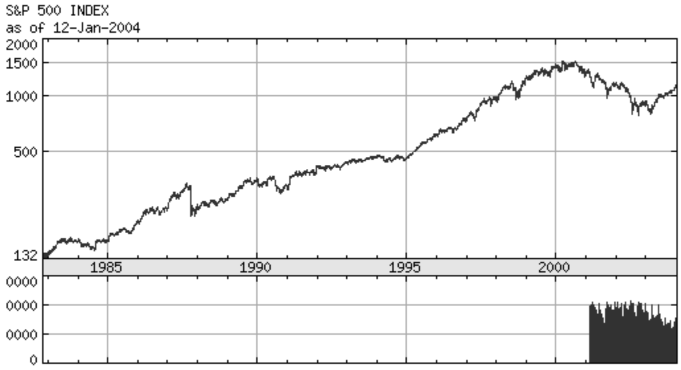
The NYSE registered as a securities exchange with the US Securities and Exchange Commission on October 1, 1934. The governing committee was the primary governing body until 1938, at which time, the exchange hired its first paid president and created a thirty-three member Board of Governors. The Board included exchange members, non-member partners from New York and out-of-town firms, as well as public representatives.

In 1971, the exchange was incorporated as a not-for-profit corporation. In 1972, the members voted to replace the Board of Governors with a twenty-five member Board of Directors, comprising of a Chairman, twelve representatives of the public and twelve representatives from the securities industry.

The New York Stock Exchange is the largest equities marketplace in the world. The listed companies worth more than 27.1 trillion in global market capitalization are traded on NYSE as of 31.12.2007.

- As of December 2007, 421 non-US companies were listed on NYSE.
- The total market capitalization of NYSE at the end of the year 2007 was $11.4 trillion.

Figure 3: The movement of the S&P 500 from 1950 to 2003



Nasdaq

It is the world's first electronic stock market incorporated in 1971. With its bold initiatives, it came out with a lot of innovations and became a world market leader in stock trading. As the world's largest stock market in the United States, it has 4,000 listed companies.

The primary index of National Association Securities Dealers and Automated Quotes (NASDAQ) is the NASDAQ composite. NASDAQ has an Exchange Traded Fund (ETF) called NASDAQ-100 tracking stock (NASDAQ symbol: QQQ). The other indices on NASDAQ are the NASDAQ Biotechnology Index, and the NASDAQ Financial-100 Index.

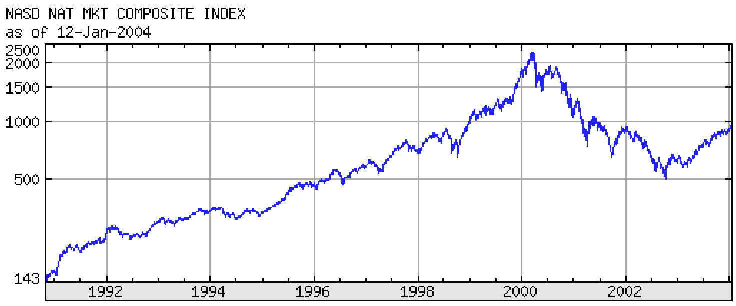
The NASDAQ is one of the most active exchanges in the world today. In 2001, NASDAQ handled 471.2 billion shares, with a peak volume of 3.2 billion shares and daily share volume of 1.9 billion shares. Its share volume topped other US markets on 247 of the 248 trading days in 2001, equating to 99.6%. In the last decade, the NASDAQ experienced a 1,041% growth in share volume.

The market capitalization has more than quadrupled over the last 10 years, from $508 billion in 1991 to $2.9 trillion in 2001, a 470% increase. Also, in 2001, the NASDAQ became the first US stock exchange ever to meet the ISO 9001 Quality Standards. NASDAQ has one of the lowest bids-ask spread among the world bourses.

In early 2000, the NASDAQ composite peaked at above 4600 points, but shed 77.5% of its value in the next three years to reach 1350 in mid April.

By the end of 2007, 3200 securities are listed on NASDAQ. Out of which 335 are non-US companies from 35 countries representing all industry sectors.

Figure 4: The movement of the NASDAQ Composite Index from 1985 to 2003



General-terms Used in Stock Markets

Earnings Per Share: Shareholders are concerned about the earnings of the firm in two ways. One is availability of funds with the firm to pay their dividends and the other to expand their interest in the firm with the retained earnings. These earnings are expressed on a per share basis which is in short called EPS. EPS is calculated by dividing the net income by the number of shares outstanding. It is calculated as follows:

$$\text{Earnings Per Share (EPS)} = \frac{\text{Net Income (PAT)}}{\text{Number of Outstanding Shares}}$$

Price Earning Ratio: The price-earnings ratio (P/E) multiples is calculated by taking the market price of the stock and dividing it by earnings per share.

$$\text{Price-Earnings multiple} = \frac{\text{Market price of the share}}{\text{Earnings per share}}$$

This ratio gives the relationship between the market price of the stock and its earnings by revealing how earnings affect the market price of the firm's stock. It is the most popular financial ratio in the stock market for secondary market investors. The P/E ratio method is useful as long as the firm is viable business entity, and its real value is reflected in its profits.

The main use of P/E ratio helps to determine the expected market value of a stock. For example, Firm A may be having a P/E of 5 and firm B may be having a P/E of 9. Let us say, both the firms have an EPS of Rs.3. If the average P/E of the industry in which they operate is 7, then:

Market value based on PE of industry	= 7 x 3	= 21
Market value of firm A	= 5 x 3	= 15
Market value of firm B	= 9 x 3	= 27.

Dividend Yield: This is the ratio of Dividends Per Share (DPS) to market price of the share.

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price of the share}}$$

This ratio gives current return on investment. This is mainly of interest to the investors who are desirous of getting income from dividends. No dividend yield exists for firms which do not declare dividends.

The general movement of the stock market is usually measured by averages or indices consisting of groups of securities that are supposed to represent the entire stock market or its particular segments. Thus, Security Market Indices (or) Security Market Indicators provide a summary measure of the behavior of security prices and the stock market.

Now, let us discuss in detail the salient features of the principal share price index numbers used in India i.e., the Bombay Stock Exchange Sensitive Index (BSE Sensex) and the Bombay Stock Exchange National Index (BSE National Index). The other known indices like the Reserve Bank of India Equity Share Index, Nifty, Financial Express, All India Equity Index and Economic Times Ordinary Share Price Index will also be described in brief for a comparative study.

However, before examining these index numbers we will look into:

A. The need for having a summary measure,

B. The objectives sought to be achieved by constructing index numbers, and

C. The factors that influence the construction of index numbers.

PURPOSE OF AN INDEX

The security market indices are indicators of different things and are useful for different purposes. The following are the important uses of an index:

- Security market indices are the basic tools to help and analyze the movements of prices of various stocks listed on stock exchanges and are useful indicators of a country's economic health.
- The return on the index, which is known as market return, is helpful in evaluating the portfolio risk-return analysis. According to modern portfolio theory's capital asset pricing model, the return on a stock depends on whether the stock's price follows prices in the market as a whole; the more closely the stock follows the market, the greater will be its expected return.
- Indices can be calculated industry-wise to know their trend pattern and also for comparative purposes across the industries and with the market indices.
- Generally, market indices are designed to serve as indicators of broad movements in the securities market and as sensitive barometers of the changes in trading patterns in the stock market.
- The growth in the secondary market can be measured through the movement of indices.
- The index can be used to compare a given share price behavior with past movements.
- The investors can make their investment decisions accordingly by estimating the realized rate of return on the index between two dates.
- Funds can be allocated more rationally between stocks with knowledge of the relationship of prices of individual stocks with the movements in the market.

BSE – Sensex

The absence of an index of equity prices reflecting the general trend of the market at the end of the day's session was felt from a long time, by the share brokers and investors and also by newspapers who do not compile their own index numbers. With this point in view, the stock exchange of Mumbai compiled and published a sensitive index of equity prices from January 2, 1986 onwards. The index called "The Stock Exchange Sensitive Index for Equity Prices" contained cyclostyled quotations from "The Daily Official List" of stock exchange.

- **Choice of Base Year:** The financial year 1978-79 was chosen as the base year. Considerations for the choice were the price stability during that year and the proximity to the current period.
- **Method of Compilation:** The method of compilation was the same as used by Standard & Poor, USA,[1] in the construction of their share price indices. The index for a day is calculated as the percentage of the aggregate market value of the equity shares of all the companies in the sample on that day to the average market value of the equity shares of the same companies during the base period. This method of compilation had the advantage that it had the necessary flexibility to adjust for arbitrary price changes caused by the issue of rights and bonus shares.
- **Weighting:** The price of each component share in the index was weighted by the number of shares outstanding so that it would influence the index in proportion to its respective market importance. The current market value for any particular share was obtained by multiplying the price of the share by the number of shares outstanding. A drawback in using market capitalization as the weight in the index is that the companies influence the market by the sheer size of their business and the way they finance their projects.

1 It is one of the best known indexes in USA, published by Standard & Poor's Corporation – USA. This index measures the price index of 500 widely held equity shares, mostly of the New York Stock Exchange. It is considered to be more representative of stock market trends and often called S & P's 500 index. The S & P's 500 index has 400 industries, 40 public utilities, 20 transportation companies and 40 financial institutions.

- **Adjustments for Bonus Issues:** When a company included in the compilation of the index issues bonus or subdivides or consolidates the existing equity shares, the new weighting factor will be the number of equity shares outstanding after the bonus issue, subdivision or consolidation has become effective. This new weighting factor will be used while computing the index from the day the change becomes effective.
- **Adjustments for Rights Issues:** When a company included in the compilation, issues rights shares, the weighting factor for that share is increased by the number of additional shares actually issued. An offsetting or proportionate adjustment is then made to the Base Year Average.
- **Other Issues:** Weighting factors are revised when new share issues are made by way of conversion of debentures, of loans into equity by financial institutions, mergers, etc. The Base Year Average is also suitably adjusted to offset the increase in the market value thus added. Similarly, when convertible/non-convertible bonds/debentures, preference shares etc., are issued as rights to equity shareholders, the Base Year Average is suitably adjusted on the basis of the ex-rights price of the equity share.

Box 3: All About Market Timing

Market Timing is a top down view of the market and its prospects. This is an approach that attempts to determine when to be in the market, when to be out of the market and when to short (bet on a price decline by borrowing stock and selling with the hope to buy it back at a cheaper price and repay at cheaper prices). Market timing includes the following four components:

Trends of Interest Rates: The future behavior of interest rates, i.e., the tightening or easing bias of the Central Bank. Interest rates are critical to market values for three reasons. Stocks are basically the present value of future earnings. An investor invests his money in an expectation of certain rate of return. The higher the general level of risk-free rates, the greater the expected rate of return and the lower the present value of future returns. Additionally, higher rates of return available in fixed income instruments drain money from the stock market by reason of deteriorating supply and demand dynamics. Finally, many companies employ debt in their capital structure. Higher borrowing costs hurt earnings. Lower rates or the expectation of lower rates has the opposite effect.

Investor Sentiments: This is also a contrarian's indicator. The more bullish the investor sentiment, the more bearish it is for the market. Various proxies are used to determine investor sentiment, including investor surveys as well as ratios of put premiums to call premium, mutual fund cash, new issues of new stocks versus all stocks in the benchmark index, etc.

The Valuation of the Market as a Whole: Various ratios, including Price earnings, Price to cash flow, Price to sales, and Price to book value are viewed against historical averages and ranges and subsequent market behavior. Additionally, the relationship between risk-free interest rates is reviewed. The lower the interest rates, the higher the P/E in most circumstances. Interest rates are critical because they determine the rate at which future cash flows are discounted. They determine the relative attractiveness of other fixed income investments and finally rates determine borrowing costs for companies.

The Technical State of the Market: The market can be considered extended and vulnerable if it is trading above its moving averages, is overbought using de-trending oscillators (stochastic, MACD, Wilder RSI, etc.), the Central Bank is tightening liquidity and interest rates are rising, valuations are high by most measurements, and sentiment is bullish. The market is considered oversold and attractive if the opposite conditions exist.

Source: Portfolio Organizer, August 2001.

BASE CHANGES

Base changes are in effect of proportional adjustments in the Base Year Average Market Value to offset arbitrary price changes in market values upon which the index is based. The formula for changing the Base Year Average is as follows:

$$\text{New Base Year Average} = \text{Old Base Year Average} \times \frac{\text{New Market Value}}{\text{Old Market Value}}$$

To illustrate, a company issues rights shares which increases the market value of the shares of that company by, say, Rs.100 crore. The existing Base Year Average, say, is Rs.963.93 crore and the aggregate market value of all the shares included in the index before the rights issue is made is, say, Rs.2,294.72 crore. The New Base Year Average will then be:

$$\text{Rs.}963.93 \times \frac{(\text{Rs.}2,294.72 + \text{Rs.}100.00)}{\text{Rs.}2,294.72} = \text{Rs.}1,005.94$$

This figure of Rs.1,005.94 crore will be used as the Base Year Average for calculating the index number from then onwards till the next base change becomes necessary.

LIMITATIONS OF VARIOUS INDICES

Though stock market indices are the basic tools to help and analyze the movements of price of the stock markets and are a useful indicator of a country's economic health, they have their own limitations also. The following points deal with those limitations:

Whenever a company issues rights in the form of convertible debentures (to be converted at a later stage) or other instruments (warrants) entitling the holder to acquire one equity share of the company at a specified price at a notified future date, the equity capital increases only on conversion of debentures or the exercise of warrants/SPNs, option for equity shares but the market adjusts the ex-rights price of the share immediately (on the day the share starts trading ex-rights) on the basis of the anticipated increase in equity capital and likely reduced earnings per share, etc. Hence, some modification is needed to adjust the equity capital suitably in advance. But the exact procedure by which this can be done is very difficult to state since the internal market mechanism which adjusts the ex-rights share price is almost impossible to know precisely.

Again, this is a common limitation of all the indices and so far, the increased equity capital is considered only after the debentures are converted into shares and are acquired for warrants/SPNs and the new shares are listed for trading on the stock exchange.

The coverage (in terms of number of scrips, number of stock exchanges used and the respective weights assigned) is different for all the indices and hence, each index may give only a partial picture of the movement of prices or the state of the market presented may be misleading.

The financial institutions like ICICI, IDBI, LIC, GIC, etc., sometimes convert the loans extended by them to companies into equity shares at a specified date. This causes sudden and significant changes in the market capitalization and hence the weights assigned to those scrips change violently.

The stock market indicators covered here have been in use for many years and have satisfied the needs of millions of investors and stockbrokers. But the stock markets, by their very nature, are very dynamic and hence, the indices should be revised or adjusted periodically to reflect the changed conditions so that they continue to be relevant. Whenever prices of scrips listed on more than one stock exchange are used, most liquid prices (on any one stock exchange) should be used (rather than the present practice of using the arithmetic average of prices on all the exchanges, as the same scrip may not enjoy identical degree of liquidity on all exchanges). The limitations indicated may not be eliminated totally, but appropriate adjustments are certainly called for. The classification of industries into various groups for calculation of various industry indices is presently rather vague and presents problems in the case of diversified companies. This should be made uniform or the classification should be made in such a way that it reflects the major operations carried on by each company. Overall, one can say that the various stock market indicators devised have more or less served their purpose, despite their limitations but these can be made more effective and dynamic by introducing appropriate modifications of the existing ones to serve the investing public better.

Executing Trades

Persons at the Stock Exchange

Types of Orders

The major types of orders are as follows:

a. *Limit Orders:* Order limited by a fixed price. It may or may not include brokerage.

b. *Best Rate Order:* To execute the buy/sell order at the best possible price.

c. *Immediate or Cancel Order:* Order shall get canceled if not executed immediately at the quoted price.

d. *Limited Discretionary Order:* To provide discretion to the broker to execute order at a price this is almost approximate to the price fixed by client.

e. *Stop Loss Order:* A particular limit is given for sustenance of loss. If the price falls below that, the broker is authorized to sell immediately to stop further occurrence of losses.

f. *Open Order:* When client does not fix any time or price limit for execution of order.

Execution of Order

Order is normally executed on any of the trading days. After the setting up of electronic trading, the orders are executed by the quotes available on the screen.

Margin Trading

Buying on margin means borrowing money from a broker to purchase stock. Margin trading allows one to buy more stock than normal. To trade on margin an account is required. The margin account is a credit based account. In an account one can avail loan to buy stocks, marginable securities act as collateral for the loan. Securities traded in the margin account are the marginable securities. Like any other loan there is interest charged on the amount borrowed. One should read the margin agreement and understand its implications. One is required to maintain an equity amount that ranges from 25%-40%. This is otherwise called as maintenance margin. There are certain costs included in margin trading. They are trade commissions, and interests charged on margin debt. Interest is calculated daily and debited in the margin account say every 15th of the month. Margin trading offers another avenue to the brokers for earning income on account of interest earned on such accounts. This keeps the brokers still in business as there is a steady decline in income from brokerage fee. With restrictions on bank financing of equities, it has become all the more important to have such a borrowing and lending mechanism in place.

Margin trading is considered risky as it does not suit everyone. This is because losses are amplified same as the gains are. Therefore there is an increase in the risk of one’s portfolio. An investor purchasing securities has to pay for them fully in cash. However, when a part of the transaction value is paid by the investor and the rest is paid by the brokerage firm, then it is called margin-based transaction. Purchasing securities by borrowing a portion of the transaction value and using the securities in portfolio as collateral is called margin trading. The transaction is done on the expectation that the stock price will either rise or fall which enables him to make greater profits. Conversely, an investor can have a short sale through margin account. In other words, it means borrowing securities from the brokerage firm with an intention to sell it, hoping that the prices will decline. The part of the transaction that the investor has to deposit with the broker is called margin. This is considered as the initial equity in the margin account of the client or the investor.

In the developed markets, there is no concept of carry forward trading but margin trading is permitted. It means the investors can buy or sell on payment of a margin, but the trades have to be squared within the same day. The financing is usually provided by banks and financial institutions. But in India, the banks and financial institutions have a limited role while brokerage firms are prohibited from providing such finance. The solution to such need is margin trading which is strictly a loan-based transaction. Although a new concept in India, margin trading has been popular and successful in developed markets. For the first time margin trading in India was recognized as a specific banking activity under which the funds are extended to brokers for share purchases on behalf of investors. An individual limit for the broker is set and is linked to the networth, assets and collateral securities that have been pledged. The term for margin trading is decided by the broker and the concerned client and the rate of interest is fixed by the banks.

Short Selling

It is the selling of a security which is not owned by the seller or any sale that is completed by the delivery of a security borrowed by the seller. It is the process of selling the borrowed stock in the hope that the price of the stock will fall, so that the short seller can buy-back at a profit. In other words short sellers expect to buy-back the securities at a lower rate than the price at which they sold. That is, short sellers make profit when the stock price goes down. They involve a lot of risks and pitfalls. It is also considered as an advanced investment technique. Most of the investors misunderstand the process of short selling. Usually people think of investing as buying an asset, holding it while appreciates in value, and then selling it to make profit.

Box 4: Short Selling
• The investor borrows shares and sells them. The profit or the loss earned depends on the difference between the prices when the shares are borrowed compared to when they are returned. • The investor makes money or profit only if the stock price falls. • Short selling is subject to the payment of interest and also to the rules of margin trading. • The investor must pay the lender any dividend or rights declared during the tenure of the loan. • The main reasons for short selling include speculation and hedging. • Short selling is very risky. Sometimes the investor can lose more money than invested. • A short squeeze is when a large number of short sellers try to cover their positions at the same time and thus, drive up the price of a stock. • Some people consider short selling as unethical or bad for the market. • Short selling contributes to the market by providing liquidity and efficiency. • Some unethical traders spread false information in an attempt to drive the price of a stock down and make a profit by selling short.

Investment Process

Analysis of Industry Performance

The success or the failure of a company to a large extent is influenced by the environment of the industry in which it operates. A thorough understanding of the industry facilities the evaluation process of overall performance of the company. The second step in the fundamental analysis of the common stock is the industry analysis. Convinced that the economy and the market are attractive from the standpoint of investing in common stocks, the investor should proceed to consider those industries that promise the most opportunities in the near future. Industry analysis involves several steps. Industries are analyzed in terms of their stage in the life cycle, which is the first step. The idea is to assess the general health and current position of the industry. This may be followed by an assessment of the position of the industry in relation to the business cycle and macroeconomic conditions; an analysis of the competitive structure prevailing in the industry and a study of the impact of government policy changes on the industry generally follow the above mentioned steps.

Analysis of Company Performance

Valuation of a firm cannot be done without considering the prevailing economic environment. An analyst cannot estimate the sales, cost or the capital investment unless there is an adequate understanding of the macroeconomic environment in which the firm operates. Thus analysis of a firm is a top-down approach whereby the analyst first studies the macro aspects and uses them to deduce the prospects of the firm's current environment. Once an investor identified the industry in which investment has to be made, the next step will be to select a firm within the industry. A firm's stock price is calculated from its fundamentals and it has to be compared with the ruling market price to make a decision on investment in the firm's stock.

Theories of Common Stock Valuation

Growth Theory

The theory studies the analysis of corporate and industry data to select reputed concerns that show continuing growth from one business cycle to another and a growth rate that exceeds the overall economy. Embedded in this theory is that, the investor seeks returns in the form of capital growth rather than dividend income. If an investor can classify and obtain the stock of such companies in their early developmental and growth stages, and the companies go on to become leaders in a growing field, the investor most likely will have impressive results. Another approach of the growth theory is to purchase mutual funds that focus on certain industries which the investor considers to be growth industries. An alternative is to invest in funds with growth or belligerent growth as investment objectives. This way the investor gets professional management in selecting growth stocks. However, if the investor analyzes carefully and invests for long-term, then the growth stock approach will yield handsome results.

Value Investing

The value investing approach was popularized by Benjamin Graham and David Dodd in their classic work, *Security Analysis: Principles and Techniques* originally published in 1934. The value investing theory calls for investing in the stocks of good quality companies that have strong balance sheets and whose stocks are temporarily undervalued by the stock market. This undervaluation may be because of some temporary setback for the company. The value investor takes into account good quality stocks that are currently out of favor in the market. This theory involves careful scrutiny and considerable patience. The value investors view that there is little market risk involved because the stocks they consider are selling at a low price.

Making Investments

Through an Investment Advisor

Independent advisors design investment strategy, identify or evaluate mutual funds or help professional managers to implement strategy and monitor the strategy and performance of the portfolio. They are usually hired by individuals. These advisors manage investment portfolio for a fee based on the percentage of the assets. These advisors often come from a general financial planning background and therefore are able to incorporate appropriate planning and income tax strategies into the investment plan.

Through Broker

Brokerage firms offer their customers with extensive array of services and financial products. These firms bid accounts with check-writing privileges and also provide accessibility to credit cards and other credit facilities. More important professional assistance in selecting and managing securities that are compatible with investors' investment objectives and goals are also provided by these brokerage firms. Of course, for the services availed, payment is made in the form of commission to the broker. If the investor decides to invest through brokers, then it is very important for the investor to share his or her entire financial picture with the broker and articulate the goals and objectives very clearly. It is also very important that the broker understands these goals and objectives very clearly.

Through Professional Money Manager

If the investor has a large sum of money to invest, then, he or she should consider a money manager. Money managers are well educated, professionally trained and experienced in the field of investments. All money management firms require that the investor maintains an account with the firm. Most of the firms require an account size which ranges from Rs.5,00,000 to Rs.1 million. Professional managers charge a fee which is a percentage of the assets under their management. A typical annual fee is 1% on the first Rs.1 million under management. In addition to this, they are also entitled for a commission that depends on whether their firm has the ability to execute the trade. Sometimes the managers' fee is based on the value of the portfolio. If the portfolio value is high, then, a higher fee is paid to the manager.

Through Mutual Funds

One of the alternatives of purchasing securities is the owning mutual funds. A mutual fund is defined as a trust that pools the savings of a number of investors who share a common financial goal. The most important distinguishing feature of a mutual fund is that the contributors and the beneficiaries of the fund are the same class of people, namely the investors. A mutual fund's objective is to invest the funds collected, according to the wishes of the investors who created the pool. In many markets these wishes are as eloquent as "Investments Mandates". Usually, the investors appoint professional investment managers, to manage their funds. The same objective is achieved when professional investment managers create a "product" and offer it for investment to the investor. This product represents a share in the pool, and pre-states investment objectives. For example, a mutual fund, which sells a money market mutual fund, is actually seeking investors willing to invest in a pool that would invest predominantly in money market instruments.

Through an Annuity

This is a contract between the investor and an insurance company. The investor invests in the contract and the insurance company pays a series of payments for a fixed number of years or for lifetime. The payments can be either immediate or delayed. There are two types of annuities immediate and deferred annuities. In immediate annuity the investor invests in annuity and payments start immediately. In deferred payment, the premium is paid and payments do not start immediately. It usually starts after a year.

Online Investing

Currently there are over 80 active trading members who have been granted permission by the exchange for providing Internet-based trading services. These members are categorized as follows:

- Institutional players.
- Large brokers.
- VC-funded dotcoms.
- Broker plazas. (a system which facilitates brokers and investors to directly trade on the exchange using a common interest infrastructure.)

Online trading offers the investors the following benefits:

- **Reach:** The reach of online trading spans to all areas where internet connectivity is available.
- **Empowerment:** Since all decision-making is with the investor, with sufficient and relevant information on his stocks, the investor is empowered to take decisions based on his own judgment.
- **Convenience:** The share broking account integrates with the investors banking, broking and the share depository accounts. This enables the investor to trade in shares without going through the hassles of tracking settlement cycles, writing cheques and transfer instructions, and chasing brokers for refund cheques.
- **Speed:** The speed of executing the transaction is more as compared to a phone based trade.
- **Control:** With online trading, the investor can be assured of the execution of the transaction placed, thereby having complete control over the trades.
- Internet trade expected to be 20% to 25% of the overall trades in the next few years, thereby providing a large market to the broking industry.

SUMMARY

- The financial markets provide an annexure for investing in shares and other securities. For investing in stocks, the stock exchanges are a pre-requisite in the secondary market. In the primary market shares can be subscribed for, directly from the issuing company.
- Stock markets in India and abroad have undergone several evolutionary changes in the past few decades. The art and science of investing have also seen the advent of many new techniques and measures.
- Portfolio Management services, which are just taking root in India, are subject to several regulatory pressures and restrictions as of now. Similarly, Internet-based trading is at an infant stage – only time will tell how the Indian capital markets will progress further.

Chapter XIII

Investing in Fixed Income Securities

After reading this chapter, you will be conversant with:

- Bond Markets
- Bond Investing Strategies
- Types of Bonds
- Calculation of Bond Returns
- Risk from Investing in Bonds

Introduction

In comparison to equities, bonds appear to be less glamorous and exciting. In general they are less risky on the cash flows accruing to the holders as compared to the shareholder. Bond prices fluctuate less than the equity prices and the investor who desires superior performance has to be on the lookout for even small differentials in prices and returns.

BOND MARKETS

What are Bonds?

Bonds are debt investments where the investor lends money to an entity which needs money for a specified period of time at a definite interest rate. In exchange to the money, the entity issues a certificate or a bond that states the interest, namely the coupon rate to be paid to the investor and when the money borrowed should be returned. Interest on bonds is usually paid every 6 months or semi-annually. In order to value the bond correctly, it is important to understand the terms and conditions of the bond. These terms define the contractual rights of the bondholder and of the issuer and determine the cash flows that the bondholder will receive. Bonds are contractual loans where investors and the institutions pay premium for borrowing in return for financing which is called coupon or interest.

People borrow money at some point of their life. Just like how people need money companies also need money for meeting their day-to-day expenses or for investment purpose, etc. The basic problem is that companies need money far more than the money provided by the average bank. One way to raise money is by issuing bonds to the public. The organization that sells a bond is called issuer. The issuer must pay the investor something extra for the privilege of using his or her money. This extra payment is the interest which is paid at predetermined rate and time. This interest rate is otherwise called as the coupon rate. The date on which the issuer has to repay the amount borrowed is called the maturity date.

In bond markets, we find a large variety of instruments like bonds issued by financial institutions, public sector undertakings and those issued by private companies.

When compared to the primary and the secondary markets of government securities corporate bond markets are not big in size. The financial institutions raise funds through bond issues as they cannot access retail deposits like banks. Only the financially sound PSUs approach the bond markets. Specified PSU bonds are tax-free and get traded at low yields.

The investors in these markets are mainly banks, financial intermediaries, mutual funds, etc. Most of the issuers, to save issue expense, approach the institutional investors for the issue of bonds rather than making a public issue. The rates fixed in the bond markets depend on the different issue categories. Top rated private corporate bonds and the PSUs are treated on par while the financial institutions charge less interest rates or coupon rates on their issues.

The growth of bond market in India is constrained by many factors such as lack of good quality issues, supporting legal and regulatory infrastructure, high issue expenses, etc. There has been a barrier to the wider participation of the retail segment, because of risky nature of debt market. The size of the Indian bond market is small in ratio when compared to the government borrowings has been another reason for the slow growth of bond market. Almost 90% of the new issues were privately placed which lead to distorting transparency, price discovery and excluding huge set of individual investors from participation.[1]

1 http://www.hindu.com

NRIs Investing in Bond Market

Non-resident Indians started eyeing the Indian bond market as a means to earn investible surplus as RBI imposed certain ceilings because of which the interest rates on rupee and dollar deposits lost their attraction. Money market dealers and bankers accepted the fact that there were enquires from high net worth individuals (NRIs), about opening accounts with the local banks. But the money market dealers and the bankers were unenthusiastic to explain about the nature of these investments. Some of the NRIs who have invested taken the help of local advisors to evaluate their investments. There are also certain banks that provide advisory services to NRIs as they may be able to keep track of the day-to-day movements in the market. Some market players confided that there was a trepidation that resident Indians might be routing money through the NRIs into the market, as the domestic bond market was flourishing. The RBI and some of the top bankers implemented certain measures which were aimed at improvement of retail participation in the debt market.

Characteristics of Bonds

FACE VALUE/PAR VALUE

The face value or the nominal value of a bond can be thought of as principal amount on which interest is paid by the issuer. In many cases, this is also the amount which is repaid at the end of life of the bond. This is also often the price at which the bond is originally issued by the issuer, unless the issue is at a premium or discount.

COUPON RATE

Bonds pay interest periodically at a pre-specified rate of interest. This is known as the coupon rate. In other words, it is the amount the bondholder receives as interest payment. Interest is paid half-yearly, monthly, quarterly, or annually. The coupon is expressed as the percentage of the par value. For example, a bond of the face value of Rs.1,000 with a 10% coupon payable semi-annually will pay Rs.50 as interest every six months. The dates on which the interest payments are made is known as the coupon due dates. There are two types of interest rates – floating rate and fixed rate. A rate which stays as the fixed percentage of the par value is called fixed rate. Adjustable interest rate payment is called floating rate. Floating rate bonds are issued recently by institutions such as IDBI, ICICI and also corporates such as Tata Sons, Arvind Mills etc. These bonds have maturities of either 3 years or 5 years.

MATURITY DATE

The maturity date of a bond is the date on which the investors' principal is repaid. A bond is often described by specifying the coupon rate, the name of the issuer and the maturity date. Some bonds do not repay the principal amount in one installment but spread it out over several years. In this case the date of last installment is often taken as the maturity date though the very notion of a maturity date becomes less useful in this case. The maturity at issue refers to the time to maturity from the date of issue of the bond and the residual maturity refers to the time to maturity at any subsequent point of time. For example, a bond with a maturity date of 2020 issued in 2005 has a maturity at issue of 15 years, but in 2015 its residual maturity is only 5 years. A bond that matures within 1 year is less risky when compared to the bond which matures in 20 years. The longer the time to maturity, the higher will be the rate of interest.

REDEMPTION PREMIUM AND CALL OPTION

Certain bonds have redemption or call options that provide the issuer to repay the principal at a specified date before maturity. Bonds are commonly called when the existing interest rates have dropped significantly since the time of issue. Before the purchase of the bond, the investor should ask if there is any option to call. If yes, the investor should calculate 'yield to call', before taking the investment decision. Bonds are not always redeemed at par on the maturity date. In other words, the repayment on the maturity date is not necessarily equal to the face value. Some bonds may pay a redemption premium in addition to the face value. For example, in the case of a bond with a face value of Rs.1,000, and redemption premium of 5%, the amount repaid on maturity will be Rs.1,050 and not Rs.1,000.

PUT OPTION

Bonds may also contain a put option which entitles the bondholder to put the bonds back to the issuer for redemption before the maturity date. This provides the investor the option of requiring the issuer to repurchase the bonds at a specified time but prior to maturity. Investors make use of this provision when they are in need of money or if the interest rates have increased since the date of issue. For example, in 1994 a company issued a bond with a maturity of 10 years (redeemable in 2004), which is putable any time after 3 years (i.e., after 1997). Suppose the bond has a coupon of 15% while in 2001, interest rates have gone up and a similar company is issuing new bonds at a coupon of 17%. The bondholders could then buy these fresh bonds and put his existing 15% bonds back to the issuer for redemption. If the bonds do not have a put option, the holder cannot do this and would, therefore, be stuck with the lower coupon rate till 2004.

BOND PRICE

The price of the bond in the market is often expressed as the percentage of face value. For example, if the price of a bond with a face value of Rs.5,000 is stated as 105, the actual price would be Rs.5,000 x 105/100 = Rs.5,250.

BASIS POINT

A basis point is simply one-hundredth of one percent. Changes in interest rates and differences between two interest rates are usually stated in basis points for the sake of convenience. For example, if interest rates rise from 8.25% to 8.40%, we say that the rate has risen by 15 basis points. Similarly, if the yield on a high grade bond is 11.5%, while the yield on a low grade bond is 12.25%, we say that the yield spread is 75 basis points. The use of this unit of measure serves to highlight the fact the bond portfolio manager is always fighting for that last basis point of return and cannot afford the luxury of the equity manager who may be content to measure returns in percentage points.

BOND INVESTING STRATEGIES

While constructing a portfolio it is quite important to consider the risk-return profile of an investor. The portfolio of an investor who is willing to take high risks to earn high returns might consist of common stock. On the other side, the portfolio of an investor whose only objective is to minimize the risk might consist wholly of securities issued by government whose default risk is almost nil. Most of the investors find that their investment needs are modest and usually prefer less volatility in returns. These investors will be at an advantage if corporate bonds are incorporated into their portfolios. We know that each and every security in the portfolio contributes to the total risk. Some securities individually or as a group tend to increase the risk while some others tend to decrease it. There are different constituents of a portfolio, which are selected in such a way that their returns move in opposite directions negating the effect of one on the other so that a portfolio of little or no risk can be constructed. Quantatively, this association is measured by correlation. Therefore the correlation between the constituents should be as low as possible if not negative. This fact should be taken into account while constructing a portfolio, as bonds normally not only possess lower risk than common stocks, but also tend to reduce the portfolios' risk more than proportionately than the reduction in the overall returns.

The interest paid on the bonds is tax deductible expenditure unlike dividends. Consequently, an issuer will be able to offer better interest rates on bonds, an advantage to the investor. Unlike the stockholder who faces uncertainty regarding the rate as well as returns on his investment, a bondholder receives interest payments regularly irrespective of the profits of the firm since the payment of interest is an obligation on the part of the issuer unlike dividend which is discretionary and dependent on the profits of the firm. Also, in case of the firm being liquidated, the debt-holder will have a preferential rights over a stockholder to recover his investment.

Buy-and-Hold Strategy

One of the simple investment strategies is to identify a security with the desired characteristics and hold it till maturity or redemption and reinvest the proceeds in similar securities. This strategy is known as buy-and-hold strategy. Buy-and-hold investors do not trade actively with the objective of increasing their returns. They buy the bond with a maturity (or duration) close to their investment horizon to reduce price and reinvestment risk. When a security is held till maturity, price risk is eliminated and the return on the security is controlled by the coupon payments and reinvestment rate. Therefore, cash flows over life of the security are determined by the coupon payments received and subsequently reinvested.

An important point in buy-and-hold approach is identifying bonds with attractive yield and maturity profiles. The investor has to choose carefully from the available bonds based on the analysis of quality, coupon level, term to maturity and important indenture provisions such as call, sinking fund features, etc. Though management of the portfolio is passive, selection of bonds is based on a careful analysis.

Buy-and-hold strategy is suitable for income maximizing investors such as pensioners, bond mutual funds, endowment funds, insurance companies, etc. The objective of these investors is to maximize yield over the investment horizon. In some cases, following active bond management strategies may be difficult because of the market impact of large cash flows of large funds.

Another feature of buy-and-hold approach is its low level of risk. As we have already seen, main source of risk for bonds, interest rate risk, can be limited to reinvestment risk using the buy and hold approach. Price risk is eliminated under buy-and-hold strategy because the security is held till maturity and redemption payment realized would be the same as expected. This also makes the buy-and-hold strategy attractive for risk-averse investors.

Therefore, buy-and-hold strategy will be suitable for investors with the objective of maximizing income with minimum risk.

Bond Ladder Strategy

Another form of buy-and-hold passive strategy of bond portfolio management is bond laddering. Bond laddering involves investing in bonds with several maturity dates instead of single time horizon as in the case of simple buy-and-hold strategy. This process of bond management is called laddering because of the various rungs of investment established over the maturity ladder. An illustration of bond laddering is given in table 1. The investments are staggered by maturity over the next five years. This staggering of maturity minimizes fluctuations in the level of current income.

Table 1: Buy-and-Hold Bond Ladder Strategy

Issuer (Company)	Credit Rating	Par Amount (Rs.)	Current Semi-annual YTM (%)	Maturity (Year)
M	A	10,00,000	5.0	2001
N	BBB	10,00,000	7.0	2002
O	AA	10,00,000	6.0	2003
P	AAA	10,00,000	6.0	2004
Q	AAA	10,00,000	7.5	2005

One of the most attractive features of the laddered buy-and-hold strategy is that there are few expectational requirements regarding future interest rate movements. By staggering the maturities of the securities, the investor is assured that money will be available for reinvestment at regular intervals. When interest rates decline, the investor loses on short-term securities since the entire redemption amount has to be invested, whereas he gains from the long-term investments since they remain locked at higher rates. Similarly when interest rates increase he gains from short-term investments since the redemption amount can be reinvested at higher rates whereas he loses from long-term investments since they remain locked at lower rates. Thus an evenly distributed portfolio across maturity ladder helps in offsetting the interest rate risk. However, the coupon inflows will be subjected to reinvestment risk. This lessens the pressure on the investor to make interest rate forecasts for several years in the future. Laddering also ensures better diversification. Since investments are spread over different time horizons, bond laddering ensures better diversification.

The downside is that no consideration is given to the total return potential of the portfolio. Nevertheless, although the focus on providing a steady stream of income may dampen the total return potential, this approach provides flexibility in designing a portfolio that will meet an investor’s specific needs and holding period requirements. Furthermore, once the portfolio is established, very little time is needed to manage the securities. Only when a bond matures the investor needs to be actively involved. Thus, the laddered buy-and-hold approach is passive in terms of its management style.

TYPES OF BONDS

Corporate Bonds: These bonds are generally traded in the secondary market and the price of the bonds depends on the market interest rates prevailing at the time of trading. Corporate bonds are debt securities issued by a corporation. It has a par value; income from it is taxable and it has a term to maturity. A company can issue bonds in a similar way it issues stocks. Maturity generally ranges as follows:

– Short-term corporate bonds: up to 5 years.

– Intermediate-term corporate bonds: up to 12 years.

– Long-term corporate bonds: above 12 years.

Corporate bonds are exemplified by higher yields because there is a higher risk of default. Sometimes corporate bonds are considered very rewarding fixed income securities because of the risk taken by the investor. At the same time, the company’s credit quality is very important because higher the quality, the lower interest rate the investor receives. The price will appreciate if the coupon rate is higher than the prevailing rates. As such, bonds are quoted at a premium. Conversely if the coupon rate on the bond is less than the prevailing market rates, then the bonds are quoted at a discount.

Zero-coupon Bonds: They are deep discount bonds. They pay no coupon. They are issued at a discount to face value. The difference between the purchase price of the bond and the face value is the interest earned by the bondholder during the holding period. Treasury bills are the examples of this kind of bonds.

Floating Rate Bonds: Interest rates on these bonds are floated along with some reference rate in the market. For example, a bond can be issued with a feature that the interest rate on the bond is 1% above the bank rate. The rates of interest is always in tune with the market rates because of this, the interest rate on the bond keeps changing, as the bank rate changes.

Indexed Bonds: In indexed bonds, the principal and coupon payment are linked to a market index like inflation on the price index. Indexed bonds are attractive to investors as they are safer than the conventional bonds in terms of interest rate risk and purchasing power risk. Because both coupon and principal payments of an indexed bond are adjusted for inflation, an investor can count on the steady purchasing power provided by the coupon interest payment during the life of the bond. Further, when an indexed bond matures, its principal has the same purchasing power as when it was invested.

