Introduction to Insurance

MODULE 4

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Insurance

- Insurance is the pooling of fortuitous losses by transfer o such risks to insurers who agr indemnify insureds for such lo to provide other pecuniary benefits on their occurrence to render services connecte with the risk.

Basic characteristics of Insura

- Pooling of losses
- Payment of fortuitous (happening by chance) l
- Risk transfer
- Indemnification

1. Pooling of losses:

Pooling or sharing of losses is the heart of insuranc
Pooling is the spreading of losses incurred by a
over the entire group, so that in the process, av
loss is substituted for actual loss.

Pooling involves grouping of large number of expo
units to provide a substantially accurate predic
losses by the law of large Numbers.

Basic characteristics

- Pooling offers sharing of losses by entire group and prediction of future losses with greater accuracy by of large numbers
- Assume 1000 farmers in moodabidre taluk and if on average 1 house burns every year the loss is 200000 absence of pooling or loss sharing the loss is 200000 loss sharing it comes down to 200000/1000= 200. so helps in substitution of average loss of 200 for the ac of 200000
- The insurer on the other hand can more accurately the average loss which results in risk reduction base large numbers. *The law of large numbers states that greater the number of exposures the more closely v actual results approach the probable result that are expected from an infinite number of exposures. Ex: coin 10 times and a million times*

Basic characteristics

- In another example accident chances can be accurately predicted during a *mela* than on a r day because of law of large numbers.
- Most insurers do not know the true probability ar severity of losses. They estimate average probab average severity of losses based on historical da Objective risk varies inversely with square root of of cases. Greater the number better is the predi and lower is the premium charged to each clien

2. Payment of fortuitous losses:

Fortuitous loss is one that is unforeseen and unexpe and occurs as a matter of chance. Insurance companies pay fortuitous losses and not intentio losses.

Basic characteristics

3. Risk transfer:

A pure risk (pure loss, no gain) is transferred fro insured to the insurer who is typically in a stro financial position to pay the losses than the Pure risks that are transferred are risk of prem death, poor health, disability, destruction ar of property and personal liability lawsuits.

4. Indemnification:

Indemnification means that the insured is resto his or her approximate financial losses prior occurrence of loss. Eg: fire policy, auto liabi policy, disability insurance

Requirements of an insurable

- Insurers insure pure risk but not all pure risks are insura Certain requirements must be fulfilled before a pure be insured. There are 6 requirements of an insurable
- 1. Large number of exposure units:

  There must be a large number of roughly similar bu identical risk exposure units so that the insurer can p loss based on the law of large numbers. This helps p loss and spread premium across clients
- 2. Accidental and unintentional loss:
- Ideally the loss must be fortuitous and outside the co the insured. If the insured causes a deliberate loss he should not be indemnified.
- If intentional losses are paid moral hazards increase causing an increase in premium resulting in reductio clientele. This reduces predictability of losses.
- Secondly, the law of large numbers is based on rand occurrence of events. An intentional loss is not rand will therefore affect predictability.

- 3. Determinable and measurable loss:
- Means of the loss should be definite as to cause place and amount. Life insurance easily meets requirements. But there are cases like disability is difficult to determine where people can fake disability/injury. Measuring it is also not easy. It depends upon the will power of the client to rehabilitate and get back to work.
- 4. No catastrophic loss:
- Catastrophe goes against the advantages of p and sharing risk. Insurance technique become unviable under catastrophe. Insurers wish to no catastrophe but it is not possible all the time. Fl hurricane, tornadoes, earthquake, forest fires, natural disasters happen. There are three ways insurer avoids catastrophe losses viz re-insuranc dispersing coverage area and financial instrum catastrophe bonds.

- 5. calculable chances of loss:
- An insurer must be able to calculate both th
average frequency and average severity o
losses with some accuracy. This helps them
calculate a premium that suffices paying fo
and maintain some profit. Certain losses like
catastrophe losses are difficult to estimate a
private insurers have difficulty in covering th
without govt support.
- 6. economically feasible premium:
- Premium must be affordable by the insured
be substantially lower than the face value o
policy. To maintain an affordable premium
chance of occurrence must be very low. If c
of occurrence >40% then premium >sum as

- Based on these 6 requirements it is
to insure most personal risks, proper
risks and liability risks as requiremen
insurable risk can be met easily.
However, market risks, financial risks
production risks, and political risks a
difficult to insure by private insurers
These are speculative and require
of insurable risks are difficult to mai
Also, each risk is capable of produ
catastrophe. Ex political risk turning
a war.

