Open Vocational Education Programme

Diploma in Insurance Services

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PRINCIPLES OF INSURANCE

Designed & Developed
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Diploma in Insurance Services

PRINCIPLES OF INSURANCE

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Before you begin reading your lessons and start your training, there are a few words of advice that I would like to share with you. We, at the NIOS, are well aware that you are different from other learners. We realize that there are many of you who may have rich life experiences; you may have prior knowledge about trades and crafts that are part of your family's legacy; you may have a sharp business sense that will make you fine entrepreneur one day. Most importantly, you have the drive and motivation that has made you enroll with this institution, which believes in the spirit of freedom. Yes, we are aware that you have many positive aspects in your personality, which we respect and relate to them.

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Studying for a vocational course is different from any other academic course. Here, while the marks obtained in the examination will indicate your grasp on your subject knowledge, your real achievement will be when you are able to apply your vocational skills in the market. I hope that this skill-based learning will help you perform your tasks better .This course of One year duration Diploma Course in Insurance Services developed by leading experts of Insurance sector. It is a multi-skilled programme, which will expose you to a variety of skills in Insurance sector. We hope that you will find it useful. On behalf of NIOS, I wish you the very best for a bright and successful future.

Dr. S. S. Jena
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Dear Learner,

In the fast expanding world of activities, learning new skills has become a necessity. Learning and re-learning has become essential for all. In such an environment, vocational education has assumed great importance. Vocational education, as a stream of education, promotes skill development and training of youth and directs them towards meaningful employment.

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Diploma in Insurance Services is a One year Diploma course in Insurance Services. This course has been developed with the help of many leading experts of Insurance Sector. The course syllabus is designed keeping in view the requirements of the insurance sector.

This is multi-skilled programme, which will expose you to variety of skills. It includes Business Environment, Principles of Insurance, Life Insurance, General Insurance and Legal framework. This will help in identifying learner's preference for future vocation. We are confident that this course will prove to be beneficial to you.

We wish you all the best in your future career.

Dr. K. P. Wasnik
Director (VE)
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Dear Learner,

This programme is specially for all those who are school dropouts and have started small enterprises, want to work in the Insurance sector as a skilled workforce and contribute substantially to the progress of India.

The multi-skill content with hands-on experience of this programme stimulates the intellect by going through concrete operations and then abstracting the concepts. At the same time by giving a variety of skills usable in everyday life, allowing them to form their preferences and know their aptitudes thus enabling them to choose a career. It also improves their self-image and gives them confidence and hope for the future.

The Insurance sector has completed its full circle in the year 2000, i.e. Private sector to Public sector and now back to Private sector. After 44 years, the monopoly of Life Insurance Corporation is no more and after 27 years four Public Sector general Insurance companies lost their monopoly. As on date there are 50 life and general insurance companies and few are queue to get license.

These insurance companies need trained manpower to be present on all India basis. To cater the needs of the insurance industry NIOS has designed a course namely "Diploma in Insurance Services" for the students who have minimum qualification of 12th standard.

In this module the student will be made familiar with the principles of commercial contracts as well as insurance on which the insurance business is transacted.

As the insurance sector in divided in to two segments i.e. Life and non life therefore the principles are explained separately to avoid any confusion to the students.

We hope that this programme will help you to carve an niche in your career and play an important role in the society.

With best wishes.

Dr. Ajay Garg
Senior Executive Officer
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ACKNOWLEDGEMENT

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RISK & INSURANCE

1.0 INTRODUCTION

Risk is a part and parcel of our daily lives. Risks are all around us whether we are aware of them or not. We may be familiar with some of the risks and then there are others, which may have escaped our attention. There are risks, which we have learned to live with such as "Will I live to see this year through" and than there are risks, which do not cross the mind like "The possibility of house or property getting damaged by an earthquake or lightening".

For example: Whenever you go out of your house the parents are worried that the possibility of accident on roads. Risk of accident is involved.

As & when you go to attend marriage of your relative out of town along with your family members and you lock your house and your parents always feel risk of theft.

1.1 OBJECTIVES

At the end of this lesson you will be able to know

- Risks in life
- How it can be avoided ?

1.2 WHAT IS RISK?

Risk has been defined as the **possibility of occurrence of an unfavourable deviation from the expected** i.e. what you want to happen does not happen or vice versa what you do not want to happen, happens. When such unexpected events occur there is invariably a sense of loss, which may or may not be

measurable in terms of money. When your vehicle gets unexpectedly stolen there is a monitory loss but if your Favourite pet dies unexpectedly you feel a great loss but this loss is not measurable. Since an unfavourable deviation from the expected always results in loss, we can also define risk as the **possibility of occurrence of loss.**

Our expectations are mostly positive. We expect our car to be exactly where it was parked in the same condition as when we left it and are unpleasantly surprised if we find it is not there or that it has been damaged when we return. Once we realize that our expectations are less than certain and that actual events may differ from what we expected, **uncertainty** creeps into the mind and **uncertainty is something, which most people are not comfortable with.**

The knowledge of risk and its potential to cause loss creates uncertainty and gives rise to a feeling of **insecurity** which leads to **worry** amongst people and once they are worried enough they will give the problem some thought and try to find a solution, and this is where **Insurance** comes in.

A man is aware that he may die unexpectedly and is worried that in case such an event does happen his family will have to face a lot of hardship and so to mitigate his worry he goes in for life Insurance. Another person may be aware that there is a possibility of his vehicle meeting with an accident and is worried that he may not be in a position to afford its replacement or repair therefore he opts for Motor Insurance. **Insurance provides a means for reducing the adverse impact of unexpected losses** and lessen the worry factor letting a person breathe more easy.

Worry, insecurity and uncertainty are all very negative factors, which adversely affect the output or performance of individuals or even business houses.

A worker who is insecure in his job and is worried by this insecurity will be less productive than his counterpart who is secure. Worry not only leads to reduced production resulting in higher cost but it can also be the cause of accidents as worried workers are more likely to be careless than those who are concentrating on their duties.

Even Business houses when they are uncertain about the future may not be willing to invest more.

Thus we see that Risk with its resultants uncertainty, insecurity and worry definitely have an economic and a psychological cost.

1.3 SOURCES OF RISK

Risk as we have seen is all about losses. In the absence of possibility of loss there would be no risk thus it is important to know about the factors, which cause or contribute towards the occurrence of loss or extent of loss. There are two such factors and these are **"Perils"** and **"Hazards".**

PERILS

Perils cause the deviation in events from those that we expect. They are the immediate cause of loss. Their very existence ensures that we are surrounded by risk for example flood, death, sickness, theft, terrorism etc. and these are discussed below.

1. Natural Perils:

Our very existence on the planet earth ensures that we live with risk as the almighty in all his wisdom has although gifted nature with many sources of energy unbalance or disturbances beyond limits take the form of risk called perils, which can lead to unexpected losses. There are unexpected natural phenomena, which year in and year out cause untold misery, loss of life and property. The most recent example in the Indian context being the Gujarat Earthquake on Jan 26th 2001, which caused widespread devastation. Nearly 20,000 lives were lost, numerous villages and localities were razed to the ground and lakh were rendered homeless. There is no stopping the fury of nature and the havoc that it plays with mankind. Volcanic eruptions, fire due to lightning, landslides, cyclones, hurricanes, storms, floods, the vagaries of weather, unseasonal rainfall and prolonged dry spells, hailstorms are some other examples of natural risks that can cause losses. These perils are also called **Act of God perils,** and there is little that mankind can do to stop them, he can only learn to live with them and devise means to lessen the negative impact.

A global survey of losses for the year 2006 conducted by Sigma estimated the insured losses due to natural calamities at 14.8 billion dollars and out of this 12.6 billion dollars was on account of floods alone (while looking at these figures we have to bear

in mind that these are only for insured losses, the actual figure may be actually much more).

40% of the lives lost during the year in catastrophes were on account of natural disasters with a major contribution being the lives lost due to floods in India & Bangladesh in and Southern Africa in February'2000 and Tsunami in 2005-06.

2. Man Made Perils:

Then there are the manmade perils, which cause loss, these are an outcome of our society and are the violent actions and unethical practices of people, which result in deviation from the expected. There are many of these but only a few are being discussed to illustrate their significance.

(a) Theft: - Page – 3 of your daily newspaper provides a fair idea about this rampant malady in our society. The entire page is full of incidents of thefts of motorcycles, daylight robberies and burglaries loss to human life by accident, terrorism, enmity, adulteration murder etc. The figure for the exact extent of losses due to such incidents is not available for India but a study done by the FBI in USA way back in 1974 estimated that such losses in material terms alone exceeded $3 billion that year. Not only outsiders but insiders also steal. Employees steal tools, equipments and goods from their employers worth millions every year.

(b) Riots, Strikes and Malicious Damage: - These are perils, which every property owner faces. During Riots miscreants damage, Public and Private property, loot stores, inflict injury or death to innocent people and the police personnel and bring business to a standstill causing untold damage. Similarly strikes sometimes turn violent resulting in damage to life and property. Strikes also result in loss of production causing huge monetary losses, which may even result in bankruptcy. Vandals target unoccupied houses when the proprietors are on vacation and damage the property, in some cases setting it on fire. Cars parked in the street are also often vandalized.

(c) Accidents: - Accidents are caused by people and they cause injury to themselves or to others and also damage to property. Automobile accidents alone contribute the maximum share of losses due to this peril. As per WHO study each year "Road Traffics" take the lives of 1.2 million

men, women & children around the world and seriously injure millions more. In addition to automobile accidents, accidents due to carelessness of humans result in huge losses to property and life. A carelessly dropped cigarette can lead to fire resulting in heavy losses to property and even life. Thousands of workers lose their lives and limbs every year in industrial accidents caused by human error or carelessness.

In one of the reports by Sigma for the year 2006 puts the global figure of man made insured losses at 5 billion dollars with 50% being attributed to Industrial fires. 11700 people lost their lives and out of these 65% were killed in transport related disasters (which appreciating the extent of losses. We must remember that Sigmas report is only a study of major disasters and only 350 events during the year have been evaluated / studied. The figures therefore just give an idea whereas the ground reality may be even more alarming).

3. Economic Perils:

The third category of Perils or cause of Risk is economic in nature and the examples of this type of Risk are Depression, Inflation, Local fluctuations and the instability of Industrial firms.

Depression in the market leads to low production levels and an increase in unemployment. Low production results in reduced profits or losses for business houses whereas unemployment stops the income of individuals causing mental and physical suffering.

When Inflation is there in the economy the buying power of money declines and the real value of savings and income is reduced. People whose livelihood is based on fixed income such as pensioners (Retired persons) during such periods are the hardest hit and may find it impossible to make both ends meet.

This fluctuation in the general economy can cause unfavourable deviation from the expectations and create risks for both Industries firms as well as individuals.

Sometimes it so happens that even though the general economic condition in the country is stable there are some areas, which may experience recession. These are known as

local fluctuations and can effect the Individuals or the business houses in the same manner as the general fluctuation in economy i.e. Depression & Inflation. When particular area is effected the value of investments made in the area declines and jobs are also lost.

At time it is the individual firms which are to blame. The owners lose part or whole of their investment and workers lose their jobs. There are many towns and communities, which are dependent on one single Industry for their well being and when this Industry fails or decides to shift operation the entire town or community is exposed to risk.

Hazards

While perils are the direct cause of loss **hazards are the underlying factors, which increase the probability of occurrence of loss.** There are conditions, which are more hazardous than others e.g., working, as an electrician is a more hazardous occupation than that of a banker as it is more susceptible to accidents. Owning a property on the banks of Ganga is more hazardous than a property in Chandigarh as it is exposed to the risk of damage due to floods. Similarly dealing in textiles is more hazardous than dealing in hardware as the risk of loss due to fire is greater. There are three kinds of hazards:

(i) Physical (ii) Moral (iii) Morale

(i) Physical Hazard: These are hazards, which are related to the physical aspects of the property, which may influence the chances that the property may be damaged or which may increase or decrease the losses incurred due to a particular risk.

The location of a building affects its vulnerability to losses due to fire, floods, earthquakes etc. A residential building close to a unit manufacturing crackers will be more susceptible to losses than a building located in a purely residential area.

Construction of a building also affects the extent of loss. A building or the use to which it is being put is another example of a physical hazard. The same building will be in greater danger of loss by fire if it was used for storing petroleum products than if it was being used as an office or a departmental store.

(ii) Moral Hazard: Moral hazard also affects the probability of loss occurring and the risk is increased. A dishonest person may set his own house or property on fire to avail the Insurance benefit. An unscrupulous trader may arrange for a robbery in his own store to get the benefits. Whenever persons of doubtful integrity buy an Insurance policy the risk increases because loss becomes a certainty.

(iii) Morale Hazard: This is not to be confused with moral hazard, which involves dishonesty but morale hazard is an attitude of lack of concern about the outcome of his actions. An example of this is a person who is careless about stubbing out cigarettes and just throws them around not in the least bothered that his action may cause fire. Bad house keeping is another example of a morale hazard as this also increases the chances of loss occurring.

INTEXT QUESTIONS 1.1

1. Define risk.
2. What are the different types of perils?
3. Distinguish between Moral and Morale hazard.

1.4 TYPES OF RISKS

Risks can be classified into two categories **Pure Risks** and **Speculative Risks.**

To illustrate the difference between the two types of risk let us take the example of a property owner. When a person purchases a property, he is exposed to the risk of damage or loss to his property due to fire. In the event of a fire occurring he will suffer a loss and there is no possibility of him gaining anything if a fire occurs. Simultaneously the value of his property may increase or decrease due to various factors. The areas where the property is located may develop into a prime locality and the value of his property will increase or alternatively the area may not develop but instead becomes uninhabitable because of pollution and the value of his property may decrease. Thus by purchasing the property he exposes himself to the risks of either gaining or losing.

In the first case there was only the chance of a loss occurring this is known as **pure risks** whereas in the second there is a

chance of either gain or loss this is known as **speculative risk**. Thus we see that in the same instance i.e. the purchasing of a property the owner exposes himself to both Pure and speculative risk.

Pure risks are those where in case of any unexpected happening the result is only loss whereas in **speculative risks** an unexpected occurrence can possibly result in gain or loss.

When a person gambles or he buys shares there is a chance that he may lose or win or that the share prices may go up and he gains or the share market crashes and he loses. These are **speculative risks**. Risks as we have mentioned earlier is the possibility of loss but when there is also a chance of gain then these risks are called speculative risks.

It is said that the profit that a businessman earns is his reward for bearing a speculative risk. No businessman willingly exposes himself to pure risk because in pure risk there is no gain. It is a universal fact that if one has to live in this risk prone world, one has to expose himself to the pure risks. Pure risks are a part of the environment and are all pervading.

