FINAL EXAMINATION SET 2

MODEL ANSWERS TERM – JUNE 2023

PAPER – 20B

RISK MANAGEMENT IN BANKING AND INSURANCE

Time Allowed: 3 Hours **Full Marks: 100**

The figures in the margin on the right side indicate full marks.

Where considered necessary, suitable assumptions may be made and clearly indicated in the answer.

SECTION – A : RISK MANAGEMENT IN BANKING

Answer to Question No. 1 and 6 are compulsory; answer any three from Question No. 2, 3, 4 & 5.

1. (a)

Sl. No.	Answer	Justification
(i)	(b)	When there is a financial loss to bank arising from legal suits filed against the bank or by a bank for applying a law wrongly, it is called as Legal Risk. Basel II classified legal risk as a subset of operational risk in 2003. This conception is based on a business perspective, recognizing that there are threats entailed in the business operating environment. The idea is that businesses do not operate in a vacuum and in the exploitation of opportunities and their engagement with other businesses, their activities tend to become subjects of legal liabilities and obligations.
(ii)	(c)	Foreign Exchange Risk is the potential loss due to changes in the value of Bank's Assets or Liabilities resulting from exchange rate fluctuations. Foreign exchange risk applies to the losses that an international financial transaction may acquire due to currency changes. Also known as currency risk, FX risk, and exchange-rate risk, it illustrates the possibility that an investment's value may decrease due to changes in the relative value of the involved currencies. Investors may experience jurisdiction risk in the form of foreign exchange risk.
(iii)	(d)	Market discipline refers to the process by which market participants, such as depositors and shareholders, monitor the risks of banks, and take action to limit excessive risk-taking.
(iv)	(c)	The capital ratio is calculated using the definition of regulatory capital and risk-weighted assets. The total capital ratio must be no lower than 9%.
(v)	(b)	Financial institutions will be required to hold a capital conservation buffer of 2.5% to withstand future periods of stress, bringing the

		total common equity requirement to 7% (4.5% common equity requirement and the 2.5% capital conservation buffer).
(vi)	(c)	It consists of three main pillars: minimum capital requirements (Pillar 1), supervisory review (Pillar 2) and market discipline (Pillar 3). Pillar 3 of the Basel framework aims to promote market discipline through disclosure requirements for banks.
(vii)	(d)	The major risks faced by banks include credit, operational, and market risks. Prudent risk management can help banks improve profits as they sustain fewer losses on loans and investments. The capital adequacy ratio (CAR) is an indicator of how well a bank can meet its obligations. Also known as the capital-to-risk weighted assets ratio (CRAR), the ratio compares capital to risk-weighted assets and is watched by regulators to determine a bank's risk of failure. It's used to protect depositors and promote the stability and efficiency of financial systems around the world.
(viii)	(c)	The NSFR is defined as the ratio between the amount of stable funding available and the amount of stable funding required. The net stable funding ratio is a liquidity standard requiring banks to hold enough stable funding to cover the duration of their long-term assets. For both funding and assets, long-term is mainly defined as more than one year, with lower requirements applying to anything between six months and a year to avoid a cliff-edge effect. Banks must maintain a ratio of 100% to satisfy the requirement. Introduced as part of the post-crisis banking reforms known as Basel III, the ratio ensures banks do not undertake excessive maturity transformation, which is the practice of using short-term funding to meet long-term liabilities. It was finalised by the Basel Committee in October 2014.

2. (a) The uncertainties associated with the risk elements impact the net cash flow of any business or investment. Under the impact of uncertainties, variations in net cash flow take place. These variations could be favourable as well as unfavourable. The possible unfavourable impact is the “RISK” of the business. However, it should be understood that the ‘unfavourable impact of uncertainties’ or ‘risk in a business’ is not constant or of a fixed magnitude. It can vary depending on the degree of severity of the adverse variations of uncertain factors.

The criticality of risk management in the management processes of any organisation becomes apparent when viewed from the angle of the very survival of an organisation particularly in severely adverse business situations. In such situations, the cash flows are affected and losses may be high enough to wipe out the capital employed in the business resulting in its bankruptcy. Such a situation may be avoided if the loss potential of a business can be controlled. The loss potential of a business is strongly correlated to the uncertainties of business factors as it is the outcome of their adverse impact. In other words, the loss potential of a business is correlated to the risks in the business, and therefore, the risk exposure of a business needs to be managed so as to limit the potential losses in adverse situations to a level that can be absorbed by the organisation without affecting its continuity.

