

CHAPTER 1: INTRODUCTION TO INSURANCE

Life insurance – History and evolution - History of insurance - Insurance through the ages - Modern concepts of insurance - History of insurance in India - Life insurance industry - How insurance works - Risk management techniques - Risk avoidance - Risk retention - Risk reduction and control - Risk financing - Insurance vs Assurance - Insurance as a tool for managing risk - Considerations before opting for Insurance - Role of insurance in society - Insurance and Social Security.

- Insurance provides protection against economic losses arising as a result of unforeseen events and serves as an instrument of risk transfer.
- The **Babylonian traders** had agreements where they would pay additional sums to lenders, as a price for writing off of their loans, in case a shipment was lost or stolen. These were called „bottomry loans“. Under these agreements, the loan taken against the security of the ship or its goods had to be repaid only if and when the ship arrived safely, after the voyage, at its destination
- Practices similar to Babylonian traders were prevalent among **traders from Bharuch and Surat**, sailing in Indian ships to Sri Lanka, Egypt and Greece.
- The **Greeks** had started benevolent societies in the late 7th century AD, to take care of the funeral – and families – of members who died. The **Friendly Societies of England** were similarly constituted
- The **inhabitants of Rhodes** adopted a practice whereby, if some goods were lost due to jettisoning¹ during distress, the owners of goods (even those who lost nothing) would bear the losses in some proportion
- **Chinese traders** in ancient days would keep their goods in different boats or ships sailing over the treacherous rivers. They assumed that even if any of the boats suffered such a fate, the loss of goods would be only partial and not total. The loss could be distributed and thereby reduced.
- In India the principle of life insurance was reflected in the institution of the joint-family system in India, which was one of the best forms of life insurance down the ages. Sorrows and losses were shared by various family members in the event of the unfortunate demise of a member, as a result of which each member of the family continued to feel secure.
- The break-up of the joint family system and emergence of the nuclear family in the modern era, coupled with the stress of daily life has made it necessary to evolve alternative systems for security. This highlights the importance of life insurance to an individual.
- **Lloyds**: The origins of modern commercial insurance business as practiced today can be traced to Lloyd's Coffee House in London. Traders, who used to gather there, would agree to share the losses, to their goods being carried by ships, due to perils of the sea. Such losses

used to occur because of maritime perils, such as pirates robbing on the high seas, or bad sea weather spoiling the goods or sinking of the ship due to perils of the sea.

- **ii. Amicable Society for a Perpetual Assurance** founded in 1706 in London is considered to be the first life insurance company in the world.

History of insurance in India

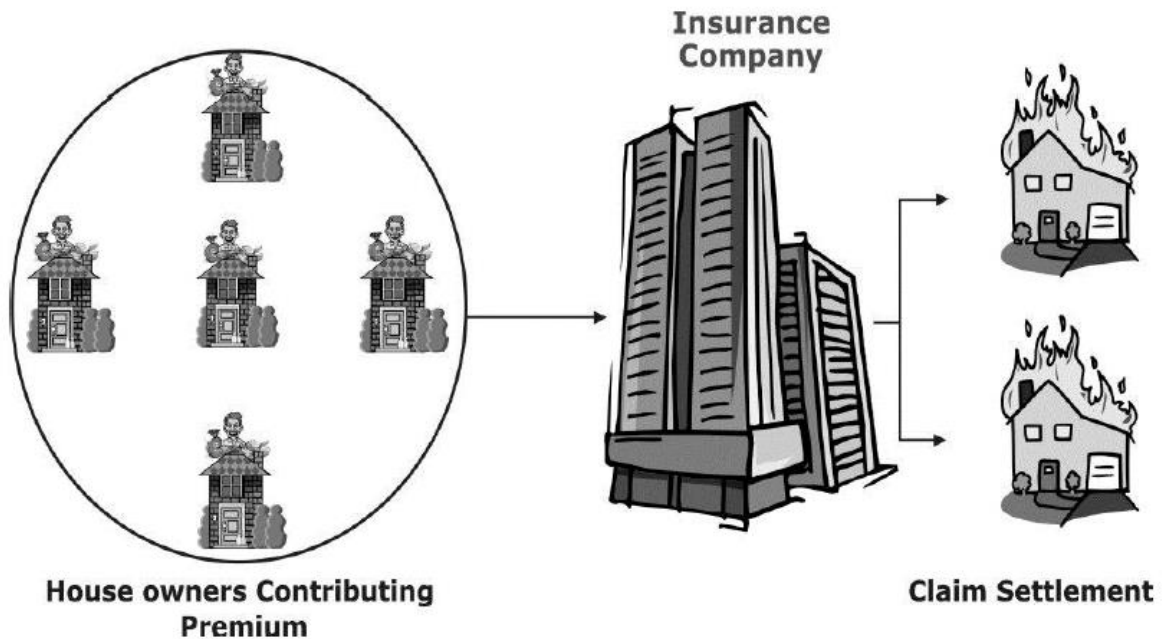
The Oriental Life Insurance Co. Ltd	The first life insurance company to be set up in India was an English company
Triton Insurance Co. Ltd.	The first non-life insurer to be established in India
Bombay Mutual Assurance Society Ltd.	The first Indian insurance company. It was formed in 1870 in Mumbai
National Insurance Company Ltd.	The oldest insurance company in India. It was founded in 1906 and it is still in business.

