SESSION - 06

INSURANCE DOMAIN

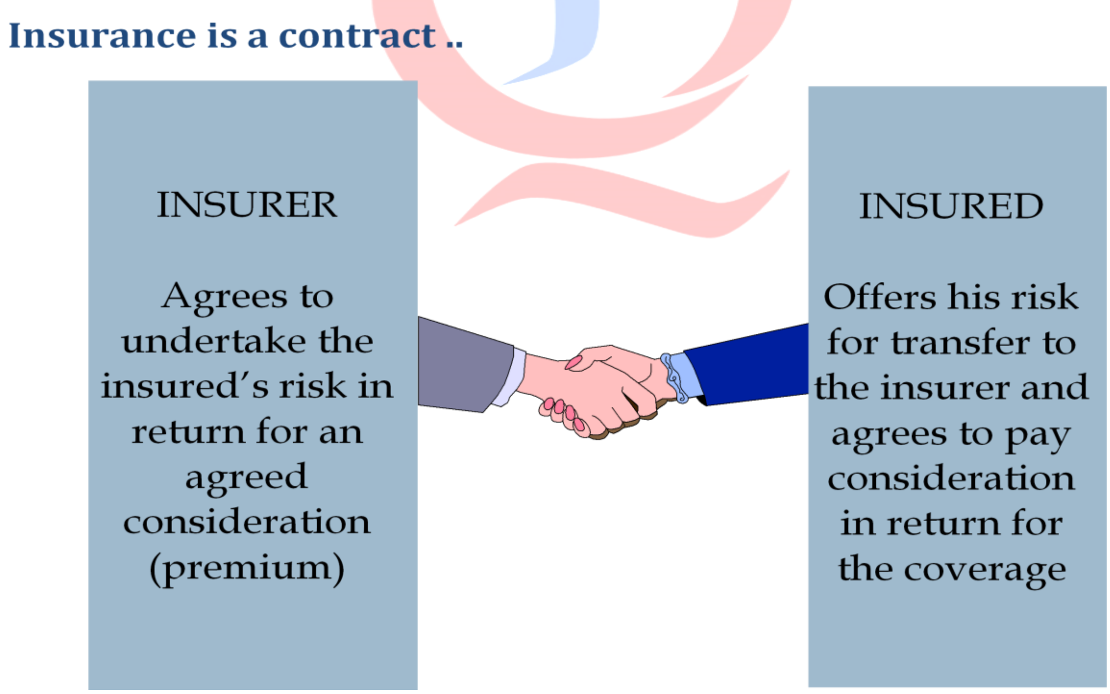
Insurance Concepts

Risk is uncertainty about the future. Insurance is Risk Management Technique

Insurance: A transfer system, in which one party – the insured – transfers the chance of financial loss to another party – the insurer.

In insurance parlance, risk is the

- uncertainty about potential losses
- which could cause financial setbacks
- Only Pure Risks are insurable
- Insurance results in the risk being transferred to the insurance company
- Sharing of risk among large groups is the basis for insurance



Functions of Insurance

Primary functions

- *Collective bearing of risk*
- *Provide certainty*
- *Provide protection*

Secondary functions

- *Prevention of losses*
- *Small capital to cover large risks*
- *Contribution towards development*
- *Source of savings, therefore investments*
- *Foreign exchange earnings*
- *Risk free trading*

- **Law of Large Numbers** - A Mathematical principle which enables the insurers to make predictions about losses.
- It states that as the number of similar but independent exposure units increases, the relative accuracy of predictions about future outcomes (losses) based on these exposures also increases.
- An exposure unit is a measure of loss potential and is used in pricing insurance.

E.g.: In a HO-W Insurance, each home is an exposure unit. The insurer insures thousands of home owners who face the same uncertainty.

- **Premium**: Is a small periodic payment the insured pays for long term insurance coverage.

Calculation of Premium:

Premium = Rate x Number of exposure units

Ideally Insurable Loss Exposures:

- Insurance companies generally prefer to provide insurance for the loss exposures that have the following characteristics:

  a. Large number of similar exposure units.
  b. Losses that is accidental
  c. Losses that definite and measurable.
  d. Losses that is not catastrophic.
  e. Losses that is economically feasible to insure.

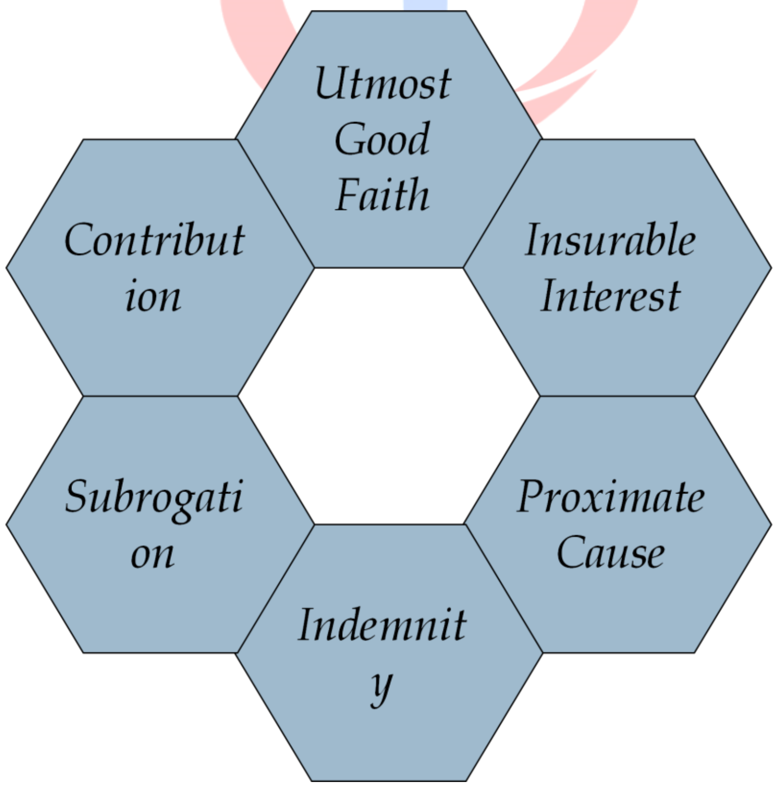
Check Point:

✓ Voice of a singer…is it an ideal loss exposure???