This aspect of risk management creates an imperative to develop methods to measure risk so that an organisation is aware of the risk it is carrying for its business, i.e., it has a measure of its potential losses in severely adverse situations and may ensure adequate capital availability for its continuance or limit its risk exposure to the extent of the capital available.

While the measure of potential losses in severely adverse situations determines the adequacy of capital for continuity, the losses arising on account of risks in a business nevertheless, have to be accounted for. This is done by treating it as a cost of business. There is a probability of loss associated with all risks. This is factored into pricing. This is another aspect of the risk management processes which not only identifies various risks in the business or revenue model but also estimates the probability of loss associated with such risks. It may be noted that this process is critical as overestimation of loss on account of risks may result in overpricing resulting in loss of business. Underestimation of losses, on the other hand, may result in lowering of profits, which would affect planned Risk-adjusted Return on Capital (RAROC).

Controlling the level of risk to an organisation's capacity to bear the risk is the essence of risk management and requires not only the identification of risks but also their measurement, control, mitigation and estimating the costs of risk. Since risk management happens to be a job that requires special skills and has an objective which is more orientated towards the control aspect of business, it not only requires a separate setup in the organisation but also needs a well-defined framework that guides the risk management function.

(b) Dealing in foreign currencies and with counter parties in another country, will sometimes result in country risk. Movement of funds across international borders creates uncertainty with regard to their receipts and payments and this uncertainty is defined as country risk. The foreign parties may be unwilling or unable to fulfil their obligations for reasons, such as imposition of exchange and other controls by the central bank or the government regulation, on which the parties do not have any control (externalization). Country risk is considered very high in the case of countries which are facing problems related to foreign exchange reserves, balance of payments, management of resources, liquidity, etc.

Country risk is usually controlled by fixing country wise exposure limits and, the risk being dynamic, it has to be constantly monitored, more particularly in case of difficult countries. The difficult countries may give high returns, as not too many countries, banks or parties may wish to take exposure on such countries.

It would be worthwhile to mention that country risk is different from the usual credit and other risks associated with lending decisions, like credit risk, settlement risks, liquidity risk, etc.

A country risk arises, when the counter party or the borrower or the buyer is a good credit risk and does not have any desire to default, but by local laws or directives, is forbidden by the government or the central bank to honour the commitment. A sovereign risk is larger, when the counter party is the foreign government itself or any of its agencies, and enjoys sovereign immunity under the laws, with no legal recourse to other party. Another dimension of sovereign risk could be a change in the government policies, or the change in the government itself, which could invalidate the previous contracts and thus forbid the parties concerned to complete or take recourse for the same.

While sovereign risk cannot be completely avoided when dealing with another country, it can be suitably reduced by inserting disclaimer clauses in the documentation and also making the contracts and the sovereign counter parties subject to a third country jurisdiction.

Comments: Country Risk is the risk associated with those factors which determine or affect a country’s ability and willingness to pay on schedule interest and amortization on its external debt. More specifically, it is the credit risk of borrowers in a country as a whole viewed from a specific country perspective. It differs from sovereign risk in that the latter is the credit risk of a sovereign government as a borrower. Thus, country risk analysis consists mainly of the assessment of the political and economic factors of a borrowing country which may interrupt timely repayment of principal and interest. Country risk needs to be treated as a separate risk- different from the credit risk of individual borrowers because the borrowers don't have any control over these factors. The country risk analysis results are used as pre-lending as well as post-lending decision tools. Prior to lending, decisions such as whether or not to lend, how much to lend, and how much risk premium it should charge, are based on the measured risk. After lending, periodic country risk analysis serves as a monitoring device, providing a prewarning system. The result of the analysis is also used to determine the need for bank loan portfolio adjustment and the discount prices of loans when they are sold in the secondary market.