Pure risks which every individual families, firms and other organisations are exposed to can be broadly classified as follows:

(i) Personal Risk: Since all losses are ultimately borne by the people it can be said that all risks are personal but there are some losses such as loss of income, mental or physical suffering etc. which have a direct impact on people. Therefore the risk of premature death, sickness, disability, unemployment and even dependent old age are put in this category of Personal risk.

(ii) Property Risk: The possibility of loss to an asset such as damage to a building due to fire or damage to a vehicle in an accident or theft of vehicle. These sort of risks fill in the category of Property Risk.

(iii) Liability Risk: This is the risk of becoming legally bound to compensate or to pay for damage to the person or property of others.

1.5 WHO FACES RISK ?

Risks as we have seen are inevitably a part of our lives and every individual or business/ Industrial house is exposed to

the possibility of loss. The risks faced by the individual or family and the Industry are common but they differ in nature and the extent of loss.

It will be simpler if we discuss the risks faced by the Individual or family separately from the risks faced by the Business houses/ Industries.

1. Family Risks

The term family for all practical purposes henceforth includes an individual who may be living with the family or separately.

(i) Personal Risks

Death: When a person dies the income that he earns with his efforts stops. When death will strike is uncertain and the risk is there at any age. In addition to the loss of income when the head of family dies the family is subjected to expenses on last illness, funeral expenses and settlement of estate not to mention the mental and social burden which cannot be measured in monetary terms but is without doubt very high.

Disability

This may not be as serious as death but it has definite impact on the income. Expenses will increase due to medical care for the disabled family member. Poor health as a result of an accident or illness is one of the most important risks which a family has to face.

Retirement

A person may survive pre-mature death or disability but he still faces loss of income to maintain a reasonable standard of living during retired lifetime.

Unemployment

This risk is also an important one for every family. The current industrial & economic scenario is not very conducive for employment and a lot of companies industrial houses are downsizing, cutting down on the labour force. Voluntary Retirement Scheme and Retrenchment are the order of the day.

(ii) Property Risk

All families in addition to the risk of loss of income or increased expenses also face the risk of loss to property. Loss to property

results not only in reduction of Assets but also in loss of income. Examples of property risk are innumerable but to illustrate the extent and nature some are being mentioned here. Homes may be destroyed by fire, floods and storms; cars may be damaged in an accident, burnt, be lost, stolen or destroyed; Savings may be lost in stock market crashes or failure of banks.

(iii) Liability Risk

An individual because of his negligence may become responsible for injury to the person or damage to the property of others for which he has to pay compensation and expose the family to such a risk. With a greater awareness amongst the common man the liability risks is ever increasing and the courts in their judgements appreciating the value of human life and right are awarding huge amounts as compensation for which any individual or family can be beyond imagination and intolerable.

2. Business Risks

As we have already said, businesses also face the same risks as the family but in a different manner and the magnitude is bigger.

(i) Personal Risks : The death or disability of an employee who is instrumental in the successful running of the business enterprise can result in loss of business and profits. If a partner in a partnership concern dies, the partnership is dissolved and the surviving partners can suffer loss of Income. In the case of disability of a key employee or partner the firm may be burdened with his medical expenses and may be obliged to continue paying his salary. Firms also to have face the risk of the death or injury to their employees and the burden, which has been transferred to them by law or by contract. The workmen compensation Act 1923 is an example whereby the financial burden resulting from disablement or deaths of an employee is placed upon the employer.

(ii) Property Risk : Business houses suffer direct and indirect losses due to property risk. Direct losses can be as a result of various perils much the same as for the family such as destruction of building, machinery and stocks in fire or

due to other perils such as storms and flood. In addition dishonest employees may steal from the firm not only material goods but also ideas causing great loss. In this competitive era business houses spend a lot of money on research and development of new concepts but if these are stolen and handed over to other firms in the same field the returns expected from these investments are lost causing great loss. Equipment and property may be damaged or destroyed by rioters or employees on strike. Strike also cause loss of production.

These direct losses may only be a part of the total loss because apart from direct losses due to property damage the business houses also have to bear the indirect loss incurred due to stoppage of operations, disruption in production (Loss of profits) that they may have to face.

(iii) Liability Risk : As in the case of family business, firms also are liable to others for bodily injury or property damage but the exposure is greater than the family as the firm is responsible for the acts of a large number of employees as also the products or services that it deals in.

1.6 HANDLING RISKS

Now that we know that risks are a part of our daily lives we must know how to handle them. Risk management will be discussed in detail under "Practice of General Insurance" and here we shall only make a passing reference to this important aspect.

Some of the methods used to handle risks are Risk Avoidance, Loss Prevention and Reduction, Risk Retention and Risk Transfer. For convenience sake these are briefly being dealt with separately but in practice two or more are used in combination.

1. Risk Avoidance:

The simplest way to deal with risk is to avoid it together. If a factory is to be located on the banks of a river, which is prone to floods every year then it may be decided to shift the site to a safer location. Some people avoid the risk of death or injury in an aeroplane crash by traveling by surface transport only. Organisation like the Armed forces and even some corporate

Notes

houses restrict the number of their officers traveling in a single aircraft or vehicle together to avoid the risk of all of them dieing in an accident. Though this is the simplest way it is not always practicable.

2. Loss Prevention and Reduction:

Possible loss due to risks may be eliminated or minimized by Loss Prevention and Reduction measures. Some measures such as strict enforcement of "No Smoking" regulations may eliminate fire losses whereas measures such as installation of sprinkler systems and other appliances may reduce the extent of loss due to fire.

Good manufacturing units spend a lot on safety devices and measures and enforce strict rules of conduct within their premises to eliminate or reduce the occurrence of accidents thus minimise their losses & expense incurred on treatment and compensation to employees.

Segregation of hazardous processes from others in a manufacturing unit and isolation of hazardous goods such as petroleum products from non-hazardous goods in a storage facility are some examples of the method of loss Prevention and Reduction.

3. Risk Retention:

It may be consciously decided to retain some risks. Small losses, which may occur frequently may be absorbed by the firm as normal operating expenses such as minor damage or loss of goods in transit.

A financially sound firm may **create an Insurance fund** to which regular payments are credited and from which losses are paid as and when they occur.

This method is used to take care of the domiciliary medical expenses of employees by some large companies having a big workforce.

Some individuals retain the risk of contracting cancer due to smoking not knowing that smoking causes cancer and other even though knowing of it rationalize and pretend that the risk does not exist by saying. "It won't happen to me".

4. Transfer of Risk:

Risk transfer occurs when the activity that creates the risks is transferred to another. For example if a particular process of manufacture is hazardous the firm may decide to get it outsourced i.e. get the job done from a specialized sub-contractor outside so that the associated risks are transferred.

Similarly when a person hires an equipment the owner may insert a condition in the contract that any damage to the equipment shall be the responsibility of the hirer. Lease and rental agreements are an example of this method of handling risk. A rental agreement carries the clause that the equipment shall be returned to the owner in good condition, ordinary wear & tear accepted. Guarantees are also a form of risks transfer where the buyer transfers the risk of purchasing a defective new item back to the manufacture. Most consumer goods coming in the market now are sold with the guarantee that in case of any manufacturing defect or non-performance the equipment will be replaced/ repaired by the manufacturer. Earlier it was not so and the buyer used to purchase the materials at his own risk and in case of defect had to bear the loss.

There are innumerable ways to transferring the risks and these are only a few illustrations but **the most important method of Risk transfer is Insurance.**

The general guidelines for handling risk are given in the table below:

Types of risk	Suitable Method
Low Frequency and low severity	Retention of Risk
High Frequency and Low severity	Loss control
High Frequency and high Severity	Risk avoidance
Low Frequency and high severity	Risk transfer (Insurance)

1.7 SUMMARY

Risk, which is the possibility of an unfavourable deviation from expectation, causes uncertainty to a person who is both exposed to it and aware of his exposure In many instances uncertainty is unpleasant if not unbearable and reaction to it creates a deterrent to economic activity. Perils causes deviations

from expectations and hazards increase the likelihood of such occurrences. Hazards may be physical, moral or morale. The sources of perils and hazards are social, physical and economic. Risk is a common characteristics of the environment for individuals, families and firms. All are exposed to personal risk, property risk and liability risk.

1.8 TERMINAL QUESTIONS

1. What are various sources of risk?
2. Distinguish between Pure Risks & Speculative risks.
3. Explain various risk assumption.

1.9 OBJECTIVE TYPE QUESTIONS

1. Risk is _____ of occurrence of loss. (Possibility/ impossibility)
2. Earthquake is _____ perils. (natural/ manmade)
3. Inflation is _____ perils.(economic/natural)
4. There are _____types of hazards(two/three)
5. Pure Risks are ____.(Insurable/non-insurable)

Choose the correct options

6. Statement A: Risk can be avoided.

   Statement B: Risk can be transferred.

   a. Both statements are correct
   b. Both statements are wrong
   c. Statement A is correct
   d. Statement B is correct

7. Statement A: Pure risks are insurable.

   Statement B: Speculative risks are not insurable.

   a. Both statements are correct
   b. Both statements are wrong
   c. Statement A is correct
   d. Statement B is correct

8. a. An individual does not face risks
   b. A business organization only faces the risks
   c. Both an Individual and business organization face the risks.
   d. Animals also faces the risk and can be insured.

9. Statement A: Business risks consist of personal, property and liability risks

   Statement B: Family risks consist of personal , property and liability risks.
   a. Both statements are correct
   b. Both statements are wrong
   c. Only statement A is correct
   d. Only statement B is correct

10. Statement A: Morale hazard means lack of concerns.

    Statement B: Moral hazard means dishonesty.
    a. Both statements are correct
    b. Both statements are wrong
    c. Statement A is correct
    d. Statement B is correct

1.10 ANSWERS TO INTEXT QUESTIONS

1.1

1. Risk is the possibility of occurrence of an unfavourable deviation from the expected that is occurrence of undesirable contingency.

2. i) Natural Perils, ii) Manmade perils-Theft, Riots, strikes and malicious damage, accidents iii) Economic Perils

3. Moral hazard means dishonesty of the person and Morale hazard carelessness of a person

1.11 ANSWER TO OBJECTIVE TYPE QUESTIONS

1.9

1. Possibility

2. Natural

3. Economic
4. Three
5. Insurable
6. a
7. a
8. c
9. a
10. a

Notes

2

INTRODUCTION TO INSURANCE

2.0 INTRODUCTION

In the preceding chapter the nature and significance of risk and method of handling risks has been explained. As we have seen the possibility of loss creates uncertainty, which has undesirable economic and psychological effect. When we speak of methods of handling risks we are talking about efforts to reduce uncertainty. While no approach to risk problems is used to exclusions of all others the single most important an widely used alternatively for most families & business is insurance.

2.1 OBJECTIVES

At the end of this lesson you will be able to know

- The concept of insurance
- How insurance works
- Need of insurance
- How the insurance helps the economic development of the country

2.2 NATURE OF INSURANCE:

There are three schools of thought, which have defined the nature of Insurance as follows:

1) **Insurance in terms of the relationship between the insured & the insurer – transfer device:**

   According to this school, Insurance may be defined as the transfer of pure risk from the insured to the insurer.

Notes

The insured is the person or firm or company confronted by risk and the insurer is a person or firm or company, which specializes in the assumption of risk. The primary business of the insurer is risk assumption for a fee.

2) Technical:

This school of thought defines Insurance in terms of techniques or mechanics it involves. According to Prof Mehr & Cammack, Insurance is a device for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable. The predictable loss is then shared proportionately by all units in the combination. Therefore, it implies both that uncertainty is reduced & losses are shared. Further, it is said that a device will be deemed Insurance if

(i) it implies the law of large numbers so that the requirement of future funds to cover losses are predictable with reasonable accuracy.

(ii) it provides some definite method for raising these funds by levies against the units covered by the scheme.

In short, the essential features of Insurance are the manner in which losses are predicted & shared.

3) Combination:

According to the third school of thought, Prof. Willet defines **Insurance as a social device for making accumulations to meet uncertain losses of capital, which is carried out through the transfer of risks of many individuals to one person or to a group of persons.** Wherever there is accumulation for uncertain losses, or wherever there is transfer of risk, there is one element of Insurance, only when these are joined with the combination of risk in a group is the Insurance complete. Another way to state this is to say that "Insurance is a transfer of risk with the added features of (i) combination of risks (ii) an estimate of future losses".

Although each of the authors have defined Insurance differently but they are all thinking about virtually the same thing when they use the term Insurance. If we sum up all schools of thought then the Insurance can be well defined as follows:-

"Insurance is a social device which combines the risks of individuals into a group, using funds contributed by members of the group to pay for losses."

The essence of the Insurance scheme is that it is a

1) Social science
2) Accumulation of funds
3) It involves a group of risks
4) Transfer of risk to the whole group

2.3 BACKGROUND

Insurance as security is need of all human beings. No animal, no plant nor mountains and oceans want any security, like man does. Man is afraid of uncertainty, fears and death. Although a reality, one day each one will die; early or later, timely or untimely is the question, which has no answer. He is afraid of risk & losses in future. He is ever in search of security & certainty. In early history man lived in-groups and communities to be secure.

At the earlier stage, whenever an earning member would die due to disease or death, the other members of the social group (or family or clan) would contribute to bail the survivors in the family out of financial difficulties. This contribution was in the shape of food- clothing and shelter. Even today we donate money, food, clothing and other materials of life to rehabilitate the family whose breadwinner has left for his heavenly abode, unfortunately, suddenly, sadly. (Also people, friends, relatives even today contribute towards marriage, education, healthcare expenses or mishap).

Later, as commercial considerations grew stronger and stronger; nucleus family growth became a common practice these contributions and sharing started becoming individualistic and took the shape of 'premium'. The 'assurances' which were earlier by will and practice became a commodity (though intangible). Thus the concept of Insurance grew. Any person who would not contribute, or would contribute less according to his paying capacity was denied reciprocal help or promise of help, or was given help in proportion to his contribution which he had been contributing as a faithful obedient member of the society.

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In earlier days, in India, on an unexpected death of breadwinner in any family, the villagers or neighbourhood would collect funds to help the survive in the family and such practice continues even now. Today also, when after death – "Bhog" or "Kirya"s takes place, relatives give money to the survivors though this may not be adequate collection to meet expenses of remaining part of life when there is no breadwinner. **Insurance is on similar pattern.**

2.4 PURPOSE OF INSURANCE

Every human being has fear in his mind. The fear whether he will be able to meet the basic needs of the life i.e. Food, Clothing and Housing (Roti, Kapda and Makkan). He has fear not only for himself but also for his dependents. The source of income to meet his basic needs may be through service or business. If he is able to meet his basic needs then he acquires the assets i.e. vehicles, property or jewellery etc. Then he gets additional fear of saving the assets from destruction. (The assets may be destroyed through accident, fire or earthquake etc. and the income may be cut off due to certainty i.e. old age and death or uncertainty i.e. accident, illness or disability.)