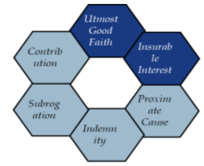
✓ Gambling is it an ideal loss exposure??

✓ Robbery \Theft is it an ideal loss exposure???

Principles of Insurance



Principles in detail



Utmost good faith

- *The Applicant (Policyholder) is bound to make full disclosure of all material facts*
- *The Insurer is bound to make full disclosure of all provisions in the contract*
- *(Material Facts - Facts that influence the insurer's judgment and rate of premium to be charged)*

Insurable interest

- *Insured should have a pecuniary (financial interest) in the subject matter of insurance and he should suffer a financial loss on the occurrence of the insured event*
- *Helps to separate insurance from gambling*
- *Implies legal right to insure*
- *Does not arise from relationship alone*

Principles in detail

Proximate cause

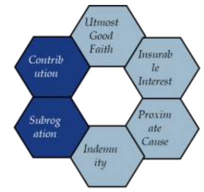
- *The admissibility of a claim under a policy is determined by confirming whether the proximate cause leading to the event is covered*
- *It is defined as:*

~ *the active efficient cause*
~ *that sets in motion a train of events*
~ *which brings about a result*
~ *without the intervention of any forces from a new/independent source*

Indemnity

- *An insured can recover a loss under a policy only if he has insurable interest*
- *He can recover the loss only to the extent of his insurable interest*
- *Insurance of persons are usually not policies of strict indemnity, because the value of life is not exactly ascertainable*

Principles in detail



Subrogation

- *Subrogation is the transfer of rights of rights and remedies of the insured to the insurer who has paid the loss*
- *This arises out of the indemnity principle that the insured can not recover more than his insurable interest*
- *Obviously not applicable to Life Insurance*

Contribution

- *Contribution is the right of an insurer who settles a claim to recover from other insurers who are liable for the same loss*
- *Like subrogation, not applicable to Life Insurance*

Insurance industry segments

Life & Annuities

- *Loss of Life*
- *Savings for future*
- *Retirement benefits*
- *Individual and group*

Property & Casualty

- *Loss of Assets / Property*
- *Loss due to Liability*
- *Personal / Commercial*
- *Individual and group*

Health

- *Health Risks*
- *Disease & Disability*
- *Healthcare in old age*
- *Individual and group*

Types of Insurance

- **Property Insurance**: Property Insurance covers the costs of accidental losses to an insured's property. The insured could be a person insuring his house and personal property or a business insuring its building, inventory and equipment.
- Provides Insurance Cover for property against damages
- Generally classified as Marine, Fire, Motor, & Miscellaneous insurance

Line of Insurance Business:

- Line of insurance is just another way of saying type of insurance.
- **Personal Lines**: is any type of insurance purchased by individuals and families to cover non business loss exposures.
- **Commercial Lines**: Insurance is any type of insurance that covers loss exposures for business and organizations.

Check Point….

- ✓ Can you name some Policy types which come under Personal Lines??
- ✓ Can you name some Policy types which come under Commercial Lines?

E.g.: Fire & Allied lines, Crime, Ocean & inland marine insurance come under Property insurance.

- **Liability Insurance**: Liability insurance also called as third-party insurance as, three parties are involved: the insured, the insurance company and the party who is injured or whose property is damaged by the insured.

E.g.: Auto Liability & Personal Liability come under Liability Insurance.

- **Life Insurance**: Life Insurance generally reduces the adverse consequences of premature death of a family member, by providing funds to replace the lost income and to pay expenses associated with final illness.

E.g.: Whole Life Insurance, Term Life Insurance & Universal life Insurance are the types of Life Insurances.

- Provides Insurance Cover against death (Early Death)

- Provides annuity benefits when grow older (Long Living)
- Provides range of products for risk coverage & saving

Health Insurance: Health Insurance is designed to protect individuals and families from financial losses caused by accidents and sickness.

- Health Insurance provides coverage against
- Hospital expenses
- Surgical expenses
- Physicians expenses
- Supplemental Coverage provides coverage against
- Dread disease
- Critical illness
- Long-term care
- Dental & vision care

Important Insurance Terminologies:

A. Insured
B. Insurer / Insurance Company
C. Liability
D. Insurable Interest
E. Insurable Risk
F. Agent
G. Application
H. Broker
I. Peril
J. Physical hazard
K. Moral Hazard
L. Policy
M. Cover Note
N. Coverage
O. Endorsement
P. Indemnity
Q. Exclusion

E.g.: Medical Insurance & Disability income insurance come under Health Insurance.

Government Insurance Programs:

- Some federal government insurance programs exist because huge amount of financial resources are needed to provide insurance to its citizens.
- Federal Government programs provides insurance for Catastrophic losses.

  E.g.: Social Security, National Flood Insurance Program.

