PRINCIPLES OF INSURANCE

UNIT I :

Definition of Risk and uncertainty – Classification of Risk – Insurance- meaning ,nature and significance – Principles of Insurance – Reinsurance- and Privatization of Insurance Business in India.

INTRODUCTION:

INSURANCE:

Insurance is a contract in which the individual or an entity gets the financial protection in other words reimbursement from the insurance company for the damage (big or small) caused to their property.

The insurer and the insured enter a legal contract for the insurance called the insurance policy that provides financial security from the future uncertainties.

The parties - individual ie **insured** and the insurance company called **insurer**.

In this agreement, the insurer promises to make good the losses of the insured on the happening of the contingency and the insured pays a premium in return for the promise made by the insurer.

Definition - **Insurance** is defined as a co-operative device to spread the loss caused by a particular risk over a number of persons who are exposed to it and who agree to ensure themselves against that risk.

Insurance is a contract, represented by a policy, in which an individual or entity receives financial protection or reimbursement against losses from an insurance company. The company pools clients' risks to make payments more affordable for the insured.

Insurance is contract between two parties (one the insurer and second the insured) whereby the insurer agrees to undertake the risk of the insured in consideration of some amount known as premium and in return promises to compensate a fixed sum of money to the insured party on happening of an uncertain event like DEATH.

Ghosh and Agarwal : Insurance is a co-operative form of distributing a certain risk over a group of persons who are exposed to it.

Mowbray and Blan : Insurance is a social device for eliminating or reducing the cost to society of certain types of risk.

Nature or Characteristics of Insurance:
On the basis of the definitions of insurance discussed above, one can observe the following nature or characteristics:

1. Contract
Insurance is a contract between the insurance company and the policyholder wherein the policyholder (insured) makes an offer and the insurance company (insurer) accepts his offer. The contract of insurance is always made in writing.

2. Consideration
Like other contracts, there must be lawful consideration in insurance also. The consideration is in the form of premium which the insured agrees to pay to the insurer.

3. Co-operative Device
All for one and one for all is the basis for cooperation. The insurance is a system wherein large number of persons, exposed to a similar risk, are covered and the risk is spread over among the larger insurable public. Therefore, insurance is a social or cooperative method wherein losses of one is borne by the society.

4. Protection of financial risks
An insurer is protected from financial risks which can be measured in terms of money. As such insurance compensates only financial or monetary loss or risks.

5. Risk sharing and risk transfer
Insurance is a social device for division of financial losses which may fall on an individual or his family on the happening of some unforeseen events. When insured, the loss arising out of the events are shared by all the insured in the form of premium. Therefore the risk is transferred from one individual to a group.

6. Based upon certain principles

The insurance is based upon certain principles like insurable interest, utmost good faith, indemnity, subrogation, causa-proxima, contribution, etc.

7. Regulated by Law

Insurance companies are regulated by statutory laws in almost all the countries. In India, life insurance and general insurance are regulated by Life Insurance Corporation of India Act 1956, and General Insurance Business (Nationalization) Act 1972, and IRDA Regulations etc.

8. Value of Risk

Before insuring the subject matter of the insurance contract, the risk is evaluated in order to determine the amount of premium to be charged on the insured. Several methods are being adopted to evaluate the risks involved in the subject matter. If there is an expectation of heavy loss, higher premiums will be charged. Hence, the probability of occurrence of loss is calculated at the time of insurance.

9. Payment at contingency

An insurer is liable to pay compensation to the insureds only when certain contingencies arise. In life insurance, the contingency — the death or the expiry of the term will certainly occur. In such cases, the life insurer has to pay the assured sum.

In other insurance contracts, the contingency — a fire accident or the marine perils, may or may not occur. So, if the contingency occurs, payment is made, otherwise no payment need to be made to the policyholders.

10. Insurance is not gambling

An insurance contract cannot be considered as gambling as the person insured is assured of his loss indemnified only on the happening of such uncertain event as stipulated in the contract of insurance, whereas the game of gambling may either result into profit or loss.