Junk Bonds: Junk bonds are high yield bonds issued by companies and are considered highly speculative because of high risk of default. They offer high interest rates. Junk bonds are mainly for rich individuals who have a lot of appetite for risk. These bonds require a high degree of analytical skills in selection, particularly specialized knowledge of credit. Their credit ratings are low and are typically rated as BB, BA or less.

International Bonds: They are divided into two categories – namely, foreign bonds and eurobonds. Foreign bonds are issued by a borrowing company in another country and the bond is denominated in the currency of the country where it is marketed or sold. For example, an Indian company sells bonds in USA in dollars. Eurobonds are issued in the currency of issuing country but sold in other countries. For example, a dollar denominated bond sold in UK and a rupee denominated bond issued in USA.

Treasury Bonds: Bonds that are issued by government are known as treasury bonds. For example, dated securities released by the government. These bonds are normally issued for longer maturity.

Discount Bonds: A bond, when valued less than its face value is called a discount bond. This means that the bond is either highly risky or offers low coupon rates.

Callable Bonds: They give the right to the issuer to redeem the bond prior to its maturity, at a specified price called the call price. These bonds are beneficial to the issuers when the coupon interest paid by the bond is higher than the prevailing interest rates. Basically the company can issue the same bonds at a lower interest rate leading to a lower cost of financing.

Puttable Bonds: These bonds can be redeemed prior to maturity at the initiative of the bondholders. These bonds are more advantageous to the investors as they get an opportunity to redeem their bonds when the prevailing market interest rate is more than the coupon interest on the bonds. This feature enables the investors to unlock their current investment and invest in more profitable avenues.

Other Types of Bonds

SECURED VERSUS UNSECURED BONDS

Bonds can be classified into secured bonds and unsecured bonds. Unsecured bonds do not have any charge on any specific assets of the company while secured bonds carry a fixed or floating charge on the assets of the company. The distinction between the secured and the unsecured bonds becomes relevant in case the issuer defaults in the payment of the interest or principal. The secured bondholders are entitled to take possession of the security given to them and realize their dues by selling these assets. This right is valuable to the bondholders provided the security has enough value is easily saleable and has not been simultaneously given as security to other creditors as well. All these factors have to be examined while evaluating a secured bond. Unsecured bonds are not backed by any security but the bondholder need not worry about this if he believes that the company is financially sound and is unlikely to default. But, if things do go wrong, the investor will have no way of proceeding against the assets of the company.

SENIOR VERSUS SUBORDINATE BONDS

The senior bondholders have to be paid before the subordinate bondholders. In other words if the assets of the company are insufficient to pay even the senior bondholders, they get whatever amount that can be realized and the subordinate bondholders will get nothing. If the assets are little more the senior bondholders may be paid in full and the subordinate bondholders may get partial payment. But if the company has sufficient assets all bondholders will be paid in full. In general, the company may have more than two classes of debt and the rules regarding the seniority of these different classes can become quite complex.

REGISTERED AND UNREGISTERED BONDS

Debentures can be classified as registered and unregistered, based on the dimension of transferability. Unregistered bonds are freely negotiable and can be transferred by a simple endorsement. On the other hand, registered bonds can be transferred only by executing a transfer deed and filing a copy of it with the company. The registered debenture holders receive interest cheques automatically from the company whereas interest is paid on bearer debentures only on presentation.

CONVERTIBLE AND NON-CONVERTIBLE BONDS

Bonds can be classified into convertible and non-convertible depending upon whether they carry a conversion feature or not. Convertible bonds are the ones which can be converted into equity shares at the option of the bondholders. In this case, the ratio of conversion or alternatively the conversion price and the period during which the conversion can be affected are specified at the time of the issue. Convertible bonds can be either fully convertible or partly convertible. In case of partly convertible bonds, the non-converted portion will carry interest until it is repaid as per the provisions of the indenture.

CALCULATION OF BOND RETURNS

The investor in bond typically receives income from the following:

i. Interest payments at a contracted rate i.e., coupon interest.

ii. Capital gain or loss arising out of sale of the bond.

iii. Cash realization on sale of bond.

iv. Redemption of the bond by the issuer at a contracted value.

Items (i) and (ii) constitute returns to the bond investor, while (iii) and (iv) are principal recoveries. An investor's income on bond investment depends on whether he holds the bond to maturity or disinvests before maturity. If the bond is held till to maturity, cash flows (i) and (iv) will accrue. However, if he sells before maturity he receives cash flows (i), (ii) and (iii) above. The return to the bond investor can be measured in terms of the following:

a. Current Yield (CY).

b. Yield-to-Maturity (YTM).

c. Realized Yield (RY).

Current Yield

CY is measured by comparing (i) with the prevailing market price. Thus,

$$CY = \frac{\text{Coupon interest}}{\text{Prevailing market price}}$$

Illustration 1

An 8% bond (Face value of Rs.100) selling for Rs.96, would have a current yield of

$$r_c = \frac{8}{96} = 8.33\%$$

Current yield of bonds selling at par would be equal to the coupon interest rate. Current yield of bonds selling at a premium (discount) would be less (more) than the coupon interest rate.

An important drawback of current yield is that it considers only coupon income as a source of return to the investor, ignoring interest and capital gains (loss) that would also accrue to him.

Yield-to-Maturity

The correct way of computing the return on any asset involves considering the entire sequence of cash flows and their timing and calculating the Internal Rate of Return (IRR). In the case of a bond, there is a cash outflow (equal to the price of the bond) when the bond is bought and there are cash inflows when the periodic interest coupons are received and there is also a cash inflow when the redemption value is received on maturity. Calculating the IRR of this stream of cash flows gives the true return on the bond which is known as the Yield-to-Maturity (YTM).

Thus, yield-to-maturity is measured by comparing the present value of (i) and (iv) to the prevailing market price.

Illustration 2

Consider a bond with an annual coupon of 12.5% redeemable on 1/7/x4 selling at Rs.80.60 on 1/7/x1. What is the return earned by the investor, who buys the bond on 1/7/x1 and holds it till maturity?

The investor incurs a cash outflow on 1/7/x1 of Rs.80.60 and receives interest of Rs.12.50 each on July 1 in x2, x3 and x4. On maturity (1/7/x4), he also receives Rs.100. The structure of cash flow is thus:

Date	1/7/x1	1/7/x2	1/7/x3	1/7/x4
Cash flow	Rs.–80.60	Rs.12.50	Rs.12.5	Rs.112.50

Solution

The IRR of this stream of cash flows works out to 22% as shown by the following calculation.

Date	1/7/x1	1/7/x2	1/7/x3	1/7/x4
Cash flow	Rs.80.60	Rs.12.50	Rs.12.50	Rs.112.50
Present value of cash flow at 22%	Rs.80.60	Rs.10.25	Rs.8.40	Rs.61.95
Net Present Value	0.00			
The YTM is therefore 22% compounded annually.				

In bond valuation, the convention is to quote yields in terms of half-yearly (semi-annual) compounded rates of interest. This convention is useful because most bonds have semi-annual coupons; therefore, the YTM of such a bond selling at par would be equal to the coupon rate only if the YTM uses semi-annual compounding. Since 11% compounded half-yearly equals 22% compounded annually, the yield-to-maturity of the bond would be quoted as 11% rather than 22%. However, for simplicity, in many of our illustrations, we shall assume annual coupons and annual compounding of the interest rates.

For the mathematically inclined, the semi-annually compounded YTM can be defined as the value of r which solves the following equation:

$$P = C_1\left(1+\frac{r}{2}\right)^{-t_1} + C_2\left(1+\frac{r}{2}\right)^{-t_2} + \ldots + C_n\left(1+\frac{r}{2}\right)^{-t_{2n}} + RV\left(1+\frac{r}{2}\right)^{-t_{2n}} \quad \text{Eq. (1)}$$

Where P is the price of the bond today, C_1 is the next coupon and t_1 is the time from today till the next coupon date and, in general, C_i is the ith coupon and t_1 is the time (in years) from today at which this coupon will be received, while $t2_n$ is the time to maturity and RV is the redemption value.

Eq. (1) essentially restates algebraically the IRR calculation except that it uses semi-annually compounded rates of interest. This equation can be solved by trial and error either manually or using a computer.

For a bond with a constant semi-annual coupon redeemable at par, we can use the formula for the present value of annuities to obtain:

$$P = C\ PVIFA\left(\frac{r}{2}, 2n\right) + RVPVIF\left(\frac{r}{2}, 2n\right) \quad \text{Eq.(2)}$$

Where ‘C’ is half-yearly coupon.

This equation can also be solved by trial and error. This formula is especially useful when there are several more coupons to be received, because, in this case, Eq.(1) would have a large number of terms (one for each coupon in fact).

APPROXIMATION TO YTM

Many investors do not bother to calculate the YTM, and instead analyze the return earned in a very simple way. The reason is that the total return consists of interest payments and the capital gain/loss on redemption. The average annual return is then:

$$\text{Average annual return}^2 = \frac{\text{Annual interest + Capital gains}}{\text{Number of years}}$$

Similarly, one can also calculate the average investment as the average of the current price and the redemption value. Many investors then compute the yield as the average annual return divided by the average investment.

From the Illustration 13.2, the annual interest is Rs.12.50, the total capital gain is Rs.19.40, the annual capital gain is Rs.6.47, the annual average return is Rs.18.97 and the average investment is Rs.90.30[3]. Hence, the yield by this method works out to Rs.18.97/Rs.90.30 = 21%. We have already seen that the correct yield is 22% compounded annually an error of 100 basis points. The reason for this error is that the approximate calculation ignores the fact that capital gains and the interest are received at different points of time. To compute an average return is not quite correct.

2 Annual return can also be calculated by the formula, $\frac{C + (F - P)/n}{(F + P)/2}$ where ‘C’ is coupon, ‘F’ is the redemption value and ‘P' is the purchase price.

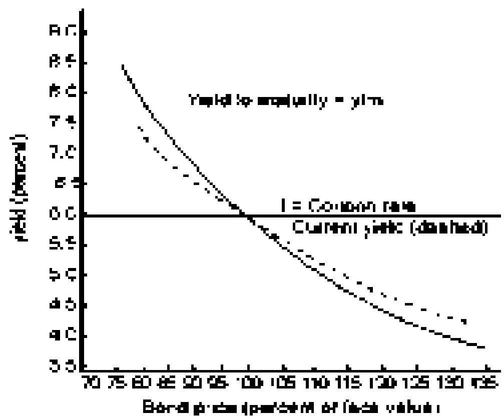
3 Average investment is equal to half the redemption price and purchase price, i.e. (F + P)/2.

Many other approximations of this kind are in common use. Some approximations do not use the notions of average investment, but divide the return either by the redemption value or by the price. There are some who divide the annual interest by the price and divide the capital gains by the redemption value. All these approximations involve the same error of ignoring the timing of the cash flows. While some of them may give a nearly correct answer, but for some bonds they can all be off by a hundred basis points or more.

These approximations are, however, very useful in calculating the YTM by trial and error since they provide a very good initial guess, the process of trial and error gives the true YTM in a few steps.

Figure 1 illustrates how current yield, yield to maturity and coupon rate interact with the market price of a bond of face value of Rs.1,000 with coupon rate of 6% and 25 years to maturity.

Figure 1



The above figure depicts graphically the fact that the current yield and yield to maturity varies inversely with the market price.

From the above figure it is also clear that

a. If market price = face value, i = YTM = current yield.

b. If market price <face value, i <current yield <YTM.

c. If market price >face value, i >current yield >YTM.

Realized Yield

Realized yield is the yield actually earned by the investor on his investment and depends on the reinvestment rate and the holding period chosen by him.

ASSUMPTIONS UNDERLYING YTM

The YTM of a bond represents the expected or required rate of return on a bond. While computing the YTM, the following assumptions are made:

1. All coupon and principal payments are made on schedule.
2. The bond is held to maturity.
3. The coupon payments are fully and immediately reinvested at precisely the same interest rate as the promised YTM.

The YTM and the realized yield would be equal if the above conditions are fulfilled. Any violation of the above assumptions will cause YTM to differ from realized yield.

Let us see the effects of relaxing the above assumptions on realized yield.

An investor may hold a bond to maturity, or decide to sell the bond before that. Similarly, the reinvestment rate, or the rate at which coupon payments are reinvested can be more or less than the promised YTM.

After relaxing the assumptions on holding period and reinvestment rates, the returns available to the investor can be redefined as follows:

- If the investor disposes the bond before maturity, the price at which he sells the bond[4] depends on the reinvestment rate.
- Since the reinvestment rates are different from the YTM, the interest earned on the coupon interest will be at the reinvestment rate and has to be separately considered.

The total returns to an investor, as already noted, is

= Coupon interest + Interest on interest + Capital gains (or loss).

We shall consider these components in detail for the effect of interest rate changes, and varying the holding periods on the total return.

Coupon Interest

Coupon interest, as already known to us, is stated in the bond indenture and is computed by applying the interest rate to the face value of the bond.

Interest on Interest

The coupon interests received on bonds may be reinvested and in turn earn interest. The interest on interest can be computed as,

$$I = C_1(1+r)^{n-1} + C_2(1+r)^{n-2} + C_3(1+r)^{n-3}......$$

$$+ C_n(1+r)^0 - [C_1 + C_2 + C_3 + ... + C_n]...... \qquad \text{Eq. (3)}$$

In case of equal coupons received, the above equation will reduce to

$$= C_t\left(\frac{(1+r)^n - 1}{r}\right) - \sum_{t=1}^{n} C_t \quad = C_t\,FVIFA_{r,k} - n.C_t \qquad \text{Eq. (4)}$$

where 'r' is the relevant reinvestment rate.

Illustration 3

Consider a 13% bond (face value Rs.200) redeemable after 5 years at a premium of 5%. Let the purchase price of the bond be Rs.191.50.

The YTM of the bond is the value of 'r' in the equation:

Rs.191.50 = 26 $PVIFA_{r,5}$ + 210 $PVIFA_{r,5}$

At r = 15%, the RHS of the above equation

= Rs.87.152 + Rs.104.37 = Rs.191.52

The YTM of the bond is about 15%.

The interest on interest earned by the bond, if the reinvestment rate is equal to the YTM, is

= 26 $FVIFA_{15,5}$ – 26 $\times$ 5

= Rs.175.29 – Rs.130 = Rs. 45.29

Suppose the reinvestment rate is 12%, the interest on interest would be

= 26 $FVIFA_{12,5}$ – 26 $\times$ 5

= Rs.165.18 – Rs.130 = Rs.35.18

4 The market price available on the bond would also depend on the market interest rates. An increase in interest rates would be accompanied by a fall in market prices and vice versa. It may be different from the acquisition price, resulting in capital gains or losses.

The realized yield can vary from the promised YTM if coupons are reinvested at a rate different from the YTM. In the above case, while the promised interest is Rs.175.29, only Rs.165.18 can be realized if the reinvestment rate available is 12%. A fall in interest rates, therefore, reduces the return available from the interest on interest component.

Suppose the bond is not held to maturity, the interest on interest component would vary with the holding period. The interest on interest at both the reinvestment rates, 12% and 15% for various holding periods, is summarized below:

Table 2 : Interest on Interest

At reinvestment Rate	1	2	3	4	5
15%	26 x $FVIFA_{15,1}$ – (26 x 1) = 0	26 x $FVIFA_{15,2}$ – (26 x 2) = 3.9	26 x $FVIFA_{15,3}$ – (26 x 3) = 12.3	26 x $FVIFA_{15,4}$ – (26 x 4) = 25.82	26 x $FVIFA_{15,5}$ – (26 x 5) = 45.29
12%	26 x $FVIFA_{12,1}$ – (26 x1) = 0	26 x $FVIFA_{12,2}$ – (26 x 2) = 3.12	26 x $FVIFA_{12,3}$ – (26 x 3) = 9.72	26 x $FVIFA_{12,4}$ – (26 x 4) = 20.25	26 x $FVIFA_{12,5}$ – (26 x 5) = 35.18

CAPITAL GAIN (LOSS)

If the bond is held to maturity, the redemption value is known in advance, but if the bondholder decides to disinvest before maturity, the price at which he will be able to dispose it off should be determined.

Returning to the basic bond valuation equation (also the equation of the YTM), we are aware that the price at which a bond is expected to sell, is the present value of future cash inflows discounted at the YTM rate. With the help of this equation, we can determine the expected market price for any holding period, up to the maturity of the bond, using the formula

Market value at the end of t years

$= C \times PVIFA_{r,(n-t)} + F \times PVIF_{r,(n-t)}$

Where,

r = reinvestment rate

n = term to maturity

t = holding period.

Illustration 4

Reconsider the previous illustration. The redemption value of Rs.210 can be realized if the bond is held to maturity. The expected market prices for various holding periods at a reinvestment rate of 15% (YTM) and the capital gains that would arise if the bond is sold at that price is given below in Table 3.

Table 3 : Capital Gains

At Reinvestment Rate of 15%	Holding Period (Years)				
	1	2	3	4	5
1. Purchase Price (Rs.)	191.5	191.5	191.5	191.5	191.5
2. Market Price at the end of the holding period (Rs.)	26 x $PVIFA_{15,4}$ + 210 x $PVIF_{15,4}$ = 194.35	26 x $PVIFA_{15,3}$ + 210 x $PVIF_{15,}$ = 197.54$_3$	26 x $PVIFA_{15,2}$ + 210 x $PVIF_{15,2}$ = 201.04	26 x $PVIFA_{15,1}$ + 210 x $PVIFA_{15,1}$ = 205.32	210 = 210
3. Capital gain (2) – (1) (Rs.)	2.85	6.04	9.54	13.82	18.5

We shall work the capital gains at a reinvestment rate of 12% to illustrate the effect of a different reinvestment rate, on the capital gains component. Table 4 provides the capital gains for various holding periods. The inverse relationship between YTM and market prices results in increased capital gains when interest rate falls to 12%.

Table 4: Capital Gains

At Reinvestment Rate of 15%	Holding Period (Years)				
	1	2	3	4	5
1. Purchase Price (Rs.)	191.5	191.5	191.5	191.5	191.5
2. Market Price at the end of the holding period (Rs.)	26 x $PVIFA_{12,4}$ + 210 x $PVIF_{12,4}$ = 213.46	26 x $PVIFA_{12,3}$ + 210 x $PVIF_{12,}$ = 211.97_3	26 x $PVIFA_{12,2}$ + 210 x $PVIF_{12,2}$ = 211.31	26 x $PVIFA_{12,1}$ + 210 x $PVIFA_{12,1}$ = 210.75	26 x 0 + 210 = 210
3. Capital gain (2) – (1) (Rs.)	21.96	20.47	19.81	19.25	18.5

Total Return

As noted earlier, total return comprises of the three elements explained above – namely coupon payments, interest on interest, and capital gains.

Let us consider the total returns for the bond while coupons, interest on interest, and capital gains for varying holding periods, have already been computed by us.

The total returns earned for various holding periods and the two reinvestment rates can be summarized as follows:

Table 5 : Total Return

(Rs.)

At Reinvestment Rate		Holding Period (Years)				
		1	2	3	4	5
15% (YTM)	Coupon Income	26	52	78	104	130
	Interest on Interest	0	3.9	12.3	25.82	45.29
	Capital Gains	2.85	6.04	9.54	13.82	18.5
	Total Return	28.85	61.94	99.84	143.64	193.79
12% (YTM)	Coupon Income	26	52	78	104	130
	Interest on Interest	0	3.12	9.72	20.25	35.18
	Capital Gains	21.96	20.47	19.81	19.25	18.5
	Total Return	47.96	75.59	107.53	143.5	183.68

From table 5, we can see the combined effect of varying the holding period, and the reinvestment rate on the total return. It can be observed that two opposing forces work on the return. A fall in interest rates reduces interest on interest, while increasing the capital gains. This is due to the inverse relationship between YTM and the market prices. The choice of the holding period can be made after considering the realized yield.

Realized Yield

As already mentioned, the realized yield on a bond is the actual yield earned by an investor, and is computed as the value of 'r' in the equation.

$P_o (1 + r)^n$ = Total cash flows received by the investor.

In other words, realized yield is the rate that equates the future value of the purchase price to the total cash flow realized on the bond. The above equation can be rewritten as

$P_o\ FVIF_{r,n}$ = Total returns + Purchase Price.

Total returns include coupon income, interest on interest and capital gains realized on sale. Adding the purchase price results in considering the cash flows arising out of sale.

Alternatively, realized yield can also be looked upon as the discount rate, that discounts the total cash inflows to the purchase price.

Illustration 5

Consider the total return computed in Table 5. The realized yield for both the reinvestment rates, and various holding periods, would be computed as follows:

The realized yield for holding period of 1 year[5], at reinvestment rate of 15% is computed as the value of 'r' in the equation –

$$\text{Rs.}191.5\ \text{FVIF}_{r,1} = \text{Rs.}28.85 + \text{Rs.}191.5$$

$$\text{Rs.}191.5\ \text{FVIF}_{r,1} = \text{Rs.}220.35$$

$$\text{FVIF}_{r,1} = \text{Rs.}1.150$$

Looking at the FVIF tables, we find the value for r = 15%. The realized yield, therefore, is 15%.

The realized yield for holding period of 1 year, at reinvestment rate of 12%, is computed as the value of 'r' in the equation –

$$\text{Rs.}191.5\ \text{FVIF}_{r,1} = \text{Rs.}47.96 + \text{Rs.}191.5$$

$$\text{Rs.}191.5\ \text{FVIF}_{r,1} = \text{Rs.}239.46$$

$$\text{FVIF}_{r,1} = \text{Rs.}1.250$$

The value of 'r' lies between 24% and 28%. Using linear approximation,

$$r = \text{Rs.}24 + \left(\frac{\text{Rs.}1.250 - \text{Rs.}1.240}{\text{Rs.}1.280 - \text{Rs.}1.240}\right) \times 4$$

$$= \text{Rs.}24 + (0.25 \times 4) = 25\%$$

The realized yield for both the reinvestment rates for various holding periods is summarized in Table 6.

Table 6 : Realized Yield (%)

Reinvestment Rate	Holding Period (Years)				
	1	2	3	4	5
15%	15	15	15	15	15
12%	25	18.54	16	15	14.4

Realized yield thus depends on the holding period chosen and reinvestment rate available. In an environment of falling interest rates, the investor realized a lower yield as term to maturity approaches. He benefits by shortening his holding period and realizing capital gains. Realized yield falls beyond a holding period of 4 years (at interest rates of 12%) because the reduction in interest on interest is not offset by increase in the capital gains component.

Analysis of Convertible Bonds

With the repeal of the Capital Issues Control Act and the enactment of SEBI Act in 1992, the rules of the game applicable to convertible bonds have changed. As per SEBI guidelines issued in June 1992, the provisions applicable to fully convertible bonds and partially convertible bonds are as follows:

- The conversion premium and the conversion timing shall be pre-determined and stated in the prospectus.
- Any conversion, partial or full, will be optional at the hands of the bondholder, if the conversion takes place at or after 18 months but before 36 months from the date of allotment.
- A conversion period of more than 36 months will not be permitted unless conversion is made optional with 'put' and 'call' options.
- Compulsory credit rating will be required if the conversion period for fully convertible bonds exceeds 18 months.

5 Student may also use the approximation formula ARY = 2C + $[P_s - P_o)/N_s]/(P_s + P_o)/2$; where P_s = expected price at the end of the holding period of N_s years and ARY = approximate realized yield.

From the SEBI guidelines it is clear that convertible bonds in India presently can be of three types:

a. Compulsory convertible bonds which provide for conversion within 18 months.

b. Optionally convertible bonds which provide for conversion within 36 months.

c. Bonds which provide for conversion after 36 months but which carry 'call' and 'put' features.

Valuation of Compulsorily Convertible (Partly or Fully) Bonds

One who holds a compulsorily convertible (partly or fully) bond will receive:

- A certain number of equity shares on part/full conversion.
- A certain stream of interest and principal repayments.

Hence the value of such a bond is equal to the sum of

- The present value of equity shares receivable on conversion.
- The present value of interest and principal payments receivable on the bond.

To illustrate the valuation of such a bond, let us consider an example.

Illustration 6

Kavya Alloys Limited has announced a rights issue of Partly Convertible Debentures (PCDs) to part finance its Rs.11 crore vertical integration program. As per the terms of this issue, 14% PCDs of Rs.100 each will be issued at par. The convertible part of the debenture (Part A) of Rs.40 each will be converted into two equity shares of Rs.10 each, 12 months from the date of allotment. The non-convertible part (Part B) of Rs.60 each will be redeemed after seven years. Interest will be paid semi-annually.

An equity investor of the company contemplating subscription to this issue seeks your advice. You are provided with the following data:

	Year Ended	March 31, 2003	March 31, 2004	March 31, 2005	March 31, 2006
Panel A	EPS (Rs.) Bonus (Ratio)	4	3.1 1:3	3.5	4.1

	Month	January 2006	February 2006	March 2006	April 2006	May 2006
Panel B	Average P/E ratio	13	12.4	11.6	10.5	9.5

The investor requires a rate of return of 24% p.a. compounded half-yearly.

The intrinsic value of the above PCD is calculated as follows:

A. Present value of interest payments

$= 7 \times \text{PVIF}_{(12,1)} + 7 \times \text{PVIF}_{(12,2)} + 4.2 \times \text{PVIFA}_{(12,12)} \times \text{PVIF}_{(12,2)}$

$= (7 \times 0.893) + (7 \times 0.797) + (4.2 \times 6.194 \times 0.797)$

$= 32.56$

B.

Year Ended	1998	1999	2000	2001
Bonus Adjusted	4	4.13	4.67	5.47

Growth rate (g) implict in the bonus adjusted EPS can be obtained from the equation

$4(1+g)^3 = 5.47$

$g = 0.11$

Projected EPS $(4.1 \times 1.11) = 4.55$

Average P/E ratio between (January – May, 2001)

$$= \frac{(13 + 12.4 + 11.6 + 10.5 + 9.5)}{5}$$

$= 11.4$

Projected market price after twelve months

$= 4.55 \times 11.4$

$= \text{Rs.}51.87$

Present value of the market value of conversion after twelve months

$= \text{Rs.}103.74 \times \text{PVIF } (12,2)$

$= \text{Rs.}103.74 \times 0.797$

$= \text{Rs.}82.68$

C. Present value of the non-convertible portion redeemed after seven years

$= \text{Rs.}60 \times \text{PVIF } (12,14)$

$= \text{Rs.}60 \times 0.205$

$= \text{Rs.}12.3$

D. Intrinsic value of the PCD $= A + B + C$

$= \text{Rs.}127.54$

$= \text{Rs.}128$

As intrinsic value is Rs.128, the investor can be advised to subscribe to the issue.

Assumptions

i. All coupon and principal payments are made on schedule.

ii. The non-convertible part of the PCD is held to maturity.

iii. The coupon payments are fully and immediately reinvested at the interest rate equal to the coupon rate.

iv. The market price on the date of conversion is in line with the investor's expectation.

RISKS FROM INVESTING IN BONDS

Bonds are generally less risky than equities. Primarily, bonds involve two types of risks – namely, default risk and interest rate risk.

Default Risk: This arises when the issuing company defaults on the interest or principal obligations. In case the company goes bankrupt and is unable to repay its debt fully, a part of the investment may be completely lost, and even the remaining part may be paid after a long delay resulting in opportunity losses. Investors should always recognize that even if no money is lost, the loss of present value or opportunity loss can be very substantial if there is a long delay.

Interest Rate Risk: In certain cases, bonds may be sold before maturity. In some other cases, the redemption value of the bond may be reinvested in other bonds. It is only in some cases that the maturity of the bond exactly matches the investment horizon of the investor. Even in such cases, the annual interest on the bond may have to be reinvested unless it exactly matches the annual requirements of funds of the investor. In all these cases the yield-to-maturity of the bond does not represent the true return to the investor over his holding period unless the interest rates remain unchanged throughout the holding period. The holding period return is thus subject to interest rate risk.

Bond Rating and Quality of Investment

Bond Rating System: It is an evaluation process of the possibility of default by the bond issuer. This evaluation is done on the basis of the financial condition and the profit earning potential of the bond issuer. Bond rating services are provided by Standard and Poor's, Moody's Investors' Service and Fitch Investors' Service. Bond ratings start at AAA, which means the highest investment quality and the rating services generally ends at D, which means default in payment.

The bond rating system helps the investors analyze companies' credit risk. Blue chip company bonds are safe investments and have high ratings while risky companies have poor credit rating. The exhibit below represents the bond rating scales from various rating agencies: S&P, Moody's and Fitch.

The major providers of credit rating services in India are CRISIL and ICRA. The rating symbols followed by them are similar to those given in the Table 7.

Table 7

Grade	Bond Rating		Risk
	Moody's	S&P/Fitch	
Investment	AAA	AAA	Highest Quality
Investment	AA	AA	High Quality
Investment	A	A	Strong
Investment	BBB	BBB	Medium Grade
Junk	BA, B	BB, B	Speculative
Junk	CAA/CA/C	CCC/CC/C	Highly Speculative
Junk	C	D	In Default

If a company falls below A rating, it means the credit quality changed from investment quality and may eventually fall to junk status. Ratings generally represent the opinion of the rating agency on the ability of the issuer to repay the principal and interest on the issue made. Bonds with one of the top four ratings from one or both agencies are often considered to be acceptable for investment and bonds with lower ratings are considered by the rating agencies as having varying degrees of probability for default.

CRISIL Composite Bond Index – A Benchmark

This index came into existence due to collaboration of CRISIL with AMFI (Association of Mutual Funds in India). This index is the benchmark for the performance of the debt funds in the Indian financial market. It involves tracking the returns of the instruments like the call index, the AAA index, the AA index, etc. to arrive at the index figure through Weighted Average Method. This is a singular tool developed by CRISIL to provide to the investors. It is a convenient, realistic and easily understandable technique for analysis and evaluation of the bond market movements. This index serves as an indicator and helps in determining the variation in the performance of the index. It is a useful tool to track volatility, estimate correlations and develop hedging instruments.

INVESTING IN BONDS

Usually bonds provide two kinds of income to the investors –

1. They offer current income
2. They may also bring in capital gains.

The current income comes from the interest payments received over the life of the bond. Bonds may also provide capital gains which occur when the market interest rates fall. A basic trading rule is interest rates and bond prices move in opposite directions. In other words, when interest rates rise, bond prices fall and when the interest rates fall, bond prices rise. The current income and the capital gains earned from the bonds may help the investor to get high returns. Bonds are also considered as the best way of earning high current income – a way to earn fat returns from capital gains. Generally, investments in bond issues are used for the conservation and long-term accretion of capital.

BOND INDEX AS INVESTMENT OBJECTIVE

When there is absence of liabilities, that are to be matched, the investment objective may be to either match or outperform a designated bond index. The bond market indexes that are available can be classified as broad based market indexes and specialized market indexes. The former consists of Lehman Brothers' Aggregate Index, the Saloman Brothers' Broad Investment Grade Bond Index (BIG), and the Merrill Lynch Domestic Market Index. The bond market sectors covered by these indexes are treasury, agency, investment grade corporate, mortgage backed securities and Yankee markets. All the above mentioned indexes exclude non-investment grade issues.

Specialized market indexes concentrate on one sector of the bond market or a sub-sector. Non-brokerage firms have also created specialized indexes for sectors. There are also specialized indexes that have been created to better reflect the liability structures of say, pension funds.

Indexing Strategy: Under this strategy, a bond portfolio is formed with the objective of replicating the performance of a selected index. Performance is measured in terms of total return realized over the investment horizon. Sources of total return over the investment horizon are change in portfolio value, coupon interest received and reinvestment income.

This strategy of bond portfolio management has grown dramatically since it was first introduced in 1979 in the USA.

REASONS FOR INDEXING

One of the primary reasons behind indexing is that it provides an excellent means of diversification, which is basically provided by the broad bond index portfolios. Further any index portfolio that is designed to match a broad bond index has an exposure not only to treasury and agency sectors, but also to industrial, utility, finance, dollar denominated foreign and asset-backed sectors. It will also have a broad exposure to the yield curves with holdings from one year to over 30 years of maturity. These sources of diversification of the portfolio results in lower risk than one can achieve from less diversified portfolios. Another reason for indexing being the lower cost of indexed portfolios. The lower cost may be in the form of lower management fees as well as lower transaction costs associated with lower portfolio turnover rates. Due to lower tracking error risk, a bond indexing strategy should give results which are consistent in its performance relative to the index. So, regardless of the market direction, the investor can be assured of the performance of a diversified broad index.

SUMMARY

- Bonds are generally perceived to be safer than equities. They provide a stable returns. However, in India, the retail participation is quite low in both government bond and corporate bond markets.
- The measures taken recently by the government to improve the interest of the small investors should be helpful in improving the situation in the long run.

<u>**Chapter XIV**</u>

Introduction to Mutual Funds

After reading this chapter, you will be conversant with:

- Basics of Mutual Funds
- Advantages of Investing in Mutual Funds
- Disadvantages of Investing in Mutual Funds
- Selection of Suitable Mutual Funds
- Types of Mutual Funds
- Legal and Regulatory Framework
- Performance Analysis of Mutual Funds

Introduction

A Mutual Fund is considered as one of the important tools of financial planning. It can be described as the foundation and building block for any type of financial plan relating to time, i.e., long-term or short-term, high or low-risk and for different clients such as retail, affluent or institutional.

Mutual Funds offer a great variety of products such as Equity Funds, Sector Funds, Income Funds, Gilt Funds and Money Market Funds. These can be tailored individually or in combination to suit the appetite of a particular investor. The portfolio should be an equal mix of potential returns, risk diversification, liquidity and tax efficiency, thus providing an array of Funds to meet financial needs. A special feature that sets Mutual Funds apart from other financial products is that they offer life and individual property insurance against foreseeable and unforeseeable events.

Using Mutual Funds as the core foundation of their financial planning strategies, financial planners are able to make professional Fund Managers as their allies and overcome the risk of tracking financial markets themselves. All this would result in financial planners and clients concentrating on the strategic or asset allocation decisions, i.e., focusing on the client’s needs and deciding on how much to allocate in various asset classes. Thus, division of work helps financial planners to concentrate on their client and choose the best allocation for a particular asset class. Thereby, duplication of work is avoided and effective, efficient plans are worked out.

The Fund Manager is required to follow the mandate and investment objective specified in the Offer Document of the scheme. A careful and diligent financial plan and asset allocation can limit his boundaries; thus, restricting him from going beyond the scheme’s stated objectives. All this would help the financial planner to monitor the Fund Manager by tracking the portfolio/investment strategy and see that it conforms to the Offer Document/stated investment objectives of the scheme.

BASICS OF MUTUAL FUNDS

A mutual fund is defined as a trust that pools the savings of a number of investors who share a common financial goal. In other words, a mutual fund is a puddle of money, collected from investors and is invested according to certain investment objectives. The significant feature of a mutual fund is that the contributors and the beneficiaries of the fund are the same class of people, namely the investors. The term ‘mutual’ means that investors contribute to the pool, and also benefit from the pool. There is no other plaintiff to the funds. The income earned through these investments and the capital appreciated realized by the scheme are shared by its unit holders in proportion to the number of units owned by them. A mutual fund’s objective is to invest the funds collected, according to the wishes of the investors who created the pool. In many markets these wishes are as eloquent as “Investments Mandates”. Usually, the investors appoint professional investment managers, to manage their funds. The same objective is achieved when professional investment managers create a “product” and offer it for investment to the investor. This product represents a share in the pool. For example, a money market mutual fund, which issues units, is actually seeking investors willing to invest in a pool that would invest predominantly in money market instruments.

Characteristics of Mutual Funds

- Mutual fund units are actually owned by the investors who have pooled their funds, that is they have ownership in their hands.
- Usually investment professionals and other service providers manage mutual funds for which they earn a fee from the fund.
- The funds that are collected from the investors are in turn invested in a portfolio of marketable securities and the value of the portfolio is updated everyday.

- The investors' share is denominated in units. The value of the units changes with the change in the portfolio's value, every day. The value of one unit of investment is called Net Asset Value or NAV.
- The investment portfolio of mutual fund is created according to the stated investment objective of the fund.

ADVANTAGES OF INVESTING IN MUTUAL FUNDS

An investment in stocks, bonds and other financial instrument requires considerable proficiency and constant management, to enable the investor to take informed decisions. Investors in the current mutual funds industry of India have the choice of 31 mutual funds, under 376 schemes. Though the categories of products offered can be classified under about a dozen standard heads, rivalry in the industry has led to pioneering revision to standard products. It is possible only for the investors to decide the manner in which their returns would be distributed, and choose from daily, monthly, quarterly or annual pay-outs; or reinvestments of dividend into the mutual fund product itself or growth option that would seek growth in the investment over distribution of income. The most important benefit of product choice is that it enables investors to chose options that suit their return requirements and risk appetite. Investors can combine the options to arrive at their own mutual fund portfolios that fit with their financial planning objectives.

Reduction in Risks

Mutual funds invest in an assortment of securities. This means that all funds are not invested in the same investment path. It is well known that risk and returns of various investment options do not move uniformly with one another. If a pharmacy company share is going down, the debt markets may be moving up. Therefore, holding a portfolio that is diversified across investment avenues is a wise way to manage risk. When such a portfolio is liquid and marked to market, it enables investors to evaluate the portfolio continuously and manage risks more efficiently.

Portfolio Diversification

Diversified investment improves risk-return profile of the portfolio. Small investors may not have the amount of capital that would allow optimal diversification. By offering a readymade diversified portfolio, mutual funds enable investors to hold a diversified portfolio. Though investors can create their own diversified portfolios, the costs of creating and monitoring such portfolios can be high, apart from the fact that investors may lack the professional expertise to manage such a portfolio. Since the corpus of mutual funds is substantially big as compared to individual investments, optimal diversification becomes possible.

Professional Management

Mutual Funds are managed by investment managers and are prearranged by trustees and bound by the investment management agreement. Asset Management Companies (AMCs) are also required to be adequately capitalized, and are closely synchronized by SEBI. An AMC competing for funds under management therefore brings in significant professional proficiency and is bound by regulatory and trustee obligations. AMCs are bound by regulations which ensure that which trustees are able to check the act of AMCs and there are a number of safeguards and prudential regulations in the interest of investors. Investment managers and funds are also bound by the rules issued by AMFI, which cultivate professional standards in the industry.

Reduction of Transaction Costs

The transactions of mutual funds are generally very large. These large volumes attract lower brokerage commissions and other costs when compared to the smaller volumes of the transactions entered into by individual investors. The brokers quote a lower rate of commission due to two reasons. The first is the competition for the institutional investors' business. The second reason is that the overhead costs for executing a trade do not differ much for large and small orders. Hence for a large order these costs spread over a larger volume, enabling the broker to quote a lower commission rate. Mutual Funds provide the investor the advantage of economies of scale, by virtue of their size. Though the individual investor's payment may be small, the mutual fund itself is large enough to be able to reduce the costs in its transactions. These benefits are passed on to the investors.

Liquidity

Most of the funds sold today are open-ended. That is, investors can sell their existing units, or buy new units, at any point of time, at prices that are related to the NAV of the fund on the date of the transaction. This enables investors to enjoy a high-level of liquidity on their investments. Since investors continuously enter and exit funds, funds are actually able to provide liquidity to investors, even if the underlying markets, in which the portfolio is invested, may not have the liquidity that the investor seeks. For example, the debt markets are wholesale markets, where minimum trade lots, are Rs.25,000 onwards. However, investors in debt funds can invest as little as Rs.500, and withdraw the same at NAV related prices, at any time.

Availability of Various Schemes

Mutual funds generally offer a number of schemes to suit the requirements of the investors. Thus the investors can choose between regular income schemes and growth schemes, between schemes that invest in the money market and those that invest in the stock market. Some schemes provide value added services. For example, automatic reinvestment schemes reinvest the distributed income automatically, thus making the management of funds easier. In case of direct investment in securities, the reinvestment of income in the same proportion as the assets held is very difficult and sometimes impossible. Funds that invest in overseas market offer the additional advantage of international diversification, which may otherwise not be feasible to the lay investor. Mutual funds are allowed to invest in overseas markets through those schemes that are meant for overseas investments or a part of domestic investment schemes. The schemes that are invested in the overseas market can be open-ended or close-ended. The fund should have the approval of the unit holder to invest in overseas markets if there is no provision in the offer document. But Mutual Funds interested in investing overseas must file an offer document with SEBI. The Mutual Funds must disclose the fees and expenses involved to the unit holders.

Convenience and Flexibility

Mutual funds possess features such as regular plan (i.e., one can invest in installments), regular withdrawal plans (also called systematic withdrawal plans or SWP) and dividend reinvestment plan (also called systematic investment plan or SIP). Because of these features, one can systematically invest or withdraw funds according to one's needs and convenience. Mutual Fund Units are usually not issued in the form of certificates, with a minimum denomination. They are instead issued as account statements, with the facility to hold units in fractions up to 4 decimal points. It is also simpler for investors to make additional investments, to repurchase a part of their investments, to re-invest dividends to convert their holdings in one fund into a holding in another and to alter the investment options regarding their periodical dividends. These facilities make it possible for small investors to regularly save a fixed amount in a mutual fund, and create saving plans that suit their saving habits and financial goals.