- In 1912, the **Life Insurance Companies Act** and the **Provident Fund Act** were passed to regulate the insurance business. The Life Insurance Companies Act, 1912 made it compulsory that premium-rate tables and periodical valuation of companies be certified by an actuary. However, the disparity and discrimination between Indian and foreign companies continued.
- The **Insurance Act 1938** was the first legislation enacted to regulate the conduct of insurance companies in India. The Controller of Insurance was appointed by the Government under the provisions of the Insurance Act.
- Life insurance business was nationalized on 1st September 1956 and the **Life Insurance Corporation of India (LIC)** was formed.
- **Nationalization of non-life insurance:** With the enactment of General Insurance Business Nationalization Act (GIBNA) in 1972, the non-life insurance business was also nationalized and the **General Insurance Corporation of India (GIC) and its four subsidiaries** were set up.
- The passing of the Insurance Regulatory & Development Act, 1999 (IRDAI) led to the formation of Insurance Regulatory and Development Authority of India (IRDAI) in April 2000 as a statutory regulatory body both for life, non-life and health insurance industry. IRDA has been subsequently renamed as IRDAI in 2014

How insurance works

Insurance may thus be considered as a process by which the losses of a few, who are unfortunate to suffer such losses, are shared amongst those exposed to similar uncertain events / situations

Diagram 2: How insurance works



There is however a catch here.

- i. Would people agree to part with their hard-earned money, to create such a common fund?
- ii. How could they trust that their contributions are actually being used for the desired purpose?
- iii. How would they know if they are paying too much or too little?

Obviously, someone has to initiate and organize the process and bring members of the community together for this purpose. That „someone“ is known as an „Insurer“ who determines the contribution that each individual must make to the pool and arranges to pay to those who suffer the loss.

a) Firstly, there must be an asset which has an economic value. The **ASSET**:

- i. May be **physical** (like a car or a building) or
- ii. May be **non-physical** (like name and goodwill) or
- iii. May be **personal** (like one's eyes, limbs and other aspects of one's body)

b) The asset may lose its value if a certain event happens. This chance of loss is called as **risk**. The cause of the risk event is known as **peril**.

c) There is a principle known as **pooling**. This consists of collecting numerous individual contributions (known as premiums) from various persons. These persons have similar assets which are exposed to similar risks.

d) This pool of funds is used to compensate the few who might suffer the losses as caused by a **peril**.

e) This process of pooling funds and compensating the unlucky few is carried out through an institution known as the **insurer**.

f) The insurer enters into an insurance **contract** with each person who seeks to participate in the scheme. Such a participant is known as **insured**.

There are two types of risk burdens that one carries – **primary and secondary**.

a) Primary burden of risk

The **primary burden of risk** consists of losses that are actually suffered by households (and business units), as a result of pure risk events. These losses are often direct and measurable and can be easily compensated for by insurance

B) Secondary burden of risk

The **secondary burden of risk** consists of costs and strains that one has to bear merely from the fact that one is exposed to a loss situation. Even if the said event does not occur, these burdens have still to be borne

Risk management techniques

1. Risk avoidance

Controlling risk by avoiding a loss situation is known as risk avoidance. Thus one may try to avoid any property, person or activity with which an exposure may be associated.

2. Risk retention

One tries to manage the impact of risk and decides to bear the risk and its effects by oneself. This is known as self-insurance.

3. Risk reduction and control

This is a more practical and relevant approach than risk avoidance. It means taking steps to lower the chance of occurrence of a loss and/or to reduce severity of its impact if such loss should occur.

4. Risk financing

This refers to the provision of funds to meet losses that may occur.

a) Risk retention through self-financing involves self-payment for any losses as they occur. In this process the firm assumes and finances its own risk, either through its own or borrowed funds, this is known as self-insurance. The firm may also engage in various risk reduction methods to make the loss impact small enough to be retained

b) Risk transfer is an alternative to risk retention. Risk transfer involves transferring the responsibility for losses to another party. Here the losses that may arise as a result of a fortuitous event (or peril) are transferred to another entity.

Insurance is one of the major forms of risk transfer, and it permits uncertainty to be replaced by certainty through insurance indemnity by the firm.

Insurance vs Assurance

- Insurance refers to protection against an event that **might** happen whereas assurance refers to protection against an event that **will** happen.
- Insurance provides cover against a risk while assurance covers an event that is definite e.g. death, which is certain, only the time of occurrence is uncertain. Assurance policies are associated with life cover.