11. Insurance is not a charity

Premium collected from the policyholders under an insurance is the cost of risk so covered. Hence, it cannot be taken as charity. Charity lacks the element of contract of indemnity and compensation of loss to the person whosoever makes it.

12. Investment portfolio

Since insurers' liability to pay compensation to the insured arises on the happening of certain uncertain event, the insurers do not have to keep the collected premium with them. They invest the premium received in selected securities and earn interest and dividend on them. Thus, the insurers have two sources of income: the insurance premium and the investment income (i.e. interest / dividend) which occurs over time.

<u>Major Catagories of Insurance</u>

Life and Health Insurance - life; accident and sickness; disability

General Insurance- automobile; home; liability; commercial; crime. It

is also referred to as **Property and Casualty Insurance**.

Social Insurance - Hospital and Medical Plans; unemployment insurance , benefits; workers compensation.

PRINCIPLES OF INSURANCE:

The concept of insurance is risk distribution among a group of people, hence co-operation becomes the basic principle of insurance in addition to probability.

However to ensure fairness and proper functioning of the Insurance contract the following seven principles are essential:

1. Utmost Good Faith
2. Insurable Interest
3. Indemnity
4. Proximate Cause
5. Subrogation
6. Contribution
7. Mitigation of Loss (Minimization)

1.Principle of Utmost Good Faith:

The very basic principle is that both the parties in an insurance contract should act in good faith towards each other i.e. they must provide clear and concise information related to the terms and conditions of the contract.

The Insured should provide all the information related to the subject matter and the insurer must give clear details regarding the contract.

Eg – Jacob took a health insurance policy. At the time of taking insurance, he was a smoker and failed to disclose this fact. Later, he got cancer. In such a situation the Insurance company will not be liable to bear the financial burden as Jacob concealed important facts.

2. **Principle of Insurable interest:**

This principle says that the individual (insured) must have an insurable interest in the subject matter. Insurable interest means that the subject matter for which the individual enters the insurance contract must provide some financial gain to the insured and also lead to a financial loss if there is any damage, destruction or loss.

Eg – the owner of a vegetable cart has an insurable interest in the cart because he is earning money from it. However, if he sells the cart, he will no longer have an insurable interest in it.

To claim the amount of insurance, the insured must be the owner of the subject matter both at the time of entering the contract and at the time of the accident.

3.Principle of Indemnity:

This principle says that insurance is done only for the coverage of the loss hence insured should not make any profit from the insurance contract. In other words, the insured should be compensated the amount equal to the actual loss and not the amount exceeding the loss. The purpose of the indemnity principle is to set back the insured at the same financial position as he was before the loss occurred. Principle of indemnity is observed strictly for property insurance and not applicable for the life insurance contract.

Eg – The owner of a commercial building enters an insurance contract to recover the costs for any loss or damage in future. If the building sustains structural damages from fire, then the insurer will indemnify the

owner for the costs to repair the building by way of reimbursing the owner for the exact amount spent on repair or by reconstructing the damaged areas using its own authorized contractors.

4.Principle of Proximate Cause:

This is also called the principle of 'Causa Proxima' or the nearest cause. This principle applies when the loss is the result of two or more causes. The insurance company will find the nearest cause of loss to the property. If the proximate cause is the one in which the property is insured, then the company must pay compensation. If it is not a cause the property is insured against, then no payment will be made by the insured.

Eg Due to fire, a wall of a building was damaged, and the municipal authority ordered it to be demolished. While demolition the adjoining building was damaged. The owner of the adjoining building claimed the loss under the fire policy. The court held that fire is the nearest cause of loss to the adjoining building and the claim is payable as the falling of the wall is an inevitable result of the fire.

In the same example, the wall of the building damaged due to fire, fell down due to storm before it could be repaired and damaged an adjoining building. The owner of the adjoining building claimed the loss under the fire policy.In this case, the fire was a remote cause and storm was the proximate cause hence the claim is not payable under the fire policy.

5.Principle of Subrogation:

Subrogation means one party stands in for another. As per this principle, After the insured i.e. the individual has been compensated for the incurred loss to him on the subject matter that was insured, the rights of the ownership of that property goes to the insurer i.e. the company.