Mutual fund managers inform investors periodically, about the performance of the fund. They disclose the NAVs daily and in most cases this information is available on phone and on internet onsites like www.valueresearchonline.com and www.mutualfundsindia.com. The complete portfolio of the fund and commentaries of the fund managers on how they are managing the fund are also available to investors. Many mutual funds also provide additional information on the maturity profile of the investments, credit quality of their portfolios and the behavior of NAV over the period since commencement of the fund. Investors can make conversant decisions about their mutual fund investments, from these disclosure made by funds.

DISADVANTAGES OF INVESTING IN MUTUAL FUNDS

The following are the important disadvantages of investing through mutual funds:

- **No Control Over the Costs:** Funds usually have different kinds of fees that reduce the overall pay out. The fees may be two types one is the shareholders' fees that is in the form of redemption and load fees and are paid by the shareholders. The other kind of fee is the annual fund operating fee that is charged as an annual percentage usually ranging from 1%-3%. These fees are charged to the investors irrespective of the performance of the mutual fund. Since investors do not directly monitor the fund's operations they cannot control the costs effectively.
- **No Tailor-made Portfolios:** Mutual fund portfolios are created and marketed by AMCs into which investors invest. They cannot create tailor-made portfolios and therefore customized products can be made.
- **Managing a Portfolio of Funds:** As the number of mutual funds increases and to tailor a portfolio for himself, an investor may be holding a portfolio of funds, with the costs of monitoring them and using them, being incurred by him.
- **No-Choice:** The investors cannot choose the securities they want to invest in, or the securities they want to sell.
- **Performance:** The investors face the risk of the fund manager not performing well.
- If the fund manager's compensation is linked to the fund's performance he may be tempted to show good results in the short-term, without paying attention to the expected long-term performance of the fund. This would harm the long-term interests of the investors. Another disadvantage of investing in mutual funds is the management fees charged by the fund. It reduces the returns available to the investors.
- Lastly, while investors in securities can decide the amount of earnings they want to withdraw in a particular period, investors in a mutual fund have no such discretion as the amount of earnings that are to be paid out to the investors in a particular year is decided by the mutual fund.

Mutual Fund Evaluation

The data for evaluating mutual fund can be found in its prospectus, quarterly and annual reports. The following financial parameters should be used in analyzing a fund and its management:

- **Total Return:** It indicates the impact of appreciation of its value and dividends (if any). It is becoming increasingly common to find total-return numbers published in newspapers, magazines or other sources. One can calculate total return using the following formula:

  $$TR = \frac{\text{Distributions + Change in NAV}}{\text{NAV at the beginning of the period}} \times 100$$

  Distribution is the income received by the investors for having their money in the mutual fund. The components of dividends are stock dividends, bond interest etc.

- **Expense Ratio:** It is the ratio of total recurring expenses (fees, commission etc.) to average net assets. Lower numbers are desirable. Since the expense ratio fluctuates it is better to compute an average over the last three or five years. There are certain important aspects related to expense ratio.

  Small funds tend to have higher expense ratios than larger ones, which benefit from economies of scales since their management fees and other costs are being spread over a bigger asset base. Stock funds have higher expense ratio when compared with the fixed income securities. Funds that invest internationally tend to have higher expense ratios compared to domestic portfolios due to higher cost on research and foreign investment.

- **Portfolio Turnover:** This measures the amount of buying and selling done by the management. It is defined as the lesser of assets purchased or sold divided by the funds' net assets. A 100% turnover implies that management holds each stock or bond on average for one year, 50% for about two years and 200% for six months and so on. Turnover varies by type of fund and the investment philosophy of the manager. Some managers seek quick profits and will tend to buy and sell aggressively. Some follow long-term buy and hold strategy. Funds that rely on futures, options and short-selling strategies could be expected to have high turnovers and transaction costs.

- **Good Performers:** The past performance should not be taken into account while analyzing a fund. A comparison should be made with similar funds to gauge the relative performance of the scheme during the specified period. Performance, when compared with market return will show whether the scheme has outperformed the market or not. Investors should avoid those funds that have logged consistently below par-results over several years. Investors should also take into account the fact that a good performance in a particular scheme by mutual fund does not imply that same performance would be repeated in other schemes.

- **Size of the Fund:** A funds' size or total assets is another factor to consider. Mutual funds in India range from under Rs.10 crore to more than Rs.10,000 crore. The following are the advantages of small portfolios:

  1. ***Easier to Maneuver:*** It is easier to reshuffle holdings in small funds than in large funds. It would be difficult and time-consuming for large funds to eliminate certain big positions. To minimize the adverse price impacts of selling large holdings, the stock might have to be sold into the market gradually over a period of several weeks or months.
  2. ***Lower Expense Ratio:*** With more assets under management, large funds will enjoy economies of scale. Other things being equal, lower expense ratios lead to improved results.
  3. ***Large Funds Attract and Retain Better Talent:*** The organizations that run large funds are generally prestigious and have the money to compensate the best portfolio managers and analysts.
  4. ***Certain Funds do Best with Large Portfolios:*** Money market and debt funds can perform better with more assets due to the nature of the fixed income markets. In such funds transaction sizes tend to be very large and bigger blocks, will provide a better return along with minimizing transaction costs.

- **Cash Flows:** It refers to the net new money invested in a mutual fund or in other words, it is the excess of new purchases over redemption during a specified period. The following are the main advantages of large net cash inflow that may accrue to the mutual fund scheme:

  1. The fund manager can use the new money to add to positions in stocks he or she already holds. This additional demand will normally raise the price of the stock. More so, if the fund invests in smaller firms with shares outstanding.

2. The manager would not have to sell stock X to buy Y. The fresh money would be invested in Y allowing X to remain in the portfolio with an additional chance to grow.

- **Analyzing Fund Management:** The return on a fund depends not only on the quality of portfolio but also on the quality of management. An asset management company manages the mutual fund. For example, Kotak Mahindra Asset Management Company has different schemes in debt and equity. The performance of mutual fund depends on the amount of expertise available with the managing company. The fund managers are crucial as the return depends on their investment strategies. The information about their qualification and experience is given in the performance report.

SECTION OF SUITABLE MUTUAL FUNDS

Size of the Fund: Investors should always avoid tiny and small funds because of relatively high expenses associated with small funds, along with the possibility that a small fund may not survive or may undergo a change in objectives in the search for greater acceptance in the market place.

Age of the Fund: In most cases a fund should prove its merit over a period of at least three or five years. A new fund introduced by an established investment management firm and modeled on its traditional investment philosophy should be considered.

Time of Launch: In case of new issues, one should avoid investments in those schemes launched at the time when Sensex (i.e., BSE) is at its pinnacle or the listed stocks, which are the target portfolio composition of the schemes, are over valued.

Cost of Ownership: Cost includes front-end sales charges, redemption charges and expense ratios. One should avoid schemes with front-end sales charges and evaluate the expense ratio in determining investment decision.

Mutual Fund Prospectus and Balance Sheet

A prospectus is an offer document issued at the time of new issue as an invitation to the public to subscribe to the units of a particular scheme. It contains the key information about the terms, conditions and the features of the schemes and the application form. All mutual funds are required to give information about their schemes as per the format of the offer document prescribed by SEBI. Everyone agrees that the prospectus is the single best source of information about a mutual fund, yet as many as 75% of investors do not use this critical document when investing their savings and retirement assets. The reason being the prospectus contains more information and is full of detailed information and uses complex terminology. As the minimum an understanding of the following important aspects is necessary:

Highlights of the Scheme: The main features of the scheme like the sponsor, quality of service and benefits are included.

Risk Factors: Some of the risk factors are standard in nature. For example, mutual funds and securities investments are subject to market risks and there can be no assurance that the scheme objectives will be achieved. Hence such risks cannot be avoided. However some risks are specific in nature arising due to investment objective of investment strategy and the pattern of asset allocation of the scheme. For example, the AMC may choose to invest in unlisted securities that offer attractive yields. But this may increase the risk of the scheme's portfolio. A proper analysis of such risks is important before making investment.

A straight forward reading of a mutual fund's annual accounts provides an understanding of how each scheme has fared that year. The seemingly inoffensive notes attached to the annual accounts of mutual fund scheme may hide several litigations involved.

Summary of Expenses: These expenses include the advertisement expenses, commission to agents/brokers, Registrars' expenses, printing and marketing expenses, postage and miscellaneous expenses, bankers' fees, legal fees. These expenses are charged at the time of the initial issue and sale and repurchase of units of the scheme.

Registration of Mutual Fund

An application of registration of a mutual fund shall be made to SEBI in Form A by the sponsor. Every application for registration under regulation C shall be accompanied by non-refundable application fee as specified in the SEBI regulations. An application which is not complete in all respects shall be rejected. But before rejecting such application, the applicant should be given an opportunity to complete such formalities with in a specified period of time as suggested by the board. The board may require the sponsor to furnish such further information or clarification as may be required. For the purpose of grant of a certificate of registration, the applicant has to fulfill the following:

- The sponsor should have a sound track record and general reputation of fairness and integrity in all his business transactions.
- In case of existing mutual funds, such fund should be in the form of a trust and the trust deed should have been approved by the Board.
- The sponsor has to contribute at least 40% of net worth of the asset management company.
- The sponsor or any of its directors or the principle officers to be employed by the mutual fund should not have been guilty of fraud or have been convicted of an offense involving moral turpitude or has not been found guilty of any economic offense.
- Appointment of trustees for the mutual fund in accordance with the provisions of the regulations.
- Appointment of Asset Management Company to manage the mutual fund and operate the scheme of such funds in accordance with the provisions of these regulations.

CONSIDERATION OF APPLICATION

The board may, on receipt of all information, decide on the application. The board may register the mutual fund and grant a certificate in Form B on the applicant paying the registration fee as specified in the Second Schedule. There are certain terms and conditions of registration:

- The trustees, sponsor, the asset management company and the custodian shall comply with the provisions of the SEBI regulations.
- The mutual fund shall inform the board if any information or particulars previously submitted to the board were misleading or false in any material respect.
- The mutual fund shall inform the board, of any material change in the information or particulars previously furnished, which have a bearing on the registration granted by it.
- Payment of Fees.
- **Rejection of Application:** Where the sponsor does not satisfy the criteria mentioned, the application will be outright rejected.
- **Payment of a Service Fee:** A mutual fund shall pay before April 15 each year a service fee as specified in the Second Schedule for every financial year from the year following the year of registration. The board may not permit a mutual fund that has not paid service fee to launch any scheme.

Procedure for Action in Case of Default

- **Suspension of Certificate:** The board may suspend a certificate of mutual fund if such mutual fund contravenes any of the provisions of the SEBI regulations.
- Fails to furnish any information or provides wrong information relating to its activity.
- Fails to submit periodical returns.
- Does not co-operate in any inquiry or inspection conducted by the board.
- Fails to comply with any directions of the board.
- Fails to resolve the complaints of the investors or fails to give satisfactory reply to the board in this behalf.
- Indulges in unfair trade practices in securities.

Cancellation of Certificate

The board may cancel the certificate registration granted to a mutual fund, if such a mutual fund:

- Is guilty of fraud or has been convicted of an economic offense.
- Has been guilty of repeated defaults.
- The mutual fund or the AMC trustee of that mutual fund indulges in price manipulation affecting the securities market and the investors' interest.
- The financial position of the mutual fund deteriorates to such an extent that the board is of the opinion that its continuance is not in the interest of unit-holders and other mutual funds.

Key Terms Used

Net Asset Value: The net asset value is the market value of the assets of the scheme minus its liabilities. The net asset value per unit on any business day is computed as follows:

$$\frac{\text{Market value of the fund's investments} + \text{Receivables} + \text{Accrued income} - \text{Liabilities} - \text{Accrued expenses}}{\text{Number of units outstanding}}$$

There are certain factors affecting NAV of a fund:

- Sale and purchase of securities
- Sale and repurchase of units
- Valuation of assets
- Accrual of income and expenses.

The regulations governing the accuracy of NAV calculations are as follows:

i. **Accrued Income and Expenses:** The correct accrual of all incomes and expenses is a requirement for computing NAV. In practical terms these are just estimates. For example, the investment manager's fees has to be accrued everyday for computing NAV but the fee is based on weekly average of net assets. Changes in NAV due to the assumptions about accruals should not impact NAV by more than 1%.

ii. **Sale and Purchase of Securities and Units:** The purchase and sale of securities has to be recorded in the books of the fund, and this impacts the net assets of the fund. Sale and repurchase of units alters the number of unit holders outstanding in the fund, and impacts the denominator of the NAV equation.

iii. **Initial Expenses:** When a mutual fund scheme is launched, certain expenses are incurred. These relate to printing and mailing, advertisements, commission to agents, brokerage, stamp duty, marketing, and administration. Known as initial or pre-operational expenses, they are linked to the corpus of the scheme. The fund has to give a break up of these expenses in the prospectus.

iv. **Recurring Expenses:** Apart from the initial expenses, mutual funds incur recurring expenses every year. These expenses include items like the asset management fees, registrar's fees and custodial fees and are charged to the profit and loss account of the scheme.

v. **Sales and Repurchase Load:** Sales or front-end load is a charge collected by a scheme when it undertakes fresh issue of units or shares. Suppose a mutual fund issues Rs.1,00,000 worth units having a face value of Rs.10 each. The company incurs some initial issue expenses, which may be around 1% of the face value, or in other words, the company may levy an entry load. Schemes that do not charge a load are called 'No Load' schemes. Repurchase or 'Back-end' load is a charge collected by a scheme when it buys back the units from the unit holders. It is because of the front-end and back-end loads that mutual fund schemes are at a premium and repurchased at a discount to NAV. Repurchase price is usually less than the reissue price.

Market Price, Redemption Price, Repurchase Price and Sale Price

A close ended scheme has to be necessarily listed on a recognized stock exchange to ensure that its participants enjoy liquidity. Generally, the market price of a close-end scheme tends to be lower than its NAV. If the market price is lower than the NAV, the scheme is said to be selling at a discount. If it is higher, the scheme is said to be selling at a premium. The redemption price is the price at which close-end schemes redeem their units on maturity at NAV related price. In addition to listing, the mutual fund may also offer the facility of repurchase and sale on a continuous basis. The repurchase and sale price is usually linked to the NAV. Unlike a close-end scheme, an open-end scheme is not ordinarily listed on the stock exchange. Hence, the mutual fund has to stand ready to repurchase and sell its units or shares on a continuing basis. The repurchase and the sale prices are of course closely linked to the NAV after adjusting, if any, for repurchase and sales load. The calculation can be done as follows:

Ongoing sales price = Applicable NAV/(1 + sales load)

Repurchase price = Applicable NAV/(1 – exit load)

Rate of Return: The periodic rate of return on a mutual fund scheme is calculated as follows:

Rate of return for the period

$$= \frac{\text{NAV at the end of the period} - \text{NAV at the beginning of the period} + \text{Dividend paid during the period}}{\text{NAV at the beginning of the period}}$$

The compounded annual return on a mutual fund scheme represents the return to investors from a scheme since the date of issue. It includes reinvestment of dividends and makes adjustments for bonus and rights. It is calculated on NAV basis. It reflects the return generated by the fund manager on NAV. In this calculation, it is assumed that the dividend is reinvested at the NAV prevailing on the day it is paid. On price basis, it reflects the return to investors by way of market or repurchase price.

Factors Conducive to the Growth of Mutual Funds

On observing the past trends, it can be seen that certain factors are essential for the growth of the mutual funds industry. These factors are:

INVESTOR BASE

A mutual fund makes it possible for investors to earn a higher return on their capital by pooling the capital of a large number of small investors and investing the pooled sum in a diversified manner. As the small investors cannot diversify on their own, their presence acts as a catalyst for the mutual funds to grow. As different investors have different investment requirements, their presence also acts as an incentive for the mutual funds to come up with new schemes, thus helping in further evolution of the industry.

RETURNS ON MARKET

Mutual funds invest in a diversified manner; the returns generated by them are generally reflective of the market returns. Higher the market returns, higher the expected returns from mutual funds. Higher expected returns attract more investors, giving a boost to the mutual funds.

INVESTMENT AVENUES

The presence of certain investment avenues make mutual funds more attractive than direct investment. One example of such investment avenues is money market instruments. These instruments generally involve a large minimum investment which makes it impossible for a small investor to invest directly. Another example is investment in real estate. While a small investor may not be able to invest in real estate, especially on a diversified basis, internationally, there are mutual funds dedicated to such investments and are called Real Estate Mutual Funds (REMF) such funds are not presently not operating in India. Then there are some investment avenues which require in-depth knowledge of complex instruments, for example, securitized debt, derivatives, etc. Small investors may not have the knowledge to understand the complexities of such instruments on their own, and may find it preferable to depend on the expert knowledge offered by mutual fund managers. The presence of such instruments makes investments flow to mutual funds.

TYPES OF MUTUAL FUNDS

Mutual Funds differ from each other on the basis of various factors like their term, their investment objectives, the type of investors and the load. Given below are the various classes of Funds:

- *Term of the Fund* – Open-ended Vs. Close-ended.
- *Investment Objective* – Growth Funds, Income Funds, Balanced Funds, Specialized Funds, etc.
- *Types of Investors* – Offshore Funds, Pension Funds, etc.
- *Management Style* – Managed Funds Vs. Index Funds.
- *Load* – Load Funds, No-load Funds, etc.

Classification based on Term of the Fund

The basic difference between two Mutual Funds can be their term structure. A Mutual Fund may either be open-ended or close-ended. An open-ended Fund remains open for issue (and redemption) of its units throughout its unlimited duration. Some examples of open-ended Mutual Fund schemes are Alliance-95, Birla Advantage, Canganga, etc. A close-ended Fund can issue units only in the beginning, and cannot redeem them or reissue them till the end of their fixed investment duration. Some examples of close-ended Mutual Fund schemes are BOB EISS-9S, Canpep-9S, ICICI Power, etc.

As an open-ended Fund is required to redeem its units at any time the investors wish to liquidate their holdings, a relatively higher portion of its assets need to be highly liquid. There would be situations where, in a given period of time, the redemptions would be more than the purchases made by new unit holders, forcing the management to liquidate some of the Fund's assets to meet the shortfall. Due to this possibility, an open-ended Fund needs to invest in highly marketable securities. A close-ended Fund does not face this problem, as it does not require redeeming its units before the maturity of the Fund. Hence, it has more flexibility as compared to an open-ended Fund for investing in less readily marketable securities. However, the units of a close-ended Fund generally quote at a discount, for which investments in less marketable securities is partly responsible.

However, nowadays, this distinction is becoming blurred with close-ended Funds being allowed in some countries to redeem a part of their units before the end of the duration, with the redemption being periodic in some cases. In some places, close-ended Funds are even allowed to reissue these redeemed units. Further, internationally, Unit Trusts offer both open-ended and close-ended schemes. Certain close-ended Funds offer their schemes again and again to the investors, making them virtually open-ended.

There are new types of Funds coming up in the international market. One such Fund is the Interval Fund, which is basically an open-ended Fund with redemptions allowed only after pre-specified intervals. An extended-payment Fund allows an open-ended Fund more days for making payment to the investors on redemption of units. Both these kinds of Funds can manage their liquidity better as compared to an ordinary Mutual Fund.

In India, SEBI has specified the following guidelines for open-ended and close-ended Funds:

1. The regulations define a close-ended scheme as any scheme of a Mutual Fund in which the period of maturity of the scheme is specified.
2. An open-ended scheme is defined as a scheme of a Mutual Fund which offers units for sale without specifying any duration for redemption.
3. Every close-ended scheme is required to be listed on a recognized stock exchange within six months from the closure of the subscription. However, such listing is not mandatory where:
   a. The scheme provides for periodic repurchase facility to all the unit holders. In such cases, the Fund is allowed to impose restrictions on the extent of such repurchase.

      Or

   b. The scheme provides for monthly income and offers repurchase of units at regular intervals.

      Or

   c. The scheme caters to special classes of persons like children, widows, etc., and offers repurchase of units at regular intervals.

   Also, the details of such repurchase facility should be clearly disclosed in the Offer Document, and the scheme should open for repurchase within a period of six months from the closure of subscription.
4. A close-ended Fund may redeem its units and reissue them at its choice.
5. A close-ended scheme may be converted into an open-ended scheme, provided its Offer Document discloses such option and the period of such conversion and the unit holders have the choice of redeeming their units in full at NAV based prices.

6. A close-ended scheme is allowed to be rolled over at the end of the maturity period if:

    a. The purpose, period and other terms of roll-over, and

    b. All material details of the scheme, including the likely composition of assets immediately before the roll over, the net assets and the Net Asset Value of the scheme are disclosed to the unit holders and the information is forwarded to SEBI. The unit holders not desiring to opt for the roll-over have to be given the option to redeem their holdings in full at Net Asset Value based price.

7. Both open-ended and close-ended Mutual Funds are not allowed to borrow, except for temporary liquidity requirements for the redemption of units or payment of interest or dividend to the unit holders. This borrowing capacity is limited to 20% of the net assets of a scheme for a maximum period of six months.

Classification based on Investment Objectives

Mutual Funds are formed with different investment objectives as given below:

GROWTH FUND

The objective of Growth Fund scheme is to provide capital appreciation for the medium to long-term investors. These schemes normally invest a major portion of their funds in equities and are willing to bear short-term decline in value for possible future appreciation in the Net Asset Value of the scheme. These schemes are not for investors seeking regular income or needing their money back in the short-term but are suitable for investors in their prime earning years or investors seeking growth over the long-term. Some examples of Growth Funds are Franklin India Prima Fund, Reliance Growth, Prudential ICICI Power Fund.

INCOME FUND

The aim of such Funds is to provide regular and steady income to investors. These Funds or schemes generally invest in fixed incomes such as bonds and corporate debentures. Capital appreciation in such schemes may be limited. These are suitable for retired people and others with a need for capital stability and regular income. Some examples of Income Fund are Sundaram Bond Saver (G), PNB Debt Fund (G), HDFC Income, etc.

BALANCED FUND

The aim of such Funds is to provide both growth and income by periodically distributing a part of the income and capital appreciation to investors or reinvesting (in case of reinvestment scheme) such growth and income and capital appreciation to enhance the Net Asset Value of the Fund. They invest in both units and fixed income securities in the proportion indicated in their Offer Document. Such Funds are suitable for those investors, who are willing to take some risk and seek both income and capital appreciation. Some examples of Balanced Fund are LIC Dhanaraksha 89, Templeton India Pension Plan (G), Canpremium Growth Plan.

SPECIALIZED FUND

These Funds invest in particular industries, instruments, sectors or markets. For example, Funds have their investments in specific industries like UTI Petro Fund, JM Basic Fund, Prudential-ICICI Technology Fund, etc. Then there are Funds, which invest largely in equity instruments, i.e. Equity Fund like JM Equity, or in the debt instruments, i.e., Bond Fund like Kotak Bond Deposit, or in the money market instruments, i.e., Money Market Fund like Kotak Gilt

(Government Securities). The objective of Industries and Equity Fund is to provide capital gains while that of Bond and Money Market Fund is to provide liquidity and income.

Funds that invest solely in foreign markets are referred to as International Fund (also called Off-shore Fund). Some examples of Off-shore Fund in India are India Magnum Fund, LG India Fund, India Liberalization Fund, etc. The majority of such Funds are routed through Mauritius. Funds that invest both in domestic market and international market are referred to as Global Funds. SEBI allowed Mutual Funds to invest in the international market.

Conditions for Investments in ADRs/GDRs/Foreign Securities

a. The Mutual Fund can make investments in –

   i. ADRs/GDRs issued by Indian companies.

   ii. Equity of overseas companies listed on recognized stock exchanges overseas.

   iii. Foreign debt securities in the countries with fully convertible currencies, short-term as well as long-term debt instruments with highest rating (foreign currency credit rating) by accredited/registered credit rating agencies, say A-1/AAA by Standard & Poor, P-1/AAA by Moody's, F1/AAA by Fitch IBCA, etc.

   iv. Government securities where the countries are AAA rated.

   v. Units/securities issued by overseas Mutual Funds or Unit Trusts which invest in the aforesaid securities or are rated as mentioned above and are registered with overseas regulators.

b. The Mutual Fund can invest in ADRs/GDRs/Foreign securities within overall limit of US $4 bn. with a sub-ceiling for individual Mutual Funds which should not exceed 10% of the net assets managed by them as on March 31 of each relevant year, subject to a maximum of US $150 mn. per Mutual Fund.

Internationally, there is a category of Funds that invest in a portfolio of other Mutual Funds. Such Funds are called Multi-Fund.

TAX SAVING FUND

These Funds offer tax rebates to investors under tax laws as prescribed from time to time. This is possible because the Government offers tax incentives for investment in specified avenues. HDFC Tax Plan 2000(G), Escorts Tax Plan (G), and UTI Equity Tax Savings Plan are some of the examples of Tax Saving Fund. The objective of these Funds is to help the tax paying investors to minimize their tax liability.

MONEY MARKET MUTUAL FUNDS (MMMFs)

Money Market or Liquid Fund provide easy liquidity, preservation of capital and moderate income. These schemes invest exclusively in safer short-term instruments such as Treasury Bill, Certificates of Deposit, Commercial Paper and Interbank Call Money, Government Securities, etc. These Funds are appropriate for corporate and individual investors as a means to park their surplus funds for short periods. For example, BoB Liquid Fund (G), Reliance Liquid Fund and Treasury Plan (G).

INDEX FUND

An Index Fund is a type of Mutual Fund that tries to mirror a market index, like Nifty or Sensex, as closely as possible by investing in all the stocks that comprise the index in proportion equal to the weightage of those stocks in the index. Thus, Index Funds are designed to replicate the performance of a well-established stock market index or a particular segment of the stock market. Unlike other types of Mutual Funds, these are passively Managed Funds wherein the Fund Manager invests the funds in the stocks comprising the index in similar proportions. They may, at times, hold their stocks for the full year even if there are changes in the composition of index. This helps in reducing transaction fees. Apart from reduction in risk, the other advantages of this type of Mutual Fund are: (i) facility for indirect investment in blue chip stocks that constitutes the index, (ii) possibility of achieving diversification across a variety of sectors say at least 20-25 sectors, (iii) relatively low cost of management. Index Funds are considered appropriate for conservative long-term investors looking at moderate risk, moderate return arising out of a well-diversified portfolio.

A few Index Funds were launched in the recent past to reduce the bias of Fund Managers in stock selection and to provide a return at par with the index. They are UTI Master Index Fund, UTI Index Equity Fund, Franklin India Index Fund, IDBI Principal Index Fund, etc. Templeton launched the Franklin India Index Tax Fund in February 2001 which is the first tax saving Index Fund based on S&P CNX Nifty. The performance of Index Fund is generally similar to that of their benchmark indices.

EXCHANGE TRADED FUND

Exchange Traded Funds (ETFs) are innovative products, which first came into existence in the USA in 1993. These have gained prominence over the last few years with over $140 billion (as on January 2003) invested in about 280 ETFs in over 30 indices globally. About 60% of trading volumes on the American Stock Exchange are from ETFs. In the US, the major ETFs include the SPDRs (linked to S&P 500), QQQs (linked to Nasdaq 100) and Diamonds (linked to the DJIA).

ETFs provide exposure to an index or a basket of securities that trade on the exchange like a single stock. They have a number of advantages over traditional open-ended Index Funds as they can be bought and sold on the exchange at prices that are usually close to the actual intra-day NAV of the scheme. They are an innovation to traditional Mutual Funds as they provide investors a Fund that closely tracks the performance of an index with the ability to buy/sell on an intra-day basis. Unlike listed close-ended Funds, which trade at substantial premia or more frequently at discounts to NAV, ETFs are structured in a manner which allow it to create new units and redeem outstanding units directly with the Fund, thereby ensuring that ETFs trade close to their actual NAVs.

Like any other Index Fund, ETFs are usually passively Managed Funds wherein subscription/redemption of units works on the concept of exchange with underlying securities. Units can also be bought and sold directly on the exchange. The Funds have all the benefits of indexing such as diversification, low cost, and transparency. As the Funds are listed on the exchange, costs of distribution are much lower and the reach is much wider.

These savings in cost are passed on to the investors in the form of lower prices. Further, exchange traded mechanism helps to reduce the cost of collection, disbursement and other processing charges to the minimal. The structure of ETFs is such that it protects long-term investors from inflows and outflows of short-term investors. This is because the Fund does not bear extra transaction cost when buying/selling due to frequent subscriptions and redemptions. Tracking error, which is divergence between the price behavior of a position or portfolio and the price behavior of a benchmark of an ETF, is likely to be low as compared to a normal Index Fund. ETFs are highly flexible and can be used as a tool for gaining instant exposure to the equity markets, equalizing cash or for arbitraging between the cash and futures market.

Benchmark Mutual Fund launched the first ETF in India, Nifty BeES (Nifty Benchmark Exchange Traded Scheme) based on S&P CNX Nifty in December 2001. It is bought and sold like any other stock on NSE and has all characteristics of an Index Fund. It would provide returns that closely correspond to the total return of stocks included in Nifty. One can buy or sell Nifty BeES in exactly the same way as one buys/sells any share. Each Nifty BeES is approximately 1/10th of the S&P CNX Nifty. Nifty BeES are in dematerialized form and are settled like any other share in T + 2 rolling settlement. ETFs give investors the opportunity to buy or sell an entire portfolio of stocks in a single security, as easily as buying or selling a stock. They offer a wide range of investment opportunities. The BSE has also constituted an ETF called SPICE, which started trading on January 13, 2003. The BSE & Prudential ICICI Mutual Fund conceptualized it as a hybrid product combining the features of both a Mutual Fund and a stock; SPICE was at 1/100th value of the Sensex.

ETFs also offer hedging and arbitrage opportunities. Investors can go long or short in ETFs to hedge against possible losses in equity exposures. There are also real time arbitrage opportunities among cash, futures and ETF markets. Moreover, ETFs have no compulsory redemption dates, allowing investors to hold on to their positions for as long as they want. ETF products are different from an Index Fund in more ways than one. Unlike an Index Fund, where units are issued in return for cash and redeemed as per the NAV value in just cash, an ETF issues units in lieu of units and vice versa; also unlike an Index Fund, ETF unit-holders have beneficial rights in the underlying units that can be redeemed once a week at the NAV based prices. The only exit route in an Index Fund is selling at NAV based prices at the end of a trading session. But ETF unit holders can exit any time during the day and consequently have access to easy liquidity at the market prices. The proponents of ETFs are highly confident about getting a broad-spectrum retail participation in ETF from the secondary market.

LEVERAGED FUND

The investment objective of Leveraged Fund is to increase the value of the portfolio and benefit the unit holders by gains exceeding the cost of borrowed funds. Leveraged Fund engage in speculative and risky investments, like short sales to take advantage of declining market. These are not common in India.

HEDGE FUND

A Hedge Fund can be classified as an alternative investment. Alternative investments are investments other than stocks and bonds. A US “Hedge Fund” usually is a US private investment partnership invested primarily in publicly traded securities or financial derivatives. Because they are private investment partnerships, the SEC limits US Hedge Funds to 99 investors, at least 65 of who must be “accredited”. (“Accredited” investors often are defined as investors having a networth of at least $1 million.) A relatively recent change in the law allows certain Funds to accept up to 500 “qualified purchasers”. In order to be able to invest in such a Fund, the investor must be an individual with at least $5 million in investments or an entity with at least $25 million in investments. The General Partner of the Fund usually receives 20% of the profits, in addition to a fixed management fee of usually 1% of the assets under management. The majority of Hedge Funds employ some form of hedging – weather shorting stocks, utilizing “puts”, or other devices.

Classification based on Types of Investors

There are some categories of Funds that are different from other Funds because of their investor profile. An example of such Funds is Pension Fund. These are the Funds that manage the pension money of their clients. For example, Kothari Pioneer Pension Plan Fund.

Classification based on Management Style

Funds can also be classified on the basis of the way they are managed. The corpus of the Fund may be managed either actively or passively. Active management of Funds involves gathering of security specific information, analyzing it, and selecting those securities that are most expected to fulfill the investment objectives. This process entails a heavy cost that is charged to the scheme. Funds, which manage their corpus actively, are called actively Managed Funds. On the other hand, passive management of funds involves selection of a market index. After an index has been selected, the securities that form a part of the index are bought in the proportion in which they are represented in the index. No further transaction is done and these securities are held till a need to liquidate the corpus arises. If a part of the corpus is required to be liquidated for redemption purposes, it is liquidated in the same proportion in which the securities are held. The cost of managing Funds passively is quite less as compared to active management. Index Funds, which are based on BSE or NSE, are examples of passively Managed Funds.

Index Funds perform in line with the performance of the index, which is reflective of the performance of the market as a whole. Active management of Funds is undertaken with the aim of performing better than the Index Funds. However, empirical evidence suggests that risk-adjusted after-cost returns from actively Managed Funds may not necessarily be higher than the returns from Index Funds. It remains an area of great debate.

Classification on the Basis of Load

A Fund incurs two types of costs – marketing costs and operating costs. While the operating costs of the scheme are charged to the scheme's earnings, the marketing costs may not be so charged. On the basis of chargeability of marketing costs to the scheme, Funds can be classified into load funds and no-load funds. Load funds charge the marketing costs to the scheme, while the no-load funds do not. The no-load funds recover the marketing costs as part of the management fee.

Load funds are of two types – front load and back load. In a front load fund, the load is charged at the time the investors invest in the fund. In the case of back load fund, investors are required to pay the load charges while exiting from the fund.

SEBI has given certain guidelines for load and no-load funds. These are:

i. Schemes may be launched on a "load" basis or on a "no-load" basis. Schemes may also be launched on a "partial load" basis wherein a part of the load would be borne by the scheme and the rest by the Asset Management Company. A "partial load" scheme would be treated as a load scheme for other regulatory purposes.

ii. Schemes may also be launched on a "mixed" basis. It refers to two classes of units being issued in the same scheme – one with load and the other without load. In such cases, the Offer Document is required to contain a worked out example clearly explaining the implications of the load on the NAV.

iii. If the initial expenses of floating a scheme exceed six percent of the initial resources raised under that scheme, such excess is required to be borne by the Asset Management Company.

iv. In case of a close-ended load scheme, the initial issue expenses are required to be amortized on a weekly basis over the period of the scheme. If the scheme provides for a partial redemption during the life of the scheme, the amortization should be done on a weighted basis, with the number of outstanding units determining the weights for the relevant periods.

v. In case of an open-ended load scheme, the initial issue expenses are required to be amortized over a maximum period of five years.

vi. The recurring issue expenses for an open-ended scheme are required to be charged to the scheme in the same year in which they are incurred. They cannot be amortized over a period of time.

vii. In the case of both close-ended and open-ended schemes launched on a load basis, the unamortized portion of the initial issue expenses shall not be deducted from net assets for the purpose of calculation of NAV. However, the deduction has to be made for arriving at the NAV figure in order to determine the maximum management fee payable to the Asset Management Company.

viii. For a no-load scheme, the management is allowed to charge an additional management fee from the scheme up to 1% of the weekly average corpus of the scheme in any financial year.

Further, in such a scheme, the management is entitled to charge a 'contingent deferred sales charge' (in other words, a load) on redemptions during the first four years of the scheme, subject to the following limits:

During the 1st year	Maximum 4% of the redemption proceeds.
During the 2nd year	Maximum 3% of the redemption proceeds.
During the 3rd year	Maximum 2% of the redemption proceeds.
During the 4th year	Maximum 1% of the redemption proceeds.

This provision has been incorporated for giving the management some flexibility for incorporating disincentives for investors coming out of the scheme in the early years.

ix. In the case of a load scheme, the scheme bears recurring selling and distribution charges. In case of a no-load scheme, such charges are to be borne by the Asset Management Company.

The classifications given above are not mutually exclusive. For example, an open-ended scheme may be a growth scheme or an income scheme. Similarly, there can be a Managed Fund with or without load.

LEGAL AND REGULATORY FRAMEWORK

Securities and Exchange Board of India (SEBI) is the apex regulator of capital markets. Issuance and trading of capital market instruments and the regulation of capital market the intermediaries is under the purview of SEBI. SEBI is the primary regulator of mutual funds in India. SEBI has enacted the SEBI (Mutual Funds) Regulations, 1996, which provides the scope of the regulation of mutual funds in India. It is mandatory that mutual funds should be registered with SEBI. The structure and the formation of mutual funds, appointment of key functionaries and investors, investment restrictions, compliance and penalties are all defined under SEBI Regulations. Mutual funds have to send a seven-year compliance reports to SEBI. SEBI is also empowered to periodically inspect mutual fund organizations to ensure compliance with SEBI regulations. SEBI also regulates other fund constituents such as AMCs, trustees, custodians, etc.

RBI is the monetary authority of the country and is also the regulator of the banking system. Earlier bank sponsored mutual funds were under the dual regulatory control of RBI and SEBI. Money market mutual funds which invested in short-term instruments were also regulated by the RBI. These provisions are no longer in vogue. SEBI is the regulator of all mutual funds. The present position is that RBI is involved with the mutual fund industry, only to the limited extent of being the regulator of the sponsors of bank-sponsored mutual funds. Specifically if the sponsor has made any financial commitment to the investors of the mutual funds, in the form of guaranteeing assured returns, such guarantees can no longer be made without the prior approval of the RBI. RBI will review the financial condition and capital adequacy of the sponsored bank, before permitting it to make such guarantee.

RBI is the issuer of government securities and also the regulator of money market. Mutual funds invest in these securities and are affected by the RBI stipulations on the structure pricing and trading of these instruments. For example, recently RBI has decided that non-banks would be phased out of the call money markets, over a period of time. This decision impacts mutual funds ability to invest in call markets. The finance ministry is the supervisor of both the RBI and SEBI. The Ministry of Finance is also the appellate authority under SEBI regulations. Aggrieved parties can also make appeals to the MOF on the SEBI rulings relating to mutual funds.

The AMC and the trustee company may be structured as limited companies, which come under the regulatory purview of the Company Law Board (CLB). The provisions of the Companies Act 1956, are applicable to these company forms of organizations. The CLB is the apex regulatory authority for companies. CLB is also the appellate authority for all issues relating to the Companies Act. Any grievance against the AMC or the trustee company can be addressed to the CLB for redressal. The Registrar of Companies (ROC) oversees the compliance by the AMC and trustee company, with the provisions of the Companies Act. Periodic reports and annual accounts have to be filed by these companies with the ROC. The Department of Company Affairs (DCA) is responsible for the formulation and modification of the laws relating to companies, including the Indian Companies Act. The DCA also has the powers to prosecute directors for non-compliance with provisions of the Act.

If a mutual fund has listed its scheme on stock exchanges, such listings are subject to the listing regulation of stock exchanges. Mutual funds have to sign the listing agreement and abide by its provisions, which primarily deal with periodic notifications and disclosure of information that may impact the trading of listed units. Since mutual funds are structured and registered as public trusts, under the Indian Trusts Act they also come under the regulatory preview of the office of the public trustee, which in turn reports to the charity commissioner. The board of trustees and the trustee companies have to comply with the provisions of the Indian Trusts Act.

Investing in Mutual Funds: Understanding the Process

The mutual fund is required to file with SEBI a detailed information memorandum, in a prescribed format that provides all the information about the fund and the system. This document is also called as the prospectus or the offer document, and is very detailed and contains most of the relevant information that an investor would need. An abridged version of the offer document, in a prescribed format, is appended to the application form. Investors can get a summary of the offer document, in the abridged version, which is also called as the key information memorandum. Investors have the right to ask for a free copy of the offer document.

The offer document is very detailed and can run into 100 pages or more. It usually contains all information about the scheme that is being sold, namely, the objective of scheme, the asset allocation, sale and repurchases procedures, the load and expense structure, and the accounting and valuation policies. Apart from this core information, the offer document also contains details regarding the structure of the mutual fund, it's constituents, and the performance of existing schemes of the mutual fund. Its also contains operational details about how to apply and what the investors' rights and obligations are.

The offer document is very important to an investor for the following reasons:

Information about the product and its attributes are in the offer document. Therefore it forms the basis for the investors' decisions. Offer document is a legal document that specifies the particulars of the offer made by mutual fund and before buying the mutual fund product an investor must read and understand the terms of the offer. The following are the summary contents of the offer document:

Primary Information

- Summary information about the mutual fund, the scheme and the terms of the offer.
- Mandatory disclaimer clauses as required by SEBI.
- Glossary of terms in the offer document, which defines the terms used.
- Standard and scheme specific risk factors pertaining to the scheme being offered.

Fund-specific Information

- Constitution of fund, details of sponsor, trustees and AMC.
- Financial history of sponsor for 3 years in summary form.
- Details of Director of boards and trustees of the AMC.
- Details of the fund constituents.

SCHEME ATTRIBUTES

Fundamental attributes of the scheme. This includes type, investment objective, investment pattern, and terms of the scheme with regard to liquidity, fees and expenses, valuation norms and accounting policies and investment restrictions, if any.

The cover page of the offer document contains the following information:

- Name of the mutual fund.
- Name of the scheme.
- Type of scheme.
- Name of AMC.
- Classes of units offered for sale.
- Price of units.
- Name of the guarantor in case of assured return schemes.
- Opening, closing and earliest closing date of the offer.
- Mandatory statements.

