Financial Institutions and Markets
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Lecture – 27
Insurance Companies

So, we discussed about the provident fund and pension fund which are the most important financial instruments, which are available in the Indian financial system. And today we will be discussing about another most important institutions, which work to minimize the risk of the market participants that is basically the insurance companies.

Because in the risk management process the risk can be managed in various ways. One is you can manage the risk through hedging using the derivatives kind of instruments or using the gold and other instrument which are available. You can also minimize the risk through the insurance policy. Here managing risk means basically you are transferring the risk from one individual to another individual, so that is why for risk management prospective the role of insurance companies are quite large and the insurance companies basically play very significant role in the growth process of the particular economy.

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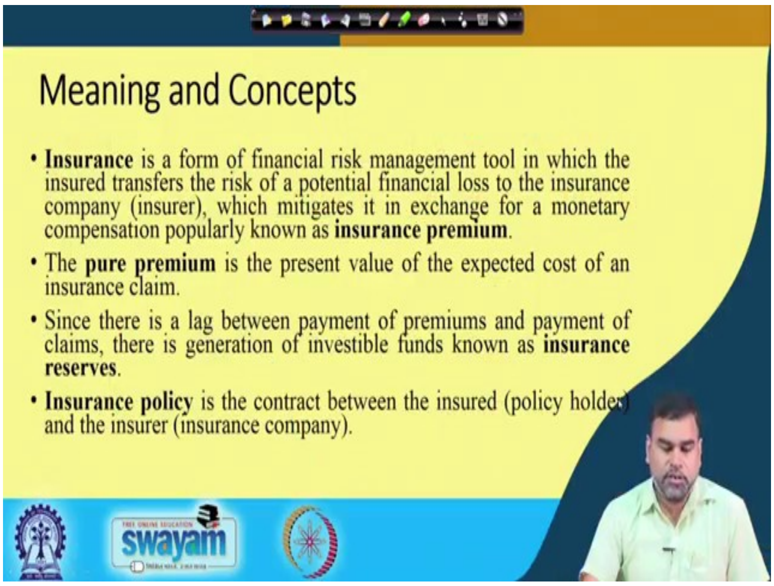

So, let us see that there are different concepts we use in whenever we go for the insurance policy, then what are those kind of concepts how we define those concepts. Already I told you that insurance is a form of financial risk management tool, in which the insured transfer the risk of a potential financial loss to the insurance company, which is insurer, which mitigates in an exchange for a monetary compensation popularly known as insurance premium, that means we regularly pay this insurance premium and why you are paying the insurance premium?

We are paying the insurance premium if there is any kind of uneven situation can arise at any point of time through that particular insurance premium whatever we have paid, the insurance company has to pay the amount of losses what the particular insured has incurred. So, in this context, the insurance premium is basically a kind of money which is deposited to the insurance companies to get the benefit for the risk mitigation for any kind of unforeseen circumstances.

So, there are different type of premium, one component to the pure premium. The pure premium is nothing but the present value of the expected cost of an insurance claim. And since there is a lag between payment of the premium and payment of the claims, there is generations of investable funds which are insurance reserves. So, insurance company can use that concept called the insurance reserves.

And insurance policies basically what, it is a contract between the insured or the policyholder and the insurer, which is basically the insurance company. And this is the way the insurance policy that is why we should always get a policy document or a particular contract whenever you go for any kind of insurance policy or we buy any kind of insurance policy from any type of companies.

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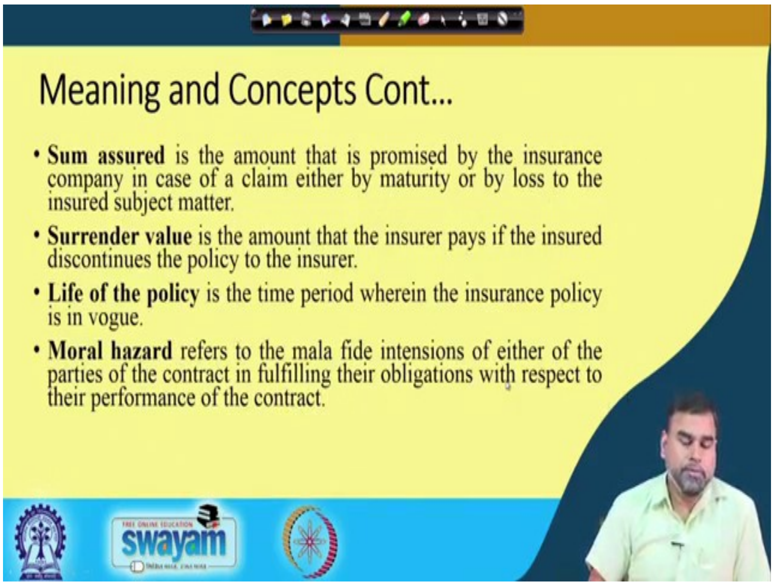

