Dip 102:
Principles and Practice of Insurance

- Introductions
- Course Outline
- Course objectives
- Assessments –Cats 30%, Final Exam 70%

Principles of insurance

- Principles of insurance define the rules which guide the conduct of insurance business;- they define the boundaries of the trade;
- Principles have evolved and developed historically i.e. over time.
- Some of the principles have been codified into statutes -The UK Life Assurance, 1774 is the oldest statute to deal with an insurance principle-insurable interest.

Definition of a Principle

A principle is:

- A basic truth, law or assumption
- A fixed or predetermined policy or mode of action
- A basic or essential quality or element determining intrinsic nature or behavior
- **A basic law or rule underlying a particular theory or philosophy**

Principles of Insurance

- The principles of insurance determine **what is insurance and what is not.**
- **Six** basic principles:
- Insurable interest
- Utmost good faith
- Indemnity
- Proximate cause
- Subrogation
- Contribution

Insurable interest

- Definition:
- It is the **legal right** to insure arising out of a **financial relationship**, **recognized at law** between **the insured** and the **subject matter of the insurance**

Subject matter of insurance

- The subject matter of insurance can be any **form of property or an event that that may result in a loss of a legal right or creation of a legal liability.**
- The subject matter of insurance under fire policy can be buildings, stock or machinery;
- Under a liability policy it can be a person's legal liability for injury or damage;
- with a life assurance policy the subject matter is the life being assured;
- In marine insurance it can be the ship, its cargo or the ship owner's legal liability to third parties for injury or damage.

Subject matter of insurance

- To locate insurable interest- take note of one fundamental fact.
- It is not the house, ship, machinery, potential liability of life that is insured but **the pecuniary interest** of the insured in the subject matter which is insured.
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Subject matter of contract

- This concept is at the root of the doctrine of insurable interest and was expounded in the case of **Castellain** v. **Preston (1883)** in these words,

NB; What is it that is insured in a fire policy? Not the bricks and the materials used in building the house **but the interest of the insured in the subject matter of insurance.**

- **it is the interest of the insured in the subject matter of the insurance which is insured, hence the importance of insurable interest.**

Essentials of insurable interest

a) There must be some property , right, interest, life, limb or potential liability capable of being insured;
b) Such property, right, interest etc. must be the subject matter of insurance;
c) The insured must stand in a relationship with the subject matter of insurance whereby he benefits from its safety, wellbeing or freedom from liability and would be prejudiced by its damage or the existence of liability;
d) The relationship between the insured and the subject matter of insurance must be recognized at law.

Statutory Development- Historical development of insurable interest

- The fact that it seemed unjust to allow people to effect policies in respect of risks where they had no legally recognizable financial involvement had not escaped the attention of the courts.
- For some time the practice had been for courts to refuse to enforce claims made under policies that appeared to conceal some gambling transaction.

1. Marine insurance act 1745

- This Act forbade the issuing of policies of assurance which were made by **'any person or persons, bodies corporate or political on any ship or ships belonging to his Majesty or any of his subject or on any goods, merchandise or effects, laden or to be laden, on board of any ship, or ships, interest or no interest, or without further proof of interest, or by way of gaming or wagering, or without benefit of salvage to the assurer'.**
- Every such assurance was, to all intents and purposes, null and void.

Marine insurance act 1745

- The reference to ‘interest or no interest or without further proof of interest’ relates to the practice which had developed of attaching a clause to marine policies which stated that holding of the policy was the only proof of interest required.
- Thereafter, any policy issued ‘policy proof of interest’ (P.P.I) where the nature or extent of the interest could not be defined with certainty was a ‘honour’ contract only since the parties could not sue upon the courts.

2. Life assurance act

- The 1745 Act only related to marine insurance and it was still possible to gamble on lives and other events.
- The Life Assurance Act 1774, sometimes referred to as **the Gambling Act**, was introduced and it forbade the making of any policy, **‘on the life or lives of any person or persons, or on any other event or events whatsoever, wherein the person or persons for whose use, benefit, or on whose account such policy or policies shall be made, shall have no interest, or by way of gaming or wagering.’**

2. Life assurance act

- The essential features of the act are as follows:
  - Insurance on the lives of persons or on any other event whatsoever whereby the person benefiting from the insurance has no interest shall be null and void;
  - No policies on lives or other events shall be lawful, without the name of the person for whose benefit of the policy is being inserted in the policy;
  - No greater sum shall be recovered than the amount of the interest of the insured;
  - The act did not extend to insurance on ships, goods or merchandise (non-life business)

3.Marine insurance act 1788

- In the United Kingdom, by 1788 it was illegal to make policies on British ships and goods laden on them.
- The loophole appeared to be policies affected on goods unconnected with a ship.
- The Act of 1788 remedied the position and insisted on insurable interest for policies on any ship or ‘any goods, merchandises, effects **or other property whatsoever’**
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3. Marine insurance act 1788

- The Act also required the name of one person interested or concerned to be inserted on the policy document.

3. Marine insurance act 1788

- The legislation up to this date had been restricted to insurance contracts and the Gambling act 1845 was therefore introduced to render all contracts of gambling or wagering null and void.
- One effect of this, as far as insurers were concerned, was that insurance contracts where no insurable interest existed were rendered null and void as such contracts were nothing more than wagers

4. Marine Insurance Act 1906

- This Act repealed the 1745 Act and those parts of the 1788 Act relating to marine insurance.
- The act codified these previous statutes and declared void any marine insurance contract where no insurable interest existed at the time of any loss.
- The Act is also interesting as it defines insurable interest in the following terms:

4. Marine Insurance Act 1906

NB In particular a person is interested in a marine adventure where he stands in legal or equitable relation to the adventure or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or maybe prejudiced its loss, or by damage thereto, or by the detention thereof, or may incur liability in respect by thereof.

5. Marine insurance (gambling policies) act 1909

- Although gambling or wagering contracts were unenforceable nothing had been done to make them illegal until the passing of the 1909 Act.
- **By its terms it was a criminal offence to effect a marine policy where no insurable interest existed or where there was no *bona fide* expectation of there being an interest.**

6. Marine Insurance Act Cap 390 of 1968 Kenya

- This act reinforces various decisions regarding insurable interest upheld by statutes made in the United Kingdom
- It stated that every person has an insurable interest as and when interested in a marine adventure.

- The act further states that

“a person is interested in a marine adventure where he or she stands in any legal or equitable relation to the adventure or to any insurable property at risk, therein, in consequence of which he or she may benefit by the safety or due arrival to insurable property, or may be prejudiced by its loss, or by damage thereto, or by the detention thereof, or may incur liability in respect thereof”.

Subject to this Act, every lawful marine adventure may be the subject of a contract of marine insurance.

6. Marine Insurance Act Cap 390 of 1968 Kenya

- There is a marine adventure where "**any insurable property is exposed to maritime perils**; the earning or acquisition of any freight, passage money, commission, profit or other **pecuniary benefit,** or the security for any advances, loan or disbursements, is endangered by the exposure of insurable property to maritime perils; or any liability to a third party may be incurred by the owner of, or other person interested in or responsible for, insurable property, by reason of maritime perils".

7. The Insurance Act cap 487 of 1987

- The Insurance Act, In particular, in section 94 0f the Act it is stated that:
- “Subject to this Act, no policy of insurance shall be issued on the life or lives of any person or persons, or on any other event or events whatsoever, wherein the person or persons for whose use, benefit, or on whose account such policy or policies shall be made, shall have no insurable interest.

An insurable interest shall be deemed to be had by:

(a) A parent of a child under eighteen years of age, or a person *in loco parentis* of such a child, in the life of the child to the extent of funeral expenses which may be incurred by him on the death of the child

(b) a husband, in the life of his wife;

(c) a wife, in the life of her husband;

(d) any person, in the life of another upon whom he is wholly or in part dependent for support or education;

(e) a corporation or other person, in the life of an officer or employee thereof; and

(f) a person who has a pecuniary interest in the duration of the life of another person, in the life of that person.

7. The Insurance Act cap 487 of 1987

- A child's advancement policy effected either before, on, or after the appointed date shall not be void by reason only that the person effecting the policy had not at the time the policy was effected an insurable interest in the life of the child."

Insurance and Wagers

- For all intent and purposes, nobody should liken insurance to a wager in as much as there are very important differences as the following comparison shows.

INSURANCE AND WAGER

Insurance contract	Wager
Insurable interest in the subject matter is essential	The interests are limited to the stake to be won or lost and, as such, they are not recognized by law.
The insured is immune from loss and his identity is known before the event	Either party can win or lose. The loser can not be identified until after the event.
Full disclosure (*uberrima fides*) is required by both parties to the contract	Full disclosure is not required by either party.
In most cases an indemnity only is secured	The stakes are not paid by way of indemnity. Payment is made without suffering loss beforehand.
The contract is enforceable at law	

CREATION OF INSURABLE INTEREST

1. At common law

- In circumstances, (other than those mentioned in creation of insurable interest by contract and by statute below), where the essentials of insurable interest as described previously apply, it can be said that one has acquired insurable interest at common law.
- Examples of this would be ownership of the property, or the potential liability we have to others if we are negligent.

CREATION OF INSURABLE INTEREST

2. By contract

- In some contracts a person contracts to be liable for something for which he or she would not be liable in the absence of the contractual condition.
- A landlord is normally liable for the maintenance of property he owns, rather than the tenant.
- Many modern leases, however, contain a condition which makes the tenant responsible for the maintenance or repair of the building.
- Similarly, in building contracts, the contractor may be responsible for the negligence of sub-contractors or of the employer.

By contract

- Clearly, such contracts place the tenant or the contractor in a legally recognized relationship to the building or the potential liability and thus give them and insurable interest which would not be present in the absence of the contracts.

3. By statute

The main statutes in Kenya which support the creation of insurable interest are:

- Marine Insurance chapter 390 of 1968;
- The Insurance Act chapter 487 of 1987.

STATUTES MODIFYING INSURABLE INTEREST

- Over the years the liability of certain people was considered to be too onerous and statutes were passed to modify this liability. When the responsibility was modified it followed that the insurable interest was correspondingly reduced and it was for this reason that we are interested in these modifying statutes at this stage.
- One point worth bearing in mind is that while the statutes modified liability in certain instances, in others they left a full liability with the person who was originally liable. As a result the practical position relating to insurable interest may be unaltered.

STATUTES MODIFYING INSURABLE INTEREST

(a)Carriers' Act 1830.

A common carrier is exempted from liability for certain valuable articles of greater than £10 each, except where the value of the item has been declared and any extra charge paid.

(**b) Carriage of goods by sea Act 1971**.

Liability of the carrier in this case is limited to 10,000 gold francs per package or unit, or 30 gold francs per kilo gross weight of the goods lost or damaged, whichever is the higher.

STATUTES MODIFYING INSURABLE INTEREST

(c) Hotel Proprietors' Act 1956

where people have booked sleeping accommodation at an hotel and provided the hotelier displays a copy of the schedule of the Act in a prominent position, his liability for loss of or damage to the property of guests is limited to £50 any one article and £100 any one guest.

- These limits do not apply where the loss or damage was brought about by the negligence of the proprietor or his staff, or in the case of goods deposited or offered for safe keeping.

STATUTES MODIFYING INSURABLE INTEREST

(d) Trustee Act 1925.

Trustees can effect fire insurance on trust property up to three quarters of the value, paying the premium out of trust income.

- This Act does not alter the fact that in his own right the trustee can insure the property for its full value.

APPLICATION OF INSURABLE INTEREST TO MAIN FORMS OF INSURANCE

- In fact it is not sufficient simply to define the principle of insurable interest and discuss its development. What is of greater value is to understand its application to the everyday transaction of insurance.
- Here we will look at three of the more common forms of insurance:
  - life assurance
  - property
  - liability insurances

Life assurance

- It is true that everyone has **unlimited insurable interest** in their **own life** and theoretically, is entitled to effect a policy for any sum assured. In practice, the cost of the policy often limits a person's ability to insure his or her own life.
- In addition to having insurable interest in one's own life, a person who is married also has an interest in the life of **his or her spouse.** In this way, wives can effect policies on the lives of their husbands and *vice versa*.
- **A blood relationship does not imply an automatic insurable interest.** This cover is really for funeral costs.

Life assurance

- In line with our definition of insurable interest, **certain people can insure the life of another person to whom they bear a relationship, recognized at law, to the extent of a possible financial loss.**
- Accordingly, **partners** can insure each others' lives up to the limit of their financial involvement, as they would stand to lose on the death of any one of them.
- In the same way a **creditor** stands to lose money if a debtor dies before repaying the loan and therefore has insurable interest to the extent of loan plus interest**.**

Property insurance

- There is no doubt that insurable interest is perhaps most easily identified in property insurances.
- It normally arises out of **ownership** where the insured is the owner of the subject matter of insurance, as in the case of a motor owner insuring his vehicle, a sportsman insuring his golf clubs or a shopkeeper insuring his stock.
- There are however cases involving legal relationships and financial interests other than full ownership, and these include:

Property insurance

(**a)Part or joint owners**.

- A person having a partial interest in some property is entitled to insure the full value of that property rather that just to the extent of his actual interest.
- This does not mean that he will benefit in any way should the property be destroyed completely as he is looked upon as a trustee for the other owner or owners.
- When he receives any claim money that exceed his own financial interest he does so as an agent for the others and holds such money in trust for them

Property insurance

(b)Mortgagees and mortgagors:

- Mortgages are most common in the area of house purchase and involve a building society, the mortgagee, and the purchaser, the mortgagor.
- Both parties have insurable interest, the purchaser as the owner of the house and the building society as the creditor.
- The interest of the mortgagee is limited to the extent of the loan.
- The normal practice in house purchase is for the building society to insist on the house being insured by the mortgagor in joint names of the mortgagor and the mortgagee as a term of the mortgage contract.

Property insurance

(**c)Executors and trustees:**

- Executors and trustees often have a need to effect insurance on property they assume control over.
- They are legally responsible for the property under their charge and this gives rise to their insurable interest in it.

- (d**)Bailees**: A bailee is a person legally holding the goods of another for payment or gratuitously. Pawnbrokers, launderers and watch repairers are examples of bailees and each has a responsibility to take reasonable care of the goods and look after them as if they were his own

Property insurance

(e)Agents:

- Where a principle has insurable interest his agent can effect insurance on his behalf.

(**f)Husband and wife:**

- Each spouse has an insurable interest in the property of the other in much the same way as they have mutual insurable interest in each other's lives.

C. Liability insurance

- Ordinarily, a person has insurable interest to the extent of any **potential legal liability** he may incur by way of damages and other costs.
- It is not possible to predetermine what the extent of that interest is as we do not know in what way and how often we may incur a liability.
- It could be said that the extent of a person's interest in liability insurance is without limit.
- In fact, while this is so in a theoretical sense, in a practical situation, liability to pay damages is based largely on legal precedents.

Liability insurance

- This means that whether a case is settled in or out of court the damages awarded against the insured will have been calculated bearing in mind similar incidents in the past
- As far as insurable interest is concerned, the insured still has no exact figure representing his interest but must wait until the case is settled. This is different from a person insuring a large ship
- He does know the maximum loss sustainable but not the size of any one loss.
- The same point, however, underlines both cases. The insured has insurable interest up to the limit of his potential liability, whatever it may be, or up to the extent of his financial interest as owner etc., in the ship.

6: When insurable interest must exist

- The Marine Insurance Act chapter 390 of 1968 states that the assured must be interested in the subject matter insured at the time of the loss though he need not be interested when the insurance is effected.
- It should be understood that in marine insurance, cargo may change hands from time to time while in transit.
- The marine insurance policy is one of the essential documents in the transfer of title in such cases, and the buyer of goods is thus permitted to have a legitimate insurable interest in the goods from the time of transfer even though he did not have an interest when the policy was effected.

When insurable interest must exist

- In life assurance, as we have already seen in the life assurance act, insurable interest is required at **inception.** In 1854, the case of **Dalby v The India and London Life Assurance Company** set down the principle that the interest need only be valued at inception and so there is no requirement for insurable interest at the time of the claim.
- In other insurances, being contracts of indemnity, **insurable interest is only required at the time of loss.** The Gaming Act 1845, requires insurable interest at inception in effect, since contracts without it would be wagers. Prior to this, it had been held in property contracts at least that there had to be insurable interest at inception **(Sadler's Co. v Badcock (1743))**

INSURER'S INSURABLE INTEREST

- Insurance companies do themselves have their insurable interest in the liability to pay claims to insureds and this interest gives them the right to seek insurance, reinsurance, and still satisfy the doctrine of insurable interest.

Enforceable at law

- The mere expectation of acquiring insurable interest in the future, however certain that expectation is, may not be enough to create insurable interest. The case of **Lucena v. Craufurd (1806)** provided an illustration of this point.
- **… suppose the case of the heir-at-law of a man who has an estate worth £20,000 a year, who is ninety years of age, upon his deathbed intestate, and incapable from incurable lunacy of making a will, there is no man who will deny that such an heir-at-law has a moral certainty of succeeding to the estate, yet the law will not allow that he has any interest, or anything more than a mere expectation.**

Enforceable at law

- Two apparent exceptions from the general rule should be mentioned:

(a) It is possible for a legal right to be created which is based upon an expectancy. For example, if someone has expectancy under a will, they might prefer to raise some money on the potential security of that expectancy. Let us say that Mr. A expects to inherit under a will and contracts to sell his expectancy to Mr. B for £2000 now.

A condition of the contract is that in the event of Mr. A being disinherited, he will repay the £2000 to Mr. B. Mr. B runs the risk that Mr. A will predecease the creator of the will. He can insure Mr. A's life to protect his interest. Mr. B's interest arises out of the contract, not out of the expectancy.

Enforceable at law

(b)Certain people have certain legal rights, but only an expectancy that those rights will materialize.

- If a trader owns some property or goods and sells them, he has a legal right to any profits which the price may allow.
- He expects a profit if the property or goods remain undamaged. If the property or goods are destroyed, the expectancy to the legal right is defeated.
- This expectancy to profit is insurable

Equitable interest

- Equitable interest may arise in a number of ways, for example, where a formal mortgage deed has not been drawn up by the lender will have an equitable interest in the property; such an equitable interest is enough to create insurable interest.
- Lawful possession of property normally supports insurable interest provided that such possession is accompanied by responsibility

Financial valuation

- It is usual to understand that the amount of insurable interest must be capable of financial valuation.
- This is relatively straightforward in the case of insurance of property, liability and rights interests.
- It is difficult to do so in the case of one's own life or the life of a spouse where it is viewed that there is unlimited interest.
- In respect of other policies in the life of another, certain interests are capable of valuation e.g. a creditor on the life of debtor for the amount of the debt, plus interest and insurance premium.
- For other cases such as an employer on an employee's life, the interest must be in a reasonable way capable of valuation in money.

ASSIGNMENTS

- We have noted already that it is the interest of a person in the subject matter of the insurance that is insured by a policy.
- Any assignment or transfer of that policy from one person to another may change underwriting considerations, as the new holder of the policy may not have the same insurable interest. Assignment of a policy, often referred to as transfer of rights, can be carried out but in the case of **personal contracts** the prior consent of the insurer is required.

Personal contracts

- This refers to those contracts in which the normal day to day activities of the insured and his attitudes to the subject matter of insurance may influence whether or not a loss arises and the extent of that loss if it happens.
- The particular insured satisfied the insurers in these respects when the proposal was accepted, and, if he wishes to transfer the insurance to someone else, the insurer must be given the chance to vet the new proposer.

Assignment of personal contracts

- Normally, assignment of personal contracts will only be valid with the consent of the insurers.
- Thus, policies covering property, liability and pecuniary (or rights) interests are not freely assignable.
- When the insurer consents to the assignment of a policy, a new contract is in fact created.
- The process of entering such a new contract is termed **novation**.
- It is possible that the process of asking for the insurer's approval could create difficulties in some circumstances. For example, when a person dies, his contract would lapse and the property or other risk would be uninsured and the beneficiary or trustee would have no cover until he was aware of the death and had time to arrange cover.

Transfer of interest by operation of law

- Insurers frequently seek to alleviate such hardships by giving their consent by a policy condition, so that, in event of a transfer of an interest in the subject matter of insurance by will or operation of law, they will automatically transfer the insurance as well.
- At first renewal there would be a duty to disclose the new interest if such disclosure had not been made before then.

Assignment of marine policies

The Marine Insurance Act chapter 390 of 1968 is explicit on assignment.

The act states that

"Where the assured assigns or otherwise parts with his interest in the subject-matter insured, he does not thereby transfer to the assignee his rights under the contract of insurance, unless there is an express or implied agreement with the assignee to that effect"

The marine insurance policy is an essential document in the custom of maritime trading in the transfer of title to cargo. It must be understood, however, that since cargo is not within the custody or control of the owner for most of the time, the marine insurer is not prejudiced by a change in ownership.

Assignment of marine policies

- In the case of hull assurance, however, the ship owner has control of the management of the ship and therefore of the likelihood of loss.
- For this reason insurers usually treat hull policies as personal contracts and a policy condition prohibits transfer of the insurance without agreement.

Assignment of life policies

- The assured under a life policy has a reversionary interest in that his or her enjoyment is deferred until the policy matures or death occurs.
- In view of the reversionary interest, life policies are **freely assignable.**
- **I**n addition, the conduct of the assured does not have the same effect, in the majority of cases, as to the likelihood of a claim arising, compared with non-life covers.

Absolute assignments

- Life policy proceeds may be assigned to anyone whether or not they have an insurable interest in the life assured.
- As with personal contracts discussed previously, the assignee acquires all the rights and the liabilities of the original assured.

Conditional assignments

- In many cases, the assignment of a life policy is not given absolutely and is by way of a conditional assignment for the purpose of giving security to a mortgagee for a loan given.
- On repayment of the loan and interest, the original assured has the right to have the policy reassigned to him.
- This is termed as **legal mortgage.**

Conditional assignments

- At times, the policy may just be deposited with the lender.
- The legal interest does not pass to the mortgage acquiring an equitable interest in the property mortgaged.
- In this case, there is not an assignment of the policy and in the event of a claim, the mortgage would have to prove his right in equity.

Assignment of policy proceeds

- Another less complex, form of assignment is where the proceeds of a policy are assigned as in the case of a house owner assigning the proceeds of the household insurance policy to a roof repairer.
- There is generally no objection to assignment of policy proceeds in this way as the insured is still in a contractual relationship with the insurers and must comply with all conditions and terms of the policy.
- Insurers absolve themselves when making such payments by asking the person receiving the money to sign a form discharging the insurer from any further liability.

DIP 102
Principles and practice of Insurance

UTMOST GOOD FAITH

Outline

1. Concept of utmost good faith
2. Application of utmost good faith to contracts of insurance
3. Importance of disclosure of material facts
4. Consequences breach of utmost good faith
5. Modification of utmost good faith in the practice of insurance

Definition

- The duty of utmost good faith can be defined as

 ‘ a positive duty to voluntarily disclose, accurately and fully, all facts material to the risk being proposed, whether asked for or not’.

- As the insurer knows nothing about the risk and the man who comes to him to insure knows everything, it is the duty of the proposer, to make a full discloser to the underwriter without being asked of all the material circumstances .
- This is expressed by saying it is a **contract of the utmost good faith.**

Concept of utmost good faith in Insurance contracts

- Insurance contracts are different from commercial contracts which are subject to the doctrine of caveat emptor- buyer beware.
- So long as one is not being misled, its not necessary to disclose any information, examine to product being sold/services rendered, bargain and once bought, contact is valid for commercial contracts
- Caveat emptor not does not apply to insurance contracts because only one party knows about the risk being proposed and the other party largely relies on the information disclosed.

Concept of utmost good faith in Insurance contracts

- The nature of the subject matter of insurance, and the circumstances pertaining to it, are facts particularly within the knowledge of the proposer.
- The insurers are not generally aware of these facts unless the proposer tells them.
- While the proposer can examine a specimen of the policy before accepting its terms, the insurer is at a disadvantage as he cannot examine all aspects of the proposed insurance which are material to him.
- Only the proposer knows or should know, all the relevant facts about the risk being proposed.

Concept of utmost good faith in Insurance contracts

- The insurer can have a survey carried out but he must rely on information given by the proposer in order to assess those aspects of the risk which are not apparent at the time of a survey
- The insurer needs the information to decide whether or not to accept the risk proposed and if they accept, at what terms and conditions.
- A duty is therefore imposed on the proposer to disclose fully and truthfully all relevant and material facts about the risk being proposed

Utmost good faith

- In order to make the situation more equitable the law imposes a duty of ‘uberrima fides’ or ‘utmost good faith’ on both **parties to an insurance contract.**
- The duty of full disclosure rests on the underwriter also (Carter V. Boehm (1766) and they must not withhold information from the proposer, which leads him into a less favorable contract
- The contract is deemed to be one of faith or trust and most contracts of a fiduciary nature are subject to the same doctrine.

Utmost good faith

Implications from the definition:

1. Each party should tell the truth to the other and nothing but the truth
2. Obligation is not limited to questions asked
3. Failure to reveal information gives aggrieved party right on regard the contract as void.

Reciprocal duty on insurer

Insurer is not expected to:

1. Make untrue statements during negotiation of the contract
2. Issue policies not authorized under the insurance Act
3. Issue ambiguous policies
4. Take advantage of the insured's ignorance by offering inadequate claims
5. Conceal discounts on premium due to the insured for good features on the risk e.g. no claim discount, sprinklers discount.

Material fact

- A material fact is every circumstance or information which would influence the judgement of a prudent insurer in assessing the risk or any circumstance which influences the insurer's decision to accept or refuse the risk or determination of the premium or the other terms and conditions of the contract.
- 'reasonable underwriter' should be the test of whether a fact is material or not, and the rule may be changed in the future.
- At the present time it is immaterial whether the proposer regards the matter as material or indeed, whether the individual insurer regards a fact as material, the **test being the view of a prudent or reasonable underwriter**.

Material facts

- Any fact which would influence the insurer in accepting or declining a risk or in fixing the premium or terms and conditions of the contract is material and must be disclosed.
- The fact must be material at the date at which it should be communicated to the insurer.
- A fact which was immaterial when the contract was made, but later becomes material, need not be disclosed in the absence of a policy condition requiring continuous disclosure.
- It is not for a particular insured or a particular insurer to decide what is material, but ultimately for the courts to decide at the time of dispute what a prudent or reasonable insurer would decide.

Facts which must be disclosed

- Full facts relating to and description of the subject matter of insurance.
- Facts which make risk exposure greater than would be expected from normal nature e.g. storage of flammable materials in a building
- External factors that make the risk greater than normal e.g. location next to explosives factory
- Fact that would make amount of loss greater than normal e.g. thatch roof
- Existence of other Insurances

Facts which must be disclosed are:

- Previous losses and claims under other policies;
- Previous declinature or adverse terms imposed on previous proposals by other insurers;
- Facts restricting subrogation rights due to the insured relieving third parties of liabilities which they would otherwise have;

Examples of facts requiring disclosure

- **Fire Insurance**: the form of construction of the building and nature of its use
- **Theft Insurance**: nature of stock and its value
- **Motor Insurance**: the fact that a vehicle will be driven regularly by someone other than the insured
- **Marine Insurance**: in cargo insurance, the type of packaging of goods

Examples of facts requiring disclosure.