The following mandatory statements should appear in the offer document:

A statement to the effect that the offer document sets forth consistently, the information about that the prospective investor ought to know before investing, and that the offer document should be retained for future reference.

A statement to the effect that the scheme particulars have been prepared in accordance with SEBI (Mutual Fund) Regulations, as amended till date and filed with SEBI, and the units being offered for public subscription have not been approved or disapproved by SEBI nor has the SEBI certified the accuracy or adequacy of the offer document.

There are certain standard risk factors involved. Mutual fund and securities investments are subject to market risks and there is no assurance or guarantee that the objective of the mutual fund will be achieved. As with any investment in securities, the NAV of units issued under the scheme can go up or down depending on the factors and forces affecting capital markets. It should be clearly stated past performance of the AMC/mutual fund/sponsor does not indicate the future performance of the scheme and the name of the scheme does not in any manner indicating either the quality of the scheme or its future prospects and returns.

Since the offer document is very detailed, it is not feasible for mutual funds to provide them to all prospective investors. SEBI regulations allow mutual funds to summarize the key points in a summary document called as the key information memorandum. It is mandatory that the key information memorandum is made available to all investors along with the application forms. SEBI does not approve or disapprove anything contained in the offer document. Mutual funds have to get the terms of all their schemes approved by SEBI, and have to file the offer document with SEBI. The offer document has to be prepared according to the format and norms laid down by the SEBI Regulations. SEBI only verifies whether all the necessary disclosures have been made and whether the terms of the offer are clearly defined so that investors can take an informed decision. The contents of the offer document are verified by the trustees and the compliance officer signs the document, certifying that the information contained therein is true and fair and is in accordance with SEBI regulations. The compliance officer has to also certify that the constituents of the fund are all SEBI registered entities. The AMC is responsible for the contents and the accuracy of information in the offer document.

Investors can buy the units of a mutual fund. The number of units bought by an investor represents his holdings in a mutual fund. The price, at which each unit is being sold, is announced by the mutual fund. This is called as the sale price. For example, a new mutual fund scheme usually offers units at a price of Rs.10 each. An investor wanting to invest Rs.1,000 in this scheme, will buy 100 (1000/10) units. In the existing mutual fund scheme, the price is announced by the mutual fund everyday, and is based on the NAV of the fund. The investor can either buy a fixed number of units, or can invest a fixed sum of money. For example, if the sale price of XYZ equity fund was Rs.23.49 an investor wanting to buy 1000 units will be able to do so, by investing Rs.23,490. On the other hand, if the investor decides Rs.25,000 given the price, he will be allotted 1,064.2826 units (25,000/23.49). This calculation assumes that there is no sale load applicable to the investor.

There is a minimum amount to be invested in mutual funds. All mutual fund schemes specify the minimum amount that has to be invested, and the multiples thereof. For example, if a mutual fund may specify that minimum investment is Rs.1,000 and subsequent investments have to be in multiples of Rs.500. These restrictions are usually not applicable to inter-scheme and inter-option switches and reinvestment. For example, consider an investor having 100 units invested at Rs.10 each, and having chosen the dividend reinvestment option. If the fund declares a dividend of 15%, the amount eligible for reinvestment is Rs.150 (Rs. 1.50 x 100). These dividends will be re-invested, though they are lower than the minimum investment of Rs.500.

If a scheme is open-ended, the investor can invest on any given day, at the price quoted by the mutual fund. Usually mutual funds have a distribution network, made up of distributing agents, investor service center and branch networks. An investor can buy units of the fund from any of these agencies, who sell units on behalf of the mutual fund.

If the fund is close-ended, the mutual fund has an initial offer period. During this period, investors can buy units at a price that is fixed, for the whole period. In many cases the price is Rs.10 or Rs.100 per unit. After the closure of the initial offer, the mutual fund closes further direct sales to investors. Investors who want to invest in a closed-ended fund, after the initial offer period, have to buy units from the stock markets. Close-ended funds have to list their units on a stock exchange to enable this. In the financial papers, the quoted price of traded mutual funds is usually published. However, it is quite possible that units are not regularly traded on the stock exchange, resulting in units not being available when an investor wants to buy them.

There are four channels that are currently used for the distribution of mutual funds:

- Individual Agents
- Distribution Companies
- Banks and Non-banking Financial Institutions
- Direct Marketing Channels.

Mutual funds have their own internal guidelines on the appointment and terms distributing agencies. There are at present no mandatory registrations for distributors. There are also no regulatory requirements regarding who can be an agent or the fees and commissions payable to them. Mutual funds agents' commission has two components. Initial commission and trial commission. Initial commission is paid as fixed percentage of amount mobilized by the agents. Some agents tend to pass on the initial commission to the investors in the form of an incentive or rebate. Trail commission is paid periodically, on the funds that remain invested in the scheme. Every agent has a unique number by which he is identified. This number is quoted on the application forms collected by him. Mutual funds pay trail on the period for which an investor bought in by the agent, stay invested in the scheme. Trail is effective way to restrict the practice of rebating and link commissions to the period for which fund mobilized are actually available to the mutual fund. The rates of commission are decided by the mutual funds themselves, and are not subject to regulations of SEBI or AMFI.

Eligibility to Buy Mutual Fund Units

Mutual funds usually specify in their offer documents the categories eligible to invest in a given scheme. Usually all categories of investors except for foreign nationals and entities are eligible to apply. However there can be special schemes for specific categories which are not available for other categories of investors. For example, a fund may have special scheme for trusts and charitable organizations in which other categories are not eligible to apply. In some cases, the minimum investment limit is very high, intending to attract institutional and large investors. The following categories of investors are eligible:

1. Resident individuals
2. Indian companies
3. Indian trusts and charitable institutions
4. Banks
5. Non-banking financial institutions
6. Insurance companies
7. Provident funds
8. Non-resident Indians
9. Overseas corporate bodies
10. SEBI registered foreign institutional investors.

Agents should check the list of eligible investors, before accepting an application form from a prospective investor.

DOCUMENTS RELATING TO OWNERSHIP

In terms of practice that has evolved in the mutual funds industry, mutual funds have stopped issuing certificates to investors, in their open-ended schemes. Investors instead get an account statement, which shows their holdings and the price at which they were bought. Mutual fund holdings of an investor are identified by the account number. Investors can, if they wish, consolidate their holdings in a mutual fund across various schemes and receive a consolidated account statement. The account statement is computer generated and has no signature. It is also not an instrument that can be traded or transferred. It is a very safe way of holding mutual fund units. The account statement shows the holding details, the number of units outstanding and the value of the holdings. All transactions relating to purchase of units, redemption of units, dividends, re-investment etc., are shown in the account statement. The investors' holdings in a mutual fund scheme on a particular date are also called as outstanding holding. This means on that date, the investor is due to receive value for the given number of units against his name. Along with the account statement, mutual funds also provide transaction slips, which enable investors to buy more units, or sell whole or part of their holdings. An investor can however demand to receive a certificate by writing to the registrar. In a close-ended fund investors usually receive certificates as proof of purchase. These certificates are negotiable instruments, and can be transferred from one person to another. When an investor buys units in the market, the seller will pass on the certificate to the buyer, by signing on the reverse. The buyer then has to lodge the certificate with the registrar and the transfer agent, who will register the buyer and his holdings in the mutual fund's books. Certificates usually have an account number, a distinctive number and the certificate numbers for the units actually held. The details of holding are printed on the certificate. Certificates can be issued in market lots of 50 units each, or as a consolidated Jumbo Certificate.

The application form, signed by the holders, is equivalent to acceptance of the offer of the mutual fund, and is the legal document of the transaction. The mutual fund has to provide all relevant information, state all rights and obligations in the offer document which is legal document of offer. The mutual fund is expected to specify the terms, and the investor is expected to read, understand and sign the application forms, in acceptance of the offer. A mutual fund may be able to absolve itself of the legal responsibilities, by disclosing its position in the offer document. An investor cannot claim ignorance of such a provision, after having signed the application forms. The application form binds the investor as having read and understood the terms and conditions of the offer and the formal willingness to abide by such terms and conditions. The disclosure norms for the offer document ensures that all relevant information required for an informed decision by an investor are provided in the offer document and that such information is correct, authentic and verified.

The frequency of the account statement is stated in the offer document. In most cases, investors receive an annual statement if there are no transactions in a year. For every transaction during the year, namely, sale or purchase of units, re-investment of dividends, etc., and the updated account statement is sent to the investor. In modern times mutual funds have provided investors the facility of phone service and internet service. Investors can check the balances in their accounts and effect transactions through the phone and the internet.

It is possible for multiple owners to hold units jointly in mutual funds. Every holding in a mutual fund can have up to 3 joint holders. The first holder is entitled to receive all the information and notifications, as also the dividend payments and the redemption process. Investors can specify the nature of joint ownership which can be on "joint basis" or on "either or survivor basis". If ownership is on joint basis redemption requisition has to be signed by all holders. In the case of "either or survivor" basis, it is sufficient if one of the holders signs the redemption request. The redemption proceeds however, are payable only to the first holder, in both cases.

The application form contains certain information about the investor. The information includes name, address, telephone and other contact details, occupation, age and the name of the guardian in the case of minor. They seek information to ascertain the tax status of the investor, namely residential status, whether individual, Hindu Undivided Family etc., in order to know the obligations of mutual fund with regard to tax deduction at source. Some mutual funds seek more information about the investor to profile their clients. Mutual funds require investors to provide bank details in the application form. This is to enable electronic transfer of dividend and repurchase proceeds without risk of loss from theft or cheques.

PRECAUTIONS FOR THE INVESTOR

Most important of all, there are certain precautions investors should take while investing in mutual funds:

- Always the investor should keep a photo copy of the application form. This can be filed to know the manner in which application was made (single, joint ownership and order of ownership). Investors will also be able to see how they have signed the forms (many investors change their signatures over time; some investors use both Hindi and English signatures; some investors have different signatures for banking and investment transactions). Investors will also know the choice they have exercised (dividend and redemption option).
- The investor must preserve the counterfoil/acknowledgement issued by the collecting agency. This acknowledgement has the application number. If account statement or certificate is not received, the acknowledgement is the proof of purchase, with which investors can approach the registrar and the transfer agent.
- It is preferable to have joint ownership so that investments will pass on to the joint owner in the event of death of the first holder.
- It is important to fill up the nomination details in the application. This will enable legal heirs to claim the holdings without procedural delays. Nominations that do not indicate the guardian of a minor are not valid. Guardian indicated will have to be a person other than the holders of the investment.
- Cheques should be crossed and application number and name should be written on the back of the cheque. Most mutual funds do not accept outstation cheques, post-dated cheques or postal orders.
- Existing investors can quote their unique account numbers so that their holdings will be consolidated. This is helpful in tax matters and in keeping investment information in a consolidated manner.

There is a minimum period for which an investor has to stay invested in a mutual fund. Mutual funds usually do not have lock in periods, during which time investors cannot exit the fund. Mutual funds may create products with lock in periods. Repurchase information can be found in the offer document. There are two normal situations when investors are restricted from exiting the fund:

1. An open-ended fund may announce an initial offer period, during which time it will only sell units. There may be no repurchase during that period. The fund will announce a date from which further sales and repurchases will take place.
2. Some special fund schemes can be designed to have a minimum period of investment. For example, investments in special 'Equity Linked Savings Scheme' are eligible for tax rebate. In order to enjoy the tax rebate, the investor is required to stay invested for a minimum period of 3 years. In an extraordinary situation, mutual funds can, with notice to the investors through a national daily, impose temporary lock in periods. Investors have to check the offer document to see if the mutual fund has sought such a right for itself.

If the fund is open-ended, the investor has to send the repurchase requisition slip, duly completed and signed, to the registrars and transfer agents. In modern times, it is possible to lodge repurchase requests on the internet also. If the fund is close-ended then the investor should send the original certificate, discharged by signing on the reverse, to the registrar and the transfer agent.

Investors have to provide bank details for all repurchase requirements, so that the amount can be directly credited. Where cheques are issued, they are issued with the bank details printed on them. This is to prevent fraudulent encashment of repurchase cheques. It is a mandatory SEBI requirement that redemption cheques are issued with bank account details of the investor printed on them. In an open-ended mutual fund the holdings of the investor are maintained in fractions, up to 4 decimal points. Mutual fund units can therefore be bought and sold by investors in fractional terms, subject to conditions if any, on minimum amounts to be invested. Mutual funds may also like to stipulate the minimum lot in which repurchases have to be made. Investors should look for this information in the offer document.

Investors can use the proceeds from a repurchase to buy units of another scheme of the same fund or units of another fund. Buying units of one scheme by repurchasing the units of another scheme is called switching. The switching options to an investor depend on how his account is serviced. If the account is serviced through a bank, which specifically offers the services of inter-fund switch, investors can buy units of another mutual fund. In all other situations, repurchase is routed through the registrar and the transfer agent. Though the same registrar and transfer agent may be handling the accounts of many mutual funds, they usually treat inter-fund switches like separate repurchase and sale, for which they require separate instructions from the investor.

If the investor wants to buy units of another scheme of the same fund, most funds allow such switch to take place easily. In many cases, there are lower loads or no loads at all on such switches. Many funds also provide option of automatic switches between schemes as special products to investors. Using these schemes, for example, investors can re-invest the periodic dividends from an income fund into an equity fund of the same mutual fund. Many mutual funds identify investors with account numbers/units, which help them to consolidate holdings and also effect switches quickly.

RIGHTS OF INVESTORS

There are certain rights enjoyed by the investors with respect to service standards that they can expect from mutual funds:

- Investors are entitled to receive dividends declared in a scheme, within 30 days.
- Redemption proceeds have to be sent to the investor within 10 business days from the date receipt of such request by the AMC. Delays in this respect will lead to the AMC paying a penal interest on the proceeds at a rate specified by SEBI from time to time. (The current rate is 15% and is to be borne by the AMC or sponsor and not the fund).
- If an investor fails to claim the dividend or redemption proceeds he has the right to claim it up to a period of 3 years from the due date at the then prevailing NAV. After the expiry of this period, investors will be eligible to receive the NAV prevailing at the end of the 3rd year.
- Mutual funds have to allot units within 30 days of the IPO and also the scheme for redemption if it is open-ended scheme.
- Mutual funds have to publish their half-yearly results in at least one national daily, and publish their entire portfolios at least once in six months. Such disclosure should be done within 30 days from the six monthly account-closing dates of the fund.
- Trustees will have to ensure that any information having a material impact on the unit holders' investments should be made public by the mutual fund.

- If 75% of the unit holders' so decide:
  - A scheme can be wound up.
  - Meeting of the unit holders can be called.
  - Appointment of the AMC of the mutual fund can be terminated.
- If there is any change in any fundamental attribute of a scheme the unit holders have to be notified through a letter. They also have the right to repurchase at NAV without any load, before such a change is effected.

Unitholders have the right to inspect the following documents:

- Copies of the trust deed, investment management agreement and agreements with fund constituents.
- Memorandum and Articles of Association of the AMC.
- Unabridged balance sheet of the mutual fund schemes, sponsor and the AMC.
- Text of the SEBI Regulations.

There are certain limitations to the rights of the investors:

- Investors cannot sue the trust, as they are not distinct from the trust which is only the registered owner of their funds.
- Investors can lodge complaints against trustees or the AMC. Investors can also lodge complaints with SEBI for non-compliance with SEBI regulations by sponsors, AMC or the trustees.
- Investors cannot be compensated if the performance of the fund is below expectations. Investors have to fully bear the risks associated with the schemes. Only explicit guarantees provided in the offer document by sponsor or AMC is enforceable under law.
- There are no legal remedies to a prospective investor. In order to enjoy any of the above rights, he must be registered investor with the fund.

Taxation of Mutual Funds

Open-ended Mutual Funds are exempt from income tax under Section 10(23D) of the Act.

Table 1: Tax Impact on Various Mutual Funds

	Securities Transactions Tax (STT)	Dividend Distribution Tax (DDT)	Long-Term Capital Gains (LTCG)	Short-Term Capital Gains (STCG)
In case of Equity-oriented Mutual Funds	The unit holders will have to pay STT at the rate of 0.125 percent at the time of purchase and sale of units.	STT is payable by MF and not by investor. MF has once again been exempted from DDT.	No LTCG tax is payable. Exempt u/s 10(38).	STCG is taxable at 10 percent + Sur Charge (SC) + Education Cess (EC).
In case of Debt oriented Mutual Funds	The unit holders will not have to pay STT.	DDT is 12.5 percent in case payee is individual or HUF, and 20 percent if the payee is corporate or other person as firm etc.	The LTCG tax rate is 20 percent with indexation or 10 percent without indexation, whichever is less.	STCG is taxable as per normal tax rate i.e. 10 to 30 percent as the case may be.

	Securities Transactions Tax (STT)	Dividend Distribution Tax (DDT)	Long-Term Capital Gains (LTCG)	Short-Term Capital Gains (STCG)
Non-delivery based transactions; as day trader, arbitrageur or future and options	STT is 0.025 percent in case of day traders, etc., and 0.017 percent in case of derivatives. But credit for the same can be taken from normal income tax.	DDT is not applicable, as these traders do not take delivery.	Not applicable as the profit is taxable as business profits, so tax rates are normal rate of taxation.	Not applicable as the profit is taxable as business profits, so tax rates are normal rate of taxation.
Delivery based transactions (in case of investor in securities)	The tax rate is now proposed at 0.0125 percent, payable by both the buyer and the seller upon delivery of the securities.	Companies have to pay DDT at 12.5 percent and dividend is exempted in the hand of payee as per Section 10(34).	No tax payable on LTCG.	Tax is payable @ 10 percent on STCG + SC + EC.
Delivery based transactions (in case of dealer in securities)	The STT is now proposed at 0.0125 percent, payable by both the buyer and the seller upon delivery of the securities. But credit for the same can be taken from normal income tax.	Companies have to pay DDT at 12.5 percent and dividend is exempted in the hand of payee as per Section 10(34).	Not applicable as the profit is taxable as business profits, so tax rates are normal rates of taxation.	Not applicable as the profit is taxable as business profits, so tax rates are normal rates of taxation.
In case of non-listed shares	STT is not payable, as they are not traded on stock exchange.	Companies have to pay DDT @ 12.5 percent and dividend is exempted in the hand of payee as per Section 10(34).	LTCG is payable at 20 percent.	STCG is taxable as per normal tax rate, i.e. 10 to 35 percent as the case may be.

Source: Business World, September 6, 2004.

Load

Load is the factor that is applied to the NAV of a scheme to arrive at the price. If a commission is paid to agents to bring in new business this represents the cost incurred by the mutual fund for additional sale. The fund may therefore decide that investors who are already in the scheme need not bear this cost. Therefore, it may decide to impose this cost on the new investors by increasing the price at which they can buy units. This is called the sales load. Similarly, if an investor stays in a fund for a short while and decides to repurchase his units, the fund may incur some costs in liquidating the portfolio and paying off this investor. The fund may want to impose the cost of this operation on the exiting investor in the form of a load. This is called an exit load.

Load is a percentage adjustment to the NAV. If there was no load, investors will be able to buy and sell their units at the NAV. However, if there is an entry load, new investors will pay price that is higher than the NAV to the extent of the load. Similarly, investors who exit will take away a sum that is lower than the NAV to the extent of the load.

Mutual funds have a choice. Mutual funds may decide to impose no loads or only the sales load or the exit load. If there are no loads, then the costs associated with sales and repurchases are being borne by the AMC, and not imposed on the mutual fund scheme. In some cases, mutual funds may decide that the exit load will depend on the period for which the investor has stayed in a scheme. The longer the investor stays, the lower the load. This system is to ensure that short-term investors pay a higher load than long-term investors.

Regulation section 49(3) of SEBI (Mutual Funds) Regulations, 1996 has laid down certain parameters for the determination of sale price and repurchase price of mutual funds. Some of the mutual funds use two methods for the sale and repurchase NAV computation that led to variations in the amount payable to the investors or the number of units allotted to them. SEBI decided that a uniform method shall be used for the computation of sale and repurchase prices. The following are the formulas that shall be used:

Sale Price = Applicable NAV $\times$ (1 + sales load)

Repurchase Price = Applicable NAV $\times$ (1 – exit load)

If the applicable NAV is Rs.12 and sales or the entry load is 3% and the exit or repurchase load is 2% then the sale price will be Rs.12.36 and the repurchase price will be Rs.11.76.

Maximum Load

SEBI regulates the maximum load that a mutual fund can charge. There are 2 regulatory requirements:

- The sale price cannot be more than the NAV by more than 7%; and
- The repurchase price cannot be less than the NAV by more than 7%. That is, the maximum load can be only more than 7%.

The above two points mean that the 7% limit applies to the sale and repurchase price, though the fund is free to impose the load on either of them or both. For example, if the NAV is Rs.10, the mutual fund can charge a sale price not higher than Rs.10.7 or a repurchase price that is not lower than Rs.9.3. However, mutual funds cannot charge these two prices. If the sale price is Rs.10.7 the repurchase price cannot be lower than Rs.9.95 (Rs.10.7 $\times$ Rs.0.93). If the repurchase price is Rs.9.3 the sale price cannot be higher than Rs.9.95 (Rs.9.3 $\times$ Rs.1.07). In the case of close-end funds the regulatory limit is a 5% load. The sale and the repurchase price cannot be more/less than the NAV by 5% of the NAV.

Equity Markets and Mutual Funds

The investment pattern in a mutual fund depends on investment objective. The AMC team includes the research analysts, fund managers and dealers appointed by AMC itself. The fund manager is held responsible for all the investment decisions taken and also takes decision on the investment pattern, of the scheme based on the objectives of the scheme. Information with regard to various investment opportunities are provided by the research team and the dealers implement the decision of the fund manager. The fund manager uses both primary and secondary markets for actually investing the funds. The deals are placed through the fund's brokers and the custodians take care of the back office operations involved in the investment decisions. The research team evaluates the features of the stocks and recommends the same to the fund managers. The various types of equity research include the following:

A study of the earnings potential of a company by taking into consideration various factors which have an impact on the performance of the company is called Fundamental Analysis. Similarly, a study of historical price and volume traded data of a company in order to recognize the behavioral patterns of prices that are used to predict the future of the share prices is called Technical Analysis. The use of mathematical models for arriving at the valuation of companies and the influence of various factors impacting the performance of the company is Quantitative Analysis.

Return on Investment in Mutual Funds

The following are the methods for computing the returns on mutual fund products:

- Percentage change in NAV.
- Simple total return.
- ROI or the total return with dividend reinvestment.

PERCENTAGE CHANGE IN NAV

Percentage change in NAV is an absolute measure of return, which finds the NAV appreciation between two points of time, as a percentage. For example, if the NAV of a fund was Rs.46.90 at the beginning and Rs.55.30 at the end of the year, the percentage change in NAV

$$= \frac{\text{Rs.}55.30 - \text{Rs.}46.90}{\text{Rs.}46.90} \times 100 = 17.91\%$$

The general formula is: $\frac{\text{Absolute change in NAV}}{\text{NAV at the beginning}} \times 100$

SIMPLE TOTAL RETURN

The total return method takes into account the dividends distributed by the mutual fund and adds it to the NAV appreciation to arrive at returns.

Suppose an investor bought units of a mutual fund scheme at a price of Rs.12.45 per unit. The face value of the unit is Rs.10. He redeems the investment a year later at Rs.14.80 per unit. During the year, he also receives dividend at 5%. The rate of return on his investment can be computed as follows: –

$$\frac{\{(\text{Rs.}14.8 \; - \text{Rs.}12.45) + \text{Rs.}0.50\}}{\text{Rs.}12.45} \times 100 = 22.89\%$$

The amount (Rs.14.8 – Rs.12.45) represents the capital gains earned by the investor. 0.50 is the dividend amount received, which is 5% of Rs.10, the face value of the unit. The rate of return is the percentage return the investor makes on his investment of Rs.12.45 from these two sources.

TOTAL RETURN WITH DIVIDEND REINVESTMENT

In this method, assumption is made that dividends are re-invested into the scheme as soon as they are received at the then prevailing NAV. Total return with reinvestment is calculated as follows:

$$\left(\frac{\text{Value of holdings at the end of the period}}{\text{Value of holdings at the beginning of the period}} - 1 \right) \times 100$$

Value of the holdings at the beginning of the period = Number of units at the beginning $\times$ Beginning NAV.

Value of the holdings at the end of the period = Number of units held at the beginning + Number of units reinvested) $\times$ NAV at the end.

Number of units reinvested = Dividends/ex-dividend NAV.

An investor buys 75 units of a fund at Rs.9.5 on Jan.1, 2001. On June 30, 2001 he receives dividends at the rate of 10%. The ex-dividend NAV was Rs.10.25. On December 31, 2001 the fund's NAV was Rs.11.25.

The beginning value of the investment is Rs.9.5 $\times$ 75 = Rs.712.50

No. of units reinvested = 75/10.25 = 7.31

End period value of investment = 82.31 $\times$ Rs.11.25 = 925.98

The Return On Investment (ROI) is = {(925.98/712.5) – 1} $\times$ 100 = 29.96%.

PERFORMANCE ANALYSIS OF MUTUAL FUNDS

Benchmarks are independent portfolios and a representation of behavior of returns from the market. They are not managed by fund managers. In simple words, a standard for evaluating the performance. To better understand the concept of benchmark it is very important to know the job of a fund. For example, the S & P CNX Nifty is a portfolio of 50 securities traded on the National Stock Exchange. The BSE Sensitive index is a portfolio of 30 securities traded on Bombay Stock Exchange. The movement of these indices represents the movement in prices and returns on the stocks traded in the equity market. Suppose an investor invests in a index fund – he will compare the return from index fund with the return from the equity market. If the fund manager is managing an equity portfolio, which invests only in equity but is not an index fund, investors may want to know his performance compares with an independent portfolio like the Nifty or the Sensex. These independent portfolios which are used to understand fund manager performance are called benchmarks.

The benchmark for every kind of mutual fund scheme could be different. It is more important that the benchmark portfolio matches the mutual fund portfolio in objectives and is representative of the returns and risk of the market in which the mutual fund portfolio is invested. For example, if the objective of mutual fund is to invest only in information technology stocks, the appropriate benchmark is an index of technology stocks rather than broad market index. If the mutual fund invests 50% of its fund only in equity and the rest in debt, the benchmark should also be a combination of an equity index and a debt market index in the same proportion. If the mutual funds invest in money market, the benchmark should comprise of money market instruments. Thus, it is important that benchmarks that are chosen for evaluating the performance of the mutual funds are appropriate.

Mutual Funds in India

The Mutual Fund industry started with the setting up of Unit Trust of India. The money market mutual fund segment has a total corpus of $1.48 trillion in the USA against a corpus of $100 million in India. The entry of private sector and foreign institutions in 1993 provided a boost to the Indian mutual fund industry in the form of different schemes launched. The Government of India took the initiative of developing mutual fund industry by offering various tax soaps in the budget and enabling it to play an important role in mobilization of savings and in the development of the financial market.

Till 1960s, the Indian mutual fund industry was not in existence. In 1963, the Government of India took the initiative by passing the UTI Act, under which the Unit Trust of India was set-up as a statutory body. The designated role of UTI was to act as a mutual fund. This was expanded in 1985 to make UTI a financial institution as well. UTIs first scheme called the US-64 which was an open-end scheme was launched in 1964. It subsequently launched a number of schemes to suit the differing needs of the investors. Till 1987, UTI was the only mutual fund in the market since no one else was legally allowed to set-up mutual funds. In 1987, the public sector institutions like banks, financial institutions and insurance companies started establishing mutual funds, following the government's decision to allow them to do so. State Bank of India became the second one to launch a mutual fund when it launched the SBI mutual fund in November, 1987. It was followed by Canbank Mutual Fund, LIC Mutual Fund, etc. In this regulated area, UTI was acting more as a vehicle for the implementation of the economic policies and the development activities of the Government than as an investment vehicle for the investors.

Finally in 1992, the Government allowed private sector players to set up mutual funds. Subsequent to this, a number of private sector mutual funds came up. A few of them are Kothari Pioneer MF, ICICI MF, Birla MF, Morgan Stanley MF, and Tauras MF. As the number of mutual funds increased giving a choice to the investors, the competition in the industry has also increased, thus jolting the hitherto complacent public sector mutual funds into action. As a result, the investors not only had a wider choice regarding the kind of schemes and the sponsor of the mutual fund they started getting better service even from the old players. These private sector funds provided an added advantage to the investor. These were generally set-up in partnership with foreign mutual funds, with the latter providing the technology and the experience in managing funds. The investors could derive the consequent benefits by investing in these funds.

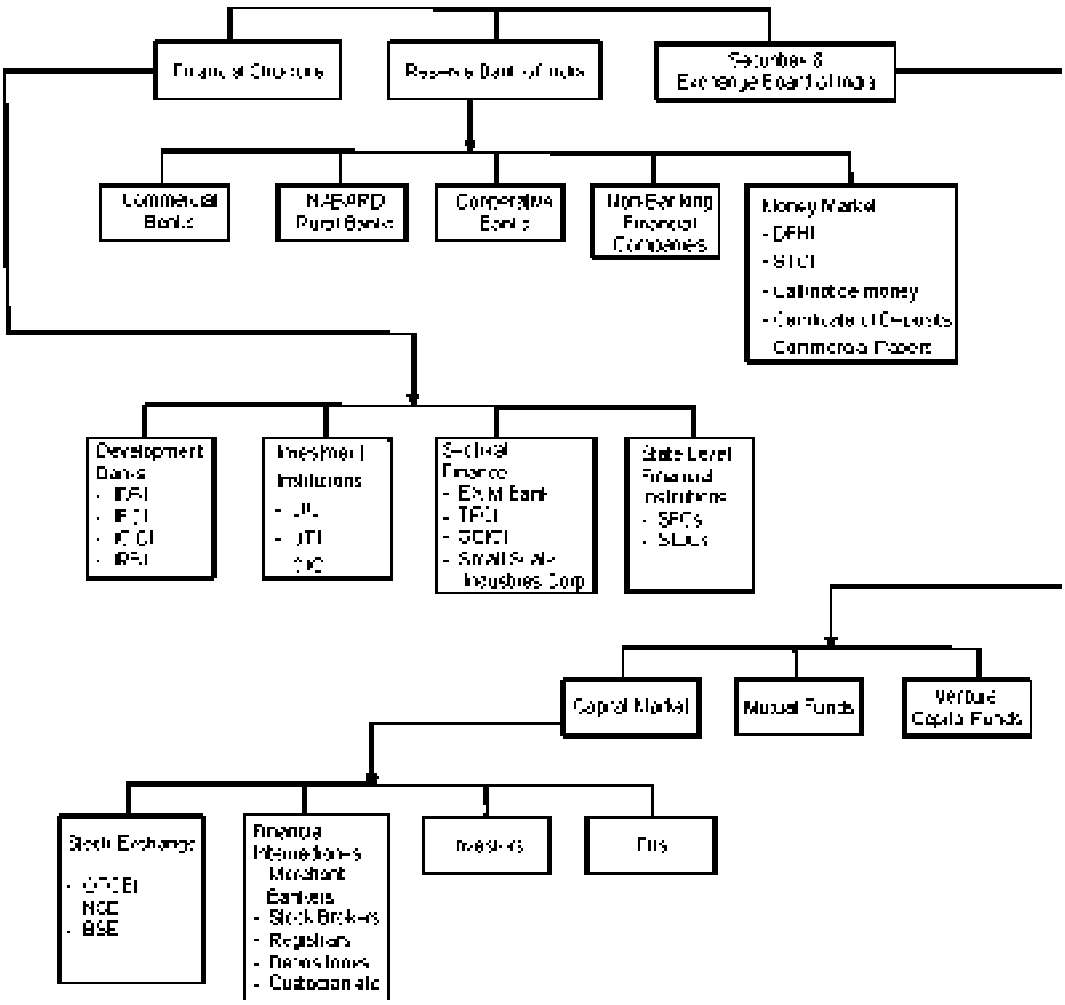
In India, both close-ended and open-ended investment companies are called mutual funds. Except the Unit Trust of India all mutual funds in India are organized and set-up under the Indian Trust Act as Trusts. Their role is to accept savings from the investors and invest the same as per the objectives incorporated in the next trust deed to manage diversified portfolio for the investors.

Role of Mutual Funds in Financial Markets

Indian financial institutions play a vital role in asset formation, intermediation and contribute substantially in microeconomic development. In the process of development, Mutual Funds play an important role in bringing stability and liquidity in the financial market, and this has been proved in the developed countries like the United States, the United Kingdom and Japan.

Classification of Indian financial system is given in Figure 2 below.

Figure 1: Financial System of India



Source: Mutual Funds and Investment Portfolio by Dr. J.C. Verma.

India is in the initial stages of a revolution that has already peaked in the United States. In the United States, the asset base of Mutual Funds is much higher than its bank deposits. In India, Mutual Funds assets are only 10 percent of the bank deposits; but this trend has begun to change in the last few years. Mutual Funds in India have emerged as strong financial intermediaries and are playing a very important role in bringing stability to the financial system and efficiency to resource allocation. Mutual Funds help corporates to raise funds for their financial needs and provide an avenue of investment to investors to park their savings. This leads to an overall growth of the economy. The major chunk of household savings in India, which earlier went to bank deposits, is now being taken up by Mutual Funds. Recently, the Government has announced that dividends from domestic companies and Mutual Fund units will be tax-free in the hands of shareholder/ investor; this gave a boost to Mutual Fund Industry. Also TDS (Tax Deducted at Source) provisions on bank deposits is a move which makes investment in debt and Mutual Funds more attractive as no TDS rules are applicable here. All these steps help to move the funds from bank deposits to the capital market through the Mutual Fund schemes.

Table 2: Comparison of Investment in Banks Vs. Mutual Funds

	Banks	Mutual Funds
Returns	Low	Better
Administrative Expenses	High	Low
Investment Options	Less	More
Network	High Penetration	Low but improving
Liquidity	At a Cost	Better
Quality of Assets	Not Transparent	Transparent
Interest Calculation	Minimum Balance between 10th and 30th of Every Month	Everyday
Guarantee	Maximum Rs.1 Lakh on deposit	None

Source: www.pwcglobal.com

The active involvement of Mutual Funds in promoting economic development can be seen not only in terms of their participation in the savings market but also in their dominant presence in the money and capital market. A developed financial market is critical to overall economic development, and Mutual Funds are playing an active role in promoting an active healthy market. Mutual Funds increase liquidity in the money market. The assets holding pattern of Mutual Funds in India indicates their dominant role in the money and capital market. Indian Mutual Funds strongly support the debt market. While non-UTI Mutual Funds tended more towards equities and debentures, the UTI due to its special structure, has rendered better support to Government securities market. The private corporate sector in India is a deficit sector and the gap between demand and supply of financial resources is met by funds raised through loans, advances and issuance of securities. However, the buoyancy in the capital market during the ’90s has increased the reliance of the corporate sector on security financing. The changing pattern of corporate financing indicates that the banking sector is losing its importance vis-à-vis the ‘other financial sector’ (including Mutual Funds). Direct financing by Mutual Funds to the corporate sector has substantially increased after the SEBI guidelines allowed the corporate sector to reserve 20 percent of public issues for Indian Mutual Funds. Mutual Funds have also widened the private placement market for corporate securities. Mutual Funds have enabled the corporate sector to raise capital at reduced costs and have opened an avenue for alternate source of capital.

SUMMARY

- Mutual Fund is considered as one of the important tools of financial planning. It can be described as the foundation and building block for any type of financial plan relating to time, i.e., long-term or short-term, high or low-risk and for different clients such as retail, affluent or institutional.
- The transactions of mutual funds are generally very large. These large volumes attract lower brokerage commissions and other costs when compared to the smaller volumes of the transactions entered into by individual investors.
- Mutual funds generally offer a number of schemes to suit the requirements of the investors. Thus the investors can choose between regular income schemes and growth schemes, between schemes that invest in the money market and those that invest in the stock market.
- A mutual fund makes it possible for investors to earn a higher return on their capital by pooling the capital of a large number of small investors and investing the pooled sum in a diversified manner.
- The presence of certain investment avenues makes mutual funds more attractive than direct investment. One example of such investment avenues is money market instruments. These instruments generally involve a large minimum investment which makes it impossible for a small investor to invest directly.
- A close-ended scheme may be converted into an open-ended scheme, provided its Offer Document discloses such option and the period of such conversion and the unit holders have the choice of redeeming their units in full at NAV based prices.
- The objective of Growth Fund scheme is to provide capital appreciation for the medium to long-term investors. These schemes normally invest a major portion of their funds in equities and are willing to bear short-term decline in value for possible future appreciation in the Net Asset Value of the scheme.
- An Index Fund is a type of Mutual Fund that tries to mirror a market index, like Nifty or Sensex, as closely as possible by investing in all the stocks that comprise the index in proportion equal to the weightage of those stocks in the index.
- Exchange Traded Funds (ETFs) are innovative products, which first came into existence in the USA in 1993. These have gained prominence over the last few years with over $140 billion (as on January 2003) invested in about 280 ETFs in over 30 indices globally.
- Leveraged Fund engage in speculative and risky investments, like short sales to take advantage of declining market. These are not common in India.
- A Hedge Fund can be classified as an alternative investment. Alternative investments are investments other than stocks and bonds.
- Securities and Exchange Board of India (SEBI) is the apex regulator of capital markets. Issuance and trading of capital market instruments and the regulation of capital market the intermediaries is under the purview of SEBI.
- Load is a percentage adjustment to the NAV. If there was no load, investors will be able to buy and sell their units at the NAV. However, if there is an entry load, new investors will pay price that is higher than the NAV to the extent of the load.

Chapter XV

Retirement Planning

After reading this chapter, you will be conversant with:

- The Basics of Retirement Planning
- Sources of Retirement Income
- Types of Annuities and Annuity Schemes
- Potential of Pension Funds

Introduction

Retirement planning is a process of arranging one's finances so that one can achieve his or her financial and personal goals in retirement. Retirement planning starts with defining one's needs, objectives or goals and current situations. Once the goals are established, the financial planner will prepare a broad strategy based on these goals. A comprehensive plan is implemented which takes into account the current needs as well as the retirement objectives. Plans for retirement is not something that takes place the year before retirement, but involves long-term plans and effort to implement the dreams. Retirement plan determines estimation of retirement income. This income does not accumulate overnight. It involves three things:

Goals: It involves setting realistic objectives for retirement. A vision of what the retirement income should be, the standard of living to be maintained.

Financial Arrangements: Involves the lifestyle required for retirement. If the lifestyle is too rich then arrangements should be made to meet the budget.

Discipline: There should be a certain discipline to be maintained to save for rich lifestyle during the course of working career.

THE BASICS OF RETIREMENT PLANNING

Overview of Retirement Planning

It used to be that retirement was not a serious issue because people never expected to live beyond fifties. If there occurred any financial emergency like medical expenses or any other expenses mounted beyond expectations then the children were assumed to take the role of financial caretaker. But now, the view of retirement planning has changed radically over the past 50 years. This is prim due to change in the life expectancy and also the belief that the best of the years to be spent is the retirement age. Retirement is considered as the age to travel, leisure and realizing the dreams. Retirement planning is a very important phase of personal financial planning. It largely depends on the portfolio of savings and investments.

Deciding when to begin retirement life is a big question. Individuals are so much involved in issues like buying a house, changing jobs or starting a family that no time is found to decide on when to start retirement. Irrespective of age and financial picture, planning for retirement should not be ignored. Power of compounding becomes beneficial when early retirement planning is made.

Retirement goals should be set in a realistic manner. The retirement goals should be reviewed annually by a knowledgeable and experienced retirement professional. The sooner an individual starts planning for retirement the better it is. Without planning it is not possible to meet both financial and non-financial goals. Planning allows assessing situations and identifying potential problems. Advanced planning allows improving the situation and helps in dealing the potential problems in an improved manner. Therefore savings earlier rather than late will help in accumulating funds for retirement. This can be illustrated with an example:

Monthly Savings to Accumulate Rs.1,00,000	
Number of Years Before Retirement That You Start Saving	Monthly Savings Required to Accumulate Rs.1,00,000 (8% interest)
10	Rs.550
20	Rs.170
30	Rs.70
40	Rs.30

Importance of Retirement Plans

Retirement is an important phase for financial and physiological circumstances for employees, productivity issues for the employers and social implications for the government. Therefore people should prepare themselves properly and analyze their requirements after retirement. First step in analysis is when they are planning to retire, whether to retire before or during the normal retirement age, whether to leave the work immediately or slowly but surely, whether to join any other work etc. The individuals should be aware of what they are planning to do after retirement, what is the standard of living they like to maintain, and the benefits and protection they would like to keep or lose etc.

It is important for employers to help their employees for their retirement. Government should encourage employees and the employers for preparation of retirement, promote the availability of alternative options available for retirement. To maintain the standard of living pension plans must be encouraged and facilitated.

1. **Early Retirement Plan is very Important to Avail the Advantage of Time Value of Money:** If from age 25-65 years, one invests Rs.5,000 per month @ 9%, at the age of 65, he or she would have a savings of Rs.24,00,000 in the retirement fund. But here the question arises – why think about retirement at an early age?