Then we have another concepts which are related to insurance that is sum assured, you might have seen in your policy document there is an amount which is written that is called the sum assured. Then what do you mean by the sum assured? The sum assured is basically nothing but if the amount that is promised by the insurance company, in case of a claim either by maturity or by a loss to the insured subject matter. For example, you have a life insurance policy, you are paying 5000 rupees per annum and your sum assured is basically 500000s and the policy is for let 10 years or 15 years.

So, if you have paid that premium regularly there is no such kind of default within that, then the sum assured will give you the idea that after the maturity or before if there is any kind of mishappening happens, then the particular insurance company has promised to pay that sum assured amount to the person, who has gone for buying this insurance policy. The sum assured is a very important concept or important notion which is used, whenever we go and invest in the insurance market or we buy the insurance policy for any specific reasons.

Then we have another concept called the surrender value. If you go and read your insurance policy document, you will find all those concepts which is basically provide you with the example that how these concepts work whenever we are buying this insurance policy.

We have the surrender value, which is nothing but the amount that the insurer pays, if the insured discontinues the policy to the insurer that means for example, you want to stop your insurance policy after 5 years, but let the maturity is 15 years; you are not able to pay that premium and you want to close it.

If you want to close it, then there are certain kind of agreements which are already designed or already made that what should be the surrender value for that particular insurance policy. And that surrender value or surrender amount will be paid to you and with that within that particular regulations, whatever already mentioned in that particular policy document.

Life of the policy means, it is the time period where the insurance policy is in running positions or in the vogue that means, that is working. At any point of time if you do not pay the policy premium also that can be stopped for a temporary period of time and again as for the rules and regulations or terms and conditions which are mentioned in the policy document, you can again start or renew that particular insurance policy whenever you need. So, because of that what basically here we are trying to see that the life of the policy always work up to the maturity period.

Then another concept is the moral hazard, which refers to the mala fide intentions of either of the parties of the contract in fulfilling their obligations with respect to their performance of the contract. There are sometimes some kind of moral hazard issues happen, if any kind of parties or any other parties will create certain kind of or they will get away from their obligations and try to create certain kind of problem, which may create the inconvenience either to the policyholder or maybe the insurance companies.

So, those kind of things are very much important whenever you go for the insurance policy, also to understand how this insurance policy basically works in that particular system. So, these are the different concepts which are used and mostly this sum assured this surrender value, then your premium these are very important concepts whenever we go for any kind of insurance policy or to invest the money in the insurance policy.

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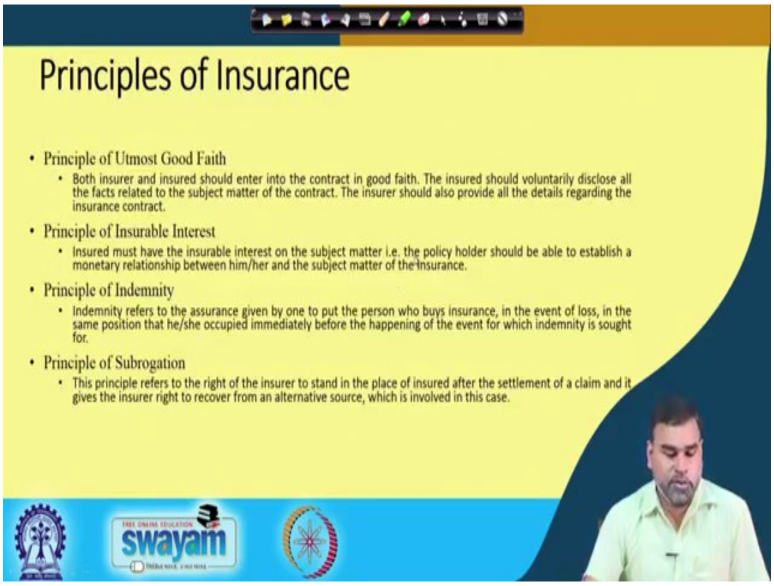

So, there are a different kind of principles of insurance, whenever we go for any kind of insurance we follow different principles or both the parties follow the different principles. On different principles, the insurance policy basically best. What are those principles? The first one is the principle of utmost good faith that means, both insurance company and the insurance policy holder enter into the contract in a good faith that means, here what we are ensuring the insured or the policyholder voluntarily disclose, all the facts related to the subject matter of the contract. And the insurer should also provide all the details regarding the insurance contract, there should not be any hidden kind of rules and regulations imposed in that.