Insurance Operations:

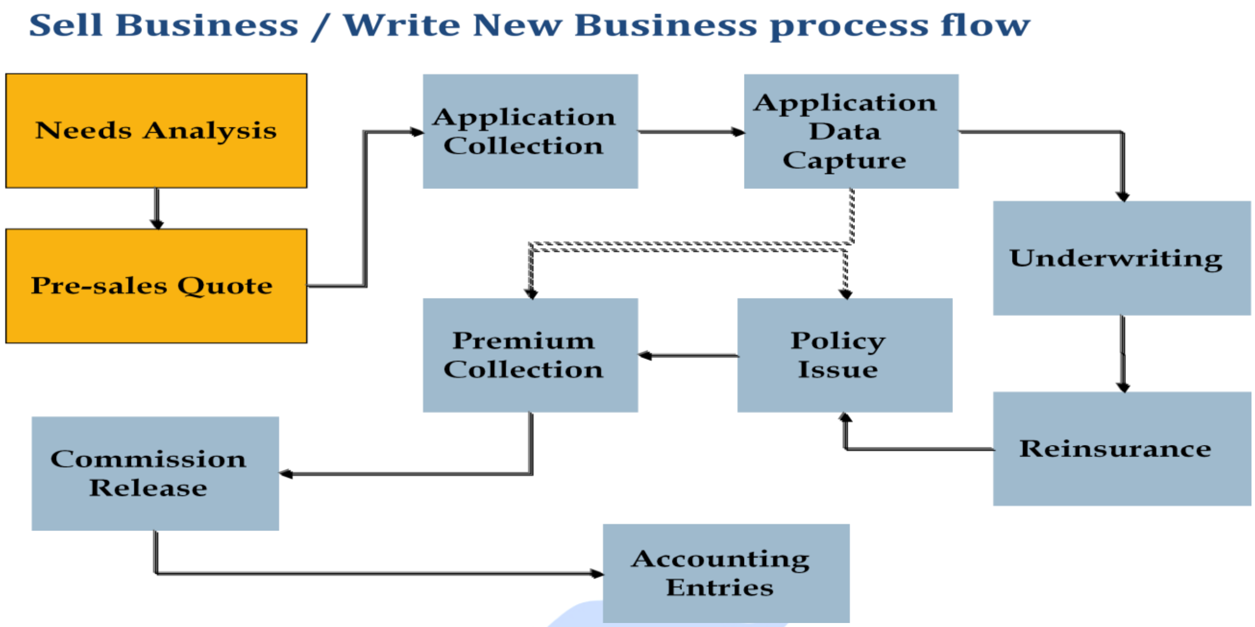
Main Operations of Insurance Companies are:

1. Marketing
2. Underwriting
3. Claim Handling
4. Ratemaking

- **Marketing**: Insurance Marketing is the process of identifying customers, selling and delivering a product or service. Other important aspect of marketing are advertising and marketing management.

Agents & Brokers:

- **Agents:** Legal representatives of the insurance company for which they have contractual agreements to sell insurance.
- **Brokers:** An independent business owner or firm that sells insurance by representing customers rather than insurer.
- The authority of the Agent and Brokers are generally stated in a written document called a **Agency agreement** or **Agency contract.**



- **Underwriting**: Underwriting is the process by which insurance companies decide which potential customers to insure and what coverage to offer. Underwriters are insurance company employees responsible for selecting insured's, pricing coverage's, and determining policy terms and conditions.
- **Underwriting is a heart of a Insurance Business**. To a large extent a company's goals depends on the effectiveness of its underwriting.

Underwriting process involves:

- **Selecting Insured**: Selecting those applicants who meet the company's underwriting guidelines.
- **Pricing Coverage**: Pricing the coverage to charge the premium commensurate with the exposure.

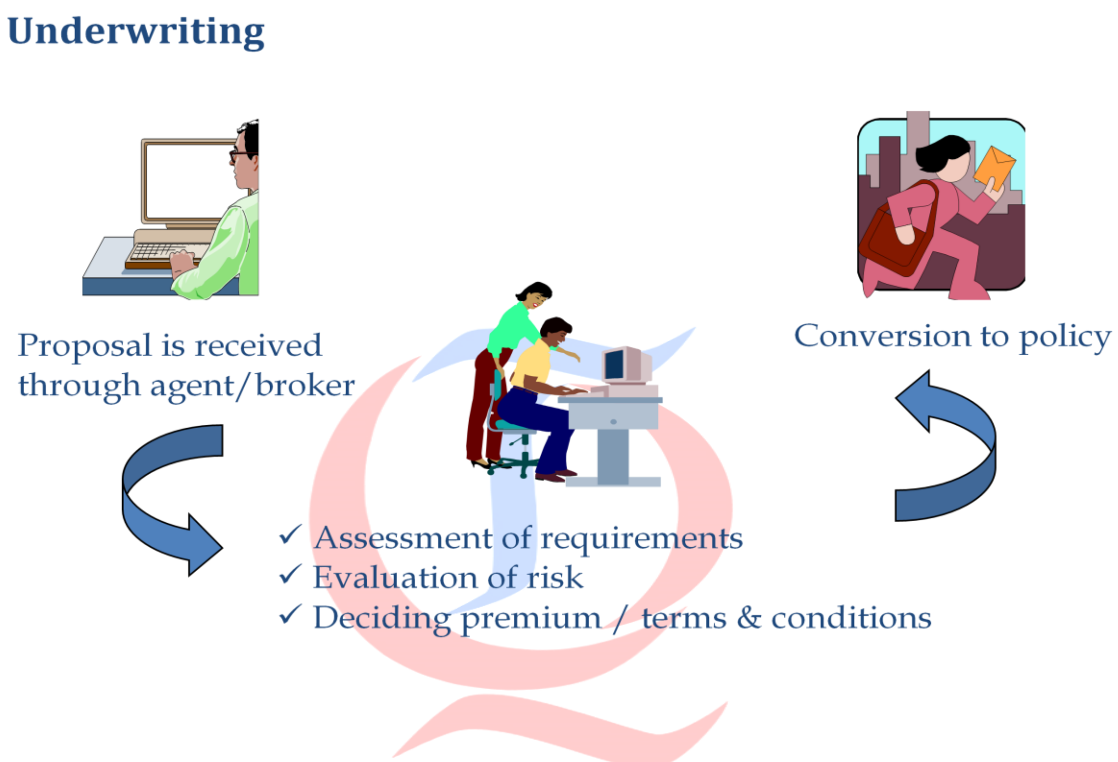
Determining policy terms and conditions

- **Monitoring underwriting decisions** to see whether they have desired effect or not.
- Underwriting management sets the company's guidelines in order to make optimal use of resources and avoid adverse selection.