- **Life Assurance**: previous medical history
- **Personal Accident** Insurance: previous medical history which might make an accident more likely, the results more severe, or the recovery slower than normal
- **In all cases of insurance**: previous loss experience and all facts which the proposer could be reasonably expected to know e.g. a landlord should know the nature of occupancy of his property by a tenant

Facts which need not be disclosed

(a) **Facts of law**: everyone is deemed to know the law;

(b) **Facts which an insurer is deemed to know:** facts of common knowledge such as in the usual or normal processes within a particular trade;

(c) **Facts which lessen the risk**: the existence of an alarm system in a theft risk or sprinklers in a fire risk;

Facts which need not be disclosed

(d) **Facts about which the insurer has been put on enquiry**: the most common example is where the proposer has referred the insurer to the claims record under a previous policy or with a previous insurer and they do not follow up this line of enquiry. The insurer will be regarded as having waived his right to the full information;

(e) **Facts which the insurer's survey should have noted**: material facts which are clearly visible, or which any reasonable surveyor would enquire about. On the other hand, the proposer is not permitted to conceal material matters from the surveyor

Facts which need not be disclosed

(f) **Facts covered by policy condition**: a fact which is superfluous to disclose by reason of any expressed or implied warranty e.g. that burglar alarms are regularly maintained

(g) **Facts which the proposer does not know**: one cannot be expected to disclose what is outside one's knowledge, but if it should have been within that knowledge there will be a duty to disclose it.

(h)**Facts (convictions) which are 'spent'**: these are stale cases.

Duration of the duty of disclosure

- The principle of utmost good faith may be applied:
- At common law
- Contractual duty
- At renewal
- Alterations to the contract

a. At common law

- The duty at common law starts at the **commencement of negotiations** for a contract and **terminates when the contract is formed** i.e. when there is offer and acceptance.
- During the currency of the contract, the duty is one of good faith, not of utmost good faith, in that at common law there is no need to disclose changes while the contract is running.

Duration of the duty of disclosure

b. Contractual duty

- Sometimes the conditions of a policy extend the common law position by requiring full disclosure during the currency of the contract, and giving the insurer the right to refuse to underwrite the change.
- In other cases, the policy condition may require disclosure of certain types of facts only.

Duration of the duty of disclosure

c. Position at renewal

- The duty of disclosure at time of renewal depends on the type of contract
- **Long term business**: in these types of assurance (life assurance and permanent health) the assurer is obliged to accept the renewal of premium if the assured wishes to continue the contract and there is no duty of disclosure operating at renewal.
- **General business**: in other cases renewal requires the assent or agreement of the insurer and in such cases the original duty of disclosure is revived.
- The facts as applying at the time of negotiating the renewal must be disclosed.

Duration of the duty of disclosure

d) Alterations to the contract

- If during the currency of the contract it is necessary to change the terms of it e.g. increase the sum insured or alter the description of property insured or alter the description of property insured, then there is a duty to disclose all material facts relating to the alteration.
- Applies to both long term business and general insurance business.

Representations

Representations

- These are written or oral statements made during the negotiations for a contract.
- Some of these statements will be about material facts and others will not.
- Those which are material must be substantially true or true to the best knowledge or belief of the proposer.

Warranties

- In ordinary commercial contracts, a warranty is a promise, subsidiary to the main condition of the contract, a breach of which would leave the aggrieved party with the right to sue damages only.
- Warranties in insurance contracts are fundamental conditions which go to the root of the contract, and allow the aggrieved party to repudiate the contract.

Warranties

- A warranty is the undertaking of the insured that:
  - Something shall be done; or
  - Something shall not be done; or
  - A certain state of fact exists; or
  - A certain state of fact does not exist

Warranties

- Warranties are imposed usually for the following reasons:
- To ensure that some aspect of 'good housekeeping' or good management is observed e.g. in a fire insurance that rubbish is cleared up each night, or in theft assurance that an intruder alarm system is kept in good order under a contract of maintenance.
- To ensure that certain features of higher risk are not introduced without the insurer's knowledge, since the premium charged has been based on the fact that they are not present. An example of this would be where no oils were stored and therefore not charged in fire insurance. It would be warranted that no oils are kept or only a limited amount is kept. E.g petrol and mineral oil warranty in fire policy

Warranties

There are 2 types of warranties:

1) Express warranty

- Warranties are usually expressed or written into insurance contracts.
- They must be strictly accurate, even slight deviations from the facts contained in the warranty will create the right of the aggrieved party to avoid the contract in law.
- Frequently warranties are encompassed into the contract by the statement in the policy that the proposal form is the basis of the contract and on the proposal form there is a declaration by the insured as to truth of the answers given to the best of his knowledge and belief.

Warranties

b) Implied warranty

- Normally, warranties must be written conditions of the contract but, in marine insurance, there are implied warranties or undertakings that the vessel is seaworthy and that the adventure is lawful. (Marine insurance act 1906, sections 39 and 41).
- It is generally held that implied warranties do not exist in other classes of insurance.
-

Comparison of representations and warranties

A **Representations**

- Need only be substantially correct
- It's breach (misrepresentation) must be material to allow repudiation
- Do not normally appear on the policy

Warranties

- Must be strictly and literally complied with
- Any breach gives the right to repudiate
- Are written into the policy except for implied warranties.

CREATION OF THE INSURANCE CONTRACT

- A very high proportion of insurance business is brought about by the services of insurance intermediaries.
- For some of these, the bringing together of a proposer and insurer is their full-time business e.g. insurance brokers and insurance agents.
- In other cases, the arrangement of insurance contracts is brought about by intermediaries whose main business is in another field e.g. garages, solicitors, accountants, estate agents, building societies and banks.

CREATION OF THE INSURANCECONTRACT

Disclosure and the use of agents

- In law, all intermediaries are agents of the principal whom they represent.
- Insurance practice generally refers to the part-time intermediary as an ‘agent’ whereas the full-time specialist is called a broker or a consultant.
- Where a principal engages another person to act for him in negotiating a contract, the principal is liable for the fraud or concealment of information.

CREATION OF THE INSURANCE CONTRACT

- Where an agent, acting for an insurer, accepts a premium for a risk even though he knew that the insured had broken a policy condition, the insurer cannot avoid the policy.
- This is the doctrine of **‘estoppel’**. `
- This concept arises out of the principle of equity. Sometimes one party makes a concession which he or she is under no obligation to make and for which he or she receives no consideration.
- If the other party relies on this concession it would be unjust if this other party was to suffer loss by the concession being withdrawn retrospectively.

CREATION OF THE INSURANCE CONTRACT

- A similar situation arises in the case of Murffit v. Royal. Here we have an agent with no authority to issue cover but the company had ratified his *ultra vires* action on two previous occasions. This led the policy holder to think that the agent had authority to issue cover and he would have been prejudiced if in this fact was not the case.

CREATION OF THE INSURANCE CONTRACT

- **The insured, intermediary and insurer**
- Where the insured uses an intermediary the knowledge of the agent is imputed to the principal and vice versa, and this knowledge, where material, must be communicated to the insurer.
- Difficulties sometimes arise as to whether an agent is an agent of the proposer or of the insurance company. In the one transaction he can be an agent of both, but the individual actions within that transaction will decide on whose behalf he is acting at a particular time.

CREATION OF THE INSURANCE CONTRACT

- The following distinctions may be helpful.
- **The agent is the agent of the proposer**
- If the only recognition he receives from the insurers is the payment of commission (Bancroft v. Health (1990)
- If he and the proposer are in collusion over fraud against the insurers
- If he fills in, alters, or adds to the answers in a proposed form, and the proposer knew or ought to have known of this (Newsholme Bros. v. Road Transport and general (1929))

CREATION OF THE INSURANCE CONTRACT

- The following distinctions may be helpful.
- If he completes a forms on the proposer's behalf and the form incorporates a wording to the effect that if the form is completed by someone other than the proposer, that person is deemed to be the agent of the proposer (Facer v. Vehicle & General Ins. Co. Ltd (1964))
- If an agent gives advice to the proposer as to the cover he requires and the market in which he should place his business
- If the agent gives the insured advice about how to formulate his claim

CREATION OF THE INSURANCE CONTRACT

- **The agent is agent of the insurance company**
- If he has express authority from them to receive and handle proposal forms
- If he handles the forms according to a previous course of business with the insurers and within an implied authority that has arisen
- If he surveys and describes the property on the insurers behalf
- If he acted without express authority where (i) the company ratifies his action or (ii) where the company has ratified such action in the past

CREATION OF THE INSURANCE CONTRACT..

- **The agent is agent of the insurance company**
  - If he expressly or impliedly has authority to collect premiums
  - If he is instructed by the insurers to ask questions and fill in the answers on a proposal form, he is the insurer's agent even when the proposal contains a declaration to the contrary

CREATION OF THE INSURANCE CONTRACT.

Duties rights and liabilities

Duties of agent to principal

- He must act with due care and skill for that class of agent.
- For example, there is a higher duty of skill resting on an insurance broker since he is holding himself out to be an insurance expert, than on a solicitor or accountant acting as an agent whose expertise lies in other areas

CREATION OF THE INSURANCE CONTRACT

- He must act in accordance with the terms of his agency contract, which maybe oral, written or implied from actions, and he must carry out all legal instructions
- He must act in perfect good faith with his principal, disclosing to him all material facts relating to the contract. He must not accept secret commissions.
- It will be assumed through custom of the trade that insurance intermediaries are paid commission by the insurers. In the event of the insured appearing to be unaware of these fact, it must be disclosed to him

CREATION OF THE INSURANCE CONTRACT

- He must account to the principal for all monies received on his behalf
- He must perform his duties in person to comply with the rule *delegatus non potest delegare* (an agent must not delegate his duties to another).
- There are, however, certain important exceptions to this rule:

-where custom sanctions delegations

-where delegation is necessary to the proper performance of the agent's duties

-where there is an express or implied agreement to allow delegation

- Delegation of duties by a broker to his staff would likely fall within the exceptions, but in the case of other agents the right to delegate may be restricted.

CREATION OF THE INSURANCE CONTRACT..

b. Duties of principal to agent

- To pay the agreed remuneration
- To indemnify the agent against all losses, liabilities, and expenses incurred in the normal course of the agency work.
- The expenses of running an insurance agency/brokerage are generally held to be paid by the agent out of his commissions.
- On the other hand, brokers frequently pay premiums on behalf of clients, and for this they are entitled to be repaid.

CREATION OF THE INSURANCE CONTRACT

Liabilities of agent

- Liable for breach of warranty of authority.
- If an agent purports to act as an agent when he has not been given that authority, he is liable to compensate the party with whom he contracts.
- He is liable to his principal where he commits a tort which lays his principle open to a loss.
- There are many cases where agents/brokers have failed to carry out instructions regarding arrangement of cover and have had to compensate the insured for uninsured losses

BREACH OF THE DOCTRINE OF UTMOST GOOD FAITH

- Breaches of utmost good faith arise under one or both of the following grounds:
- **Misrepresentation**, which can be either innocent of fraudulent
- **Non-disclosure,** which can be innocent or fraudulent - concealment.

BREACH OF THE DOCTRINE OF UTMOST GOOD FAITH

Misrepresentation

- Whether innocent or fraudulent, a misrepresentation must:
- Be substantially false
- Concern facts which are material to the assessment of the risk, or material to the benefits obtained by the proposer
- Have induced the recipient to enter into a contract of insurance if the right to avoid the contract is to be enforceable

BREACH OF THE DOCTRINE OF UTMOST GOOD FAITH

- **Non Disclosure**
- This will arise or give grounds for avoidance by the second party if:
  - A fact within the knowledge of the first party (either actual or presumed by law)
  - A fact which is not known to, nor deemed to be known to the second party party, and
  - A fact calculated, if disclosed, to induce the second party either not to enter the contract at all, or else only to enter it at better terms; (to the second party)

Breach of Utmost good faith

- How breaches are dealt with depeands on whether the breach is;

➢ Innocent

➢ Deliberate

➢ Material to the risk

➢ Immaterial to the risk

3
Remedies for breach of Utmost Good Faith

- The aggrieved party has the following options:

1. Repudiating the contract '*ab nitio'*, Contract becomes void from the beginning – for deliberate misrepresentation
2. Avoiding liability for a claim – deliberate breach
3. To sue for damages in addition to (i) above and if concealment or fraudulent misrepresentation is involved
4. To waive his rights to (1) and/or (2) above and allow the contract to carry on unhindered – for innocent breach.
5. The insurer may impose a penalty in the form of additional premium for an innocent breach

- The aggrieved party must exercise his option within a reasonable time of discovery of the breach, or it will be assumed that he has decided to waive his rights.

BREACH OF THE DOCTRINE OF UTMOST GOOD FAITH

Compulsory insurances

- Certain insurances, for example, motor (third party injuries), are required by statute.
- The purpose of these statutes is to try to ensure that insurance money will be available to the employer or driver/user to enable them meet injury claims from third party.
- The Road Traffic Act prohibits the insurer from avoiding liability on the grounds of certain breaches of utmost good faith.

BREACH OF THE DOCTRINE OF UTMOST GOOD FAITH

- Insurers however, endorse their policies to the effect amounts paid in claims which would not have been in the absence of statutory limitations, may be recovered from the insured.
- The practical difficulties of recovering from an insured are so great that often insurers do not enforce this right.

Modification of Utmost Good Faith under the Insurance Act

- An insurer may avoid an insurance contract on the grounds of misrepresentation of material facts of the risk being proposed regardless of whether the misrepresentation was fraudulent, negligent or innocent.

- **Section 81 (1) of the Insurance Act** provides that a policy of life assurance **shall not** be avoided by reason only of **an incorrect statement** made either in the proposal form or other document upon which the policy was issued unless the statement is material and was made either:

Modification of Utmost Good Faith under the Insurance Act

- Fraudulently or
- Within three years before the date on which the policy is sought to be avoided or the date of the death of the assured whichever comes first.
- Section 86(1) of the Insurance Act stipulates that no policy of life assurance shall be avoided by reason of misstatement of the age of the life assured.

DIP 102
Principles and practice of insurance

Proximate cause

1. Definition
2. Nature of the perils related to proximate cause
3. Operation of proximate cause
4. Modification of proximate cause

Introduction

- In an insurance contract it is necessary to state the perils against which cover is provided, so that the intention of the parties is clearly defined **i.e scope of cover**
- What is meant by an insurance against fire, or accident, or maritime perils may appear as easy to understand, but where does the operation of the perils start and when does their effect end?
- All contracts are subject to conditions and frequently these conditions in insurance contracts will state that certain causes of loss are excluded or that certain results of an otherwise insured peril are excluded.

Introduction

- The reasons for this are simple; the additional cover may warrant an additional charge which has not been factored in the premium for the policy, or the peril may be one which insurers regard as a fundamental risk and more properly dealt with by the state (for example, war risks or nuclear explosive devices).
- For any loss to be payable, the peril causing must be an insured peril

Definition of Proximate cause

- Proximate cause is defined as the **active**, efficient cause that sets in motion a **train of events which brings about a result**, without the intervention of any force started and working actively from a new and independent source.
- The proximate cause is not the first cause and not the last cause: it is the **dominant cause.**
- The proximate cause of loss is the peril that is most closely linked to and triggers the loss- producing event
- Proximate cause is based on the principle of cause and effect – having proved the effect and traced the cause, it is not necessary to go any further i.e the cause of cause

- In general, causation is to be understood by applying common sense standards.
- For example, explosion is to be determined by its everyday meaning and not as an extremely rapid fire, as a chemist might view it.
- In a similar way it was decided in **Commonwealth Smelting Ltd & Another v. Guardian Royal Exchange Assurance Ltd 1984,** that centrifugal disintegration was not an explosion even although those nearby heard a loud bang and doors were displaced and fragments of metal were thrown over a considerable distance.

- Stating that a cause is active and efficient, means that there is a **direct link** between the train of events one can logically predict what the next event in the train of events will be, until the result under consideration takes place.
- If there are several causes operating, the proximate one will be the **dominant or the most forceful** one operating to bring about the result.

Nature of the Perils relevant to Proximate cause

- The perils relevant to an insurance claim can be classified under three headings:
  a) **Insured perils**: those named in the policy as insured e.g. fire, lightning and (qualified) explosion.
  b) **Excepted or excluded perils**: those stated in the policy as excluded, either as causes of insured perils e.g. riots, earthquake, or war, in the wording below, or as result of insured perils e.g. explosion in condition 3 or the under noted wording.
  c) **Uninsured or other perils**: those not mentioned at all in the policy e.g. storm, smoke and water are not excluded, nor mentioned as insured in a fire policy. There will be no cover for the second and third.

Identifying the proximate cause

- Loss can be caused by:
  - Single event/cause
  - Series /train/chain of events
  - Concurrent causes
  - Remote cause

Train of events

- Rarely does a single event take place and cause a loss.
- Something may have caused the loss-making event to happen, and perhaps something else caused that cause and so on – one event following and resulting from the other causing the loss
- Example: Imagine a row of six dominoes(BOWLING) standing on their ends so that the space between each is only about half the height of each domino. If we tap the top edge of domino 1 and cause it to fall against domino 2, it in turn will fall against domino 3 and so on, until domino 6 falls down. Here we have a train (or chain) of events bringing about a result (the fall of domino 6) and the active, efficient cause which set it all in motion was our act of knocking over domino 1

- If an observer of this experiment had stopped domino 3 from touching domino 4, and then changed his mind and knocked over domino 4 himself, the proximate cause of domino 6 falling would have been that observer.
- There had been an intervention to the chain we started and so we were no longer the proximate cause of domino 6 falling.

Causation

- In practical situations, it is sometimes difficult to determine the efficient cause of a loss, as the volume of case law on the subject illustrates.
- Frequently, it is fairly obvious what the initial event and the last event were.
- The difficulty arises in deciding if there is a direct chain of causation between them, or some new force has intervened to supersede the initial cause as the event bringing about the ultimate loss.

- One way of coming to a decision is to start with the first event in the chain and ask oneself what is logically likely to happen next.
- If the answer leads one to the second event and this process is repeated until one reaches the final event, then the first event is the proximate cause of the last.
- If, at some stage in the process, there is no obvious connection between one link in the chain and the next, then there is a break in the chain and something else must be the cause of the loss.
- Another method is to start at the loss and work backwards along the chain, asking oneself, at each stage, 'why did this happen?' In the unbroken chain, one arrives back at the initial event.

Examples

Some real-life illustrations

(a)

A strong wind blew down the wall of corrugated iron sheets;

- This falling wall broke electrical wiring
- The broken wiring short-circuited and sparked
- The sparks caused a fire to a nearby timber building
- The fire brigade was called
- They used water hoses to put out the fire and to cool neighboring buildings
- The water caused damage to the un-burnt contents of the timber building and to the neighboring buildings.

➢ Using the methods described above, one sees a direct line of causation between the strong wind, the collapse of the wall, the burning damage and the water damage.

(b)

- An earthquake overturned an oil stove
- The spilt oil caught fire from the burning wick
- The burning oil set fire to the building
- The first building, by radiated heat , set fire to a second building
- The last two were repeated several times
- Eventually, 500 meters away from the first fire, a building caught fire from its neighboring building
- ➢ The fire in this building was held to be proximately caused by the earthquake

(c)

- A dropped cigarette sets fire to sacks in the garage
- Fire developed and overheated acetylene gas cylinder
- The cylinders exploded
- A wall of the garage was blown out and burning materials were blown onto a neighboring building
- The building caught fire

(d)

- Lighting damaged a building and weakened a wall
- shortly afterwards, the wall was blown down by high winds

(e)

- Fire damaged a wall and left it weakened
- Several days later a strong wind blew the wall down.

In this **Gaskarth v. Law Reunion Co**. **(1876**), it was decided that the fire was not the proximate cause of the wall falling down but the wind.

Remote Causes

- The difference between examples (d) and (e) is that in (e) it was felt that the fire was the remote cause whereas we are concerned with the proximate cause **(Everett v. London Assurance (1865).)**
- In (d) the wind occurred shortly after the lightning damage whereas in (e) several days passed between the fire and the strong wind.
- A series of event which is broken by a new event independently from the event causing the loss is a **remote cause**
- There is a broken sequence

- In cases like this where damage has occurred but there is no imminent likelihood of further loss, then the original cause becomes weaker as the prime cause as time goes by.
- In practical terms, the possibility of effecting repairs or securing the property from further loss is the important point. If time was too short as in (d), the initial cause is usually held to be the proximate cause. If there was time but nothing was done as in (e), the original cause is deemed to be too remote.
- It is important to note that where damage is serious and further loss is almost inevitable, the initial cause will be the proximate one while attempts at removing the danger are made and until the danger is removed. Examples (f) and (g) illustrate this.

(f)

- It was wartime
- A ship was hit by an enemy torpedo
- She was badly holed and in danger of sinking
- The master managed to reach port
- Repair work was started
- The ship blew up
- The ship was still in danger of sinking; this risk was aggravated by the storm
- To save the harbor from being blocked by the sunken ship, the harbor master ordered her out of port
- She succumbed to the storm outside the port

Since the danger of sinking had never been removed, the war was deemed to be the proximate cause (**Leyland Shipping Co. v. Norwich Union Fire Insurance Society (1918).)**

(g)

- Fire seriously damaged a building
- A wall was in danger of collapsing onto the building next door
- For safety reasons, the local authority ordered demolition
- During demolition the wall fell to the neighboring premises.

Once again, the danger of collapse had not been removed and fire (or its cause) was the proximate cause of damage to the neighboring building **(Johnson v. West of Scotland Insurance (1828).)**

In (f) and (g) the storm and demolition respectively were deemed to be remote or contributory causes but not the active efficient causes.

Concurrent Causes

- Two or more events occurring simultaneously and resulting in loss
- Occasionally, two causes which are independent of each other may occur at the same time and each contributes to the loss.
- For example:

(h) A fire breaks out during a storm but is not caused by the storm, and there is some burn damage and some wind damage

(i) Equally a fire could break out during a riot but independently of it

- Damage is done by both the original fire and the fire started by the rioters.

The standard fire policy

- The wording of the fire policy is the best one available for illustration of the doctrine of proximate cause, since it deals with the clear chain of events and also other instances where the policy wording overrules the normal results of the principle.

- Excerpt from standard fire policy:

Operative clause

1a) Fire (whether resulting from explosion or otherwise) not occasioned by or happening through; its own spontaneous fermentation or heating or its undergoing any process involving the application of heat.

1b) Earthquake, Subterranean Fire, Riot, Civil commotion, War, Invasion, act of foreign enemy, Hostilities (whether War be declared or not), Civil war, Rebellion, Revolution, Insurrection or Military or Usurped power;

(2) Lighting;

(3)Explosion, not occasioned by or happening through any of the perils specified in 1(b) above,

I. Of boilers use for domestic purposes only
II. In a building not being part of any Gas Works, of Gas used for domestic purposes or used for lighting or heating the building

B) Condition 3(a) and (b)

3. This Policy does not cover

(a) Destruction or damage by explosion (whether the explosion be occasioned by fire or otherwise), except as stated on the face of the policy

(b) Loss or destruction of or damage to any property whatsoever resulting or arising there from or any consequential loss directly or indirectly caused by or contributed o by or arising from

.

(i) Ionizing radiations or contamination by radioactivity from any nuclear fuel or from any nuclear waste from the combustion of nuclear fuel

(ii) The radioactive, toxic, explosive or other hazardous properties of any explosive nuclear assembly or nuclear component thereof.

Application of Proximate cause to the Fire Policy

The examples which were used to illustrate proximate cause will now be used to illustrate the operation of the policy.

(a) In example (a) above, the perils were strong wind – collapse-short circuit-sparks-fire-water.

The policy states that fire is covered and the excluded causes are shown in paragraph 1(b) of the policy wording. Since none of these exclusions brought about the fire, the burning damage must be covered. Water is not mentioned as insured, but the cause of water damage was the fire which is not insured. The water damage is deemed to be a direct result of the fire and part of the insured loss by the peril. (**Stanley v. Western Insurance Co. 1868).)**

b) In the second example, earthquake led to one fire after another and so to fire at insured's premises. The last fire damage, which was the subject of **Total Broadhurst Lee Co.'s** claim, was not covered since the cause of that fire could be traced back to the earthquake, an excepted peril.

(c) Lightning-weakened wall-wall collapses

Storm

In this case the prime cause was the lightning with the storm as the remote cause denoted by the dotted line. In parallel with our discussion in (a), the damage would all be covered.

Storm

(d)Fire-weakened wall

In this case, it will be recalled that the collapse was held to be too remote from the fire and it would not be covered i.e. the effective cause was storm.

(e) In this case although sinking was an insured maritime peril, there was no claim since war was an excluded cause. There was a direct chain between war and the sinking.

(f) Here since the fire was the active cause of the wall being dangerous, the collapse was directly due to the fire and was insured.

Modification of the Application of the principle of Proximate cause

The fire policy

The section of the fire policy which we have used in our illustrations has led to straightforward applications of the principle. However, policies sometimes contain wordings which mean that the cover does not follow the normal application.

Example (c) above is a chain of events which falls into this category. For example:

Dropped cigarette-fire-explosion-fire

The first fire is covered and one would expect that the direct result of it, the damage caused by the explosion of the acetylene gas cylinders, would also be covered. An examination of condition 3(a) however shows that explosion after fire is excluded.

Since this explosion is an excepted peril, one would expect that the second fire caused by it would be excluded also. The words in brackets at the start of the operative clause amend the normal application of the doctrine. Fire, even if caused by an excluded form of explosion, is insured.

If we examine clause 1(a) of the operative clause, we see two other examples of the policy wording restricting the application of the principle.

Spontaneous fermentation (combustion) is excluded by the qualifying words ‘its own’ limit the exclusion to the property igniting spontaneously. If that property then set fire to another property, the second fire is insured even though caused by an excepted peril.

Equally, although fire damage to property undergoing a process of heating is excluded, any fire spreading from that is covered.

Modification of the Application of the principle of Proximate cause

- Life Assurance
- Section 82 states that a policy cannot be avoided just because death of the life assured cause by suicide
- Life insurers incorporate a suicide clause to provide cover for suicide only it takes place after one or 2 years of the policy being effected.

Indirect Causes

Policy wordings dealing with exclusions sometimes exclude a peril if it is included directly, or indirectly, by another one e.g. excluding death directly or indirectly caused by war.

In the case **Coxe v. Employers' Liability Insurance Corporation Ltd (1916),** their policy excluded death caused directly or indirectly due to war. During wartime, sentries were posted along a railway line, and an officer, who was inspecting these sentries, was knocked down and killed by a train. His death was directly or proximately due to an accident and not war. However, if there had been no war, he would not have been on the line, so that war was an indirect cause of his death.

Under the terms of that policy, war, even as an indirect cause, prevented a claim being paid.

Events A Events B

Fire Fire

DAMAGE

Storm Riot

.

If events A occur concurrently but independently of each other and it is not possible to distinguish which part of the damage was caused by the fire and which part of the storm, all the damage is deemed to be insured since no excluded peril is involved.