For example, somebody is going for a health insurance. If the insurance company or agent will ask you that are you a chain smoker; let you are a chain smoker, but you have hided you basically hide that information, they said I am not a smoker, but if there is any probability that you are suffering from any heart attack or you are suffering from any disease which can be created due to the smoking, then that means you are basically not following the principle of at most good faith.

The insurance company believes that whatever information you are providing that is also correct and one whatever information they are providing in the policy document that is also correct, so that is why the both parties enter into the contract with a good faith that is the first principle of the insurance. The good faith is very important here you have to keep in the mind.

Then another one is the principle of insurable interest that means what? The policyholder should be able to establish a monetary relationship between him or her and the subject matter of the insurance that means what? So whenever basically this principle of insurable interest is designed, in that case what we are trying to do the policy holder can say that okay, this particular thing or this particular information is correct and there is some kind of monetary values what I am disclosing that is also correct.

So, if there is something wrong with that maybe, who are the particular person who has going to get that benefit that also should be given to the policy holder to the insurance companies and such that the insurable interest will be intact that means, there is a monetary relationship which can be established between the insurance company and the policyholder, unless that particular contract may not work.

Then we have the principle of indemnity. The indemnity means it refers to the assurance given to put the one person who buys the insurance in the event of the loss, in the same position that he or she occupied immediately before the happening of the event of which indemnity is sort for. That means for example, there was some damage, let there is a general insurance you have ensured that particular event and there was some damage to that.

So, immediately as per the indemnity clause, the person let you are organizing the function and there was some mishappening has happened and the organizer has signed the agreement with that particular company, who is basically performing there. And if any kind of mishappening or any kind of damage happens to that, then it is organizer who basically pays that particular money through that insurance.

So, the principle of indemnity and whatever information we are providing in terms of that particular damage and all that also should be correct and that damage had happened at one particular point of time and that should not be a periodical damage which has already occurred and we are trying to mix up the damage with the existing damage to get back more money from the insurance company that is basically called the principle of indemnity. Then we have the principle of subrogation.

Then what do you mean by the principle of subrogation? Here, it refers to the right of the insurer to stand in the place of insured after the settlement of a claim and it gives the insurer right to recover from an alternative source which involved in this case. Let, who is responsible for this? Whether this particular damage has happened because of my fault or the damage has happened because of something else, it is not available or it is not applicable for the life insurance.

So, if any kind of damage which can happen to a particular event or particular thing, then who is responsible for that if there is somebody else who is responsible for this, then that person also we have to recover the money from that and the insurance companies may not be that way burdened by that, so that is we call it the principle of subrogation.

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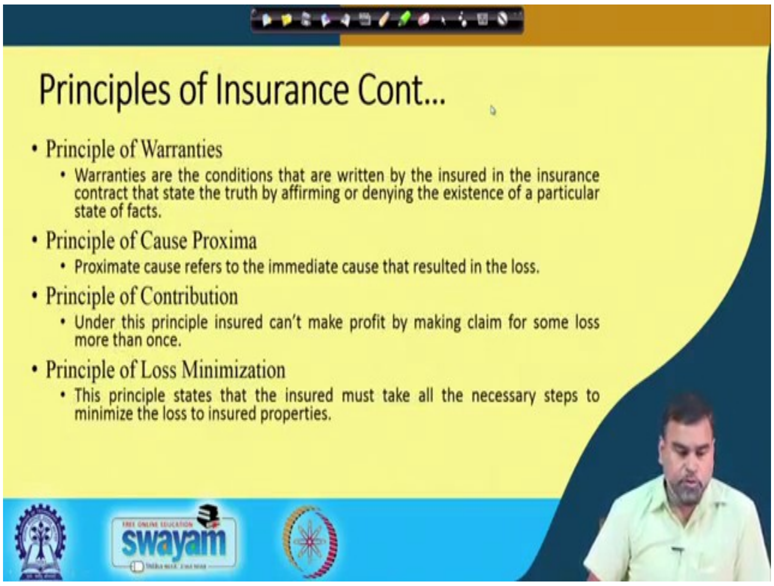

Then we have another principle that is called the principle of warranties. The warranties basically what? The warranties are the conditions that are written by the insured in the insurance contract that state the truth by forming or denying the existence of a particular state of facts, what does it mean? If you see for example, a bank has gone for insurance or there was some fire which was happened to that particular bank and because of that lot of wastage or lot of damage has been made.

