What Insurance is?

Life Insurance is a contract whereby the insurer, in consideration of a certain premium undertakes to pay a stipulated sum to the life assured or to the beneficiary upon the expiry of a fixed period or death of the person, whose life is insured.

Insurance is one of the most important institutions of modern society. It gives economic security and stability to the lives of individuals, families, enterprises and communities. It is said that every man must have three basic things to survive - food, shelter and clothing. Next to these, one needs insurance. It is the one factor which protects and ensures continuity of the first three.

All insurance has four components: First of all there must be an **asset** which has economic value.

Secondly the asset is exposed to the **chance of loss** [termed as risk] in its economic value due to possible happening of an event, known as the risk event.

Thirdly such economic losses that may be suffered by an unfortunate few are met from a fund into which the contributions of many individuals, similarly, exposed to that risk are **pooled** in. The chance of making a loss [the risk] thus gets transferred from the individual to the pooled fund. Finally the arrangement for meeting such loss is made by an institution called the insurer through a **contract of insurance.** In sum the four things involved in insurance are: Asset, Risk, The Pooling principle and The Contract

Asset: The term asset signifies something that has economic value and so provides benefits to its owner. There are broadly three different kinds of assets.

Property – One's physical possessions that have economic value. Examples are house, factory, inventory of goods and raw materials, vehicles, cash and valuables.

Good will – One's name, reputation and prestige that may be destroyed by an accident. For example, a doctor whose patient dies at his hands may be held liable for the death and may suffer loss of reputation and even have to pay damages.

The Person: One's personal self [Life and health] that may be affected by disease or even death.

Risk: Risk has been defined as the chance of a loss. When we say chance, it means that there is a probability between 0 and 1 that the loss may occur. For example, when we say that there is a three in a thousand chance that a house may catch fire, it means that out of every 1000 houses exposed to the possibility of a fire 3 may actually suffer from it. The probability is expressed as 3/ 1000 or 0.003.

The effect of a risk is termed as the Expectation of the risk. It is measured by considering two factors – its probability of occurrence and the loss impact in case it occurs. Let us consider the above example. The probability of occurrence of fire is 3 / 1000. Let us suppose that in the event of a loss, the amount of loss suffered on average is about Rs 50000. This means:

Expected value of risk = 3 / 1000 x 50000 = 150

The cause of the loss is known as **peril.** Fire and lightning are perils that can lead to loss of property. Cancer and Kidney disease are similarly perils that can lead to loss of life. Other examples of peril are car accidents and theft of jewellery.

While peril is the cause of the risk, its probability of occurrence as well as its amount of loss may be increased or decreased due to the presence of certain factors. These are known as **Hazards.** For example, while cancer is the cause of death, the chance of suffering from cancer can be increased by smoking. Smoking thus is a hazard. Similarly if houses are made of dried leaves they can catch fire more easily. On the other hand if there is a fire extinguisher at hand, the loss impact of a fire can be minimized. Broadly we may have two types of hazard. Firstly there is **Physical hazard** which is a physical condition that increases the chance of loss. An example is defective wiring in a building. There also is **Moral Hazard,** which refers to dishonesty or character defects in an individual or even carelessness of action that increases the frequency or severity of the loss. For example a factory owner setting fire to his factory to claim insurance or a car driver who drives rashly after taking insurance

Pooling and Transfer of Risk: Consider the above example.If 3 houses catch fire and each such instance causes a loss of Rs 50000. The total amount of loss is Rs 150000. If this amount were to be distributed among the 1000 houses exposed, the amount each would have to contribute would be 150000/ 1000 = 150. As we can see above, this is the expected value of the risk. The third requirement for insurance is that there is a fund into which small amounts [in the above case it is Rs 150] are contributed and pooled in. The fund makes it possible to transfer the likely impact of loss from the unfortunate few to the many.

Insurance may thus be defined in five words as: **Risk Transfer through Risk Pooling**

The Insurance Contract: any person using his reasoning would ask how such transfer and pooling would be achieved. Who is to decide how much contribution to collect? What is the guarantee that the money would actually buy one's security and not be lost? The final requirement of modern commercial insurance is that it is organized by an institution known as an insurer who enters into a **contract of insurance** with the individual wishing to protect his assets. The latter is known as the insured.

What insurance does?

We have seen in the previous section what exactly happens in insurance. Let us now understand what its role is and how it helps individuals and the community. For this purpose it is necessary to look a little more closely into certain concepts associated with risk and its management.