If the damage can be separated out, only that part caused by the fire will be insured.

Where an excluded Peril is involved

- In the case of Events B, if the damage cannot be separated, none of it is covered since an excluded peril is involved.
- It can be separated out, only that part caused by the fire is covered by insurance.

Summary

(a) **The insured peril need not be the initial cause;**

(b) **The insured peril must not be a direct result of the operation of an excluded peril** (unless the policy wording specifically overrules this)

(c) **Damage, as the direct result of an insured peril is covered even although the immediate peril causing that damage is not mentioned in the policy** (unless the policy specifically excludes the results as shown in the fire policy above) e.g. water or smoke damage after fire are covered.

(d) **Property can be covered even though the named peril does not actually cause damage to the insured property, so long as the named peril does operate and its results cause loss to the insured**. For example, if the building next door to the insured goes on fire and the only damage the insured suffers is by water or smoke, his fire policy will operate (provided the original fire was not caused by a peril named as excluded in the insured's policy);

(e) **The risk insured against must actually take place.** The fear of losing goods by an insured peril is not loss by that peril **(Moore v. Evans (1917));**

(f) **Further damage to the subject matter due to attempts to minimize a loss already taking place, is covered.** Therefore water damage from sprinklers or firemen's hoses is covered **(Johnson v. West of Scotland Insurance (1828));**

(g**) Novus actus interveniens** i.e. a new act intervening. We have seen in the definition from the **Pawsey** case that the intervention of a new act is outwith the doctrine. Thus, if during a fire onlookers cause damage to surrounding property, the cause of such damage is the misdemeanor of the crowd and not the fire **(Marsden v. City & County Assurance Co. (1865));**

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(h) **Last straw' cases.** In instances where the original peril has meant that loss was more or less inevitable, the original peril will be the proximate cause even though the last straw comes from another source **(Leyland Shipping Co. Ltd v. Norwich Union (1918)** and **Johnston v. West of Scotland (supra)).**

Summary of examples by class of business

- The only way in which to gain a good understanding of the doctrine is to study case law from different classes of insurance

Marine insurance

Leyland Shipping Co. v. Norwich Union (1918). The ship eventually sank in a storm, but she had been badly holed by a torpedo, and although she had reached port, she was later ordered out by harbor master in case she sank during the storm and blocked the harbor. The danger of sinking from the torpedo was the dominant cause which was still operating when the storm blew up.

Ionides v. Universal Marine Insurance Co. (1863). A captain lost his course and took his ship inshore to try and pick out a lighthouse. Due to hostilities the light was extinguished and the ship ran aground. The hostilities and loss of the light were deemed to be too remote to be the proximate cause.

Fire insurance

Harris v. Poland (1941). It is the intention of insurance to cover risks which are accidental or fortuitous to the insured. In fire insurance there must also be something on fire which should not be on fire. The insured hid money and jewellery in the grate (fireplace) and also inadvertently lit a fire. The judge likened the loss to something accidentally falling into the fire and allowed the claim.

Everret v. London Assurance Co. (1865). Premises were damaged by an explosion half a mile away, this explosion was caused by a fire. It was held that the fire was too remote and the damage was caused by the explosion. The rule *'In jure non remota causa sed proxima spectaur'* determined the case.

- **Gaskarth v. Law Union Insurance Co. (1876)** fire had left a gable wall standing but a subsequent gale blew it down, and it was held that the whole of the damage was caused by lightning.
- The crucial factor seems whether the original peril was still operating and was the dominant cause of the loss. In the first case it was evidently felt that the wall was secure after the fire, whereas in the second case this was not so and the gale operated before remedial action could be taken.
- **Johnston v. West of Scotland Insurance Co. (1828)** where a building was left in a dangerous state by fire, and Glasgow's Dean of Guild ordered the demolition of the building. During the demolition process, the gable fell on top of the insured's premises, and this was held to be fire damage. Since the building was in dangerous state following fire, the risk from the fire was still operating until the danger was removed. The demolition contractors were attempting to minimize that risk by a planned demolition but were unsuccessful.

Other classes of insurance

Burglary:Winikofsky V. Army and Navy General (1919). Where thieves took advantage of a blackout during an air raid it was held that war was not the proximate cause.

Livestock:Shiell's V.Scottish Assurance Corporation Ltd (1889). Where a livestock policy provides differing benefits following injury and death, the death benefits are payable where an injury requires the animal to be slaughtered on humane grounds.

Glass:Marsden V. City and County Assurance Co. (1865). Where a mob tore down shutters and broke a window while a fire raged in nearby premises, this was held not to be a loss proximately caused by fire but a glass claim.

Personal accident insurance

Etherington v. Lancanshire and Yorkshire Accident Ins. Co. (1909). The insured fell from his horse, suffered some injuries which forced him to lie in cold and damp conditions whereby he contracted pneumonia and died. It was held that he died of an 'accident' which was insured and not a disease which was excluded.

Coxe v. Employers' Liability Assurance Corporation (1916). An army officer had a personal accident policy excluding death directly and indirectly due to war. In wartime he was walking along a railway line to inspect sentries when he was killed by a train. The proximate cause of his death was an accident but remotely he was on the line because of the war and the policy did not cover his death. War is only the remote cause but the use of the words 'or indirectly' made it highly relevant. The active cause was the accident.

Liability insurance

Vandyke v. Fender (1970). Where an employee was injured while a passenger in a car provided by his employer to take him to and from work, he was not injured in the course of his employment since there was no obligation on him to use that method of transport.

Gray v. Barr (1971). Gray had an affair with Mrs. Barr. Barr thought one evening that his wife had gone to Gray's house, he went there with a loaded shotgun. Barr did not believe Gray when he said that Mrs. Barr was not there, and he (Barr) went upstairs to see for him-self, firing a shotgun in the ceiling to frighten Gray. A scuffle broke out during which the gun went off and Gray was killed. Barr was acquitted of murder and slaughter and attempted to claim an indemnity under his public liability insurance for a claim against him by Mrs.Gray.

It was held that the proximate cause of Gray's death was his liaison with Mrs. Barr. The judges could not agree on (a) whether the first or second shot was the proximate cause of Barr's loss nor on (b) whether the cause was accidental or not. However, all four judges agreed that it would be against public policy for him to be indemnified and so his claim failed.

The use of a gun is the crucial point here since it is well established in law that one is entitled to an indemnity under the third party section of a motor policy for culpable manslaughter.

Dip 102 :Principles and Practice of Insurance

Indemnity

Outline

1. Principle of indemnity
2. Methods of providing indemnity
3. Application of the principle of indemnity
4. Measurement of indemnity
5. Factors limiting indemnity
6. Modification in the operation of indemnity

Principle of Indemnity

- One dictionary definition of the word ‘indemnity’ is, ‘the protection or security against damage or loss or security against legal responsibility’.
- The idea of security and protection fits well with our knowledge of the development of insurance and gives some hint to the meaning of indemnity.
- We look upon indemnity as a mechanism by which insurers provide financial compensation in an attempt to place the insured in the same pecuniary position after the loss as he enjoyed immediately before the loss.

Indemnity

- Therefore Indemnity is defined **as placing the insured in the same financial position after a loss as one occupied immediately before the loss occurred.**
- No one should benefit from a loss otherwise there would be more losses!
- This is easily applicable to a general insurance contract but not life and personal accident insurance policies.
- **Life assurance** and **personal accident insurance** contracts are **not** contracts of indemnity as it would not be possible to grant indemnity, for example, to someone who has lost a life or limb.
- Such contracts are **benefit** contracts, as they are agreements to pay a specified sum of money.

Link with insurable interest

- There is a link between indemnity and insurable interest as it is the insured's interest in the subject matter of insurance that is in fact insured.
- In the event of any claim the payment made to an insured **cannot therefore exceed the extent of his interest** and as we will see later there often are cases where insureds receive less than the value of their interest.
- As with insurable interest, the principle of **indemnity relies heavily on financial evaluation** and this leads us to consider the position of those policies where such valuation is difficult. In life assurance and personal accident insurance and in these cases indemnity is not possible.

- Another way of phrasing this same point is to say that life and personal accident policies are not contracts of indemnity as the value of a persons life or limb can not be measured by money.
- There can be exceptions to this general rule where policies are effected in the case, for example of a personal accident policy effected by an employer on his staff where the policy is intended to provide him with any amount he would have to pay in wages to a sick employee.
- While life and personal accident contracts are not generally regarded as being contracts of indemnity that is not to imply that care is not exercised in arranging cover.
- Rather than caution being exercised at the time of a claim, as in the case in the indemnity contracts, caution is exercised when the contract is effected in life and personal accident business.

- In life assurance the amount by which a person may be insured is limited by his own ability to meet premiums.
- In personal accident policies offering weekly benefits it is limited to an amount that will not provide an unreasonably high benefit in relation to a person's normal earnings.
- Similarly, in life assurance, the underwriter would ensure that the sum assured on the life of a debtor or partner is a reasonable estimate of the amount of interest to comply with the Life Assurance Act 1774 – that they do not benefit more than their interest.

Methods of Providing indemnity

REPLACEMENT

CASH

INDEMNITY

REISTATEMENT

REPAIR

1. Cash payments.

- An insurance contract pays money - in the vast majority of cases, the claim is settled by giving the insured a cheque for the amount payable under the policy. Bank transfers are now also common.
- In liability insurance, cash (i.e. cheque) payments are always made although, in the majority of cases, the money is paid to the third party direct.
- This saves the trouble of the insurance company paying the insured and the insured having to pay that amount to the third party.

Cash Payments

- Most commonly used method
- Used in almost all classes of general insurance
- Only method for third party injury claims
- Simple and easy to use

2. Repairs

- Insurers make extensive use of repair as a method of providing indemnity in motor insurance where garages are authorized to carry out repair work on damaged vehicles.
- In practice insurers appoint specific garages which carry out repair work on their behalf.
- Repair is also common for other policies – domestic package household goods, machinery and equipment under all risks and engineering policies

3. Replacement.

- The most common example of replacement is found in glass insurance where windows etc are replaced on behalf of insurers by glazing firms.
- Insurers normally enjoy a discount in view of the past amount of work paid by them.
- Replacement can also be used in specific cases where it seems the most acceptable method to both parties.
- An example may be where a diamond is lost from a ring containing two stones.
- The best method of replacement may be for the insurer to direct the insured to a jeweler in order that an attempt could be made in matching the existing diamond by replacing the lost one.
- An increasing use of replacement is being made by some motor insurers where a nearly new car is destroyed and replaced by a similar model.

Replacement

- The insured obtains a new car and the insurer enjoys the benefits of any discounts.
- This is a deviation from the strict interpretations of indemnity in view of the wear and tear suffered by the destroyed vehicle, but not deducted from the new one.
- The amount of deviation will be marginal since the true indemnity value represented by the retail second-hand price of a nearly new car will be very near the cost of a new car.
- Also used in engineering policies – new for old equipment with the insured contributing for betterment.

4. Reinstatement

This is a much overused word in insurance.

- It is used as a means by which indemnity can be provided; under ‘extensions in the operations of indemnity’ and in relation to reinstating the sum insured.
- As a method of providing indemnity, it refers to **property** insurance and the case where an insurer undertakes to restore or rebuild a building damaged by fire.
- Fire policies give the insurer the option of substituting the contract to pay money with one to provide a building. Such a decision is fraught with difficulties.

Difficulties of choosing reinstatement.

- The insurer must restore the property substantially to the same condition as before the loss.
- If the property falls short of the original in any material way, the insurer will be liable in damages for breach of the building contract.
- Unless the policy so provides, the insurer cannot limit their expenditure to the sum insured since they are bound by their election to substantially reinstate irrespective of cost.
- After election to reinstate, insurers are liable to the insured for bad workmanship and are held liable in damages where building regulations would only permit a smaller building to be built.

For these reasons, it is almost certain that an insurer would never contemplate an election to reinstate a building today.

Application of the principle of Indemnity.

- The exact amount of the compensation is not known before the loss occurs in cases of damage to property, liability insurance and other non-life policies, but in the case of life insurance and personal accident policies the amount of money to be paid in the event of a claim is generally known before the claim takes place.
- The method by which indemnity is to be measured depends on the class of the insurance involved.

1. Marine insurance:

- The Marine Insurance Act 1906 provides for both unvalued and valued policies.
- The insurable value in an unvalued policy must subsequently be computed according a formula.
- In a valued policy, the insurable value is mutually agreed between the insured and insurer.
- In both kinds of policy there is a fixed insurable value operative from the commencement of risk and unaffected by subsequent market fluctuations.
- It usually corresponds with the sum insured.
- In event of a loss, the measure of indemnity is the value fixed by the policy

- In marine insurance it is customary to issue **agreed value** policies.
- The agreed value is adopted because of its commercial advantage and is not contrary to section 1 of the Act, which provides that the insurer undertakes to indemnify the assured 'in manner and to the extent thereby agreed against marine losses'. The ship (hull) policy allows for fair value to the ship owner, and the cargo policy allows the merchant to insure his profit as well as the actual cost price of the goods.
- To this end, commercial indemnity, instead of a strict indemnity, is provided.
- In the event of total loss, the measure of indemnity is the value fixed by the policy.
- Where there is partial loss of goods, a settlement is made of a proportion of the agreed value according to the amount of depreciation. In the event of a partial loss of ship, the indemnity is represented by the cost of repairing the damage.

2. Property insurance

- The general rule is that the measure of indemnity in respect of the loss of any property is determined not by its cost but by its **value at the date of loss**.
- If the value has increased during the currency of the policy the assured is therefore entitled to an indemnity on the basis of the increased value, subject of course to policy limits such as **sum insured or average**.
- In assessing the amount of this value, no allowance is to be made for loss of prospective profits or other consequential loss or for mere sentimental value.
- These are very general guidelines and examples of their application.

2a.Buildings

- In practical terms, the indemnity sum of loss or damage to buildings has been calculated as the cost of repair or reconstruction at the time of loss less any allowance for ‘betterment’.
- Betterment can take two forms.
- Firstly, when property is repaired or replaced, certain aspects may be in a better condition than immediately before the loss e.g. new plumbing, electrical wiring, and decoration.

- If a deduction was not made for the amount of wear and tear or obsolescence of the plumbing, wiring or decoration, the insured would be better off after the loss than before in the value of his asset.
- The other way in which betterment can arise is where the repaired or replaced article is better than the original one was when it was new e.g. an extra storey is added to a building or sprinklers are installed during the reconstruction when the building previously had no sprinklers.
- This latter type of betterment is never the concern of the insurer in an indemnity only policy and the extra cost has to be borne entirely by the insured.

Buildings

- At one time, the market value of a building was frequently higher than its replacement cost and buildings were usually replaced in their old form. Nowadays this is often no longer the case.
- The construction industry is changing and it would be uneconomical to replace some buildings either in the same design or size.
- Market value is frequently lower than the cost of replacement or even the cost of repair.

The current position with regard to building losses may be summarized as follows:

- If the insured intends to repair or reinstate the property in its previous form, then indemnity is the cost of that work less an allowance for depreciation as appropriate;
- If the insurer contends that the insured does not intend to reinstate, the onus is on the insurer to prove it and, in the absence of such proof, indemnity will be the reinstatement costs less depreciation.

- If the insurer contends that market value is the measure of indemnity, the onus is to prove (i) that there is a market for such a building and (ii) the level of value in that market. In **Pleasurama Ltd v. Sun Alliance and London Insurance Ltd (1979),** the court decided that the reinstatement cost should be awarded since it was not possible to prove the value of a bingo hall which had been destroyed;
- Where there is evidence that the insured is a willing seller of the property at the time of loss, the market value less site value will be the measure of indemnity. In **Leppard v. Excess Insurance Co. Ltd (1979),** indemnity was fixed at Kshs. 4,000,000 being the advertised price of Kshs. 6,000,000 less site value of Kshs. 2,000,000 compared with an estimated reinstatement value less betterment of over Kshs. 8,000,000 and a sum insured of Kshs. 12,000,000.

2b. Machinery and contents other than stock

- In most cases, there is no ready second-hand market for such property. When it is disposed of, it is destroyed or sold as scrap and so the insured cannot purchase a replacement second-hand.
- Indemnity is therefore valued as **the cost of repair or replacement less an allowance of wear and tear**, if applicable.
- Certain types of property have a ready second hand market and, in such cases where serious damage has occurred, the article may be replaced by the insured purchasing second hand and indemnity would be that price plus any additional carriage and installation cost.
- Examples of commodities where the retail price of second hand goods is used are motor cars and certain office equipment. It is worth noting that, in the case of motor cars, indemnity for a 'write-off' would be the market value, of a vehicle of the same make, model, age, mileage and condition, and not the trade-in price.

2c. Manufacturers’ stock-in-trade

Manufacturers stock can comprise:

- Raw materials
- Work in progress
- Finished stock
- Indemnity value is not concerned with what the damaged or destroyed stock has cost the manufacturer but with what it will **cost him at the time and place of loss to replace the goods to the condition they were in when destroyed**.
- In the case of raw materials, this will be **replacement cost including delivery to site.** In the case of other stock, it will be those raw material costs, plus labor and other costs necessary in production, at the prices ruling on the day of the loss, to produce the half-made or fully completed goods which were lost.

2d. Wholesalers' and retailers' stock-in-trade

Indemnity is the cost at the time of replacing the stock, including transport and handling costs to the insured's premises.

2e. Obsolescence

- When dealing with stock losses, one must always be conscious that not all stock produced will necessarily be sold and it may be felt that the replacement value will be higher than what the stock would fetch in the market.
- In such cases, a settlement must be arrived at which will not pay the insured more than what his financial position would have been had the loss not occurred.

2f. Household goods

- The same considerations as machines and contents apply but one added problem is often encountered where the insured attaches some sentimental value to a damaged or lost article. Sentiment is a subjective value, not capable of any objective measurement and if the insured is to be placed in the same **financial** position after a loss, then such a settlement should exclude any thoughts of sentiment.
- As indemnity is based on the cost of replacing at the time of loss, subject to wear and tear deductions, it is essential to review sums insured annually to keep abreast of price increases (**new prices**), for these increases certainly exceed depreciation especially in the case of durables such as kitchen equipment, furniture and the like.

2g. Farming stock

- In the case of both livestock and produce, the **local market price** is the basis of any indemnity calculation.
- Whereas in other commodities, the insured is not entitled to potential profit on sale, this is not so with farming stock. In normal markets, there is a buying price set by the merchant and a higher selling price.
- In the case of farming stock, there is one market price on any particular day, whether one is buying or selling, so the replacement cost is the same as the **selling price**.
- If the livestock or produce was being produced for sale, then indemnity will be the market price less any processing, handling or transport costs saved because of the destruction.
- If the lost property was for farm consumption e.g. dairy cows, straw, feedstuffs, then they must be replaced and the market price must be increased for any costs necessary to place the replacement stock at the farm.

Farming stock

- From time to time, various price guarantees may be available to a farmer and, if he does not sell the goods due to their destruction, he may lose the difference between the market price and the guaranteed price.
- If this is the case, indemnity will require that the insurer pays this difference.

3. Pecuniary insurances

- In guarantee policies, the measure of indemnity is comparatively easy to ascertain as it will amount to the **actual financial loss** suffered by the insured as a result, say, of the dishonesty of a cashier.
- In business interruption insurance it is a little more difficult to establish indemnity but it is one of the very few policies where the steps to be taken in the event of a claim are detailed.
- With the help of the insured's accountants it is necessary to try and establish what profit the firm would have made if the fire or other insured peril had not occurred and compare this to what actually was made, and the difference provides the basis of indemnity.

4. Liability insurance

- Indemnity is most easily established in liability insurance.
- It is the amount of any court award or negotiated out-of-court settlement plus costs and expenses arising in connection with the claim.

Salvage

•Where property is destroyed to the extent that it has ceased to exist then the problem of salvage obviously does not arise.

• Where property is not damaged but remains in a deteriorated or damaged condition the question of salvage arises.

Example: A supermarket where stock has been damaged extensively by fire.

• The goods are not destroyed but are damaged by smoke; they are in other words in a deteriorated condition.

• The insured can only claim the value of the loss to him, which would probably amount to having the goods cleaned, unless he agrees to hand over the goods that are left to the insurers.

- **If the insured does not agree to treat the property as wholly destroyed he cannot insist on having it wholly made good to him.** This was established as long ago as 1873 in the case of **Rankin v. Potter** and on the basis of that decision property insurers are entitled to any materials left following damage where they have agreed to pay a loss in full. In the supermarket example the insurers would take over the salvaged goods, or more likely a loss adjuster would do so on their behalf, and sell them to reduce their overall outlay.

Salvage

- If property is not wholly destroyed, the choice of whether it is treated as a total loss or not rests with the insurers.
- The insured cannot 'abandon' the salvage to the insurers except in marine insurance
- This is the common law position, but sometimes insurers insert a clause in their contracts to emphasis the point.

Abandonment

- This applies only in marine insurance where, in the event of a **constructive total** loss, the assured is entitled to abandon all rights in the subject matter to the assurer and claim for a total loss. According to the Marine insurance Act 1906, s. 60, there is a total constructive loss where:
- **The assured is deprived of the possession of his ship or goods by a peril insured against, and it is unlikely that he can recover the ship or goods, as the case may be, or the cost of recovering the ship or goods, as the case may be, would exceed their value when recovered.**

Abandonment

- The definition imagines a situation where the property is not destroyed completely, as in the case of a total loss, but it is as good as lost as far as the insured is concerned, as for example in the case of a ship which runs aground on a sandbank and cannot be refloated.
- The insured abandons her to underwriters and the claim is dealt with as if it was a loss with the vessel becoming the property of the insurers.
- Abandonment is not permitted in fire and non-fire damage to property policies.

Indemnity and Insurer's Liability

- In all the points which have been discussed so far, we have been concerned with what indemnity is or what the insured has lost.
- In settling losses, the amount of insured's loss should first be assessed and then the policy terms looked at to ascertain if the insurer is liable for the amount of that loss.
- In many cases, by choice of the insured, or by poor insurance arrangements, the insurer will not be liable to pay a full indemnity.
- In other cases, the insurer's liability will be more than indemnity because of extensions to a basic indemnity contract.

Factors limiting the payment of indemnity

- Sum Insured
- Average
- Excess
- Deductible
- Franchise
- Policy limits

1. Sum assured

- The maximum amount recoverable under any policy is limited by the sum insured or the limit of indemnity.
- In policies having a sum insured, the insured cannot recover more than the sum insured even where indemnity has a higher figure.
- Indemnity very often exceeds the sum insured especially where policies have not been updated over a number of years.
- In policies having a limit of indemnity, or limit of liability, that limit is the maximum amount payable.

Sum insured

- An exception to this general rule is where costs and expenses in connection with liability claims are paid over and above the limit of liability.
- The use of the phrase maximum amount recoverable does not imply that this is the amount payable to the insured.
- The actual amount payable is governed by a number of considerations. **All that is implied here is that the sum insured or limit of liability is the maximum recoverable.**

2. Average

- Where there is under-insurance the insurers are only receiving a premium for a proportion of the entire value at risk and any settlement will take this into account using the formula:

$$\frac{\textbf{Sum insured} \times \textbf{loss}}{\textbf{Full value}}$$

- When average operates to reduce the amount payable the insured really receives less than indemnity but, theoretically, he is being considered his own insurer for a portion of the risk and in a sense should 'indemnity himself' for the balance not received from the insurers.

Average

- **Note:** One interesting development in recent times has been the move towards applying some form of average on household insurance policies, a class of business traditionally free of average.
- Household insurers have been experiencing large losses partly due to under-insurance and the application of average is considered, by some, to be an answer to this.

3. Excess

- An **excess** is an amount of every single claim which is not covered by the policy. Excesses are quite common on private car policies where, for accidental damage to the car itself, the insured might agree to pay the first Kshs. 5,000 or some other amount for the repairs of his car.
- Theoretically we could say that the insured is really his own insurer for the Kshs. 5,000, Kshs. 10,000 or whatever value excess represents.
- When the excess applies the insured receives less than the indemnity from his insurer.

4. Franchise

- The operation of a **franchise,** distinguishable from an excess as when the amount of the franchise is exceeded, the whole loss is paid including the value of the franchise, will also limit the amount payable.
- The franchise is not in common use but is sometimes found in marine insurance, and a time franchise (7 days) is sometimes found in personal accident and illness, insurance and in certain engineering interruption policies (30 minutes).

5. Limits

- Many policies limit the amount to be paid for certain events by the wording of the contract itself. – single article limits, any one claim, any one event etc
- The household contents policy normally has a wording that says,**No one curio picture work of art……..is deemed to be of greater value than 5% of the sum insured on contents.**
- In the event of a work of art valued at Kshs. 10,000 being destroyed in a household fire, where the contents sum insured was Kshs. 57,000, subject to the insured not having intimated to the insurers that he wished the item covered, he would receive less than the indemnity.

Limits

- A different wording to the one used above is where insurers say,
- **In the event of a loss not more than Kshs. 10,000 will be paid in respect of any one item.**
- In this case they acknowledge that items in excess of Kshs. 10,000 may exist but that any claim payment would be limited to that figure.
- In either case it is for the insured, and his advisers, to ensure that he is adequately protected.

6. Deductibles

- One aspect of commercial insurance that has increased over recent years and shows signs of increasing is the use of deductibles.
- A deductible is the name given to a **very large excess**. An industrial insured may consider that it has the resources to meet fire claims up to Kshs. 500,000 in any one period of insurance and is confident in its own ability to prevent fires.
- They may approach an insurer and receive a discount from the premium. In the event of a claim they will not receive indemnity as they have decided that they will settle for less than indemnity in order to obtain the savings in premium.

Factors that extend the operation of indemnity(modifications)

- Reinstatement.
- Household contents insurance ‘new for old’
- Agreed additional costs
- Valued policies

1.Reinstatement.

- Here is the second use of the word reinstatement. Its use here refers to the method used in arriving at the amount payable in respect of a claim under a property policy covering buildings or machinery.
- The insured can request that his policy be subjected to the **'reinstatement memorandum'** and as a result the method of settlement will provide the insured with an amount that has been calculated without deduction of wear, tear and depreciation.
- The insurers agree to pay the full cost of the reinstatement, at the time of the reinstatement

Reinstatement

- This would mean that the settlement includes indemnity plus wear, tear and depreciation in addition to the effects of inflation between date of loss and eventual date of reinstatement.
- This is a very valuable cover
- The problems posed by betterment still exist and insurers protect themselves by saying that they will pay for reinstatement to the position when new but that the property must not end up in a better or more extensive condition than when new.
- An element of contribution would be required from the insured in the event of the unavailability of exactly the same machine with available machines being better.

Reinstatement

- Reinstatement cover is not paid for by an increase in the rate per cent but is paid for by the fact that the sum insured has to represent that not less than the cost of reinstatement at the time of reinstatement.
- Sums insured will, therefore, be substantially higher on reinstatement policies than on indemnity contracts and consequently the premium paid will also be greater.

2. Household contents insurance ‘new for old’

- This is similar to the reinstatement covers described above and is found in different forms on different policies.
- At its basic level the insurer agrees to pay for reinstatement of contents if they are destroyed within a certain number of years of their purchase, say three or five, without deduction of wear and tear.
- In a fuller form ‘new for old’ cover is offered without time limit for all contents with the exception of items such as clothing and linen.