As you know, the old age and death is certain for every human being while the accident, illness, disability and destruction of assets may be by random. The number of accidents will take place but with whom is uncertain. Therefore, to overcome this problem, **the Insurance plays a very important role.**

The principal source of income of an individual comes from the compensation for work performed by him. If this source of income gets cut off then: -

Family will make social and economic adjustments like:

- Wife may take employment at the cost of home making responsibilities
- Children may have to go for work at the cost of education.
- Family members might have to accept charity from relatives, friends etc. at the cost of their independence and self-respect.
- Family standard of living might have to be reduced to a level below the essentials for health and happiness.

The basic threats which all of us may encounter to varied extent and which result in cut off of income or sudden increase in - uncalled for expenses (beyond our means or higher than our earnings) i.e. dislocates the human life, are: -

- ILLNESS (malnutrition, environment, chronic) – uncertain
- ACCIDENT – (uncertain)
- Disability – Permanent or Temporary (uncertain)
- OLD AGE – (certain)
- DEATH – (certain)

LIFE INSURANCE is an arrangement through which a person can plan for the continuation of income when uncertainties and certainties (i.e.) illness or Accident and death or old age disrupt or destroy his ability to earn his livelihood.

Therefore the Insurance is

1. The business of insurance is related to protection of human life, human created assets, human disability and business liabilities possessed by human beings which have a definite value, and
2. Assets and human life generate benefit and income for the owner and his/her family members, and
3. Loss of assets / human life for any reason stops the benefits and income to the owner and family members respectively, and
4. Results in falling of living standards in the family, quality of life and future growth of the associated family members, and
5. Insurance is a mechanism that helps to reduce such adverse consequences through pooling, spreading and sharing of risk.

Thus life insurance business is complimentary to the Government efforts in social management.

INTEXT QUESTIONS 2.1

1. Define nature of Insurance s per third school of thought.
2. Most common example of insurance.

Notes

2.5 NEED OF INSURANCE

(a) To provide Security and Safety

The Life Insurance provides security against premature death and payment in old age to lead the comfortable life. Similarly in general Insurance, the property can be insured against any contingency i.e. fire, earthquake etc.

(b) To provide Peace of Mind

The uncertainty due to fire, accident, death, illness, disability in the human life, it is beyond the control of the human beings. By way of Insurance, he may be compensated financially but not emotionally. The financial compensation provides not only peace of mind but also motivates to work more and more.

(c) To Eliminate Dependency

On the death of the breadwinner, the consequences need not be explained. Similar to the destruction of property and goods the family would suffer a lot. It could lead to reduction in the standard of living or begging from relatives, friends or neighbours. The economic independence of the family is reduced. The Insurance is the only way to assist and provider them adequate at the time of sufferings.

(d) To Encourage Savings

Life Insurance provides protection and investment while general Insurance provides only protection to the human life and property respectively. Life Insurance provides systematic saving because once the policy is taken then the premium is to be regularly paid otherwise the amount will be forfeited.

(e) To fulfill the needs of a person

a) Family needs

b) Old age needs

c) Re-adjustment needs

d) Special needs: Education, Marriage, health

e) The clean up needs: After death, ritual ceremonies, payment of wealth tax and income taxes are certain requirements, which decreases the amount of funds of the family members.

(f) To Reduce the Business Losses:

In business the huge amount is invested in the properties i.e. Building and Plant and Machinery. These properties may be destroyed due to any negligence, if it is not insured no body would like to invest a huge amount in the business and industry. The Insurance reduced the uncertainty of business losses due to fire or accidents etc.

(g) To Identify the Key man:

Key man is a particular man whose capital, expertise, energy and dutifulness make him the most valuable asset in the business and whose absence well reduce the income of the employer tremendously and upto that time when such employee is not substituted. The death or disability of such valuable lives will prove a more serious loss than that fire or any hazard. The potential loss to be suffered and the compensation to the dependents of such employee require an adequate provision, which is met by purchasing an adequate life policies.

(h) To Enhance the Limit:

The business can obtain loan but pledging the policy as collateral for the loan. The insured persons are getting more loan due to certainty of payment at their death.

(i) Welfare of Employees:

The welfare of the employees is the responsibility of the employer. The employer is supposed to look after the welfare of the employees. The provisions are being made for death, disability and old age. Though these can be insured through individual life Insurance but an individual may not be insurable due to illness and age. But the group policy will cover his Insurance and the premium is very low in group Insurance. The expenditure paid on account of premium will be allowable expenditure.

2.6 HOW INSURANCE WORKS

Theory of probability: It says an event may happen. Say 10 % in a year. For example, in a particular city having a population of 1 lakh on an average-200 people die in accident, 800 people get injured and disabled, another 2000 die natural death, & 7000 die of disease.

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This data as per statistic is certain.

Then what is uncertain?

Uncertainty is as to who will die or get disabled during day to day high risk prone fast life.

Although, number is known, but name, age, time, place and extent is not known. If it is known that 200 persons are prone to accidental death in a year, it is not known which 200 individuals?

Due to this certainty, that 10,000 people will die in an accident, or get injured and disabled or die natural death or die of disease; All 1 lakh people will fear accident, possibility of injury or death and its consequences to varying degree as per their age, behaviour, nature of work, environment hazards and many other factors. Grown ups and breadwinners may fear more and dependents may fear less.

If in a city of 1 lakh houses & shops, there are about 1000 thefts every year, though some particular 1000 people are affected by the theft, all others (may be more than 90,000) will fear theft, and will like some solution to this problem.

Human life is a unique income generating asset. When other assets depreciate with age, it appreciates. Creator of all these assets is a human being, whose efforts have gone a long way in owning them.

Before Assurance or Insurance companies came, there were social arrangements in India which almost played similar role but to an limited extent as we have already given the examples in the beginning of this chapter which explains how **"Many would contribute to mitigate losses of a few".**

This method of sharing losses of a few by many is the basis or core philosophy of insurance.

Insurance companies started from individual effort i.e. an individual or group of individuals pooled funds in a partnership or company and started offering a definite payment (called claim) in every case of death or disablement of the participating individuals, against a small amount received (called premium).

For example look at the following numerical: -

Suppose in a year,

Total **Deaths feared**	Total and **Disabilities**	Total Persons **Who wanted to insure**
200 lakh	800	Entitled for claim and agreed to contribute: -Rs.1 (say)

Death payment, say = Rs.1 lakh

Disability payment, say = Rs.50,000/-

Death claims amount for the year = Rs. 2,00,00,000/- (200 X 1 lakh) – (a)

Disability amount for the year = Rs. 4,00,00,000/- (800 X 50,000) – (b)

Total outgo (expected) (a + b) = Rs. 6,00,00,000/- (6 crores)

Therefore, minimum contribution which 1 lakh persons should have made to meet the claims 6 crores / 1 Lakh = Rs. 600 per year

Thus with a small amount of Rs. 600/- each 1 lakh people feel assured for payment of Rs. 1 lakh each in case of death, and Rs. 50,000/- in case of disablement.

And if that individual had to provide for himself, by himself then the entire Rs.1 lakh or Rs.50,000/- would have to be arranged by the unfortunate person himself-

Thus losses are spread in the insurance system.

But is this small sum of Rs-600/- really the premium?

Answer to this question is - No & Not the least.

We will have to **add all costs & expenses of management** (which go on decreasing in proportion of large-ness of the number of people contributing or buying the insurance policy). **(Let us assume it to be say Rs. X)**

Then, add provision of profit to the entrepreneur, share holders since everybody opens his shop for profits, for gains, and not as a charitable house, (or else the shop will close). **(Let it be say Rs. Y)**

Further, there has to be the provision of **a standing fund (reserve), to off-set large natural calamities** (floods, earthquakes, volcanic eruptions, or large-scale accidents like

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Concorde Aeroplane crashing or Sahara air bus going into flames or disasters like Gujarat Earthquake or loss to life, property and business in 11th Septmeber'2001 terrorist attack – Manhattan or Pentagon). **(Let it be say Rs. Z)**

Then the total premium comes to [Rs.600+X+Y+Z]

This is a very rough and crude example of arriving at cost of an Insurance product. Experts called actuaries specialize in design and right pricing of Insurance products.

2.7 INSURANCE AS A SOCIAL SECURITY TOOL

- United Nations Declaration of Human Rights 1948 provides: -" Every one has a right to adequate standard of living for health and well being of himself and his family, including food, clothing, housing, medical care, necessary social services and the right to security in the event of unemployment, sickness, disability, widowhood, or other lack of livelihood in circumstances beyond his control."
- Under a socialistic system the responsibility of full security would be placed upon the state to find resources for providing social security. In the capitalistic left to the individuals. The society provides instruments which can be used in securing this aim. Insurance is one of aim. In capitalistic society too there is a tendency to provide some social security by the state under some schemes where members are required to contribute.
- In India, Article 41 of our Constitution requires the State (with in limits of its economic capacity and development) to make effective provision for securing the right to work, to education and to provide public assistance in case of unemployment, old age, sickness and disablement.
- Part of the obligations under Article 41 are met by the State through the mechanism of Life Insurance.
- Where breadwinner of family dies, family's income stops to that extent, affecting the economic condition. Life Insurance provides such alternate arrangement as we have discussed above.Otherwise another family would have been pushed into the lower strata of society. The lower strata creates a cost on society. Poor people cost the nation by way of subsidies etc.

- Life insurance helps in restoration of the adverse economic condition so caused.
- Some of the legislation passed by the Govt. of India to protect the rights and to provide benefits to the common man as a part of its efforts to provide social security to its dominions is discussed in brief below:

(a) Workman Compensation Act 1923:

This perhaps was the earliest act to be enacted for the benefits of the workers. Before this Act was passed workers who met with accidents while performing their duty not only lost their limbs or lives but also were denied any medical aid and more often than not were simply removed from the job and lost their livelihood placing them and their families in great difficulty. By passing this act the liability of employer was fixed and he is now required by law to pay compensation to victims of accidents while on duty. The amount of compensation has been fixed in accordance with the extent of injury, disability and linked to the workers salary and age on the date of accident.

(b) Employee State Insurance Act 1948:

The purpose behind this legislation was to provide medical aid to workers and their families working in industries located in certain notified areas. Under this act a part of the salary a small amount (at present 1.75%) is deducted from the workman's salary and some part is contributed by the Employer (at present 4.75%) and the same is deposited with the Employee State Insurance corp. With the funds thus collected and with more contributions from the state and Central Govt., Dispensaries and Hospitals have been set up all over the country where the worker members and their families are provided health care free of cost. Under this scheme regular periodic payment are made to workers if they are unable to attend duty due to illness and there is provision for payment of pension in the case of permanent partial disability or death.

(c) Motor Vehicle Act 1988:

The Motor Vehicle Act was amended in 1988 to make Third Party Liability Insurance compulsory thus no uninsured vehicle is allowed to ply the roads or in any

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public place in India. The need of this enactment was felt due to the growing number of vehicles and the increasing number of accidents causing injury and death of the people involved in the accident and not being able to get relief from the owner/ driver of the vehicle because of long protracted legal battle involved, which many victims could not afford. The Act now provides that irrespective of the fact that the fault was of the driver/ owner or not (No-fault) the victim of an accident will be entitled to a payment of Rs. 50,000/- in case of death and Rs. 25,000/- in the case of grievous bodily injury. Motor Accident Claim Tribunals (MACT) have been set up by the State Government to provide speedy redressal of Third Party claims. Damage to property of Third party is also covered and the limit is Rs.6,000/-.

Motor Vehicle Act also provides for the creation of a "Solatium Fund" to cater to the victims of Hit and Run cases. The fund is created by the contribution from Insurance companies, state and central Government and the victims of Hit & Run cases are entitled to receive Rs.25,000/- in case of death and Rs.12,500/- in the case of grievous bodily injury.

(d) Public Liability Act 1991:

The Bhopal Gas tragedy of 1984, which resulted in many deaths and caused untold suffering to lakhs of people prompted the enactment of this legislation. To recap the incident, poisonous gas escaped from the manufacturing plant of Union Carbide leading to one of the worst industrial disasters of recent times. The victims even now; 17 years later are yet to get adequate relief and continue to suffer.

The public liability act now makes it compulsory for all individuals, companies, industries involved in handling of hazardous substances to insure against any untoward happening so that immediate succor is made available to the victims from the Insurance companies.

Other than passing legislations to improve social security the Government also initiated certain schemes under which Insurance is provided to the economically and socially backward people and workers of the unorganized sector at highly subsidized rates. Some of the schemes introduced by the Govt. of India are -

(e) (PASSS) Personal Accident Social Security Scheme:

Introduced in 1985 for the benefit of Poor families i.e. (whose income does not exceed Rs. 7,200 per year). The scheme provided for a payment of Rs.3,000/- in the event of death due to an accident of any person in the age group of 18 to 60 who is the earning member of the poor family. The premium is borne by the Central Government and the expenses for implementation of the scheme by the state Government.

(f) (NAIS) National Agricultural Insurance Scheme or the (RKBY) Rashtriya Krishi Bima Yojna introduced in 1999 with the objective of providing Insurance coverage and financial support to farmers in the event of failure of crops as a result of calamities, pests and diseases. The premium is low and 50% subsidy in premium is allowed to small & marginal farmers which are shared by the Central and State Government.

(g) Hut Insurance Scheme:

Introduced in 1988, for the benefit of very poor families (i.e. those whose annual income does not exceed Rs.4,800/-p.a.). The scheme provides that in case of destruction of Hut due to fire, compensation of Rs.1,000/- for hut & Rs.500/- for belongings shall be paid. The premium is borne by the Central Government.

In addition, to the above schemes the Government has also introduced insurances at subsidized rates for farmers (cattle Insurance), for women (Raj Rajeshwari Mahila Kalyan Yojna), for the girl child (Bhagyashree child welfare policy) and Gramin Personal Accident policy etc. for the benefits of the common people. These shall be discussed later on in the course (under GIC Products) but all this goes to show how through legislations or through Govt. sponsored schemes the Insurance sector acts as a tool for implementation of social security measures.

2.8 ROLE OF INSURANCE IN ECONOMIC DEVELOPMENT

In addition to contributing to the economy by preserving human life values and assets and protecting loss, Insurance also aids in economic development. To grow economy, the Govt. needs capital to finance infrastructure i.e. Roads, bridges, industrial

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farm communication and Railways lines which requires the huge investment. Individual or Govt. is unable to provide such funds. As the life Insurance contracts are long term contacts. Therefore, insurer by investing funds that flow to them from their many policyholders have become the principal source of capital for the economy.