Reinsurance:

- One of the main important aspect of the Underwriter is to arrange for Reinsurance.
- Types of Reinsurance are:

a. **Treaty Reinsurance:** Is an arrangement whereby a reinsure agrees to reinsure automatically a portion of all eligible insurance of the primary insurer.
b. **Facultative reinsurance:** Involves separate transaction for each reinsured policy. That is, the reinsure evaluates individually each policy it is asked to reinsure.



Claim handling

Claim handling enables insurance companies to determine whether a covered loss has occurred and, if so, the amount to be paid for loss. Claims are generally handled by Claim Representatives.

- **Claim**: Demand by a person or business seeking to recover from an insurance company for a loss that might be covered in the insurance policy.
- The employees of the insurance company who handle the claims are called as **Claim representative** or **Adjuster.**
- The responsibilities of a Claim representative are:

  a. Respond promptly to the submitted claim.
  b. Obtain adequate information
  c. Properly evaluate the claim

d. To treat all parties fairly.

- The person who submits the claim to an insurance company is called a claimant.
- In liability insurance the claimant is the third party. In all other cases the claimant is the insured (primary or first – party).
- Independent Adjusters are independent claim representatives who offer claim handling services to insurance companies for a fee.

Claim Handling Process:

- The Claim Handling process generally involves three steps:

a. Investigation
b. Valuation
c. Negotiation and Settlement

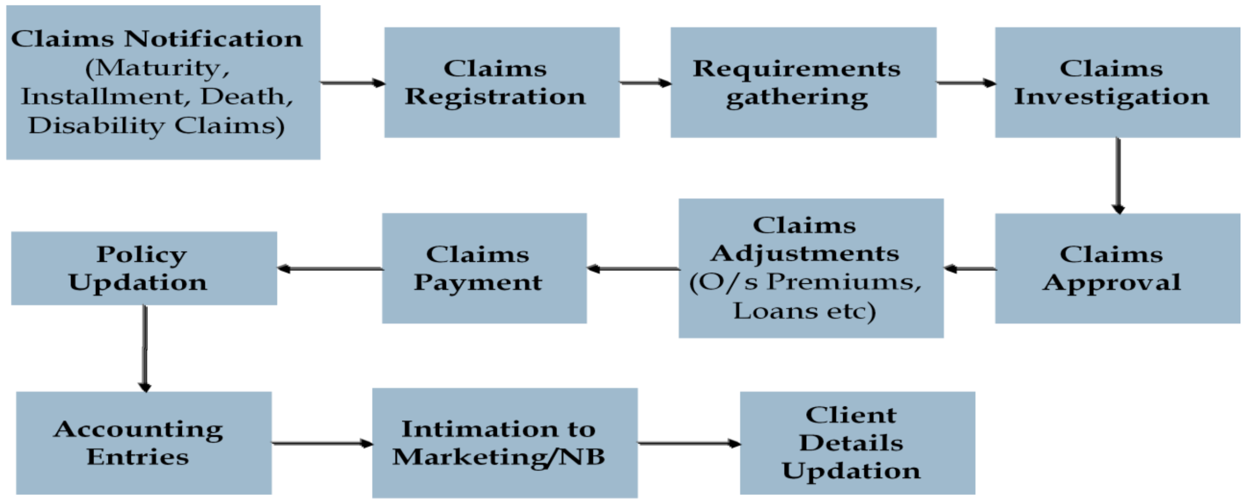
Valuation:

- Common Property Valuation Methods:
- **Actual Cash Value(ACV):** The cost to replace the property minus an allowance for the property's depreciation.
- **Cost to Replace**: Is calculated on the basis of like kind & Quality.
- **Depreciation:** Allowance for physical wear and tear.
- **Replacement Cost Analysis**: In this case, deduction for depreciation is not a part of the valuation.
- **Agreed Value**: Agreed value is a method of valuating property in which the insurer and the insured agree on the value of the property at the time the policy is written and that amount is stated in the policy declarations.

Negotiate and Settle:

- After the claim representative and the insured agree on the amount of the settlement, Other factor that can affect the insurers cost for property claims is: "Subrogation"
- **Subrogation**: Subrogation is the insurers right to recover payment from a negligent third party. When an insurer pays an insured for a loss, the insurer assumes the insured's right to collect damages from a third party responsible for loss.

Claims process flow



Rate Making: Rate making is the process by which insurers determine the rates to charge the thousands of similar but independent insured's.These services are also called as Actuarial services.

Actuarial

Conduct research on

- trends in mortality
- policy lapse
- company expenses

Develop products based on

- market feedback
- financial feasibility
- Calculate Legal reserve, Liabilities & Premium rates
- Liaise with regulators, Prepare and submit all relevant reports to Regulators
- Review product /company performance
- Suggest course correction, if needed

Check Point….

✓ Identifying Customers …comes under

A. Marketing
B. Underwriting

- ✓ Pricing Coverage comes under

A. Underwriting
B. Rate Making

Solvency of Insurance Company:

- The ability to pay expenses and still make a reasonable profit is a measure of an insurance company's solvency, that is, its long – term financial strength.
- **Income**: Insurance companies receive income from two major sources. The first is the sale of insurance and the second is from investments it makes.
- **Written Premium:** Total Premium on all policies put into effect, or "written" during a given period. Even if the premium is not collect
- **Earned Premium**: Is the portion of the written premium that applies to the part of the policy period that has already occurred.
- **Unearned Premium**: The portion of the written premium that applies to the part of the policy period that has not yet occurred.
- **Investment Income**: As insurance company handles large amount of money , it invests available funds in the stock market or purchase bonds to generate additional income.
- Insurance companies select high-quality investments that are relatively secure and that can be readily converted to cash. E.g.: Stocks & Bonds.

Check Point….

- ✓ Sam paid a premium of $1200 on January 1st 2010 for a Annual policy.

Q1. As on Jan 1st 2010. How much is the Written Premium ???