3. Agreed additional costs

- Normally, in property insurance the insured normally incurs additional costs as a result of a fire or other damage.
- The insured may have to remove debris from the site, comply with public authority requirements when rebuilding, and incur architects' and surveyors' fees.
- These costs can be included within the insured's cover and any payments relating to them will amount to more than strict indemnity.

Agreed additional costs

- **Note**: In special cases additional costs are met where indemnity would not be ‘fair’.
- This arises where agricultural products are destroyed and in view of the limited supply of these commodities the price will rise.
- This means that the insured would have to pay the inflated price to replace his lost goods, the loss of which caused the price increase.
- Insurers in such cases have agreed to compensate the insured and this constitutes more than strict indemnity.

4. Valued policies

- Valued policies are used in marine insurance and in certain other special cases.
- Where there is an article of particular value for example a piece of jewelry or work of art, the insured could obtain the advice of an expert on value and arrange a policy where the amount to be paid in the event of a total loss is determined at inception.
- It can be argued that valued policies do not modify indemnity as in the case of partial losses indemnity still operates and in the event of a total loss all that has been done is to agree the measure of indemnity before the loss.

DIP 102

SUBROGATION

Principle of subrogation

Definition:

- This is the right of one person ,having indemnified another under a legal obligation to do so, to stand in the place of that other and avail himself of all the rights and remedies of that other, whether enforced or not.

Relationship between indemnity and subrogation

Corollary of indemnity:

- The principle of subrogation is introduced as a corollary of indemnity and prevents an insured from recovering from both parties.
- If the insured is indemnified by his insurer, he must give up all rights and remedies he may have against the third party to the insurer.
- The insurer will thus acquire the right to stand in the place of the insured and avail all of his right and remedies against the guilty party to the extent that he has indemnified the insured.

Subrogation

- If the insured himself succeeds in recovering from the third party after he has been indemnified by his insurer, he holds that further compensation as a trustee for his insurer to the extent that the insurer is entitled to.

Subrogation

- A good example is where an insured vehicle is damaged due to the negligence of a third party.
- The owner of the vehicle is compensated by his insurer under the insurance policy.
- He is also entitled to compensation from the third party that damaged the car.
- If this was allowed, the owner of the vehicle (the insured) would have recovered from both the insurer and the third party, therefore being more than indemnified.

Subrogation

- The principle was put forward that the insurer, having indemnified a person, was entitled to receive back from the insured anything he may receive from any other source.

HOW SUBROGATION RIGHTS MAY ARISE:

1. Rights arising out of tort.

- Tort can be defined as a civil wrong. It forms part of common law and includes negligence, nuisance, trespass, defamation and other legal wrongs.
- When the insured has sustained some damage, lost rights or incurred a liability due to the tortious actions of some other person then the insurer, having indemnified him for his loss, is entitled to recover the outlay from the wrongdoer involved.

Rights arising from tort

- A good example would be in the case of a negligent motorist who could strike and damage your buildings.
- The person suffering the loss could have a policy to indemnify him, in addition to the indemnity from his insurers; the insured would have a right, in tort, against the motorist.

Rights arising from tort

- The insurers assume these rights and attempt to recover their outlays from the appropriate party.
- Any action the insurers take is in the name of the insured and his permission would be sought if legal action was found to be necessary.

Rights arising from tort

- Another good reason for seeking the insured's permission to take legal action is that he may well have an uninsured claim he wants to include.
- The law does not allow you to sue a person more than once arising out of the same event.

2.Rights arising out of contract.

- In respect to subrogation, we are concerned with the following cases:
  a. Where a person has a contractual right to compensation regardless to fault.
  b. Where the custom of trade to which the contract applies dictates that certain bailees are responsible.
- A good illustration is the breach of rights under a tenancy agreement.

3.Rights arising out of statute.

- A good example is the Insurance Act which came into effect in 1987.
- This act indicates the amount which must be maintained as capital for each insurance company at each particular time.

When Subrogation Rights are Waived

Subrogation rights are not exercised in the circumstances :

- “knock-for-knock” agreement
- Workmen’s compensation policy.

“knock-for-knock” Agreement

- A “knock-for-knock” is an inter-company agreement which stipulates that insurers who are signatories to it will not exercise subrogation rights against each other for the damage to their own insured’s vehicles.

“Knock for knock” agreement

- Each insurer will repair its insured’s car and no claim will be lodged against the insurers of the negligent vehicle.
- This agreement is based on the principle that in the long run, the number of times insurer A’s insured will be at fault will be the same as the number of times insurer B’s insured will be at fault.
- **“Knock-for-knock” agreements reduce administrative and litigation costs.**

Workmen compensation

- If an employee injures another at workplace, the workmen's compensation insurers will compensate the injured employee but desist from pursuing the employee who caused the injury.

Subrogation

- It should be noted that most companies make these principles as part of the conditions in the policy to emphasize their importance.
- The insured must comply with these conditions for a claim to be payable.

Principle of Contribution

- Contribution applies to contracts of indemnity only.
- It supports the principle of indemnity as it is a corollary of indemnity and prevents the insured from being more than indemnified in the case that he has more than one policy of insurance covering the same subject matter of insurance.

Definition:

Contribution is the right of an insurer to call upon others similarly, but not necessarily equally liable to the same insured to share the cost of an indemnity payment.

- The fundamental point here is that if an insurer has paid a full indemnity, it can recoup an equitable proportion from the other insurers of the risk.
- If a full indemnity has not been paid, then the insured will wish to claim from the other(s) also to receive an indemnity and the principle of contribution enables the total claim to be shared in a fair manner.

How contribution may arise:

Only under the following circumstances;

1. If the policies are concurrent and in force at the time of loss.
2. If the policies cover a common interest.
3. If there are at least two contracts of indemnity covering the same subject matter of insurance.
4. If the policies cover the same peril or perils which gave rise to the loss.
5. If each policy must be liable for the loss.

When contribution may arise:

A)At common law, contribution will only arise after the insured has received full indemnification; this is still the case in marine insurance.

B)In all other non-life policies, there is a contribution condition attached to the policies making insurers liable only for their retable share of the loss.

•In a leading case in contribution that was decided in the United Kingdom, it was established that for contribution between policies to arise in law, interests in the subject matter of insurance must be the same or common.

Application of the principle of contribution in the practice of insurance

- **At common law:**

  A situation may arise where an insured may have more than one insurer. The insured may in this case, confine his claim to one of the insurers if he so wishes.

- **By contractual agreement:**

  Most policies contain a contribution condition that the insurer is liable only for his ‘rateable proportion’ of the loss. The insurer is liable for his share only and the insured is left to make a claim against the other insurer(s) if he so wishes to be indemnified.

The basis of contribution:

The insurers may use the principle of contribution to share the loss using a rateable proportion of the sum insured or on independent liability basis.

- **Rateable proportion:**

  There are two methods of how rateable proportions should be calculated.

  For sum insured, assuming that policy A covered a sum of Ksh.1, 000,000/=, policy B Ksh.1, 200,000/= and policy C 1,500,000/=, the insurers would pay as follows:

Contribution

- Policy A: $\frac{\text{Ksh.1, 000,000}}{\text{Ksh.3, 700,000}} \times \text{loss}$
- Policy B: $\frac{\text{Ksh.. 1,200,000}}{\text{Ksh. 3,700,000}} \times \text{loss}$
- Policy C: $\frac{\text{Ksh. 1,500,000}}{\text{Ksh. 3,700,000}} \times \text{loss}$

- In a paraphrase, it is possible to argue that each policy should pay in proportion to its liability for the loss.
- This is because consideration should be put into restrictive terms which might vary from policy to policy.
- Hence, if A's liability was Ksh.500, 000 and B's Ksh.1, 000,000 and C's Ksh.1, 000,000 of a Ksh.1, 500,000 loss, after the operation of average:

A would pay: $\dfrac{\text{Ksh. }500{,}000}{\text{Ksh. }2{,}500{,}000} \times$ Ksh.1, 500,000 =Ksh.300, 000

Similarly, B and C would pay Ksh.600, 000

The approach is called 'the independent liability method'.

Contribution

- **Property Policies(not subject to average)**

  Where property policies are involved which are not subject to average, and in which the subject matter of insurance (property) is identical, the loss is settled in proportion to the sums insured.

$$\frac{\text{Sum insured by particular Insurer} \times \text{loss}}{\text{Total of sums insured by all insurers}}$$

Example 1

Company A insures house building for Ksh.1, 000,000

Company B insures it for Ksh.2, 000,000

A loss by fire of Ksh.1, 200, 000 would be apportioned as follows:

Office A would pay: $\dfrac{\text{Ksh.1, 000,000}}{\text{Ksh.3, 000, 000}} \times \dfrac{\text{Ksh.1, 200,000}}{1}$ =Ksh.400, 000

Office B would pay: $\dfrac{\text{Ksh.2, 000, 000}}{\text{Ksh.3, 000, 000}} \times \dfrac{\text{Ksh.1, 200, 000}}{1}$ =Ksh.800, 000

<u>Ksh.1, 200, 000</u>

For non-average policies which are in contribution but they are not concurrent, (i.e. the property covered is not identical), sums insured are still used as a basis.

Other Property Policies

- Where policies are subject to average, or an individual loss limit applies within a sum insured even when such policies are non-average, one must use the '**independent liability'** method to calculate the proportions.
- The **'independent liability'** method is the amount an insurer would have to pay if he was the only insurer covering the loss.
- In fact, as more and more policies become subject to average and as limits become more common, this method is used almost universally.
- In non-concurrent non-average losses, it is sometimes used in preference to the **'mean method'** if the insurers agree, due to its simplicity.
- Currently where contribution does arise, it is the most frequently used method.

Example 2

Property is insured with A and B for Ksh. 2,000,000 and Ksh.1, 000,000 respectively, subject to pro rata average. The value of the property at the time of loss is Ksh.4, 500,000 and the loss under consideration is

Ksh.450, 000

Step 1

The first step is to find what each insurer would pay if it had the only policy in force. To find A's independent liability, average is applied to the loss

$$\frac{\text{A's Sum Insured}}{\text{Value at Risk}} \times \frac{\text{Loss}}{1}$$

$$= \frac{\text{Ksh.2, 000,000}}{\text{Ksh.4, 500,000}} \times \frac{\text{Ksh.450, 000}}{1} = \text{Ksh.200, 000}$$

Similarly, B's independent liability is:

$$\frac{\text{Ksh.1, 000,000}}{\text{Ksh.4, 500,000}} \times \frac{\text{Ksh.450, 000}}{1} = \text{Ksh.100, 000}$$

Ksh.300, 000

The wording of the average condition makes the insured their own insured for the amount of under-insurance, in this case:

Ksh.4, 500,000 – (Ksh.2, 000,000+Ksh.1, 000,000) =Ksh.1, 500,000

Step 2

If the sum of the insurers' independent liabilities (Ksh.300, 000 in this case) is less than, or equal to, the loss, then each pays his independent liability.

Step 3

If sum of the independent liabilities is more than the loss, the loss is shared in proportion to these liabilities.

i.e. $$\frac{\text{Insurer's Independent Liabilities}}{\text{Total of all Insurer's Independent Liabilities}} \times \frac{\text{Loss}}{1}$$

Contribution

Example 3

A's sum insured is Ksh.4, 500,000, B's sum insured is Ksh.1, 000,000 with both policies subject to pro rata average; the loss is Ksh.450, 000 and the value is Ksh.4, 500,000, as before.

Step 1 - Average

A – Since average does not apply, its liabilities = loss = Ksh.450, 000

B's liability is $\dfrac{\text{Ksh. }1{,}000{,}000}{\text{Ksh.}4,\ 500{,}000} \times \dfrac{\text{Ksh.}450,\ 000}{1} = \dfrac{\text{Ksh.}100,\ 000}{\text{Ksh.}550,\ 000}$

Contribution

Step 3 since total is more than the loss

A pays $$\frac{\text{(its liabilities) Ksh.450, 000}}{\text{(Total of the liabilities) Ksh.550, 000}} \times \frac{\text{(Loss) Ksh. 450,000}}{1}$$

= Ksh.368181.81

+

B pays $$\frac{\text{Ksh.100, 000}}{\text{Ksh.550, 000}} \times \frac{\text{Ksh..450,000}}{1} = \text{Ksh}\frac{\text{.81818.15}}{\text{Ksh.450, 000}}$$

These examples have illustrated the method with concurrent policies, but it can be used equally well with non-concurrent policies.

Contribution

Example 4

Sums insured, subject to pro rata average

A covering all contents	Ksh.2, 000, 000
B covering all contents	Ksh.1, 500, 000
Values at risk – Stock	Ksh.2, 000, 000
– Other contents	Ksh. 500,000

Loss Ksh.1, 000,000 on stock

Contribution

A's independent liability:

$$\frac{\text{Ksh.}2{,}000{,}000}{\text{Ksh.}2{,}000{,}000 + \text{Ksh.}500{,}000} \times \frac{\text{Ksh.}1{,}000{,}000}{1} = \text{Ksh.}800{,}000$$

B's independent liabilities =

$$\frac{\text{Ksh.}1{,}500{,}000}{\text{Ksh.}2{,}000{,}000} \times \frac{\text{Ksh.}1{,}000{,}000}{1} = \frac{\text{Ksh.}750{,}000}{\text{Ksh. }1{,}550{,}000}$$

Contribution

A pays $\frac{\text{Ksh.800, 000}}{\text{Ksh.1, 550,000}} \times \frac{\text{Ksh.1, 000, 000}}{1}$ = Ksh. 516, 129.00

B pays

$\frac{\text{Ksh. 750, 000}}{\text{Ksh.1, 550, 000}} \times \frac{\text{Ksh. 1,000,000}}{1}$ = $\frac{\text{Ksh. 483, 871.00}}{\text{Ksh. 1,000, 000.00}}$

- **Liability insurances:**

  There are times when more than one liability policy can cover the same loss, though not common.

  In England, such a situation came before the courts in **Commercial Union Assurance v. Hayden (1977)** when it was confirmed that the independent liability method should be used.

Contribution

Example:

Public liability policy A has a limit of indemnity any one accident of Ksh. 4,000,000

Public liability policy B has a limit of Ksh. 5,500,000

Their insured is liable to a third party for Ksh.4, 250,000

Policy A's independent liability is its limit = Ksh. 4,000,000

Policy B's independent liability is the loss =<u>Ksh. 4,250,000</u>

Total <u>Ksh. 8,250,000</u>

Contribution

A pays $\frac{\text{Ksh.4, 000,000}}{\text{Ksh.8, 250,000}} \times \frac{\text{Ksh. 4,250,000}}{1}$ =Ksh. 2,060,606

B pays $\frac{\text{Ksh. 4,250,000}}{\text{Ksh. 8,250,000}} \times \frac{\text{Ksh. 4,250,000}}{1}$ =<u>Ksh. 2,189, 394</u>

<u>Ksh. 4, 250,000</u>

If the loss had been less that Ksh. 4,000,000 they could have shared the loss equally since the independent liability of each would have amounted to the loss.

Modification of contribution

- **Non-contribution clauses:**

  It is possible for the equitable right to contribution to be removed by a clause in one or both of the policies. A good example is where **a policy shall not apply in respect of any claim where the insured is entitled to indemnity under any other insurance.**

  This means that the policy would not contribute if there was another insurance in force.

  It is also possible for the given words below to be added to the clause above:

  'Except in the respect of any excess beyond the amount which would have been payable under such other insurance had this insurance not been effected.'

  Incase the insured has a claim under this policy containing the full clause

More specific insurance clauses:

- Incase of a policy is issued to cover a wide range of property, there is sometimes a clause identical to the one quoted above added to prevent contribution between the wide range policy and any which might be more specific in their cover.

- A good example is whereby a fire policy on stock would not contribute with a marine cargo policy in a dockside warehouse, except for any excess of value not covered by the marine policy.

Questions:

1. (a) Define subrogation.

   (b) State briefly how subrogation is a corollary of indemnity?

2. Mention three ways in which subrogation rights may arise.

3. (a) Define the principle of contribution.

   (b)How is the principle of contribution a corollary of indemnity?

4. State briefly how contribution may arise.

5. Describe briefly how the principle of contribution operates.

DIP 102 UNIT-7

THE UNDERWRITING PROCESS

Underwriting

- Information for risk assessment can be gathered from various sources:
  - Proposal forms
  - Brokers slips/risk notes
  - Surveyors reports
  - Other questionnaires/reports e.g medical reports

1. PROPOSAL FORMS

A proposal form is a document that is drafted by the insurer and seeks answers from the proposer regarding the main material facts of the risk to be insured.

The reader should clearly understand that the **proposer's duty of disclosure** is not limited to the questions asked and he must disclose such additional information or material facts as may apply.

The proposal form is **not required by law** and is not used in certain circumstances, but it is a convenient method of gathering information.

Functions of a Proposal Form:

The proposal form is useful because it ensures:

- Speed;
- Accuracy;
- Convenience in handling of offers to be insured.

The main function of the proposal form is to record the necessary **information** which will enable the underwriter to assess the nature of the risk being proposed.

The form ensures that all requests are presented in a uniform and systematic manner.

It is for this reason that insurance companies have drafted documents in the form of questionnaires for each class of insurance business.

Proposal forms

Sometimes offer and acceptance may be made orally but it is good business practice to have the proposal form completed before the policy is drafted and issued.

The proposal form also **serves as the basis upon which a contract is established.**

Some proposal forms contain a declaration that the form is the basis of the contract and that the insured guarantees the truth of the answers contained therein.

It is further indicated in the proposal form that any misrepresentation will be in breach of the contract rendering it void.

Another purpose of the proposal form is that it serves as an effective **tool for advertisement**.

Many proposal forms contain details of the cover available under the company's standard policy for that class of insurance; sometimes other types of policy and cover available from the insurer are also listed.

In such circumstances, it is called a '**proposal and prospectus'.**

It should be noted that the issue of a proposal form to a potential client does not commit the insurance company to accept this proposal.

The information obtained from the completed form about the physical and or moral nature of the risk being proposed may mean that it is unacceptable by the insurer.

A proposal form may be competed for **quotation purposes only,** hence the legal offer will come from the insurer, leaving the proposer to complete the contract by acceptance or to reject the offer as he wishes.

Use of Proposal Forms

There are circumstances where practice or convenience demands that proposal forms be dispensed with namely:

- **Marine insurance**, where the use of **a broker's slip** is sufficient. An exception to this is the insurance of small pleasure crafts and other minor risks;
- In **large fire insurance**;
- Proposal forms are usually dispensed with fro such risks for various reasons:
  - There would not be sufficient space on the form to describe all the property to be insured;
  - The broker will have summarized the relevant information in offering the risks

Proposal forms

In other classes of insurance, proposal forms are required even for large risks with the exception of some engineering and aviation risks where surveys are be carried out.

In some unusual or contingency risks, the preparation of a form might be difficult due to the varying nature of information required from one type of risk to another.

Style of proposal forms

- Each company has its own form of each class of business
- Most companies, however, tend to have short forms containing general and particular questions that require a simple ‘yes’ or ‘no’ answer.

General Questions

The majority of proposal forms contain general questions, irrespective of the class of insurance.

They are not specific to the risk and may apply to many different proposals.

These are discussed here below:

a. Proposer’s name

This is important for several reasons:

- It identifies one of the parties to the proposed contract.
- The name of the proposer may also indicate the nature of the physical or moral hazards.
- The name of the proposer may indicate the nature of their trade.
- A particular name may be that of someone with whom the insurer does not wish to do business with because of doubtful integrity.
- A foreign sounding name puts the insurer on enquiry as to the proposers experience in the country.

b. Proposer’s Address

This is an important factor in underwriting motor insurance, theft insurance and all risks insurance in which geographical areas present different chances of loss. The proposer’s address is also required for correspondence purposes.

c. Risk Address

It could be possible that the address at which the risk is located is different from the insured’s home address or the firm’s registered address. This risk address is particularly important in fire, theft, motor and other property and liability insurance.

d. Proposer's occupation

There are certain occupations that present abnormal hazards such as:-

- Miners.
- Airline crew.
- Jockeys – in case of life and personal accident covers.
- Commercial travelers.
- Representatives in the case of car insurance.
- Plastics manufacturers.
- Wood workers in the case of fire insurance.

e. Previous and present insurance history

It is normal practice for the new insurer to consider:

- Special terms.
- Premiums.
- Declinature of proposer's business in the past.
- Before deciding whether to accept or not.

f. Claims or Loss History

The insurer may wish to know of previous losses, whether insured or not, which would be covered by the form of insurance being proposed. It is normal practice for many forms to restrict such information to that occurring in the last three to five years.

There is a duty on the part of the proposer to declare relevant information whether specifically asked for or not. However, public opinion on disclosure is changing and underwriters may require being more specific in their questions in the future, as the courts are likely to follow the trend of public opinion.

b. Specific Questions

Apart from the general questions discussed above, the underwriter is interested in gathering certain information related to one specific type of insurance being proposed.

Each proposal form will contain specific questions relating to the hazards concerned. Below are examples of the type of information the underwriter will be concerned with for the particular or specific insurance.

1. **Fire insurance**
   - Construction and use of buildings and their value.
   - Nature and value of sum insured.
   - Nature of processes carried on.
   - Extensions of cover required.
2. **Motor insurance**
   - Type of cover required – that is, whether comprehensive, third party, fire and theft or third party only.
   - The type and use of the vehicle.
   - Details of the vehicle, that is, for example, the make and model type of body, year of make, capacity and the value.
   - Driver’s age, experience, previous claims and accidents.

3. Life and personal accidents insurance

- The age, occupation and medical history of the life to be insured.
- Height, weight and details of hazardous pastimes.

4. Public liability insurance

- Description of work carried on.
- Details of lifting plant and vehicles other than those licensed for road use.
- Number of employees to be insured and their total annual wage roll.
- Details of any dangerous materials being used.
- Limits of liability to be covered.

5.Employer's liability insurance

- Numbers and groupings of employees and their annual wage roll per group
- Details of dangerous machinery, boilers, pressure vessels and lifting apparatus that may be used.
- Details of dangerous substances used.

Signature and Declaration

Most proposal forms contain a signature and declaration which signify that the form is the basis of the contract, and that the proposer will accept the insurer's form of contract.

If the premium is adjustable, it will provide for this. The other effect of the declaration is that the proposer warrants the accuracy of the information provided to the best of his knowledge and belief. A warning of the consequences of non-disclosure of material facts is included in the declaration

POLICY FORMS/DOCUMENTS

- Insurance law is based on the law of contract. The contract existed when one party, usually the insurer, accepted the offer of the other, usually the proposer.
- After the contract has been made between the insured and the insurer, it is recorded in a document called a ‘policy’.
- The policy is the evidence of the existence of the contract.
- In the event of a dispute accruing it is the policy to which the court’s attention will be drawn as it is assumed that it show the agreement or intention of the parties, unless insured can bring evidence to show that there is a discrepancy between eh policy and the contract.

POLICY DOCUMENT

B1. Scheduled form

A scheduled policy document is one in which the different parts are separated form one another and the specific information relating to the contract are detailed in a list or schedule. These are discussed briefly here below:

B1aThe Heading

The full name and the registered address of the insurance company is clearly printed at the top of the first page.

B1bThe Recital Clause (or the Preamble)

The Preamble Clause

This is the clause regarding the preamble to the details of the cover, and it recites the circumstances in which the policy will operate. The clause usually covers two points;

- That the premium has been paid or there is an agreement that it will be paid
- That the proposal form is the basis of the contract and is incorporated in it.

B1-c the Operative Clause

The clause is like the heart of the policy because it details the type of event insured against. For a standard fire policy, it will show the extent of cover regarding damage by fire, lightning or explosion (subject to qualifications or exceptions).

This clause can be lengthy such as in the case of a comprehensive motor policy in view of the types of loss or damage or liabilities which are insured.

B1-d.Exceptions

It is not possible to grant an all inclusive insurance. It is important to detail instances in which this policy will not operate. Such exceptions differ from one type of policy to another and are listed in a separate section or are included immediately after the insured peril. An example of such an exception is riot in on fire policy, while radioactive contamination from a nuclear fuel would apply to almost all policies.

B1-e.Conditions

All policies are subject to conditions whether stated in the document or not. Conditions exist in two major categories:

A. Express and implies.

B. General and particular.

Implied conditions

There are conditions which are implied by law to apply to all insurance contracts even although they do not appear in writing.

These conditions include:

- That the insured has an insurable interest in the subject matter insured;
- That both parties have observed utmost good faith in their negotiations leading up to the contract;
- That the subject matter of insurance actually exists;
- That the subject matter of insurance can be identified.

Express conditions.

- On the other hand there are express conditions written down which are expressed or stated in the policy

These conditions vary from one class of insurance business to another and are further subdivided into;

- General conditions
- These conditions usually deal with maters as reinforcement of a common law provision such as
- Misrepresentation and fraud;
  - Alterations that need to be brought to the attention of the insurer;
  - Restrictions in cover;
  - Claims procedures;
  - Privileges to either party such as the right of the insurer to assume possession of a fire damaged building or the right of a life assured to surrender his policy;
  - Contribution with other insurers on the risk, subrogation, and arbitration.

General conditions

May also provide a cancellation clause for the benefit of the insurer and special provision as to how the insured takes care of the insured property.

Particular conditions

These conditions relate to extensions of cover beyond the one contained in the printed policy or special warranties that may be applied to govern the manner in which the insured operate his premises.

classifications of conditions

- Conditions can also be classified into:
- Conditions precedent to the contract;
- Conditions subsequent to the contract;
- Conditions precedent to liability.

Conditions precedent to the contract

These are conditions which must be fulfilled before the contract becomes valid, such as implied conditions mentioned earlier.

Conditions subsequent to the contract

These are conditions expressed in the contract and can be either general or particular.

These conditions must continue to be met throughout the period of the contract to maintain its validity. A good example is change of situation in a fire policy.

Conditions precedent to liability

These are conditions which must be complied with before there is a liability for a claim. The conditions are expressed in the policy, say, for example, the claims procedure.

Life assurance

It is, however, worth noting that in life assurance, express conditions of either a general or particular name are further classified as:

Restructure which cover such issues as occupation, residence or war, risks;

Privilege; for example, days of grace, surrender, paid-up, or loans;

Special for example, payment of premiums by installments

Marine insurance

In marine insurance the policy documents do not have the above discussed conditions. The policy wording is standard but can be adjusted when necessary by the addition of ‘Institute clauses’.

8B-1.The Schedule

This is the front of the policy which records the details of the particular contract

B-2.The signature or attestation clause

The policy document is prepared by the company and is signed on behalf of the company by a senior official.

In some policy forms, the signature of a senior official for example, the chairman or general manager is printed and the official issuing the policy will merely counter sign or initial the policy as evidence of the company's undertaking to honour both the printed and typewritten parts of the document.

B3.The Specification

These are additional typewritten pages that may be added to the policy. The total sum insured would show on the schedule, but the specification would show the divisions of this amount over the various items insured.

The specification will also show additional clauses that may be deemed necessary.