3. (a) **Gap or Mismatch Risk**: A gap of mismatch risk arises from holding assets and liabilities and off-balance sheet items with different principal amounts, maturity dates or repricing dates, thereby creating exposure to unexpected changes in the level of market interest rates.

An example of this risk would be where an asset maturing in two years at a fixed rate of interest has been funded by a liability maturing in six months or a liability maturing over a period but getting repriced periodically. The interest margin would undergo a change after six months /repricing period, causing variation in net interest income.

The risk that the interest rate of different assets, liabilities and off-balance sheet items may change in different magnitude is termed as basis risk.

An example of basis risk would be to say in a rising interest rate scenario asset interest rate may rise in different magnitude than the interest rate on corresponding liability creating variation in net interest income.

The degree of basis risk is fairly high in respect of banks that create composite assets out of composite liabilities. The Loan book in India is funded out of a composite liability portfolio and is exposed to a considerable degree of basis risk. The basis risk is quite visible in volatile interest rate scenarios. When the variation in market interest rate causes the NII to expand, the banks have experienced favourable basis shifts and if the interest rate movement causes the NII to contract, the basis has moved against the banks.

(b) These guidelines seek to address the issues involved in computing capital charges for interest rate related instruments in the trading book, equities in the trading book and foreign exchange risk (including gold and other precious metals) in both trading and banking books. Trading book for the purpose of capital adequacy will include:

i. Securities included under the Held for Trading category.
ii. Securities included under the Available for Sale category.
iii. Open gold position limits.
iv. Open foreign exchange position limits.
v. Trading positions in derivatives, and
vi. Derivatives entered into for hedging trading book exposures.

Banks are required to manage the market risks in their books on an ongoing basis and ensure that the capital requirements for market risks are being maintained on a continuous basis, i.e., at the close of each business day. Banks are also required to maintain strict risk management systems to monitor and control intra-day exposures to market risks.

Capital for market risk would not be relevant for securities, which have already matured and remain unpaid. These securities will attract capital only for credit risk. On completion of 90 days delinquency, these will be treated on par with NPAs for deciding the appropriate risk weights for credit risk.

4. (a) Capital for credit risk is required to meet abnormal losses arising out of risk of default of bank's borrowers. However, in so far as risk of default across various borrowers and exposures differ, capital requirement also differs. In view of this, under standardised approach, different but prescribed risk weights are assigned to borrowers/types of exposure to differentiate risk of default associated with them. Exposure duly risk weighted with appropriate risk weight is termed risk weighted asset (RWA). Capital requirement for credit risk is based on RWA.

Total RWAs for credit risk of a bank is the sum of risk weights of customer-wise credit exposures covering its entire credit outstanding where, the risk weight of an exposure depends upon the type of borrower and exposure and the level of adjusted exposure. Revised framework for capital adequacy adopted by Reserve Bank of India specifies varying risk weight depending upon type of exposures/borrowers.

The adjusted exposure would depend upon outstanding fund-based facilities, un-availed portion of the sanctioned fund-based facilities and outstanding non-fund-based facilities net of allowable reductions if such exposures are secured by permissible securities.

Therefore, determination of total RWAs for credit risk of a bank is basically a five-stage process comprising of:

- ✓ Determining Adjusted Exposure.
- ✓ Determining Allowable Reduction.
- ✓ Determining Applicable Risk Weight.
- ✓ Determining RWA for the Exposure.
- ✓ Consolidation of RWAs of all Exposures.

(b) Liquidity risk is the inability of a bank to meet such obligations as they become due, without adversely affecting the bank's financial condition. Effective liquidity risk management helps ensure a bank's ability to meet its obligations as they fall due and reduces the probability of an adverse situation developing. This assumes significance on account of the fact that liquidity crisis, even at a single institution, can have systemic implications.

Liquidity is having enough cash to meet the current needs and liquidity risk is the current and prospective risk to a bank's earnings and equity arising out its inability to meet the obligations when they become due. Thus, effective liquidity risk management is the management of liquidity by raising sufficient funds either by increasing liabilities or by converting assets promptly and at a reasonable cost. It has now become imperative for banks to have an adequate liquidity risk management process commensurate with its size, complexity and liquidity risk profile as one size does not fit all.

