CHAPTER SIX

INSURANCE

6.1 Concept of Insurance

The Commission on Insurance Terminology of the American Risk and Insurance Association has defined insurance as *the pooling of fortuitous losses by transfer of such risks to insurers, who agree to indemnify insured for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk.*

6.2 Historical Development of insurance

The historical development of insurance can be traced back thousands of years, with the concept of risk-sharing and protection against loss evolving over time. Here are some key milestones in the history of insurance:

1. **Ancient Origins (Pre-1000 BC):** The earliest forms of insurance can be seen in ancient societies. For example, Chinese traders in the 3rd millennium BC distributed their cargo across multiple vessels to reduce the risk of loss. In ancient Babylon, merchants used loans to finance trade expeditions, with the understanding that the loan would be canceled if the goods were lost or stolen.

2. **Marine Insurance in the Mediterranean (14th Century):** The development of marine insurance can be traced to Italian city-states like Genoa and Florence in the 14th century. These cities had active trade routes, and merchants began to form informal associations to pool their resources and protect against the risks of sea voyages. These associations laid the foundation for modern marine insurance.

3. **Lloyd's of London (17th Century):** In 1688, Edward Lloyd's coffeehouse in London became a hub for shipowners, merchants, and underwriters. It was at Lloyd's that the first formal marine insurance policies were underwritten. Over time, Lloyd's evolved into a renowned insurance market, expanding beyond marine insurance to various other types of coverage.

4. **Fire Insurance (Late 17th Century):** In response to the Great Fire of London in 1666, the concept of fire insurance gained prominence. Nicholas Barbon is often credited with

founding the first fire insurance company in 1680, offering protection against fire-related losses.

5. **Life Insurance (18th Century):** The concept of life insurance emerged in the 18th century. The first life insurance policies were designed to provide financial support to families after the death of the insured. The Amicable Society, founded in London in 1706, is considered one of the earliest life insurance companies.

6. **Industrial Revolution (19th Century):** The rapid industrialization and urbanization of the 19th century led to increased demand for various types of insurance, including property, liability, and workers' compensation insurance. The insurance industry expanded and diversified to meet these needs.

7. **Government Regulation (20th Century):** In the 20th century, governments around the world began to regulate the insurance industry to ensure fair practices, solvency, and consumer protection. The establishment of insurance regulatory bodies became common.

8. **Global Expansion (20th Century):** Insurance companies expanded their operations internationally, providing coverage for a wide range of risks on a global scale. Reinsurance, which involves insurers sharing risk with other insurers, also became a critical component of the industry.

9. **Modern Insurance (21st Century):** The insurance industry has continued to evolve in the 21st century, driven by technological advancements, data analytics, and the introduction of new insurance products such as cyber insurance and climate risk coverage. Digital platforms and insurtech companies have also transformed the way insurance is sold and underwritten.

6.3 Elements of an insurance transaction

Four elements are required for an insurance transaction to be complete

(i) *A contractual agreement***:** An insurance contractual agreement is a legally binding contract between two parties: the insured and the insurer. This agreement outlines the terms and conditions of an insurance policy, including the rights, responsibilities, and obligations of each party.

(ii) *A premium payment:* Insurance premium payment is the process by which policyholders make payments to their insurance providers to maintain coverage under an insurance policy.

(iii) A benefit payment occasioned by circumstances defined in the insurance contract.

(iv) The *presence of a pool of resources* held by the insurer to reimburse claims. The pool is able to provide a stronger guarantee as it becomes larger because of pooling of resources. The law of large numbers allows the average loss per insured unit to fall close to the true expected loss.

6.4 Basic Characteristics of Insurance

Insurance plan or arrangement typically includes the following characteristics:

■ pooling of losses

■ Payment of fortuitous losses

■ Risk transfer

■ Indemnification

i. Pooling of Losses

Pooling or the sharing of losses is the heart of insurance. Pooling *is the spreading of losses incurred by the few over the entire group, so that in the process, average loss is substituted for actual loss.* In addition, pooling involves the grouping of a large number of exposure units so that the law of large numbers can operate to provide a substantially accurate prediction of future losses. Ideally, there should be a large number of similar, but not necessarily identical, exposure units that are subject to the same perils. Thus, pooling implies:

(1) The sharing of losses by the entire group

(2) Prediction of future losses with some accuracy based on the law of large numbers.

The primary purpose of pooling, or the sharing of losses, is to reduce the variation in possible outcomes as measured by the standard deviation or some other measures of dispersion, which reduces risk.

ii. Payment of Fortuitous Losses

A fortuitous loss *is one that is unforeseen and unexpected by the insured and occurs as a result of chance.* In other words, the loss must be accidental. The law of large numbers assumes that losses are accidental and occur randomly. For example, a person may slip on a slippery floor and break a leg. The loss would be fortuitous.

iii. Risk Transfer

Risk transfer is another essential element of insurance. With the exception of self-insurance, a true insurance plan always involves risk transfer. Risk transfer *means that a pure risk is transferred from the insured to the insurer, who typically is in a stronger financial position to pay the loss than the insured.* From the viewpoint of the individual, pure risks that are typically transferred to insurers include the risk of premature death, excessive longevity, poor health, disability, destruction and theft of property, and personal liability lawsuits.

iv. Indemnification

A final characteristic of insurance is indemnification for losses. Indemnification *means that the insured is restored to his or her approximate financial position prior to the occurrence of the loss.* Thus, if a house burns in a fire, a homeowner's policy will indemnify or restore the insured to previous position.