Such specifications become necessary in large insurances for example, industrial fire risks whereby there may not be sufficient space on the scheduled page to record all the particulars.

B4. collective policies

Sometimes, the values at risk and/or the potential hazards are too great for one company to cover by itself. In such circumstances, the broker will approach several companies to co-insure and cover 100% of the value.

The leading office usually carries the highest percentage of the sum insured. It carries out the survey and prepares the specifications on behalf of all the insurers and send, to them details of each company’s share of the sums insured, first and renewal premiums, including a copy of the specific specifications.

If the co-insurers agree to the terms of the policy, they issue a ‘signing slip’ giving the leading office authority to sign on their behalf.

The leading office will then prepare and sign a collective policy on behalf of the co-insurers.

A collective policy is the same as any other policy but has three exceptions:

- The policy has no heading, that is, the company’s name and address do not appear on the policy document;
- The word ‘insurers’ is need in the clauses instead of ‘the company;
- All the companies on the risk are listed in the policy including the percentages of the total amounts and their reference numbers which are also the policy numbers. These numbers will be used by the companies to complete their records in their policy registers.

Endorsements

It may become necessary from time to time to make changes in the wording of a policy in order to accommodate changes in sums insured, substitution of one item for another, etc. This may require issuing a new policy which is not only expensive but also time consuming.

An 'endorsement slip' takes care of such alterations. The slip attached to the policy by the company or broker (or the leading office). In case of collective policies one endorsement is prepared on behalf of all the insurers by the leading office.

Some companies however, issue a new schedule showing an up-to date position instead of an endorsement slip particularly for polices that have several items or sections.

Other companies list possible endorsements in the printed policy document and incorporate them into the schedule.

6. Trends for the Future

The insurance industry has faced criticism over the years over the language used in the policies and which the layman could not understand.

Attempts have been made, however to make the policies easily understood and then print them using plain English.

There are also attempts to redesign policies some of which have been printed in booklet form instead of foolscap or A4 paper.

Most companies are printing a heading in bold type each section of the policy and even to each condition. This helps the layman to identify the various sections of the policy such as exclusions, claims procedures and the like.

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CONSTRUCTION OF POLICIES

It is well established in law that the general rules of construction and interpretation should apply to insurance contracts as well as to other contracts.

It should be understood that there is no legal requirement that insurance contracts must be evidenced by a written policy except those relating to Marine and guarantee insurances.

However, as a precautionary measure, the parties should set down in writing the terms of their agreement.

The policy is the evidence of the contract between the insured and the insurer and it shows their intentions regarding the subject matter of insurance

1. The general principle

It is assumed that the full intention of the insured and the insurer is shown in the policy.

In the event that a dispute arises as the courts will only decide what the words in the policy mean as it is the general assumption that the parties meant to say what is written down.

The meaning of words

Ordinary meaning

In all probability, it is presumed that the words used are to be construed in their ordinary and popular sense even by the ordinary man in the street would construe. For example, that the word fire means flame or actual burning.

Commercial meaning of words

Unless the context of the sentence indicates otherwise, words with a common business or trade meaning will be construed with that meaning.

Legal meaning of words

Words that are defined by a statute will be held by the very definition. In some cases, some words in the policies have previously been subject to court process and in normal circumstances, decisions made by a higher court are binding on a lower court while at the same time, courts of legal standing may rarely make contradictory decisions.

c.Printed, typed and handwritten words

Should there be a contradiction between the standard printed policy form and the typed or handwritten parts it will be assumed that the typed or handwritten parts expressed the intentions of the parties to the contract and hence the original printed words will be overruled.

If an endorsement contradicts other parts of the contract, the meaning of the endorsement will prevail since it is the later document.

d.Express and implied terms

Elsewhere, a contradiction between the express and implied terms arise, the express terms of the contract will prevail since, these clearly indicate the initial intention of the parties to the contract.

e.Contra Proferentem rule

In the event that the wordings on the contract present ambiguity, they will be held against the drafter of the contract, that is, the insurer. Insurers have an obligation to use words with clear meanings in their policy drafting failure to which the insured will be given the benefit of the doubt.

Rectification

Should either party (usually the insured) be of the opinion that a mistake has arisen in the policy drafting, they can ask for the policy to be rectified to correct the error.

Normally this is done by issuing a new policy or by endorsement. In the event of the insurer declining to alter the policy, the other can apply to the courts to have the rectification made so that the policy may be a true evidence of the contract.

COVER NOTES AND CERTIFICATES

1. Cover notes

Evidently, policy documents may take a long time to prepare and some proof that insurance cover is in force may be necessary before the policy is issued.

In some cases the insurers may be ready to issue cover, but may not have all the required information to prepare the policy due to various reasons which are:

Incomplete premises.

In order to carry out a survey. In other instances the insurers may be prepared to issue only a company cover until a survey is carried out reserving the right to cancel the cover if the survey report proves the risk to be unsatisfactory.

In all these circumstances the insurers may confirm the initial cover by a cover note and most insurers have books of cover notes preprinted.

Only the particulars of the individual case require to be filled in and the note agreed by an authorized official.

The original is given to the insured; a copy is retained in the file while a second copy is retained in the book for audit purposes.

It must be clearly understood, however, that cover notes have the same legal status as the policy and that they are evidence that there is a contract in force.

Effective period of cover notes is restricted to 15 or 30 days but a continuation may be issued if there are outstanding matters to be cleared before a policy is issued. It is, however, prudent to remind those concerned when issuing such continuation.

In the event of loss during the period the cover note is in force, the insurers are liable in the terms of their standard policy unless special terms have been included in the cover given.

a. Use of cover notes

Cover notes are commonly used in property insurance.

In life assurance, temporary life cover is issued if the premium is paid along with the proposal form.

The company has the option to reject or confirm permanent cover after the underwriters have considered the proposal form.

In many cases, the company issues a ‘letter of acceptance’ (which is legally the offer) if the proposal is acceptable and the proposer completes the contract by paying the first premium.

b. Motor insurance and cover notes

In motor insurance, the cover note is usually two documents in one:

a)A cover note as evidence of a commercial contract between the insured and the insurer;

b)A certificate of insurance.

The certificate is a separate document issued by the insurers as required by sections of concerning compulsory act limit cover.

The certificate relates to The Insurance (Motor Vehicles Third Party Risk) act or Criminal law while the cover relates to civil law.

It is not uncommon for the courts to refuse that a motorist was insured for purposes of The Insurance (Motor Vehicles Third Party Risk) act and yet the cover note was found to be binding for purposes of third party injury claims.

This may happen because the insured had not received the cover note and according to criminal law the note is not effective until he has, whereas in civil law the note is binding form the time it is signed.

Certificates of insurance

Normally when insurance cover is compulsory by law, it is usual for a certificate of insurance to be required by the statute as it is the case with **motor insurance and also in the Workers Benefit Insurance Scheme.**

Motor insurance and also in the Workers Benefit Insurance Scheme.

a)Motor Insurance

The Insurance (Motor Vehicles Third Party Risk) Acts requires that where a vehicle is on the public highways, there is in force a policy of insurance covering the users liability for third party personal injuries caused by the vehicle or its use.

Such a policy is ineffective (according to the Act) until a certificate of insurance is issued by the insurer to the policy holder.

The policy must show:

- The registration mark of the vehicle or if in unspecified form a description of the type of vehicle insured;
- The name of the policyholder;
- The inception date of the cover;
- The expiry date of the cover;

- The persons or classes of persons entitled to drive;
- The limitation to the use of the vehicle for example, a normal private car certificate would exclude commercial travelling.
- Certification that the insurers are authorized motor insurers for the purpose of the Act.

When a policy is prepared it is normal practice to issue a certificate dated from the original time at which the cover becomes effective and expiring at next renewal.

It must be understood, however, that the certificate, or the cover incorporating one, must be delivered to the policy holder in order for it to be effective as required by law, of the insurance.

b.International motor insurance cards

- Most countries have some form of compulsory third party motor insurance and for ease of proof of having such cover when a motorist crosses borders; insurers in each country have set up national bureau to guarantee such cover through issuance of international motor insurance cards.
- Within the COMESA region such cards are yellow in colour, similar to the Green cards in Europe, the Orange card in Northern Africa and the Brown card in West Africa.

C.Work injury benefit act

The Act establishes the requirement for insurance cover against the employers' legal liability for injury and disease in respect of the employees.

The Act also requires that the employer must display at each place of business a certificate from the insurers that he or she is insured against such risks.

The certificate must show:

Name of policy holder;

Policy number;

Date of commencement and expiry of insurance

Wording that satisfies the terms of the Workers injury Benefits Act;

Signature of insurers' representative.

d.Marine cargo

- Oil carrying vessels may not leave or enter ports and terminals without a certificate of insurance.
- Certificates are also issued in respect of marine cargo insured under a floating policy.
- Banks and consignees may require evidence that an individual consignment is insured before discounting the Bill of Exchange.
- Marine certificates, however, are issued by mutual agreement and are not required by law.

Nature of long term agreements

- In general insurance contracts insurers may agree to give a premium discount in consideration of the insured offering to renew the contract for a period of time normally from three years to five years.
- The amount of discount earned will be determined by the number of years usually 5%-7.5% for a term of 5 years.
- Under the agreement both sides to the contract benefit. The insured gets the reduction in premium and the insurer has the knowledge that business will be offered for renewal.
- If the insured breaches the agreement they are required to refund the discounts enjoyed.
- However, if the insurers introduce adverse terms the insured is not bound to uphold the agreement.

Cancellation:

- The parties have to give a notice of cancellation of contract before the expiry date, usually 14 days.
- If the insurer initiates the cancellation they allow a pro-rata premium refund.
- A short-term period premium is charged if the insured invokes the cancellation.

Reinstatement of the sum insured

- The successive series of partial losses have the effect of reducing the sum insured by the amount of the claim paid.
- For the risk to be adequately covered after the occurrence of a loss the sum insured needs to be reinstated to its original amount for the unexpired period of insurance.
- A pro-rata additional premium is usually payable.
- However, if the amount of additional premium is insignificant the insurer may reinstate the sum insured at no additional premium.
- Sometimes the reinstatement of loss clause is incorporated in the policy whereby the sum insured is automatically reinstated.

Questions

1. Outline the usefulness of a proposal form in insurance documentation.
2. State briefly the two points covered by the preamble clause in a policy document.
3. Outline the implied conditions which are implied in insurance contracts.
4. List the information which must be shown in respect of a certificate of motor insurance.
5. Identify the exceptions normally found on a collective policy.

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DIP 102

Renewals

The underwriting process

- Information for risk assessment can be gathered from various sources:
- ➢ Proposal forms
- ➢ Brokers slips/risk notes
- ➢ Surveyors reports
- ➢ Other questionnaires/reports e.g medical reports

The underwriting process

- Surveys may be necessary for:
- Large properties
- Property particularly exposed to storm damage
- Where contents, valuables have large sum insured/exceed certain limits
- Where the loss history is poor either from a series of losses or one single large incident
- where the property of of non standard construction eg thatch or timber
- The survey report will report on the full description of the risk, give an assessment of the level of risk, indicate the maximum probable loss/ sum insured and give recommendations on loss prevention measures.

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The underwriting process

- Role of an underwriter:
- Assessment of risks brought into the pool
- Decide whether to accept the risk or not
- If accepting, determine the suitable premium/rating
- Determine terms and conditions and scope of cover to be offered
- Issue the relevant documentation – certificates, covernotes, policy documents, endorsements

The underwriting process

- Factors considered by the underwriter in their role:
  - Nature of the risk
  - Company policy on the risk
  - Claims experience
  - Sum insured/ limit of liability
  - Capacity of the insurer to underwrite the risk
  - Reinsurance arrangements of the insurer
  - Legal principles of insurance must be complied with
  - Risk must be insurable – must have the characteristics of insurable risks

Renewals

- Except for life policies and other long term contracts such as permanent health insurance, insurance contracts are usually for a period of one year only.
- It is, however, not good business practice to issue a new policy every year and hence the original contract makes provisions for the renewal of the policy either in the preamble or in the schedule if the parties wished to enter into another contract for the next year.

Renewals

- If there is offer and acceptance the same policy document can apply to each subsequent period.
- It must be clearly understood that although the original document is still used, each year of its renewal is legally a separate contract and therefore the duty of disclosure must apply at the time of the renewal of the contract.
- To the insurer, the benefit of renewal is continued business
- To the insured, the benefit of renewal is continued cover on the same or better terms.
- There is, however, no obligation (legal or moral) on the part of company to invite renewal.

Renewals

- In the case of annual policies, there is **no compulsion** on either party to renew the contract for a further period.
- In the case of long term business, on the other hand, the contract is for a specified period of years or until an event occurs, for example, death but the premium is paid in annually (or monthly) installments.
- The assured need not renew, in which case the policy will lapse, become paid up or the premiums will be paid out of the surrender value until it is exhausted.
- The assurer must however, accept renewal premium of tendered.

Renewal Documents

- It is common practice for the insurers to issue a renewal notice, say, two or three weeks before the expiry date of the current insurance.
- There is, however, no legal requirement to issue such a reminder, but by doing so the insurer is attempting to make sure that the cover does not lapse due to the insured forgetting that his policy is expiring.

The renewal notice usually show the following information:

- The insured’s name;
- The type of insurance;
- The sum insured;

Renewal Documents

- The premium at which the policy may be renewed;
- The renewal date;
- The address to which the remittance should be sent for example, the company's local branch, or the credit broker or agent.
- At times insurers issue endorsements or amended schedules with the renewals imposing new terms from the start of the new insurance year.
- These could relate to some minor free extension of cover on a household policy, or an increased young driver's excess in motor insurance.

Renewal Documents

- A perforated remittance slip is usually attached showing the policy number, insured's name and premium which should be detached by the insurer and forwarded with his remittance.
- A notice is included on the remittance slip or the renewal notice to the effect that any changes in the risk since inception or since the last renewal must be imitated to the insurers

Legal Status

- The issue of a renewal notice is a courtesy gesture as there is no legal requirement to do so.
- The exact legal status of the renewal notice once issued depends upon the wording
- If the notice merely reminds the insured that his policy expires on a certain date, it serves no legal purpose and the insured would then offer to renew with the company accepting or rejecting the offer.
- Nevertheless, if the notice invites the insured to renew, it will be regarded as a legal offer, only requiring acceptance by the insured.
- Whichever wording is used neither of the party is under any obligation to proceed with the renewal and the offer can be withdrawn before it has been accepted.

Days of grace

- It is customary to allow the insured 15 days (or 30 days in the case of some life policies) after the renewal date in which to pay the premium.
- This concession is known as days of grace.
- If the insured pays the premium within this 15-day period, the cover continues in full and if a loss has occurred between the renewal date and the date of payment, the insured will be able to recover.
- Should the insured initiate by word or action, either before renewal date or within the days of grace that he does not wish to renew, the concession is lost and the policy lapses on the renewal date.

Days of grace

- For life policies, however, if the renewal premium is not paid within 15 days, the policy does not lapse immediately.
- A condition known as 'non-forfeiture' comes into effect and the premiums are paid out of the surrender value until it is exhausted.
- Days of grace do not apply to some polices for example, under motor renewals where the premium must be paid on or before the expiry date to obtain full cover.
- It is an offence under the Road Traffic Act to have a vehicle on the road without a valid certificate in respect of motor insurance.
- Renewals are also not issued in short period and marine polices.

Renewal terms

- In most cases, the terms on which the company is prepared to renewal the annual contract may be different from those previously applying (especially for motor insurance)
- Reasons for revising renewal terms:
- The increase in claims incidences – bad claims experience
- General cost of claims leading to general increase in rates compared with the previous year – could be market agreement
- Sometimes it is necessary to alter the terms cover in order to improve it and even increase the excesses.
- Change in company/underwriting policy on various classes or particular risks

Long term agreements

- It is normal practice for insurers to offer a discount in return for the insured undertaking to renew the policy for a certain number of years such discounts are offered in order to:
- Try and retain attractive business;
- Cut down survey and other operating expenses in the long term.
- Such agreements are common in property, liability and business interruption insurances, but are not available in motor insurance.
- The usual discount is 5% of the premium for an agreement covering three years. Larger discounts may, however, be given for agreements covering a longer number of years.

Long term agreements

- Under such agreements, both parties must be prepared to fulfill certain obligations;
- The insured should offer to renew at each renewal date on the terms as applying in the immediately preceding period of insurance, for each year of, say, a three year period;
- The insurer should allow the agreed discount (say 5%) if they accept the insured's offer.

Long term agreements

The insurer:

i. Is not required to accept the renewal offer;

ii. Can alter the premium from that charged in the previous year;

iii. Can alter the terms and conditions form those applying in the previous year.

The insured:

iv. Is not required to renew if (ii) and/ or (iii) above apply;

v. Is committed to the revised terms if he accepts them, and they become the agreed terms for the renewed and subsequent periods of insurance.

vi. In the event that the insured fails to offer to renew, he is in breach of the contract.

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Cancellation

- In normal circumstances, a contract can only be cancelled by one party if there is a fundamental breach of the contract by the others such a breach would have, to be concerned with the lack of insurable interest or a major breach of utmost good faith in which case the contract would be void.
- If this were to happen, the insured would be entitled to a full return of premium unless fraud or willful deception was involved.

Cancellation

- Normally, once the company is on risk, the premium is generally regarded as fully earned, since a total loss could have occurred, and, therefore, no return is legally enforceable.
- However, insurers take a lenient view when property is sold and in several other instances.
- Insurers have inserted a cancellation clause in different types of policies which give them the right to cancel, and return a portion of the premium to the insured.

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Cancellation conditions

- In many general business policies there exists a condition allowing the insurer to cancel the policy on giving the insured a certain period of notice and on making a pro rata return of premium.
- This line of action may be deemed necessary if for example:
- Some physical feature of the risk has changed to such an extent as increase the severity of loss;
- Where the insured fails to carry out a recommendation to improve some feature and had not done so, for example, failing to install and/ or maintain an alarm system in the case of theft insurance.
- Poor claims experience during the insurance period.

Cancellation conditions

- Some insurers may argue that the risk has proved to be much worse than anticipated, and hence must come off cover to protect their account.
- On the other hand, it could also be said that this is part of the risk a company takes in transacting insurance and that the policy should run its course.

Premium

- Premium is generated by developing a rate which is then applied to the sum insured.
- Rates must be approved by IRA
- Premium calculations should be enough to meet:
  - Claims cost
  - Management expenses
  - Commissions
  - Profit margins
  - Technical reserve

Premium

- The amount arrived at is loaded by:
  - Training levy – 0.2%
  - Policyholder compensation fund –0.25%
  - Stamp duty ksh 40 – for new business only
- There are various types of premiums;
  - Annual premium -arrived at by applying rates
  - Pro rata premium
  - Short period premium
  - Flat premium
  - Minimum premium
  - Deposit or adjustable premium

Return of premium

A total return of premium is given if;

1. The insurer acted ultra vires, that is, if they purported to issue a class of policy for which they were not authorized in their memorandum of association;
2. There was no consensus ad idem, that is, the parties were under a misapprehension or misunderstanding regarding the details of the contract;
3. The nature of the contract was illegal, unless the insured was aware of this fact or should have been aware of it at inception;
4. There has been a breach of one of the conditions precedent to the contract. If the breach has willful or fraudulent there would be not legal entitlement to a return of premiums;

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Return of premium

- A total return of premium is given if;

5.Under the ‘cooling off’ period for long term business, where proposer decides not to proceed with the contract

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Return of premium

- **A partial return of premium is given if;**

1. The policy contains a cancellation clause and the insurer exercises his right to cancellation. This allow for a pro rata or proportional return to be made;
2. There has been double insurance. This would apply where the insured has innocently covered more than the total value of his property with two or more insurers. A return premium in respect of the excess value above the amount of insurable interest would be agreed upon among the insurers;
3. The insurers goes into liquidation, in which case, a pro rata return is given, but it is unlikely that the liquidator will have funds to pay one hundred per cent (100%) of the return due

COLLEGE OF INSURANCE
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Return of premium

- A partial return of premium is given if;

4.There is mutual agreement to do so. This could arise in the following circumstances;

- If the insurer agrees to a request form the insured to cancel the insurance, or reduce the sum insured;
- ii. Where the policy is written on an adjustable premium basis.

Dip 102

CLAIMS

Claims

- A claim is a request by the insured to be indemnified by the insurer following a financial loss
- A loss is the occurrence of an event which results in a financial disadvantage for the insured
- A loss may not translate to a claim because the loss the event may be excluded by the policy terms or certain conditions may make the claim of such a loss invalid.

Claims

- The insurance product is unique in that its quality can only be judged when a loss occurs.
- The way in which a claim is handled will therefore have important marketing repercussions for an insurer.
- **A Contract of insurance** is an agreement between the insurer and the insured whereby in return for premium, the insurer undertakes to **indemnify** the insured against a financial loss.
- **Indemnity** is about claims settlement.
- Poor perception of claims handling affects policyholders decisions whether or not to renew with their current insurers.
- Most insurers recognize the benefits of retaining good risks at renewal hence the need for effective claims handling.

Insurance Conditions that relate to a claim

- The handling of any claim is governed by policy conditions and clauses
- These are embodied in the **policy document** and they become very relevant when a claim is intimated.

- The claims conditions are in two form:E**xpress conditions** or **implied conditions**
- They become the basis of either accepting or declining a claim
- They also helps in determining the amount payable

Express Conditions

- **1. Action by the insured**
- The insured is required to always act as though not insured with regard to the subject matter of insurance
- Insure must take reasonable precautions to avoid and/or minimize further losses.
- Report/notify to the insurer within reasonable time. If the insured fails to comply with the time limit, insurers have a right to deny liability.

Insurance Conditions that relate to a claim

- However, under the compulsory Third Party Risks Cap. 405 of the laws of Kenya, the Law specifically prevents insurers from repudiating liability by relying on breach of certain conditions
- Report to the police within 24 hours
- Should not admit liability
- Maintain property in good and serviceable condition at all times
- Co-operate with the insurers appointed service providers
- The burden of proving the claim lies with the insured by providing particulars and information required

Claims conditions

- **1. Insured's duty**

When an event that is likely to lead to a claim under a policy occurs, there are certain implied or unwritten duties and certain expenses or written duties imposed on the insured.

Implied duties

- It is required by law that the insured should act as if he were uninsured at all times and should take all necessary steps to minimize his loss.
- The insured should also not hinder the activities of the police and the fire brigade should they become involved with the loss.

Claims conditions

Express duties

- Most policies require the insurer to be notified immediately of any event which could give rise to a claim under the policy, and to be provided with full particulars within a stipulated period of, say, 7,15 or 30 days.
- It is important for the insurer to be notified as soon as possible so that full investigation of the circumstances can be made. Failure to give early speedy notification may lead to loss of certain evidence or witnesses' recall of incident may become muddled.

Claims conditions

- In most cases it is in the insured's interest to have the assistance of the insurer's claims officials or independent loss adjusters to help in preventing further loss and in speeding up the start of repairs.

Claims conditions

Rights and obligations

- Normally there are certain conditions precedent to the liability of the insurer, including;
- That the necessary details required by the insurers shall be given at the insured's expenses;
- That the insured shall not use fraudulent means to obtain benefit under the policy;
- That the insured shall allow the insurer to exercise subrogation rights if requested to do so.

Claims conditions

- **1. Proof of Loss**
- The insured has a duty to prove that;
- He suffered a loss due, to an event against which is insured;
- The value or amount of that loss. In case of the employers' and public liability claims the insurers take over the negotiations immediately and the insured will not be concerned with the amount directly.

Claims conditions

2. Insured's rights

- The insured has right that if the complies with all his duties, he is entitled to a full settlement within the terms of the policy. This settlement must be made speedily and cannot be held up pending recovery of subrogation rights or contribution rights under a market agreement.

3. Insurer's duties

- The insurer has a duty to honor the rights of the insured so long as he has complied and met his obligations.

Claims conditions

4. Insurer’s Rights

- At common law in view of their financial interest, both the insurers and the insured have right to save the subject matter of insurance through the action of loss adjusters.
- Many insurance contracts give the insurers the right of entry to premises and to take possession of property for any reasonable purpose without admitting liability for the claim.
- This enables them to make investigations as quickly as possible

Insurance Conditions that relate to a claim

- **Insurer's obligations**
- The insurer is required to deal with the claim by taking reasonable measures to minimize further losses e.g. remove vehicle from police station immediately deal with claim within reasonable time, dispose salvage to avoid deterioration in value, avoid auctioneers by paying judgments within the grace period etc
- Handle claims promptly and fairly
- Provide reasonable professional guidance to the policyholder when a claim arises
- Not to unreasonably reject a claim
- Settle claims promptly once settlement has been agreed.

Claims conditions

- **Express conditions**:

1. Actions by the insured
2. Reinstatement – optional method to pay claim
3. Average – in cases of underinsurance
4. Subrogation – before or after payment of claim
5. Contribution – two or more policies
6. Arbitration – for disputes in amounts to be paid

Claims conditions

- **Implied conditions:**
- Existence of **insurable interest** in the subject matter of insurance
- Utmost good faith- disclosure of all material facts
- Existence of subject matter of insurance

Claims procedures

- The actual procedure for handling claims varies with:
  - Class of business
  - Type of cover
  - Amount of estimated loss
- The steps of the claims handling procedure are however the same.

1.Claim notification

- This is the reporting of the claim by the insured to the insurer. It is a policy condition that all losses must be reported to the insurer
- Notification may be done either in writing or verbally
- Claim can be reported by:
- ➢ Telephone,
- ➢ fax,
- ➢ e-mail,
- ➢ text message,
- ➢ WhatsApp,
- ➢ visiting the insurer's offices

2. Completion of claim form

- After a claim is reported, a claim form is normally sent to the claimant for completion, and this will provide information regarding;

- The insured;
- place of loss;
- The nature of loss;
- The time of loss;
- A description of the property (if any)
- Its value at the time of loss
- Particulars of other insurances (other than life policies) covering the event for the insured’s interest.

Claim forms

- Claim forms enable the insurers to put together relevant information in a standard format.
- The insurers also use forms to gather the details relevant to assessing claims, including:
- Details of the insured;
- The property lost, damaged or destroyed;
- The party injured;
- Details of how the loss comes about.
- Purpose is to extract details/information of the loss from the insured,

Claim forms

- The answers given on the claim form are checked against the information given at the proposal stage, and any non-disclosure or misrepresentation often comes to light.
- The legal duty of disclosure requires full disclosure of the details of the loss event
- This allows the insurer to avoid liability if a breach of utmost good faith is established and is material to the loss.

3. Claims registration

- If te details of the claim form is acceptable, insurer opens a claim file.
- Claim is registered with details including: name and address of insured, claim number, policy number, period of insurance, sum insured or limit of liability, estimate of loss or claim reserve, other insurance policies if any.