Liquidity problems arise on account of the mismatches in the timing of inflows and outflows. Per se, the liabilities being the sources of funds are inflows while the assets being application of funds are outflows.

However, in the context of Liquidity Risk Management, we need to look at this issue from the point of maturing liabilities and maturing assets; a maturing liability is an outflow while a maturing asset is an inflow. The need for Liquidity Risk Management arises on account of the mismatches in maturing assets and maturing liabilities.

Mismatching, as we all know, is an inherent feature of banking. It's said and said very well too, that the crux of banking is managing mismatches. That is why Banks are presently called as 'Maturity Transformation Agents'. More the knowledge of the depositors, the tenor of the deposits would be come down/shrink whereas the tenor of the advances would be long. A simple housing loan has to be given for a period of 10 to 20 years. Hence, if banks were to have perfectly matched portfolios, they would neither make money nor need treasury managers to run their business. Then, anyone can manage banks.

5. (a) Operational Risk is by far the most difficult of all risk measurements. The behaviour pattern of operational risk does not follow the statistically normal distribution pattern and that makes it difficult to estimate the probability of an event resulting in losses. The historical loss distribution pattern, which may provide a method to estimate operating losses requires a data set that has statistically acceptable numbers of loss. Related data may be captured only over a period. Basel II has recognised the difficulties in measurement of operational losses. Consequently, it has provided options in the measurement of operational risk for the purpose of capital allocation purposes. They are:

1. The Basic Indicator Approach (BIA).
2. The Standardised Approach (TSA).
3. Advanced Measurement Approaches (AMA).

Of these, the Basic Indicator and the Standardised Approaches are based on the income generated. The Advance Measurement Approach is based on operational loss measurement.

(b) Off-balance sheet exposures are contingent in nature. Where banks issue guarantees, committed or backup credit lines, letters of credit, etc., banks face payment obligations contingent upon some event. These contingencies adversely affect the revenue generation of banks. Banks may also have contingent assets (for example, a bank may have purchased insurance to protect against certain negative events). Here banks are the beneficiaries subject to certain contingencies. Derivatives are off-balance sheet market exposures. They may be swaps, futures, forward contracts, foreign currency contracts, options, etc.

Contingent exposure may become a fund-based exposure. Such exposures may become a part of the banking book or trading book, depending upon the nature of off-balance sheet exposure. Therefore, off-balance sheet exposures may have liquidity risk, interest rate risk, market risk, default or credit risk and operational risk.

A bank should also examine the potential for substantial cash flows from its off-balance sheet activities (other than the loan commitments already considered), even if such cash flows are not always a part of bank's current liquidity analysis.

Contingent liabilities, such as letters of credit and financial guarantees, represent potentially significant cash drains for a bank, but are usually not dependent on a bank's condition. A bank may be able to ascertain a 'normal' level of cash outflows on an ongoing concern basis, and then estimate the scope for an increase in these flows during periods of stress. However, a general market crisis may trigger a substantial increase in the amount of drawdowns of letters of credit because of an increase in defaults and bankruptcies in the market.

Other potential sources of cash outflows include swaps, written over-the-counter (OTC) options, and other interest rate and forward foreign rate contracts. If a bank has a large swap book, for example, then it would want to consider the circumstances under which the bank could become a net payer, and whether or not the potential net pay out is significant. For example, if a bank is a swap market-maker, the possibility exists that in a bank-specific or general market crisis, customers with in-the-money swaps (or a net in-the-money swap position) would seek to reduce their credit exposure to the bank by asking the bank to buy outstanding warrants, together with any hedges against these positions, since certain types of crisis may simulate an increase in early exercise (for American style options) or requests that the bank repurchase options. These exercise and repurchase requests could result in an unforeseen cash drain, if hedges are either quickly liquidated to generate cash or to meet insufficient cash requirements.

6.

- ≈ Value of A+ Debt Security is ₹ 50 lakhs.
- ≈ Less Applicable Haircut is 6% - ₹ 3 lakhs.
- ≈ Haircut Adjusted Value ₹ 47 lakhs.
- ≈ Value of NSC (No Haircut) ₹ 30 lakhs.
- ≈ Total Value of Securities ₹ 77 lakhs.
- ≈ Value of Loan Exposure ₹ 100 lakhs.
- ≈ Net Exposure Ranking for Capital (Assuming it is BBB Rated carrying a Risk Weight of 100%): ₹ 33 lakhs.