Q2. As on May 1st 2010. How much is the Earned Premium??

Q3. As of May 1st 2010. How much is Unearned Premium.??

Q4. If Sam cancels the policy on September 1st 2010. How much is the Written Premium.??

EXPENSES:

- **EXPENSES**: The major expenses incurred by an insurance company are claim payments for insured's who have suffered losses and the costs associated with handling those claims.
- Other expenses are General expenses that relate to Marketing, day to day Operations, staffing, accounting and maintenance.
- For an insurer to be **Profitable**,

  Premium + Investment Income > Total loss payments and other expenses.

Profitability Ratio:

- Profitability ratios are generally used to analyze the financial performance of the insurance company.
- **Loss ratio** = Incurred loss expenses/Earned Premium
- **Expense ratio** = Incurred Underwriting expenses / Written Premium
  - Combined Ratio : Loss ratio + Expense Ratio
  - Investment income ratio: Net investment Income/Earned Premium
  - Overall Operating ratio: Combined ratio – Investment ratio

Overall Operating Ratio:

- An insurer with an overall operating ratio of 100% breaks even.
- If the Overall Operating ratio is greater than 100%, it indicates that an operating loss has occurred because expenses are greater than revenues.
- If the Overall Operating ratio is less than 100%, it indicates an overall operating gain because revenues are greater than expenses.
- Even monitoring financial results from past years helps to determine the accuracy of the insurance company’s loss reserve estimates.

CORE BANKING

- A core banking system is the software used to support a bank’s most common transactions.
- Core banking functions differ depending on the specific type of bank. Retail banking, for example, is geared towards individual customers; wholesale banking is business conducted between banks; and securities trading involves the buying and selling of stocks, shares and so on.
- Products that are designed to deal with multiple types of core banking functions are sometimes referred to as universal banking systems.

Core Banking Solution - is a simple solution that maintains -

1. Account - Balance in real time
2. Transaction History
3. Various parameters and rules for secured operating on these accounts and their parameters and rules.
4. Various Reports, Listings, sums on required groups for regulatory and informative purposes.
5. Interfaces for various internal, external systems for communication and exchange and invoking events and processes following a strict security policy.

Elements of core banking

- Making and servicing loans.
- Opening new accounts.
- Processing cash deposits and withdrawals.
- Processing payments and cheques.
- Calculating interest.
- Customer relationship management (CRM) activities.
- Managing customer accounts.
- Establishing criteria for minimum balances, interest rates, number of withdrawals allowed and so on.
- Establishing interest rates.
- Maintaining records for all the bank’s transactions.

Features of a Core banking solution

- Increasingly accepted multi-tiered web paradigm
- Fully deployable in 365*24*7 mode not only across delivery channels but also for all the traditional branches
- Unified and integrated delivery channel strategy
- Time-to-market advantage through the extensibility tool-kit
- Seamless integration with various other business applications both online and in batch mode. Open to external Interfaces and systems and new delivery channels
- Well thought architecture and security framework
- The solution is a highly parameterizable solution and has been designed to provide parameters at different levels for the bank to add new products by changing parameters, adding new business rules, modifying them and extending the application.

Single Sign On

- Single sign on framework enables the application users to access multiple applications through a single login id and password. All the login related validations happen in SSO.
- Logging in with your user id created by Admin gives you access to Savings, Loans, CRM (used to maintain CIF details of users)

Creating USER IDS

- The sequence of processes in SSO are :
- Role Definition –level of access is defined here
- Password policy configuration
- User Creation
- Assigning of Role (admin, clerk, manager) as to the users
- SSO profile creation
- Assigning Access rights to SSO administration and applications
- Creating user profile for the application
- Password changes for a user
- User id management(Resetting login attempts, login attempts and password changes)

- Report generation(Audit, User and Role based reports)

Objective

- Types of Loan
- Phases of Loan
- Loan life cycle process
- Loans Terminology

Terminologies

Service Outlet/Branch. Any location from where the operations can be carried out or a logical location created for reporting purpose is called as Service Outlet

Work Class: This decides the powers vested for the user to have access to Menu, over riding of exceptions, Passing/Posting powers etc.

Temporary Overdraft (TOD): A Temporary Overdraft (TOD) is a limit/facility granted by the bank to its customers for a short period

- Clean Overdraft: An overdraft which is not backed by any security is called clean overdraft.
- Secured Overdraft: Secured Overdraft is generally back by securities
- Collaterals: This is the security given by the customer for the limits availed by the customer. The securities given by the customer has to be in the approved list of collaterals. Collaterals can be : Lands/Property/Jewellery/Gold/Animal Husbandry
- General ledger is a process of consolidation of the balances of the various accounts maintained in a bank. All the accounts maintained in the Bank/Branch are classified into various categories depending upon the nature, type and behaviour of the account. Such classified accounts are grouped/consolidated daily during the batch process to arrive at a position which reflects the total turnover/business of the Bank/Branch. There are no accounting entries at GL level

Parameter Set up

- One is at Bank Level which would be applicable for the entire bank and the other is at Branch
- At Bank level: There are certain parameters with regard to General Details, Term Deposits, Loans, Transaction A/c, Exchange Rate, Fees, Collateral Module, Connect 24, FAB, Trade Finance, and Exception Handling which can be set at the Bank Level

At Branch level MICR Centre, MICR Centre/Branch/Bank Code, Branch Open Date, Type of Cash allowed, License no, Tax Circle No etc are captured

