INSURANCE

Course Code: 208

BOOK RECOMMENDED

Insurance Principles and Practice

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Insurance

Definition:

A. From functional point of view-Insurance is defined as

- a co-operative device to spread the risk
- The system to spread the risk over a number of persons who are insured against the risk.
- The principle to share the loss of each member of the society on the basis of probability of to their risk.
- The method to provide security against losses to the insured.

B. From contractual point of view-

Insurance is defined as to which a sum of money as a premium is paid in consideration of the insurer’s incurring the risk of paying a large sum upon a given contingency.

Certain sum, called premium, is charged in consideration,

A large sum is guaranteed to be paid by the insurer who received the premium against the mentioned consideration,

A certain definite sum will be made payment,

The payment is made only upon a contingency.

Nature of Insurance

❖ Sharing of Risk
❖ Co-operative Device
❖ Value of Risk
❖ Payment at Contingency
❖ Amount of Payment
❖ Large Number of Insured Person
❖ Insurance is not a gambling/ wagering
❖ Insurance is not a charity

The Role and Importance of Insurance

- Provide safety and security
- Generates financial resources
- Life insurance encourages savings
- Promotes economic growth
- Medical support
- Spreading of risk
- Source of collecting funds

Risk: Risk is uncertainty of a financial loss. – Mishra

Risk is defined as uncertainty concerning a possible loss. Another words, risk is the variation in possible outcomes of an event based on chance. -Dorfman

3 Types of Risk in Insurance

A. Financial and Non-Financial Risks

- **Financial risks** are the risks where the outcome of an event (i.e. event giving birth to a loss) can be measured in monetary terms.

- The losses can be assessed and a proper money value can be given to those losses.

- Example-Theft of a property which may be a motorcycle, motor car, machinery, items of household use or even cash.

The losses can be replaced, reinstated or repaired or even a corresponding reasonable financial support (in case of death) can be thought about.

We would call financial risks as insurable risks and these are indeed the main subjects of insurance.

Non-Financial risks are the risks the outcome of which cannot be measured in monetary terms.

Examples can be:

- Choice of a car, its brand, color, etc.
- Selection of a restaurant menu,
- Career selection, whether to be a doctor or engineer etc.
- Choice of bride/bridegroom,
- Choice of publicity etc.

Since the outcome cannot be valued in terms of money, we shall call these non-financial risks as uninsurable.

B. Pure Risk and Speculative Risks

Pure risk is the potential for losses where there is no viable opportunity for any gain. Insuring an automobile is an example of pure risk. If the insured auto is involved in an auto accident, there is most definitely going to be some sort of damage (loss). Pure risks are those risks where the outcome shall result in loss only or at best a break-even situation. We cannot think about a gain-gain situation. The result is always unfavorable, or maybe the same situation (as existed before the event) has remained without giving birth to a profit (or loss).

Speculative risks are those risks where there is the possibility of gain or profit. At least the intent is to make a profit and no loss (although loss might ensue). Investing in shares may be a good example. Pricing, marketing, forecasting, credit sale, etc. are yet examples falling within the domain of speculation.

C. Fundamental and Particular Risks.

Fundamental risks are the risks mostly emanating from nature. These are the risks that arise from causes that are beyond the control of an individual or group of individuals.

The losses arising out of such causes may be catastrophic in dimension and felt by a huge number of populations, the society or by the state although an individual may be a part of that catastrophe. The common examples are:

- Flood & Cyclone, Subsidence & landslip,
- Earthquake & volcanic eruption, Tsunami,

Normally fundamental risks were not supposed to be insurable because of the magnitude and these were considered to be the responsibility of State. Now because of demand and insurers' strength, these risks are easily insurable.

Particular risks are which usually arise from actions of individuals or even group of individuals. These are mostly men created because of their negligence, error in judgment, carelessness, and disregard for law or respect. We may call these as risks of personal nature. The common examples are:

- Fire, Explosion,
- Burglary, housebreaking, larceny, and theft,
- Stranding, Sinking, Capsizing, Collision in case of a ship, including cargo loss,

Insurance Contract

Insurance is a contract between two parties one party insurer undertakes in exchange of a fixed sum called premium to pay other party called insured a fixed amount of money on the happening of a certain event.

Certain sum, called premium, is charged in consideration,

A large sum is guaranteed to be paid by the insurer who received the premium against the mentioned consideration,

A certain definite sum will be made payment,

The payment is made only upon a contingency.

Elements of Insurance Contract

A. General Elements of Insurance Contract

- ❖Agreement (offer and acceptance)
- ❖Legal consideration (Premium)
- ❖Competent to make contract (not minor, man of sound mind, not disqualified by any law)
- ❖Free consent (free from coercion, undue influence, fraud, misrepresentation, mistake)
- ❖Legal object (not forbidden by law, not immoral, not opposed to public policy, doesn’t defeat the provision of any law)

Special Elements /Principles of insurance

- Principles of Insurable Interest
- ,, ,, Utmost Good Faith
- ,, ,, Indemnity
- ,, ,, Subrogation
- ,, ,, of Causa Proxima

1. Insurable Interest

The insurable interest is pecuniary interest whereby the policy-holder is benefited by the existent of the subject-matter and is prejudiced death or damage of the subject-matter The principle of insurable interest states that the person getting insured must have insurable interest in the object of insurance.