SECTION – B : RISK MANAGEMENT IN INSURANCE

Answer to Question No. 7 and 11 are compulsory; answer any two from Question No. 8, 9 & 10.

7. (a)

Sl. No.	Answer	Justification
(i)	(c)	Gambling, also known as wager, is betting on chance and is highly speculative. One of the wagering parties loses whatever the other person wins from a wager. Before entering into a wager, there is no chance of loss and therefore no risk. As soon as a wager is made a new risk of the prospect of losing the wager is created.
(ii)	(d)	The principle of subrogation strongly supports the principle of indemnity. According to George E Rejda, subrogation means substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance. E.g., In an accident insurance the insured victim gives legal rights to the insurer to collect damages from the negligent third party instead of collecting himself directly from the third party.

8. (a) Where in respect of any policy of life insurance maturing for payment an insurer is of opinion that by reason of conflicting claims to or insufficiency of proof of title to the amount secured thereby or for any other adequate reason it is impossible otherwise for the insurer to obtain a satisfactory discharge for the payment of such amount, the insurer may, apply to pay the amount into the Court within the jurisdiction of which is situated the place at which such amount is payable under the terms of the policy or otherwise. This happens under the following circumstances:

1. Absence of nomination by the policyholder;
2. Registration of an assignment;
3. Multiple claimants with conflicting claims with insufficient proof of title;
4. Where the claimant has approached the Court for settlement of property disputes including insurance claims;

5. Circumstances where it is impossible for the Insurer to obtain a satisfactory discharge from the claimant.

(b) When a proposal for insurance is received, the underwriter has four possible courses of action:

- Accept the risk at standard rates;
- Charge extra premium depending on the risk factor;
- Impose special conditions;
- Reject the risk.

The underwriter can accept a proposal, reject it or accept it with certain modifications. Some of the modifications that can be made are:

- Hazard incidence can be reduced: For loss prevention and minimisation, underwriters can recommend certain changes that will safeguard against physical hazards. For example, installing sprinkler systems and better fire-fighting equipment in offices will reduce damages in case of fire.

- Changing rating plans and policy terms: Sometimes a proposal that seems unacceptable at one rate may become a desirable business under another rating plan or with special conditions such as compulsory excess.

Assignments are transfer of insurance policies from Policyholder to another with or without a valid consideration. Any assignment to be valid must satisfy the following conditions:

a) Endorsement for assignment upon the policy document or by a separate instrument signed in either case by the transferor or his duly authorized agent and attested by one witness.

b) Notice of assignment to be given to the insurer and the endorsement or instrument itself or a copy thereof certified to be correct both by transferor and transferee or their duly authorized agents have been delivered to the insurer.

c) Registration of assignment by the insurer in their records after receiving the above document and effecting an endorsement upon the policy document.

9. **(a)** The main features of distinction between Agents and Brokers can be tabulatedas under:

Features	Agents	Brokers
Representation	Insurance agents represent only one company, and they	Brokers typically sell insurance products

	sell products in the company's line up. In addition to selling policies, agents also focus on improving the brand image of the company, they represent.	belonging to different companies in the market. They do not have any allegiance to a particular company and sell products based on the requirements of customers.
Training	Since insurance agents represent a particular company, they receive in-house training from their respective companies on various products offered.	Brokers are not trained by any specific companies. Since they sell a wide range of products. There are external courses that can be taken by brokers before they start selling insurance products.
Licensing	Agents who have received training must obtain a license as per the regulations put forth by the Insurance Regulatory and Authority Development of India (IRDAI). broker license.	Brokers must be licensed by IRDAI in order to operate in the market. They are expected to meet a certain level of business regulations before they can get broker license.
Accountability	An insurance company is accountable for the actions of its agents. IRDAI has the right to penalise an insurance company for any wrongdoings of its insurance agents.	Brokers have bigger accountability as they are not backed by any specific company. Brokers are bound to offer multiple products to their clients and disclose the prices of these products. Brokers can get sued for any misleading information they provide to their clients.
Knowledge	Insurance agents have in-depth knowledge in the products offered by their own companies. Although they are not required to know about all products in the market, they may have some know- ledge about their	Insurance brokers are required to have knowledge about multiple products in the market. They are bound to explain various products that seem best fit for the requirements of their clients. Also, they are accountable