Terminologies

- Office Accounts are accounts opened at the instance of the bank.
- When Interest is booked, interest goes to Interest Receivable Account, which is an office account.
- It is an account opened, without reference to a customer Id or involving a customer.
- Features like issuance of cheque book, charge calculation, minimum balance check, and interest calculations are not applicable to Office Accounts like Savings or loan accounts.
- All operations on the office account are initiated and done by the Bank.
- Office accounts are required by the banks to record transactions relating to Assets and Liability Accounts, Income and Expenditure Accounts, Inter Branch Accounts etc.
- Inventory: Inventory means stock of items that a bank holds. From the banking perspective, inventory can be classified into secured and non-secured items.
- Secured items are Demand Drafts, Chequebooks, Term deposit receipts, Travellers cheques & Gift cheques of different denominations etc, where tracking of each single unit of inventory is required.
- Non secured items are items like furniture, fixtures, stationary items etc
- Exceptions: Alerts can be generated either as a Warning, Exception or an Error. If a warning is generated it notifies the enterer, If an exception is generated it has to be authorized by a higher work class. If an error is encountered then it is against the bank policy and no user can override the same.
- Demand Drafts are payable by any other branch other than the issuing branch.
- Banker's Cheque is payable only by issuing branch.
- Demand Drafts/Banker's cheque is an important mode of remittance of money from one centre to another for the public in general. This is one of the key services offered by the Bank which generates non-fund income to the Bank.

Apart from issue and payment of Draft, other activities involved in this line of business are cancellation, re-validation, reversal, noting caution as a part of DD handling process

- **Savings Account:** This is a customer account wherein the customer maintains a credit balance. This is a liability type of account. The Product type used for such accounts is SBA. Customer is entitled to get interest on the credit balances maintained by him.

- **Current Account:** This is a customer account wherein the customer maintains either a credit or debit balance. If the customer maintains a credit balance this would be a liability account and if the customer maintains a debit balance this would be an asset account.
- **CIF ID:** Customer Information File. A customer must have a CIF for him to open an account with the bank.
- **Inactive Account:** When there are no customer induced transactions in the account for the specified period which is specified at the Product level, the status is changed to Inactive account.

Dormant Account: when there are no customer induced transactions in the account for a specified period the status is changed to Inactive account. After changing the status to inactive account if there are still no transactions for a further period which is specified at the Product level, then the status is changed to dormant account

- **Revolving OD:** Revolving overdraft is a facility offered to retail clients with credit card features such as billing date, minimum payment, and pay by date, penal interest and late fee for late payment.
- **Drawing Power:** The limit which the customer would be allowed to withdraw based on the sanctioned limit.
- **Sanctioned Limit:** This is the limit sanctioned by the bank to the customer based on the eligibility of the customer.
- **Sweeps:** It is possible that a customer can have more than one account of the same type or different types like Savings Bank, Current account, Overdraft facility, Term deposit accounts. There may be a situation that one of the SB accounts on which a cheque has been issued does not have enough funds for passing of the same but substantial amount is available in any of the other account. In such a situation the Bank may not return the cheque and would like to allow the debit to go through. In order to facilitate such a feature, SWEEPS helps the Bank.
- **Frozen Accounts:** The accounts may be restricted from either debit, credit or both operations due to various reasons. When any account has to be restricted from operations it can be frozen.
- **Lien:** Holding a part or full amount on the account so that the same is not available for the customer. There could be various reasons for which lien can be marked on the account.
- **Multi Currency accounts .** This is an umbrella account wherein the customer can have multiple savings/current accounts in different currencies account linked to a main account called the MultiCurrency Account.

The multicurrency account is represented by a consolidation currency and no financial transactions are performed on them. It is just used as an umbrella account to view the balances of all the accounts in a consolidated currency

- **Online Transaction:** A transaction which is put for an account with updating to account immediately. The user enters the transaction details.
- **Batch transaction:** The transaction is created by initiation of a process where in user intervention is not required.
- **Backdated transaction:** A transaction that is put for any account where the transaction date is a prior date.
- **Post dated transaction:** A transaction for an account where the transaction date is beyond the current date (system date/BOD date)
- **Value dated transaction:** A transaction with transaction date as BOD date. All accounting entries will be for BOD date, but the effective date of the transaction is not BOD/System date.
- **Posting of transaction:** The process of updating the balances of an account based on an entry is posting of transaction.
- **Proxy Posting:** When the user tries to post a transaction either online or through batch if the transaction
- Standing Instructions (SI) is a facility provided by the banks to its account holders who want to make payments or remittances of a recurring nature like payment of insurance premiums, subscriptions, transfer of funds, instalments to recurring deposits or loan accounts.

Instructions are created such that they run on a specific date to debit money from customer specified account of same bank

- **Proxy Posting:** When the user tries to post a transaction either online or through batch if the transaction is not going through for posting then the user can enable proxy posting which would post the transaction to a common proxy account defined. This would enable the data centre to smoothly run the End of Day process since the EOD will not go through if there are any pending transactions in the entered status.
- **Transaction Types:** Transactions have been classified into three types. They are Cash, Clearing and Transfer. The user cannot add the type of transactions. It is pre-defined.
- **Cash Transactions:** The user will be able to put through either a debit or credit transaction to the account depending upon whether he is doing a cash payment (cash withdrawal) or cash receipt (cash deposit) for the account.

- Clearing Transactions: Clearing transactions can be either inward or outward clearing.
- **Inward Clearing:** Inward clearing is a process whereby the Bank receives various types of negotiable instruments that are drawn on it by its customers and parts the resultant proceeds to the presenter of the instruments.
- **Outward Clearing:** In case of Outward clearing, the Bank gets the proceeds since it acts as a collecting agent on behalf of its customers who have tendered the instruments for credit of their accounts.