- Investments are essential ingredients for economic development of any nation. Investments by Insurance companies are in social sector, infrastructure development and government security, papers and bonds.
- Life insurance plays a major role in mobilization of pubic savings.(Rs. 75,000 crores/ year)
- Savings out of life insurance fund are utilized in investments for growth. (infrastructure bonds, Housing, Railway, equity market etc.)
- Looking to non-life side business, industry and trade would be seriously handicapped in the absence of insurance cover relating to losses due to fire, earthquake, flood, storm - natural calamities, act of God etc.)
- Wide-spread of Insurance brings in indirectly the following advantages
  - Better living standards
  - Higher productivity
  - Improved Law and Order
  - Higher GDP
  - Healthy Generation
  - Discourages bad habits and practices causing damage to human life
  - Higher mortality
  - Happy society
  - Enhanced self-esteem
  - Creative Minds
  - Entrepreneurship qualities
  - Social upliftment of the society as a whole

INTEXT QUESTIONS 2.2

1. What are the components of the Premium?
2. Explain the provisions of Article of 41 of Indian Constitution.

2.9 HISTORY OF LIFE INSURANCE

Life insurance is an organised economic activity came into force in different countries at different stages of history.

Records show that first policy providing temporary life assurance cover for a period of 12 months was issued on 18th June 1583 AD in London on the life of William Gybbons and the policy was procured by Richard Martin. The policy was Underwritten by 16 individuals for £383-6s-8d with a premium of £30-13s-4d @ 8%. The insured died on 25th May 1584 i.e. within one year of taking the policy. The underwriters disputed the claim taking the plea that the party had lived for more than 12 lunar months (month of 28 days). However the claim was finally paid after the matter was taken to the court, which ruled in favour of the insured.

The "Amicable Society" started granting fluctuating sum on death since 1705 and a fixed sum since 1757.

With gathering of mortality tables (death rate per 1000 at each age up to the age of 100 years), Life Insurance activity became some what scientific. "Equitable society" was founded in 1762 and worked on a scientific basis.

Insurance In India

It is said that Insurance was practiced in India even in the vedic times and the Sanskrit term "Yogakshema" in the Rigveda is in reference to a form of Insurance practiced by the Aryans 3000 years ago. The code of Manu which prescribes the many practices to be followed by the people for social harmony and development in Ancient India had also dictated that a special charge be made on goods carried from one city to another to ensure their safe carriage to the destination.

By 1885 there were more than 50 British and other foreign agencies having their offices in India. The success of the Managing Agents encouraged the growth of many Insurance

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offices largely with foreign capital many of which were short lived.

In India Two British Companies - the European and the Albert entered in 1870 and attempted writing business on Indian lives. The first Indian Life assurance Society was formed in the same year called "Bombay Mutual Assurance Society Ltd."

It was followed by "Oriental Life Assurance Society Ltd." in 1874, "Bharat" in 1896 and "Empire of India" in 1897.

The New India, Vulcan, Jupiter, British India General and the Universal. These five were composite and dealing both in life and general Insurance.

The Swadeshi Movement of 1905 and Mahatma Gandhis' call to Indians to give their business only to Indian Companies gave a boost to these new companies and they consolidated their position. More Indian companies entered the Life Insurance sector namely Hindustan Co-operative, United India, Bombay Life, National and Laxmi. But the going was not easy as they had little experience in the field of Insurance and they had to compete with 150 foreign offices including some of the largest Insurance groups in the world.

Insurance in Modern India

Government started exercising control on Insurance business by passing "Insurance Act" in 1912. This Act was comprehensively amended and passed as New Act in 1938 for controlling Investment of funds, expenditure and Management. The Office of Controller was established. Again, this Act was amended in 1950.

By 1955, 170 Insurance offices and 80 P.F. Societies registered companies were doing Life Insurance business in India. In view of surge in malpractices in Life Insurance business, due to the illiteracy level being high and lack in will for penetration/ spread of Life Insurance business, it was nationalised by Government of India and LIC Act was passed in June'1956, and this Act came into force from 1.9.1956.

Similarly the general insurance (which deals with non-life business i.e insurance of property) also nationalized in 1972 after merging of 55 Indian and 52 non Indian companies were nationalized by forming four general insurance companies.

The Govt. Of India, while liberalizing the Indian economy, also felt the liberalization of insurance sector because of lower penetration of insurance as compared to Indian population and its size and other developing countries. Initially the Govt. formed a Malhotra committee in 1993 to study whether the insurance sector should be opened for private players. The committee recommended to Liberalized, Privatized And Globalize (LPG) the insurance sector. In 1999, the Authority known as Insurance Regulatory & Development Authority through IRDA Act 1999 was formed.

After 44 years and 27 years of monopoly of life and general insurance respectively was broken.

Liberalisation of Insurance industry will undoubtedly benefit Indian economy, the Govt., Industry, Employee, Consumer & Society in the following manner:

Benefits to Economy

- Rapid investment
- Improve Quality to Life (New risk covers)
- Competition will bring Consumer Friendly Products
- Large Scale Mobilisation of Funds
- Insurance & Reinsurance Facilities to Major Projects
- Export Projects covered at Home

Benefits to Government

- Long Term Funds for Infrastructure
- Long Term Debt Market Instruments Available
- Increased Employment Opportunities & Compensation
- Reduced Financial Burden of
- - Rural, Social & Backward Classes
- Contributions in Calamities (Sharing of Social Responsibilities)

Benefits to Industry

- Transfer of Technical Expertise
- Innovative Products and Pricing Options

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- Improved Prospects for National Cos.
- Domestic Industry will Utilize Technology and Service Customer with Loyalty
- Market Driven Economy will Benefit Customer the most.

Benefits to Consumer

- Superior Quality at Lower Prices
- Wider Choice of Products
- World Class Service to the Consumer
- Increased Penetration of Insurance

Benefits to Employee

- Human Resource Development
- Exposure to 'State of the Art Practices"
- Greater Job Opportunities
- Higher Remuneration
- Professional Management Practices

Benefits to Society

Insurance Companies Act as Guardians in number of Ways: -

- Risk cover for Large Industry, Trade & Property are offered in Compliance to Law
- Environmental Risks get Reduced
- Hit – and – Run Compensations
- Crop Insurance for Covering Risk of Nature – Poor Rainfall etc.
- Socio Responsibilities Burden shared
  - Education • Medical • Health • Accident

2.11 LIFE INSURANCE INVESTMENT

In fact Life Insurance companies are getting the savings of an individual for longer period therefore, the Govt. has prescribed the norms how the Insurance companies can invest their funds. The norms are as follows:

Every insurer carrying on the business of life-insurance shall invest and at all times keep invested in the following manner:

1. 25% in Govt. securities
2. Not less than 50% in Govt. security or approved securities (including(1) above)
3. a) Not less than 15% in Infrastructure and Social Sector
   b) Not exceeding 35% in others capital market Investment in "other than approved Investments" can in no case exceed 15% of the fund

From the above, it will be observed that the Govt. has asked the Insurance to channel the funds to State and Central Govt. Infrastructure sectors social sector and rural sector and capital market. (For details refer the Investments regulations issued By the Insurance Regulatory Development Authority)

Benefits to Govt.

(a) Long term funds and debt instruments are available to develop the economy.

(b) Infrastructure funds are available to create roads, bridges, communication housing etc. It reduces the burden of the Govt.

(c) Investment in Rural and Social sector reduces the responsibility of the Govt. as a result of which the financial burden of the Govt. reduces.

(d) Capital market: If the insurer is investing the fund in the capital market then industry can enhance their production capacity which will have the multiplier effect on the growth of the economy.

2.12 SUMMARY

Insurance has become the necessity tool for our life. It not only provides security but also saving for future. At younger age the necessity may not be felt but as the man grows old it starts feeling the responsibility towards his family. The insurance also helps the economic development of the country as Government gets the huge funds at nominal rate of interest for longer period. Moreover, if the people are taking care for themselves about their present and future needs then Government will spend their funds in more productive manner.

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2.13 TERMINAL QUESTIONS:

1. Insurance is a need of life. Explain
2. What is mechanism of the insurance?
3. How the insurance helps in the economic development of the country?

2.14 ANSWERS TO INTEXT QUESTIONS

2.1

1. Insurance as a social device for making accumulations to meet uncertain losses of capital which is carried out through the transfer of risks of many individuals t one person or to a group of persons.
2. Kirya ceremony in any family on death of breadwinner.

2.2

1. Claim amount plus expenses of management plus profit of company plus provisions for contingencies.
2. Govt of India (within limits of its economic capacity and development) to make effective provisions for securing the right to work, to education, to provide public assistance in case of unemployment, old age, sickness and disablement.

2.15 OBJECTIVE TYPE QUESTIONS

1. Choose the correct Option
   a. Old age is only certain in life.
   b. Old age and death are certain in life.
   c. An accident is certain in life.
   d. An Illness is certain in life.
2. Life insurance business was nationalized in India in ____(1956/1947)
3. Life insurance companies are investing funds as per norms prescribed by the IRDA (True/False)
4. Insurance is a social security tool. (True/False)

5. Insurance works on law of probability (True/False)

6. Statement A: Insurance is relevant only if there is possible economic loss

   Statement B: An event which will certainly happen cannot be insured.

   a. Only A is true b. Only B is true c. Both are true d. Neither of two

7. Statement A: Insurance provides sense of security.

   Statement B: Insurance ensures that no loss will take place.

   a. Only A is true b. Only B is true c. Both are true d. Neither of two

8. Statement A: Insurance reduces social costs.

   Statement B: Insurance is an instruments of social security.

   a. Only A is true b. Only B is true c. Both are true d. Neither of two

2.16 ANSWERS TO OBJECTIVE TYPE QUESTIONS

2.15

1.	b	2.	1956
3.	True	4.	True
5.	True	6.	c
7.	a	8.	c

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3

ESSENTIALS OF INSURANCE CONTRACT

3.0 INTRODUCTION

The fundamental principle of Insurance is mathematical; its application is financial; and its interpretation is legal. For the layman to understand the Insurance principle he should be an actuary (who design and price the insurance products); to understand its application to financial problems, he need not be a financial; and to understand its legal concepts, he need not be a lawyer. The subject of Insurance covers a vast array of topics. This and the following chapters are concerned with these topics.

Insurance may be defined as a contract between two parties whereby one party called insurer undertakes in exchange for a fixed sum called premium to pay the other party called insured a fixed amount of money after happening of a certain event.

Insurance policy is a legal contract & its formation is subject to the fulfillment of the requisites of a contract defined under Indian Contract Act 1872.

According to the Act **"A Contract may be defined as an agreement between two or more parties to do or to abstain from doing an act, with an intention to create a legally binding relationship."**

Since Insurance is a contract, certain sections of Indian Contract Act are applicable.

3.1 OBJECTIVES

At the end of this lesson you will be able to know;

- Features of commercial contract
- Principles of contracts for insurance

3.2 ESSENTIALS OF COMMERCIAL CONTRACT

A. Elements of General Contract

1. Offer & Acceptance
2. Consideration
3. Legal capacity to contract or competency
4. Consensus "ad idem"
5. Legality of object

B. Elements of Special Contract relating to Insurance

1. Life Insurance
   a. Utmost Good Faith (Uberrima Fides)
   b. Insurable Interest
2. General Insurance
   a. Utmost Good Faith (Uberrima Fides)
   b. Insurable Interest
   c. Indemnity
   d. Subrogation
   e. Proximate Cause

The essentials of any Insurance Contract are discussed as under with reference to the life Insurance only.

1. Offer & Acceptance:

In Life Insurance an offer can be made either by the Insurance company or the applicant (proposer) & the acceptance will follow. e.g., subsequently

(a) An offer made by the Insurance company to proposer that the premium amount will be Rs.100/- per annum for the Insurance amount of Rs.1000/-. It is for the proposer to accept the offer or not.

(b) An advertisement in the newspaper about the availability of different life Insurance policies is an invitation for an offer. If a proposer makes an application then it will be offer from the applicant and the Insurance company may or may not accept it.

(c) An offer may be considered accepted either when the Insurance company issues the policy or the first premium is paid by the applicant.

As stated above in example **(a)** if the applicant pays the first premium of Rs.100/- to the Insurance company then the contract is completed as both the parties have accepted the offer.

Similarly, if the company issues the policy in above stated example **(b)** then the offer is accepted by the Insurance company & the contract is completed. In fact, in life Insurance contract the effective date of the policy is very important; when the premium is paid with the application but no conditional receipt is issued the contract is not in force until the policy is delivered to the applicant. The payment of the premium with the application constitutes the offer and the delivery of policy is its acceptance.

Further, if the premium is paid with the application & conditional receipt is issued, the effective date of the contract depends upon the provisions of the conditional receipt. There are three types of conditions as follows:

(a) The condition may be that the Insurance becomes effective as of the date of the application or medical examination whichever is later. A claim arising after this date will be paid even if the application papers have not reached the competent / Approving Authority, provided of course, that the facts on the application & the results of the medical examination are such that the company would have accepted the application had the applicant lived.

(b) The second type of conditional receipt used by a company is the **approval form**, which provides coverage beginning with the date the application is approved by the company. This form does not offer the insured protection for the period from the date of the application until it is approved by the company.

(c) A third type of receipt is the **unconditional binding receipt**. According to this receipt the company binds the Insurance from the date of the application until the policy is issued or the application is rejected. The companies using this type of receipt place a time limit usually from 30 to 60 days. This binding receipt is beneficial to the prospects because he becomes insured from the time the application is filed. This form of receipt is not widely used.

The offer or proposal and its acceptance may be verbal or in writing but in Insurance contracts these are in writing. In General Insurance the Insured offers to purchase an insurance from the Insurer and this offer is in the form of a proposal form and the Insurer after studying the proposal can either reject the proposal or accept it. In case he accepts he issues a cover note or a letter of acceptance. In the latter event the acceptance letter becomes a counter offer or proposal, which is accepted on payment of premium by the insured.

2. Consideration:

There is no validity of a contract if there is no consideration, which is the act or promise offered by one party and accepted by the other as the price of his promise. In Insurance contracts the consideration is the premium that the Insured pays to the Insurer as the price of the promise that the Insurer has made that he shall indemnify the insured. Hence premium payment is the consideration on part of the insured and the promise to Indemnify is the consideration on part of the Insurer.

INTEXT QUESTIONS 3.1

1. When is the insurance contract considered to be completed?

2. What is consideration in any insurance contract?

3. Legal Capacity to Contract or Competency:

For an agreement to be binding on all parties, the parties involved must have the legal capacity to enter into a contract.

With respect to the insurer, if the company is formed as per laws of the country & empowered to solicit insurance then the insurer is capable of entering into an agreement.

Notes

With respect to the insured, the person should be of legal age i.e. 18 years and of sound mind.

If a contract is made with an underage the application may be held unenforceable if the minor decides to repudiate it at a later date. In Insurance contract the insurer is bound by the contract as long as the underage wishes to continue it. If the minor repudiates his contract, the law will allow him a refund of all premium paid.

Insanity or mental incompetence precludes the making of a valid Insurance contract.

4. Consensus "ad idem" (Same mind):

The understanding between the insurer & insured person should be of same thinking or mind. The reasons for taking the Insurance policy should be understandable to both the parties.