4. Claims review

- This is the analysis of the claim
- Also referred to as claims assessment or investigation
- Information on the proposal form is analyzed against information from the claim form to confirm if the insurer is liable
- Action taken after this will depend on the size of claim, type of claim or circumstances of the claim
- The claim will be either be valid or invalid
- A claim may be declined or declared invalid at this stage

Claims review

- For large claim, insures appoint specialists to advise on:
- the cause of loss – ascertain policy liability
- extent of loss
- best method of indemnity
- Some specialists include loss adjusters, motor assessors, investigators

Claims review

Loss adjusters:

- investigate causes of loss
- Report on the circumstances of loss, protection and disposal of salvage
- Advise on the mitigation/reduction of further loss
- Advise on the procedures to be followed and actions to be taken and interpretation of policy wordings
- Negotiate the amount of the loss to be paid
- Check that policy conditions and warranties have been complied with
- Verify sums insured
- Collect evidence and advise on subrogation rights
- advise the insurer on policy liability
- Recommend the amounts payable
-

Claims review

- Motor assessors:
- Assess the extent of damage to motor vehicles
- Advise method of settling claim
- Check damage is consistent with insured’s statement
- Check if claim is exaggerated
- Can be independent specialists or employed by the company

Claims review

- Investigators:
- Mainly appointed for liability claims
- Investigate circumstances surrounding injuries or deaths to third parties
- Can be called as witnesses in courts
- Their reports can be used in court
- May rely on doctors to determine causes of death or extent of injuries

Claims review

- A claim may be invalid if:
- The peril causing the loss is not covered under the policy
- There is non compliance of policy conditions and warranties
- The insured caused the loss deliberately
- Insured colluded with others to cause the loss
- Insured did not suffer any loss
- Insured had no insurable interest in the subject matter of insurance

Claims review

- A claim is valid if:
- The peril is covered under the policy
- The insured has insurable interest in the property
- Policy conditions and warranties have been complied with

4. Claim review

- In motor vehicle damage claims, the insurer's own motor engineer or an independent one) will inspect the damage and agree terms with the garage personnel. The same process apple's to engineering claims.
- In other property cases, it is common practice for insurers to appoint a firm of loss adjusters to investigate the claim and make recommendations regarding payment.
- In liability claims, the insurers' own staff generally negotiates with the third party or their lawyers, unless the case is going to be contested in the courts, when the insurer will appoint a lawyer.

5.Claims settlement

- For minor claims, a cheque is normally sent to the claimant on receipt of the completed claim form and satisfactory proof of value or cost of repair.
- Once loss adjusters complete their investigations, they issue a report to insurers for settlement.
- Once settlement is agreed, the insurer sends a discharge voucher to insured for signing as agreement of amount to be paid and final discharge of liability
- Payment is then through Cash, repair or replacement or reinstatement

Claims settlement

Cash

- Easiest and most popular way of paying claims
- Straight forward payment to the insured – Cheques or transfer to bank account, mpesa
- Payment to another party with finanacial interest e.g. mortgagee
- Only mode of payment used to pay third parties in liability claim

or

Claims settlement

- Repair – used mainly in motor vehicles and engineering policies – machines, electronics
- Reinstatement- if there is a reinstatement clause under the policy – mostly fire policy -not used often as it is fraught with difficulties
- Replacement – new for old – household claims mainly. New motor vehicles

The amount payable

Property policies

- In property insurance the amount payable will be determined according to whether the policy is issued:
- On an indemnity basis;
- On a reinstatement basis;
- On a valued basis.
- It is important to note that insurance may not always settle the full amount payable under a claim due to inadequate arrangement of cover regarding:
- the sum insured being exhausted;
- An excess or franchise:
- A limit for example, 5% of the sum insured per article;
- The operation of average.

The amount payable

- **The meaning and effect of average**
- In insurance business, the word ‘average’ has two different meanings as used in relation to marine insurance on one hand and to other property insurance on the other hand.
- **(a) Marine insurance**
- Here the word ‘average’ means ‘partial loss’ and it is qualified by the word ‘particular’ or the word ‘general’

The amount payable

- ***1. Particular average.***
- This relates to partial loss affecting one particular interest for example, the hull or a particular consignment of cargo. The policy may exclude or be free of particular average' meaning that partial loss affecting the individual rather than all involved in the maritime venture, are excluded.
- ***2. General average.***
- It is possible that during a voyage, a ship gets into difficulties and a total loss looms. In an attempt to save the ship, it may be necessary to willfully incur a loss, for example, by jettisoning deck cargo. If such sacrifice is successful and the ship reaches port, all parties whose interests were at risk will share the loss (including the interest in the cargo jettisoned), such a loss is termed a general average sacrifice.

The amount payable

- **(b) Non-Marine Property Insurance**
- Here the word average means to share the loss and is used by insurers to combat the problem of under-insurance. If an average clause is inserted in a policy, the insured will become an insurer for the proportion under-insured, and share in contribution.

Common forms of average clauses includes;

- ***Pro rata conditions of average***
- This is applicable to almost all fire and theft policies.
- If a sum insured is low compared with the value at risk the insured will have contributed too little to the common pool i.e., sum insured x rate % instead of actual value x rate%. In order to correct this imbalance, policies subject to the prorate condition will only pay such proportion of the loss as the sum insured bears tot eh value at risk, i.e.,
- <u>Sum assured x loss</u>
- Value

Average

- Where the first loss insurances are arranged the sum insured cannot be used as it has been agreed that it will be substantially lower than the declared value at risk.
- But, to whatever degree the declared value at risk is a factor which the underwriter takes into account in fixing his rate and average is sometimes incorporated into these insurances on the basis of;
- <u>Declared total value x loss</u>
- Actual total value
- (Subject to the limits of the first loss sum insured)

Average

- **The special conditions of average**
- A 75% condition of average is applied to agricultural produce at farms.
- In this case the insured will only share in the loss if the sum insured is less than the stated percentage, i.e., 75% of the value as insured at this time of the loss. If average does apply it is the pro rata condition mentioned above which applies.

Average

- **The two conditions of average**
- This clause is applicable to fire insurance covering stock in certain warehouses. It would be applied to an insurance covering stock in several situations or of several types when there was a possibility that other polices might be in force covering more limited situations or more limited types of stock.
- The second condition states that the wider ranged policy does not insure what is more specifically insured by the narrower ranged ones and for the application of pro rata average as stated above the value at risk is construed accordingly.

Average

Reinstatement Average

- Where a property policy is subject to reinstatement condition (but not to any other inflation clauses) a special form of average applies.
- Reinstatement average applies where the sum insured is less than 85% of the reinstatement value at the time of loss,

The amount payable – liability policies

- For liability insurance claims, the amount payable is discussed between the insurer and the third party. The insurer takes over all the negotiations and the settlement will reflect the level of damages awarded in similar cases which have gone to court.
- The vast majority is, however, settled out of court and will reflect compensation or loss of earnings, suffering and future disability.
- In the case of negligence on both sides, the amount payable will be allocated in proportion to the share of contributory negligence.
- In some cases, the insurer will pay interest on the insured’s proportion of blame, and in most cases will also pay the total legal costs.

The amount payable

C4. The amount payable – life and personal accident policies

- In these policies, the capital sums, that is, for death, loss of limbs or eyes, are so specified in the policy and on receipt of proof of the event having taken place, the insurer proceeds to pay the appropriate amount where there are weekly benefits payable for temporary disability or total disablement the duty is on the insured to prove that:
- He or she is temporary or totally disabled as defined in the policy;
- The disablement is due to an event insured against.
- Medical evidence is usually required to substantiate the claim and the extent of such disablement.

Ex-gratia payments

- These are payments made out of grace or kindness and not out of any legal obligation under contract.
- In certain cases, policyholders have no legal right to a claim payment because the event causing loss or the property damaged or lost are outside of the scope of the policy.
- The insurer can make an ex-gratia payment or part payment due to various considerations namely:
  - That there was a genuine oversight at some level in the insurance arrangement;
  - That a hardship would be created;

Ex gratia payments

- That the decision on liability is a border-line one;
- The case involves a valued client or broker;
- To keep the good name of the company.
- It is however; important for insurers to make such payment sparingly as the insurer is in a sense a trustee of the common pool used paying claims covered by the policy.

To whom claims are payable

- Most claims are settled by payment to the insured except in liability claims where payment is made to the third party and lawyers. In rate circumstances the insurers may exercise their option to repair or replace as provided in the doctrine of indemnity.
- if payment is not made to the insured, it may be made to;
  - His legal representatives for example, in death claims, or when a person is a minor, or bankrupt or of unsound mind;
  - Any person to whom the insured has assigned the proceeds of the policy for example, the building form in the case of building repairs;
  - Another party by order of the court, by a garnishee order;
  - A purchaser of a building under the Purchaser's Interest Clause of the Standard Fire Policy.

Payment by mistake

Payment by mistake may not be recovered where:

- The payment was ex-gratia;
- A compromise payment was negotiated with the insured;
- The insured had waived their rights of enquiry before payment;
- Payment was made under compulsion of legal process;
- There was a mistake of law.

Claims Recoveries

- Insurer is able to recover part of the claims paid from:
  - The insured through excess imposed on the policy
  - Pursuing subrogation rights
  - Reinsurers
  - Other insurers for coinsurance arrangements

REINSTATEMENT OF THE SUM INSURED OR LIMIT AFTER LOSS

- In relation to the sum insured, reinstatement refers to cases where partial losses have been paid and the amount of the loss deducted from the sum insured. Reinstatement of the sum insured does not apply in life assurance or personal accident policies. It is applied in the following cases under certain circumstances.

- **Fire insurance.**

- The sum insured is reduced by the amount of any claim and must be increased, if need be, and a pro rata premium paid. Where small losses are involved insurers often reinstate the sum insured free of charges.

REINSTATEMENT OF THE SUM INSURED OR LIMIT AFTER LOSS

- **Non-fire property insurance**

Here the sum insured is reduced by the amount of any loss and must be reinstated. This, however, does not apply to glass policies or to money policies where there is no sum insured.

- **Liability insurance**

The limit of indemnity would only be reinstated where these was an aggregate limit, say, Ksh.5, 000, 000 any one year of insurance. In that kind of insurance cover, each loss payment would be deducted from the aggregate limit and the insured may well have to consider additional cover.

REINSTATEMENT OF THE SUM INSURED OR LIMIT AFTER LOSS

- **Marine insurance**
- Under a marine policy partial loss payments are not deducted from sums insured and, therefore, several independent sums can be paid, that in aggregate, may even exceed the sum insured.
- Where there has been unrepaired damage and the total loss, all within the same period of insurance, the insured will only receive the total loss payment on the other hand, where the total loss precede unrepaired damage but occurs in a subsequent period of insurance the insured is entitled to both the total loss of the agreed value and the reasonable cost that would be incurred in relation to unrepaired damage.

REINSTATEMENT OF THE SUM INSURED OR LIMIT AFTER LOSS

- **Pecuniary insurance**
- No reinstatement of sum insured is possible in the case of fidelity guarantee insurance but in business interruption insurance the sum insured must be reinstated.

CLAIMS AGREEMENTS

- For all practical purposes, the insured has a right of recovery under his policy and also from a third party by way of;
- Tort,
- Statute;
- Custom of trade
- Contract.

- The insured will usually intimate the claim to his company and subrogate to them his rights against the third party. Alternatively he may recover from the third party and so be denied his claim against the insurer because of the doctrine of indemnity. The insured may also be covered against the risk by more than one company, i.e., there may be contribution among the insurers towards the cover.
- In order to simplify and speed up the settlement of claims without having to resort to the courts for decisions, various agreements have been made amongst insurers as to how such incidents will be apportioned or shared between them, without regard to their legal position.
- The agreement also helps to keep down the level of premiums in the long run.
- The agreement is between insurers and should, however, not prejudice the interest of their respective insured.

Market agreement in claims

Examples of such agreements include;

- The knock-for-knock agreement in regard to vehicle damage repairs whereby each insurer pays his own vehicles repair costs;
- Third party sharing agreements for personal injuries in motor and employers liability claims;
- Apportionment, or non-apportionment, as the case may be, in fire losses.
- These agreements may not always be strictly followed in the insurance market place and it is not unknown for some insured's to have disregarded and/or complained about their rationale.
- Their continued use and application is a matter of discretion and commitment on the part of the players.

Claim Disputes

- Disputes between the insurer and the insured regarding claims are inevitable. Such disputes may be in relation to:
- The question of whether or not the insurer is liable;
- If so, how much that liability is.
- Disputes are around liability and quantum – amount to be paid

Claim disputes

- There are various ways of solving such disputes;
- The claimant should be seen by a claims official or the independent loss adjuster and in the cases, the matter can be negotiated or explained to the reasonable satisfaction of both parties;
- **1.Litigation** -The insured may sue the insurer in the courts where decision will be made. This action, however, should be a last resort.
- Disadvantages include that it is slow, costly, bad publicity, limited expert or technical knowledge of insurance or area of commerce insured
- **2.Arbitration** – most property policies also contain an arbitration condition which restricts the insurer's basic right to go to law on a dispute regarding amount, where liability has been admitted. Such a case may be heard by an independent arbitrator whose judgment is legally binding to both parties.

Claims Disputes

- The process of arbitration is guided by appropriate legislation regarding the matter. Such legislation also allows the parties to agree on the person to act as arbitrator or, if they cannot agree, for the courts to appoint a suitable person.
- Insurers have deemed arbitration desirable on the following grounds;
- **Speedier than court action**;

Court actions may take several months before a decision is made, whereas arbitration hearings can take place within a few weeks;

Claim disputes

- Insurers have deemed arbitration desirable on the following grounds;
- **Expert judgment;**

A judge is unlikely to be an expert in the area about amount or value, whereas an arbitrator agreed upon is most likely to be an expert in the valuation of the type of property involved, and so a fairer judgment is likely;

- **Heard in private**;
- The hearing will be in private rather than open court and so the insurer is less likely to receive bad publicity in the press;

Possibly less costly;

- The process may be less costly than a court process though the difference is minimal as counsel will often be employed.

Claims Disputes

- **3. Mediation and conciliation**. – third party appointed t assist in reaching an agreement- facilitates process of coming to a compromise using their negotiation skills. Advice given is not binding to parties.
- **4. Commissioner of insurance** – for disputes relating to life assurance claims not exceeding 100,000/-. Decisions are legally binding. Plays a conciliatory role.

Fraud in claims

- Fraud is attempting to get services or payment by dishonest means.
- Fraudulent actions can be through:
- ➢ False statement of a material fact with intent to deceive the insurer, untrue facts which lead to a loss,
- ➢ Falsification and alteration of documents and records including police documents
- ➢ Exaggeration of loss
- ➢ Issuance of fake documents e.g. certificates

Fraud in claims

- Insurers have the recourse to cancel the policy if fraud is proved
- They can also sue the insured – litigation
- Fraud costs the insurance industry a lot of money and IRA supports all efforts to combat fraud including setting up the IFU – Investigative Fraud investigative unit to prosecute persons perpetuating fraudulent activities

DIP 102

REINSURANCE

COLLEGE OF INSURANCE
NAIROBI
PROFESSIONAL EXCELLENCE

Reinsurance

- The main reason why the insuring public seek insurance is primarily the desire for financial security - that is, in the event of the occurrence of a risk the insured's do not suffer loss and the insurer will make good the loss.
- The insurance market, therefore, exists to take upon itself the risks of the insuring public.
- Insurers charge premiums and invest the money wisely so that all losses can be paid. Shareholders in public insurance companies buy shares in the hope of earning some dividend thus increasing their wealth. These dividends can only be realized if the company is making profits.

Reinsurance

- The insurers are, therefore in business to make this profit and provide a return for their shareholders by assuming the risks of others.
- One way Insurance companies seek financial security is to transfer or insure part or the whole risk they accept to another company – a reinsurance company.
- The practice of insuring risks again is termed as **reinsurance.**
- The company that provides the reinsurance facility to the insurance companies is known as the reinsurer.
- The reinsurer and the insurer enter into a reinsurance agreement which details the conditions upon which the reinsurer would pay the insurer's losses in exchange for payment of reinsurance premium by the insurer.

The purpose of Reinsurance

- Reinsurance has various purposes/benefits including:

➢ Risk spreading;

➢ Capacity boosting;

➢ Stabilization

➢ Security;

➢ Protection against catastrophe;

➢ Financial strengthening;

➢ Creating confidence.

Risk spreading

- Insurance is a mechanism by which the impact of losses is spread. Reinsurance also serves this purpose – it is a mechanism by which direct insurers can spread their losses. The direct insurer may not want a concentration of liability in any one type of business, any one class of risk, any one geographical area, or in any other classification.
- Thus reinsurance continues the basic principle by spreading the risk over an even wider field – nationally, geographically and even internationally.
- The wider geographical spread helps in recovery after a major loss.

Capacity boosting

- The capacity of an insurer is the amount of insurance business it can accept. By reinsuring part of certain risks, insurance companies can be able to accept more of the original risks. For example, a particular insurer may not want to provide a cover in which the sum insured is in excess of, say, Ksh.5,000,000/-.

If such an insurer receives a proposal where the sum insured is, say,Ksh.6,000,000 they could accept the whole Ksh.6,000,000 with the knowledge that reinsurance exists for the Ksh.1,000,000/- not retained by themselves.

- This will result to growth/increased capacity within the insurance market as a whole and added prestige to the individual insurer.

It is worth noting, however, that increase in capacity can sometimes cause problems:

Capacity boosting

- In the event of 'over capacity' in the market whereby there are more insurers and reinsurers chasing the same number of risks. This will result in supply exceeding demand hence a fall in prices.
- On the same note, while the premiums may fall, to the advantage of the insured companies, the cost of claims does not fall.

The result can be very poor loss ratios as the same value is paid for claims yet a lower amount of money have been received in premium.

Increased capacity enables:

1. An insurer to accept larger risks than would have been possible without reinsurance
2. Underwrite types of business which would normally be avoided by insurer

Stabilization

Both the insured and the direct insurer do not know when a claim will occur or what it will cost.

- The insurance company, however, has a greater experience of handling losses, and can use statistical techniques to predict losses and their costs, although there is still a high degree of uncertainty.
- Reinsurance assists the direct insurers to stabilize their loss level by removing some of the uncertainty. For example, an insurer who has issued a products liability policy with an indemnity limit for any one occurrence of Ksh.8, 500, 000 may agree with a reinsurance company or companies that they (direct insurer) will pay the first Ksh.1, 000, 000 of each claim, leaving the reinsurer(s) to settle the balance.
- This enables the insurance company to reduce chances of fluctuation in claims costs and the company can now prepare more accurate budgets and reserves based on a more certain claims expenditure estimate.
- This arrangement is referred to as stabilization or smoothing of losses.

Stabilization

- The individual insured too have no idea what his loss will be nor does he know how often a loss may occur. Instead of having fluctuation from year to year, the insured agrees on a definite annual loss and pays the premium.
- The premium reduces the loss from year to year and removes any element of uncertainty.
- Reinsurance protects the insurer from the effect of large losses which could be financially crippling.

Security

- ➢ Security is the ability to pay claims and the reinsurer provides this by:
- Guaranteeing liquidity in the event of a loss
- Protecting the insured against sudden fluctuations in the cost of cover
- Protecting the shareholders of the insurance company against a serious reduction or even total loss of their capital
- It protects the insurance fund as the original insurer and by extension, and it provides additional security not only to the original insurer but also for the original policy holders.

Protection against Catastrophe

- Reinsurance acts as a cushion to protect insurers from the possible eventuality of occurrence of losses of catastrophic proportions which may arise from:
- **Accumulation of risk**
- An underwriter may find that, despite efforts to spread the risks, they end up with risks which are very close to one another, for example, a single large fire in a shopping mall could produce claims of several different policies;
- Alternatively, a train clash could result in a large number of individual insureds being killed or injured in one event.
- The linking of different insurance products may also generate a number of claims under different policies for example, in a fire; there is material damage and business interruption insurances.
- **Exposure to catastrophe perils**
- Some risks can be widespread in their effects, for example, storm, floods, earthquake, riot and civic commotion.

Many individual losses can be generated from one event.

Confidence

- One of the basic merits of insurance is to give confidence to policyholders. By removal of a large number of uncertainties, a manufacturer of goods may be willing to invest more money in the business. The existence of reinsurance gives the direct insurer exactly the same confidence and encourages expansion of its business.
- A good example is found where the direct insurer wishes to offer insurance in an area which it had no previous dealings. With limited experience in the new area, the insurer may rather be hesitant. The availability of reinsurance does, however, remove many of the uncertainties and should make the insurer a little more confident.

- If the direct office was considering offering professional indemnity insurance for the first time, it may not want to encounter a claims ratio greater than 80%, i.e., when claims paid are compared with premiums received, the result should not be greater than eighty percent (80%).
- The insurer may agree with a reinsurer or reinsurers, that if the ratio goes beyond eighty percent (80%) the reinsurers would pay the balance or part of it.
- This gives the insurer confidence to underwrite the class of business.

Financial strengthening

- Reinsurers give financial viability and strength by:
- Protecting insurer's balance sheet and its profit and loss account
- Protecting the image and reputation of the insurer by enhancing its ability to pay claims
- Protects the market share of the insurer by giving it capacity to underwrite business for growth and pay claims on time
- Protecting the insurer's share prices

Reinsurance Terminology

There is need to comprehend some of the terms commonly used in the study of reinsurance

Cede: The passing of insurance business from an insurer to a reinsurer.

Cedant : The direct insurer that passes part of its business to a reinsurer.

Cession: The actual amount of business passed by the insurer to a reinsurer.

Retention: Is the amount of risk which an insurer retains for his own account so that is the event of loss, the net loss will not exceed the company's limit for that class of risks also referred to as 'line'.

Limit: The maximum amount of money which an insurer is prepared to lose on an average risk of a particular class of insurance.

Sometimes, the term 'retention limits' is used to refer to a retention where the Estimated Maximum Loss (EML) is (one hundred percent) 100%

Line: An amount of risk which an insurer keeps for its own account which is the maximum net loss that can be sustained on that risk by the cedant.

Reinsured: A company that accepts insurance risks underwritten by a direct insurer.

Reinsurer: A company that accepts insurance risks underwritten by a direct insurer.

Retrocession: A second reinsurance i.e., where the reinsurer, decides, after having accepted a cession, to arrange a further reinsurance on its part of the risk.

Retention

- The insurer decides on a retention limit before transferring part or whole of risk to a reinsurer.
- This is their limit of liability on their own account and it is expressed in monetary terms.
- Retentions apply to:
  - ➢ a single risk or series of risks
  - ➢ A single loss or a series of losses

Retention

- Deciding retention limits is an important matter as retaining too much may weaken the insurer's financial strength and weaken its asset base while retaining too little may mean giving away premiums unnecessarily and running at less than optimum position.

Retention

- Factors which influence the choice of retention include:

➢ Asset, capital, free reserves and solvency

➢ Size and nature of portfolio, premium income and profitability

➢ Types of risks and pattern of losses

➢ Reinsurance type and cost

➢ The Market environment

➢ The type of reinsurance

Types of Reinsurance

There are two main types of reinsurance

1. Treaty reinsurance
2. Facultative reinsurance

3. Treaty reinsurance

- A treaty is a formal, legally binding agreement.
- The agreement is made between the ceding office (the insurer) and the reinsurer(s), that the insurer will cede and the reinsurer(s) will automatically accept all the cessions which are offered within the terms of the treaty

Treaty Reinsurance

- **Such terms of the treaty may include:**
  - The type of risk acceptable;
  - The geographical area in which risks are located;
  - The size of risks;
  - The amount of risk which is acceptable;
  - The time period in which the treaty will operate.

Treaty Reinsurance

There are two types of treaty arrangements

1. Open treaty;

- An open treaty is one in which the ceding insurer provides the reinsurer a list containing details of all the risks ceded to the treat, including the name of the insured, sum insured, premium rate, ceding insurers retention, etc.
- This list is known as a **bordereaux**.
- This type of treaty is however, rarely used.

Treaty Reinsurance

2. Blind treaty

- In a **blind treaty**, only accounting details concerning shares of premium and losses due by each party are reflected.
- It is the most popular treaty
- The reinsurer does not see what they are reinsuring.
- They only know that, it is not a type of risk which is included by the treaty and that their share is within any minimum and maximum limits laid down by the terms of the treaty.
- Since this method is automatic and does not provide for negotiations once in force, it is prudent for the reinsurers to be cautious when doing business and only enter into the agreement when they are fully satisfied as to the standing of the insurance company and its underwriting records.
- The reinsurer has the right to examine the direct offices records on any claim or risk.

Treaty reinsurance

- The main advantage of the treaty method is that the ceding office can give immediate cover to the public, knowing that they have reinsurance cover form the moment the agreement is made.

2. Facultative Reinsurance

- This is the oldest form of reinsurance.
- In this method, each risk is reinsured separately and each party is free to decide whether to reinsure or not and whether to accept the reinsurance or not.
- The reinsurer is also free to choose how much of the risk to insure and what premium commission rate to charge.
- **It is commonly used where:**

➢ The treaty capacity has been filled and insurer requires more capacity ;

➢ The risk is outside the terms of the treaty;

➢ Unusual risks/ hazardous risks and insurer lacks experience on potential of the risk

➢ Where insurer does not want to cede the risk to its treat so as not to affect treat rating

➢ Due to unique commercial, financial or strategic reasons

Facultative Reinsurance

- The ceding office is obligated to make full disclosure of all material facts relating to the risk including:
- ➢ The class of business;
- ➢ The ceding company's net retention;
- ➢ The rate of premium;
- ➢ The period of insurance;
- ➢ The percentage to be reinsured;
- ➢ The location of the risks;
- ➢ Copies of plan or survey report of the risk and all other relevant details.

Facultative Reinsurance

Disadvantages:

- It is relatively expensive because of accruing administrative costs;
- The risks offered are likely to be heavier by way of extra hazards and may be of higher value;
- Immediate decisions concerning facultative cover cannot be made. For this reason, the ceding office cannot provide immediate cover to the insuring public.

Facultative Reinsurance

Advantages:

- A major advantage of a facultative cover is that the ceding office can choose those risks which require protection, thereby, keeping the maximum amount of the original premium.
- Does not cause treaty to become unbalanced
- Appropriate to protect hazardous risks
- Best for unusual risks
- Loss experience will not affect treaties which can remain protected
- Used to cover large risks exceeding treaty capacity

Other types of Reinsurance

Pools

Pools are in most cases arranged for exceptionally hazardous risks.

- When using this method, the cedant will reinsure (one hundred percent) 100% into the pool and does not retain any of the risks accepted in the direct market.
- Each member of the pool accepts a prearranged percentage of the business and share in the losses and profits in these proportions.

Pools are commonly used in such risks as:

- Nuclear energy;
- Certain aviation risks;
- Life assurance;
- Coronary cases.

- The use of pools has enabled the provision of cover for risks which would otherwise be uninsurable, or only accepted for very low sums insured.

Other types of Reinsurance

Reciprocity

- This is the method of mutual exchange of insurance or reinsurance business between different underwriters.
- Insurers with similar accounts in different territories may exchange a portion of each other's business by reinsuring one another.
- The hope is that a good result in one territory will offset a poor result in another territory, and that poor results will not coincide in both territories simultaneously.

Methods Reinsurance

- There are a number of different types of reinsurance cover available to suit the different needs and requirements in insurance business.
- Within the two main types of reinsurance (Treaty and facultative reinsurance) there are two broad methods;

➢ Proportional reinsurance covers – Surplus, Quota share and Facultative obligatory;

➢ Non proportional reinsurance covers – Excess of loss(risk excess of loss, event excess of loss, catastrophe excess of loss) and stop loss.