Transfer Transactions:

Transfer transaction is initiated when there is a need of transfer of funds from one account to the other. In Transfer transaction, the user has to enter both debit and credit transactions and also has to ensure that the set is balanced – The sum of both debit and credit transactions should match/agree

- **Transaction Sub Types:** Each of the Cash, Clearing and Transfer transaction has sub types.
- **For cash transactions:** The sub types supported are Normal Payment, Normal Receipt, Cross Currency Receipt, Cross Currency Payment, Cash transfer, ECS outward transaction, ECS inward transaction.
- **Normal Payment and Normal Receipt:** Normal Payment and Normal Receipts are cash transactions involving one currency.
- **Cross Currency Receipt and Cross Currency Payment:** Cross Currency Receipt and Cross Currency Payment transactions happens between two different currencies.
- **Cash Transfer:** Cash Transfer transactions are basically for internal use of the Bank and is put through for cash movement between the Cash account of the Bank and the Cash Account of individual teller accounts
- **For clearing transactions:** The sub types supported are Inward clearing, outward clearing.
- **For Transfer transactions:** The sub types supported are Inward clearing, Outward clearing, Bank induced, Customer induced, Interest Collection, Interest paid, Standing instruction, Bank induced standing instruction, Account revaluation, Service Charges, Back office transaction, ECS outward transaction, ECS inward transaction
- **ECS:** Electronic Clearing System. This is a system where in the clearing process happens without physical movement of instrument.
- **Transaction ID:** A financial transaction put through into the system will have a unique identification number. These are referred to as Tran id and Part Tran serial number in . A set or a bunch of transactions (credit and debit transactions) put

through in one instance is referred to as a Tran id. A Tran id can have multiple credits and multiple debits where the sum of all debit and credit entries matches. Under a Tran id the individual credit or debit transactions are referred as a Part transaction and will have a part Tran serial number. A set or a Tran id will be treated as either posted/verified when all the transactions, either debit or credit are individually posted/verified to the concerned accounts. Posting of a transaction is not possible until the debit amount and credit amounts are matched (transaction is balanced).

- **Transaction Status:** There are three statuses which can be associated with a transaction. They are Entered, Posted and Verified.
- **Entered Status:** When a transaction is entered system generates a Tran ID and the transaction record is saved. But the account balance will not be updated till the transaction is posted.
- **Posted Status:** The process of updating the balances of an account based on an entry is posting of transaction.
- **Verified Status:** Verification process does not have any financial implication.
- **Deleted Status:** A transaction can be deleted prior to posting

LOANS

- Types of Loan
- Phases of Loan
- Loan life cycle process
- Loans Terminology

What is loan

- Bank lends Funds to Individuals/Industries from the deposits made by customers
- Bank earn profit by interest charged on loans
- Hence loans are assets to bank

Types of Loan

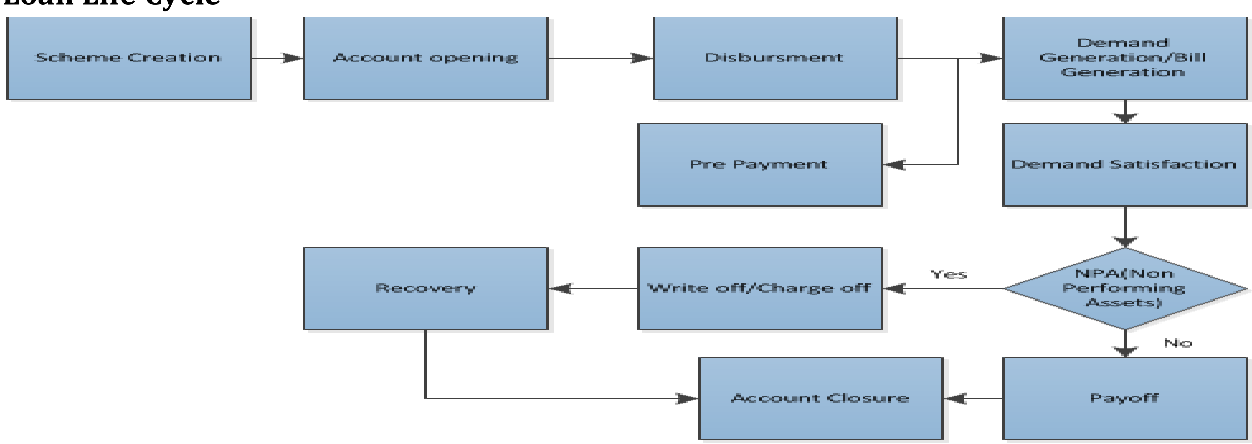
- Retail Loan(Product type LAA)
  - ✓ Home Loan
  - ✓ Vehicle Loan
  - ✓ Personal Loan
  - ✓ Student Loan

- ✓ Salary Loan
- ✓ Agriculture loan
- ✓ Commercial Loan(Product type CLA)

Phases of Loan

- ➢ Pre Sanction
  - ✓ Application & relevant documents will be collected from the customer.
  - ✓ Credit appraisal of the customer
  - ✓ Credit report preparation and submission to the concerned authority
- ➢ Sanction
  - ✓ Loan is sanctioned to the customer
- ➢ Post Sanction
  - ✓ Execution of loan papers
  - ✓ Opening of loan account
  - ✓ Disbursement of loan
  - ✓ Follow up and Recovery of Loan
  - ✓ Asset Classification and Non Performing Assets
  - ✓ Writing off loan accounts
  - ✓ Handling of recoveries subsequent to writing off

Loan Life Cycle



Product creation

Main parameters at Product level are:

- Interest
- Currencies
- Fees
- GL code
- EI/Non EI
- Interest calculation method
- Repayment mechanism

Terminologies

- FLOWS
- Flow is a code.
- Every Transaction either a Debit or a credit to a Loan account is associated with a flow code/ID.
- Eg : Loan account is opened and disbursement has been made . Say transaction ID is TXN1223. TXN1223, would be mapped to DISB Flow code created and stored in table backend which records all the activities on loan account. Similarly, EIDEM, for demand generation, INDEM, when interest is collected. Amount collected would be stored against flow id in table.

Based on the flow, the system has to do some internal storing of information, processes, validations etc.

- This is required to arrive at the Demand, Collection and Balance position of an account thus reflecting the overdue position of an account. This is also useful for classification of assets into performing and non-performing assets.

Flows…..

- The flows are categorised into following categories.
- Disbursement
- Collection
- Demand
- Equated instalments

- Transfer

Flows –Disbursement

- DISBURSEMENT:
- Represents loan amount released to the account holder based on the sanction limit. Normally disbursement flows will happen while opening.
- Single or multiple disbursements in a loan account. In case of multiple flows disbursement will happen subsequent to account opening.
- Disbursement flow is associated with debit transactions except in case of reversals of disbursement.