Both parties to the contract should be of the same mind and there must be consent arising out of common intention. Both parties should be clear about what the other is saying. The Insurer should know what the insured wants and the insured should know what the insurer is offering and both should be agreed on this. For example, if an Insured seeking a fire policy is issued a burglary policy there is no consent arising out of common intention.

5. Legality of Object:

To be a valid, a contract must be for a legal purpose & not contrary to public policy. Insurance is legal business therefore it cannot be illegal on the part of the insurer. An individual can take the life Insurance of his own life or his/her family members. If an individual takes a policy on the life of an unknown person it will not be a valid contract as it will amount to gambling.

Another example is that the contract will not be legal if it has anything to do with stolen property or if it is in respect of any unlawful activity. Hence Insurance of stolen goods or the Insurance of smuggling operation shall not stand scrutiny in the court of law and such contracts will be void.

3.3 SUMMARY

In addition to the above features which are common to commercial contracts as well as contracts of Insurance, Insurance contracts are subject to certain special principles evolved under common law in UK and are followed by the Indian courts. These principles are known as the **fundamental principles of the law of Insurance** and these are discussed in the following chapters.

3.4 TERMINAL QUESTIONS:

1. Explain the various features of any commercial contract.

3.5 OBJECTIVE TYPE QUESTIONS

1. Choose the correct option

   a. In an insurance contract an insurer makes an offer and the prospect accepts it.

   b. In an insurance contract a prospect makes an offer and an insurer accepts it.

   c. In an insurance contract an offer and acceptance is not a requirement.

   d. In an insurance contract no principles of contact are applicable.

2. The consideration for the insurer under an insurance contract is a_____(premium/sum insured)

3. The consideration for an insured under an insurance contract is a_____(compensation/premium).

4. Choose the correct options

   Statement A: The minor can enter in to an insurance contract.

   Statement B: The person with unsound mind cannot enter into an insurance contract.

   a. Both statements are correct

   b. Both statements are wrong

   c. Statement A is correct

   d. Statement B is correct

5. Choose the correct options

   Statement A: Insurance is lawful business.

   Statement B: The insurance is not a gambling.

   a. Both statements are correct

   b. Both statements are wrong

   c. Statement A is correct

   d. Statement B is correct

3.6 ANSWERS TO INTEXT QUESTIONS

3.1

1. On accepting the proposal by the insurance company the insurance contract is completed.

2. Premium paid by the person to the insurance company and any compensation paid by the insurance company.

3.7 ANSWERS TO OBJECTIVE TYPE QUESTIONS

3.5

1. b

2. premium

3. compensation

4. d

5. a

Notes

4

PRINCIPLES OF LIFE INSURANCE

4.0 INTRODUCTION

In the previous chapter, we have discussed essentials of Insurance contact. But in this chapter, we explained one of the important type of Insurance i.e. Life Insurance. If somebody suffer economic hardship and dies, at that time Dependent Survivors needs life Insurance. Life Insurance is a way to replace the loss of Income that occurs when the earning member of family dies. It is a contract between insured phases and the company that is providing the Insurance. If insured pus on dies while the contract is in force, the insurance company pays a specified sum of money to the person on persons you name as beneficiaries.

4.1 OBJECTIVES

At the end of this lesson you will be able to know:

- Various principles applicable to life insurance contract.
- In case any of these principle is missing the insurance contract will become void.

4.2 UTMOST GOOD FAITH

The commercial contracts are normally subject to the principle of "Caveat Emptor" i.e. let the buyer beware. In most of these contracts each party to the contract can examine the item or services which is the subject matter of contract. For eg. If you go to the market to buy vegetables then you have to be careful yourselves about quality while buying the vegetables and after buying you cannot question the vendor.

Notes

Each party believes in the statement of the other party. So long as there is no attempt to mislead & the answers are given truthfully, the question of avoiding the contract would not arise.

In the Insurance contract the product sold is intangible. It cannot be seen or felt. Most of the facts relating to health, habits, personal history and family history are known to one party only, the proposer. The insurer can know most of these facts only if the proposer decides to disclose these facts. It is true that the underwriter can have the assistance of medical report for life Insurance proposal. Sometimes, these aspects are not detected by the medical examination. e.g., a person suffering from high B.P. or diabetes can manage to hide these facts from the examining doctor. The history of past serious sickness, operations and injuries can be suppressed. These aspects may affect the life expectancy of the proposer. Hence, these constitute material information from the underwriter's point of view. Non-disclosure of such facts would put the insurer as well as the community of policyholders at a disadvantage.

It is for these reasons that the law imposes a greater duty on the parties to an Insurance contract than in case of other commercial contracts. This duty is one of utmost good faith **(uberrima fides)**. It is the duty of the assured to make a full disclosure to the underwriter without being asked. In a contract of Insurance, there is an implied condition that each party must disclose every material fact known to him. This type of contract is called uberrima fides i.e. contract of utmost good faith.

Hence utmost good faith can be defined as a positive duty to disclose accurately & fully all facts material to the risk being proposed whether requested or not.

The material fact is the material, which would influence the judgement of a prudent insurer in fixing the premium or determining whether he will cover the risk.

Therefore, facts regarding age, height, weight, previous medical history, smoking/ drinking habits, operations, details of earlier Insurances and hazardous occupation must be disclosed.

There are certain circumstances, which need not be disclosed e.g.:

(a) Facts which every one is supposed to know in general

(b) Facts of common knowledge

(c) Facts which lessen the risk

(d) Facts which could be reasonably discovered by reference to previous policies records of which are available with the insurer

In Insurance contract, the level of good faith above the level of what is in the usual commercial transaction is required. Therefore, Insurance contracts are based on the principles of warranty, representation and concealment. We must understand the nature of warranty, representation and concealment.

4.3 WARRANTY:

A warranty in Insurance is a statement or condition which is incorporated in the contract relating to risk, which the applicant presents as true & upon which it is presumed that the insurer relied in issuing the contract.

In fact, Marine Insurance developed the doctrine of warranty because the marine underwriter was rarely called upon or got a chance to inspect the ship as it might be lying thousands of miles away at ports or in voyage. Therefore, he had to depend entirely upon the word of the person seeking the Insurance. Hence, all information in the application for the Insurance was warranted to be absolutely exact and true. **If it turned out to be untrue, the Insurance was voidable whether the misstatement was intentional or unintentional, material to the loss or immaterial.**

INTEXT QUESTION 4.1

1. If a person is suffering from Cancer/heart disease whether it is duty of person to inform to the insurance company.

4.4 INSURABLE INTEREST

The Insurance Act 1938 doesn't define the insurable interest but it has been defined as follows by Mac-Gillivray

"Where the assured is so situated that the happening of the event on which the Insurance money is to become payable

Notes

would as a proximity cause, involve the assured in the loss or diminution of any right recognised by law or in any legal liability there is an insurable interest in the happening of that event to the extent of the possible loss or liability."

The object of Insurance should be lawful for this purpose, the person proposing for Insurance must have interest in the continued life of the insured & would suffer pecuniary loss if the insured dies. If there is no insurable interest, the contract becomes wagering (gambling) contract. All wagering contracts are illegal & therefore null & void.

Own Life Policy

So long as the Insurance is on one's own life, the "Insurance Interest" presents no difficulty. A person has insurable interest in his own life to an unlimited extent. The absence of a limit in this case is reasonable. When a person insures his life he obtains protection against loss to his estate; for in the event of his untimely death the estate would not benefit by the future accumulation he hopes to make during the normal span of life. It is not easy to compute with any degree of certainty what the future earnings of a person would be. Hence no limit may be fixed in respect of life Insurance he may effect.

Where, however, insurer rejects a proposal for an amount of assurance, which is disproportionate to the means of the proposer, it is not normally for lack of Insurable interest but on considerations of "moral hazard". Indeed it may also be presumed in a case where a person proposes for a policy for a large amount, which he may not be able to maintain having regard to his income, that it will be financed by some other person and that there is no insurable interest.

INTEXT QUESTION 4.2

1. Whether can you take life insurance policy of Mr Amitabh Bachan?

4.5 INSURANCE ON THE LIFE OF SPOUSE

As a wife is normally supported by her husband, she can validly effect an insurance on her life for adequate amount. The service and help rendered by the wife used to be thought of as the basis of insurable interest which supports any policy which a man takes on the life of his wife. In Griffiths v. Elemming the

Court of Appeal in England stated that it was difficult to uphold such interest on the basis of pecuniary interest but thought that such interest could be presumed on broader grounds.

Parent and Child

Following the practice in U.K. in India also a parent is not considered to have insurable interest in the life of the child. The same is the case with a child in respect of his parent's life. Whether this position requires to be reviewed now appears to be engaging the attention of people here.

A Hindu is under a legal obligation to maintain his parents. Even as per traditional law Sec.20 of the Hindu Adoption and Maintenance Act has given statutory form to the legal obligation. The parents have, therefore, a right to maintenance subject to their being aged or infirm. An order for maintenance of parents may also be passed under Sec. 125 of the Code of Criminal Procedure, 1973. It may be stated, therefore, that a parent has pecuniary interest in the life of the child, and an assurance effected on that basis cannot be hit by Sec.30 of the Contract Act as a wagering contract.

However, it may be noted that the pecuniary interest is not a present interest unless the parent is unable to maintain himself or herself at the time when the Insurance is effected. It may therefore, be argued that a parent cannot have insurable interest in the life of the child until the right to maintenance arises; but when a person is not able to maintain oneself how can he be expected to have the means to insure the life of his children?

As a matter of fact in India, even today a child is a potential breadwinner for the parents in their old age. The present affluent circumstances of a parent do not alter that situation. Under the traditional law a right to maintenance could be claimed only against the sons; the statute has now extended the obligation to the daughters as well.

Having regard to the social and economic set up of the people in the country a review of the question seems to be appropriate.

On the life of other relations

In the case of other relations, insurable interest cannot be presumed from the mere existence of their relationship. Moral obligations or duties are not sufficient to sustain an insurable interest.

Notes

In every other case, the insurable interest must be a pecuniary interest and must be founded on a right or obligation capable of being enforced by Courts of law.

The following are illustrations of such cases of insurable interest:

(a) Employer – Employee: An employer has insurable interest in the life of his employee, and the employee in the life of the employer;

An employer can create insurable interest in the lives of his employees by undertaking to provide monetary benefit to the family or estate of the employees in the event of death. Group Insurances effected by companies on the lives of their employees are on the basis of such insurable interest.

(b) Creditor – debtor: A creditor has insurable interest in the life of his debtor upto the amount of the debt;

This is not a satisfactory basis; for in the event of death of the debtor after the debt has been repaid, the creditor would still be entitled to the policy moneys and thus can be in a position to gain by the death of the debtor once the loan is repaid. The better arrangement would be for the debtor to take out a policy for the required amount and mortgage the policy to the creditor. The creditor then cannot take benefits under the policy in excess of his dues.

(c) Partner: A partner has insurable interest in the life of his co-partner to the extent of the capital to be brought in by the latter.

(d) Surety and principal debtor-Co-surety: A surety has insurable interest in the life of his co-surety to the extent of the proportion of his debt and also in the life of his principal debtor.

Effect on Contract when Insurable interest is not present:

Where, therefore, the proposal is on the life of another, unless the proposer has insurable interest in the life to be assured, the contract shall be void. Lack of insurable interest is a defence, which the insurer may plead in resisting a claim. There may be also cases where Insurance

on one's own life is surreptitiously financed and held by another for his benefit, which if detected by the insurer, may be declared void.

As a life Insurance contract is not one of indemnity, the existence of insurable interest and the amount thereof will have to be considered at the time of effecting the contract since lack of such interest would render the contract void. If insurable interest existed at the inception of the policy, the contract would be enforceable though such interest might cease later.

4.5 SUMMARY:

Insurance contracts are influenced by number of legal principles i.e. commercial as well as insurance. As the insurer does not any thing about the proposer therefore, the duty of disclosing the material facts has been imposed on the proposer. The decision of the insurer will depend upon the material facts disclosed by the proposer. The insurable interest should also be present at the time of taking the policy. No one can take the policy in the name of third party with which the proposer is not having any legal relationship and financial loss in case of any mishap with the proposer.

4.6 TERMINAL QUESTIONS:

1. It is the duty of the assured to make a full disclosure to the underwriter without being asked. Discuss.

2. Is it essential that insurable interest should be present in every insurance contract? If yes, explain.

4.5 OBJECTIVE TYPE QUESTIONS

1. Choose the correct Option

   Statement A: Commercial contracts are subject to the principle of "Caveat Emptor"

   Statement B: Insurance contracts are also subject to the principle of "Caveat Emptor"

   a. Both statements are correct

   b. Both statements are wrong

   c. Statement A is correct

   d. Statement B is correct

Notes

2. Insurable interest means

   Statement A: Legal right to insure.

   Statement B: Have suffered financial loss.

   a. Both statements are correct

   b. Both statements are wrong

   c. Statement A is correct

   d. Statement B is correct

3. One of the fundamental principles of life insurance is

   a. There is an insurer & policyholder

   b. Utmost good faith

   c. Insurable interest

   d. Both b & c

4. Facts which need to be disclosed.

   a. Facts of common knowledge

   b. Facts which lessen the risks

   c. Facts which every one is supposed to know in general

   d. Family History

5. Non disclosure/Misrepresentation/Concealment of _____ information makes contract voidable. (Material/ Immaterial)

   True/False

6. A person has insurable interest in his own life.

7. Parents have insurable interest in the life of child.

8. A creditor has unlimited insurable interest in the life of debtor

9. An employer has an insurable interest in the life of his employees to the extent of the value of his services

10. The duty of disclosure of material facts arises in life insurance:

    a. only during the proposal stage

b. Only during the policy period if there is a change in risk

c. Only at the time of renewal

d. All of the above

4.6 ANSWERS TO INTEXT QUESTIONS

4.1

1. Yes the person should disclose to the insurance company as per the principle of utmost good faith otherwise at the time claim the insurance can refuse to make the payment.

4.2

1. No you can not take such policy because you have neither legal relationship nor you will loose financially in case of any mis-happening with Mr Bachan life.

4.7 ANSWERS TO OBJECTIVE TYPE QUESTIONS

4.5

1.	c	2.	a
3.	d	4.	d
5.	material	6.	True
7.	False	8.	false
9.	true	10.	d

Notes

5

FUNDAMENTALS/PRINCIPLES OF GENERAL INSURANCE

5.0 INTRODUCTION

After studying, the life insurance and its importance, the over aspect of insurance other than 'Life Insurance' would is General Insurance. In this chapter, we cover various aspect of General Insurance such as Principles of utmost Good faiths material fact Principle of Insurable Insures and Principle of Indemnity.