	competitor's products just for the sake of comparison. .	for the information they provide to customers. Hence, extensive knowledge about multiple products is a mandatory requirement for brokers.
Compensation	The commissions offered to agents are typically higher than that of brokers. The income earned by agents are relatively stable as they provide service under the wing of only one company. Companies may pay extra compensation based on the performance of agents.	Brokers sell multiple products, and commissions are based on the sale they make. Brokers must advise their clients about the products they sell and charge fee from the companies. Based on the type of policies sold, brokers could experience variations in their income.
Personalized Service	Agents may be able to provide personalised service to their clients since they have a limited customer base for the products they sell. Moreover, agents represent the image of a company and they act accordingly, to ensure personalised service.	Brokers offer good service for their clients with the help of their professional knowledge. However, the wide customer base they have might prevent them from offering personalised service to their clients.
Volume of business	For insurance agents, the volume of business is limited since they deal with the products of only one company.	Brokers, on the other hand, have access to multiple insurance products in the market, and their volume of business is often much higher.

The Regulator IRDAI has prescribed very straight guideline for the Agents and Brokers regarding their code of conduct in the interest of the policy holder. In case these intermediary agents or brokers are found guilty of misconduct or mis-selling, the IRDAI can cancel the licences of the agents / brokers and de-bar them from doing business.

(b) **Paid up Value**: When one stops paying premiums after a certain period, the policy continues but with lower sum assured. This sum assured is called the paid-up value. The paid-up value also refers to the value of a life insurance policy which lapses after acquisition of surrender value, but is not surrendered, the policy does not lose any benefits. The sum assured shall be redeemed in the same rate as the number of years the premium actually paid been to the total number of years for which the premium is payable. However, the policy is not eligible for any future bonuses.

Surrender Value: Surrender is voluntary termination of a Policy contract only by the Policyholder. More the number of premiums paid; more is the surrender value. Surrender value factor is a percentage of paid-up value plus bonus. If the Policy has acquired surrender value, then surrender value is paid to the Policyholder and the contract comes to an end.

Under Traditional products, the rules for Surrender value are as follows:

i) No Surrender Value for Term, Health & Annuity products.
ii) For Premium Paying Term (PPT) of 10 years or more, surrender value gets acquired after paying 3 years' premiums.
iii) For PPT less than 10 years, surrender value gets acquired after 2 years premium.
iv) Minimum amount payable as Guaranteed Surrender value (non-single):

✓ 30% of premiums paid (less survival benefits paid) if surrendered in second and third policy years;
✓ 50% if surrendered between fourth and seventh;
✓ 90% of surrendered in last 2 years (for less than 7 year);
✓ Beyond 7-year term, to be decided in file & use document (which gives the product features including policy benefits and premiums payable) to be filed by the Life insurer with the Regulator.

If a policy holder wants to discontinue his policy, he can opt for the paid-up value of the policy, as in paid up value option policy remains valid and sum assured reduced in the same ratio as the number of years the premiums actually paid bears to the total number of years for which premiums are payable and surrender value option the policy is terminated.

10. (a) We often find the terms “risk” and “uncertainty” used interchangeably. However, a distinction needs to be drawn between the two. Risk is often thought of in terms of chance (or probability) of loss. Uncertainty falls into two broad categories. There are those for which the probability of occurrence is calculable either on a priori grounds or through the statistical analysis of a series of similar events that have occurred in the past. The remainder do not lend themselves to such measurement either because their occurrence follows no discernible pattern or because they are unique events. The importance of uncertainty arises from its influence on the process of decision-making of individuals, businesses as also society.

While risk is a state of nature, uncertainty is a state of human mind. It is therefore possible to consider a situation risky if a number of outcomes is possible and the actual outcome that materializes is not known in advance. Thus, risk is defined as the relative variation of the actual outcome from the anticipated or expected outcome. For instance, for a manufacturing firm, the development of a new product is risky as the profits from the sale of the product in the market are uncertain before the actual sale. Likewise, the development of a new drug by a pharmaceutical company is characterized by risk because of the range of possible outcomes with regard to the market reception for the drug.