Proportional Reinsurance

- Under proportional reinsurances, the amount retained and the amount ceded represent certain proportions of the cover accepted by the ceding office and the premium received by the ceding office will be shared in these same proportions.
- The whole risk is split in some proportions between the ceding office and the reinsurer and in the event of a loss; both the cedant and the reinsurer will be called upon to share the claim.

Proportional reinsurances are further subdivided into:

- Quota share treaty,
- Surplus treaty,

Reinsurance

- Proportional
  - Quota share
  - Surplus
- Non-proportional
  - Stop Loss
  - Excess of loss

The quota share treaty

- Under this form of proportional reinsurance, the ceding office must reinsure such proportion of every risk as stated in the treaty.
- The cedant cannot retain all of any risk no matter how small the sum insured.
- With surplus treaty business, the direct underwriter may be tempted to accepted poorer class of business and keep a low retention and or keep very high retentions on good risks. This would be to the disadvantage of the reinsurers especially when there are a large number of lines in the treaty.
- Under quota share, the freedom of choice in business/risk to both the cedant and the reinsurer(s) is removed and reinsurer gets an equitable share of good and bad risks.

Quota share treaties are commonly used where:

- A company has not been in a particular business for a long time and hence its underwriting experience is unknown and yet it requires substantial reinsurance protection;
- A company's surplus treaty claims experience has been poor and quota share is the only form of reinsurance cover available to it;
- It is preferred as a means of saving costs by way of earning higher commission rates than on surplus treaties and cutting the administrative time on making retention decisions.
- Both surplus and quota share treaties are blind treaties and the reinsurers are unaware of the individual risks being insured.

The ceding office prepares periodic accounts showing the proportion of premium due to the reinsurers and the proportion of claims due from them

The Quota share treaty

- Advantages

➢ All losses are covered irrespective of size

➢ Simple to administer

➢ More balance premium

➢ Popular for new or small companies trying to secure market share without high exposure

The Surplus treaty

- The ceding office has a treaty arrangement whereby reinsurers will accept any surplus risk over the retention of the ceding office.
- The ceding office will have advised potential reinsurers of its pattern of acceptance limits so that when a risk is proposed the ceding office has a free choice, within the specified limits of how much it will retain on its own account.
- The reinsurers are compelled to accept up to the number of lines (the way in which the capacity of any proportional reinsurance is managed) specified in the treaty if reinsurance is desired.
- Surplus treaties are expressed as a number of lines, for example, a five line treaty or an eight line treaty, etc.

- In order to increase its underwriting capacity, the ceding office may at times enter into a **second surplus treaty** with another group of reinsurers who will write a certain number of lines in addition to those written under the first surplus treaty.
- It should be noted that the second surplus treaty will not become involved in a risk until the ceding office has fully committed the first surplus treaty.
- A surplus treaty (or contract) is usually arranged in advance to give the ceding office the facility to automatically reinsure any risk that is desired, and cannot be arranged in order to accommodate a particular proposal being offered. Similarly, if a company has only one surplus treaty, it cannot arrange a second surplus because the first surplus is full in relation to a particular risk.

- If a ceding office cannot accept a whole risk because of lack of treaty facility, it must adopt other measures to correct the situation, such as:
  - Limiting the direct acceptance;
  - Arranging facultative cover for the balance, or;
  - Arranging co-insurance in the direct market for the balance.
- Reinsurers are prepared to carry five or eight (or the specified number) of times of the retained amount.
- If a direct insurer had a five-line treaty, they could accept business from the public up to six times their retentions that is, keep their retention one line) and cede five lines to the reinsurers for example, a fire-line surplus treaty cedant whose retention sis Ksh.200, 000 could, therefore, accept business of Ksh.1.2 m of any risk knowing that it would retain its own account of Ksh.200, 000 and reinsure five times that amount. i

Surplus treaty

Example:

Direct office Ksh. 4 million = 1 line

Reinsurer(s) Ksh. 20 million = 5 lines

Evidently, the reinsurers have in effect taken $^5/_6$ of the risks and agreed to pay $^5/_6$ of any claim. For instance, should there be a claim of Ksh. 2.4 million; the final settlement would be as follows:

Direct office $^1/_6$ x Ksh.2, 400, 000 = Ksh.400, 000

Reinsurer(s) $^5/_6$ x Ksh.2, 400, 000 = Ksh.2, 000, 000

- More than one reinsurer may be involved in the arrangement. Nevertheless there is no relationship between the number of lines and the number of reinsurers involved

Surplus treaty

For example in the same claim of Ksh.2, 400, 000 insurers, A, B, C, D may accept 50%, 20%, 15% and 15% respectively of the total amount ceded. The resultant split up of the amount ceded and the claim would be as follows:

	Split of account ceded	**Split of claim**
Reinsurer A	Ksh.10, 000,000(50%)	Ksh.1, 000, 000(50%)
Reinsurer B	Ksh.4, 000, 000(20%)	Ksh.400, 000(20%)
Reinsurer C	Ksh.3, 000, 000(15%)	Ksh.300, 000(15%)
Reinsurer D	Ksh.3, 000, 000(15%)	Ksh.300, 000(15%)
	Ksh. 20 million	**Ksh. 2 million**

- The four reinsurers A, B, C, and D would pay 100% of the 5/6ths of the claim amounting to the total of Ksh.2, 000, 000 leaving the direct insurer to pay the remaining 1/6th, i.e., Ksh.400, 000.

Surplus treaty

- **Advantages** of surplus treaty
  - Offers larger capacity
  - Allows cedants other proportional facilities that require smaller limits
  - Attracts higher commission
  - Allows cedants to vary its retention upon a particular risk
- **Disadvantages** of surplus treaty
  - More unbalanced and therefore difficult to place
  - Difficult to administer
  - Volatile results because of the imbalances

Non-proportional Reinsurance

- In non-proportional covers, the ceding office and the reinsurers do not share each loss in fixed proportions - In fact, they do not share some losses at all.
- The ceding office will underwrite its retention as a form of first loss insurance, that is, **it will bear all losses up to a certain figure**, and the reinsurers will deal with the balance of any loss above this figure which is usually an upper limit.
- The main forms of non-proportional reinsurance covers are:
  - Excess of loss;
  - Excess of loss ratio/stop loss.

Excess of loss Reinsurance

- This is a form of reinsurance in which the reinsurer only becomes involved if a claim exceeds the amount of loss retained by the ceding office.
- The reinsurers only step in and pay the balance when the cedant's retention, in any one loss, is exceeded.

For example, an excess of loss treaty could be arranged to cover Ksh.900, 000 in excess of Ksh.100, 000 arising out of any one event.

For a variety of losses the results would be as follows:

Loss amount	Direct office pays	Reinsurance(s) pay
Ksh. 75, 000	Ksh. 75, 000	Nil
Ksh. 500, 000	Ksh. 100, 000	Ksh. 400, 000
Ksh. 1,200, 000	Ksh. 100, 000	Ksh. 900, 000

As clearly illustrated, a problem arises with the last claim in that there is still an amount of Ksh.200, 000 left even after the reinsurer has contributed in the loss.

This amount would have to be paid by the ceding office hence increasing their payment to Ksh.300, 000 in circumstances where they did not want to pay more than Ksh.100, 000.

When a ceding office anticipates losses in excess of the reinsurance facility that it has arranged it can negotiate a **second excess of loss treaty.**

Excess of loss Reinsurance

It is common for insurers to have three or four excess of loss treaties. Using the same case scenario, such an arrangement would be illustrated as follows:

Fourth excess of loss Ksh. 1.5 million in excess of Ksh. 3.5 million

Third excess of loss Ksh. 1.5 million in excess of Ksh. 2 million

Second excess of lossKsh. 1 million in excess of Ksh. 1 million

First excess of loss Ksh. 900, 000 in excess of Ksh. 100,000

Direct office retention the first Ksh.100, 000+

Excess of loss Reinsurance

- In this example, the cedant has arranged excess of loss protection up to the amount of Ksh.5 million.
- Each progressive layer of excess of loss cover becomes less expensive as losses of higher severity are more unlikely.
- The evidence to this fact is seen in the use of the term **working layer** which is normally applied to the cedant's retention and the first excess of loss treaty.
- Other treaties are known as **catastrophe layers**

Excess of Loss Reinsurance

- **Advantages**:
  - Simplest of all to administer
  - It enables insurer to maximise retained premium –retain all the profitable business
  - It is ideal for protection from accumulation of losses
  - Has high profit margins

Excess of loss Reinsurance

- **Disadvantages:**
  - Volatile if claims experience is unsatisfactory
  - No commissions
  - Premium is payable in advance
  - Limitations of reinstatement so cover can be exhausted
  - Rates do not follow original terms
  - Insurer may have larger retention than the ideal

Catastrophe covers

- Even in circumstances where the direct office has arranged proportional and/ or excess of loss reinsurance, it could still be possible that the insurer suffers from an unexpected large loss due to the accumulation of losses from more than one insured arising out of the one event e.g. it is possible for hundreds of losses to fall on one company arising out of widespread storm or earthquake.
- The proportional and/or excess of loss reinsurance will have catered for claims stemming from individual insured's and which exceeded the cedant's retentions.
- The aggregate of all amounts retained by the ceding office could be greater than it would be financially sound to retain. The catastrophe cover would share some of the aggregate net liability, falling to be paid by the ceding office, with the reinsurance market.

Excess of loss ration/stop loss

- This form of reinsurance is different from the rest in that it does not deal with individual risks or individual events.
- It is designed to prevent wide fluctuations of the net claims ratio of a particular account over one financial year compared with another.

- As an example, if the average ratio of net claims to premium income in a company's theft account was sixty percent (60%), over a period of years compared with the average ratio of net claims, the underwriter might wish to prevent the ratio going much above seventy percent (70%) annually and would arrange reinsurance accordingly.
- Correspondingly, it is normal practice to require the primary underwriter to bear a share, say ten percent (10%) of any layer of reinsurance.
- If the underwriter arranged on stop loss cover for ninety percent (90%) while bearing the balance of ten percent (10%) of any excess of claims ratio above seventy percent (70%) up to one hundred percent (100%), then in the event of net claims on that class of insurance amounting to Ksh.10, 500, 000 compared with net premium income of 10, 000, 000, the result will be as follows:

Ceding office			**Reinsurer**
1st Ksh.7, 000, 000	70%	Ksh.7, 000, 000	Nil
Next Ksh.3, 000, 000	30%	Ksh.300, 000 (10%)	Ksh.2, 700, 000(90%)
Next Ksh.500, 000	5%	Ksh.500, 000	Nil
	105%	Ksh.7, 800, 000	

The purchase of the stop loss reinsurance has the effect of reducing the net claims ratio from 105% to 78% of premiums. It is the general expectation however, that reinsurers would only be called upon to pay on rare occasions, and that there would be never be a balance of loss above the level of the stop loss cover, evidently, claims ratios vary from year to year, hence, there would always be a margin between the average ration (60% in this case) and the start of the reinsurance layer 70% in this case). The reinsurance is meant to protect the company from any abnormal experience and not just the normal year to year fluctuations.

Underwriting considerations

For proportional treaties

- Retention of the reinsured/cedant
- Scope of the treaty i.e. classes of business involves, perils covered and territorial scope
- Required capacity of the treaty
- Commission – flat commission, sliding scale and profit commission
- Financial issues concerning settlement of accounts, cash calls, deposits and portfolio transfer
- Basis of treaty – accounting year basis or underwriting year basis

Underwriting considerations

- **For Non proportional treaties:**
  - Retention of the reinsured/cedant
  - Scope of the contract- classes covered, exclusions, definition of loss occurrence and reinstatements
  - Basis of cover
  - Prior Reinsurances

In summary

- Note that surplus, quota share and excess of loss reinsurances are designed to protect the ceding office form claims arising from the individual insured risks.
- Catastrophe covers, on the other hand, relate to the accumulation of net retentions from an individual event affecting many insured's, while excess of loss ratio relates to the entire account for a class of business over the financial year.

Reinsurance Premiums

- The calculations of premiums differ for proportional and non-proportional covers.
- This is because in the proportional insurance the reinsurers already know what proportion of each claim they will bear, while in the non-proportional covers, this is only known after the loss has occurred.

Proportional Reinsurance premiums

- The reinsurers will receive a premium based on the same proportions in which they shared the risk, and will share claims with the direct office.
- In order to mitigate against costs incurred by the direct office in processing the business, such as, survey costs, advertisement, administrative charges and commission to the broker/agent, the reinsured pays a commission to direct office, usually in excess of the commission paid to the broker/agent by the direct office.

Proportional Reinsurance premiums

- There can also be a profit commission where the reinsurer contract states that additional commission will be paid to the direct office if the treaty is more profitable than the specified amount.
- Sometimes, direct insurers can use reinsurance brokers in arranging their reinsurance protection. The reinsurance broker acts as an intermediary between the ceding office and the reinsurer. The broker receives payment from the reinsurer by way of brokerage which is calculated as a fixed percentage of the premiums ceded.

Non-proportional Reinsurance premiums

- Calculation of premiums for excess of loss ratio and excess of loss is rather tedious since the reinsurer is not accepting a fixed proportion of risk where it is possible to base a premium on that proportion.
- In non-proportional covers, the actual involvement of the reinsurers is only known after the losses have occurred.
- To overcome this problem, a method of rating non-proportional premiums known are **burning cost** is commonly used.
- Under this method, the reinsurer looks back over a number of years and expresses the amount of any payment it would have made in each year as a percentage of the ceding offices premium income.

Application of Reinsurance

- It is not possible to state with absolute certainty what forms of reinsurance are best suited for particular classes of direct insurance business.
- As discussed earlier, proportional reinsurances depend upon accepting a proportion of risk, paying claims in the same proportion of the direct insurer's premium. This is only possible where the extent of the risk is known before hand, as in property insurances
- In the case of liability business, however, there is no reasonably foreseeable limit to the amount which may be paid and for such forms of direct insurance the non-proportional reinsurances are more appropriate.

Property insurance

- In property insurance, **proportional** forms of reinsurance are preferred as in most cases; there is a fixed sum insured upon which a proportion can be calculated.
- **Surplus** and **quota share treaties** are commonly used in the property market with **facultative** cover catering for risks excepted by the treaty reinsurers or for catastrophe cover.
- **Excess of loss** reinsurance is also widely being used in the property field.
- These forms of reinsurance are also available in case where several direct insurers share a risk as co-insurers on a collective policy.

Liability insurance

- **Excess of loss** reinsurance is used almost exclusively by liability insurers as it relies on the value of claims instead of a proportion of the risk.
- It can also be used to the liability sections of other policies, for example, motor.

Marine and aviation

- Marine and aviation risks are actually a combination of property and liability insurances, hence, direct insurers must arrange reinsurances to suit such perils.
- **Facultative** reinsurance is commonly used in the marine market as well as **quota share and excess of loss reinsurance.**
- The **catastrophe aspect** of marine and aviation risks may be catered for and the **pooling** method of reinsurance used.

Life and personal accident

- The reinsurance arrangement for life and personal accident contracts are correspondingly different from those in non-life field(Benefit vs Indemnity policies)
- For ordinary life risks, **reassurance** may be arranged on a facultative or treaty basis.
- The difference between reassurance and reinsurance lies in the basis upon which reassurance is provided.
- There are two options which are available:
  - Original terms
  - Risk premium basis

Life and personal accident

- **Original terms**
- The reinsurer divides the total premium and sum assured in a given proportion, with the reassurer following all the terms and conditions of the ceding office's policy hence the term original terms.
- The reinsurance of a proportion of the original sum assured can be accepted on whatever terms are agreed by the two parties.
- Commonly used for term assurance where reinsurer is liable for a proportion of the original policy throughout the policy duration and pays the due share of any claim or surrender value.

Life and personal accident

Risk Premium Basis

- It is true that a life office earns interest or investment income generated by policyholders' premium. Thus, the life office will be able to start building a reserve fund against potential death claim.
- The risk which has to be reassured is indeed the mortality rise above the level of retention which is technically known as the **death strain**.
- In the first year or two of the policy, the reassurance sum insured will be the full difference between the **retention and the sum assured**.
- As the reserve accumulates, it will eventually exceed the retention and then only the difference between the reserve and the sum assured needs to be reassured. The reassurance cover will eventually reduce to nil, while the rate to be applied to it will be the risk rate for the life assured's age each year. This rate will therefore increase.

Life and personal accident

Risk Premium Basis

- The premium effect is that initially the premium will rise each year since the difference between direct sum assured and the retention that is, the risk) will be reducing while the mortality rate will increase as the life assured grows older.
- As the reserve fund builds up beyond the retention level, the rate of increase in the reserve will be greater that the increase in the mortality rate.
- The overall effect is that the premium will rise in the early stages of the reassurance and reduce in the later stages

Reassurance Pools

- Reassurance pools exist in the case of substandard lives including for those assureds with a history of chronic diseases such as diabetes or coronary heart disease.
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Dip 102

Consumer Protection in insurance

Consumer Protection in insurance

Outline:

- The nature of consumer protection in Insurance
- Statutes relating to insurance Consumer protection
- Self regulatory measures in practice regarding consumer protection

Consumer protection in Insurance

- Consumer protection is also known as consumerism.
- Modern concept that has taken root in developed markets to prevent exploitation of consumers of insurance products and services
- Players come together and develop codes of ethical practices governing members
- These codes are backed by statutory regulation to ensure compliance

Consumer protection in Insurance

- With world being a global village, insurance practice in Kenya will be harmonized with global practice in the developed countries hence revision of provisions that may be considered as not consumer friendly.
- Consumers are also increasingly aware of their rights to quality products and services leading to outlawing of various provisions that negatively affect the rights of the consumer
- In Kenya, Consumers are **moderately** aware of their rights to quality and value for insurance products and services so the insurance Act Cap 487 has made provisions to protect the consumer and regulate the insurance market

Consumer protection in Insurance

Reasons why consumer protection is required in the insurance industry

1. It is a demand by modern society;
2. It is a legal requirement under Insurance Act that insurance companies must not offer substandard products to consumers;
3. To protect ordinary consumer who may not understand the technical language and terms incorporated in insurance practices;
4. To ensure the ability of the insurer to respond to a loss since insurance is a promise to compensate in future;
5. To restrict insurers from issuing policies for which they are not authorized;
6. It prevents loss to one party if the other is in breach of the insurance contract.

Consumer Problems

- From complaints reported from the IRA, there are possible causes of consumer problems:
- **Future security** – promise to pay when a loss occurs be actualized, capacity of insurer to respond to loss event by competent staff, insurers to remain solvent to protect the interests of the policyholders
- **Understanding documents –** Technical terms and provisions, ambiguous, complex wording, legal phrases that an ordinary consumer does not understand
- **Information provided before purchase-** some pre purchase information is misleading e.g. All risks, incomplete information that does not allow consumer to compare covers, claim services, surrender values etc. in order to make informed decisions
- **Service providers –** they may conduct duties unprofessionally, unethically and bring disrespect to the insurance industry or cause insurers to pay unwarranted claims

Consumer protection measures in insurance

Statutory regulation- Insurance Act cap 487 of 1984

- **Restrictions on operations.**

- The Act imposes specific restrictions on the operation of insurance business and categorizes provisions for long term business and general business operations including the capital base requirements.
- The Act established the Insurance Regulatory authority (IRA) in 2006 and effective from 1st May 2007 which is charged with regulation, supervision and development of the insurance industry.

Consumer protection in insurance

IRA does this by:

- Ensuring compliance with the provisions of the Insurance Act cap 487
- Licensing of insurers, brokers, agents, service providers in respect of requirements for each category as required by the Act.
- Ensuring that all members of the insurance industry conduct their business ethically and in accordance with the Act
- Approving all insurance products/policies before they are launched for sale by the insurance companies

Consumer protection in insurance

- Authorization
- Regulation of insurance companies
- Regulation of Intermediaries and service providers

Measures contained in the Insurance Act to protect Consumers of Insurance services

1. Requirement for registration to carry out insurance business as an insurer or a reinsurer. To do so one must be registered under the Insurance Act – section 19
2. Customers should not be victimized for incorrect statement in the proposal form in a contract of life assurance. Unless it is done fraudulently or was made within a period of three(3) years immediately preceding date on which the policy sought to be avoided or date of death of life assured whichever comes earlier – section 81
3. A policy of insurance should not be avoided due to misstatement of age of life assured – section 86 (1)
4. A policy of insurance should not be avoided merely on the ground that the person whose life is assured dies due to committing suicide, an act of insecurity or suffers capital punishment –Section 82.
5. Insurer may pay into a court account any amount payable in respect to a policy where no sufficient discharge can be obtained from the claimant –section 104 (1)

Measures contained in the Insurance Act to protect Consumers of Insurance services

5. Insurer may pay into a court account any amount payable in respect to a policy where no sufficient discharge can be obtained from the claimant –section 104 (1)

6.No policy should be cancelled due to non- payment of premium if the policy has been in existent for more than three (3) years and the surrender value exceed the amount of debt owing to the insurer that is the non forfeiture clause in life policies – section 90(1).

7.No policy shall be issued on the life or lives of any person where the person benefiting has no insurable interest – section 94(1)

Self Regulation

- Apart from statutory regulation, Self regulation of insurance business is becoming a good form of control
- It is voluntary and involves stakeholders coming together and drawing up rules and regulations to govern their own operations. Bodies like AKI,AIBK, ILARS,IIK etc. have been formed to regulate conduct of members, act as lobby groups to advocate their interests and concerns to government and other stakeholders

Self Regulation

Advantages of self regulation:

- Having code of conduct agreed by members takes less time unlike the lengthy parliamentary legislation
- Enforcement mechanisms are not costly and do not involve bureaucracy and unnecessary delay like statutes
- Voluntary membership and self made regulations create an affinity to the codes of conduct and better chance to enthusiastic compliance as they are not imposed like acts of parliament.
- Self regulation develops quickly into self discipline as members are motivated to be their own watchdogs
- Self regulation is flexible and can respond to changing needs unlike the lengthy amendments to acts of parliament
- Self regulation supplements statutes of parliament and ensure that ther is order among members of the industry

Self Regulation

Disadvantages of self regulation:

- Voluntary codes of conduct do have the power of the law so the insured has no recourse if a member does not in compliance
- The codes of conduct are drawn by insurance providers who view the consumer needs from their own point of view and hence may not be as comprehensive as an Act of parliament
- Some statements used in the codes of conduct such as reasonable etc are ambiguous and not clear on who will decide what is reasonable or not unlike statutes which are drafted by legal experts and interpreted by the courts if there is ambiguity.

Self Regulation

- Codes of conducts are voluntary leaving the consumer to wonder of the insurer is adhering to all or part of the codes.
- Codes of conduct are rarely published and may not be accessible to all consumers
- Some insurance players do not subscribe to the associations formed and are therefore not bound by these rules.

Dip 102

Micro insurance

Micro insurance

- The insurance industry has mostly focused on the upper/middle income segments of the population but there is now a growing recognition by the industry that they need to move down market in order to provide cover to those in the lower income bracket;
- The urban market is saturated and insurance growth opportunities are in the rural and low income segments.
- Insurance which is sold to the low income persons is referred to as micro-insurance;
- Micro-insurance policies are characterized by low premiums and low sums insured;
- Here, “**micro**” refers to the small financial transaction that each insurance policy generates.

Micro insurance

- Micro insurance is the protection of low income people against specific perils in exchange for regular premium payments proportionate to the likelihood and cost of the risk involved.
- New development in microfinance (savings and credit)
- Target group is smallholders and micro entrepreneurs who conduct business and generate income on a small scale
- It may involve:
- Risk pooling for protection of low income households
- Insurance involving low levels of premiums

Micro insurance

- **Characteristics of Micro insurance clients:**
  - Vulnerable to risks
  - Often work in the informal economy
  - Have irregular cash flows
  - Manage risks through a variety of informal means including social networks
  - Limited familiarity with formal insurance
  - May not trust insurance companies

Risk Mitigation strategies

- Many of this target group normally handle their risks through:
- ➢ Self insurance
- ➢ Informal group based measures
- ➢ Social protection – transfer risk to government, public health facilities etc.
- ➢ Formal insurance – regulated insurers and large mutual benefit orgs

Risks faced by the low income earners

- Micro insurance policies have been designed in recognition that even those who earn low (and often irregular incomes) are exposed to risks and need to be covered;
- These people tend to be the majority in developing countries such as Kenya;
- Examples of risks that people in this segment are exposed to are motor cycle and motor vehicle accidents, sickness, other types of accidents, disability, untimely death, crop failure, sudden changes in weather, drought, fire, malicious damage and pest infestations;

Challenges facing low income sector

- Low and irregular earnings;
- Little or no savings and possess very limited capacity to access social services such as medical treatment on a regular basis;
- Other undesirable social effects of poverty include malnutrition, drop-out from school for the children, civil unrest, entry into the world of crime, drug addiction, and sexual exploitation;
- As many low-income people do not have access to adequate risk-management tools, they are vulnerable to fall back into poverty in times of hardship;

Challenges

- Examples:
- If the breadwinner dies children may have to drop out of school and enter the world of crime;
- High hospital bills may force a family to take out loans at high interest rates or sell family assets, further compounding their state of poverty;
- Hence, the low income sector needs insurance even more than the high income sector

Characteristics of Micro insurance

- Micro insurance is distributed by a variety of non traditional intermediaries and guided by the same six principles of conventional/traditional insurance - insurable interest etc
- The insured may be an aggregator such as a cooperative, seed dealer, fertilizer distributor, tea factories, bank, Non- Governmental Organization (NGO) and the like;
- Few questions are asked in the in the proposal forms and sometimes, proposal forms are not used at all;
- Individual sums insured are small and hence premiums payable are also small;

Characteristics of Micro insurance

- A global policy is issued to the aggregator through whom the policy was sold;
- No policy documents are issued to the individual insureds;
- Mobile phones are increasingly being used to collect premiums and settle claims.

Micro insurance products

- Common types of micro insurance policies include:
- ➢ Loan protection policies/ credit insurance
- ➢ Health insurance/ Medical expenses policies
- ➢ Funeral/Last expense policies;
- ➢ Motor cycle policies;
- ➢ Household insurances policies;
- ➢ Small scale agriculture insurance policies includes livestock insurance
- ➢ Life assurance – endowment, pension, education policies
- ➢ Personal accident
- ➢ Disability policies
- ➢ Property insurance – fire, burglary.
- ➢ Travel insurance

Types of micro insurance policies

- **Health insurance** is the most in demand as illness is one of the primary concerns of the poor but it is one of the least available because of the high cost attaching to it due to
- The moral hazard, fraud adverse selection predominant in this class
- Widespread disease and poor hospital facilities makes claims very frequent
- **Life assurance** of low sums insured maybe the most widely available micro insurance product – credit, education endowment policies and pension schemes
- **Funeral/Last expense** is in high demand due to high costs of burial
- **Property insurance** – fire, theft, domestic package and agricultural policies to cover fire, theft and or natural hazards

Underwriting of Micro Insurance

- The principles of insurance guide micro insurance in the same way as conventional insurance policies and they apply in the same manner.
- The underwriting process is also the same as that of traditional insurance with some distinct features:
- Documentation is simple and easy to understand
- The policies are of small amounts/ low sums insured
- The policies may be provided as a group policy
- Clients are allowed to pay premium in instalments through aggregators
- A variety of intermediaries may distribute the policies
- Proposal forms may or may not be used
- **Micro insurance claims are handled the same way as conventional insurance claims**

Approaches to Marketing Micro insurance

- Micro insurance is designed to have low premiums and therefore relies on large numbers to break even.
- The distribution channel is therefore crucial and is part of the package for success.
- The distribution channels are different than those of traditional methods because:
- The channels need to develop new expertise to deliver new products and be capable of selling to those with no expertise of insurance
- The channel is important in delivering value to clients and enhancing viability for the providers
- The distributors carry out various functions across the value chain
- The channels have their own expectations and interests – Ins. companies need to understand them, align objectives and develop a value proposition for all.