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Two examples- fire and unemployment

- Read text by Rejda page nos 23 and 24

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Adverse selection and insura

- Insurers have to deal with the problem of adverse se
Adverse selection is is the tendency of persons with
higher than average chance of loss seeking insuran
standard rates which if not controlled by underwritin
results in higher than expected loss levels. In such ca
insurer is said to be "adversely selected against" eg
risk drivers, low health individuals seeking insurance
normal rates
- This can be controlled by careful underwriting. Unde
refers to the process of selecting and classifying app
for insurance. Applicants who meet the standard ar
insured at standard rates and others are either deni
insurance or charged higher premiums.
- Policy provisions are also made use of to prevent ad
selection eg suicide clause in insurance and pre-ex
clause in health insurance.

Insurance v/s gambling

- Insurance is often confused with gamblin there are 2 important differences betwee two
- 1. gambling creates a new speculative ri while insurance is a technique for handlin already existing pure risk. Betting 500 on creates new risk while buying a fire insura for 500 takes care of fire risk
- 2. gambling is socially unproductive as w gain comes at the expense of losers. Insu is socially productive as both the insurer the insured stand to gain

Insurance v/s hedging

- Hedging transfers risk by purchase of futu contract. Insurance although transfers ris not the same as hedging
- 1. insurance contract transfers an insurab risk while hedging transfers an uninsurab such as price risk.
- 2. insurance can reduce the objective ri an insurer by law of large numbers while hedging does only risk transfer to someo who thinks he can handle it and not risk reduction by law of large numbers

Types of insurance

Life insurance:

Without profit (term insurance) With profit (Endowment, money back), market linked

Non-life insurance

- General insurance- Health, marine, fire, personal accident, vehicle insurance,

- Miscellaneous insurance- fidelity guaran crop insurance, burglary, flood, cattle, ca transit insurance

(assignment: refer and prepare a 10 mark on types of insurance. It is a MLQ)

Essentials/principles of insurance contr

- 1. Nature of contract: offer and acceptance of contract, free consent, competent person- pro major with sound mind, premium is the conside effective policy date, Conditional receipt
- 2. Utmost good faith: uberrimae fidei, is the bas insurance contract. Both parties must disclose a material facts related to the contract. Ex: age, education, health, imflammable material, fire detection, type and condition of car
- 3. Insurable interest: reason to insure without it th contract is void and unenforceable. fundamen principal. Must be pecuniary interest.
- 4. Indemnity: 'make good the loss' all insurance life, PA and health are indemnity contracts. Me full amount of loss will be paid example, marine insurance.

- Causa proxima: the nearest peril is deem
to be the cause of the loss. It is not nece
to go into the cause of the cause. If the
closest peril is the one insured against th
insured must be compensated.
- Rat made hole in sugar bags and water
came in. sugar was insured against wate
Loss was paid
- Oranges were insured against collision.
Collission happned but oranges spoiled
because of delay and mishandling. Loss
not paid
- Contribution: in case of more than one
insurance the insurers are to share the lo
proportion to the amount assured by ea
one of tem. A[[lies to indemnity contrac
fire and marine insurance.

- Risk attached: risk must be attached to the po
the premium to run. If there is no risk the policy
run and the premium can be claimed back e:
burnt, ship arrived safely.
- Mitigation of loss: in the event of mishap, the in
must make reasonable efforts to mitigate the l
absence of which the insurer may refuse to pa
- Subrogation: transfer of all the rights and reme
available on the subject to the insurer after the
indemnity has been effected. It means substitu
the insurer in place of the insured. If a car is da
by a truck the owner gets paid by insurance a
insurer gets the right to sue the truck owner.
- Term of policy: policy covers a specified numb
years as term of the policy

Elements of insurance cont

- Application
- Binders
- Policy forms- heading, body, back, endorsements

READ FUNDAMENTALS OF INSURANCE CONTRACT BY P K GUPTA (Assignment)

Indian insurance industry