- **Burden of risk:** Insurance is necessary because it helps to shoulder the burden of risk which one would otherwise have borne alone.

What is burden of risk? It may be defined as the costs, losses and various kinds of disabilities one has to bear or suffer as a result of being exposed to a given loss situation.

There are two types of such burden – primary and secondary.

The **primary burden** of riskconsists of losses that are actually suffered by one as a result happening of the risk event. For example an earthquake can result in much loss of property and livelihood. An accident can result in loss of both eyes and lead to inability to work and earn. Insurance is a tool that helps to meet such loss consequences. The person who suffers gets compensated by the community of insured people through the help of the insurer.

But what if such an event were not to occur? Does the insured still bear any burden? The answer is yes – there is a secondary burden.

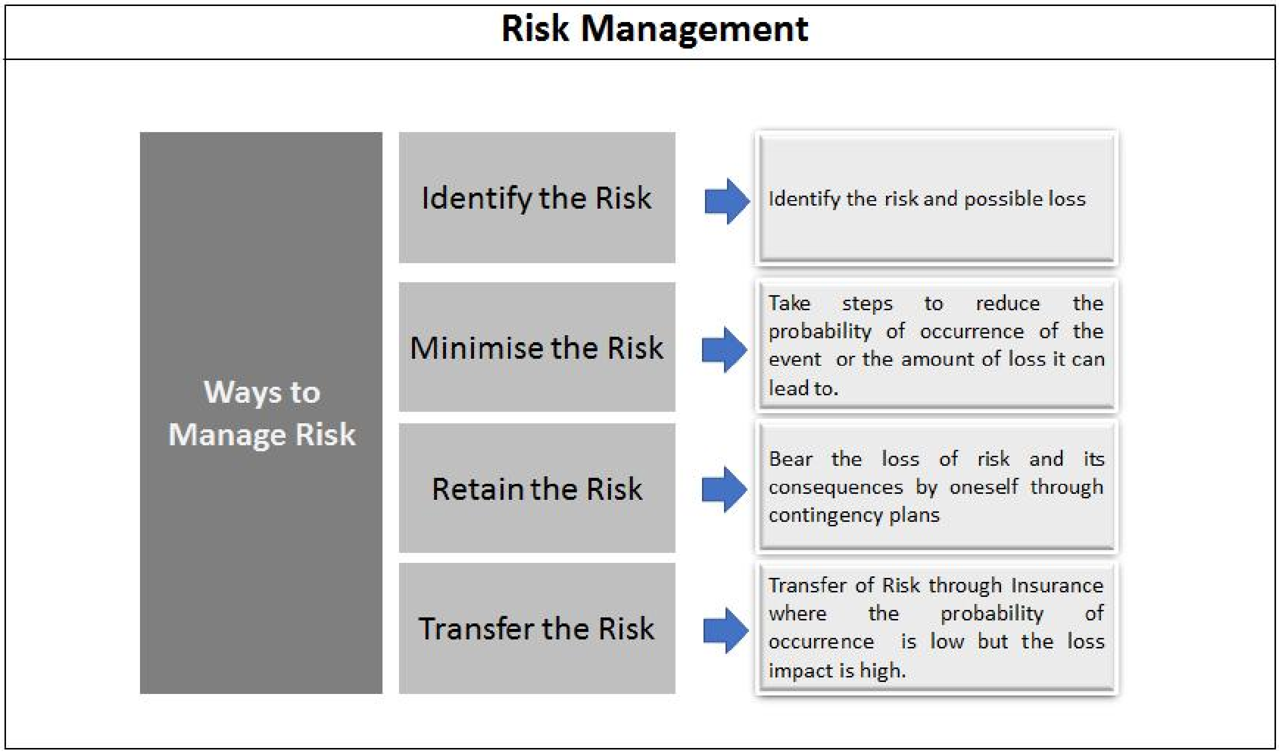
The **secondary burden** of risk consists of costs and discomforts one has to bear as a result of uncertainty arising from exposure to a loss situation. For example there is Physical and mental strain caused by fear and anxiety. It is rightly said that more than anything else, what one pays for when buying insurance is **Peace of mind.** Secondly if there was no insurance, one may feel the need to have a **reserve fund** for use in an emergency. However keeping such a fund has an opportunity cost. The amount could have been used more profitably elsewhere. Taking insurance helps the individual to get rid of such burdens. It also enables the insured to plan and use resources more efficiently because one does not have to worry about accidents and contingencies.