   - People are spending more time in retirement, say, 16-20 years of life after retirement.
   - Private pension and government benefits are not sufficient to maintain and cover the standard of living.
   - Inflation is a big question. Therefore it may be assumed that inflation may diminish the purchasing power of retirement savings.

2. **Conducting a Financial Review in Retirement Planning:** Review of assets like housing or land: if it is owned, probably the single and the biggest asset. Or else if there is large equity then it can be converted into an annuity mortgage or sold and the proceeds invested for regular income. If there is any asset in the form of life insurance, then the cash value of the life insurance can be converted into annuity. Other form of assets like stocks and bonds should also be reviewed.

3. **Estimation of Retirement Expenses:** Spending patterns keep fluctuating. There may be expenses which may be reduced or increased. Expenses like formal clothes may be reduced and more casual outfits may be preferred. Federal income taxes may be probably lower. Housing expenses may be paid off but insurance and house tax may go up. Miscellaneous expenses like gifts, medical expenses, health and life insurance, expenses for leisure activities etc., may go up.

4. **Planning for Retirement Housing:** Deciding where to live and considering the cost and standard of living and other expenses. Needs keep changing, therefore, deciding on the type of house required to live. Staying at their present houses is what most people prefer.

   There are certain tips to be followed for retirement planning:

   - One should recognize the importance and the need for retirement planning.
   - Current assets and liabilities need to be analyzed.
   - An estimation of retirement spending needs should be made.
   - Retirement housing needs to be identified.
   - Retirement income should be determined.
   - Based on the retirement income one should prepare a balanced budget.

SOURCES OF RETIREMENT INCOME

No one can really predict the amount of social security benefits that will be paid 30-40 years from now. Social security is viewed as a foundation of ones' retirement income. People who earn more than their normal wage base will be entitled for a lower percentage of Post-retirement benefit or wages. But this lower percentage is availed through social security. There are three sources of retirement income for the retired people. They are social security, investments in stocks, bonds and pension plans. The amount received retirement depends on a number of variables, the most important of which is pre-retirement earnings. The social security includes retirement benefits, disability income, pension, etc. Social security retirement benefits include basic social security benefits that are very important to the retired people and their dependents. In other words they include the following: old age benefits and survivors' benefits.

Old Age Benefits: Workers, once they reach the age of 65, and if they are fully covered under social security, will start receiving old-age benefits. But if one retires earlier say at the age of 62 then he or she may receive a reduced benefit that is 80% of the full amount. If the retiree has a spouse of 65 years or older, then the spouse may be entitled to benefits equal to one-half of the amount received by the retired worker. If both husband and wife are salaried then in such a case both may be eligible for social security benefits. When they retire they can avail the retirement benefits in two ways: (1) Avail the benefits to which each is entitled from his or her account. (2) Take husband and wife benefits and benefits of the higher-paid spouse. If each takes his or her own full share then there will be no spousal benefits; therefore it will be more effective to take the benefits of the higher-paid spouse.

The flag of life insurance reached Indian shores during the rule by East India Company. We cannot, at the same time, forget that our own society had already developed a potent instrument to provide social security in the shape of *"Joint-Family System"* whose utility cannot be underestimated. When the modern concepts of insurance were not known, the joint family system in our country looked after all members, widows or orphaned children included, very effectively. But with the slow but steady abuse and disintegration of that system, emergence of life insurance became inevitable alternative to provide social security to the families of deceased individuals.

Survivor's Benefits: The spouse is eligible to receive survivor's benefits from social security if a covered worker dies. These payments include a small lump sum payment and monthly benefit checks. The eligibility of a surviving spouse includes that he or she must be at least 65 years of age or should have a dependent and unmarried child of the deceased worker in his or her care. For qualifying for full benefits the surviving spouse must be at least 65 years of age, reduced benefits are payable between ages 60 and 65. If the children of the deceased worker are 16 years of age and the spouse is less than 60 years of age, then the monthly benefits cease and do not resume until he or she turns 60. This period is called widow's gap.

TYPES OF ANNUITIES AND ANNUITY SCHEMES

Annuity literally means an Annual Payment, but can be described as periodical payments depending on the status – time or life. In the Indian context, annuity and pension can be considered synonyms. An Annuity contract providing for payment of the periodical payment for a certain number of years is known as *Annuity Certain*. In such contracts, the Purchase Price (also called Consideration Amount) paid is returned with interest in installments. Every such annuity payment contains a Capital content and Interest content. The great advantage of Annuity Certain is the absence of risk of losing capital. The great disadvantage is that the periodical payment will stop automatically at the end of the selected term, when probably the need for income is higher.

Different Types of Annuities

Annuities can be classified into several groups based on –

a. Commencement of Annuity Payments

b. Premium Payment Methods

c. Number of Annuitants

d. Refund Feature.

There are two types of annuities depending on the time when the annuity payment begins. They are (a) Immediate Annuity and (b) Deferred Annuity.

Immediate Annuity: Under Immediate Annuity, the first benefit payment is due one payment interval from the date of purchase of the annuity. If the interval chosen is *monthly,* the first payment will be due one month from the date of payment of the purchase price. Similarly for other intervals like quarterly, half-yearly or yearly chosen by the annuitant. This annuity is always purchased with a single premium.

Deferred Annuity: Deferred Annuity can be purchased with either a single premium or periodic payment of premiums. Here the annuity payment begins certain number of years after the commencement of the contract. If the purchase price is not paid in one lump sum (i.e., single premium) at the commencement, the same can be paid in installments (premiums) spread over the deferment period. Such installments can be equal or unequal. The annuity payment commences after the deferment period.

Life Annuities can be purchased with either *Single Premiums* (i.e., full purchase price is paid at the commencement of the contract) or *Periodic Payments* (either equal or unequal). But in no case, the insurance company commences payment of the annuity till the Purchase Price is received in full.

Annuity payments can be made with reference to a single life or more than one life. In the latter case, the contract is called Joint-Life Annuity. The two important types of such contract are the Joint-Life Annuity or Joint and Survivor Annuity, whereunder annuity payments continue till the second annuitant is alive.

An Annuity contract can also provide refund of a part of or full purchase price. There will be variations depending on the obligation of the insurer before and after commencement of annuity payments.

Some of the Annuity Plans

Let us now discuss some of the annuity plans of the Life Insurance Corporation of India. One very important feature of the annuity plans of LIC of India is that, unlike the foreign insurance companies, no distinction is made between Male and Female annuitants in respect of the rates of annuities.

i. **New Jeevan Akshay (Immediate Annuity):** The purchase price is payable in lump sum and the annuity payment commences one year, six months, three months or one month after the date of purchase. The payment ceases with the last installment falling due prior to date of death of the annuitant. If so desired by the annuitant, payments can be made certain for 5, 10, 15 or 20 years and thereafter so long as the annuitant is alive.

   The rate of annuity (per annum) per Rs.1,000 of purchase price for an immediate annuity (without any certain period) varies from Rs.122.50 for age 40 to Rs.152.00 for age 60. If the annuity is guaranteed for say 10 years and payable thereafter till death of the annuitant, the rate of annuity varies from Rs.122.00 for age 40 to Rs.144.20 for age 60. The same rates are applicable to male or female annuitants.

ii. **New Jeevan Dhara (Deferred Annuity):** Under this plan, premium can be paid in a single sum at the commencement of the policy or in installments spread over the deferment period. The maximum deferment period allowed is 25 years.

The single premium or the periodical payments accumulate to what is called "*Cash Option*" at the end of the deferment period. The annuitant has the option either to take the cash option on the deferment date in cash or allow it to be converted into an annuity as an Immediate Annuity (without any certain period) or an Immediate Annuity (with certain period of 5, 10, 15 or 25 years and then till death of the annuitant). The rates of annuity are the same as mentioned in respect of New Jeevan Akshay Policy above.

In case of the death of the annuitant during the deferment period, the following payments are made by the LIC of India to the legal heirs:

a. *Death Within the First Three Years*: Total amount of premiums received or the single premium will be refunded (without interest).

b. *Death After the First Three Years but before the Deferred Date*: Total amount of premiums received or the single premium with an interest of 3% compounding yearly.

iii. **Immediate Annuity (with return of purchase price):** LIC of India also offers an immediate annuity plan with a Refund Feature. In case of death of the annuitant, the purchase price is refunded. The annuity rate per Rs.1,000 of purchase price varies from Rs.111.70 at age 40 to Rs.120.00 at age 60.

iv. **Deferred Annuity (with return of 'cash option'):** LIC of India also offers a deferred annuity plan with a Refund Feature. Upon the death of the annuitant, the notional cash option is refunded. The rates of annuity per Rs.1,000 of cash option are the same as mentioned in (iii) above.

v. LIC of India also offers Annuity Certain plans as Immediate Annuity or Deferred Annuity. In the case of annuity certain, a single premium is payable and in respect of Deferred Annuity, premiums can be paid in lump sum or in installments spread over the deferment period. Annuity is guaranteed for a certain period of years only from 5 years to 20 years.

Under Immediate Annuity Certain Policy, the rates of annuity for a purchase price of Rs.1,000 vary from Rs.236.95 for a guaranteed period of 5 years to Rs.96.35 for a guaranteed period of 20 years. Under Deferred Annuity Certain, the rates of annuity for a cash option of Rs.1,000 vary from Rs.245.50 for a guaranteed period of 5 years to Rs.99.85 for a guaranteed period of 20 years.

In respect of both these annuities certain, payments are not linked to the longevity of the annuitant.

vi. **Jeevan Sarita:** This is a Joint-Life Last Survivor Annuity with Insurance Protection and Return of Corpus. The benefits (Death or Maturity) are payable partly in lump sum and partly in the form of life annuity with return of the corpus.

vii. **Jeevan Suraksha:** Generally, annuities do not cover risk of death or disability. But the Jeevan Suraksha Plan is an exception. This is a Deferred Annuity Plan and can be given with or without life cover. The Annuitant can pay a Single Premium at the commencement of the Policy or in Yearly, Half-yearly, Quarterly or Monthly installments spread over the deferment period. From the Vesting Date, normal pension (a life annuity) calculated on the Cash Option (i.e., accumulation of premiums on the Deferred Date) will be paid. The following additional options also are available to the annuitant on the Vesting Date:

a. Annuity can be guaranteed for 5, 10 or 15 years and life thereafter, or

b. Annuity payable for lifetime only, or

c. Annuity for life with return of purchase price on the death of the annuitant, or

d. Joint-Life and Last Survivor Annuity under which 50% of the Normal Annuity will be paid to the spouse on the death of the annuitant.

The Annuitant may also exercise an option to receive 25% of the cash option in lump sum on the deferred date in which case the balance of the cash option will be converted into an annuity of his choice.

If the Annuitant dies during the deferment period, 50% of the Normal Annuity the Annuitant would have received from the Vesting Date will be paid to the Spouse, if the Policy is with Life Cover. If the Policy is taken without life cover, premiums paid are refunded, without interest, if death takes place within the first three years and with interest if death takes place after three years.

LIC of India has also introduced an Endowment Type of Funding under Jeevan Suraksha Policy. The Deferment Period (Minimum 5 years and Maximum 35 years) will be the term under this Endowment Type variation of the Policy. In case of death of the policyholder during the deferment period, the sum assured with any additions will be utilized to purchase an annuity to the spouse. There is an option to the spouse to commute 25% of the death benefit, in which case the balance of the lump sum will be converted into an annuity. On Maturity, the policyholder will have the option to commute 25% of the Maturity Benefit (Sum Assured and any additions), in which case the balance of the amount will be converted into an annuity. If the commutation option is not exercised, the full maturity benefits will be converted into an annuity.

Variable and Fixed Annuities

Annuities are a method of controlling the risk that a person may live long enough to run out of money. Life insurance protects an individual if he dies too early; and annuities protect an individual if he lives too long.

The investor gives money to the insurance company. The insurance company puts that money in its investment portfolio. A 'Fixed Annuity' is one in which the insurance company takes the investor's money, invests that money, and then agrees to pay the investor a specified and predetermined monthly amount of money beginning on a certain date. A 'Variable Annuity' is one in which the investor agrees to let the amount of monthly payout depend on the performance of a specific insurance company portfolio. The payout will vary depending on the performance of the investment portfolio.

When payout begins, the amount that the Fixed Annuityholder receives will already be predetermined. The payout of the Variable Annuityholder will continue to vary based on the continued performance of the investment portfolio.

This risk to the variable annuityholder is called 'investment risk'. The period of time in which the individual is putting money into the annuity is called the 'Accumulation Period'. The period of time in which the individual is receiving the payout is called the 'Annuity Period'. Because of the investment risk inherent in variable annuities, they are declared as a security. Only a stockbroker can sell them. Also, both types of annuities are insurance products and the broker selling them must also have the appropriate insurance licenses. A fixed annuity is not a security. With a fixed annuity, the insurance company incurs the risk. No matter how badly their investment portfolio performs, the annuitants are still guaranteed a certain payout.

Normally, variable annuities are long-term in nature and used for retirement planning. Usually, the insurance company's objective with this type of investment portfolio is long-term capital growth. Normally, all the proceeds from the insurance company's policyholders go into the 'General Account'. This general account is invested quite conservatively. However, the money received from variable annuityholders goes into a different account. This account is called the 'Separate Account'. The separate account is invested less conservatively than the general account.

An Annuity Alternative to Variable and Fixed Annuities: There is an alternative to either/or of variable and fixed annuities. This is called the 'Combination Annuity'. It is partly fixed and partly variable. This type of annuity will allow the individual to receive his annuity partly of in a fixed manner and part of it will be variable. The benefit of this type of annuity is that it takes some of the uncertainty out of having only a variable annuity. The percent in each part of the annuity can be set to each individual's needs. It does not have to be 50/50. It could be 75/25 or any other combination the annuitant feels comfortable with. One of the other benefits of this type of annuity is that it will protect the investor from a disinflation period.

There are six options allowed to the annuitant or his spouse (in case of his death) regarding the type of annuity:

i. Pension for life

ii. Pension guaranteed for 5 years and then for life

iii. Pension guaranteed for 10 years and then for life

iv. Pension guaranteed for 15 years and then for life

v. Pension for the life assured reducing to 50% to the spouse on the death of life assured

vi. Pension for life with return of purchase price.

Pension market in our country is still in the incubation stage. The Government of India has already started feeling the heat with respect to the Pension payable to their employees on superannuation. The Government's liability on this account has increased from 6% of GDP to 8%. The society is also aging. At present only 6% of the population is above 60 years of age. This is likely to increase to 12% by the year 2010. The social consequences of these demographic changes are of serious concern. Various social security measures will have to be initiated. Government by itself cannot bear the entire burden. The recent experience in the United States of America is also a trend setter. Slowly and steadily the people of America have been moving towards personal funding of pensions away from dependence on their Government. In fact the total premium collected in the USA in the Pension Market is many times more than the life insurance premiums collected. In our country also the Government has already set up an expert committee to study the entire situation and make recommendations regarding the creation and development of Pension Market in the country. There are already suggestions that there should be a separate Regulatory Authority for Pension Market. The private insurance companies who made their entry into insurance market are eagerly awaiting the release of Regulatory guidelines and norms by the Government of India for tapping the pension market. Mean while we should await the types of Pension Products which will enter the market, it will be educative to study some of the Products available in foreign markets.

The Indian Psyche

It was observed that in spite of the great need for pension plans, the funds under annuities of LIC of India constitute hardly 5% of the total Life Fund. This only shows that the Pension market is not just underdeveloped but remains virtually untouched in our country. Various reasons are ascribed for this failure.

One of the main reasons is what we may call "the Indian psyche." Once the annuity payments commence it just continues throughout the life time of the annuitant. There is no option to foreclose it and take the surrender value. The normal Indian tendency is to look with suspicion any 'lack of option'. This makes many shy away from purchasing an annuity. It is rarely realized that the absence of the option to foreclose the policy and take the surrender value provides immunity against pressures to part with one's life time savings.

Traditionally we had the joint family system. A hundred years ago, the rates of mortality as well as the birth rate were very high and life expectancy was well below 50. That is, the number of dependent old persons to the number of active young persons would have been quite low. With the rate of mortality at the beginning of 21st Century being less than 20% of that at the beginning of 20th Century and gradually reducing birth rate, this ratio is getting dramatically altered. The younger generation may, therefore, find it increasingly difficult to support the older generations. It means that each generation has to build up a fund to take care of their needs after retirement. This fund is known as the Pension Fund. Awareness has to be generated that every one should start contributing to this fund right from the time he/she takes up an employment or starts earning. Only such awareness can ensure social stability.

The Pension funds generate social stability not only by ensuring the independence of each generation from the succeeding generations but also by raising the general level of the economy. The potential of the Pension Market, its importance to the economy and the likely strategies of the new entrants to penetrate this dormant market cannot be overlooked.

POTENTIAL OF PENSION FUNDS

To assess the potential of the pension market, one will have to assess the premium income likely to be generated in this segment. The premium amount a person can pay is a proportion of his/her income.

Let us take an example. As per the Income Tax returns filed for the financial year 1993-94 (Assessment Year 1994-95), the total income of those who filed the returns was Rs.70,000 crore. Let us take that out of this, Rs.30,000 crore pertain to the individual salaried persons (who already may be having some retirement benefit), Public Sector Undertakings and Public Limited Companies. The balance Rs.40,000 crore pertain to (a) Partnership/Proprietary firms, and (b) Professionals and other self-employed persons. This is the segment that has virtually remained untapped and therefore, should constitute the target group for the Pension Market. There are many others who do not file tax returns, probably because they do not attract tax. There are many others who do not disclose some part of their income. Taking all these into consideration, the real income of these target groups can be taken as Rs.60,000 crore. The above is an estimate for the year 1993-94. But we have to consider the income for the year 2001-2002, the first year in which the private insurance companies were functioning. Assuming a rate of growth of 10% (slightly higher than the average rate of inflation), a conservative estimate of the income would be about Rs.1,25,000 crore. With a proper marketing strategy, 5% of this can be diverted towards premiums under Pension Products. Let us also safely assume that in the first year of their operation, the companies can procure only 1% (Rs.1,250 crore) and gradually rise this to 5% within 10 years.

The share of 'premiums under pension plans', in the total income will grow at the rate of 17.5% during the first 10 years. The total income of the segment will also be growing under the effect of industrial growth and inflation. Assuming this growth rate to be 10%, the combined effect of these two growth rates, the premium income under pension products is likely to grow at the rate of 27.5% per annum. The overall cost ratio can be taken as 10% and yield is likely to be 10%. During the first 10 years, the outgo in the form of Pension Payments will be negligible. Based on these reasonable assumptions, the Pension Fund at the end of 10 years from now will be approximately Rs.55,000 crore and the premium income in the tenth year alone will be of the order of Rs.11,000 crore. By the end of 15th year the pension fund will exceed Rs.1,50,000 crore, assuming that the share of premiums under pension products will not grow beyond 5% of the total income. It took four decades for LIC of India to reach this level in respect of its Life Fund.

Impact of Pension Funds on the Economy

What will be the impact of this on the national economy? The Pension Funds are not just long-term but very long-term funds. They are ideal for investment in infrastructure projects, which are necessary in developing countries. The development of infrastructure will accelerate industrial growth and generates additional income and employment. This again increases the premium income under both life insurance and pension plans. The all-round growth resulting from this beneficial cycle will bring about social stability.

The size of private pension funds (i.e., pension funds managed by employers for the benefit of their employees and funds managed by Insurance Companies) in UK is US$ 1,050 billion. It is only a fraction in our country. One may feel that a developed and a developing country are not comparable directly. It is, however, to be remembered that the number of persons in India who can afford to purchase pension policies will be higher than the population of UK.

In view of the immense advantages to the individual and the society through pension funds, it is necessary that the Government should also come out with sufficient tax concessions. In UK, for example, any individual who is self-employed or employed in a non-pensionable job or employed in a pensionable job but does not want to join his employer's scheme can avail of personal pension schemes marketed by life insurance companies. Contributions (or Premiums) to these schemes qualify for tax relief up to 17.5% of the relevant earnings, with higher percentages applying to those aged 36 and over. There is a cap of Pound Sterling 60,000 on the 'relevant earnings' per annum.

In India, all contributions paid by an individual whether to a Pension Scheme or purchase of an individual annuity qualify for a tax relief up to 20% of the contributions. These contributions together with many other forms of savings totaling up to Rs.60,000 in a year qualify for this tax relief. In the year 1987, the Government took the first concrete step to encourage contributions to pension schemes when it declared that premiums paid under the two annuity plans of LIC of India viz., Jeevan Dhara and Jeevan Akshay will qualify for a tax relief up to Rs.10,000 under Section 80 CCA. But, instead of improving upon it, further, the Government withdrew that concession within five years and also allowed the said policy owners to surrender their policies. Again in the year 1996, the Government took the initiative in reintroducing the tax concession, this time under Section 80 CCC (1) of the Income Tax Act. Taking advantage of this concession, LIC of India introduced a well-designed and attractive Pension Plan, Jeevan Suraksha. It is to be seen as to what further initiatives the Government will take in the days to come to promote the Pension Market in the country.

Pension and Employee Benefit Funds

The origin of pension funds can be traced to the late 1800s, but it is their tremendous growth in the last 25 years that established them as one of the most influential institutional investors in the United States. Pension and Employee benefit funds dominate the investment scenario of the United States, the United Kingdom, Japan and Canada. Almost 90% of the pension funds in Japan, the United Kingdom and Canada are mid-size and large private and public sector employee funds. Their benefit plans are defined. However, in the United States this percentage is around 80%.

The asset allocation structure for pension funds can differ for both a country and type of plan. Exact data for the various employee benefit funds across several countries is difficult to collect. A brief outline is given below:

a. The highest equity exposure of 65 percent of total assets is found in the United Kingdom pension funds, where 10 percent of the funds are invested in real estate.

b. Japanese pension funds devote least to equities, with 25 percent in common stock and 3 percent in real estate.

c. North American pension funds typically fall in between the above two extremes with public sector funds investing lower amounts (30% – 40%) than private sector funds (50% – 60%) for defined benefit plans.

It is found that, when individuals have choice in deciding the contribution of the pension plans, they prefer asset mixes with high proportion in guaranteed investment contracts floated by life insurance companies (60% – 70%). In the last 25 years, the attention towards pension funds came mainly from interested parties like executives, actuaries, consultants, investment managers, accountants and the investment professionals, regulators and legislators. The fundamental rule of the investment business is to know one's client, as the investment manager will not be able to properly manage the assets of the clients without a thorough understanding of their needs. To understand the nature of a pension fund client, we have to understand two basic types of pension arrangements: (1) Defined benefit (2) Defined contribution. There can be more types of pension funds plans like stakeholders' pensions, pensions by self-employed, group pension schemes, personal pension.

Company Pension Schemes: There are two types of company pension schemes:

Defined Benefit Scheme is one which pays a regular income in retirement, which is normally a portion of the salary last drawn. The main income is two-thirds of the final salary.

A Defined Contribution Scheme is one which provides an income that is dependent on how much one's contribution grows in value. Here the pension is based on the amount of contribution paid and the return generated from the installments. In other words, it means that pension will be low if investment returns are poor or if the contribution value is eroded by losses or other factors.

As a member of defined benefit scheme or defined contribution scheme, ones' contribution should not exceed 15% of their earnings. But in reality the contribution levels usually range from 3% to 5% of earnings. Sometimes group personal pension schemes and stakeholder pensions are sponsored by employers but do not form the part of company pension scheme.

Group Personal Pension Scheme: It operates more or less like individual personal pensions, usually offering lower charges. When employers do not wish to manage their own schemes, they often set up group personal pension arrangements. Just like the defined contribution schemes, the benefits are based on contributions made by an individual and his employer, together with investment returns achieved.

Stakeholder's Pension Scheme: Since April 2001, all employers were supposed to make a stakeholder pension as a default scheme available for staff who does not qualify for the company scheme. It offers an inexpensive savings options and in time may replace define contribution arrangements.

The features of stakeholders' pension

- CAT marking which means low costs, easy access and fair terms.
- Available to employed and self-employed.
- Either supervised by trustees or run by an authorized stakeholder manager either in the style of occupational pension or personal pension.
- Up to 10% of stakeholder contributions can be earmarked for life assurance benefits.
- Contributions are always paid net of basic rate tax irrespective of employment status.
- Stakeholder pension providers reclaim the tax deducted.

Personal Pensions: They suit those people who are self-employed and have no other way of providing a pension apart from a stakeholder plan and those who are employed but do not have the option of joining a company's scheme or do not want to join a stakeholder scheme. When a personal pension is availed, one aims to make regular contributions from his/her earnings which the pension provider invests that contribution, any contributions by the employer, plus the return on investments make up a pension fund. A statement is usually sent showing the growth of the fund. Each year, 17.5% is paid to an individual's pension on the net relevant earnings. As it gets older the percentage increases to 40%. Any contributions made to personal pension plan attract tax relief. The US at the age of 50, one can begin drawing benefits. Unlike occupational pensions, this does not depend on whether or not one is retired. On retirement, one can take up to 25% of the fund from a personal pension plan as a tax-free lump sum. The level of personal pension will depend on the following factors:

- How much money was contributed and the term of contribution.
- The level of charges made by the pension provider.
- The performance of the investments on the pension plan.
- Prevailing rates of annuity at the time of purchase (starting of pension).

Personal pension allows one to save for retirement in a very tax-efficient way.

Employed Persons

One should check to see whether the employer has a pension scheme and whether one is eligible to join it. If it is permissible, it is almost always the best option to join the employer's scheme. However, if the employer does not run a pension scheme, then one can apply for a personal pension plan, which the employer can also contribute to.

Self-employed Persons

As a self-employed person, one is eligible to receive the Government's basic old age pension. If self-employed, then one can contribute to a personal pension plan. It is, extremely important to start saving early for a pension on retirement.

Self Directed Retirement Plans

IRAs: It is a retirement investing tool in the US that can be either an Individual Retirement Account or Individual Retirement Annuity. There are several types of IRAs – Traditional IRAs, Roth IRAs, SIMPLE IRAs, and SEP IRAs. A retirement plan established by employers, self-employers, partnerships, sole proprietorships, etc. An IRA allows eligible employees to set aside a part of their pre-tax compensation as a contribution to the plan. This is otherwise called as elective deferral or salary deduction.

Traditional and Roth IRAs are established by individual taxpayers, who are allowed to contribute 100% of compensation up to a specified maximum dollar amount. Contributions to the Traditional IRA may be tax-deductible depending on the taxpayer's income, tax-filing status, and coverage by an employer-sponsored retirement plan. Roth IRA contributions are not tax-deductible. SEPs and SIMPLE IRAs are retirement plans established by employers. Individual participant's contributions are made to SEP IRAs and SIMPLE IRAs.

SEP IRAs (Simplified Employee Pension Plan): The simplified employee pension plan is established by employers, sole proprietorship, partnership firms etc. Here the employers make tax-deductible contribution plans on behalf of eligible employees. The employer is allowed a tax deduction for plan contributions that are made to each eligible employees' SEP IRA on an optional basis.

The features of SEP IRAs are as follows:

1. Established and funded by businesses which includes the sole proprietorship.
2. Must be established and funded by the employer's tax filing deadline, including extensions.

3. Contribution limit is 25 percent of compensation or $40,000, whichever is less. For a sole proprietor, the contribution limit is 20 percent of the sole proprietor's adjusted net business income.
4. Contributions within the limits is deductible on the employer's business tax return.
5. Earnings grow on a tax-deferred basis.
6. Distributions will be treated as ordinary income and subjected to income tax and early withdrawal penalties if an individual is under age $59\frac{1}{2}$ when the withdrawal is made, unless one is eligible for an exception.

Traditional IRAs: Individual taxpayers are allowed to contribute 100% of compensation up to a specified maximum dollar amount to their Traditional IRA. Contributions to the Traditional IRA may be tax-deductible depending on the taxpayer's income, tax-filing status, and coverage by an employer-sponsored retirement plan.

Roth IRAs: An individual retirement plan that bears many similarities to the Traditional IRA. Contributions are never deductible, and qualified distributions are tax-free. A qualified distribution is one that is taken at least five years after the taxpayer established his/her first Roth IRA and when he/she attains age $59\frac{1}{2}$, disabled, or using the withdrawal to purchase a first home (limit $10,000), or deceased (in which case the beneficiary collects).

Spousal IRAs: A traditional or Roth IRA established and funded by an individual for his/her spouse. These plans are typically set up when the spouse has little or no income, as they provide added benefits in that case. The contribution limits and eligibility requirements are the same for a spousal IRA as they are for a regular IRA**.**

Education IRAs: A savings plan for higher education. Parents or guardians are allowed to make non-deductible contributions to an education IRA for a child under 18.

Extended IRA: An IRA that allows a second-generation beneficiary to continue to distribute the assets over the life expectancy used by the first-generation beneficiary, thereby extending the IRA. An individual who inherits an IRA asset from the original IRA owner is referred to as the first-generation beneficiary. This individual is able to distribute the assets over his/her life expectancy or the remaining life expectancy of the IRA owner. If the first-generation beneficiary subsequently dies, his/her designated beneficiary is the second-generation beneficiary.

This type of IRA is being used by those who no longer need – nor want – to spend all of their IRA assets at the same time. Extended IRAs can have extensive tax benefits as second generation beneficiaries are allowed to continue distributions over the life expectancy used by the first-generation beneficiary, thereby spreading the tax burden from distributions over a long period.

Voluntary Retirement Schemes: They are also called as voluntary early retirement schemes. They form an innovative concept by the public sector banks that evolved in India in 2000-2001. They offered retrenchment of workforce of the public sector banks with employees willing and participating. It was an attractive package with terminal benefits and compensation that motivated all the employees to take up an early retirement, realizing the goal of the banks to shed their surplus manpower. The experienced gained by the public sector banks encouraged government to extend the methodology to shedding excess manpower in public sector undertakings and civil services.

According to the scheme, permanent employees with 15 years of service or 40 years of age are eligible for the scheme with exgratia amounting to 60 days salary. Employees who are eligible for VRS but do not want to avail the facility of VRS have the choice to go on a time off or on a vacation for 5 years. The right of refusal to give VRS has been given to the bank management and any recruitment against the vacancies of VRS was strictly rejected. Banks undertook a complete manpower planning exercise before offering the VRS. According to earlier estimates the average outgo per employees under the VRS ranged between Rs.3-4 lakh. There was a difficulty faced by the banking industry on the calculation of the aggregate because one could not estimate as to how many would opt for VRS. To minimize the immediate collision on banks, the scheme allowed them to reel the payments in two installments, with a minimum of 50 percent of the amount to be paid in cash immediately. The remaining payment can be paid within six months either in cash or in the form of bonds. After the implementation the average estimated cost per head for the entire set of 26 banks turned out to Rs.5.93 lakh. For the 18 nationalized banks, the average cost was estimated at Rs.6.70 lakh, while for SBI and its seven associate banks, the figures were Rs.6.52 lakh and Rs.5.72 lakh respectively. The response to the VRS offer was more among the officers when compared to the clerical and other sub-staff. The estimated cost was worked out on the basis of the exgratia payment that would be given to the applicants. This included all payments under the scheme, and excluding cost of regular terminal benefits for which banks were required to make provisions on an ongoing basis.

1. **Eligibility**

   All permanent employees with 15 years of service or 40 year. However following employees will not be eligible for this scheme.

   - Specialists' officers/employees, who have executed service bonds and have not completed it, employees/officers serving abroad under special arrangements/bonds, will not be eligible for VRS. The Directors may however waive this, subject to fulfillment of the bond and other requirements.
   - Employees against whom Disciplinary Proceeding are contemplated/ pending or are under suspension.
   - Employees appointed on contract basis.
   - Any other category of employees as may be specified by the Board.

2. **Exgratia Amount:** 60 days salary for each completed years of service or the salary for number of months service is left, whichever is less.

3. **Other Benefits**

   - Gratuity
   - Pensions
   - Leave Encashment.

4. **Miscellaneous Features**

   - It will be the prerogative of the bank's management either to accept a request for VRS or to reject the same depending upon the requirement of the bank.
   - Care will have to be taken to ensure that highly skilled and qualified workers and staff are not given the option.
   - There will be no recruitment against vacancies arising due to VRS.

- Before introducing VRS banks must complete their manpower planning and identify the number of officers/employees who can be considered under the scheme.
- Sanction of VRS and any new recruitment should only be in accordance with the manpower plan.

5. **Funding of the Scheme**

- Coinciding with their financial position and cash flow, banks may decide payment partly in cash and partly in bonds or in installments, but minimum 50% of the cash instantly and in remaining 50% after a stipulated period.
- Funding of the scheme will be made by the banks themselves either from their own funds or by taking loans from other banks/financial institutions or any other source.

6. **Periodicity**

- The scheme may be kept open up to 31.3.2001.

7. **Sabbatical**

An employee/officer who may not be interested to take voluntary retirement immediately can avail the facility of sabbatical for five years, which can be further extended by another term of five years. After the period of sabbatical is over he may re-join the bank on the same post and at the same stage of pay where he was at the time of taking sabbatical. The period of sabbatical will not be considered for increments or qualifying service for person, leave, etc.

SUMMARY

- With the longevity of the population increasing, the importance of proper retirement planning is also increasing. The pension fund sector, which is growing now will play a strong role in the time to come.
- Retirement is an important phase for financial and physiological circumstances for employees, productivity issues for the employers and social implications for the government.
- Workers, once they reach the age of 65, and if they are fully covered under social security, will start receiving old-age benefits. But if one retires earlier say at the age of 62 then he or she may receive a reduced benefit that is 80% of the full amount.
- The spouse is eligible to receive survivor’s benefits from social security if a covered worker dies. These payments include a small lump sum payment and monthly benefit checks.
- Annuity literally means an Annual Payment, but can be described as periodical payments depending on the status, time or life. In the Indian context, annuity and pension can be considered synonyms.
- Under Immediate Annuity, the first benefit payment is due one payment interval from the date of purchase of the annuity. If the interval chosen is monthly, the first payment will be due one month from the date of payment of the purchase price.
- Deferred Annuity can be purchased with either a single premium or periodic payment of premiums. Here the annuity payment begins certain number of years after the commencement of the contract.

- Annuities are a method of controlling the risk that a person may live long enough to run out of money. Life insurance protects an individual if he dies too early; and annuities protect an individual if he lives too long.
- It was observed that in spite of the great need for pension plans, the funds under annuities of LIC of India constitute hardly 5% of the total Life Fund. This only shows that the Pension market is not just underdeveloped but remains virtually untouched in our country.
- The origin of pension funds can be traced to the late 1800s, but it is their tremendous growth in the last 25 years that established them as one of the most influential institutional investors in the United States.
- Group Personal Pension Scheme operates more or less like individual personal pensions, usually offering lower charges. When employers do not wish to manage their own schemes, they often set up group personal pension arrangements.
- Since April 2001, all employers were supposed to make a stakeholder pension as a default scheme available for staff who does not qualify for the company scheme. It offers an inexpensive savings options and in time may replace define contribution arrangements.
- Personal Pensions suit those people who are self-employed and have no other way of providing a pension apart from a stakeholder plan and those who are employed but do not have the option of joining a company's scheme or do not want to join a stakeholder scheme.
- An employee/officer who may not be interested to take voluntary retirement immediately can avail the facility of sabbatical for five years, which can be further extended by another term of five years.

Chapter XVI

Estate Planning

After reading this chapter, you will be conversant with:

- Objectives of Estate Planning
- Need for Estate Planning
- Estate Planning Process
- Using Wills for Estate Planning
- Using Trusts for Estate Planning

Introduction

Rakesh got a massive heart attack and was immediately hospitalized. He has three children. The eldest daughter is married; the younger ones are still in college. After being discharged from hospital, he realized that he had made no will and no financial provisions for his children. He called up his lawyer and started the process of estate planning which would secure his children's future.

Estate planning is nothing but formulating a plan for proper distribution and disposition of property to one's family members. In other words estate planning is a transfer of a person's property from one generation to another according to a person's wishes and discretion. Estate planning is important as it provides the disposition of property according to the wishes of the individual after the death of the individual. It is the process through which financial support is made available to the family members. It not only helps in proper management of one's financial affairs but also helps in comfortable retirement.

ESTATE PLANNING – OBJECTIVES

Estate planning can be said to be successful if it is able to achieve the following objectives:

- To determine the heirs or beneficiaries of the estate.
- To provide financial support to the dependents.
- Reducing the costs involved in transfer of assets.
- Planning the way the beneficiaries will receive the assets.
- To determine how the estate property has to be distributed.
- To provide appropriate liquid assets to meet the estate obligations.
- Deciding on the executor and co-executors, who will settle the estate.
- To undertake proper retirement planning.

Methods of Disposing Off the Property

The methods of transferring an individual's wealth to others can be broadly classified as follows:

- Transfer during lifetime
    i. Life time gifts through irrevocable trusts and custodianship
    ii. Exercise of power of attorney
    iii. Selling the property within the family.
- Transfers at death
    i. By will – outright transfer or through testamentary trusts
    ii. Through life insurance benefit to individuals or trusts.
- Annuities and other forms.

NEED FOR ESTATE PLANNING

Estate planning should be a part of everyone's financial plan, whether a person is married with children or is single. It is essential to properly account one's property and provide financial help to the dependents when the person is no more. There are two main areas of estate planning which discussed hereunder:

People Planning

People planning involves anticipation of the needs of one's near and dear ones. It is a process of providing adequate resources for the people for proper continuation of their lives. People planning is important for individuals who have minor children or dependents who are mentally or physically handicapped.

Asset Planning

Asset planning is required when an estate involves a closely held business. It is necessary to maximize the assets value both during the lifetime of the owner and after his death.

Estate Break Up – The Reasons

An estate may shrink or reduce in value due to various reasons which are beyond the control of the individual. They are discussed hereunder:

- *Death Related Costs:* On the death of a person, a number of expenses remain unpaid and bills to be settled. The expenses may be in the form of funeral expenses, medical bills, probate expenses and other administrative expenses.
- *Inflation:* Inflation is another problem which may reduce the value of property.
- *Lack of Liquidity:* The property may not be sold when needed, due to lack of buyers or bargain at low value, and thus there may be difficulty in covering the unpaid medical bills and other expenses.
- *Improper Uses of Assets:* Assets may be transferred to beneficiaries who may not be able to handle them and thus it may lead to misuse of property.
- *Disabilities:* The bread earner of the family may become disabled. It hampers the future of the dependents and may diminish the value of the estate.

ESTATE PLANNING PROCESS

The estate planning process consists of the following seven steps:

- *Estate Planning Goals:* The first step is to assess the situation with respect to the family, its financial condition and accordingly formulate the planning goals.
- *Gather Data:* Gather information required for proper estate planning with respect to the information regarding the family.
- *Value the Assets:* The next most important step is to value the estate. For this, a proper list of assets has to be made and then the value of the assets should be determined.
- *Beneficiaries:* The next step is to determine the beneficiaries who would benefit from the estate.
- *Estimation of Transfer Costs:* Transfer costs need to be estimated and provision has to be made for them.
- *Implementation:* The plan has to be implemented strictly, and advice from the attorney can also be taken when needed.
- *Review:* It is essential that the plan is properly reviewed after sometime to take into consideration the inflation cost and various other factors which may affect the value of the estate.

Information Required for Estate Planning

The following information is needed for making an effective estate plan:

Personal data of the individual:

i. *Basic Details:* Name, address, occupation, health problems, details about family members, marital status, education, wills, trusts, etc.

ii. *Property:* Value of marketable securities, value of real estate and other properties.

iii. *Life Insurance:* Type of policy, name of the insurance company and its address.

iv. *Health Insurance:* Medical expense insurance details and disability insurance details.

v. *Business:* Names and addresses of businesses owned or jointly owned.

vi. *Income:* Income of the family, income of the spouse and dependents.

vii. *Finances:* Finances of the family, Economic objectives and needs of the family.

viii. *Liabilities:* Amounts to be paid to the creditors.

ix. *Documents:* Receipts of important documents deposited with institutions and copies of original documents where they are available.

x. *Employee Benefits:* Pension benefits and group insurance plans.

WILL

A will is a written, and legally enforceable expression or declaration of a person's wishes concerning the disposition of his or her property on death.

Intestacy

Intestacy is a situation when a person dies without making his will. In other words, the concerned person failed to make his will to determine the proper disposition of his property. The law prescribes various classes of survivors of the deceased person, in case such a situation arises. Normally, the surviving spouse and children are the main beneficiaries. If the deceased has no surviving spouse and children, the estate will be divided among the surviving parents, brothers and sisters.

Will Preparation

A will generally names a person, to direct the disposition of his or her property at his or her death. The person who makes the will is known as a testator and he can change or revoke the will prior to his death. After the death of the testator, the will becomes operative.

Will preparation and its cost depend on the individual circumstances. It also depends on the complexity of the document. If the will is complex involving various properties and individuals, it would be expensive than a will prescribing the property to be given to his wife and children. A will not only distributes property but also takes into consideration the various taxes due. Thus preparation of a will requires thorough knowledge of corporate, real estate and other related laws.