Considerations before opting for Insurance

- When deciding whether to insure or not, one needs to weigh the cost of transferring the risk against the cost of bearing the loss, that may arise, oneself. The cost of transferring the risk is the insurance premium – it is given by two factors mentioned in the previous paragraph. The best situations for insurance would be where the probability is very low but the loss impact could be very high. In such instances, the cost of transferring the risk through its insurance (the premium) would be much lower while the cost of bearing it on oneself would be very high. a) Don't risk a lot for a little: A reasonable relationship must be there between the cost of transferring the risk and the value derived.
- Example
- Would it make sense to insure an ordinary ball pen?
- b) Don't risk more than you can afford to lose: If the loss that can arise as a result of an event is so large that it can lead to a situation that is near
- bankruptcy, retention of the risk would not appear to be realistic and appropriate.
- Example

- What would happen if a large oil refinery were to be destroyed or damaged?
Could a company afford to bear the loss?
- c) Consider the likely outcomes of the risk carefully: It is best to insure those assets for which the probability of occurrence (frequency) of a loss is low but the possible severity (impact), is high.
- Example
- Could one afford to not insure a space satellite?

Summary

Insurance is risk transfer through risk pooling.

The origin of commercial insurance business as practiced today is traced to the Lloyd's Coffee House in London.

An insurance arrangement involves the following entities like:

- ✓ Asset,
- ✓ Risk,
- ✓ Peril,
- ✓ Contract,
- ✓ Insurer and
- ✓ Insured

When persons having similar assets exposed to similar risks contribute into a common pool of funds it is known as pooling.

Apart from insurance, other risk management techniques include:

- ✓ Risk avoidance,
- ✓ Risk control,
- ✓ Risk retention,
- ✓ Risk financing and
- ✓ Risk transfer

The thumb rules of insurance are:

- ✓ Don't risk more than you can afford to lose,
- ✓ Consider the likely outcomes of the risk carefully and
- ✓ Don't risk a lot for a little

Self-Examination Questions

Question 1

Risk transfer through risk pooling is called _____.

- I. Savings
- II. Investments
- III. Insurance
- IV. Risk mitigation

Question 2

The measures to reduce chances of occurrence of risk are known as ____.

- I. Risk retention
- II. Loss prevention

- III. Risk transfer
- IV. Risk avoidance

Question 3

By transferring risk to insurer, it becomes possible _____.

- I. To become careless about our assets
- II. To make money from insurance in the event of a loss
- III. To ignore the potential risks facing our assets
- IV. To enjoy peace of mind and plan one's business more effectively

Question 4

Origins of modern insurance business can be traced to _____.

- I. Bottomry
- II. Lloyds
- III. Rhodes
- IV. Malhotra Committee

Question 5

In insurance context „risk retention“ indicates a situation where _____.

- I. Possibility of loss or damage is not there
- II. Loss producing event has no value
- III. Property is covered by insurance
- IV. One decides to bear the risk and its effects

Question 6

Which of the following statement is true?

- I. Insurance protects the asset
- II. Insurance prevents its loss
- III. Insurance reduces possibilities of loss
- IV. Insurance pays when there is loss of asset

Question 7

Out of 400 houses, each valued at Rs. 20,000, on an average 4 houses get burnt every year resulting in a combined loss of Rs. 80,000. What should be the annual contribution of each house owner to make good this loss?

- I. Rs.100/-
- II. Rs.200/-
- III. Rs.80/-
- IV. Rs.400/-

Question 8

Which of the following statements is true?

- I. Insurance is a method of sharing the losses of a „few“ by „many“
- II. Insurance is a method of transferring the risk of an individual to another individual
- III. Insurance is a method of sharing the losses of a „many“ by a few
- IV. Insurance is a method of transferring the gains of a few to the many

Question 9

Why do insurers arrange for survey and inspection of the property before acceptance of a risk?

- I. To assess the risk for rating purposes
- II. To find out how the insured purchased the property
- III. To find out whether other insurers have also inspected the property
- IV. To find out whether neighbouring property also can be insured

Question 10

Which of the below option best describes the process of insurance?

- I. Sharing the losses of many by a few
- II. Sharing the losses of few by many
- III. One sharing the losses of few
- IV. Sharing of losses through subsidy

Answers to Self-Examination Questions

Answer 1

The correct option is III.

Risk transfer through risk pooling is called insurance.

Answer 2

The correct option is II.

The measures to reduce chances of occurrence of risk are known as loss prevention measures.

Answer 3

The correct option is IV.

By transferring risk to insurer, it becomes possible to enjoy peace of mind and plan one's business more effectively.

Answer 4

The correct option is II.

Origins of modern insurance business can be traced to Lloyd's.

Answer 5

The correct option is IV.

In the insurance context „risk retention“ indicates a situation where one decides to bear the risk and its effects.

Answer 6

The correct option is IV.

Insurance pays when there is loss of asset.

Answer 7

The correct option is II.

Rs. 200 per household should cover the loss.

Answer 8

The correct option is I.

Insurance is a method of sharing the losses of a „few“ by „many“.

Answer 9

The correct option is I.

Before acceptance of a risk, insurers arrange survey and inspection of the property to assess the risk for rating purposes.

Answer 10

The correct option is II.

Insurance may be considered as a process by which the losses of a few, who are unfortunate to suffer such losses, are shared amongst those exposed to similar uncertain events / situations.