Every life insurance sales person must note that **a person need not necessarily die, in order to benefit from life insurance. Life insurance becomes necessary because it helps to plan one's life without fear of untimely death tomorrow.**

- **Type of risk covered:** It is also necessary to know what kind of risk is covered by insurance. One can classify risk into two types. The first is **speculative risk** that we find in financial products like stocks or bonds. Such types of risk are not covered by insurance contracts.

  There is another type of risk termed as **Pure Risk.** Unlike speculative risks where there are many outcomes [yielding both gain and loss], pure risk situations have only two outcomes – the event may happen or not happen. Further, if the event happens there is a loss. If the event does not happen there is neither loss nor gain. The individual is neither better off nor worse off than before. A classic example of pure risk is that of an earthquake or an accident. These events may either occur or not – there is no third outcome. A loss can arise only if these events occur. **Insurance contracts only cover pure risks.**

- **Insurance and Risk Management:** Another point we must remember is that insurance is only one of the ways to address the problem posed by risk. There are other ways to manage risk. For instance one can **avoid risk.** One can nullify the chance of a train accident by never travelling in a train. Similarly one can **reduce the loss** from a risk either by taking steps to reduce the probability of occurrence of the event or the amount of loss it can lead to. For example good exercise and avoiding excess eating can reduce the chances of early death from heart disease. Having fire extinguishers in an office can reduce the damage that fire can cause if it occurs. Yet another way to handle risk is to bear its loss consequences oneself. This is known as **risk retention**. For example, one may keep a reserve fund for meeting any emergency expenses that may arise. Retention may be the only way to meet those risks which cannot be insured. **Transfer of Risk through Insurance** is the fourth way of managing risk. Insurance becomes ideal for those risk situations where the probability or chance of occurrence of the event is very low or even negligible but the loss impact if it occurs is considerable. For example the probability of an accident in a nuclear plant may be very low but the loss that can arise in the event of such an accident would be immense. Such situations must be insured. On the other hand it may make little sense to insure an asset that has low value [like a pencil] but has a high chance of damage and loss of value



- **When a risk becomes insurable**: From the above discussion it would be obvious that each and every kind of risk situation is not necessarily insurable. The principles of insurance can work only when certain conditions are satisfied. Let us now examine what these are

1. Firstly the Loss produced by the risk must be **definite and measurable**. It is for example, difficult to provide insurance against emotional distress. Typically insurance covers only losses that have a clear monetary or pecuniary value.
2. Secondly the Loss must be **fortuitous or accidental**. It should not have been caused deliberately. Insurance will also not cover losses that arise as assets diminish in value over time. For example, depreciation of value on account of aging and continuous use cannot be covered by insurance. However assets that lose their value prematurely as a result of damage through an accident may get compensated for.
3. The loss must not be catastrophic. It must be affecting a few people and not a wide segment of the populace. Insurers may not for example be able to cover losses arising from a thermo nuclear war or a massive epidemic.
4. Economic Feasibility and Public Policy. The purpose of the insurance contract must be legal. A murder is not legal and the murderer cannot get any protection or compensation for any losses he may face, arising from his crime.

Brief History of Insurance:

In the last section of this chapter we shall now briefly consider the history of insurance.

Modern commercial Insurance as we know it today may be said to have started about 300 years ago in London. In India, insurance began in 1818. The first Indian insurance company was the Bombay Mutual Assurance Society Ltd, formed in 1870 in Mumbai. This was followed by many others spurred by the Swadeshi movement in the early 1900s. The Insurance Act 1938, as amended from time to time, was enacted to regulate the conduct of the insurance companies in India. This Act continues to be in force, having been amended several times.

In 1956, life insurance business in India was nationalized. The Life Insurance Corporation of India (LIC) was formed on 1st September 1956. There were at that time 170 Indian and foreign companies and 75 provident fund societies transacting life insurance business in India. To regulate the Insurance Business in India, Insurance Regulatory Development Authority came into being in 1999.

Postal Life Insurance (PLI) is exempted from the provisions of the Insurance Act and is not subject to regulation by the IRDA. The Post Office Life Insurance Rues -2011 provide statutory support for PLI and RPLI business.

Postal Life Insurance (PLI) and Rural Postal Life Insurance (RPLI) refer to different types of schemes introduced by the Department of Posts from time to time.

Types of schemes

- Anticipated Endowment Assurance.
- Children Policy.
- Convertible Whole Life Assurance.
- Endowment Assurance.
- Joint Life Insurance/Yugal Suraksha.
- Whole life insurance.