Subrogation gives the right to the insurance company to claim the amount of loss from the third-party responsible for the same.

Eg – If Mr A gets injured in a road accident, due to reckless driving of a third party, the company with which Mr A took the accidental insurance will compensate the loss occurred to Mr A and will also sue the third party to recover the money paid as claim.

6.Principle of Contribution

Contribution principle applies when the insured takes more than one insurance policy for the same subject matter. It states the same thing as in the principle of indemnity i.e. the insured cannot make a profit by

claiming the loss of one subject matter from different policies or companies.

Eg – A property worth Rs.5 Lakhs is insured with Company A for Rs. 3 lakhs and with company B for Rs.1 lakhs. The owner in case of damage to the property for 3 lakhs can claim the full amount from Company A but then he cannot claim any amount from Company B. Now, Company A can claim the proportional amount reimbursed value from Company B.

7. Mitigation of Loss(Minimisation)

This principle says that as an owner, it is obligatory on part of the insurer to take necessary steps to minimise the loss to the insured property. The principle does not allow the owner to be irresponsible or negligent just because the subject matter is insured.

Eg – If a fire breaks out in your factory, you should take reasonable steps to put out the fire. You cannot just stand back and allow the fire to burn down the factory because you know that the insurance company will compensate for it.

FUNCTIONS OF INSURANCE:

The functions of insurance are classified into two as

- **1.Primary Function :**

  It Provides Certainty

  It Provides Protection

  Ensures Risk-Sharing

- **2.Secondary Function**:

  Prevention of Loss –

  Provides Capital –

  Improves Efficiency –

  Helps Economic Growth

REINSURANCE

It is known as Insurance of Insurance ie Insurance for an insurance company. It allows an insurer to write a higher level of risk and accept larger amounts than it might be able to on its own. It enables an insurer to plan ahead of time how much it is prepared to pay out for losses.

It is to insure again by transferring to another insurance company all or part of a liability assumed. It enables an insurer to control losses from a single event, an effective way spreading risk among as many people as possible.

A company that purchases reinsurance pays a premium to the reinsurance company, who in exchange would pay a share of the claims incurred by the purchasing company. The reinsurer may be either a specialist reinsurance company, which only undertakes reinsurance business, or another insurance company. Insurance companies that accept reinsurance refer to the business as 'assumed reinsurance'.

Classification of Reinsurance:

There are two basic methods of reinsurance:

i) Facultative Reinsurance, which is negotiated separately for each insurance policy that is reinsured. Facultative reinsurance is normally purchased by ceding companies for individual risks not covered, or insufficiently covered, by their reinsurance treaties, for amounts in excess of the monetary limits of their reinsurance treaties and for unusual risks. Underwriting expenses, and in particular personnel costs, are higher for such business because each risk is individually underwritten and administered. However, as they can separately evaluate each risk reinsured, the reinsurer's underwriter can price the contract more accurately to reflect the risks involved. Ultimately, a facultative certificate is issued by the reinsurance company to the ceding company reinsuring that one policy.

ii) Treaty Reinsurance means that the ceding company and the reinsurer negotiate and execute a **reinsurance contract** under which the reinsurer covers the specified share of all the insurance policies issued by the ceding company which come within the scope of that contract. The reinsurance contract may obligate the reinsurer to accept reinsurance of all contracts within the scope (known as "obligatory"

reinsurance), or it may allow the insurer to choose which risks it wants to cede, with the reinsurer obligated to accept such risks (known as "facultative-obligatory" or "fac oblig" reinsurance).

There are two main types of treaty reinsurance, **proportional and non-proportional,** which are detailed below.

Under proportional reinsurance, the reinsurer's share of the risk is defined for each separate policy, while under non-proportional reinsurance the reinsurer's liability is based on the aggregate claims incurred by the ceding office. In the past 30 years there has been a major shift from proportional to non-proportional reinsurance in the property and casualty fields.

NEED FOR REINSURANCE:

- To increase the insurer's capacity to write business
- To maintain a proper reserve/liability balance
- To reduce the effect of a catastrophic loss
- To provide stability in a fluctuating market
- To enable an insurer to cease operations quickly

PRIVATISATION OF INSURANCE BUSINESS IN INDIA

In India Privatisation started with the introduction of the New Economic Policy in 1991.The term Privatisation implies the introduction of Private ownership in publicly owned enterprises.