But whenever the bank has gone for a insurance, to ensure that particular office or particular kind of place what they supposed to do? So, in that document you see there are certain kind of provisions are mentioned what are those, the provisions are the bank should installed a fire alarm or if there is a let there is a theft. So, there also the bank has to go for kind of proper alarming system, a security of 24 by 7 should be deployed there, and there is some kind of proper locking system is available to that particular office or particular place.

So, all those things all those precautionary measures the bank has to take. So, under this circumstances if still something has happened to that particular thing, then this particular thing is insurable or the insurance company has to pay for that, but if all this kind of conditions are not satisfied or you have not done anything because of this.

Then what is happening or another thing is that if you have not followed this kind of conditions, what the insurance company has signed in that or written that contract, then there is no point of or in that particular point of time you are missing this principle of warranties. And the insurance company may deny that you have not followed these kind of thing and because of that the money cannot be paid, so that is very important from the insurance point of view, the principle of warranties.

Then you have the principle of cause proxima. What do you mean by cause proxima? The proximate cause refer to the immediate cause that resulted in the loss, what does it mean? Let there is a fire in your house or anybody’s shop, what is the cause of the fire? Let the cause of the fire is a short circuit. So, whenever the cause of the fire is a short circuit, then we have to understand whether the wiring system is proper there or not.

So, we have made that agreement with the insurance company that our wiring system is full proofed or there is proper safety measures has been taken whenever we have gone for the wiring. Then only if everything is still there are some malfunction has happened in that particular place and the fire there is a fire, then there is no problem, but still what is the cause proxima, nearest cause is what that actually we have to always ensure.

And we have to ensure that all these things are properly maintained and all these things proper care has been taken to look after those kind of issues, which may have the impact upon these kind of damage, so that also we have to always keep in the mind that is called the principle of the cause proxima.

Then the principle of contribution; under this principle insured cannot make profit by making claim for some loss more than once. People sometimes do they have made a claim, there is some vehicle accident they made a claim. Some kind of claim, they made in they go for some kind of they do some kind of forgery. And the same claim they are doing again and again, so that also again is breaching the trust between the insurance company and the policyholder, so that is another principle through which the insurance basically is based upon that is called the principle of the contribution.

Then the principle of loss maximization what does it mean whenever there is a fire, let there is a fire. So, have you informed the fire station immediately? So, if you would have informed the fire, then loss would have been less. Then the insurance company would have been paid less amount in comparison with the loss what just now have been made for that, so that also always is written or always we have to ensure that whether the principle of loss minimization is working in that particular contract or not.

So, whether if somebody has died because of some reasons, then whether he has been shifted to the doctor or not, immediate medical attention has been given to them or not or already I have given the example that if there is a fire, whether the fire station was informed or not. So, all kind of thing also should be always ensured whenever we are going for the insurance policy and the policy document is based upon all kind of eight principles on the insurance. So, this is the way the designing of insurance policy always made, whenever we are going for buying the insurance policy from the insurance market.

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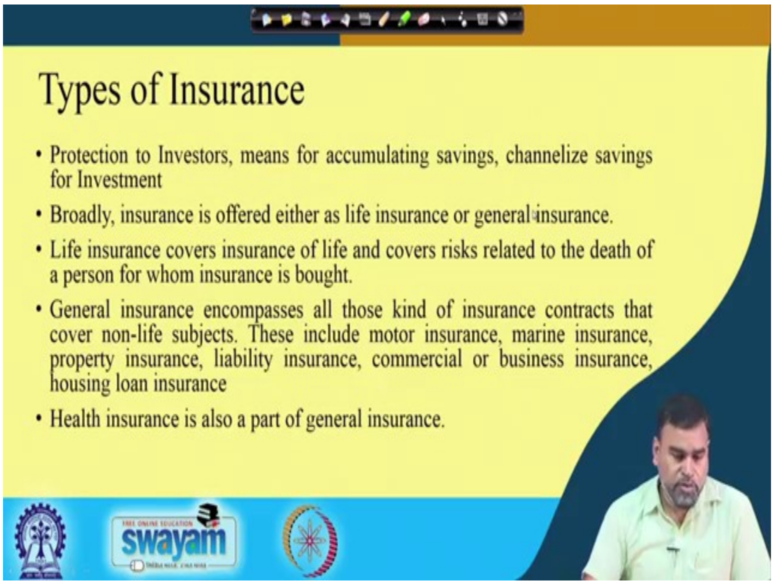

Then we will see that what are the different types of insurance which are available, already you know this. So, broadly if you see there are two types of insurance; either it is a life insurance or it is a general insurance. And the basic objective of the insurance is protection to the investors that means, accumulation of the savings in channel and one what this insurance companies do, they take the money from you they invested in the market in the different kind of assets, a different kind of investment alternatives and some returns are realized from that. And finally, what has happened if there is any kind of loss any kind of damage, then the money can be paid accordingly.