FLOW – DEMAND/BILL

- DEMAND (also known as bill):
- Demand is made on the customer for repayment of the loan amount due.
- The demand can be Principal demand, Interest demand, Bank charges demand and Other charges demand.
- Demands are raised periodically during the life cycle of the loan account.
- As and when an installment becomes due, system automatically raises a demand for the principal amount.

Flows –Collection

- This is a transaction for recovery of amount to a loan account.
- Collection flow‟s can happen during the lifecycle of the loan account, when the customer makes a repayment.
- For collection flows, it is possible to specify the offset sequence (the sequence in which the demands raised are to be offset or adjusted (such as principal first, interest next, charges etc.)).
- Collection is associated with credit transactions to loan a/c.

Flows –Transfer

- **TRANSFER :**
- A loan account can also go into credit balance in some cases.
- When the loan account goes to credit balance, it needs to be debited to transfer the credit balance.

- This debit cannot be treated as a disbursement, Interest or any other Charge. In such cases, the transaction will be Classified/Identified as "Transfer flow". "Transfer flow" is possible only if the liability of the account is nil and the interest calculation is up-to-date

- Late fee

When a loan is sanctioned, it is associated with a repayment. If the repayment is on equated installments and interest calculation is based on schedule balance method, then there may be chances that the Bank will not go in for charging penal interest on the balance outstanding. Instead they may choose to collect penalty on the defaulted amount (monthly installment amount due). This penalty is known as late fee collection.

Account Opening

- EQUATED INSTALMENT

- The repayment to a loan account could be done in equated installments. The equated installments can be monthly, quarterly or any other specified period. If the installments are of equated in nature, then the amount repaid will be adjusted towards both principal and interest.

- Interest is compounded with PMT formula, Rule of 78.

- While account opening, CIF created for customer, Product code for Retail Loans (eg Personal loan) are entered. Account opening date can be backdated or same as today. Loan Amount, Loan Repayment date every month (due date day), loan tenor has to be specified.

Disbursement

- Disbursements can be done in any of the following modes,

- - Can be one time

- - Can be multiple times

- - Can be based on disbursement schedule

- - Can be through ACH/SWIFT/ECS

- - Can be through cash

- - Can be through transfer

- - Can be through DD/Pay order

- - Recovery of charges as a part of disbursement

- Accounting entry

- Dr. Loan A/c
- Cr. SBA A/c/ DDA A/c /ACH A/c (depending on the disbursement type)

Interest booking

Interest accrued/accumulated/recognized from previous payment date to current due date but not yet paid

Demand Generation

- Both principal and interest demand can be generated
- For billing type of accounts, instead of demand a bill is generated
- Bill shows the EMI to be paid by the customer, the previous emi paid if any, Late fee if any set up and applicable along with the date and month for which bill has been raised.
- For demand model the transaction is
    - Dr. Loan Int Acct

Cr. Int receivable

Repayment Schedule/Amortization schedule

- The important components of the repayment schedule are
- Instalment flow IDs (EIDEM)
- Instalment start dates (both Principal and Interest)
- Instalment Frequency (Monthly generally, Quarterly)
- Number of instalments
- Instalment amount

Demand Satisfaction

- Customer can repay the loan in multiple methods
- ECS
- Cheque
- Cash Payment
- Debit from operative account

- HLASPAY is the online menu for demand satisfaction

Asset Classification

- Bank classifies the loan accounts based on their past due period. This is called asset classification.
- Based on days past due(DPD), accounts are classified into different delinquency cycle.
- DPD will be calculated from the last pending installment date.

Delinquency –DPD

- This is with reference to the overdue.
- There will be cycles of user-defined days. While moving a demand to a given cycle the date of demand raised and the date of repayment will be skipped.
- There is a maximum of fifteen cycles that user can define. Let us take a example for ten cycles. We take that each cycle period is of 15 days. Then the set up would be as under:
- Cycle 1 15 days
- Cycle 2 30 days
- Cycle 3 45 days
- Cycle 4 60 days
- Cycle 5 75 days
- Cycle 6 90 days
- Cycle 7 105 days
- Cycle 8 120 days
- Cycle 9 135 days
- Cycle 10 150 days

Charge off and recovery

- Some loans are not repaid, in spite of banks best efforts . A process called write off or Charge off is applied on such loans by the bank.
- Charge off is done only for accounts which are marked as Past due.
- Demand generation does not happen for an account that is charged off
- When account is charged off it is a loss to bank.

- Recovery after charge off is done when some amount is recovered from an already charged off account.

Payoff

- Payoff means collecting entire dues in the account to ensure that the balance becomes zero.
- Collection of entire dues in the account can be on maturity of the loan, subsequent to maturity or earlier to maturity.

Account Closure

- Once the balance in the account is zero the account can be closed.

Restructuring

- The restructuring or rephasement is the revision of the repayment schedule which may be necessitated because of changes in interest rates, irregular payment of installments and so on.

Deferment/Forbearance

- Applicable for student loan
- Deferment is a period during which the repayment of the principal and interest of your loan is temporarily delayed.
- The account has to be in repayment period to mark the account for deferment.
- For deferment period interest is not applicable. But for forbearance period interest will be applicable.

Exceptions

- Change in account name
- Value dated transaction - When transaction date differs from value date of the transaction this exception is raised.
- Back dated transaction - When transaction date is lesser than the BOD Date this exception is raised.
- Cash transaction
- Transfer transaction
- Clearing transaction
- Referred account closure

- Account in credit balance

Grace Period

- Grace Period is the holiday period for a loan after the loan disbursement.
- The repayment starts only after the grace period.
- Interest may or may not be applicable during grace period.

Interest Capitalization

- The interest during grace period can be added up to the principal.
- This process is called interest capitalization.