Distribution channels

Micro insurance can be distributed through several channels:

1. **Provider model** – banks and microfinance institutions offer insurance contracts directly on behalf of themselves – offering credit coupled with contacts to protect against loan defaults . Accessible to those with existing savings or active loan accounts – customer base. This is constraining as the clients need insurance over even when they do not have loans
2. **Partner – agent model** – Insurance companies partner with banks, microfinance institutions(Mfi), Non – government organizations(NGO). The insurance co. develops the products, provides finanacial capaicity, underwrites the risks, technical advice while the partners distribute the products.

Distribution channels

- **Partner – agent model** adopted by insurance companies because:
- ➢ They have access to clients
- ➢ In order to lower the transaction costs
- ➢ To enhance efficiency
- AIG using Mfi's to market its products

Distribution channels

3.Community based model :

- Local communities through welfare groups, self help groups and churches cooperate with Mfi's and develop product features and pricing and deliver the products to the clients.
- Policy holders are the owners and managers of the program.
- Premium is collected in a fund which is used to pay claims, manage the risk pool.
- Commercial insurers not involved so its risky and illegal
- It is self insurance
- Not in compliance with the Insurance Act

Distribution channels

4. Information technology- Full service/ mutual Model;

- An insurance company designs the products and chooses the delivery channels to its own clientele.
- Sums insured are adjusted and premiums made affordable to lo w income markets

5. Micro Insurance Agents (Aggregators)

- Distributions channels that are popular to the community members are used to distribute the products e.g. funeral parlors, mobile services, mobile banking, garages, consumer/ produce co-operatives, utility companies
- The group leaders(aggregators) must be licensed as agents under the insurance act to be able to distribute insurance products

Distribution channels

Choice of channel will depend on:

- The context – advantages and disadvantage's of channel
- Existing sales and services provision capacities and support needed
- Experience with financial delivery
- Types of clients - groups are better than individuals
- Scale and outreach
- Interaction with clients
- Understanding of clients/members
- Brand and trust – there is need for a strong and trusted brand

Challenges in the Growth of Micro Insurance

- While insurance plays a vital role in mitigating risks faced by the low income segments of the population, there are several challenges which must be overcome for insurance to become widely available to the poor;
- Some of these challenges are:

➢ Lack of insurance knowledge for non- traditional insurance sellers;

➢ Accessing the poor in remote areas;

➢ Collection of small premiums from many small entities can be uneconomical;

➢ Understanding the concept of insurance and how it works has always proved challenging to those with limited level of education;

Challenges in the Growth of Micro Insurance

- Understanding the risks and conducting insurance business without using proposal forms, policy documents and claim forms may create legal problems in future;
- Communicating with the poor can sometimes pose serious marketing problems e.g. in the choice of language to use;

- However despite these challenges many insurance companies are now going into micro insurance and the future looks bright for this class of business.

Dip 102: Principles and Practice of Insurance

TAKAFUL

Takaful

- Takaful is insurance which has its origin in Islamic financial services industry but operates in both Muslim and non Muslim countries
- It is steadily gaining popularity especially in the Muslim countries and whenever there is a considerable Muslim population;
- Its growth has demonstrated that there is a market segment that the conventional insurance products do not serve;
- The word Takaful stems from the Arabic verb "Kaful" which means to take care of one's needs;
- It also means mutual help and solidarity among members of a group;
- Takaful works on the principle that in any transaction, risks, profits and loss should be shared between the participants;

Takaful

- This does not seem to be the case in conventional insurance;
- Further, Muslim scholars are of the view that profits in conventional insurance may be made at the expense of sacrificing social co-operation as it has become too commercialized;
- Takaful is a unique system of mutual risk sharing and concentrates on providing maximum assistance to the unfortunate;
- It dictates that profits should be clean, non-exploitative and based on productive efforts;
- In Takaful, there should be no ambiguity or unknown and doubtful risks involved;
- There should be no deception and there should be no loss due to ignorance or absence of information;

Takaful

Tenets under which the principle of Takaful is based:

- There are three areas under the conventional insurance cited as contravening the Koran and Sharia law:-

1. Uncertainty of the contract terms,
2. Gambling nature of the insurance contract and
3. The earning of interest;

Uncertainty of contract terms

- Related to the issue of Al-gharar which means unknown or uncertain factors in the operation of a contract
- Insurance contracts have uncertainty- a loss may or may not happen
- Sharia forbids sales where there is a risk to the buyer unless the risk is normal and reasonable to the buy;
- Basic rule of Islamic agreements is that the subject matter must be clear to all parties and certain in every aspect.
- Some Islamic scholars are of the opinion that an insurance contract does not remove uncertainty because levels of loss which may occur, when it can occur and whether really the insurance policy will settle the claim still remains uncertain.

Gambling

- Islam sees conventional insurance products as a sort of gambling because:
  - One cannot tell when a claim will happen how much it will be - some people receive payment while others do not
  - The uncertainty in an insurance contract gives it an element of gambling.
- Gambling is outlawed by Islamic law

Interest

- Traditional insurance generally ensures that their investment income is maximized at the lowest possible risk;
- As a consequence, many insurance companies deposit money in interest bearing investments;
- The earning of interest is against the Sharia principles as it amount to the money owner taking proceeds without working or trading.
-

How Takaful operates

- Takaful is based on brotherhood, solidarity and mutual assistance and aims at providing mutual financial aid and assistance to the participants in case of need;
- The participants, on the other hand, mutually agree to contribute money to a central pool for this purpose;
- The premium or donation will differ based on the degree of risk;
- The intention of paying contributions as a donation by the participant changes the entire contract in that the contract is no longer a buy-sell agreement but rather a contract of participation and donation;
- Participants take out only what they need in the event of a claim;
- Hence there is no element of gambling on the fortune or misfortune of others.

How Takaful operates

- The Takaful operator (i.e. the insurance company) charges a fee for managing the fund;
- Any money left out at the end of the year, after payment of claims and the expenses of the business is distributed to policyholders who are treated as shareholders even as a small amount is given to the community;
- But when there is a short fall, the policy holders are called upon to make further contributions;
- A further point to note is that the investment income of a Takaful operator is done in accordance with Shariah laws;
- This, for example, means that the fund created cannot be invested in brewing, cigarettes, armaments, or companies dealing with pork;

How Takaful operates

- Contributions are calculated based on the value of the item to be covered and the age of the participants the family
- The aim is to ensure that the fund is sustainable- there is always money to cover a loss to the participants
- The fund may make a profit and a surplus can be declared to participants while a loss requires financial support from the promoters or managers of the portfolio.

Takaful products

Takaful may be in the form of a family plan or a general plan

1. The **family plan-** referred to as life insurance in conventional insurance, is a long term saving and investment plan with a fixed maturity period. It enhances savings, allows investments/profits earning that are sharia compliant and gives financial assistance to participants.
2. The **general plan -** referred to as a general insurance in conventional insurance, is a short term contract of joint- guarantee between a group of participants that provides mutual compensation in the event of a defined loss. Participants enter into a contract with the company on a profit sharing type of contract which also states the rights and obligations of the participants and the company.

Why Takaful is acceptable to Muslims

- The Takaful is acceptable because:
- Participants cooperate among themselves for their common good;
- Every participant pays a contribution in order to assist those of them who may need assistance;
- It falls under the donation contract which is intended to divide losses and spread liability according to the community pooling system;
- The element of uncertainty is eliminated as far as contribution and compensation are concerned;
- It does not aim at deriving advantage at the cost of other individuals i.e. it takes care of common interest.

Differences between Takaful and conventional insurance

- Takaful is the payment of premium on the basis of contribution or donation -social solidarity. It is not a buy-sell agreement like conventional insurance
- Investment income of a Takaful operator is done in accordance with Sharia laws
- Conventional insurance includes an element of al-gharar (uncertainty)
- Conventional Insurance is based on premiums paid by policyholders while takaful is based on tabarru - donations by participants,
- Conventional insurance is a form of gambling

Differences between Takaful and conventional insurance

- Conventional insurance involves risk transfer in exchange for premium while takaful involves mutual sharing of risk and no transfer of risk in done.
- Conventional insurance is profit driven while takaful is non profit and focused on social solidarity, trusteeship and co-operation. Shareholders may share in the investment returns of funds managed by trustees.
- The policy-holders in a conventional insurance company have no right to vote in the elections of the directors of the company or to see the annual accounts of the company, while in Islamic companies; these facilities are available to all participants.

Differences between Takaful and conventional insurance

- In the takaful system, if the assured dies before the policy matures, the beneficiary is entitled to the whole amount of the premiums, the bonus and dividend and a share of the profits made over the paid premiums, plus a donation from the company out of the participants/policy-holder's contributions given on the basis of donations.
- Such a transaction is seen as a mutual contribution towards the welfare of the helpless in society.
- Where the insured is still alive on the maturing of the policy, he/she is entitled to the whole amount of the premiums, a share of the profit made over the premiums, a bonus and dividends according to the company policy.

Differences between Takaful and conventional insurance

- In a conventional life insurance policy, the agent's payments are paid out of the insured's paid premiums, whereas in the Islamic model, the agents work for the company and thus are paid by the company.
- The insurable interest in the conventional system is usually paid to the policyholder, if he/she is alive at the expiry of the policy. If he/she dies before that date, the insurable interest is paid to the beneficiaries, who may include including family, servants, company, trustee, partners, mortgagor, etc. --But under the Islamic model, the insurable interest goes to the assured or his/her heirs, according to the principles of Mirth or Wasiyyah.

Takaful

- **Main features of Takaful**:
- ➢ Co-operative risk sharing
- ➢ Clear financial segregation between the interests of the participants and the operator
- ➢ Sharia compliant underwriting policies and investment strategies

Co-operative risk sharing

- A co-operative is an independent association of people united voluntarily to meet their common social, cultural and economic needs through a jointly owned and democratically controlled enterprise
- Main values of co-operatives include solidarity, honesty/openness, democracy/equality/equity, self help/self responsibility, social responsibility, caring for others
- Mutuality is at the core of takaful
- Co-operative risk sharing eliminates ambiguity

Co-operative risk sharing

Characteristics of co-operative risk sharing companies:

- Owned and democratically controlled by members with decisions taken balancing their needs and profitability
- The Mutual system focuses on customer value, results and good performance thus strengthening mutuality
- People are the focus of the business

Co-operative risk sharing

The concept of co-operative insurance is acceptable in Islam because:

- The policyholders co-operate actively for their common good;
- Every policyholder pays his subscription in order to help those who need it;
- It spreads liability in the community by a pooling system;
- It does not aim at deriving undue advantage for one at the cost of other individuals;
- The element of uncertainty is eliminated as far as determination of the premiums is concerned.

Takaful

Surplus distribution methods in Takaful:

- Distribution of the surplus to all participants
- Distribution of the surplus only to participants with no claims
- Distributions of the surplus to all participants based on the net result of each participant

Treatment of the deficit:

- ➢ Call for additional contribution from participants
- ➢ Shareholders/takaful operators providing an interest-free loan to the company – repaid by future surpluses

Takaful models

There are four sharia compliant investment models:

1. The profit sharing method (Mudaraba)
2. Free driven model (Wakala)
3. Profit sharing -free driven method (Mudaraba -Wakala)
4. Pure mutual model

Nb: Read details from notes

Sharia compliant underwriting and investment policies

- All activities of takaful must conform to Sharia principles and rules
- The rules guide underwriting and investment policies
- Areas of concern include:
- Prostitution
- Alcohol and drug related trades and industries
- Prohibited goods e.g. pork, pornography
- Fraud related activities

Sharia compliant underwriting and investment policies

- Basic Sharia compliance
- Absolute submission to Allah
- Whatever is unlawful is not permissible
- Doubtful things are avoided
- Harm must be eliminated but not by means of another harm
- Contributions are estimated using actuarial techniques and statistical methods relating to insurance operations plus prevailing global practices and the country's regulations

Regulation

- The Sharia Supervisory Board(SSB) role:
  - To review takaful operations
  - Supervise the development of Islamic insurance products
  - Determine the Sharia compliance of the products and investments

Challenges in the development of Islamic insurance covers

- Addressing the existing skills shortage – underwriters and technical personnel (training)
- Cross training managers to be knowledgeable about Islamic finance and risk management(takaful)
- Modifying supervisory rules to allow various risk profiles for takaful and conventional insurance due to different capital structure and risk appetite
- Refining regulatory rules to reflect the unique character of takaful without weakening risk management and financial stability standards, provide proper levels of consumer protection in terms of risk and disclosure of policy wordings
- Adjustments to rating methodologies to account for takaful risk pools lowers financial security due to lack of diversification, short operating history in this field and uncertainty from shareholders to cover deficits.

Dip 102

Bancassurance

COLLEGE OF INSURANCE
Driven by distinction

Bancassurance

- Bancassurance is a term coined by combining two words.
- **Banking + Insurance = Bancassurance**
- It is a French term referring to the selling of insurance products through the wide bank branch retail network.
- The concept originated in France and Spain with loan protection insurance life policies
- Typically, bancassurance denotes a relationship/alliance/partnership between a bank and an insurance/assurance company.

Bancassurance

- Bancassurance is simply the collaboration/agreement between banks and insurance companies to distribute and market insurance products to the banks existing clients and other clients.
- It is the use of the existing banking customer base infrastructure to market and sell insurance products.
- It is emerging as a major distribution channel for insurance products to boost insurance penetration and an ideal strategy for insurers to build new policyholder relationships.
- Banking penetration is fairly healthy among the urban dwellers in developing markets and using this database, technology, mobile phones, email, SMS, TV, and internet, it is cost effective to sell insurance in high volumes to banking cutomes mainly.

Bancassurance

- Success depends on raising awareness and securing support for banks as bancassurance agents
- Banks must be licensed under the Insurance Act to be bancassurance agents – to sell insurance under the given guidelines

Reasons for Bancassurance growth

- The need to reduce the ever increasing operational costs – agents/brokers commissions
- It gives insurers ownership and control of relationships with customers
- Analysis of the customer information allows discovery of the customer needs and development of products that meet the ever changing customer needs
- It also aims at building synergies between the insurance and banking sectors for one stop shopping – offering complete solutions.
- Increase business efficiency

Benefits of Bancassurance to banks

- It is a means of diversification - additional products
- Source of additional income
- Means to access multiple communication channels like mobile messaging, statement inserts, ATMS, email etc
- Means of using existing branch network for face to face contact needed in personal insurance so bank provides ‘one stop shop’ for financial services.
- Putting into more efficient use the huge customer database
- Proficiency in IT results in transaction, processing and customer service
- Helps increase customer loyalty as customer needs are analyzed and met
- Low distribution costs using existing staff hence profitable

Benefits of Bancassurance to insurers

- It is a tool for increasing market penetration and premium turnover
- An opportunity to diversify distribution methods to avoid excessive dependence on a s ingle network thus reducing the risk
- Benefits from the more trustworthy image and reliability of consumers attributed to banks - selling of insurance products requires clients to place trust in the company they deal with, Clients have that trust in Banks.
- Improved public image/defensive positioning
- Wider range of products are offered – competitive products that match the needs of customers
- Delivery at the doorstep of customers
- Offers better persistency/retention hence high premiums are achived and profitable growth
- Success in markets worldwide

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Bancassurance

Bancassurance – A Win Win Situation

Bank	Insurance Company
Customer retention	Revenue and channel diversification
Satisfaction of more financial needs under the same roof	Quality customer access
Revenue diversification	Quicker geographical reach
More profitable resource utilisation	Creation of brand equity
Enriched work environment	Leverage service synergies with Bank
Establish sales orientated culture	Establish a low cost acquisition channel

Benefits of Bancassurance to insurers

- Tapping into the banks customer base which is ideal for distribution of mass-market products such as motor vehicle policies;
- Avoiding the cost of setting up and maintaining an agency network
- Reducing the need of opening and maintaining many branches;
- Banks wider network of branches provides a quick and easy access to many clients throughout the country.

Benefits of Bancassurance to customers

- **Bancassurance allows;**
- Greater access to all financial services from the bank that offers both banking and insurance products - a one stop shop.
- Access to inexpensive insurance products due to low distribution costs. In certain products, the bank may agree to a reduced commission in exchange for a discounted premium thereby lowering the cost of the insurance product to the consumer.
- Premium payment system adapted to their needs and with easy access since the branch network is usually denser than the network of insurance outlets.
- Hassle free post sales services
- Access to new products/ services

Bancassurance models

- Bancassurance takes different forms that vary from one country to another depending on legislation.
- In all countries, regulation of bancassurance is done by the relevant authority in charge of regulating the insurance industry.
- The application for approval must be accompanied by a **bancassurance agency agreement** between the financial institution and insurers.
- Bancassurance takes different forms that vary from one country to another depending on legislation.
- In Kenya, IRA recognizes the following models:

➢ Specialist model – distribution agreement

➢ Joint venture

➢ Full integrated model

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Specialist bancassurance model

- Insurance products are distributed by insurance experts(with COP min) in a bank who are employees or representatives of an insurance company
- The partnering bank's employees identifies prospects who are then contacted by the insurance expert
- Customer base of the bank can be availed to insurance company for needs assessment and development of required products
- Bank acts as intermediary – corporate agency arrangement for a fee/commission
- No capital investment required so is cost effective for both parties
- Branding and co banding of products can be done
- There is a lack of flexibility to launch new products.
- So far bancassurance in Kenya has mainly taken this model – also popular in India
- Also called a distribution agreement
- Also known as **open architecture model** when banks have open non-exclusive distribution agreements with several companies

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Joint venture model

- This involves a bank working in partnership with one or more insurance companies.
- This model has the advantage of transfer of expertise.
- However, it may be difficult to manage in the long run

Full Integrated model

- The financial institution’s employees sells the insurance products through the existing branch network to customers.
- The institution may create a wholly owned subsidiary that is used to distribute the insurance products – a bank may create an insurance company or insurance company may create a bank
- It could also be a joint venture between bank and insurance company.
- There is an exclusive distribution agreement with the bank.
- Requires heavy capital investment
- Advantage of same corporate culture
- Very successful in Europe(France, Italy and Spain) where there are fully owned subsidiaries or joint ventures.

Licensing requirements

- Any institution that intends to carry on bancassurance must apply to IRA and indicate the model they intend to use.
- Requirements include”
- Application fee
- Written agreements with insurer(s) or any other party
- Appointment letter by insurer(s)
- Customer service charter
- Relevant board approvals
- Business plan
- Current licenses from CBK
- Details of principal officer
- Risk management framework
- Incorporation documents incase of subsidiary

Bancassurance products

- The key to success in bancassurance is above all to keep it simple.
- In practice, simple products must be offered without a host of different choices and be able to explain the product purpose and concept in simple terms even if its nature is complex.
- The customer should be able to see the benefit of the product without much interpretation.
- The products distributed must be completely suited to the banking network that is, synchronized with the bank's sales procedures that include standardization of all transactions.

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Bancassurance products

- The products must be easy for the public and, in particular, the bank customers to understand, in general, and should focus on covering their most common needs.
- The pricing structure should be simple to facilitate the selling process by the banks’ employees.
- Bank sells insurance to its clients, but can also market to non-customers

Bancassurance products

Bancassurance products can be grouped in 4 categories:

1. Finance and repayment products
2. Overdraft products
3. Capital Repayments
4. Depositors products

Sometimes 3 categories

5. Finance and repayment products
6. Depositors products
7. Simple standardized package products

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Finance and repayment products

- Banks offer Mortgage loans, business loans, personal loans an hire purchase agreements
- Banks offer loans and credit and are concerned that in the event of death or disability of the borrower, the outstanding loan may not be recoverable because of:
  - The surviving family's financial position
  - The repossessed property in case of non payment may not be saleable
  - When sold, the amount may not be sufficient for repayment of the loan
- Along with outstanding loan is the bad publicity involved in repossession of assets on the unfortunate death of its clients and harassment of surviving family
- The borrower also does not wish to leave an outstanding loan to be repaid by family after death or possible inability to repay in the event of permanent disability.

Finance and repayment products

- Credit insurance products include:
  - Asset protection policies to those taking loans to buy assets
  - Life and other related investment policies;
  - Travel insurance;
  - Motor insurance- to those taking loans to purchase vehicles;
  - Domestic package; insurance
  - Personal accident insurance
  - Fire and special perils insurance - to those taking mortgages

Overdraft products

- Banks offer overdraft facilities, Credit cards and unstructured debts to customers with accounts.
- In event of death, the amount advanced is outstanding
- Overdraft insurance cover is equal to the credit facility or the maximum pre arranged credit facility and monthly premiums are paid according to this amount.
- In event of untimely death, the insurance pays the outstanding amount

Capital Repayments products

- Banks offer loans for mortgage, education or business reasons.
- The repayment scheme can be arranged through an insurance policy
- The customer takes a loan and only pays the loan interest to the bank but takes an endowment policy equal to the loan amount and period equal to loan period
- The policy is assigned to the bank as a repayment tool whether the customer survives or not

Depositors products

- Depositors insurance – to attract depositors to open deposit accounts. Family income benefit policies are relevant here
- Pure investment products – unit linked products- life and other investment policies,
- Simple standardized products – group policies costing less than for individual covers- binders e.g. domestic packages, travel, medical, motor, personal accident, fire and perils etc

Bancassurance products

- Consumer Credit products
  - Mortgage Protection;
  - Car Loan Insurance;
  - Overdraft Insurance
  - Decreasing Term Cover; and
  - Household Insurance among others

Bancassurance products

- Whole life assurance ;
- Individual medical insurance;
- Travel insurance;
- Education policies
- Funeral insurance;
- Investment products; and
- Endowment assurances.

Bancassurance distribution channels

- Bancassurance has proved to be attractive and profitable
- Various distribution channels have been adopted to enable banks and insurers reach the intended market:
  - ➢ Career agents - trained and appointed by banks
  - ➢ Special advisers – mainly for corporate clients
  - ➢ Salaried agents – based on sales
  - ➢ Bank employees – simple standardized products
  - ➢ Corporate agencies and brokerage firms –set up by bank
  - ➢ Direct response
- Training is key to success

Consumer protection in Bancassurance

- No consumer should be compelled to buy an insurance product of its principal- prospects should decide on their own which product to buy and from which insurer
- The client's bank account should not be debited without their authority or consent
- Documentation relating to any insurance product bought should be sent to client within agreed timelines e.g. policy
- Applicants must comply with authorities guidelines on conduct for market intermediaries
- Bancassurance agents should immediately credit insurer account with premium received to facilitate cover to commence and liability to attach

COLLEGE OF INSURANCE
Driven by distinction

Consumer protection in Bancassurance

- Confidentiality of consumer data and information should be ensured
- An appropriate complaints redress mechanism should be put in place to address client's issues.

Bancassurance challenges

- Alignment of vision – short term vs long-term, top level commitment, financial sustainability of model.
- Persistency and retention of customers– importance of KPI's.
- Product value – reflected in cost savings.
- Product adjustments to keep up with needs.
- Bank's expectations – financial, client ownership, servicing aspects.
- Systems/operational constraints- weaknesses in operations set up, systems don't always work efficiently.

Bancassurance challenges

- Conflicts with other sales channels – delicate balance has to be maintained and customer given choice of channel.
- Change of personnel – change of bancassurance team or executives can lead to disruptions in business.
- Regulation – outdated regulation, limits in regulation.

Dip 102

Emerging issues and Trends

Emerging issues and trends

- Main issues are:
- Products designed to enhance insurance penetration.
- Future Trends in Underwriting.
- Emerging risks and the response of the insurance industry.

Enhancing Insurance penetration

- On average the developed countries penetration rates are about 8 %
- There is a significant room for growth of the insurance market in Kenya, and indeed many other countries since most of the population is not covered by insurance or does not even have exposure to insurance.
- As a result of this low penetration, the insurance industry, in conjunction with the government, has been putting in place measures to enhance the uptake of insurance.

Enhancing Insurance penetration

- Several measures have been taken in Kenya towards enhancing insurance penetration:
- Licensing of bancassurance
- Introduction of microinsurance
- Introduction of Takaful
- Increased focus on insurance regulation
- Digital distribution methods

Future trends in underwriting

- There is now trend to move away from stand alone general insurance products (i.e. policies generally covering one peril) such as the standard fire policy, theft, money, goods in transit, business interruption, and the like.
- One serious drawback with such products in their tendency to generate disputes as some clients interpret the meaning of the cover more broadly than what may be provided.
- There is now a trend to issue all risks asset protection policies to small and medium business enterprises which cover all the risks(other than those excluded) that such businesses are exposed to in one policy
- Stand alone policies are then restricted to large organizations which have the capacity to employ such experts.
- Policy extensions to give free cover for previously charged extensions.

Future trends in underwriting

- Collaborations in the agricultural insurance field – leading to new products in this grossly underinsured sector.
- Mergers and acquisitions of insurance companies to increase capacity and expertise of insurers.
- Online trading and provision of information/insurance services.

Emerging risks

- An emerging risk, from an insurance perspective, is an issue that is perceived to be potentially significant but which may not be fully understood or allowed for in insurance terms and conditions, pricing, reserving or capital setting.
- Key ones include:
- Political risks – PVT, war, insurrection, etc.
- Terrorism
- Fraud and other malpractices by employees, managers and directors –corruption related
- Climatic changes – extreme and unpredictable weather patterns
- Increase in earthquakes, tsunamis and other natural disasters
- Oil Risks
- Riot and Strike risks – associated with the freedom to strike – can lead to civil unrest.
- Cyber risks – Many businesses are under a greater risk of cyber attacks.

Emerging risks

- New Legislation challenges e.g. on Marine Insurance which bring to focus the capacity of local insurers – risk retention, expertise, scope of covers offered, jurisdiction and voyages covered, nature of cargo and freight to be covered etc.
- Greater complexity and exposure leading to claims handling uncertainty e.g. Large risks and accumulation of risk – mega planes, ships and companies, rise of Liquefied natural gas fueled vessels posing greater safety concerns.
- Human capital shortage
- **Conclusion**
- There are many risks that may pose challenges to the insurance industry in the medium to the long run.
- Reserves and capital bases require to be continuously enhanced if these challenges are to meet head on.
- Innovation is key to being able to address these challenges and be able to offer insurance solutions.