Information Requirements

A will should provide the following information:

i. Information related to the distribution of the assets according to the testator's wishes and needs of the beneficiaries.

ii. The probable changes in the family circumstances after the execution of the will.

iii. Proper description of the testator's desires in all the situations visualized in (ii) above.

Attorney

A will should be drafted with the help of a knowledgeable attorney. Will preparation involves a number of law and taxes and thus should not be attempted by a layman.

FEATURES OF THE WILL

Most of the wills contain the following sections:

- *Introductory Clause:* The introductory clause states the name and residence of the testator. This information determines the law that will apply.
- *Direction of Payments:* This clause directs the payment of expenses from the estate.
- *Disposition:* The disposition of the property is generally divided into various categories. The first category relates to the list of the personal property including each and every item and to whom it is to be given. This list does not appear in the will as it may change. The second category relates to the distribution or passing of money to a specific party or charity. The third category relates to the distribution of the residual assets.
- *Appointment Clause:* This clause gives names of the executors of the will, trustees, their successors and guardians for minor children.
- *Tax Clause:* In case there is no specified provision made in the will, the taxes are distributed among the beneficiaries.
- *Simultaneous Death Clause:* This clause provides for the treatment of the property in case of simultaneous death of the spouse. It is generally assumed that the spouse survives and according to this clause a specific time period is specified for which the spouse has to survive such as 30 to 60 days to become the beneficiary.
- *Execution and Attestation Clause:* The will has to be in writing and attested by the testator at the end. This is done to avoid frauds which are generally committed during preparation.
- *Witness Clause:* The will has to be signed by a witness. It is required to make sure that the will is of the deceased person only. There are generally two witnesseses who sign the will in the presence of one another. The witnesses have to mention their respective addresses in the will.

Requirements of a Valid Will

For a will to be valid, it should be of a person having sound mind. He should not make his will without any undue influence so that the will is properly executed. These aspects are further explained below:

- *Sound Mind:* To make a valid will, it is essential that the person be of a sound mind. He should not have any form of mental illness. For this, the following points need to be taken into consideration.
  - i. The person should know what the will is and is aware of its making and signing.
  - ii. He should know what property he owns.
  - iii. He should have proper understanding of the relations such as spouse, children, etc.
  - iv. Should have proper knowledge of how to distribute the property.
- *Freedom of Choice:* While preparing the will, the testator should not be influenced through coercion, threats, etc. as it may affect his freedom of choice.
- *Proper Execution:* The will should be properly executed. For that, the will should be made in accordance with the laws of the state. In addition to this, it should be demonstrated that the will is that of the testator only.

Changing or Revoking the Will

Until the death of the testator, the will cannot be operated. The will can be changed any time as long as the testator is mentally capable. The will can be revised by the testator, in case there is change in the circumstances related to the beneficiaries or his own financial stability. There may be births, deaths, marriage, and divorce in the family which may lead to change in the will. A will can either be changed or revoked.

CHANGING THE WILL

The testator may draw up a codicil to make minor changes to an existing will. It is a small document reaffirming all provisions of the will except the one to be changed. The codicil should also have witness and should be formally executed. In case a number of changes are substantial, it is better to make a new will than modifying the old one. The old will should be destroyed. But in some cases, it is better to preserve the old will as it may become operative, if the new will cannot be executed due mental incapability of the testator.

REVOKING THE WILL

A will can be revoked in two cases, either by the testator himself or by law of the state. The testator can revoke the will in the following circumstances:

- Drawing up another will, which will revoke all previous wills.
- Making a codicil, which revokes all other wills than the one being modified.
- Making a will that is consistent with all the previous wills being made.
- If the will is mutilated, torn or burnt with the intention of revoking it.

The will is revoked by law, when it has certain provisions which are inconsistent with the prevalent state laws. If there is certain variation in the provisions specified in the will, the law of the land will prevail. In certain cases the will is revoked, for example, if the testator marries or divorces after making the will, and he has children or adopts a child, after making a will and thus the provisions related to the spouse and children will change according to the changed circumstances.

Safeguarding the Will

The will should be kept safely and the copies of the will should be kept with the attorney. The will may also be kept with the attorney who has drafted it. But this may make the choice of the attorney to trouble the testator.

Letter of Last Instructions

A letter of last instructions may be drafted by the testator to include certain recommendations which cannot be included in the will. It is an informal memorandum having the following directions:

- Funeral instructions.
- Place of the will.
- Suggestions with respect to the business.
- Personal matters which cannot be handled publicly.
- Legal and accounting services.
- Suggestions for dividing the property.
- Explanations with respect to the actions taken in the will.

Administration of the Estate

People usually have assets, debts, etc. So at the time of death, the estate and the claims with respect to liquidation, if any, have to be properly administrated. A person may be appointed to take care of all these matters. In some cases the personal representative of the deceased person may take care of all this. He may collect the assets, pay the bills, settle claims and distribute the remaining assets to the entitled beneficiaries.

Estate Planning Documents

Apart from the will and letter of last instructions, there should be other documents also to protect one's interest and that of the family. The following are the main documents.

POWER OF ATTORNEY

If a person is affected by a serious illness, it essential that an individual is named by him to take care of his financial affairs. The power of attorney transfers enormous powers to the named person. The power of attorney has to be cleared by the firms where investments have been made by the individual. A power of attorney can be held by anyone, a spouse or a relative, who is trustworthy.

LIVING WILL

Living will provides for the treatment that a person wants and to what extent. This document helps in giving instructions relating to the medical care that a person may require in case he or she is not in a position to give his consent or instructions.

DURABLE POWER OF ATTORNEY

Through durable power of attorney a person authorizes an individual to make health decisions for the testator temporarily or permanently. Unlike the living will, instructions can be given for any situation when the testator is unable to communicate his wishes and not only when he is terminally ill.

TRUSTS

Forming trusts is another tool available for estate planning. A trust facilitates the transfer of income and property to another party. A trust is a legal relationship where one of the parties known as the 'trustor' transfers the property to another party known as the 'trustee' for the benefit of a third party known as the 'beneficiary'. The property placed in the trust is known as the trust principal. The trustee who holds the legal title should use the property and the income generating from it for the benefit of the beneficiary. A trust is generally in the form of a written document.

The trustor gives instructions with respect to the use of the property and how to use the income generated from the property. The trust may be 'living' or 'testamentary'. A living trust is when the trust is funded during the life of the trustor, whereas the testamentary trust is created by a will and funded by the probate process. A trust can be revocable or irrevocable.

Purpose of Trusts

A trust is created mainly for the following main reasons:

- **Income Tax and Estate Tax Savings:** A trust may be created to save taxes. A person may transfer the tax burden to a trust and thus the income earned by the trust properties will have a lower tax to pay.
- **Management and Conservation of Property:** Trusts are also created for minors or people who are incapable of handling their assets. People may be incapable due to their wrong attitude towards life, are of young age or due to illness, etc. People who are very busy or have less time for managing their financial affairs can also create trusts to manage their assets and conserve them on behalf of their beneficiaries.

Selecting a Trustee

A trustee should have the following qualities:

- Sound knowledge in managing the business or properties involved.
- Knowledge of the needs beneficiaries.
- Skill in managing the trust.
- Impartiality in decision-making.

Types of Trusts

The following are the most common forms of trusts:

LIVING TRUST

A living trust is funded during the life time of the trustor himself. A trust may be revocable or irrevocable and may function for a specified time or may continue even after the death of the trustor.

TESTAMENTARY TRUSTS

A trust created by the will of the deceased person is known as a testamentary trust. The testamentary trust comes into existence only after the will is probated. The property is transferred to the trustee to fund the trust. This may also be directed by a court.

IRREVOCABLE LIFE INSURANCE TRUST

An irrevocable trust can be created where the main asset is the life insurance of the trustor. Thus the trustee can acquire the proceeds of the policy as the policy will not be included in the estate of the trustor.

SUMMARY

- Passage of the rights of ownership of an individual to his heirs can be very striky and involve several legal complications. Planning the estate early on in the life can avoid a lot of troubles for the survivors.
- People planning is important for individuals who have minor children or dependents who are mentally or physically handicapped.
- A will not only distributes property but also takes into consideration the various taxes due. Thus, preparation of a will requires thorough knowledge of corporate, real estate and other related laws.
- The power of attorney transfers enormous powers to the named person. The power of attorney has to be cleared by the firms where investments have been made by the individual. A power of attorney can be held by anyone, a spouse or a relative, who is trustworthy.
- A trust is a legal relationship where one of the parties known as the ‘trustor’ transfers the property to another party known as the ‘trustee’ for the benefit of a third party known as the ‘beneficiary’.
- Trusts are also created for minors or people who are incapable of handling their assets. People may be incapable due to their wrong attitude towards life, are of young age or due to illness, etc.

Chapter XVII

Alternate Investment Options

After reading this chapter, you will be conversant with:

- Advantages of Alternative Investments
- Art
- Gold
- Antiques
- Commodities
- Real Estate
- REITS
- Real Estate-Related Mutual Funds
- Charity

Introduction

The number of the alternative investment vehicles available to investors is really huge. It is almost impossible for any investor to allocate his funds in every type of alternative investments. Hence a considerate and careful approach is essential while selecting the appropriate alternative investment vehicles. For our convenience, alternative assets can be divided into two categories, based on their liquidity and volatility. The first category of more liquid and volatile assets includes energy derivatives, Real Estate Investment Trusts (REITs), currency overlays and managed futures. The second category of more illiquid and less volatile assets can include venture capital, distressed debt, long-term arbitrage, oil and gas and real estate. The selection of the proper alternative asset should be based on different needs of the various investors.

The most important determinant in deciding the alternative investments is to understand the nature and the risks involved in that investment. First, the size of the alternative investment and its diversification impact should be decided. To decide the benefit of the diversification, the correlation with the market and other assets should be determined. Any investor considering the investment in alternative investments can utilize various quantitative methods for comparing the expected correlation of one asset class relative to the other. Apart from the risk and return consideration, the following factors are also important in deciding the selection of alternative investments:

Table 1: Factors Affecting Selection of Alternative Investments

• Leverage	• Concentration
• Performance and experience	• Benchmark
• Volatility	• Timing and amount of the cash flows
• People	• Liquidity
• Investment process	• Tax
• Fees	• Risk Management
• Legal	

Source: Alternative Investment Strategies by Sohail Jaffer.

The final selection of an alternative investment depends on the characteristics of the investors, their experience and future expectations. Although the risk and return trade-off is the primary concern for any alternative investors, there are some secondary and extremely important factors concerning liquidity, tax considerations, legal issues and benchmarking. These factors should always be considered before investing in alternative investments. A full analysis of potential alternative investment vehicles is the most important issue in understanding their risk and return level.

ADVANTAGES OF ALTERNATIVE INVESTMENTS

There are three important advantages of alternative investments:

a. Diversification of the portfolio;

b. Flexibility to fit the requirement of different kinds of investors; and

c. Potential to offer a more efficient way of reaching specific markets and respective asset classes.

The diversification benefit attached with the alternative investments is possible because of low correlations of the alternative assets with traditional asset classes. Hence, inclusion of the alternative assets in traditional portfolio can reduce the risk of the portfolio, and improve portfolio stability. Alternative investments are very flexible and they can be tailored to meet desired specific risk/return trade-offs for different classes of investors. Finally, alternative investments provide an opportunity to access certain markets and asset classes. For example, alternative investments in timberland, farmland, oil and gas and commodities can provide a steady return and lower risk to an investor. Investors can achieve these benefits by choosing the best alternative – managers having sound knowledge of these investment vehicles. The main problem attached with the alternative investments is that most of the investors will find it difficult to integrate the alternative assets in their portfolio consisting of traditional assets. Generally, we find two model sets for the allocation of funds; the first set is very simple and requires investments in both traditional and non-traditional assets. According to this model, the allocation of funds in these two asset classes is based on economic and risk characteristics and also on the time and resources required for effective management and evaluation of their activity. Other important factors, which should be considered, include liquidity, transaction costs, regulatory environment attached to the alternative assets, etc. This approach requires investors to choose traditional assets like stock, bond and cash and in addition invest in alternative assets to gain extra benefits and to make extraordinary returns and enhance the flexibility of the portfolio. In other words, this approach uses alternative assets as a compensatory tool.

In contrast to the first approach, the second set involves investments in each type of traditional and alternative investment. This can be done by allocating P percent to domestic stocks, Q percent to domestic bonds, R percent to venture capital, S percent to oil and gas, T percent to international private equity, U percent to hedge funds, V percent to leverage buyouts, W percent to managed futures, X percent to distressed debt and similarly in other investment avenues. This approach is more disciplined.

ART OBJECTS

Objects which possess aesthetic appeal because their production requires skill, taste, creativity, talent, and imagination may be referred to as art objects. According to this definition, paintings, sculptures, etchings, and so on may be regarded as art objects. The value of an art object is a function of its aesthetic appeal, rarity, reputation of the creator, physical condition, and fashion.

This section describes briefly two of the more commonly bought art objects, viz., paintings and antiques.

Paintings

Paintings appear to be the most popular among objects of art. In the last decade or so, interest in paintings has grown considerably, the substantial appreciation in the market value of paintings of Hussain, Raza, Menon, and others.

The prospective investor with an inclination to buy paintings should bear in mind the following guidelines:

a. **Put Bets More on Fledging Painters:** Works of established painters may be too expensive and beyond the reach of the small investors. More important, the expected appreciation in their value may not be considerable. Hence, it makes more sense to buy good quality paintings done by fledging painters – the potential Hussains of tomorrow. True, when one bets on an ‘emerging’ painter, he is taking some risk. Often, the potential rewards justify such risk.

b. **Develop a Sense for the Quality of Painting:** Even if the investor does not have the skills of a connoisseur, he can judge the basic qualities of painting by looking at attributes like spontaneity, maturity of strokes, balance of color, and originality. Over a period of time one can refine his sensibility, provided of course he has a basic aesthetic sense.

Bullion-Lure of Gold

Bullion comprising gold and silver is a favorite avenue of investment to Indian investors as:

- They provide a hedge against inflation.
- The sentimental and social value attached to these precious metals.
- It has ornamental value and medicinal uses.

GOLD

Gold is one of the most valuable assets in any economy. It has been used in India primarily as a form of saving by the housewives. It used to be a money metal and public memory tells that gold is universally acceptable as a medium of exchange and it is now used for its 'Store of Value' function. Although the price of gold is always on the rise and it fetches higher resale value, in India, it is retained for the feeling of security and status it gives rather than for sale or with the intention of making profit or income on this investment. Gold to the investor in the recent years has become very important mainly because of rise in prices due to inflation. Investment in gold may be in the form of gold coins, gold bars or gold jewelry.

ANTIQUES

An object of historical interest may be regarded as an antique. It could be a coin, a manuscript, a sculpture, a painting, or any other object.

If one is interested in investing in an antique, bear in mind the following:

a. The owner of an antique is required to register it with the Archeological Society of India. If the registering authority is satisfied about the authenticity of the antique, it issues a 'Certificate of Registration'.

b. Whenever an antique is sold the registering authority has to be informed and the ownership must be transferred.

c. Export of antiques, in general, is banned. In exceptional cases, it is allowed only at the instance of the Director General of the Archeological Society of India.

d. The government has the right to acquire an antique if it is felt that the same must be kept in a museum for the general good.

e. Antiques are available in places like Chor Bazar (Mumbai), Mullick Market (Calcutta), and Burma Bazar (Chennai). However, it may not be easy to get good bargains at these places. To buy antiques at bargain prices, investor has to actively look for them in smaller towns and villages.

f. There is a flourishing market for 'fake' antiques. These are objects which are chemically treated to give an 'antique' look, though they are not genuine antiques.

g. Antiques tend to appreciate in value over time, but in a very unpredictable manner.

h. Antiques seem to make sense only for those who has patience to wait and who derive psychological satisfaction from owning objects of historical interest. One may even argue that, since very few investors have the ability to assess the value of antiques, investments in these may largely be left to connoisseurs.

COMMODITIES

As mentioned earlier, commodities are tangible goods that can be used for various purposes. They include goods like agricultural products such as grain, oilseeds, wheat etc, and metals like sponge iron, aluminum ingot, etc., to name a few, except financial assets. These commodities are traded through a mutual agreement between the buyer and the seller to exchange a commodity at a given price. The commodity contracts are highly standardized except for the price and are influenced by the demand and supply forces. These commodity contracts are generally in the form of futures and options.

REAL ESTATE

Land and House property is also called real estate. This investment is taken by a large number of people for hedging against the inflation rates. A real estate represents a very attractive investment proposition for the following reasons:

- Capital appreciation of real estate is, in general, very high. Real estate in most of the towns in India have appreciated ten times or so in the last 10-15 years.
- Loans are available from various quarters for buying or constructing a residential property.
- For wealth tax purposes, the value of a residential property is reckoned at its historical cost and not at its present market price.
- Interest on loans taken for buying or constructing a residential home is tax deductible within certain limits.
- Ownership of a residential property provides psychological satisfaction.

Due to the above formidable advantages, a residential property represents the most important part of the portfolio for most of the investors. But, the return on these investments depends on the following rules:

a. The holding period of the property is important.

b. A person who does not have enough time to supervise his property should not invest in it.

c. Property requires care. If it is rented out, there is a requirement of repair and maintenance.

d. Investment in real estate is also very risky. Although the average rate of return is high, a cautious investor should not think of property because it involves the exercising of a lot of pressures in the form of tax payments, like capital gains tax, annual property tax and so on.

Factors concerning liquidity, tax considerations, legal issues and benchmarking, should always be considered before investing in alternative investments. A full analysis of potential alternative investment vehicles is the most important issue in understanding their risk and return level.

REAL ESTATE INVESTMENT TRUSTS (REITS)

A REIT is a company that owns, operates income-producing real estates such as apartments, shopping centers, offices, hotels and warehouses. In most cases, REITs own and operate the real-estate property.

But, some REITs also finance real estate. The shares of many REITs are freely traded, usually on a major stock exchange. To qualify as a REIT, a company must distribute at least 90% of its taxable income to its shareholders annually. A company that qualifies as a REIT is permitted to deduct dividends paid to its shareholders from its corporate taxable income. As a result, most REITs remit at least 100% of their taxable income to their shareholders and therefore owe no corporate tax. However, in India, REITs are yet to be allowed. The Indian government is still examining the possibility to allow real estate mutual funds.

REITs are classified as equity, mortgage or hybrids. Equity REITs own and operate income-producing real estate; these are primarily real estate operating companies engaged in a wide-range of real estate activities, including leasing, property development and tenant services. One major distinction between REITs and other real estate companies is that a REIT must acquire and develop its properties primarily to operate them as part of its own portfolio rather than resell them once they are developed. Mortgage REITs lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of loans or mortgage-backed securities.

REITs invest in a variety of property types: shopping centers, apartments, warehouses, office buildings, hotels, and others. Most REITs specialize in one property type only, such as shopping malls, self-storage facilities or factory outlet stores. Health care REITs specialize in health care facilities, nursing homes and assisted living centers.

REAL ESTATE-RELATED MUTUAL FUNDS

Mutual fund industry has shown an impressive growth in performance over the last few years and is continuing to do so. It is considered to be the safest investment avenue because of its well-diversified portfolio. Mutual funds' performance is better now when compared with their previous year's performance. The funds industry has grown by 65% on year-to-year basis during the year 2005-06 as compared to just 9% during the year 2004-05. The latest entrant in the field of mutual funds industry is 'Realty Fund' or Real Estate Mutual Fund (REMF), an option with huge investment potential.

The idea of REMFs is not new in India. The proposal was put forth almost a decade ago for introducing these funds. But at that time, the authorities were doubtful as they believed that such funds being speculative in nature, if permitted will lead to an increase in speculative trading that may not be beneficial for an economy. But now, the way they are looked at it has changed. Securities and Exchange Board of India (SEBI) and Association of Mutual Funds in India (AMFI) have set up a committee to advise on the introduction of REMF in India; the committee have submitted its report and now, trading in these funds is allowed. SEBI approved the guidelines for dealing in REMFs on June 26, 2006.

CHARITY

Monetary donations play an important role in the global economy without individual or corporate contributions, many social service organizations could not exist or do the jobs they currently perform to help others. A high percentage of income-earners donate a portion of their salary to worthwhile causes. These might be health organizations that sponsor research to find cures and treatments or public service entities like the local library system etc. charity also provides a Tax benefit to the individual Donating.

Box: Alternative Investment Strategies

Hedge Fund Styles and Strategies: There are a number of ways in which alternative investment managers differ from traditional money managers. One of the most significant differences is the alternative investment manager's expanded scope of non-traditional investment instruments and techniques. While alternative investment managers employ a wide variety of different strategies or styles, they can be classified into six main categories:

Fund of Funds: Strategy Neutral; Strategy Specific Fund of Funds is an important hedge fund style that allows investors, through a single investment, to access a variety of hedge fund managers – often for much less than typically required for direct participation in each of the underlying individual funds. This blending of different hedge fund strategies and asset classes aims to provide a more stable long-term investment return than any of the individual hedge funds. There are a range of funds, which vary in the number of underlying managers (5 to 100), and the strategies on which they focus. Strategies vary from style-specific funds to those with a bias to a specific style, normally equity long/short, and those with a style neutral objective.

Equity/Long Short: Long/Short; Sector Specific An Equity Long/Short hedge fund involves share-based investing on both the long and short side of the market across a range of sectors, categories and regions. This is the largest sub-sector of hedge fund styles and tends to be more correlated to benchmark indices because of a bias towards net long market exposure.

Event Driven: Merger Arbitrage; Distressed Securities Event Driven hedge funds seek to capitalize on market mis-pricings related to a specific event, such as a merger, restructuring or bankruptcy. Sub-strategies include merger arbitrage and distressed securities investing.

Managed Futures: Systematic Trend Following; Discretionary-Managed Futures is a hedge fund style that invests in futures and currencies on a global basis. The most common form involves the use of a systematic approach to trade a widely diversified range of markets and contracts based on identified trends.

Market Neutral/Arbitrage: Equities – Balanced; Convertible Bond Arbitrage; Fixed Income Arbitrage Market Neutral/Arbitrage is a hedge fund strategy that takes offsetting positions in closely related financial instruments with the aim of exploiting disparities in pricing relationships. Sub-strategies include equities-balanced hedge funds, fixed income arbitrage hedge funds and convertible bond arbitrage hedge funds.

Other Strategies: Global/Macro; Emerging Markets Other hedge fund strategies include Global/Macro and those focused specifically on Emerging Markets. Global/Macro hedge fund strategies seek to capitalize on country, regional and/or economic change affecting securities, commodities, and interest and currency rates by taking large directional positions in national markets based on a top-down analysis of macroeconomic and financial conditions. Asset allocation can be aggressive and this hedge fund style has been associated with a number of high profile individual managers.

www.altegris.com

SUMMARY

- Investment is carried out with the objective of getting a safe return without speculating or gambling.
- Investment can be categorized into two ways: one as financial investment and another as real investment. Financial investment can be further classified as security form of investment and non-security form of investment.
- Of late, commodity futures and options have gained popularity as they provide an opportunity to hedge or speculate in commodities.
- A REIT is a company that owns, operates income-producing real estates such as apartments, shopping centers, offices, hotels and warehouses. In most cases, REITs own and operate the real estate property.
- Commodities are tangible goods that can be used for various purposes. They include goods like agricultural products such as grain, oilseeds, wheat etc., and metals like sponge iron, aluminum ingot, etc., to name a few, except financial assets.

Chapter XVIII

Marketing of Financial Products

After reading this chapter, you will be conversant with:

- Relationship Marketing
- Selling in a Competitive Environment
- Steps in the Relationship Management Process
- Segment
- Profile
- Strategize
- Execute
- Monitor and Review
- Personal Selling Skills

RELATIONSHIP MARKETING

Philip Kotler defined relationship marketing as: "The process of creating, maintaining and enhancing value-laden relationship with valued customers, distributors, dealers and suppliers by promising and consistently delivering high quality products, good services and fair prices". Marketing is shifting from trying to maximize the profit on individual transactions rather than to building mutually beneficial relationship with consumers and other parties.

Close observation of the markets reveals the 10 most important trends in loyalty marketing affecting almost every company selling almost every kind of product in almost every marketplace. These trends are based on certain analyses and also use a technique called scenario mapping.

i. **Consumers are Smarter and they Expect More:** As the general population becomes better educated, consumers approach purchase decisions with better knowledge, and they have access to more data for comparison shopping. The Internet and the growing popularity of consumer publications (for example, publications in the automobile sector) and TV shows give consumers greater access to product information. With greater knowledge comes stronger expectations and demand for product quality and customer service. To meet these demands and add value, companies launch loyalty marketing programs.

ii. **Internet has Led to Disloyalty:** The Internet as a distribution channel for product sales and information has caused many consumers to change buying habits and methods. Research reports show record low consumer loyalty in the Internet environment. Online customers usually look at cheaper options and not necessarily branded products and services. These trends can be observed mostly in the airlines and hotel industries.

iii. **High Labor Cost:** As the cost of quality labor increases not many companies can afford the right people for service jobs. Many of them end up recruiting lower quality people for these jobs. Additionally, retail organizations and service-based call centers face increased employee recruitment and retention challenges. As a result, customer service levels are eroding. As consumers become frustrated with poor service, longer lines and other service-related problems, customer defection become a threat.

iv. **Price-based Programs:** Price or cash-based offers have taught consumers to be on the look out for the next best offer. The only way to handle this is to create high exit barriers for the existing customers.

v. **Global Market:** As the global economy openup, our companies are witnessing increased competition, and many sectors are facing foreign competition for the first time. Look at the way the local media moguls are reacting to Star News' plans and FDI in media. Many use loyalty marketing initiatives to establish stronger value propositions in the hope of blocking foreign threats to market share. Look at what the automobile distributors have done to bring back their valued old customers into their fold with their service loyalty programs and co-branded activities with other companies. Planned as a way to bring in non-warranty service business to the authorized agents, this program has expanded in a big way.

vi. **Customer-focused Technology:** The term “customer database” is outdated. Technical giants such as Microsoft and Oracle have developed, and continue to enhance, data warehousing systems that collect and mine valuable customer information in real time. And marketers are incorporating these systems to use the data for smart and ROI-based loyalty marketing programs.

vii. **Deregulation:** In India, in the beginning, customers had only price to differentiate between the first two cellular service providers. Eventually, large advertising budgets and price-based switching programs gave them more options. Then, deregulation offered them more choices. In developed countries, customers are inundated with marketing campaigns for basic telephone service, cable, electricity and even petrol, as utility companies compete for customers. Challenged with selling commodity-based service products offering little opportunity for brand differentiation, these companies look to establish increased value by developing loyalty marketing strategies.

viii. **Mergers and Acquisitions:** Mergers and acquisitions can have a significant impact on brand and product loyalty and may cause customers to look for alternatives. This trend has been especially pronounced in the financial services industry, where customers struggle to keep up with the logo changes in their cheque books. In fact, the merger of ANZ Grindlays Bank with Standard Chartered Bank has seen many loyal customers of the former switching to local banks such as ICICI or HDFC Bank.

ix. **Rising Media Costs:** Advertising has become more expensive, and marketing budgets have become tighter. The average cost of a 30-second spot during peak time has increased by more than 200% in the last five years. So, marketers need to drive increased ROI on their marketing budgets. This trend fosters loyalty programs, because loyalty marketing focuses on the existing customers whose behaviors and responses can be tracked, and marketers can pinpoint response and accurately attribute incremental revenues to marketing rupees spent.

x. **Competitors are Doing It:** Loyalty marketing has become a standard practice in many industries. Almost every hotel chain, airline and credit card company offers some type of frequent customer program; customers have come to expect them and compare benefits and rewards of competing companies. As a result, competitors are racing to introduce new perks, better benefits and some other element that no other company offers. Though Customer Relationship Management (CRM) provides a way to maintain the customer base, in order to compete effectively, the organization must have a product or service offering that is distinct and which gives the organization a clear competitive position. This process of identifying an appropriate competitive advantage is called positioning.

The latest trend in relationship marketing is personalized marketing. In personalized marketing, the main preference is given to the consumer. The consumer shopping profile is built on the website. This information is then used to compute what can be his likely preferences in other categories. These items are then shown to the customer through web cross-sell, email recommendation and other channels.

According to Buchanan and Gilles, the increased profitability associated with customer retention efforts occurs because of several factors that occur once a relationship has been established with a customer.

- The cost of acquisition occurs only at the beginning of a relationship, so the longer the relationship, the lower the amortized cost.
- Account maintenance costs decline as a percentage of total costs (or as a percentage of revenue).
- Long-term customers tend to be less inclined to switch, and also tend to be fewer prices-sensitive. This can result in stable unit sales volume and increase in dollar-sales volume.
- Long-term customers may initiate free word of mouth promotions and referrals.
- Long-term customers are more likely to purchase ancillary products and high margin supplemental products.
- Customers that stay with you tend to be satisfied with the relationship and are less likely to switch to competitors, making it difficult for competitors to enter the market or gain market share.
- Regular customers tend to be less expensive to service because they are familiar with the process, require less "education", and are consistent in their order placement.
- Increased customer retention and loyalty makes the employees' jobs easier and more satisfying. In turn, happy employees feedback into better customer satisfaction in a virtuous circle.

Methods of Monitoring Customer Satisfaction

An organization must continue to satisfy customers, but let's be honest; it is very difficult to keep 100% of your customers satisfied all the time, one reason is because needs and wants of your customers change. So, we have to monitor what is happening in our customer environment. Methods used to monitor customer satisfaction include:

- Focus groups
- Personal interviews
- Questionnaires
- Mystery shoppers
- Customer complaints
- Suggestion boxes
- Online surveys
- General comments.

In order to retain customers, we must keep up-to-date with the needs of our customers. Customer needs do not remain static and always change. Adapting and changing along with these needs will help the organization develop the relationship it wants with the customer. The benefits are well-increased profit, market share and brand awareness.

Box 1: The Tortoise, Hare and the Elephant
Relationship banking has been around for centuries, with records of it going back to the 1720s. As most of us understand it, relationship banking is the touchy-feely part of banking – where customers and bank managers interact and build-up a sort of camaraderie. The face of relationship banking has changed over the last decade or so as much has happened: Internet revolution, introduction of the Euro, greater access to international funds, and shrinkage in the international corporate loan market alongside growth in cross-border capital markets. These changes have been accompanied by changes in the approach of the banks to relationships and to customers. There is a famous fable about the hare and tortoise that we have seen quoted by some bankers in articles in describing the banking market as a whole. They have added another runner to this tale – the elephant! This was an apt way to describe the market and so we are using it here. In their opinion, the universal bank is considered to be the elephant. It is big and can offer its customers a full range of services from cash management to exit strategy, such as M&A and flotation. This one-stop shop is clearly attractive (it works in retail businesses such as supermarkets very well) but in the banking world the complexity of the transactions and activities means that relationship between the bank and its customers is often complex, as there tend to be multiple relationships as well as infighting among the different divisions – so it is more of a white elephant nowadays. The hare is lithe, speedy and always wants to win the race – this description fits investments banks. They want to win the big deals and are not interested in lending but increasingly their customers are forcing them to offer lending as a prerequisite to winning the big deals. But as this is not a core feature of their business, there is a mismatch of expectations. Investment banks should not be coerced into this. It would be wiser to create strategic partnerships with other commercial banks. Last but not the least there is the tortoise, the true old-fashioned relationship bank offering customers a range of products and services via a single point of contact – the relationship manager. It builds long-term relationships and certainly includes lending as well as treasury and financial markets products and services. Although the banking landscape may have changed, true relationship banking still sits with the tortoise and is unlikely to change in the years to come.

Source: software.silicon.com/os/0,39024651, 39118096,00.htm

SELLING IN A COMPETITIVE ENVIRONMENT

A highly competitive environment results when there are too many products chasing too few buyers.

This chapter examined the competitive environment, its regulation, its relationship to organizations and competitive strategies for operating in a competitive environment.

There are three important factors which affect the business in a competitive environment. They are:

Visibility

The first phase of growing a relationship is visibility: the banker and the customer become aware of each other. In business terms, a potential source of referrals or a potential customer becomes aware of the nature of the banks' business because of the public relations and advertising efforts, or existing customer. A combination of many such relationships forms a casual contact network.

The visibility phase is important because it creates recognition and awareness. The greater the visibility, the more widely known the bank will be, the more information the bank obtains about others, the more opportunities it will be exposed to, and the greater will be the chances of being accepted by other individuals or groups as someone to whom they can or should refer business. Visibility must be actively maintained and developed to reach the next level, i.e., credibility.

Credibility

Credibility is the quality of being reliable, worthy of confidence. Once the customer begins to form expectations of the bank – and the expectations are fulfilled – the relationship can enter the credibility stage. If the customer is confident of gaining satisfaction from the relationship, then it will continue to strengthen.

Credibility grows when appointments are kept, promises are acted upon, facts are verified, and services are rendered. The old saying that results speak louder than words is true. This is very important. Failure to live up to expectations – to keep both explicit and implicit promises – can kill a budding relationship before it breaks through the ground and can create visibility of a kind the bank doesn't want.

Profitability

The mature relationship, whether business or personal, can be defined in terms of its "profitability." Is it mutually rewarding? Do both partners gain satisfaction from it? Does it maintain itself by providing benefits to both? If it doesn't profit both partners to keep it going, it probably will not endure.

The time it takes to pass through the phases of a developing relationship is highly variable. It's not always easy to determine when profitability has been achieved – a week? a month? one year?

Visibility and credibility are important in the relationship-building stages of the marketing process. But when you have established an effective referral-generation system, you will have entered the profitability stage of your relationships with many people – the people who send you referrals and the customers you recruit as a result.

Box 2: Service Branding to Attract Customers

Services marketers can differentiate their products through value-added customer service and service quality. Branding of services also helps to differentiate them from the services of competitors. A good brand image increases the customer's trust in the service and reduces the perceived risks associated with purchase of the service.

ICICI Bank has established itself as a strong brand in the Indian financial industry, The bank's philosophy is to provide services that are better than the expectations of the customers and thereby register a strong brand image in the minds of its customers. The ICICI Bank group has focused on branding across all segments of the financial industry, be it banking, insurance, or mutual funds.

Over the years, ICICI Bank has taken up various brand building exercises to increase brand loyalty among the customers. It ran campaigns in the print media to educate the retail consumer. It also ran an 'Umbrella campaign' to convey the values of safety and security to the customers, which further reinforced its brand positioning. ICICI Bank targets its products and services at young customers with a view to establish long term and profitable relationships. The bank used Amitabh Bachchan, the Hindi film superstar, as its brand ambassador to increase brand awareness among its target customers. It also branded its bond offerings as ICICI Safety Bonds, to communicate the safety aspect.

Source: Nath, Prithviraj, and Dharmendra Sanwal. "Services Branding Delivering a Value Proposition." http://www.etstrategicmarketing.com/smJanFeb2/stra – brandp.htm.

STEPS IN THE RELATIONSHIP MANAGEMENT PROCESS

Developing, Motivating and Managing People

To build a customer relationship culture, it is important to:

- Provide training to employees in key areas requiring exceptional personal service.
- Reinforce these skills using ongoing coaching and feedback.
- Measure their current performance levels.
- Reward performance using a combination of monetary rewards and non-monetary recognition.

Establishing Effective Service Delivery

Effective processes and procedures provide the foundation for smoothing or inhibiting the material service element of the customer interaction. Efficient service delivery systems appear transparent to the customer. Poor systems create those speed bumps that necessitate personal intervention in order to satisfy the customer requirements:

- Mapping the service delivery processes.
- Evaluating critical success points in the process.
- Defining service standards and objectives for these essential points.
- Establishing service delivery procedures to optimize material service.
- Creating service level agreements to smooth internal service delivery.

Building in Continuous Development

In spite of effective service delivery processes, or well-trained service staff, things go wrong. Products have faults. Customers get frustrated. Things slip through the cracks. The organizations that are built around managing the customer experience are able to resolve these issues effectively. This process known as recovery is an important differentiator factor in building customer loyalty:

- Actively seek customer feedback and complaints: you cannot improve if you don't know what went wrong in the first place.
- Train staff how to handle customer complaints effectively using the correct mix of empathizing, apologizing and resolution.
- Make sure that the real problem is solved, not just the symptoms.
- Focus on proactive (prevention) as well as reactive (cure) problem-solving.

Ensuring Managers are the Key Change-Agents

Senior management often has the vision, intention and commitment to introduce a comprehensive customer relationship management system. The make or break element is in involving middle management in the change process, and empowering them to be the key change agents:

- Engage the management team early and often in the process.
- Involve management members in articulating the customer experience strategy.
- Teach managers coaching skills so that they are able to articulate and reinforce the key personal service skills.
- Use managers as facilitators when rolling out interpersonal skills training.
- Reward managers on establishing, monitoring and updating service delivery processes.
- Ensure managers are able to act as an example to their teams.

SEGMENT

Segmentation Procedure

Market segments can be identified by following a three-stage procedure involving: Market Survey, Market Analysis, and Profiling.

i. **Market Survey:** In this stage, the researchers conduct interviews and collect data to gain an insight into the motivating factors – the customers' attitudes and their behavior. This stage also involves collecting data on the usage pattern of customers, general behavior of the customers in the product category, demographics, psychographics etc.

ii. **Market Analysis:** In the analysis stage, the data is analyzed and the market is classified into broad segments.

iii. **Profiling:** In this stage, each of the segments is again differentiated on the basis of demographics, attitudes, purchase patterns, media patterns etc.

The following are the variables which generally form the basis of market segmentation:

a. **Demographic Segmentation:** Consists of dividing the market into groups based on variables such as age, gender, family size, income, occupation, education, religion, race, and nationality.

   Most financial service providers bank on the demographic data available with them. For instance, a credit card issuer would like the customer to visit a certain category of restaurants. If he knew, for instance, that the customer uses his credit card in Hong Kong and Singapore, he would feel much more comfortable in offering the customer a debit card that is internationally valid to help him in overseas travel more frequently.

b. **Geographic Segmentation:** Tries to divide markets into different geographical units. These units include:

   - ***Regions:*** For example, in the UK the regions might be England, Scotland, Wales, Northern Ireland or (at a more detailed level) counties or major metropolitan areas.
   - ***Countries:*** Perhaps categorized by size, development or membership of geographic region.
   - ***City/Town Size:*** Based on the size of population.
   - ***Population Density:*** For example, urban, suburban, rural, semi-rural.
   - ***Climate:*** For example, Northern, Southern, hot and cold etc.

   Geographic segmentation is an important process, particularly for multi-national and global businesses and brands. Many such companies have regional and national marketing programs, which alter their products, advertising and promotion to meet the individual needs of geographic units.

c. **Psychographic Segmentation:** In psychographic segmentation, the customers are aggregated into groups based on social class, life style or personality characteristics. For example, in the financial services sector, customers can be classified into High wealth Low income, Low wealth High income etc.

d. **Behavioral Segmentation:** Behavioral segmentation is another form of segmentation that is used by bank marketers to classify their target market thus helping them to position their services accordingly. It is based on actual customer behavior toward products. Behavioral segmentation has the advantage of using variables that are closely related to the product itself. Some behavioral variables include:

- ***Benefits Sought:*** The benefits the users expect from the service and why they opt for a particular service. For example, customers seeking a one-stop bank with a wide variety of services.
- ***Usage Rate:*** Buyers are classified into heavy, medium, occasional or non-users.
- ***Promotional Response Segmentation:*** Here, customers are grouped on the basis of responses to a particular form of promotional activity for a particular product or service.

e. **Service Segmentation:** The customers are aggregated based on the varying service offerings. The various elements of customer service that can be offered and the possible differentiation in terms of service levels within these elements represent considerable opportunity to design different packages to different market segments.

Effective Segmentation

Not all segmentations are useful. A bank can segment its prospective customers into tall and short. Though these segments are valid, they are of little use to the business. Effective segmentation can indicate gaps in the market and provide insights into the requirements of different types of users, enabling potential product offerings to be carefully positioned to meet those needs. To be effective, the segments must be:

Measurable: The size and purchasing power of the various identified segments should be measurable.

Accessible: The segments must be easily reachable and serviceable.

Actionable: The segment must be such that effective programs can be formulated and they must serve the segments.

Differentiable: The segments must be conceptually differentiable and must respond differently to different marketing elements. For example, if tall and short men respond similarly to a particular promotional campaign, they cannot be considered belonging to different segments.

Substantial: The segments must be large enough and profitable to serve and must be the largest possible homogenous group.

Apart from segmentation of the markets, service providers also look at customer behavior in terms of loyalty and divide them as follows:

i. ***Hard-core Loyal:*** These customers buy services from a single provider all the time irrespective of the service quality.

ii. ***Soft-core Loyal:*** These customers buy services from two or three service providers and have a regard for service quality.

iii. ***Shifting Loyal:*** These customers shift from one service provider to another frequently as they have high quality-consciousness in terms of service delivery.

iv. ***Switchers:*** This segment buys services from a different service provider all the time. This is the least loyal segment.