Essentials:

- ❖ There must be a subject-matter to be insured.
- ❖ Monetary relationship between the policy-holder and the subject-matter.
- ❖ Relationship between the policy-holder and the subject-matter should be recognized by law.
- ❖ Policy-holder is economically benefited by the survival or existence and or suffer loss at the death or damage of the subject-matter.

2. Utmost Good Faith

Principle of Utmost Good Faith is one of the basic features of an insurance policy. It means that both the policyholder and the insurer need to disclose all material and relevant information to each other before commencement of the contract. It means that both the **Proposer** (who wishes to buy the insurance plan) and the **Insurer** will be honest and not withhold critical information which is required to issue the insurance policy.

Responsibility of the insurance company

The insurer or its agent should disclose all critical terms and conditions of the plan, including exclusions, so that the person taking the policy knows exactly what she or he is buying.

Responsibility of the proposer

The person who wishes to take the policy should disclose all material facts which can impact the decision to issue the policy or impact the pricing decision of the insurance company.

Facts need not be disclosed by the insured

- ❖Facts which tend to lessen the risk.
- ❖Facts of public knowledge.
- ❖Facts which could be inferred from the information disclosed.
- ❖Facts waived by insurer.
- ❖ Facts governed by the conditions of the policy.

3. Principles of Indemnity

The principle of indemnity states that an insurance policy shall not provide compensation to the policyholder that exceeds their economic loss. This limits the benefit to an amount that is sufficient to restore the policyholder to the same financial state they were in prior to the loss.

In other words, the principle of indemnity ensures that the insured gets made whole from their loss but will not benefit, gain, or profit from an accident or claim. Nor will you get less than what is necessary to restore you to the same financial position.

Uses of Principles of Indemnity

- To avoid Intentional loss
- To avoid an Anti-social Act
- To maintain the premium at Low-level

Application of Principles of Indemnity

- Marine Insurance
- Fire Insurance

Exception of Principles of Indemnity- In life insurance this Principle is not applicable because the claim is predetermined and loss of death is not measurable in terms of money.

Conditions for Indemnity Principle

- The insured has to prove that he will suffer loss on his insured matter at the time of happening the event and the loss is actual monetary loss.
- The amount of compensation will be the amount of insurance. Indemnification can not more than the amount insured.
- If the insured get more amount than the actual loss, the insurer has right to get the extra amount back.
- If the insured gets some amount from third party after being fully indemnified by insurer the insurer will have right to receive all the amount paid by the third party.
- This does not apply to personal insurance.

4.Doctrine of Subrogation

Subrogation refers to the practice of substituting one party for another in a legal setting. Essentially, subrogation provides a legal right to a third party to collect a debt or damages on behalf of another party.

Subrogation in the insurance sector generally involves three parties: the insurer (insurance company), the policymaker (insured party), and the party responsible for the damages.

The process usually starts when the insurer pays out the losses of the insurance claim filed by the policymaker. When the policyholder receives the amount of money for the claim, the insurer may start the process of collecting the amount of the claim from the party that caused the damages.

Note that if the party responsible for the damages is covered by another insurance carrier, the carrier will represent the interests of the client.

Essentials of Doctrine of Subrogation

- ❖ Corollary to the principle of Indemnity
- ❖ Subrogation is the Substitution
- ❖ Subrogation only up to the amount of payment
- ❖ The Subrogation may be applied before payment
- ❖ Personal Insurance

5.Proximate Cause

Proximate cause refers to a direct cause of loss, without which the loss would not occur; therefore, it is a highly relevant principle in the insurance industry.

Proximate cause means 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 - Pawsey v. Scottish Union and National (1908).

Proximate cause is a key principle of insurance and **is concerned with how the loss or damage actually occurred and whether it is indeed as a result of an insured peril**. The important point to note is that the proximate cause is the nearest cause and not a remote cause

Functions of Insurance

A. Primary Functions:

- Insurance provides certainty
- Insurance provides protection
- Risk-Sharing

B. **Secondary Functions:**

- Prevention of loss
- It provides capital
- It improves efficiency
- It helps economic progress

Reinsurance

Reinsurance is an insurance contract between two insurance company where the ceding company (First insurer) transfers full or a part of insurance liability to another insurance company called second insurer. With reinsurance, the company passes on some part of its own insurance liabilities to the other insurance company. The risk remains the same.

Double insurance

In double insurance, the same risk is insured with different insurance companies or more than one insurance company. If in case the insured faces a huge loss then he can claim the insurance amount from different insurance companies. All the insurers will be liable to compensate the insured for the loss. But the compensation amount provided by all the insurance companies can be never more than the loss occurred. All the insurers will contribute to the actual loss proportionately and there will be no burden only on one company.