(b) A condition that creates the chance of loss or increases the chance of a loss is termed a “hazard”. Three major types of hazards are usually distinguished.

a) Physical hazard.
b) Moral hazard and
c) Morale hazard.

Physical Hazard: A physical condition that heightens the chance of loss is called physical hazard. A large number of examples of physical hazard from our daily life can be cited, such as defective electrical wiring in a cinema hall which increases the chance of fire, bad and poorly maintained roads that increase the chance of motor accidents and defective locking system on the main door of an apartment that increases the chance of theft.

Moral Hazard: Moral hazard is a condition characterized by defects in the character of an individual such as dishonesty that increases the frequency of loss or severity of loss or both. Moral hazard is a common occurrence in insurance and is not easy to control. Examples: making a fraudulent insurance claim, submitting an insurance claim for an inflated amount and setting fire to an insured godown stocked with inventory.

With a view to controlling moral hazard, insurers take a number of steps such as careful underwriting practices, and by including a number of provisions in the insurance policy such as exclusions, deductibles and riders.

Morale Hazard: Sometimes, a distinction is drawn between moral hazard and morale hazard. While, as defined earlier, moral hazard refers to a deliberate dishonesty resulting in increasing the frequency or severity of loss, morale hazard refers to carelessness or indifference to loss because of the presence of insurance. Examples include leaving the main door of a house open to make entry of a burglar easy, leaving car keys in an unlocked car door, and carelessness in regard to maintenance of health because of existence of a health insurance policy. Such careless acts increase the chance of loss.

11.

i. In the event of theft of vehicle:

≈ The insured should lodge the First Information Report (FIR) with a police station immediately, inform the insurance company and provide them with a copy of the FIR. Along with the Copy of the FIR, the following documents are to be submitted to the Insurance Company:

- Application form i.e., Claim form.
- Insurance Police.
- A Letter to be addressed to the Insurer about the Incident.
- If the Vehicle financed by the Bank. The Loan details or else Bank Account Particulars.

≈ He should also submit the Final Police Report to the insurance company as soon as it is received and extend full co-operation to the surveyor or investigator appointed by the company. An insurance policy covers theft and not negligence. If the car was not stolen because of the owner's negligence then providing both the car keys proves there wasn't any negligence on the part of the owner. At the same time, it also acts as proof that there is no intention to defraud the insurance company. Insured might get into trouble if he/she submits a fake car key. Since any stolen car incident involves FIR followed by police investigation, if the police find the car and insurer gets to know about the fact that the keys are fake, then it can be a trouble for the individual.

ii. Admissibility of the claim: In given case Mr. Deepak cannot submit the duplicate keys as it is also lost with car, so claim will not be admissible.

After the claim is approved, the Registration Certificate (RC) of the stolen vehicle has to be transferred in the name of the company and the insured needs to submit the duplicate keys of the vehicle along with a letter of subrogation and an indemnity on stamp paper (duly notarized) to the insurance company.

Normally one car key should be used to access the car lock system and when it gets damaged/stolen or worn out, then insured use the other one.

One must keep the worn out/damaged car key safe, since it can help insured get the car claim easily. Taking a car key replacement insurance rider with insured car insurance policy can help.

≈ In case of lost key replacing the car, lockset is advisable. On losing your car keys, insured need to report it to the police and get an FIR (First Information Report). Also, inform the insurer about the loss of key(s) before getting another key made in case insured are getting duplicate keys made instead of getting the entire lockset replaced.

≈ At the time of filing the insurance claim, apart from submitting both the keys to the insurer, insured must keep the following things handy:

≈ Insurance policy details, vehicle details, and copy of the FIR.

iii. **Settlement of claim in case of dispute**: The most common form of dispute that arises between the insured and the insurer is about admission of liability or the size of the claim. Disputes regarding claim amounts, where the insurer has agreed to cover the claim under the policy, are referred to an arbitrator. If the decision of the arbitrator is disputed by either party, the Consumer Forum or the Civil Court could be approached.