So, there are two types of insurance, we have life insurance and the general insurance. And life insurance covers the insurance of life and covers the risk related to the death of a person. And then if you are going for a general insurance that includes the different type of insurance, at all those kind of insurance contract that cover non-life subjects. Non-life subject include the motor insurance or the vehicle insurance, marine insurance, property insurance, liability insurance, commercial business insurance.

And nowadays we have also we can insure our loans. Your house loan and other loan also can be insured, if there is any kind of or there are some certain reasons if you are not able to repay the loan or the person who was taken the loan he or she has died, then in that context that our insurance company who pay that loan or that money will be paid by them, so that is why there are financial alternatives or financial investment alternatives are also insured nowadays, because the insurance sector is going up and more diversification is taking place in that.

Health insurance is also a part of the general insurance. The medical insurance basically the mediclaim policies, they are not a part of the life insurance, they are a part of the general insurance. So, this is the way the types of insurances are designed. Life insurance is mostly covered in terms of the life and the risk related to the life.

And the health insurance is related to your disease and all these things, which may occur. And you have the general insurance, which includes all type of rest of the insurance whatever we have. So, these are the two broad type of insurance, but again the sub classifications can be made whenever we are going to use in the practical sense for the different reasons.

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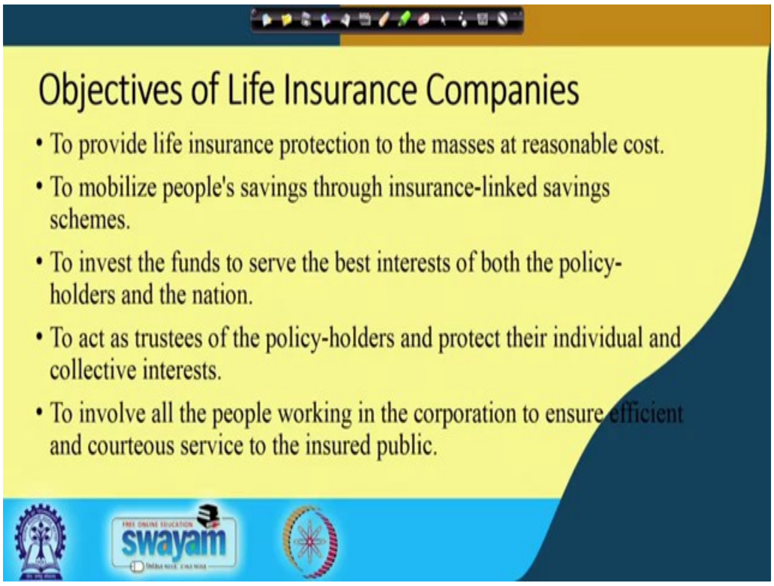

So, what is the objective of the life insurance companies? What this life insurance companies basically do? So, the life insurance companies basically provide the life insurance protection to the masses at a reasonable cost. And the basic job of the life insurance corporation of India, if we talk about India, they mobilize the people savings through insurance linked saving schemes.

Already I told you, the insurance companies are the biggest mobilizers of the savings in the Indian market. Whatever money is deposited through this insurance policy that money is basically goes to the market for the better investments and it is useful for the once this particular money is used in the productive investment alternatives, it has lot of implications for enhancement of the growth or the output.

Once the output increases, because this is used for different productive projects, productive investment projects and those things can always help to maximize their output. If the output is maximized, then automatically what happens the growth rate of the economy will be increasing or can be increased. So, in that context it is basically a major source of the savings or major source of money for the output maximization of the economy.

To invest the funds to serve the best interest of the both policyholders and the nation, because the policyholder also to get that money whenever they want. So, because of that for the survival of the policyholder and as well as the for the insurance company and as well as the betterment of the economy they invest that money in a larger variety of alternative investments, which alternative instruments are available in the market. To act as a trustee of the policyholders and protect their individual and collective interest, if it is a group insurance, they go for a collective interest; if it is individual insurance policy, they will go to protect that individual interest.