General Insurance comprises of insurance of property against fire, burglary etc, personal insurance such as Accident and Health Insurance, and liability insurance which covers legal liabilities. Suitable general Insurance covers are necessary for every family. It is important to protect one's property, which one might have acquired from one's hard earned income. Losses created to catastrophes such as the tsunami, earthquakes, cyclones etc. have left many homeless and penniless. Such losses can be devastating but insurance could help mitigate them. Property can be covered, so also the people against Personal Accident. A Health Insurance policy can provide financial relief to a person undergoing medical treatment whether due to a disease or an injury.

5.1 OBJECTIVES

At the end of this lesson you will be able to know:

- Various additional principles applicable to life insurance contract
- In case any of these principles are missing the insurance contract will become void

5.2 PRINCIPLES OF UTMOST GOOD FAITH

Both the parties to a commercial contract are by law required to observe good faith. Let us say that you go to a shop to buy an electrical appliance. You simply will not enter, pay and pick up any sample piece but will check two, three or even more pieces. You may be even ask the shopkeeper to give a demonstration to ensure that it is in working condition and also ask several questions to satisfy yourself about what you are buying. Then when you go home you find it does not work or is not what you were looking for exactly so you decide to return the item but the shopkeeper may well refuse to take it back saying that before purchasing you had satisfied yourself; and he is possibly right. The common law principle "Caveat Emptor" or let the buyer beware is applicable to commercial contracts and the buyer must satisfy himself that the contract is good because he has no legal redress later on if he has made a bad bargain. The seller cannot misrepresent the item he has sold or deceive the buyer by giving wrong or misleading information but he is under no obligation to disclose all the information to the buyer and only selective information in reply to the buyers queries is required to be given. But in Insurance contracts the principles of "Uberrima fides" i.e. of Utmost Good Faith is observed and simple good faith is not enough. Why this difference in Insurance contracts?

Firstly, in Insurance contracts the seller is the insurer and he has no knowledge about the property to be insured. The proposer on the other hand knows or is supposed to know everything about the property. The condition is reverse of ordinary commercial contracts and the seller is entirely dependent upon the buyer to provide the information about the property and hence the need for Utmost Good Faith on the part of the proposer.

It may be said here that the insurer has the option of getting the subject matter of Insurance examined before covering the risk. This is true that he can conduct an examination in the case of a property being insured for fire risk or of getting a medical examination done in the case of a health policy. But even then there will be facts which only the insured can know e.g., the history of Insurance of the property whether it has been refused earlier for Insurance by another company or whether it is also already insured with another company and the previous claim experience. Similarly a medical examination

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may not reveal the previous history i.e. details of past illness, accidents etc. Therefore Insurance contracts insist on the practice of Utmost Good Faith on the part of the Insured.

Secondly, Insurance is an intangible product. It cannot be seen or felt. It is simply a promise on the part of Insurer to make good the loss incurred by the Insured if and when it occurs.

Thus the Insurer is also obliged to practice Utmost Good Faith in his dealings with the Insured. He cannot and should not make false promises during negotiations.

He should not withhold information from the Insured such as the discounts available for good features e.g., fire extinguishing Appliances discount in fire policies or that Earthquake risk is not covered under the standard fire policy but can be covered on payment of additional premium.

In the recent Earthquake disaster in Gujarat a number of Insured failed to get any relief from Insurance Companies as Earthquake risk was not covered.

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 requested for or not".

In Insurance contracts Utmost Good Faith means that "each party to the proposed contract is legally obliged to disclose to the other all information which can influence the others decision to enter the contract".

The following can be inferred from the above two definitions:

(1) Each party is required to tell the other, the truth, the whole truth and nothing but the truth.

(2) Unlike normal contract such an obligation is not limited to any questions asked and

(3) Failure to reveal information even if not asked for gives the aggrieved party the right to regard the contract as void.

How is this duty of Utmost Good Faith to be practiced? And what are the facts that the proposer has to disclose? The answer to both the question is simply the proposer must disclose to the insurer all material facts in respect of the subject matter of Insurance.

5.3 WHAT IS A MATERIAL FACT?

Material fact is every circumstance or information, which would influence the judgement of a prudent insurer in assessing the risk.

Or

Those circumstances which influence the insurer decision to accept or refuse the risk or which effect the fixing of the premium or the terms and conditions of the contract must be disclosed.

5.4 FACTS, WHICH MUST BE DISCLOSED

i. Facts, which show that a risk represents a greater exposure than would be expected from its nature e.g., the fact that a part of the building is being used for storage of inflammable materials.

ii. External factors that make the risk greater than normal e.g. the building is located next to a warehouse storing explosive material.

iii. Facts, which would make the amount of loss greater than that normally expected e.g. there is no segregation of hazardous goods from non-hazardous goods in the storage facility.

iv. History of Insurance (a) Details of previous losses and claims (b) if any other Insurance Company has earlier declined to insure the property and the special condition imposed by the other insurers; if any.

v. The existence of other insurances

vi. Full facts relating to the description of the subject matter of Insurance

Some examples of Material facts are

(a) In Fire Insurance: The construction of the building, the nature of its use i.e. whether it is of concrete or Kucha having thatched roofing and whether it is being used for residential purposes or as a godown, whether fire fighting equipment is available or not.

Notes

(b) In Motor Insurance: The type of vehicle, the purpose of its use, its age (Model), Cubic capacity and the fact that the driver has a consistently bad driving record.

(c) In Marine Insurance: Type of packing, mode of carriage, name of carrier, nature of goods, the route.

(d) In Personal Accident Insurance: Age, height, weight, occupation, previous medical history if it is likely to increase the choice of an accident, Bad habits such as drinking etc.

(e) Burglary Insurance: Nature of stock, value of stock, type of security precautions taken.

As mentioned this is not an exhaustive list but only a few examples.

Details of previous losses is a material fact which is relevant to all policies.

5.5 FACTS, WHICH NEED NOT BE DISCLOSED

a. Facts of Law: Every one is deemed to know the law. Overloading of goods carrying vehicles is legally banned. The transporter can not take excuse that he was not aware of this provision.

b. Facts which lessen the Risk: The existence of a good fire fighting system in the building.

c. Facts of Common Knowledge: The insurer is expected to know the areas of strife and areas susceptible to riots and of the process followed in a particular trade or Industry.

d. Facts which could be reasonably discovered: For e.g. the previous history of claims which the Insurer is supposed to have in his record.

e. Facts which the insurers representative fails to notice: In burglary and fire Insurance it is often the practice of Insurance companies to depute surveyors to inspect the premises and in case the surveyor fails to notice hazardous features and provided the details are not withheld by the Insured or concealed by him them the Insured cannot be penalized.

f. Facts covered by policy condition: Warranties applied to Insurance polices i.e. there is a warranty that a watchman be deployed during night hours then this circumstance need not be disclosed.

Duration of Duty of Disclosure

The duty of disclosure remains in force through out the entire negotiation stage and till the contract is finalized. Once the contract is finalized than the contract is subject to ordinary simple good faith.

However when an alteration is to be made in an existing contract then this duty of full disclosure recovers in respect of the proposed alteration.

The duty of disclosure also revives at the time of renewal of contract since legally renewal is regarded as a fresh contract.

For example: a landlord at the time of proposal has disclosed that the building is rented out and is being used as an office. If during the continuation of the policy the tenants vacate the building and the landlord subsequently rents it out to a person using it as a godown then he is required to disclose this fact to the Insurer as this is a change in material facts and effects the risks.

(***Note:*** Please note that in long term Insurance Business the Insurer is obliged to accept the renewal premium if the Insured wishes to continue the contract and there is no duty of disclosure operating at the time of renewal. Normally Insurer arranges inspection on each renewal.)

5.6 BREACHES OF UTMOST GOOD FAITH

Breaches of Utmost Good Faith occur in either of 2 ways.

(1) Misrepresentation, which again may be either innocent or intentional. If intentional then they are fraudulent

(2) Non-Disclosure, which may be innocent or fraudulent. If fraudulent then it is called concealment.

It is important to distinguish between the two: Misrepresentation and Non-Disclosure

Breach of
Utmost Good Faith

Misrepresentation | Non-Disclosure

Innocent | Intentional (Fraudulent) | Innocent | Intentional (Concealment)

Misrepresentation :

Innocent :

This occurs when a person states a fact in the belief or expectation that it is right but it turns out to be wrong. While taking out a Marine Insurance Policy the owner states that the ship will leave on a specific date but in fact the ship leaves on a different date.

Intentional : Deliberate misrepresentation arises when the proposer intentionally distorts the known information to defraud the insurer. The selfish objective is somehow to enter the contract or to get a reduction in the premium e.g., If an applicant for motor Insurance stated that no one under 18 would drive the vehicle when in fact his 17 years old son drives frequently. Such a misrepresentation would be material as it would effect the decision of the insurer.

Non-Disclosure

Innocent : This arises when a person is not aware of the facts or when even though being aware of fact does not appreciate its significance e.g.

A proposer at the time of effecting the contract has undetected cancer therefore does not disclose it or

A proposer had suffered from Rheumatic fever in his childhood but he does not disclose this not knowing that people who have this are susceptible to heart diseases at a later age.

Deliberate : This is done with a deliberate intention to defraud the insurer entering into a contract, which he would not have done had he been aware of that fact.

A proposer for fire Insurance hides the fact knowingly by not disclosing that he has an outhouse next to his building, which is used as a store for highly inflammable material.

How To Deal With Breaches

How breaches are dealt with depends upon whether the breaches are

(1) Innocent

(2) Deliberate

(3) Material to the risk

(4) Immaterial to the risk

When Breach of Utmost Good Faith occurs the aggrieved party gets the right to avoid the contract. The contract does not become automatically void and it must decide on the course to be taken. The options available are on case-to-case basis like: -

1) The contract becomes void from the very beginning if deliberate misrepresentation or non-disclosure is resorted to with the intention of misleading the insurer to enter into a contract.

2) To consider the contract void, the bereaved party, must notify the offending party that breach has been noticed and as per the conditions of the contract he is no longer governed with the terms of the contract agreed upon in covering the risk. In case the breach is discovered at the time of claim he will refuse to honour his promise and will not pay the claim. This again occurs when there has been a deliberate breach.

3) When the breach is innocent but it is material to the fact then the insurer may impose a penalty in the form of additional Premium.

4) Where the breach is found to be innocent and is not

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material the insurer can choose to ignore the breach or waive off the breach.

5.7 PRINCIPLE OF INSURABLE INTEREST

One of the essential ingredients of an Insurance contract is that the insured must have an insurable interest in the subject matter of the contract. Insurance without insurable interest would be a mere wager and as such unenforceable in the eyes of law.

The subject matter of the Insurance contract may be a property, or an event that may create a liability but it is not the property or the potential liability which is insured but it is the pecuniary interest of the insured in that property or liability which is insured.

The concept is the basis of the doctrine of insurable interest and was cleared in the case of Castellain v/s Priston in 1883 as follows.

"What is it that is insured in a fire policy? Not the bricks and materials used in building the house but the interest of the Insured in the subject matter of Insurance."

The subject matter of the contract is the name given to the financial interest, which a person has in the subject matter and it is this interest, which is insured.

Insurable Interest is defined as

"The legal right to insure arising out of a financial relationship recognized under the law between the insured and the subject matter of Insurance".

There are four essential components of Insurable Interests

1) There must be some property, right, interest, life, limb or potential liability capable of being insured.

2) Any of these above i.e. property, right, interest etc. must be the subject matter of Insurance.

3) The insured must stand in a formal or legal relationship with the subject matter of the Insurance. Whereby he benefits from its safety, well-being or freedom from liability and would be adversely affected by its loss, damage existence of liability.

4) The relationship between the insured and the subject matter must be recognized by law.

5.8 HOW IS INSURABLE INTEREST CREATED

There are a number of ways by which Insurable Interest arises or is restricted.

(a) By Common Law: Cases where the essential elements are automatically present can be described as Insurable Interest having arisen by common law. Ownership of a building, car etc, gives the owner the right to insure the property.

(b) By Contract: In some cases a person will agree to be liable for something which he would not be ordinarily for. A lease deed for a house for example may make the tenant responsible for the repair and maintenance of the building. Such a contract places the tenant in a legally recognized relationship with the house or the potential liability and this gives him the insurable interest.

(c) By Statute: Sometimes an Act of the Parliament may create an insurable interest by granting some benefit or imposing a duty and at times removing a liability may restrict the Insurable Interest.

Insurable Interest is applicable in the Insurance of property, life and liability.

In case of property Insurance, insurable interest arises out of ownership where the owner is the insured but it can arise due to other situations & financial interests which gives a person who is not an owner, insurable interest in the property and some of the situations are listed below.

(i) Mortgagee and Mortgagers:

The practice of Mortgage is common in the area of house & vehicle purchase. The mortgagee is the lender normally a bank or a financial institution, and the mortgager is the purchaser. Both have an insurable interest; The mortgager because he is the owner and the mortgagee as a creditor with insurable interest limited to the extent of the loan.

(ii) Bailee:

Bailee is person legally holding the goods of another, may be for payment or other reason. Motors garages and watch repairers have a responsibility to take care of the items in their custody and this gives them an insurable interest even though he is not owner.

(iii) Trustees:

They are legally responsible for the property under their charge and it is this responsibility which gives rise to insurable interest.

(iv) Part Ownership:

Even though a person may have only part interest in a property he can insure the entire property. He shall be treated as a trustee or the co-owners; and in the event of a claim he will hold the money received by him in excess of his financial interest in trust for the others.

(v) Agents:

When the principal has an insurable interest then his agent can insure the property.

(vi) Husband & Wife:

Each has unlimited interest in each others life and hence they have an insurable interest in each others property.

These parties can insure each others lives as they stand to lose in the event of death of any of them.

(vii) Creditor:

Similarly a creditor may lose financially if a debtor dies before paying the loan so the creditor gets an Insurable Interest in the life of the debtor to the extent of the loan amount.

(viii) Liability:

In Liability Insurance a person has insurable interest to the extent of any potential liability which may be incurred due to damages and other costs. It is not possible to foretell how much liability or how often a person may incur liability and in what form or shape it arises. In this way Insurable Interest in Liability Insurance is different than

Insurable Interest in life & property - where it is possible to predetermine the extent of Insurable Interest.

Therefore in liability assurance the insured is asked to choose the amount of sum insured as the maximum figure that he estimates is ever likely to be required to settle the liability claims.

5.9 WHEN SHOULD INSURABLE INTEREST EXIST

(i) **In Life Insurance** Insurable Interest must exist at the time of inception of Insurance and it is not required at the time of claim

(ii) **In Marine Insurance** Insurable Interest must exist at the time of loss / claim and it is not required at the time of inception.

(iii) **In Property and other Insurance** Insurable Interest must exist at the time of inception as well as at the time of loss/ claims.

Other Salient Features of Insurable Interest

(i) **Insurable Interest of Insurers** Once the Insurers have accepted the liability they derive an insurable interest, which arises from that liability thus they are free to insure a part or whole of the risk with another insurer. This is done by reinsurance.