Benefits of Segmentation

Segmentation offers a number of advantages as it helps marketers to:

- Identify the most and least profitable customers.
- Focus on the customers who will be most likely to buy the products or services.
- Avoid the markets which will not be profitable.
- Build loyal relationships with customers by developing and offering them the products and services they want.
- Improve customer service.
- Get ahead of the competition in specific parts of the market.
- Use resources wisely.
- Identify new products.
- Improve products to meet customer needs.
- Increase profit potential by keeping costs down and also to charge a premium.

Segmentation of the market is a natural result of competition and growing consumer needs. As the competition grows, banks try to satisfy consumer needs better and better to gain the advantage. As the others follow the same and increase the levels of customer service, to gain a competitive advantage, banks will try to customize their services to suit specific individuals or a group of individuals. This is segmentation in its most fundamental form.

Market Targeting

Once the firm has identified its market opportunities, it has to decide the number of products and whom it has to target. The first step in target marketing is the evaluation of the markets followed by the selection. Apart from these steps, there are some other considerations which have to be taken into account while targeting.

Evaluating the Segments

While evaluating the market segments, the firm must look at the segments for overall attractiveness and the company's resources and its objectives. The firm must note whether a potential segment has the characteristics that make it attractive, like the size of the segment, profitability, potential for growth and risk. The firm must also consider whether or not to invest in the segment, given its objectives and resources.

The size and growth of the segment can be deduced from the current sales value, projected growth rates and the expected profit margin from the segment. The information regarding the competitors in the segment, substitute services and products, and the powers of buyers and suppliers will determine the structural attractiveness of the segment.

Another factor to be looked at while evaluating a segment is its viability. In determining the viability of a market segment, the following criteria can be looked into:

- Measurability in size and characteristics.
- Segment should be meaningful, capable of generating sufficient profits in the long run, thus justifying a separate marketing mix.
- The segment must be responsive to the marketing mix effort.

Selecting the Market Segments

After the segments have been evaluated, an organization can consider any of the five forms of target market selection. They are:

a. **Single Segment Specialization:** The organization targets only one segment of the consumers/customers. It has deep knowledge of this segment and if it manages to lead this segment, the return on investment will be high. But the risks associated with this pattern are also high. For example, if the sales in the segment start dropping or if there is a new competitor offering a better service, the ROI might plummet.

   This form of specialization is rarely taken up by the banks as the risks associated with this approach are high and financial services institutions cannot afford to look risk-prone, otherwise, attracting investments will be a very difficult prospect.

b. **Selective Specialization:** In this pattern, the organization selects a few segments which are prospective. These segments may or may not be synergetic. For example, a bank might concentrate on both car loans and individual deposits. This pattern diversifies the risks faced.

   The best example in this category is the Corporation Bank. It has a unique offering called the CAPS for the corporate customers. It is a cash management service where the bank provides liquidity management solutions to the corporate customers. The corporate banks, on the other hand, also concentrate on doing overseas business in non-resident Indian pockets.

c. **Product Specialization:** Product specialization is a form of market targeting where the firm specializes in a single product and sells it to several segments. In the banking industry, however, product specialization is not viable as no bank can afford to concentrate on a single product or service. Especially in markets like India, where the customers are vastly heterogeneous, this kind of specialization in banks is almost non-existent.

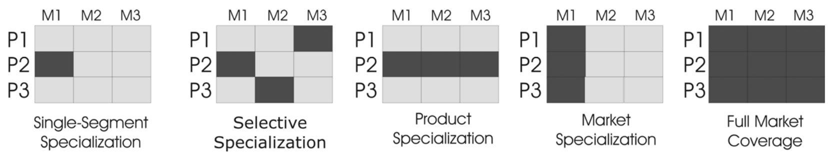
d. **Market Specialization:** Here, the organization concentrates on serving the needs of a particular customer group; here, it gains a strong reputation that becomes a platform for introducing new products for serving the group.

   ICICI Bank has built-up a reputation for remote banking services and it is constantly evolving its online banking products. It is currently the leader in the remote banking segment. The ICICI Direct Online Demat Account is the largest such account that is subscribed in India.

e. **Full Market Coverage:** Here, the organization attempts to serve all the needs of all the customer groups. This can happen when the customer groups cannot be segmented or the segments are not viable in terms of profitability or justify a separate product and/or a marketing mix. This is also attempted by large firms. Full market coverage might sometimes lead to mass customization or "segments of one".

   Large banks can usually afford to go for full market coverage, but since they lack specialization required to operate profitably in all areas, they go in mostly for selective specialization, leaving out areas which they cannot operate profitably or in which they don't have expertise in.

Figure 1: The Five Patterns of Target Market Selection



Additional Considerations

Additional consideration such as the ethical choice of the target markets, inter-segment cooperation, and interrelationships and segment by segment invasion plans must also be considered during the targeting process. Based on the targeting process, the immediate concern of the marketer is the positioning of the service in the market. Most banks today have recognized the importance of positioning their services in the customers' minds.

PROFILE

Customer Profiling

Customer profiling uses data warehousing information to help bankers understand the characteristics and behavior of specific target groups. Through this process, bankers can really understand who is subscribing to particular offers and schemes and how he/she is reacting to promotional offers and pricing changes. Some additional benefits of customer profiling include:

- Selecting target groups for promotional appeals.
- Finding and keeping customers with a high lifetime value to the bank.
- Understanding the characteristics of institutional accountholders.
- Customizing the service package to suit the individual needs of the customers.
- Reducing operating costs by targeting high response customers.

Identifying High-end Users

Data warehousing enables queries, which analyze the Recency, Frequency and Monetary value (RFM analysis) of accounts. Since the data that is stored in a data warehouse is in reference to a time frame, the time of the last transaction can be determined (recency). Next, how often transactions are made can also be determined (frequency) along with the type of the transaction made, to pay salaries or to invest in stocks and shares. Third, amount involved (monetary) in a transaction can be found. The advantage of RFM analysis is that often retail banks take up salary accounts of a large organization to improve upon their 'deposits'. Apparently, these accounts may seem to be large in monetary terms, however many retail banks may find it a bit difficult to efficiently service the large number of salaried employees that the account may inveigle. RFM analysis can be useful in identifying such high-end users who are profitable to the bank not only in monetary terms, but also in terms of service time and cost.

Fraud Detection

Data warehousing enables forensic analysis. Forensic analysis is a methodology that aims at finding patterns in the data records and then uses these patterns to mark out anomalous records or records with abnormal deviations (Kharbanda & Parthasarthi). Fraud involving loans, dubious accounts and other such fraudulent transactions which plague retail banking can be detected and corrective action can be initiated.

Improved Underwriting

Since data warehousing collects data from different sources, risk assessment, which is an essential feature of underwriting, can be improved upon. Moreover, through predictive modeling technique, which is a method employed to look for patterns in the data set probable risk areas along with their chances of occurrence can be calculated. Advanced mathematical tools and fuzzy logic are often used to get an accurate estimate of the risk factor and the involved financial aspect which arises due to the risk.

Quality Control

Retail banking, a totally service-oriented sector, is not suited for conventional quality control measures. Through predictive modeling technique, that has been mentioned earlier, operations can easily be standardized and quality control techniques like benchmarking can be implemented.

Business Forecasting

Business forecasting is another area in which data warehousing can be greatly useful. Data that has been gathered from different sources can be integrated to accurately forecast future inflows.

STRATEGIZE

The goal of relationship management is to increase customer satisfaction and to minimize any problems. By engaging in "smarter" relationships, a company can learn customers' preferences and develop trust. Every contact point with the customer can be seen as a chance to record information and learn preferences. Complaints and errors must be recorded, not just fixed and forgotten. Contact with customers in every medium, whether over the Internet, through a call center, or through personal contact, is recorded and centralized.

Many companies are beginning to achieve this goal by using Customer Relationship Management (CRM) software. Data, once collected and centralized, can be used to customize service. In addition, the database can be analyzed to detect patterns that can suggest better ways to serve customers in general. A key aspect of this dialogue is to learn and record preferences. There are two ways to determine customers' preferences: transparently and collaboratively.

Data warehouse contains data from different areas of the organization dealing with a wide variety of subjects. Such data might be critical in representing a unit as a whole, rather than being a conglomeration of differentiated units. The top management, which is entrusted with the job of forming policies and giving general direction of the bank, may find integrated data representing the 'whole organization' better suited for strategic planning.

Discovering preferences transparently means that the marketer learns the customers' needs without actually involving them. For example, at upmarket retailers, personal shoppers will record customers' preferences in sizes, styles, brands, colors and price ranges and notify them when new merchandise appears or help them choose accessories. With increased use of the Internet, companies have more opportunities to learn customers' preferences and behavior transparently. Information that can be easily collected includes:

- Words used in search engines to find your site. These can help understand how to categorize your services.
- Source of visit (search engine, other sites, directory sites, portals, banner advertising and so on).
- Individual customer measures such as number of monthly visits; time spent per visit and search patterns; orders from site; conversion (from visitor to purchaser); spending per order; spending per visit.

When marketers learn customers' preferences collaboratively, they engage in dialogue to help customers articulate their needs and identify how to meet those needs. Ultimately, this method should result in an ideal product, but it can take time. The goal of the marketer in learning preferences collaboratively is to determine a way to maximize learning without frustrating customers. Again, the web can be useful with online questionnaires and forms.

Permission marketing can also be used. This involves asking customers for permission to gather personalized information or to contact them in the future. Finally, collaborative filtering is effective for learning customers' preferences and helping them choose items they may enjoy. The book retailer Amazon.com uses this approach. The company tracks customers' preferences and purchase patterns, matches them with those of similar customers, and recommends other products based on purchases by similar customers.

When customers collaborate with marketers, they also learn their own preferences. Customers can thus have more control and ensure they get what they want. A product designed with the customer in mind is by definition not wrong, so having a customer collaborate on discovering his or her own needs encourages the customer to commit. Added to that, just being part of the process seems to increase satisfaction.

Cross-Selling

One advantage of learning a customer's preferences is that the company then has a record that can be used to cross-sell other products or services. For example, if a customer uses personal finance software, then a marketer could (as a service) offer to provide credit card information in that format. This information would be useful to the customer for financial planning and would provide a rich information bank for the marketer.

In addition to helping the customer to control his or her finances, the marketer (with permission, of course) could learn about his recent purchases. For example, if a customer began buying children's clothing, the marketer could propose related goods; or if plane tickets were bought, hotels could be suggested.

Other customer histories can help the marketer. For example, health organizations could keep a record of incidents and patient life styles that might suggest diagnostic testing and treatments. Marketers need to be careful with this information and build a relationship based on trust. Some businesses have natural advantages: People are more likely to trust a doctor or a bank than a supermarket. However, if relationships can be built and if the marketer provides valuable suggestions, the customer is likely to be loyal. It is easier for a customer to stay with a trusted company than to switch to another.

A Virtuous Circle

By learning customer preferences and focusing on long-term relationships, managers can provide products and services that fit customers' needs. They can also do this in a way that ensures loyalty. If a company earns a customer's trust and if, as a result of that trust, customers share strategic information about their preferences and needs, it will be difficult for competitors to duplicate the relationship.

As relationships develop, customers will tend to buy more from the company. Further, the more a customer buys, the more likely he or she will buy from that company again. This virtuous circle is reinforced because the more a customer buys from the trusted company; the less likely he or she is to turn to another supplier. Finally, the regular customer is more likely to switch to a premium product or service.

The ultimate reward in managing customized relationships will come if a company can transform customers into advocates.

Although price strategies may be effective in the short-term, they rarely come out best in the long run. A better strategy to transform customers into advocates is to try to meet the needs of each customer more precisely. Learning customers' preferences can not only help meet their needs better than the competition, but can also help marketers forge an enduring relationship.

Box 3: Customer Retention: The Often Overlooked Strategy

Forget that it is less expensive than acquiring new ones. Customer retention has larger ramifications in the financial services world. Just check out these statistics:

Banking

- Increasing retention by 5%, results in an 85% aggregate increase in the net present value of institutions' branch deposits.

— Frederick Reichfeld, "The Loyalty Effect," 1996

Insurance

- The longer a retail customer remains a customer, the greater the ratio of premiums paid to potential losses. If the average length of a relationship can be extended, the ratio of premiums versus expected losses increases.

— Peppers and Rogers, 2002

- The longer a property and casualty customer is a customer, the less likely they are to submit claims.

— Peppers and Rogers, 2002

In other words, customer retention is a profitable strategy. However, trends are showing that often it is an overlooked strategy. The American Consumer Satisfaction Index conducted by the University of Michigan's graduate business school, showed a fairly consistent downward cycle in satisfaction with major banks, as well as with banks as a whole. On a scale of 100, "all banks" scored just 68 compared to Walmart at 78, Publix at 81 and Cadillac at 88. The conclusion was that in its efforts to survive the downturn by eliminating substantial headcount and services, banks lost customer loyalty.

The Essentials of Customer Retention

Communicate with your customers consistently – your customer is told one thing by your branch manager, another thing by your 1-800 customer service agents. Over time, this inconsistency can create upset customers and customer attrition. Your goal should be to capture your company's existing knowledge of processes and products and find methods to radiate that knowledge throughout your organization so it can be shared with customers accurately.

Offer those products geared toward their actual needs – According to Fujitsu Consulting, 37 percent of financial services companies still have a strategic and operational focus on the products and services they sell rather than on the people they sell them to. If you're one of these companies, you may want to learn how you can use your customer information to create products that encourage profitable customer behavior while meeting the needs of your customer.

Provide quality service via your contact center – the contact center is the most customer-facing unit of most organizations. It's where customers go to get their questions answered and monitor their accounts. Whether you maintain an in-house unit or outsource, providing quality service is a basic requirement of customer retention.

Keep the profitable ones – Customer retention is only a profitable strategy if you keep your existing profitable customers. Hanging on to unprofitable customers just saps your company of its earnings and potential. What is an unprofitable customer for one company may be profitable for another.

By the way, according to a Gartner2 survey, it costs retail financial services firms $280 to find a new customer and only $57 to keep one. In other words, it costs 5 to 12 times more to acquire a new customer than it does to maintain an existing one.

Source: www.cincom.com/financial/needs/retention

EXECUTE

It is not an easy task to frame business strategies for banks in the emerging environments. The banking system in India has witnessed several changes in the past ten years and over, soon after initiation of economic reforms in 1991. Since then the country has been opened to other economies of the world.

The protection extended by the government and central bank is no longer present in the banking environment of India and banks in India are now seen to be more vulnerable to the changes occurring elsewhere in the world. Basel-II accord is one such major example, the other factors being the weakening of US dollar, Iraq war and instance of 11th September. The effect of external events on the Indian banking industry is expected to be present in future times also. The slowdown in the growth of major economies of the world has prompted the movement of capital into our economy through the routes of Foreign Institutional Investors (FIIs), Non-Resident Indians (NRls), Overseas Corporate Bodies (OCBs), and Foreign Direct Investment (FDI) when the Indian economy witnessed relatively better growth.

The fact that banking system is not susceptible to any immunity from the global events is reflected in the South Asian crisis where full convertibility was implemented. Whereas, in India, CAC is attempted in a phased manner owing to the lessons derived from the South Asian crisis. Despite caution, our country has undergone tremendous pressure of excess liquidity leading to downward pressure in interest rates.

In a situation where the world economy is sluggish and rates are declining, our domestic sector cannot have a rising interest rate. In these circumstances, an appropriate strategy has to be taken up in the backdrop of global perspective.

We have seen in the earlier chapters how strategies are formulated and chosen. Here, in this chapter, we shall endeavor to learn the aspect of implementation of strategies.

Principles of Strategic Execution

As we have dealt with strategic management, which is defined as the set of decisions and actions that result in the formulation and implementation of plans designed to achieve a company’s objectives, some of the strategic implementation principles comprise the following critical tasks:

- Formulating the company’s mission, including broad statements about its purpose, philosophy and goals.
- Developing a company profile that reflects its internal conditions and capabilities.
- Assessing the company’s external environment, including both the competitive and general contextual factors.
- Analyzing the company’s options by matching its resources with the external environment.
- Identifying the most desirable options by evaluating each option in the light of the company’s mission.
- Selecting a set of long-term objectives and grand strategies that will achieve the most desirable options.
- Developing annual objectives and short-term strategies that are compatible with the selected set of long-term objectives and grand strategies.
- Implementing the strategic choices by means of budgeted resource allocations in which the matching of tasks, people, structures, technologies and reward systems is emphasized.

Objectives – Past and Prospective

It is accepted in any business that profit is the ultimate goal. On the same lines, business strategy for banks is always framed to achieve higher profits in future. By and large, banks in India are now deriving a large portion of profits from their treasury operations. The moot question is whether it continues to be so and if so, for how long. It is evidenced that there is every reason why business strategies should have a bearing on the continued maintenance of profits and profitability.

The second major challenge before banks across the world including India is that of the managing quality of assets and recovering overdue/NPAs. The reason why the net portion of NPAs to total advances is showing a smaller percentage is only due to the fact of higher provisioning, write-offs, compromise proposals, one-time settlement scheme of the RBI and not on account of actual recoveries. We can also analyze some of the developments like introduction of Debt Recovery Tribunals (DRTs), Lok Adalats, Corporate Debt Restructuring (CDR) mechanism, Credit Information Bureau, Asset Reconstruction Companies (ARCs), Securitization Act, 2002. The Securitization Act, 2002 confered powers on banks to acquire and sell assets belonging to defaulters without intervention of courts. DRTs have been successful to some extent. Lok Adalats, have limited success in some areas where other legal redressals are relatively untested. It is praiseworthy the way the Indian courts are coming to the rescue in the best interests of bankers, by their strict interpretation of the mind of the lawmakers. The net result is bankers are now in a better position vis-à-vis the defaulting borrowers, thanks to the Securitization Act.

Besides risk, the bank has to manage with the spread which is another challenge faced by the banks at this juncture drawing adverse criticism from the depositors and borrowers alike. There is a feeling in some quarters that the banks in India are unable to contain the operational costs and expenses with the help of the spread obtained on the interest portion unlike their international counterparts. This is the reason why the real interest rates are coming down. At present, real interest rate to depositors is very low. Depositors have a feeling that lending rates to borrowers have been brought down by banks at their cost alone due to the fact that banks have not slashed their PLRs in the manner they have cut deposit rates in a short span of time.

Technology, in the times to come, will bring further changes in the Indian banking. Major banks are poised to spend huge amounts on technology. The thrust is on total branch computerization and networking of branches to enable customers to perform transactions from anywhere.

THE DUAL ASPECT OF PROFIT AND PROFITABILITY

Any focus on business strategy of a bank shall include higher profits and increased profitability. Banks shall not be excessively obsessed with maximization of market share. It has been the experience abroad that maximization of markets share results in minimized profits. It has also been the experience that the most profitable company is not with the largest share of the market. The irony continues to disturb the strategists in the banking world. The smaller banks continue to dig out real profits. It is not to say that banks should overlook market share, though it will not hurt if they did so. It should be remembered by the strategist that market share is not an advantage by itself, but only a useful factor of competitive advantage for sustainable growth.

OTHER INCOME AND OPERATING EXPENSES

In modern banking practices, it has become a well-established objective that the operating expenses should be met by other income so that excessive reliance on interest income is reduced. The strategy required is improvement of other income to meet the costs of salary, allowances and other overheads.

With regard to PSBs, operating expenses declined by 5.65% in 2001-02 over the previous year, mostly on account of VRS scheme, while other income increased by 33.6%. The increase in income was due to sale of investments. High Power Standing Committee on the lines of Asset Liability Management Committee (ALCO), Credit, NPA, and HRM Committees has to be geared up in the banks on a permanent basis.

Banks have already started looking for new areas to increase their other sources of income such as custodian services, opening of demat accounts, insurance products, and retailing of government securities.

TARGETING MID-CORPORATES

Corporates increasingly prefer the private placement route/CP for financing their working capital. For other long-term finance requirements, they are opting for External Commercial Borrowings (ECBs) and other avenues. The reasons for high cost of borrowing in the domestic market are due to relatively higher rates of interest as compared to international markets. We may not be able to bring down interest rates to the international level in near future due to: (i) high fiscal deficits of government, (ii) high interest rates on small savings, (iii) structural rigidities in interest rate structure, (iv) high gross NPAs, (v) inefficiency of banking system, and (vi) relatively high rate of inflation. In order to overcome the above deficiencies to some extent, the strategy for banks would be to depend on mid-corporates for generating interest income. In respect of mid-corporates, credit risk will be higher as against the triple-A rated companies. One cannot expect an efficient corporate to help an inefficient bank and pay higher interest. This phenomenon is prevalent in our commercial banks – Cooperative banks and Non-Banking Finance Companies (NBFC). A mid-corporate borrower tends to approach a Cooperative bank or an NBFC, if he is not able to get loan from a commercial bank. So, in order to secure his clientele, the PSB has to quote the finer rates despite indications in rating.

Further, with respect to lending to mid-corporates, if the credit risk is higher, it will fetch higher interest yield to banks. The bank has to hedge against higher credit risk and at the same time credit rating should be properly assessed. It could be a better strategy in the present circumstances as otherwise banks will have to put maximum resources in low yielding government securities and it will automatically come under “narrow banking”. The RBI has also barred banks from investing in unrated debt securities in order to contain the risk of non-SLR investments, particularly in case of privately placed issues. These moves can make banks extend credit facilities.

Strategies with the Trading Sector

Customarily, banks in India have not lent much to the trading sector compared to the industry. Consequent to the growth of service sector getting higher share of the GDP, banks have started paying their attention to this sector.

There are certain typical hindrances in trade loans. This is the reason why bankers are slow in response to their requirements of loan and advances. In these kinds of advances, the primary security often insisted was hypothecation of goods. This security has lot of practical disadvantages such as the stock secured might not be a paid item or the same might be on consignment terms.

The practice of banks insisting on submission of stock statements, following cumbersome procedural verification of the stocks/goods is among the other reasons.

Insistence of banks on due transparency in accounting, involving periodical submission of stock statements adds to inconvenience of small traders. The borrowers might be already obliged to review/renew their account, submit final accounts, etc.

In order to overcome the above practical hardships, it is high time the strategies were changed with regard to financing of trade. The banker should balance his safety requirement with the increase in the off-take of credit in this sector. Most of the dealers, distributors, stockists and wholesalers are usually persons of sound resources, who can offer fixed assets like building property or assets like gold, term deposits, etc., as a primary security in the account. Bankers should do well in relying on the mortgage and pledge of assets like immovable property like house building and pledge of gold and other movable assets rather than encouraging goods for hypothecation purposes.

Emerging Trends

Already a welcome change is seen in the way banks have caught up with new trends in advance portfolio. The growth in IT services is synonymous with the increased lending by banks. Banks gave a new fillip to the IT boom. Likewise housing and real estate loans, consumer durable loans and educational loans have witnessed a remarkable upsurge in recent times. However, banks in India are still lagging behind in the area of tourism, which has gained greater importance across the world. The change in the strategy of bankers is appreciable more in its favorable and proactive response to the previously so-called unproductive sectors, namely consumption/consumer loans.

There was a time when banks were scared to advance funds for consumption purposes. May be it was on account of the prevailing policy of government that such loans were for unproductive purposes. Banks used to entertain distrust in the recovery potential of these loans. Only staff on the rolls of the bank or some well-to-do customers could get housing, vehicle and consumer durable loans. Today, the shift towards growth in consumer loans has gathered momentum to the extent where a housing loan is available even for second or third house at a strikingly cheaper rate than for other productive advances like agriculture, industry or manufacturing.

The banks have to take some benefit out of the changed scenario when the industrial credit as proportion to the net bank rate has come down. The share in the services sector should be increased while duly preferring mortgage or like other security-backed loans in the sector. Possibly, they should rope in the third party guarantee keeping an eye on raising NPAs. The staff manning advances should come out of fear psychosis in the changed circumstances and select good and needy borrowers. Calculated risks have to be taken and advancing to the service sector will definitely fetch higher yield to the banks when compared to mere housing loans which yield lesser interest rates and other low yielding investment in government securities and call market.

GROWTH POCKETS

The bank can choose the target as either profit or market share as its business goal. We have already discussed what the international experience has been in this regard that it is sensible to target for higher profit at the cost of market share. A few of the banks are turning their goals from “profit with growth” to “growth with profit”. This change in the strategy is being backed up and also reflected in the banks’ reporting systems on performances. It is not exactly as though the market share should be fully ignored. The market share is to be ideally taken as a bye-product or fallout of the bank strategy. In order to achieve the same, customer service in the banks including CRM has to be geared up for the future potential of competitive advantage or increase in market share. The above phenomenon is happening with regard to the new generation of private sector banks like ICICI and HDFC.

The statistics indicate that mobilization of deposits and advances in the top 20 out of 100 centers have paid rich dividends in business growth. Likewise, studies indicate that if a bank is losing business share, the same was due to the loss in those 20 centers, irrespective of better performance elsewhere.

Some of the suggestions given here are towards building better potential in growth centers:

Banks shall be cautious at the continuing decline in the market share which may bring down their competitiveness as otherwise it will have a demoralizing effect on the banking staff. Past trend should not be taken as a basis for deciding on business goals. Budget should be in tune with the concept of market share rather than the trend.

Banks have to concentrate more on the following areas by improving the capacity of their branches to mobilize higher business while a change in the attitude and awareness in the business is a must for the staff.

- Computerization;
- Single window policy;
- Networking;
- Core banking; and
- Change in the business process.

Most importantly, there is a compelling and strategic need for the banks to engage suitably on exclusive basis specialized personnel in the designated categories in the emerging areas for improving the efficacy and efficiency.

MONITOR AND REVIEW

Establishing Strategic Controls

Strategic control focuses on monitoring and evaluating the strategic management process to ensure that it moves in the right direction. In other words, strategic control is concerned with tracking the strategy when it is implemented, detecting problems or changes in underlying premises, and making necessary adjustments. Strategic control answers questions such as:

- Is the organization’s internal strength still holding good?
- Are its internal weaknesses still present?
- Has the organization added other internal strength?
- Does it have other weaknesses?
- Are there new opportunities?
- Do the threats to the organization still exist, and are there any new threats?
- Are the decisions consistent with the organizational policy?
- Are there sufficient resources to achieve the objectives?
- Are goals and targets being met?
- Are the organizational vision, mission and objectives appropriate to the changing environment?

The strategic control provides feedback on the various steps of strategic management. It enables the management to find out whether the strategic management process is appropriate and compatible with organizational goals and whether it is functioning in the desired direction. Sometimes, strategic controls may initiate changes in objectives as well.

PREMISE CONTROL

Premise means an assumption. Every strategy is based on some assumptions. A firm's strategy is built around these assumptions. Premise control helps to check, systematically and continuously, whether or not the assumptions set during the planning and implementation process are still valid. If a premise or an assumption is no longer valid, then the strategy is changed along with the assumptions. Premises are primarily concerned with two types of factors – environmental, and industry factors.

ENVIRONMENTAL FACTORS

Environmental factors have a considerable influence on the success of a strategy. Examples of environmental factors are inflation, technology, interest rates, government regulation, demographic/social changes, etc. A company has a little or no control over such factors and strategies are usually based on key premises of these factors.

INDUSTRY FACTORS

Industry factors affect the performance of companies in a given industry. Strategic assumptions are made about factors such as competitors, suppliers, substitutes, and barriers to entry, etc. These factors differ from industry to industry. So, a company should be aware of the factors that influence success in the industry in which it operates.

Various premises are made out of numerous industry and environmental variables. Tracking every premise is expensive and time-consuming. So, managers should select only those premises that are likely to change and those that are likely to have a major impact on the company and its strategy. After the key premises are identified, they should be monitored, and responsibility should be assigned to the persons/departments who are qualified to provide information. Premises should be updated, on the basis of new information. Finally, key areas of the strategy that are likely to be influenced by the changes in assumptions should also be identified. For example, senior managers have to be aware of changes in a competitor's pricing policies. This is required so that they can bring about necessary changes in their own pricing or other types of strategies. In the same way, managers have to be aware of technological changes such as the growth of the Internet, which has enabled many companies to market their products internationally without even knowing their customers. Awareness and willingness to change can help create strategic advantages for the organization.

IMPLEMENTATION CONTROL

The action phase of strategic management consists of a series of steps, programs and moves undertaken over a period of time to implement the strategy. In this phase, managers undertake programs, add people, and mobilize resources. In other words, managers translate broad strategic plans into concrete actions. These actions act as goals for specific units and individuals as they go about implementing the strategy. These actions take place over the intended period of time and are designed to achieve long-term objectives.

The strategic control undertaken within the context is known as implementation control. Implementation control determines whether or not the overall strategy should be changed, in the light of unfolding events, and results of incremental steps and actions. There are two types of implementation control: monitoring strategic thrusts and milestone reviews.

Monitoring Strategic Thrusts

The implementation of broad strategies involves undertaking several new strategic projects that represent part of what needs to be done if the overall strategy is to be accomplished. Through these projects or thrusts, managers can obtain feedback that helps in determining whether the overall strategy is progressing as planned or whether it needs to be adjusted or changed.

Milestone Reviews

Managers often identify the critical milestones that will occur over the time period when the strategy is being implemented. These milestones may be critical events or major resource allocations. A milestone review involves a full-scale reassessment of the strategy and the advisability of continuing or refocusing the direction of the company. Thus, the critical purpose of a milestone review is to undertake a thorough review of the firm's strategy at a critical juncture, so as to control the direction of the strategy and company.

Special Alert Control

A special alert control reflects the need to thoroughly reconsider the company's basic strategies based on unexpected events. Such an occurrence should trigger an immediate and intense reassessment of company's strategy and its current strategic situation. Many companies delegate crisis teams to handle initial response and coordination.

Operational Control Systems

Operational control systems help operating managers to implement strategy at their level. These systems help to guide, monitor, and evaluate progress in meeting the annual objectives of company. They provide post-credit evaluation and control over short-term periods (one month to one year) for operational control systems to be effective.

Budgets

An important type of operational control systems is budget. A budget is a plan to show how much money a person or organization will earn and how much they will need or be able to spend. It states planned organizational activities for a given period of time in quantitative terms. Budgets set standards against action which can be measured and include figures such as projected income, expenditure and profits. A budget is simply a resource allocation plan that helps managers coordinate operations, and facilitates managerial control of performance. Budgets also provide a basis for negotiating short-term resource requirements to implement strategy at the operating level. Most firms use the budgeting system to control strategy implementation. Though budgets differ from organization to organization, they can be classified into three general types of budgets i.e., revenue, capital and expenditure.

Revenue Budgets

A revenue budget provides for the daily management of financial resources. It also provides key feedback as to whether the strategy is working or not. A sales budget is one such revenue budget. It gives a formal and detailed expression of the sales forecast. This sales forecast is the cornerstone of planning and also acts as the foundation for budgetary control. Sales revenue budgets give feedback on the effectiveness of a firm's approach. If the deviation is more than expected, managers can re-evaluate and adjust the firm's operational and strategic posture.

Capital Budgets

Capital budgets outline specific expenditure for plants, equipment, machinery, inventories and other capital items needed during the budget period. Preparation of these budgets needs great care, as these budgets give a definite form to the spending plans of an enterprise. Cash budgets and balance sheet budgets are often developed to control the use of capital resources along with the capital budget.

Expenditure Budgets

An expenditure budget presents the financial allocations for each department during the budget period. The expenditure budget for each functional unit and for sub-functional activities guides and controls the execution of strategy of each function. For example, firms prepare separate expenditure budgets for marketing activities and advertising activities.

Depending on how budgets are used, they can have either positive or negative effects on managerial effectiveness in organizations. On the positive side, budgets keep managers informed about organizational activities and enhance correlation across various units. Negative effects arise if the budgets are used in a rigid manner.

Banks' Perspective

INTERNAL CONTROL

Internal control is a process designed for ensuring effectiveness and efficiency of operations apart from complying with regulations with respect to financial reporting.

Addressing the objectives of business is the first priority. Second, the reliability of financial statements, which includes interim earnings releases. Third, regarding compliance with regulators as internal controls operate at various levels; they have to be evaluated on these three factors to operate effectively.

Further, the directors and management also have to be clear in terms of understanding the importance of these processes. Internal controls are closely related to the management, its processes organization structure. One has to note that controls may be less formal in structure in a small company but they can be effective relative to large companies.

The components of control systems are discussed in the following paragraphs:

ENVIRONMENT

The environment for internal control comprises management philosophy and style integrity, ethical values and competency. The structure of the organizations and the way managements set and assign the tasks and authority determine the nature of internal control.

ASSESSING RISK

Activities: The activities of control are vital to ensure tackling various risks that the organization focuses. The activities are done as per the rules and procedures at all functions and levels.

Information: For any organization, information is the backbone for effective control systems. Information regarding all aspects of operational, legal financial areas has to be identified, gathered and analyzed. Such appropriate information has to be communicated in a given time frame and to the respective people. The data to be analyzed has to be on both internal and external activities for effective business decision-making. People must understand their responsibilities and their role in the internal control system apart from communicating information about the organization. Also, external parties such as shareholders, customers, regulators, and suppliers have to be communicated well.

MONITORING

Monitoring of internal control systems has to be a continuous activity to assess the system's performance. One of the methods is ongoing monitoring, which is monitoring of operations during their course. Operations, routine management activities, supervisory activities are part of this ongoing monitoring. Separate evaluations can be undertaken to assess the risks and effectiveness of these systems.

But, all these activities have to be linked to form an integrated approach for the control system so that the purpose of organization and operating activities coexist. Due to its importance, the control systems have to be integrated into the organization's infrastructure so as to be comprehensive for smooth operations.

So, internal controls can help meeting targets of performance and profitability and at the same time to prevent losses. It aids in the reliability of financial statements, compliance of regulators, and avoid damages. But, still one must not have the viewpoint that setting internal controls would solve all the problems.

First, internal controls are meant to meet the basic objectives of business i.e., survival. They provide management information regarding organization's position with respect to meeting these said objectives. No matter how well one conceptualizes and operates, it cannot give absolute guarantee to the management that organization's objectives are met. All internal control systems have certain limitations, which get reflected in the organization such as error in decision-making, breakdowns, and circumvention by management or people. These may be due to inherent design limitations in the control systems. (Financial constraints)

RESPONSIBILITIES

The CEO is the one who must take the lead role and assume ownership and responsibility of system. The environment of the system is dependent on integrity, ethics that people do and follow. He directs, decides, and fulfills to meet the purposes of the organization. Senior managers assign responsibilities to specific persons to meet the policies of control systems, which are in turn assigned by the CEO. In a small organization, it may be CEO direct to manager or by self. There can be instances in case of emergencies.

As management is accountable to the directors, the directors' capabilities are vital as they are instrumental in guidance, governance of organization. Active board is vital going by recent corporate scandals in accounting and controlling areas. Again, it is here that the role of internal auditors is critical due to the monitory role played by them. Apart from these, the role of external auditors has its own benefits in terms of objective and independent view they bring in into audit of the organization. Other parties are regulators, customers, and rating agencies, though they may not be part of integral control system. In spite of the increased regulatory incidents with regard to corporates in the post-tech meltdown, one should not insist on excess control due to past failures. A formula could be arrived with an agreement between regulators and organizations for an integrated framework identifying the limitations of internal control.

STRATEGY AND CONTROL

Corporate strategy highlights the strategic initiative and future scenario of the corporates. It must incorporate governance risk management and internal control environment as part of strategic planning. The control systems can be built into the planning process. Controls can be incorporated into the design, which can reduce the cost of errors as monitoring reveals any deviation from the said goals. It is not easy for outsiders to judge the effectiveness of governance. It takes time and many breaks for the public to know about the breakdown of internal control. Once the public knows the deficiency in disclosures, lawsuits, drop in share price, loss of credibility to bank are all part of breach in governance.

Some of the practices must be:

- Adoption of a recognized internal control framework. Such framework must have vital elements such as:
  - *Environment:* The top management has to identify and match bank's business strategies, objectives with its philosophy, culture and ethics to have control over environment.
  - *Assessment:* Assessing risk is vital for the bank to establish appropriate risk measurement practices.
  - *Activity:* Controlling and monitoring activity is critical for the bank so as to determine news controls.

- **Assessing Efficacy of Internal Controls:** It is vital for the managers to ensure that organizations have effective internal controls. They must assess the risk at appropriate levels to match with the level of capital. The supporting functions like internal audit, accounting, legal systems have to be monitored for their efficacy. An internal auditor can also aid in effectiveness of control. Apart from the periodic assessment, an independent evaluation of management's report can be carried out. It is crucial for the internal audit team to work independently. The audit committee can utilize these reports to generate future audit plans.
- **Assessment of Operational Risk:** Due to the nature, variety of banks' products and services change in the environment, the exposures to risk has increased considerably. It is vital for managers to measure and evaluate operating risk of banks, arrive at comparison of internal controls and operational risk management.

PERSONAL SELLING SKILLS

1. **Preparation**/planning/research/approach (using facilitative methods)
2. **Introduction**/opening/approach/establish initial credibility
3. **Questioning**/identify needs/ask how and what, etc/establish rapport and trust
4. **Presentation**/explanation/demonstration
5. **Overcoming objections**/negotiating/fine-tuning
6. **Close**/closing/agreement/commitment/confirmation
7. **Follow-up**/after-sales/fulfill/deliver/admin

The Seven Steps of the Sale

1. **Planning and Preparation**
   - Ensuring to know the product/service extremely well – especially features, advantages and benefits that will be relevant to the prospect.
   - Understand what other competitors are able and likely to offer, and which ones are being considered if any.
   - Identify as many of the prospect organization's decision-makers and influencers as you can by assessing their needs, motives and relationships.
   - What are your prospect's strategic issues, aims, priorities and problems, prepare your opening statements and practise your sales presentation.
   - Prepare your presentation in the format in which you are to give it (e.g., MS PowerPoint slides for laptop or projected presentation) plus all materials, samples, hand-outs, brochures, etc., and always have spares – allow for more than the planned numbers as extra people often appear at the last minute – see the presentation section for more detailed guidance on designing formal sales presentations.
   - Prepare a checklist of questions or headings that will ensure you gather all the information you need from the meeting.
   - Think carefully about what you want to get from the meeting and organize your planning to achieve it.
2. **Introduction**
   - **Smile** – Be professional, and take confidence from the fact that you are well-prepared.
   - **Introduce Yourself** – First and last name, what your job is and the company you represent, and what your company does (ensure this is orientated to appeal to the prospect's strategic issues).

- **Set the Scene –** Explain the purpose of your visit, again orientate around your prospect not yourself.
- Ask how much time your prospect has and agree a time to finish.
- Ask if it's okay to start by asking a few questions or whether your prospect would prefer a quick overview of your own company first (this will depend on how strongly know and credible your own company is – if only a little you should plan to give a quick credibility-building overview in your introduction).

3. **Questioning**

- The main purpose of questioning is to confirm or discover the strongest or unique perceived organizational benefit that would accrue to the prospect from the product/service.
- Questioning must also discover how best to develop the sale with the organization – how they decide, when, people and procedures involved, competitor pressures, etc.
- Good empathic questioning also builds relationships, trust and rapport - nobody wants to buy anything from a sales person who's only interested in his own product or company.
- Interpret and reflect back and confirm you have understood what is being explained, and if relevant the feelings behind it.
- Questioning is traditionally treated by conventional sales people and conventional sales training as a process to gather information to assist the sales person's process.

4. **Presentation**

- The sales presentation should focus on a central proposition, which should be the unique perceived benefit that the prospect gains from the product/service.
- During the questioning phase, the sales person will have refined the understanding (and ideally gained agreement) as to what this is – the presentation must now focus on 'matching' the benefits of the product with the needs of the prospect.
- The sales person therefore needs an excellent understanding of different organizational benefits that accrue to customers, and why, from the product/service – these perceived benefits will vary according to the type of customer organization (size, structure, market sector, strategy, general economic health, culture, etc).
- Presentations should use the language and style of the audience – e.g., technical people need technical evidence; sales and marketing people like to see flair and competitive advantage accruing for their own sales organization; managing directors and finance directors want clear, concise benefits to costs, profits and operating efficiency; and generally the more senior the contact, the less time you will have to make your point – no-nonsense, no frills, but plenty of relevant hard facts and evidence.

5. **Overcoming Objections**

- Decades ago, it was assumed that at this stage lots of objections could appear, and this would tend to happen, because the selling process was more prescriptive, one-way, and less empathic; however, successful modern selling now demands more initial understanding from the sales person, even to get as far as presenting, so the need to overcome objections is not such a prevalent feature of the selling process.

- Nevertheless objections do arise, and they can often be handled constructively, which is the key.
- If objections arise, firstly the sales person should qualify each one by reflecting back to the person who raised it, to establish the precise nature of the objection – "why do you say that?" is usually a good start.
- It may be necessary to probe deeper to get to the real issue, by asking why to a series of answers – some objections result from misunderstandings, and some are used to veil other misgivings which the sales person needs to expose.
- Lots of objections are simply a request for more information, so definitely avoid responding by trying to re-sell the benefit – simply ask and probe instead; the best standard response is something like "I understand why that could be an issue, can I ask you to tell me more about why it is and what's important for you here?.."
- It is important to flush out all of the objections, and in so doing, the sales person is effectively isolating them as the only reasons why the prospect should not proceed, but then the more modern approach is to work with the prospect in first understanding what lies beneath each objection, and then working with the prospect to shape the proposition so that it fits more acceptably with what is required. See the section on negotiating.