To involve all the people working in the corporation to ensure the efficient and courteous service to the insured people or insured public. You see, efficiency is very important from the insurance point of view. Sometimes you might have seen in the advertisement in other places, after the retirement or any kind of maturity people are facing lot of problem to get back their money or maybe this insurance companies are reluctant to justify the terms and conditions which are already mentioned in the document.

So, nowadays the insurance companies are very much concerned about the services that they provide the efficient services to the public. And as well as whatever things, they are promised through the offer document that basically come to or may be reach to that particular public in a amicable manner, so that is also another objective of the insurance companies in the modern era. So, these are the different objectives what we can see.

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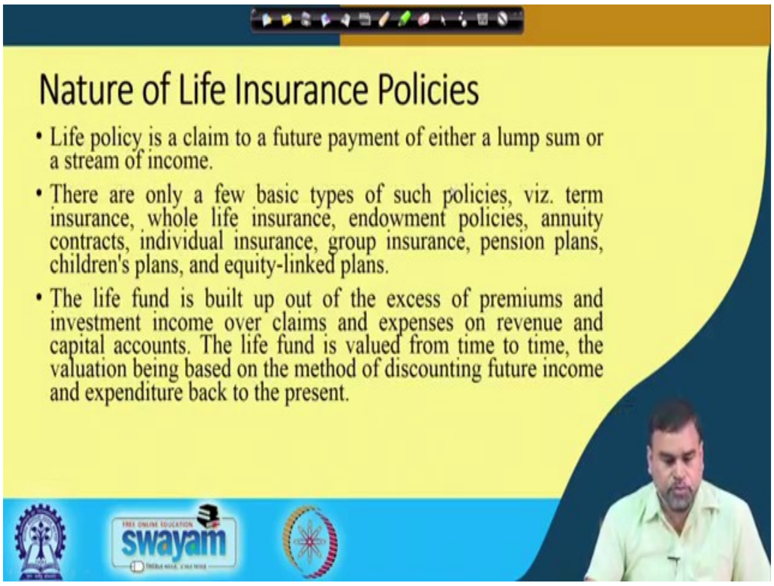

So, if you see the nature of the life insurance, the life insurance policy or life policy is a claim or a future payment of either lump sum or a stream of income. You can pay your money as a lump sum amount, there are different kind of policies. So, you can have the you can pay your money as a lump sum amount or you can also pay in the periodical basis, it can be monthly, it can be quarterly, it can be yearly.

So, there are different type of policies, which comes under the life insurance policies like term insurance, whole life insurance, endowment policies, annuity contracts, individual insurance, group insurance, pension plan, children's plan, there are some plans which are equity linked plan, there are some plans which are only income linked plan or income fund linked plan, which are mostly gives you relatively less return, but the return is assured.

And there are some plans which are highly linked to the market or equity linked plan. So, there the fluctuations of the return is relatively higher, but there is a probability that you may get more return if you are investing the money in that particular policies.

So, there are certain policies where we get this benefit the life risk coverage is there, after your insurance policy got matured also. So, there that kind of insurance LIC are other companies like Jeevan Anand policy and other type of policies what they were providing. Those kind of policies your life coverage will be there up to your death, even your insurance premium you are not paying on the coverage of that particular or the time period of that particular policy is over. So that is why there are different kind of policies which are there, on the basis of the requirement of the persons and as well as the basic necessity or the kind of requirement what this policyholder always have.

So, the life fund is build up out of excess of premiums and investment income over claims and expenses on revenue and the life fund is valued from time to time, the valuation being based on the method of discounting of the future income and expenditure back to the present. So, these are basically how the funds value is calculated, whenever the fund has been invested in the different type of investments. So, this is the way the life insurance policies work in the market.