(ii) **Legally Enforceable** The Insurable Interest must be legally enforceable. The mere expectation that one may acquire insurable interest in the future is not sufficient to create insurable interest.

(iii) **Possession** Lawful possession of property together with its responsibility creates an insurable interest

(iv) **Criminal Acts** A person cannot avail benefits from Insurance to cover penalties because of a criminal act but Insurance to take care of civil consequences arising out of his criminal act can be done. This is applicable in the case of motor Insurance where a driver found guilty of an offence which is involved in an accident receives the claim for damage to his own car and also liability incurred due to damage to another's property but he shall not be insured for the amount of penalty that was imposed for his offense.

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(v) Financial Value Insurable interest must be capable of financial evaluation. In the case of property and liability incurred it is easily evaluated but in life it is difficult to put a value on the life of a person or his spouse and this depends on the amount of premium the individual can bear. However in cases where lives of others is involved a value on life can be placed i.e. creditor can put a value on the life of debtor restricted to the extent of the loan.

Employers have an insurable interest in the lives of their employees because if the employee dies there will be cost on training of the replacement and in the case of death of a key employee there may be loss of income as well. The amount of insurable interest cannot be exactly determined but it should be reasonable and proportionally related with salary of an employee; contribution level of a key personal or equity contribution in case of partners.

Assignment of policies is possible but normally not without the permission of the Insurer because it can mean a change in the underwriting consideration as the new policyholder may not have the same insurable interest.

Fire and other Misc. policies are not freely assignable as the Insurer at the time of underwriting has satisfied himself about the Insureds attitude or treatment of the subject matter and its loss causing capability. This would however change in the case of an assignee and it is reasonable to give the insurer a chance to consider the credentials of the new proposer. **When the Insurer gives his consent to the assignment of the policy a new contract is in fact being entered into and this is called NOVATION.**

Marine cargo policies are however freely assignable without the knowledge or the consent of the Insurer the reason being that the ownership of the goods insured frequently change when the goods are still in transit and it is necessary that the benefit of the policy passes to the new owner.

In some cases only the proceeds of the policy are assigned. There is normally no objection to such assignments as the assured is still a party to the contract with the insurer and he has to continue to comply with all the terms and conditions of the policy with the only difference being that in event of a claim the insurer is directed to pay the amount to the Assignee.

Insurers protect themselves by taking a receipt from the person receiving the amount discharging the Insurer from any further liability. This condition arises often in motor claims when bills of repair are directly paid to the garage and not the owner of the vehicle. In these cases the garage owners obtain a letter of satisfaction from the owner and submit his bills to the Insurer directly for payment.

INTEXT QUESTION 5.1

1. Can you insure you house under residential building where you are storing fire works item without disclosing it to insurance company?

2. Can you take insurance policy of Red Fort situated at Delhi?

5.10 PRINCIPLE OF INDEMNITY

Indemnity according to the Cambridge International Dictionary is "Protection against possible damage or loss" and the Collins Thesaurus suggests the words "Guarantee", "Protection", "Security", "Compensation", "Restitution" and "Re-imbursement" amongst others as suitable substitute for the word "Indemnity". The words protection, security, compensation etc. are all suited to the subject of Insurance but the dictionary meaning or the alternate words suggested do not convey the exact meaning of Indemnity as applicable in Insurance Contracts.

In Insurance the word indemnity is defined as **"financial compensation sufficient to place the insured in the same financial position after a loss as he enjoyed immediately before the loss occurred."**

Indemnity thus prevents the insured from recovering more than the amount of his pecuniary loss. It is undesirable that an insured should make a profit out of an event like a fire or a motor accident because if he was able to make a profit there might well be more fires and more vehicle accidents.

As in the case of Insurable Interest, the principle of indemnity also relies heavily on the financial evaluation of the loss but in the case of life and disablement it is not possible to be precise in terms of money.

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An Insurance may be for less than a complete indemnity but it may not be for more than it. To illustrate let us take the example of a person who insures his car for Rs.4 lacs and it meets with an accident and is a total loss. It is not certain that he will get Rs.4 lacs. He may have over valued the car or may be the prices of cars have fallen since the policy was taken. The Insurer will only pay an amount equal to the value of the car at the time of loss. If he finds that a car of the same make and model is available in the market for Rs.3 lac then he is not liable to pay more than this sum and payment of Rs.3 lacs will indemnify the Insured.

Similarly in the case of partial loss if some part of the car needs to be replaced the Insurer will not pay the full value of the new part. He shall assess how much the old part had run and after deduction of a proportionate sum he shall pay the balance amount. An insured is not entitled to new for old as otherwise he would be making a profit from the accident.

However there are two modern types of policy where there is a deviation from the application of this principle.

One is the agreed value policy where the insurer agrees at the outset that they will accept the value of the insured property stated in the policy (sum insured) as the true value and will indemnify the insured to this extent in case of total loss. Such policies are obtained on valuable pieces of Art, Curious, Jewellery, Antiques, Vintage cars etc.

The other type of policy where the principle of strict indemnity is not applied is the Reinstatement policy issued in Fire Insurance. Here the Insured is required to insure the property for its current replacement value and the Insurer agrees that in the event of a total loss he shall replace the damaged property with a new one or shall pay for the replacement in full.

Other than these there are Life and Personal Accident policies where no financial evaluation can be made. All other Insurance policies are subjected to the principle of strict Indemnity. In most policy documents the word indemnity may not be used but the courts will follows this principle in case of any dispute coming before them.

5.10.1 HOW IS INDEMNITY PROVIDED?

The Insurers normally provide indemnity in the following manner and the choice is entirely of the insurer

1) Cash Payment
2) Repairs
3) Replacement
4) Reinstatement

1. Cash Payment

In majority of the cases the claims will be settled by cash payment (through cheques) to the assured. In liability claims the cheques are made directly in the name of the third party thus avoiding the cumbersome process of the Insurer first paying the Insured and he in turn paying to the third party.

2. Repair

This is a method of Indemnity used frequently by insurer to settle claims. Motor Insurance is the best example of this where garages are authorized to carry out the repairs of damaged vehicles. In some countries Insurance companies even own garages and Insurance companies spend a lot on Research on motor repair to arrive at better methods of repair to bring down the costs.

3. Replacement

This method of Indemnity is normally not preferred by Insurance companies and is mostly used in glass Insurance where the insurers get the glass replaced by firms with whom they have arrangements and because of the volume of business they get considerable discounts. In some cases of Jewellery loss, this system is used specially when there is no agreement on the true value of the lost item.

4. Reinstatement

This method of Indemnity applies to Property Insurance where an insurer undertakes to restore the building or the machinery damaged substantially to the same condition as before the loss. Sometimes the policy specifically gives the right to the insurer to pay money instead of restoration of building or machinery.

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Reinstatement as a method of Indemnity is rarely used because of its inherent difficulties e.g., if the property after restoration fails to meet the specifications of the original in any material way or performance level then the Insurer will be liable to pay damages. Secondly, the expenditure involved in restoration may be much more than the sum Insured as once they have agreed to reinstate they have to do so irrespective of the cost.

Limitations on Insurers Liability

1. The **maximum** amount recoverable under any policy **is the sum insured,** which is mentioned on the policy. The amount is not the agreed value of the property (except in Valued policies) nor is it the amount, which will be paid automatically on occurrence of loss. What will be paid is the actual loss or sum insured whichever is less.

2. Property Insurance is subjected to the **Condition of Average.** The underlying principle behind this condition is that Insurers are the trustees of a pool of premiums from which they meet the losses of the few who suffer damage, so it is reasonable to conclude that every Insured should bring a proper contribution to the pool by way of premium. Therefore if an insured deliberately or otherwise underinsures his property thus making a lower contribution to the pool, he is not entitled to receive the full benefits.

The application of this principle makes the insured his own Insurer to the extent of under-insurance i.e. the pro-rata difference between the Actual Value and the sum insured. The amount of loss will be shared between the Insurer and the insured in the proportion of sum insured and the amount underinsured. The formula applicable for arriving at the amount to be paid by the Insurance Co. is

Claim = Loss X (Sum Insured / Market Value)

Example

Mr. Sudhir Kumar has insured his house for Rs.5 lacs and suffers a loss of Rs.1 lac due to fire. At the time of loss the surveyor finds that the actual market value of the house is Rs.10 lacs. In this case applying the above formula the claim will be as under:

Loss = 1 lac sum insured = 5 lacs Market Value = 10 lacs
Therefore, 1 lac X 5 lacs / 10 lacs = 50,000/-
Claim = Rs 50,000/-

5.11 COROLLARIES OF INDEMNITY

There are two corollaries to the principle of Indemnity and these are Subrogation and Contribution.

1. Subrogation

It has already been established that the purpose of Indemnity is to ensure that the Insured does not make a profit or gain in any way as a consequence of an accident. He is placed in the same financial position, which he had occupied immediately before the loss occurred.

As an off shoot of the above it is also fair that the insurer having indemnified the insured for damage caused by another (A Third Party) should have the right to recover from that party the amount of damages or part of the amount he has paid as indemnity.

This right to recover damages usually lies with the bereaved or injured party but the law recognises that if another has already paid the bereaved or injured party then the person who has paid the compensation has the right to recover damages.

In case the insured after having received indemnity also recovers losses from another then he shall be in a position of gain which is not correct and this amount recovered from another shall be held in trust for the insurer who have already given indemnity. Subrogation may be defined as **the transfer of legal rights of the insured to recover, to the Insurer.**

CASE STUDY -

Why Subrogation is called a corollary of Indemnity and not treated as a separate basic Principle of Insurance can be traced to the judgement given in the case of Casletlan V Preston (1883) in U.K.

"That doctrine (Subrogation) does not arise upon any terms of the contract of Insurance, it is only the other proposition, which has been adopted for the purpose of carrying out the fundamental rule i.e. indemnity. Which I (Judge) have

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mentioned "it is a doctrine in favour of the underwriters or insurers, in order to prevent the insured from recovering more than a full indemnity; it has been adopted solely for that reason."

Subrogation does not apply to life and personal accidents as these are not contracts of Indemnity. In case death of a person is caused by the negligence of another than the legal heirs of the deceased can initiate proceedings to recover from the guilty party in addition to the policy proceeds.

If the insured is not allowed to make profit the insurer is also not allowed to make a profit and he can only recover to the extent he has indemnified the Insured.

Subrogation – How?

Subrogation can arise in 4 ways

(i) Tort

(ii) Contract

(iii) Statute

(iv) Subject matter of Insurance

(i) Tort: When an insured has suffered a loss due to a negligent act of another then the Insurer having indemnified the loss is entitled to recover the amount of indemnity paid from the wrongdoer.

The Insured has a right in Tort to recover the damages from the individuals involved. The Insurers assume these rights and take action in the name of the insured and take his permission before starting legal proceedings.

Another reason for seeking permission of the insured is that the Insured may be having another claim which was not insured arising from the same incident which he may wish to include because the law allows one to sue a person only once for any single event.

(ii) Contract: This can arise when a person has a contractual right to compensation regardless of a fault then the Insurer will assume the benefits of this right.

(iii) Statute: Where the Act or Law permits, the insurer can recover the damages from Government agencies like the

Risk (Damage) Act 1886 (UK) gives the right to insurers to recover damages from the District Police Authorities in respect of the property damaged in Riots which has been indemnified by them.

(iv) Subject Matter of Insurance: When the Insured has been indemnified and the property treated as lost he cannot claim salvage as this would give him more than indemnity. Therefore when Insurers sell the salvage as in the case of damaged cars it can be said that they are exercising their right of subrogation.

Subrogation – When?

According to common law the right of subrogation arises once the Insurers have admitted the claim and paid it. This can create problems for the Insurers as delay in taking action could at times hamper their chance of recovering the damages from the wrongdoer or it could be adversely effected due to any action taken by the Insured. To safeguard their rights and to ensure that they are in control of the situation from the beginning Insurers place a condition in the policy giving themselves subrogation rights before the claim is paid. The limitation is that they cannot recover from the third party unless they have indemnified the insured but this express condition allows the insurer to hold the third party liable pending indemnity being granted.

Many individuals having received indemnity from the Insurer lose interest in pursuing the recovery rights they may have. Subrogation ensures that the negligent do not get away scot free because there is Insurance. The rights which subrogation gives to the Insurers are the rights of the Insured and it places certain obligations on the Insured to assist the Insurers in enforcing their claims and not to do anything which would harm the Insurers chances to recover losses.

2. Contribution

Contribution is the second corollary of Indemnity.

An individual may have more than one policy on the same property and in case there was a loss and he were to claim from all the Insurers then he would be obviously making a profit out of the loss which is against the principle of Indemnity. To prevent such a situation the principle of contribution has been evolved under common law.

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Contribution may be defined as the "**right of Insurers who have paid a loss to recover a proportionate amount from other Insurers who are also liable for the same loss".** The common law allows the insured to recover his full loss within the sum insured from any of the insurers.

Condition of Contribution will only arise if all the following conditions are met:

1) Two or more policies of Indemnity should exist
2) The policies must cover a common interest
3) The policies must cover a common peril which is the cause of loss
4) The policies must cover a common subject matter
5) The policies must be in operation at the time of loss

It is not necessary that the policies be identical to one another. What is important is that there should be an overlap between policies, i.e. the subject matter should be common and the peril causing loss should be common & covered by both.

As said earlier common law gives the right to the insured to recover the loss from any one insurer who will than have to effect proportionate recoveries from other insurers, who were also liable to pay the loss. To avoid this the Insurers modify the common law condition of contribution by inserting a clause in the policy that in the event of a loss they shall be liable to pay only their "Rate-able proportion" of the loss. It means that they will pay only their share and if the Insured wants full indemnity he should lodge a claim with the other Insurers also.

Rateable Proportion

The accepted way to interpret the term Rate-able Proportion is exhibited. First being that the Insurers should pay in the proportion to the sum insured for example

Sum Insured Policy A	=	10,000/-
Sum Insured Policy B	=	20,000/-
Sum Insured Policy C	=	30,000/-
Total	=	60,000/-

In case of a claim of Rs.6000/- the three insurers would be liable to pay in the proportion 1:2:3 i.e. 'A' pays Rs.1000/- 'B' pays Rs.2000/- and 'C' pays Rs.3000/-.

However, the draw back of this simplistic method is that the terms and conditions of the policies may be different and it would not be prudent to ignore these terms and conditions. For example, the condition of average may apply to one or more policies or there may be an excess clause in one policy which may effect their share of contribution to the loss. It would therefore be correct to assess the loss as per the terms and conditions of the individual policy and pay the claims accordingly. If by following this method the total sum of the liability of the Insurers is more than the claim amount then the Insurers shall pay in proportion to the amount of liability of each.