6. **Closing Agreement**

- In modern selling, even using the traditional Seven Steps process, every sales person's aim should be to prepare and conduct the selling process so well that there are few if any objections, and no need for a close.
- The best close these days is something like "Are you happy that we've covered everything and would you like to go ahead?", or simply "Would you like to go ahead?"
- In many cases, if the sales person conducts the sale properly, the prospect will close the deal himself, and this should be the another aim for the sales person – it's civilized, respectful, and actually implies and requires a high-level of sales professionalism.
- The manner in which a sale is concluded depends on the style of the decision-maker – watch out for the signs: no-nonsense high-achievers are likely to decide very quickly and may be a little irritated if you leave matters hanging after they've indicated they're happy; cautious technical people will want every detail covered and may need time to think, so don't push them, but do stay in touch and make sure they have all the information they need; very friendly types may actually say yes before they're ready, in which case you need to ensure that everything is suitably covered so nothing can rebound later.
- **The Guilt Close:** "Over three years, it might seem a lot of money, but we find that most responsible people decide they simply have no choice but to go for it when it's less than a pound/dollar a day to protect your.../safeguard your..../improve your... (whatever)."
- **The Sympathy Close:** "I know you have some reservations that we can't overcome right now, but I've got to admit that I'm pretty desperate for this sale – my manager says he'll sack me if I don't get an order this week, and you're my last chance – I'd be ever so grateful if you'd go ahead – and I promise you we'd be able to sort out the extra features once I speak to our production people..." (How could anyone live with themselves using that one?....)

7. **Follow-up**

   After-sales follow-up depends on the type of product and service, but generally for every sale the sales person must carry out a number of important processes:

   - All relevant paperwork must be completed and copies provided to the customer – paperwork will cover the processing of the order, the confirmation of the order and its details to the customer, possibly the completion of installation, and delivery specification and instructions.
   - Sales reporting by the sales person is also necessary, generally on a pro-forma or computer screen, typically detailing the order value, product type and quantity, and details about the customer such as industrial sector – each sales organization stipulates the sales person's reporting requirements, and often these are linked to sales commissions and bonuses, etc.
   - The sales person should also make follow-up contact with the customer – as often as necessary – to confirm that the customer is happy with the way the order is being progressed; this helps reduce possible confusion and misunderstood expectations, which are a big cause of customer dissatisfaction or order cancellation if left to fester unresolved.
   - Customer follow-up and problem resolution must always be the responsibility for the sales person, who should consider themselves the 'guardian' of that customer, even if a well-organized customer service exists for general after-sales care.
   - Customers rightly hold sales people responsible for what happens after the sale is made, and good conscientious follow-up will usually be rewarded with referrals to other customers.
   - Follow-up is an important indicator of integrity; when a sales person makes a sale he is personally endorsing the product and the company, so ensuring that value and satisfaction are fulfilled is an integral part of the modern sales function.

To improve selling skills following tips can help an individual:

- Subscribe to sales and selling newsletters, especially to the many good free e-newsletters available from sales and selling websites, and other websites relating to behavior, business, marketing and communications.
- Read the newspapers and business supplements, which contain articles about sales and selling. Sales are not just about selling. Sales is about people and relationships, business and marketing, psychology and communications, self-confidence and attitude, belief, ethics and trust, information, quality, equipment, processes, and all of life.
- Learning opportunities for improving your understanding of selling are all around you, everywhere, on the internet, in books, magazines and articles.
- Observe sales people in selling roles – in stores, at exhibitions, and especially when they call at your door, or call you on the phone. Give them time to show you how they sell. Learn from the good and less good things that you see other sales people exhibiting. It's easy to judge whether selling is good or not: did it result in a positive experience or a sale? Or did it result in a negative experience and a feeling that the prospective customer and the seller will never speak again?

- Get yourself onto the mailing lists of the sales training organizations. Business and training exhibitions and magazines are very useful for identifying relevant providers and for adding your name to their mailing lists. Look out for free seminars which they use to promote their courses.
- Attending business and training exhibitions is a good way to meet people in the sales community, to observe sales people at work, and to add your name to their mailing lists.
- Attend talks and lectures or courses about selling – many are very low cost – some are free. You will hear about them if you are on the mailings lists of organizations providing them. Also contact your local business chamber or local government business support unit for information about such events.
- Observe politicians and business people being interviewed on TV; they demonstrate good and not so good sales techniques when they attempt to persuade, build credibility, answer questions, overcome objections, etc.
- Join a debating society. Observe how people 'sell' their ideas and propositions – again you will be able to judge what is effective and what is not. Give yourself experience in publicspeaking and debating.
- Offer to give presentations to local voluntary groups, schools, anywhere that you can practise, learn and get experience of giving presentations. Capability to speak and give sales presentations to groups is largely a question of experience and confidence. This comes from having done it. So, start now.
- If you like to listen and learn, especially while driving, buy or borrow sales training and communications audiotapes and CDs and DVDs. Sales and selling learning is not limited to sales techniques – listen to anything about communications and behavior, personal development and confidence, goals and aims, relationships and psychology, ethics and philosophy, process and systems, equipment and ICT (Information and Communications Technology), marketing and business. All these areas directly relate to and give depth to your sales and selling capabilities.
- Selling is after all mostly how you feel about yourself and making things happen for yourself. So feel good, and go make something happen.
- Modern selling requires understanding and capabilities that extend way beyond traditional 'sales training' skills.
- Modern selling is about life, people, business (and increasingly ethical business and corporate responsibility), communications, behavior, personality and psychology, self-awareness, attitude and belief. Selling is about understanding how people and systems work, and enabling good outcomes. (The word 'systems', means organizations and processes and relationships, not just systems in the sense of tools and IT.)
- Learn about other aspects of modern business, management, and self-development that interest you, and extend this principle to your people
- Develop the understanding of organizations, management and business – beyond sales training and you will greatly increase your value and effectiveness to employers and clients, and to the organizational and business world generally.
- The more you understand about how people think, how organizations work and how they are managed, the more effective you will be.

Box 4: Special Features of Product Offerings
Citibank Offers Loans with no Guarantors: Most banks require that you present a guarantor who will back you up if you default on your loan repayment. It can often be embarrassing to ask friends to stand guarantor, as most banks do not accept relatives as guarantors. Citibank gives home loans up to 90% of the property value, the highest from any bank (only Tata Housing Finance matches this offer). **Citibank Offers a Flexi-savings Account to Reduce your Cost of Borrowing:** The bank will automatically open a Saving Account from which you can give standing instructions to deduct the EMI payments for the loan. You can then prepay the loan at any point in time and be given instant credit for the same, in case you get a large lump sum annual bonus from your employer. Should you require money in an emergency at any point, you can avail an over draft on this savings account at an interest rate that is the same as that on your Home loan. This works out much cheaper than taking an overdraft on a normal savings account. **HDFC Offers Flexible (Customized) Repayment Schemes:** Keeping in mind the fact that each individual has a unique problem requiring unique solutions, HDFC has developed various repayment options like Step-up Repayment Facility, Flexible Loan Installment and Balloon Payment Scheme. **Pari Passu/Second Mortgage Arrangements:** HDFC has a tie-up with a large number of Public Sector Organizations and banks which enable it to offer loans to its employees with the flexibility of their spouse also availing a loan from his/her own employer. **Safe Document Storage Facilities:** HDFC has state-of-art storage facilities, which are theft and fire-proof, at various locations where loan and property documents are stored. In this way, valuable documents are stored safely over the period of the loan and are released almost immediately after a customer repays his loan. A customer, after availing of a loan can approach HDFC anytime thereafter to increase the Equated Monthly Installments, which will help him repay the loan faster. **Home Conversion Loan** is offered to its existing customers who are interested in moving to a new house. Through this scheme, customers can apply to have their existing loan transferred towards the purchase of the new home. Customers may also apply for an additional loan amount for the purchase of the new house. This gives the customer the option of selling their existing house, if they wish to, without having to repay their old loan. The fixed rate loan can be converted into floating rate without any penalty charges. However, the customer will be charged 2%, if he refinances the loan from another company. **HSBC Offers Flexible Interest** rate loans that can be reset every year depending on the prevailing interest rates at that point. The new interest rate will be applicable for the rolling one year. Guarantor is required only for loans more than Rs.10 lakh. **ICICI Launches a 30-year Tenure Home Loan**, the longest available. ICICI also launches a variable rate loan with a monthly interest basis versus the regular fixed rate loan that is on an annual interest basis. No guarantors are required for loans up to 20 years in most cases. No pre payment fees for any part payment as long as the loan is not fully retired, else 2% charge on prepaid amount. The customer can repay up to 33% of the outstanding loan in any year without paying penalty. **SBI Offers Home Loans with no Start-up Costs:** Most banks charge as high as 2% as processing and administrative fees. Prepayment is 2% if the entire loan is prepaid, else it is 0%. The customer can avoid this penalty by prepaying up to 99% of loan. **IDBI Bank Offers Balance Transfer Scheme:** If the customer has taken a fixed rate loan at a high rate of interest a few years back, then he can enter into an arrangement with IDBI bank to transfer the loan to them at the current lower rate of interest. The customer will also get free gifts to compensate him for the difference between the old and new EMI. The original EMI cheques will be used by IDBI to recover the loan amount from the customer over the remaining tenure of the loan. The customer will not get the benefits of any further fall in interest rates in this product.

Source: www.abodesindia.com/Loan.asp

SUMMARY

- Various factors influence consumer behavior in purchasing financial products. A situational approach can be adopted to understand buyer behavior specifically.
- Beckett's matrix classifies consumers of financial products on the basis of level of involvement and consumer confidence (which depends on the perceived uncertainty).
- Marketing has to be viewed from the perspective of three levels in an organization – corporate level, business unit level, and functional level. Marketing research is an important function that contributes to the marketing of financial products in terms of market structure analysis, market potential, and demand forecasting. To satisfy the requirements of marketers, marketing research provides information on customers, markets, and competition.
- Segmentation models can be broadly categorized into a priori and post hoc approaches. Various bases of segmentation are applicable for segmenting consumers. Financial marketers generally adopt one of the following targeting strategies – undifferentiated marketing, differentiated marketing, and concentrated marketing. It should be noted that positioning in financial products marketing differs from that of other products and services in that organizational positioning is given more importance than product-level positioning. The corporate brand can be positioned based on various factors such as price, relationship or service benefit, security benefit, user type, accessibility benefit, and perceived quality.
- Customer service is an important factor that differentiates the product offerings in the service industry. Service quality can be improved along the dimensions of tangibles, reliability, responsiveness, assurance, and empathy. Financial product marketers need to imbibe in them the philosophy of providing quality customer service in order to increase their profitability. Good customer service and proper handling of customer complaints pave the way for building lasting relationships.
- Today, banks offer innovative, customized products to attract customers. Most of them are trying to enhance their customer base. In such a scenario, customer relationship management or CRM plays a vital role. CRM has become an increasingly important domain in the management of banks. What was previously just another function in the management in banks, CRM has now evolved into a full-fledged marketing tool.
- There are also banks that are doing great business with excellent service as their unique selling proposition.
- CRM now involves information technology to collect customer information and process it so as to provide better and customized service.
- Banks realizing the importance of keeping customers in the extremely competitive market, have also started relationship banking initiatives to foster long-term and profitable relationship with high-net-worth customers.
- However, implementing CRM is not without pitfalls. Maintaining huge databases of customer data is a complex process; banks must take care not to infringe upon the privacy of the customer and yet collect as much information as possible to customize the service to suit the personal requirements. In this fierce war for higher market shares, the beneficiary is the customer as he is the king.

Glossary

Asset Acquisition Planning	:	A person in his/her lifetime decides to acquire certain assets, which may vary from acquiring a car to a house or investments in the form of buying stocks, bonds, etc.
30-day Charge Card	:	A 30-day charge card is a regular card that allows the customers to pay the monthly bill in full amount, which is billed within 10 or 20 days after the billing date.
Add-on Method	:	Add-on method is a method of calculating interest by computing finance charges on the original loan balance and then adding the interest to that balance.
Adjustable Rate Mortgage	:	Adjustable Rate Mortgage (ARM) is another form of housing loan. In this type of mortgage loan, the rate of interest and monthly payments are linked to a specific interest rate index and are adjusted at specific intervals in accordance to the changes in the index.
Annuities	:	Annuity literally means an Annual Payment, but can be described as periodical payments depending on the status – time or life.
Assessee	:	According to Section 2(7) of the Income Tax Act, assessee means and includes: • A person by whom any tax or any other sum of money is payable under the Act. • Every person in respect of whom any proceeding under the Act has been taken for the assessment of his/her income or loss or the amount of refund due to him. • A person who is assessable in respect of income or loss of another person or who is deemed to be an assessee, or an assessee in default under any provisions of the Act.
Assessment	:	The word 'assessment' is defined to include re-assessment. In the general context, the word 'assessment' means computation of tax and procedure for imposing tax liability. Under the Income Tax Act, there are seven kinds of assessments namely self-assessment, provisional assessment, regular assessment, best judgment assessment, reassessment, jeopardy assessment, and precautionary assessment.
Assessment Year (A.Y.)	:	According to Section 2(9) of the Income Tax Act (I.T. Act), assessment year means the period of 12 months starting from April 1 of every year and ending on March 31st, of the next year. An assessment year is the financial year immediately succeeding the relevant previous year. For example, the assessment period of 2008-09, starts on April 1st, 2008 and will end on March 31st, 2009.
Auction Market	:	All individuals and institutions assemble to trade securities at one area and announce the prices at which they are willing to purchase or buy.
Automated Teller Machines	:	ATMs are 24-hour banking services that have made banking very easy, accessible and error proof for the customers.
Apartments	:	Apartments are generally the most common form of housing facility available today. Apartments are available for ownership and also on rent.

Balance Sheet	:	Balance sheet gives information about the financial position of an individual at a given point of time. It helps to assess the value of the assets owned and the amount of debt owed by a person.
Bear Market	:	A market where the prices of a certain group of securities are falling or expected to fall.
Belated Return	:	Any person, who has not filed a return of income within the due date specified under Section 139(1) or within the time allowed under a notice issued u/s 142(1), can file his/her return of income within the extended time allowed under the law. These returns are termed as 'Belated Return' and can be filed within one year from the end of the relevant assessment year or before completion of the assessment, whichever is earlier.
Beneficiary (Nominee) Clause	:	A beneficiary is the person who receives the death benefits of the policy on the insured's death.
Biweekly Mortgages	:	These are loans that have payments equal to half of the regular monthly payments that are made every two weeks rather than once every month.
Blue Cross/Blue Shield	:	Blue Cross and Blue Shield plans are medical plans and not insurance policies. In these medical plans, the member needs to pay the amount in advance. Under this type of arrangement, the blue cross enters into a contract with various hospitals to provide health care services to the members covered by it.
Bond Ladder Strategy	:	Another form of buy-and-hold passive strategy of bond portfolio management is bond laddering. Bond laddering involves investing in bonds with several maturity dates instead of single time horizon as in the case of simple buy-and-hold strategy.
Bonds	:	A bond is the basic form of fixed income security. It is issued by a borrower (borrowing company) to the lender (the investor). Bonds are debt investments where the investor lends money to an entity which needs money for a specified period of time at a definite interest rate.
Budgets	:	Budgets are forecasts made by analyzing the previous periods' financial statements.
Bull Market	:	A market where the prices of a certain group of securities rising or expected to rise. Bulls are optimistic investors who expect good things to happen in the market.
Business	:	Business enterprises produce goods and services by employing labor and utilizing land, capital and technology.
Buy Downs	:	This type of financing is offered on new homes. A seller or a builder may arrange for mortgage financing, which is subsidized for the buyer.
Buy-and-Hold Strategy	:	One of the simple investment strategies is to identify a security with the desired characteristics and hold it till maturity or redemption and reinvest the proceeds in similar securities.
Bluechip Stock	:	Companies with highest overall quality are considered as Bluechips. Bluechips are financially stable with steady-dividend paying records during both good and bad years.
Callable Bonds	:	They give the right to the issuer to redeem the bond prior to its maturity, at a specified price called the call price.

Care	:	Credit Analysis and Research Ltd. (CARE) was incorporated in April, 1993, as a credit rating, information and advisory services company and was promoted by Industrial Development Bank of India (IDBI), Canara Bank, Unit Trust of India (UTI) and other leading banks and financial services companies.
Cash Surplus or Deficit	:	The net result of the income statement is the cash surplus or deficit. A cash surplus occurs when the income is more than the expenses and deficit occurs when the expenses are more than the income.
Certificate of Deposits (CD)	:	The next lowest risk category investment option after treasury bills is the Certificate of Deposit (CD) issued by banks and financial institutions. Certificates of deposits were allowed in 1989, as one of the RBI's measure to deregulate the cost of funds for banks and FIs. A CD is a negotiable promissory note issued by banks and FIs for a period up to a year. It is issued at a discount to the face value, and the discount rate is negotiated between the issuer and the investor.
Change of Policy	:	In many life insurance contracts, there is a provision for insureds to switch over from one policy to another.
Charge of Income Tax	:	According to Section 4, income tax is an annual tax on income of a 'person', charged in the assessment year at the rates fixed by the Annual Finance Act as applicable to the relevant assessment year. The tax is levied on the 'total income' of every assessee computed in accordance with the provisions of the Income Tax Act.
Co-insurance	:	The co-insurance provision stipulates that the insurer will pay a specific percentage of the loss covered in excess of a deductible.
Co-branded Credit Cards	:	Co-branded cards are those bankcards that have a tie-up with a company of another sector.
Common Stock	:	Generally when people talk about stocks they refer to common stock. Majority of the stock is referred to common stock. Common stock or shares represent the ownership in the company and their holders have the right to claim a portion of profits.
Condominiums	:	Condominium is a form of joint ownership. A condominium can be in the form of an apartment, townhouse or cluster houses. The buyer of the condominium has the ownership title of a particular unit, and joint ownership to swimming pools, lobbies, clubhouses etc.
Consumer Installment Loans	:	These loans include payments in the form of installments paid for a specified period of time. These loans are generally taken for the purchase of automobiles, appliances or furniture.
Consumers	:	Consumer is the 'king' in today's dynamic environment. Consumer's tastes and preferences determine the strategies of the business enterprises.
Convertible ARM	:	Convertible ARMs are those, which can be converted into fixed rate loans by the borrowers.
Coupon Rate	:	Bonds pay interest periodically at a pre-specified rate of interest. This is known as the coupon rate.

Credit Insurance	:	It is an insurance policy that continues the repayment of a particular debt. Most of the lenders offer credit insurance to the borrowers and a monthly premium is paid as a part of monthly repayments on the loan.
Credit Rating	:	Credit rating is assessing the creditworthiness of the borrower by reviewing his/her credit report based on the history of borrowing and repayment. This is one of the most important steps in credit assessment. Based on the credit report, the credit officer finalizes whether the borrower should be granted credit or not.
Credit Rating Agencies	:	Credit rating refers to the rating of a financial instrument on the basis of the issuer's capability to repay the interest and the principal.
Credit Scoring	:	Credit scoring is a method that helps the creditors to decide whether or not to give credit to a particular customer.
Crisil	:	Credit Rating Information Services of India Limited (CRISIL) is one of the foremost and largest credit agencies in India.
Critical Illness Rider	:	Critical illness riders, under a life insurance policy offer payment equal to the sum assured, if the life assured suffers a serious illness, irrespective of amount of expenses incurred on treatment.
Current Liability	:	Current liability generally arises from expenditure on consumable goods and services, by bills such as electricity, water charges, rent, insurance premium that are due, medical and repair bill, etc.
Customer's Collateral Security	:	Collateral security is the assets pledged by an individual to secure a debt. It is a form of guarantee provided during a default. In such a case, the creditor can seize the collateral security from the borrower.
Cyclical Stock	:	They are the stocks of the companies whose earnings follow the business cycle. Examples of cyclical industries are oil and other natural resources, steel, cement and housing, etc.
Debit Cards	:	The customer can use a debit card to make purchases wherein the amount of expenditure is directly debited against the account of the holder.
Debt Service Ratio	:	Debt service ratio reflects whether an individual's financial condition is comfortable so as to meet his/her debt obligations. It is calculated as follows: Debt service ratio = Total monthly loan payments/Monthly gross (before-tax) income
Deductible	:	Deductible is the amount not covered under the policy and is paid by the insured himself.
Default Risk	:	It arises when a company, that has issued bonds, defaults on its interest or principal obligations.
Defective or Incomplete Return	:	If the assessing officer is of the opinion that the return of income furnished by the assessee is defective, he/she has the discretion to intimate the defect to the assessee and give him/her an opportunity to rectify the defect within 15 days from the date of intimation or such time as may be extended by the assessing officer.
Defensive Stock	:	They are the stocks that are considered as counter cyclical. Prices of these stocks remain constant or may rise during the periods of economic downturn and show lacklustre results during economic upturn.

Dental Insurance : Dental insurance covers dental health care and includes injuries sustained from accidents. Coverage is also provided for oral examination, filling, extractions, dentures, oral surgery, orthodontics etc.

Depression : Depression in the economy is said to occur, when the economic activity comes to a standstill.

Diner's Club International Cards : The Diner's Club International Card is an internationally accepted charge card and has a preset limit. It is an unlimited card offered only to the high-income segment.

Disability Income Insurance : Disability income policies replace lost income when the insured is disabled as a result of sickness or injury. Payment is made because physical or mental incapacity prevents the insured from working.

Discount Bonds : A bond, when valued less than its face value is called a discount bond.

Economic Recovery : The recovery stage in the economy occurs when the production and employment levels start rising indicating a revival in the economic activity.

Employee Benefit Planning : Large firms provide employee benefits in the form of life and health insurance, disability insurance, reimbursement plans for education or it may be in the form of pension or retirement plans.

Expansion : Expansion in the economy occurs when the economy goes through high levels of employment and production.

Face Value/Par Value : The face value or the nominal value of a bond can be thought of as principal amount on which interest is paid by the issuer.

Filing Returns : Every person, if total income or the total income of any other person in respect of which it is assessable under this Act during the previous year exceeds the maximum amount which is not chargeable to income tax, is required to file a return of income within the due dates.

Financial Emergency : During a financial emergency, people tend to borrow hand loans from their friends, relatives, etc. for short period. They borrow when the liquid cash flow with them is insufficient to meet their day-to-day expenses.

Financial Services Market : The financial service industry includes all the institutions that market various kinds of financial products and the financial services. The financial services industry in India comprises of banks, insurance companies, mutual funds, credit rating agencies and non-banking financial services companies.

Fixed Deposits : Fixed deposits are saving instruments, in which a specified amount is deposited in an account for a specified tenure and the bank pays the interest accordingly. Generally, fixed deposits carry a high rate of interest as the money is locked for a longer time period, such as one year, three years or five to ten years also.

Fixed Rate Mortgage : This type of mortgage accounts for a major portion of all the home mortgages written. Under this type of mortgage, both the interest rate and the monthly mortgage payments are fixed over the entire period of the loan.

Future Value : Future value is the value to which an amount will grow if it earns a specific rate of interest over a given period.

Gold Cards : Gold cards are credit cards offered to persons in the high income category. The limit on the card starts from Rs.50,000-Rs.2,00,000.

Graduated Payment Mortgage : The graduated payment mortgages have a low initial payment for the first few years and then increase gradually for a period of 5 to 10 years and then remain fixed.

Gross Total Income : According to Section 14, income of a person is computed under the following five heads: income from salaries, income from house property, profits and gains of business or profession, capital gains and income from other sources.

Growing Equity Mortgage : These are fixed-rate mortgages where the payments increase for a specific number of years and then remain fixed or levels off.

Growth Stock : Growth stock are the stocks that can be expected to experience high rates of growth in operations or earnings.

Health Maintenance Organization (HMO) : HMO is an organization which consists of physicians, hospitals which provide health care services to its members.

Home Equity Credit Line : Home equity credit lines are similar to unsecured personal line of credit except that they are secured with a second mortgage of a person's house.

Hospitalization Insurance : Under hospitalization insurance, the cost of the hospital room and other incidental expenses are reimbursed.

ICRA : Investment Information and Credit Rating Agency (ICRA), an independent credit rating agency established in 1991, has been promoted by a number of leading public sector banks and financial institutions, such as IFCI, State Bank of India, Unit Trust of India, General Insurance Company of India and Export Import Bank of India.

Income : According to Section 2(24) of the Income Tax Act, the term 'income' is inclusive and not exhaustive. Therefore, the term 'income' not only includes those things, which are included in Section 2(24) but also includes such things, which the term signifies according to its general and natural meaning. The following are examples of income – profits, dividends, capital gains, value of perquisites, profits in lieu of salary, voluntary contributions received by a charitable or religious trust or institution, etc., sum received under a Keyman insurance policy, etc.

Income Statement : The income statement measures the financial condition of a person over a specific period of time.

Income Stock : Income stocks are those which have an elongated and prolonged record of paying high dividends.

Insurance : Insurance as a risk management tool permits the society to reduce financial risks and share losses. Insurance is an agreement wherein the insurer agrees to make good a loss suffered by the insured against a specific risk, in consideration for some specified amount.

Interest Rate Risk : This risk is the variability in a security's returns resulting from changes in the level of interest rates, other things being equal.

Intermediate Goals : Fill up the gap between the short-term and long-term goals. They are generally spread over a period of two to five years.

Internal Limits : Internal limits are constraints placed on the payment of specified expenses, even if the overall policy limits are not exceeded.

Intestacy : Intestacy is a situation when a person dies without making his will.

Investments : Investments are those assets, which earn a return for the individual. These assets are held by an individual so as to earn a profit.

Iras	:	It is a retirement investing tool in the US that can be either an Individual Retirement Account or Individual Retirement Annuity.
Irrevocable Beneficiary	:	The beneficiaries named can be changed any time, until and unless, the person is not named as an "Irrevocable beneficiary".
Junk Bonds	:	Junk bonds are high yield bonds issued by companies and are considered highly speculative because of high risk of default.
Liabilities	:	Liability indicates the debt owed by a person or a family. The debt can be in the form of loans, bank credit card charges, mortgage on housing, etc.
Liability and Insurance Planning	:	A person may have to manage his/her debt in the same way as managing his/her assets. Debt may be in the form of education loans or loan for an automobile or credit card payments.
Line of Credit	:	A line of credit signifies an agreement between a bank (and any other financial institution) and a customer for allowing the customer to maintain the maximum possible loan balance or the maximum amount of credit he/she is allowed to have outstanding at any point of time.
Liquid Assets	:	Liquid assets are low-risk financial assets such as cash, or assets that can be readily converted into cash. These liquid assets are generally needed to meet the day-to-day expenses and provide for unexpected events.
Liquidity Ratio	:	Liquidity ratio reflects how long an individual can continue paying for his/her current debts with his/her existing liquid assets in case of an income loss. It is calculated as follows: Liquidity Ratio = Liquid Assets/Total Current Debts
Living Trust	:	A living trust is funded during the life time of the trustor himself. A trust may be revocable or irrevocable and may function for a specified time or may continue even after the death of the trustor.
Lok Adalats	:	Lok Adalats handle third party Motor Insurance cases and settle losses so that speedy justice can be given to the victims and their families. Once Lok Adalat agreement is arrived at and signed, insurance company cannot appeal later.
Long-term Care Insurance	:	Long-term insurance policies promise to pay expenses if the incapacity prohibits the insured's activities of daily life.
Long-term Liability	:	The liabilities, which are due for more than a period of one year, are known as long-term liabilities.
Loss Prevention and Control	:	Loss prevention is an activity that reduces the probability that a loss will occur. Loss control, on the other hand, lessens the severity of loss when it occurs.
Managed Care Plans	:	Managed care plans are the fastest growing segment of the health industry. Under the managed care plan, the user needs to make monthly payments to the organization that provides the health services.
Market Risk	:	It refers to the day-to-day fluctuations in a stock's price caused due to various market developments.

Maturity Date	:	The maturity date of a bond is the date on which the investors' principal is repaid.
Medical Expense Insurance	:	The expenses of the insured, such as hospital, physician and other health care expenses are covered.
Motor Cycle 'B' Policy	:	The policy covers any two wheeled vehicle (inclusive of detachable side car) which is used only for social, domestic and pleasure purposes. The policy does not provide cover use for hire or reward, organized racing, speed testing and carriage of goods in connection with any trade or business or use for any purpose in connection with motor trade.
Multiple Indemnity Clauses	:	Multiple indemnity clauses provide double or triple of the face value if the insured dies in an accident.
Mutual Funds	:	A mutual fund can be best described as an ideal investment vehicle for retail investors who are not highly acquainted with the capital markets but are interested in participating in the stock market activities.
Net Asset Value	:	The net asset value is the market value of the assets of the scheme minus its liabilities. The net asset value per unit on any business day is computed as follows: $= \frac{\text{Market value of the fund's investments + Receivables + Accrued income} - \text{Liabilities} - \text{Accrued expenses}}{\text{Number of units outstanding}}$
Net Worth	:	Net worth can be defined as the actual amount of wealth owned by an individual or the family in assets. In other words, net worth is the amount available with the family after selling all the owned assets at their fair market value and payingoff all the liabilities.
Non-scheduled Banks	:	Non-scheduled banks are those joint stock banks, which are not included in the second schedule of the RBI Act on account of their non-complying with the minimum requirements for being categorized as scheduled.
Overdraft Protection	:	This form of a line of credit is provided to the customer that allows him/her to overdraw to a specified limit from his/her savings account. If a customer wants to withdraw certain amount, all that he/she needs to do is to write a cheque and the overdraft protection line automatically advances the cash.
Permanent Partial Disablement (PPD)	:	In this case, the disablement is permanent but not total. The assured may not continue his earlier profession but he may be in a position to take up a new vocation.
Permanent Total Disablement (PTD)	:	In this case the disablement is total and permanent in nature. The assured is neither in a position to carry on his earlier vocation nor take up a new profession.
Perquisites	:	A perquisite is defined as the value of any benefit or amenity granted or provided free of cost, or at a concessional rate. It represents a benefit, which has a tangible monetary value for a person. It does not, however, cover mere reimbursement of necessary expenditure.
Personal Financial Planning	:	Personal Financial Planning refers to the proper planning and implementation of well-coordinated plans to achieve financial objectives.
Personal Loans	:	It is an unsecured loan that is granted for personal use based on the borrower's integrity and ability to pay.

Phone Banking : A customer can find out the balance of his/her account by calling up his/her bank and giving the password.

Physician's Expense Insurance : It is also known as 'regular medical expense'. It covers the cost of the physician's fee for non-surgical care.

Platinum Cards : Platinum cards are high-profile internationally accepted cards given usually to the abnormally high income people in the society.

Policy Loans : A policy loan is a loan made by the insurance company to the policyholder. The policy loans are available on all life insurance policies and secured by the cash value of the policy.

Pre-existing Condition : According to this clause, coverage is excluded in case a person has some physical or mental problems at the time the insurance policy is obtained.

Preferred Stock : They represent some degree of preference of ownership in the company. With preferred shares investors are usually guaranteed a fixed dividend. The most advantageous feature of preferred stock is that in the event of liquidation the preferred shareholders are paid off before common shareholder.

Previous Year (P.Y.) : Income earned in a year is taxable in the subsequent year. The year in which income is earned is known as previous year.

Primary Market : It is a place where the investors have the first opportunity to subscribe to newly issued securities. It is the market where securities are created. Companies sell their new stocks or bonds for the first time to the public in this market. It is otherwise called as Initial Public Offering (IPO).

Principle of Indemnity : According to this principle of indemnity, the insured cannot be compensated by the insurer for an amount exceeding the insured's economic loss.

Private Car 'B' Policy : The policy covers a private car defined as any transport vehicle/car/omnibus whose unladen weight does not exceed 7,500 kgms and is used only for social, domestic and pleasure purpose and insured's own business also.

Purchasing Power Risk : With a rise in inflation there is reduction in the purchasing power of the rupee. This is known as inflation risk and it affects all securities.

Pure Endowment : Under pure endowment, the lump sum insurance amount is payable only if the insured survives till the end of the selected period.

Puttable Bonds : These bonds can be redeemed prior to maturity at the initiative of the bondholders.

Rate of Return : The periodic rate of return on a mutual fund scheme is calculated as follows:

Rate of return for the period

=

$$\frac{\text{NAV at the end of the period} - \text{NAV at the beginning of the period} \quad \text{Dividend paid during the period}}{\text{NAV at the beginning of the period}}$$

Real and Personal Property : Real and personal property is in the form of tangible assets, which one uses in everyday life. Real property includes the immovable property like a house or land.

Real Estate Mortgage : These loans are associated with the purchase of real assets such as a house or a piece of land. These loans are generally paid in the form of installments for a long-term extending up to 10-15 years or even more.

Realized Yield : Realized yield is the yield actually earned by the investor on his investment and depends on the reinvestment rate and the holding period chosen by him.

Recession : Recession results, when the economic activity declines for a period of more than six months (often mentioned as two consecutive quarters).

Recurring Deposit : Recurring deposit is another important form of savings instrument. A recurring deposit can be opened by an individual, wherein a specified amount is deposited every month in the account.

Regulations : Governments impose various regulations to safeguard interests of the consumers, investors and general public as a whole.

Residential Status of the Firm and Association of Persons : According to Section 6(4), a partnership firm and an association of persons are said to be resident in India if control and management of their affairs are wholly or partly situated within India during the relevant previous year. They are treated as non-resident in India if control and management of their affairs are situated wholly outside India.

Retail Charge Cards : Retail charge cards are issued by department stores, oil companies, car rental agencies, etc.

Retirement and Estate Planning : One of the main long-term goals of financial planning is to make proper retirement plans. Apart from maintaining one's standard of living and meeting all necessities in life, one has to take care of his/her retirement days. Apart from retirement plans, estate planning should also be done carefully for passing on the wealth to legal heirs.

Revised Return : If any person who has already submitted his/her Return of Income (R.O.I) u/s 139(1) or in pursuance to a notice u/s 142(1), subsequently discovers any omission or wrong statement therein, he/she may furnish a revised return for any previous year at any time before the expiry of one year from the end of the relevant assessment year or before the completion of the assessment, whichever is earlier.

Revolving Credit : Revolving lines of credit are open accounts that are offered by banks or other financial institutions or brokerage houses.

Risk : When a person has a financial interest in something – whether in one's own life, health, home, automobile, etc., he or she faces the risk of financial burden in case a loss or damage occurs reducing one's net worth.

Savings Account : A savings account is a type of account that can be opened in any commercial bank. The deposits made in these accounts are known as time deposits since they are expected to remain on deposit for a longer period compared to a demand deposit.

Savings and Investment Planning : As a person's income increases, the importance of savings and investment will also increase. People generally start saving for meeting unexpected situations.

Savings Ratio : Savings ratio is one of the ratios used for analyzing the income statements. This ratio indicates the cash surplus or deficit resulting from a specified period's activities. The savings ratio is calculated as follows:

Savings Ratio = Cash surplus/Income after taxes

Scheduled Banks : Scheduled banks are those banks, which are included in the second schedule of the Reserve Bank of India Act, 1934.

Secondary Market : The secondary market is that segment of capital market where the outstanding securities are traded. From the investors' point of view, the secondary market imparts liquidity to the long-term securities held by them by providing an auction market for these securities.

Shared Appreciation Mortgages : In these kinds of mortgage loans, the lender agrees to charge a very low level of interest on the funds and in turn, the borrower agrees to share a part of the increase in the property value with the lender, when the loan matures or when the property is sold.

Short Selling : It is the process of selling the borrowed stock in the hope that the price of the stock will fall, so that the short seller can buy-back at a profit.

Short-term Goals : For a period of one year or less. They are immediate goals in the form of expenses in the current period, such as education expenses for a child newly admitted in nursery school.

Silver Cards : Silver cards are internationally accepted cards offered to normal-profile sectors or low income consumers.

Single Payment Loans : A loan that is granted to the borrower for a specified period of time is called a single payment loan.

Solvency Ratio : Solvency ratio reflects the degree of exposure to insolvency. In other words, it indicates how much 'cushion' an individual has as a protection against insolvency. This ratio is calculated as follows:

Solvency Ratio = Total net worth / Total assets

Standard of Living : Represents the quality of life a person enjoys through various comforts, luxuries and necessities.

Stocks : Common stock may be defined as the residual ownership of a corporation that is entitled to all assets and earnings after other claims have been paid and that generally has voting control.

Submission of Return : Filing of income tax return is compulsory for all individuals whose gross annual income exceed the maximum amount which is not chargeable to income tax i.e. Rs.1,45,000 for Resident Women, Rs.1,95,000 for Senior Citizens and Rs.1,10,000 for other individuals and HUFs. A company or firm has to file the return of income irrespective of the whether there is a any income or loss.

Subrogation : The principle of subrogation allows the insurer to collect any amount paid by the party at fault after the claim amount has been paid to the insured by the insurer.

Subscription Charges : Subscription charges are annual charges that the customer pays for using a credit card.

Suicide Clause : All life insurance contracts have a suicide clause, according to which the policy is void if the insured commits suicide within the specified time period.

Surgical Expense Insurance : It provides coverage for surgery in or out of hospital.

Survivor's Benefits : The spouse is eligible to receive survivor's benefits from social security if a covered worker dies.

Tax Avoidance : Some people save on taxes by exploiting the loopholes in the taxation laws, until they get plugged by the legislature.

Tax Evasion : Some people reduce the tax burden by deliberately suppressing their income, or by inflating the expenditure and resorting to various types of accounting manipulation.

Tax Planning : Tax planning assumes importance for an individual, once he or she falls in the tax bracket. There are various exemptions and deductions available, under different sections of the Income Tax Act for different purposes and based on different criteria. Not considering the tax benefits available when planning the investments, can result in loss of a substantial portion of the return to taxes.

Taxation : The government levies taxes on the income of the individual, sales, real estate and personal property. Taxes form one of the main sources of revenue for the government.

Temporary Partial Disablement (TPD) : This is a temporary but partial disability. A person suffers minor injuries which are usually recovered in short period of time. The person can get back to his earlier profession.

Temporary Total Disablement (TTD) : The disablement is total but temporary. It prevents a person from carrying his vocation for a short period.

Term Insurance : The first basic need of life insurance is to provide a lump sum amount to the family in the event of the untimely death of the breadwinner. This is called *'Term Insurance'* or *'Temporary Insurance'*.

Testamentary Trusts : A trust created by the will of the deceased person is known as a testamentary trust. The testamentary trust comes into existence only after the will is probated.

The Credit Bureau : A credit report contains some valuable information about the customer. It provides information about the residential address, the current employment, and the source for the payment of bills of the customer.

The Credit Decision : After the application has been filled and sent for investigation to the bureau, then the bank should decide whether to grant the credit or not. Credit scoring is issued for credit decision.

The Credit Investigation : An investigation that involves the credit bureau to check the information on the application including the amount of income, the current debt outstanding on other loans, or whether the person holds any other credit cards, and if so, then the performance on the card is evaluated.

The Note : The formal promise made by the borrower to the lender for the repayment of the loan is written down in a note.

Time Value of Money : Time value of money is one of the most important concepts of finance. According to this concept, a unit of money received today is worth more than the same unit of money received at some future point of time.

Total Income : According to Section 2(45), total income of an assessee is gross total income received under the heads: Salaries, House Property, Business Profits, Capital Gains and Other Sources as reduced by the amount deductible under Sections 80C to 80U.

Treasury Bills : Treasury bills are issued in the form of promissory notes or finance bills by the government to tide over short-term liquidity shortfalls. These short-term instruments are highly liquid and free from default-risk as they represent the obligations of the government.

Treasury Bonds : Bonds that are issued by government are known as treasury bonds.

Trusts : A trust is a legal relationship where one of the parties known as the 'trustor' transfers the property to another party known as the 'trustee' for the benefit of a third party known as the 'beneficiary'.

Two-step Mortgage : This mortgage is also known as 5/25 and 7/35 mortgages. They are amortized over 30 years, but they have fixed rates for 5 or 7 years, and the rate may be adjusted in the later years.

Underwriting : The insurer has to decide whom it should cover and whom it should not. This function of the insurer is known as 'underwriting'.

Unsecured Loan : Unsecured loans are loans that do not require any kind of collateral security for availing the loan.

Unsecured Personal Lines : In this type of credit, the customer need not face the troubles of applying for a new loan. The customer can borrow money from bank, or other financial institutions, or brokers, etc., any time.

Value Investing : The value investing theory calls for investing in the stocks of good quality companies that have strong balance sheets and whose stocks are temporarily undervalued by the stock market.

Value Stock : These are stock of companies which are considered undervalued because they may be in an industry that is out of favor, they may be experiencing management turmoil or they may be restructuring their business operations.

Voluntary Retirement Schemes : They are also called as voluntary early retirement schemes. They form an innovative concept by the public sector banks that evolved in India in 2000-2001.

Wealth Tax : Wealth tax is charged for every assessment year in respect of net wealth on the corresponding valuation date of every individual, a Hindu Undivided Family and Companies at specified rates.