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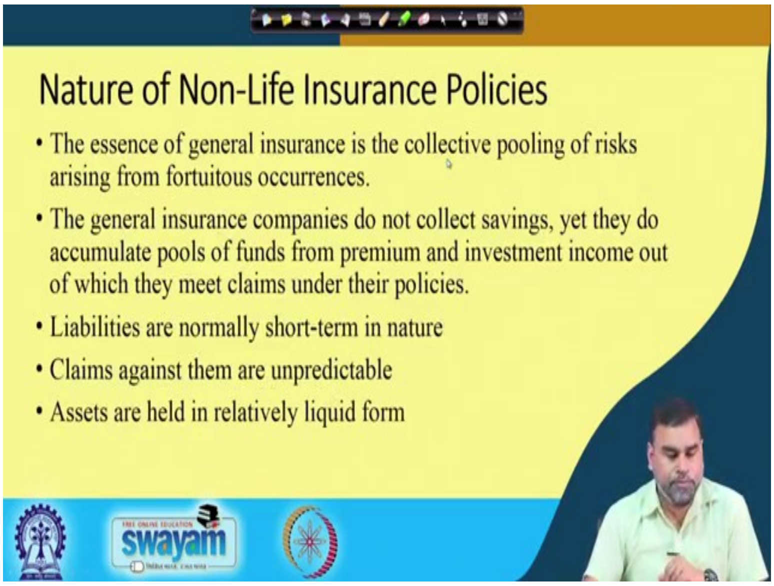

If you go by the nature of the non-life insurance policies, what are the things we can observe? The essence of general insurance is collective or pooling of risk arising from the fortuitous occurrences, which may happen because of certain events. The general insurance companies do not collect savings, yet they do accumulate pools of the funds from premium and investment income, out of which they made the claims under their policies. And this if you go by the non-life insurance policies, mostly the liabilities are normally sort out. Let vehicle insurance there must be small damage, which can happen in a periodical basis.

So, if you have a motor vehicle insurance policy, then you can claim your insurance. So, whatever liabilities the insurance non-life insurance companies face they are basically normally short term in nature. And claim against them are very unpredictable, because when you met the accident, when somebody met the accidents. So, when somebody basically any kind of thing got fire or got fire for some reasons. Nowadays, these people are also insuring all kind of festivals and all these things whenever there is any kind of bigger festival happening.

So, anything can happen to that, so that is why the claims against the general insurance or the non-life insurance is very unpredictable. So, therefore most of the time the insurance companies held their assets in the relatively liquid form. So, the investment made by the non-life insurance companies on the different assets are relatively, more liquid in comparison to the life insurance policies, so that is why the assets whatever they choose for that investment, it is relatively more liquid in comparison to the life insurance part.

So, this is what and already I told you this liabilities in the non-life insurance policies are general insurance is quite short term. This is about the nature of the non-life insurance policies, which can work.

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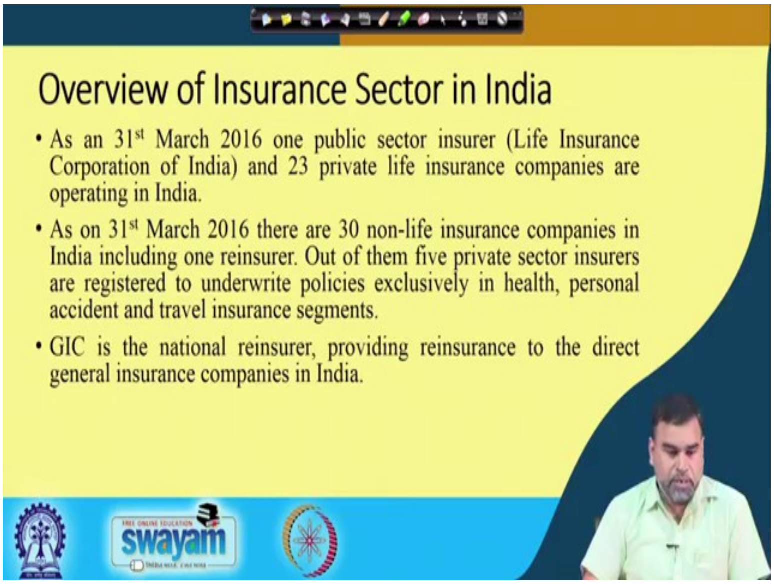

If you talk about India, in India as on 31st March 2016 whatever data I have, we have one public sector insurer that is life insurance corporation of India and 23 private life insurance companies which are operating in India.

So, we have one public sector unit that is basically LIC, then we have 23 different private companies whether it includes HDFC life, there are different companies. So, which are basically providing the life insurance services, a life insurance policies to the customers or we can say that nowadays from there what you are trying to say that the insurance companies are nowadays more open.

And there is a proper development has taken place in terms of insurance companies, because private sector is open to make this insurance business in Indian market which was not there before. So, because of that the number of private companies providing the life insurance services has been increasing continuously, so that is why we have 23 private life insurance, but 1 public sector insurance which is working.

And as on 31st March 2016 the same day, there are thirty non-life insurance companies in India, including one reinsurer and this reinsurer is basically the GIC. Out of them 5 private sector insures and a registered to underwrite policies exclusively in health, personal accident and travel insurance segments exclusively they provide the health insurance.