5.12 PROXIMATE CAUSE

There are three types of perils related to a claim under an Insurance policy

(1) **Insured Perils:** These are the perils mentioned in the policy as being insured e.g. Fire, lightening, storm etc. in the case of a fire policy

(2) **Excepted Perils:** These are the perils mentioned in the policy as being excepted perils **or excluded perils** e.g. Riot strike, flood etc. which may have been excluded and discount in premium availed.

(3) **Uninsured Perils:** Those not mentioned in the policy at all either in Insured or excepted perils e.g. snow, smoke or water as perils may not be mentioned in the policy.

Insurers are liable to pay claims arising out of losses caused by Insured Perils and not those losses caused by excepted or Uninsured perils.

Example: If stocks are burnt then the cause of loss is fire which is an Insured Peril under a fire policy and claim is payable. If the stocks are stolen the loss would not be payable as Burglary is not an Insured peril covered in fire policy Burglary policy is needed to take care of 'theft'.

It is therefore important to identify the cause of loss and to see if it is an Insured peril or not before admitting a claim.

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Need to Identify Proximate Cause

If the loss is brought about by only one event then there is no problem in settlement of liability but more often than not the loss is a result of two or more causes acting together or in tandem i.e. one after another. In such cases it is necessary to choose the most important, most effective and the most powerful cause which has brought about the loss. This cause is termed the Proximate Cause and all other causes being considered as "remote". The proximate cause has to be an insured peril for the claim to be payable.

The following illustration may help in distinguishing between the proximate cause and the remote cause.

I. "A person was injured in an accident and was unable to walk and while lying on the ground he contracted a cold which developed into pneumonia and died as result of this. The court ruled that the proximate cause of death was the accident and Pneumonia (which was not covered) was a remote cause and hence claim was payable under the Personal Accident Policy."

II. "A person injured in an accident was taken to a hospital where he contracted an infection and died as a result of this infection. Here the court ruled that infection was the proximate cause of death and the accident was a remote cause and hence no claim was payable under the Personal Accident Policy.

The Meaning of Proximate Cause

The doctrine of proximate cause is based on the principle of cause and effect, which states that having proved the effect and traced the cause it is not necessary to go any further i.e. cause of cause. The law provided the rule "Cause Proxmia non Remote spectator". The **immediate cause and not the remote one** should be taken into consideration.

Therefore the **proximate cause should be the immediate cause. Immediate does not mean the nearest to the loss in point of time but the one most effective or efficient.** Thus if there are a number of causes and the proximate cause has to be chosen the choice should be of **the most predominant and efficient cause i.e. the cause which effectively caused the result.**

Proximate cause has been defined as **"The active efficient cause that sets in motion a train of events which bring about a result without the intervention of any force started and working actively from a new and independent source".** (This definition comes from the ruling given in the case Pawsey v/s Scottish Union and National Insurance Co. (1907).

It is important to note that in **Insurance Proximate has got nothing to do with time even** though the Dictionary defines Proximity as 'The state of being near in time or space' (period or physical) and the Thesaurus given the alternate words as "adjacency of" "closeness", "nearness" "vicinity" etc. **But in Insurance Proximate cause is that which is Proximate in efficiency. It is not the latest but the direct, dominant, operative and efficient cause.**

Losses can occur in the following manners:

i. Loss due to a single cause.

ii. A series or chain of events one following and resulting from the other causing the loss

iii. A series or chain of events which is broken by a new event independently from a different source causing the loss – Broken sequence and

iv. A contribution of two or more events occurring simultaneously and resulting in loss

1) In the case of a single cause being the cause of loss then if that peril is covered the claim is payable and if not covered claim is not payable.

2) Loss due to a series or chain of events. This can be illustrated by the following example event.

a) A driver of a car meets with an accident

b) As a result of the accident he suffers from concussion (shock)

c) Because of the concussion he strayed around not aware where he was going

d) While straying he fell into a stream

e) He died of drowning in the stream

It is clear that the above is a chain of events one leading to the other. The proximate cause would be accident

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(covered under PA Policy) which resulted in concussion (Disease – not covered) and hence the claim would be payable.

Irrespective of the fact that subsequent causes are covered or not if it is established that the event starting the chain is a covered peril then claim is payable.

However if reverse were the case and the chain was started by an excepted or excluded peril then the claim would not be payable.

For e.g. A person suffers a stroke and falls down the steps resulting in his death. He will not be entitled to any claim under his personal accident policy as the chain was started by a stroke which is an excepted peril.

3. In case of the Broken sequence or Interrupted chain of events if the chain of events is started by an Insured peril but interrupted by an excepted or excluded peril then the claim is paid after deducting the damage caused by the excluded peril. For example, the burglars enter the house and leave the gas stove on leading to a fire and the house is damaged in the fire. The "burglary Insurance" will only pay for the loss due to theft but exclude loss due to fire, which is accepted peril under the burglary policy.

   In case the sequence of events started by an excluded peril is broken by an Insured peril, as a new and independent cause then there is a valid claim for even the damage caused by exempted peril. The burglars enter the house and after carrying out thefts put the house on fire. The fire policy will pay for the damages due to theft as well (which is an excluded peril).

4. In the case of loss due to concurrent causes or two or more causes occurring simultaneously then all the causes will have to be Insured perils only then the claim would be payable but even if one of the causes is an excluded peril the claim will not be payable.

Example: A house collapses due to an earthquake, which results in fire. Under the fire policy earthquake is not a covered risk, hence the claim will not be payable.

To really understand the complexities of Proximate cause and its proper identification one must go through the case studies and a few are being given hereunder.

Case Studies:

Example I

An army officer insured under a personal accident policy, which excluded accident directly or indirectly due to war during war time went to the railway line to inspect the sentries. While on the visit he was hit by a train and he died as a result of the accident. It was ruled that the policy did not cover as he was there on the line because of the war and the policy did not cover accident due to war.

Example II

A surveyor on surveying a factory damaged in a fire came to the conclusion after detailed investigation that the fire was caused by negligence as well as defective design and both these causes worked together to cause the damage. While the Insurance policy covered negligence it did not cover Defective Design and hence claim was denied.

Example III

In an incident where stocks of potatoes kept in a cold storage got damaged due to leakage of ammonia gas. The stock was insured against contamination / Deterioration / putrefaction due to rise in temperature in the refrigeration chamber caused by any loss or damage due to an accident. The Insurance company did not pay the claim saying that the leakage of gas was not accidental and hence the risk was not covered. The aggrieved approached the consumer forum which held that the leakage of gas was not foreseen or premeditated or anticipated and loosening of the nuts and bolts of the flanges. The consequential escape of gas was within the meaning of the word accident and hence ordered the Insurance Co. to pay the claim.

5.13 SUMMARY

Basically the principle of indemnity and their corollaries and proximate cause has been formulated so that any person does not make profit out of the insurance transaction. The basic purpose of insurance is that the insured is put in same financial position as he was before the loss.

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5.14 TERMINAL QUESTIONS

1. Explain the relationship between the doctrine of indemnity and the principle of insurable interest.
2. How does the principle of subrogation suplement the doctrine of indemnity?
3. Explain the presence of insurable interest in various general insurance contracts.

5.15 OBJECTIVE TYPE QUESTIONS

1. When there is a fraudulent non disclosure of material facts the insurance contracts becomes:

   a. voidable b. illegal

   c. unenforceable d. Void

2. The legal right to insure means

   a. Competence to enter into contract

   b. Insurable interest

   c. Utmost good faith

   d. Consideration

3. The principle of indemnity is applied in practice through

   a. Franchise deduction b. Deduction & depreciation

   c. Extra premium d. Excess clause deduction

4. Methods of providing indemnity are

   a. cash payment b. repair

   c. Replacement d. All

5. Statement A: The proposer need not to disclose facts which considers as not material

   Statement B: Facts which are common knowledge which the insurer is expected to need not be disclosed.

   a. Only A is true b. Only B is true

   c. Both are true d. Neither of two

6. Which of the following principles of law prevents an insured from making a profit out of his loss

   a. Insurable interest b. Caveat emptor

   c. Utmost good faith d. Indemnity

7. Statement A: The existence of other insurance must be disclosed.

   Statement B: Facts of law need not be disclosed.

   a. Only A is true b. Only B is true

   c. Both are true d. Neither of two

8. Insurable interest can be created

   a. by common law b. by statute

   c. by contract d. all of the above

5.16 ANSWERS TO INTEXT QUESTION

5.1

1. No you cannot insure your house under residential building because you are storing fire hazard material and if any claim arises then no claim will be payable.
2. No, you are not the owner of Red Fort.

   a. Only A is true b. Only B is true

   c. Both are true d. Neither of two

3. Insurers are liable to pay claims arising out of losses caused by

   a. insured perils b. uninsured perils

   c. excluded perils d. All

5.17 ANSWERS TO OBJECTIVE TYPE QUESTION

5.15

1. d 2. b

3 b 4. d

5. b 6. d

7. a 8. d

Notes

6

PECULIARITIES OF INSURANCE CONTRACTS

6.0 INTRODUCTION

So far you have studies that the Insurance contract is a contract of indemnity. The contract of Insurance is a contract in which an insurer, in consideration of a premium agrees with an insured either to indemnify him against loss caused by a risk insured against or to pay him an agreed sum of money on the happening of specified events.

The Insurance contract is unique in the sense that in addition to the contract meeting the six common conditions of commercial contracts, it is also subject to 4 special features i.e. Utmost Good Faith, Insurable Interest, Indemnity and its two corollaries, subrogation & contribution and proximate cause. The four condition which we studied in detail in the previous chapters (it is to be remembered that in life Insurance contract the special conditions of indemnity and proximate cause are not applicable). But people have misconception about the insurance which have been discussed in this chapter.

6.1 OBJECTIVES

At the end of this lesson you will be able to know:

- How the insurance is different form gambling
- What are other features of the insurance contract?
- How the dispute arises in the insurance contract

6.3 INSURANCE AND GAMBLING

Some people at times say that Insurance is a gamble, a wager or a bet where the Insured pays a small amount (Premium) to the Insurer company and the Insurer in turn offers to pay a large sum (claim) in case a particular event happens otherwise he keeps the premium. While on the surface it may appear that this is no different then a person placing a small bet on a horse with the chance of getting 10-20 times his money back if that particular horse wins. While it is true that both Insurance and gambling involve money changing hands on the basis of chance events, it is important to understand the difference between the two.

The very act of placing a bet puts a person at risk of losing money. If he had not placed the bet there would be no risk and he would not care less which horse won or not. In Insurance, whether he insures or not, the risk is there and he is exposed to the possibility of a fire damaging his house. Gambling creates the risk whereas Insurance transfers an existing risk from one party to another.

The other differences between Insurance and gambling are

(1) In Insurance, Insurable Interest is a pre-requisite whereas in gambling the interest is limited to the amount to be won or lost.

(2) The Insured is immune from loss and his identity is known before the event whereas in Gambling the loser cannot be identified before the event.

(3) Full disclosure (Utmost Good Faith) is required from both parties to an assurance contract whereas this is not necessary in a gambling contract.

(4) Insurance contract is enforceable at law whereas there is no legal recourse for any of the two parties in a gambling contract.

INTEXT QUESTION 6.1

1. Is insurance contract gambling?

2. Do you agree that the insurance & maintenance contracts are same?

Notes

6.4 OTHER FEATURES OF AN INSURANCE CONTRACT

(a) Aleatory

Insurance contracts are said to be aleatory i.e. the values given up by the parties are unequal. The insurer may pay a large claim in return for a small amount (premium) or he may not pay at all. In either case the change of values are not equal. It is not true to say that an insured will not get anything if there is no claim but what he does receive is freedom from worry whether he sustain a loss or not. The peace of mind and freedom from worry are of far greater worth than the amount of petty premium paid.

(b) Conditional:

The Insurer is not obligated to perform if the conditions set forth in the contract are not met. The Insured does not promise to meet the conditions but he cannot force the Insurer to perform unless he does so. An example of this is the condition in an insurance policy regarding notification of claims that the Insurer be informed of a loss within a stipulated time period. The Insured is not compelled to do so but the Insurer can refuse to keep his promise if the Insured does not comply with this condition. Because of this conditional nature of an Insurance contract the Insured must be fully aware of the conditions of the policy if he is to receive its protection.

(c) Unilateral:

Only the Insurer makes a promise to do something, the insured on the other hand after payment of premium does not make any promises, though he must comply with the conditions if he wants the insurer to perform. He does not promise to meet the conditions, therefore Insurance contracts are said to be unilateral as in contrast to bi-lateral contracts in which both parties make enforceable promises and either party can force the other to perform or pay damages for not performing.

(d) Personal:

Insurance contracts are personal meaning thereby that it is the loss to person and not to the property itself that is insured. You may say your car is insured but actually its you who is insured against financial loss caused by

something happening to your car. That is why when a car is sold the Insurance does not automatically pass on to the new owner. It may be assigned but only with the consent of the Insurer because it is the people who are insured and they effect the hazard and Insurer are concerned as much about the person as with the property which may be subject matter of Insurance.

(e) Adhesion:

The Insurance contracts are contracts of Adhesion. Most commercial contracts are formulated after bargaining between the parties to the contract but Insurance contracts are created by the insurers alone and they are presented to the insured and he can take them as they are or leave them. This fact influence the way courts handle disputes regarding contracts of Insurance. The rule is that if there is an ambiguous clause then it will be interpreted in favour of the Insured on the assumption that since the Insurer has worded the contract he should know what he wants to say and write it down clearly.

This is one reason why Insurance contracts are complicated. Failure to state the specifications of what is covered and what is not and that too in a clear manner can prove to be costly for an Insurance company because if there is a difference of opinion the Insurer will be the victim of court interpretation.

6.5 SUMMARY

We have discussed various features of insurance contracts but it does not mean that the disputes will not arise if these features are present. Disputes may be of two categories.

The first is whether a contract exists or not. Was there a contract? Was it in existence at the time of loss?; and these questions concern whether or not the essential condition of a contract have been met i.e. Was the purpose legal?; Was there an offer and acceptance?; Was there a consideration?; Were the parties competent?; Whether conditions of Utmost Good Faith and Insurable interest were complied with or not?.

The second general area of dispute is whether the claim is payable or not and the amount of claim, and these disputes

Notes

arise from the questions. Was the risk covered?; Has there been any breach of warranty?; Have the conditions to the policy been complied with?; Was the Sum Insured adequate?; Should the conditions of average apply or not?; Whether entire loss was due to cover risk?; etc.

6.6 TERMINAL QUESTIONS

1. What is the difference between a service contract and a contract of insurance?

2. What are other features of insurance contract?

6.7 ANSWERS TO INTEXT QUESTIONS

6.1

1. Gambling creates the risk whereas Insurance transfers an existing risk from one party to another.

2. No, we do not agree with given statement as Maintenance contract is against the expense of the inevitable whereas Insurance contracts are against the expense of the accidental and there is an element of chance, which is a basic requirement of Insurance contracts.