Thus Liberalization eventually returned to India in a much more dramatic and lasting form in 1991. Financial sector reforms were started in India in 1992–93 to promote a diversified, efficient and competitive financial system.

India's financial sector liberalization has been a comprehensive program involving issues related to banking, capital market, fiscal policy and international financial integration.

Financial sector reforms include banking sector and non-bank financial sector. The non-bank financial sector includes reforms relating to the capital market, development finance institutions, insurance and mutual funds and liberalization of capital flows.

The Indian insurance industry was revolved around two public sector players, viz., Life Insurance Corporation of India and General Insurance Corporation of India.

One of the major impetuses for the nationalization of insurance companies in 20th century was to channel greater resources towards development programs.

Malhotra Committee : A move to liberalise insurance sector was taken in April 1993 with the establishment of Malhotra committee on insurance sector reforms.

Malhotra committee was headed by R. N. Malhotra, a former finance secretary and governor of Reserve Bank of India (RBI). "

The Committee was established to assess insurance sector strengths and weaknesses in terms of the objective of

1) Providing high quality services to the public

2) Serve as an effective instrument for mobilization of financial resources for development,

3) To review the then existing structure of regulation and supervision of insurance sector and

4) To suggest reforms for strengthening and modernizing regulatory system in tune with the changing economic environment”

. The Malhotra Committee recommended introduction of concept of “professionalization” in the insurance sector by opening the insurance sector to private players and setting an independent regulatory authority to create a level playing field for all entities.

The report of the committee covered three major topics

(a) Liberalization, restructuring and regulation of insurance,

(b) Pricing of product and distribution of services, and

(c) Surveyors, reinsurance and ombudsmen.

Malhotra committee recommended that state monopoly of insurance sector should be broken up by allowing domestic and foreign private firms in the market.

The idea behind this measure was to ensure utilization of untapped potential, introduction of competition, expansion of business and better choices to customers in terms of variety of products, reduction of prices and efficient customer service.

In this direction, committee recommend certain measures to be taken

(a) no firm should be allowed to do business in both life and general insurance,

(b) insurance regulatory authority should be regulatory authority of insurance companies,

(c) auditors of the insurance company should report to insurance regulatory authority, and

(d) entry to foreign insurance companies should be on selective basis i.e. they should be required to float an Indian company preferably by way of joint ventures with Indian partners.

Insurance Regulatory and Development Authority of India

(IRDAI)

The recommendation of Malhotra committee regarding establishment of a strong, effective and independent regulatory body to protect interest of policyholders and development of insurance industry, the Government of India had established interim regulatory authority in January 1996 through an exclusive order. Later on, this Interim Regulatory Authority becomes Insurance Regulatory and Development Authority of India .

IRDAI as an autonomous body was formed on April 19, 1999. IRDAI entrusted with the task of regulating, supervising and developing insurance and reinsurance business in India. IRDAI started its functioning on April 19, 2000.

IRDAI as a regulatory authority has heavy responsibilities and difficult roles to play. On the one side, it has to protect against malpractices and secure fair treatment to policyholders. On the other side, it has to impose restrictions in such a manner that growth of insurance industry is not hampered.

OBJECTIVES OF IRDAI:

i)To protect the interest of policyholders of insurance policies;

ii) To bring about speedy and orderly growth of the insurance industry and to provide long term funds for accelerating growth of the economy;

iii) To set, promote, monitor and enforce high standards of integrity, financial soundness, fair dealing and competence of those it regulates;

iv)- To ensure speedy settlement of genuine claims, to prevent insurance frauds and other malpractices and put in place effective grievance redressal machinery;

v) To promote fairness, transparency and orderly conduct in financial markets dealing with insurance and build a reliable management information system to enforce high standards of financial soundness amongst market players;

vi) To take action where such standards are inadequate or ineffectively enforced;

vii) To bring about optimum amount of self-regulation in day-to-day working of the industry consistent with the requirements of prudential regulation.