So, the companies there are certain kind of companies who provide only the health insurance policies or provide the health insurance to that particular customers they do not provide any other kind of thing, but health insurance is already we discussed that health insurance is a part of the general insurance. So, more or less if you see GIC is the national reinsurer, providing reinsurance to the direct general insurance companies in India.

So, here what overall if you see both in terms of the life and non-life insurance coverage, there is a huge development in terms of the private sector entities, so that is why the alternatives for the customers are quite large, they can choose any of the investors or sorry any of the insurance companies they want depending upon their necessity or depending upon their requirements.

So, in this context once the sector has become open and it is not only concentrated only on the public sector units, then obviously it is a one of the best instrument or best kind of organization which provides this small savings to the aggregate economy or provides that particular money to the general circulation by that the investment can go up. So, end of the day it can have the positive impact on the output and the growth rate. So, this is about the insurance companies in India.

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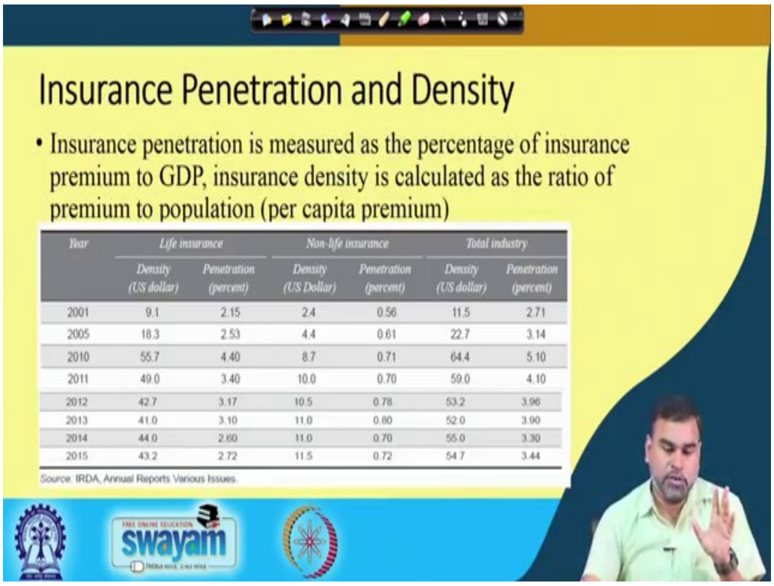

Year	Life insurance		Non-life insurance		Total industry	
	Density (US dollar)	Penetration (percent)	Density (US Dollar)	Penetration (percent)	Density (US dollar)	Penetration (percent)
2001	9.1	2.15	2.4	0.56	11.5	2.71
2005	18.3	2.53	4.4	0.61	22.7	3.14
2010	55.7	4.40	8.7	0.71	64.4	5.10
2011	49.0	3.40	10.0	0.70	59.0	4.10
2012	42.7	3.17	10.5	0.78	53.2	3.96
2013	41.0	3.10	11.0	0.80	52.0	3.90
2014	44.0	2.60	11.0	0.70	55.0	3.30
2015	43.2	2.72	11.5	0.72	54.7	3.44

Source: IRDA, Annual Reports Various Issues.

So, if you see the insurance penetration and density, insurance penetration is basically nothing but the percentage of the insurance premium to the total GDP an insurance density. If you see this is your percentage of insurance premium to GDP is called the insurance penetration and insurance density is calculated as there is insurance premium to the total population that means, per capita premium.

If you see the Indian data that both life insurance and other insurance, 2001 it was 9.1 insurance density and penetration was 2.15%, but if you go to 9.1 US dollar and 2.15 percentage in terms of the penetration in life insurance.

Now in 2015, it was 43.2 and 2.72. And whenever non-life insurance if you see, it was 2.4 it has increased to 11.5. Then in terms of the insurance penetration it was 0.56, it has become 0.72 that means, there is a clear increase in terms of both penetration and density which has happened in the Indian market.

So, overall if you see it has become 54.7 total industry and the penetration has become 3.44 as per the IRDA annual reports, this is the information whatever we have in terms of the development of the insurance sector in the Indian market, so that is basically is one of the already we told that this is important resources which provide the finance for the investment and as well as the output in the economy.

So, this is all about the insurance sector, the overview of the insurance sector which is operating in the Indian context and this is the way the insurance companies help to the policyholder and as well as the national economy as a whole.

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Please, go through this particular references for this particular session.

Thank you.