PG EC S1 04 (DSE)

TWO YEAR MASTER'S DEGREE COURSE

(CBCS in Accordance with NEP 2020)

SEMESTER - I

ECONOMICS OF INSURANCE

ECONOMICS

Surya Kumar Bhuyan School of Social Sciences

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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COURSE INTRODUCTION

“Economics of Insurance" is one of the course of M.A. in Economics programme of this University. The course entitled Economics of Insurance is designed to help the learners to have a deep understanding on various concepts and theoretical perspectives related to Economics of Insurance. This course comprises 14 units. The first unit of the course discusses the basics of insurance. This unit will help you understand the meaning of the term insurance, principles of insurance, role of insurance, types of insurance, risk pooling and risk transfer, quest for economic security, exposure to losses and economic and legal perspectives. The second unit deliberates on the types of insurance. Important concepts discussed in the unit include life vs. non-life insurance, classification of insurance and social vs. private insurance. The third unit will introduce you to the concept of risk and insurance. In this unit, we will discuss the fundamentals of risk and uncertainty, pure risk and speculative risk, expected utility and demand for insurance and moral hazard. The fourth unit deals with the risk management and risk sharing. This unit explains the concept of risk, types of risk, risk management, enterprise risk management, essentials of risk management and elements of risk management such as risk assessment, risk control, risk financing and world-wide risk sharing. The fifth unit discusses on the reinsurance. The important topics covered in this unit are concept of re-insurance, fundamentals of reinsurance and reinsurance markets in developing countries. The sixth unit will help you to acquire knowledge on the relation between insurance and economic development. In this unit, we will discuss the concept and significance of insurance, need for insurance,role of insurance in the economic development, insurance institutions as financial intermediaries and insurance institutions as investment institutions. The seventh unit deals with the fundamentals of life insurance and health insurance, functions of life insurance, plans of life insurance, legal aspects of life insurance and functions of health insurance. The 8th unit of this course discusses selection and classification of risk and basics of premium construction. A model health insurance format of indivitual health insurance and explanation of the basic items are given in unit 9. Unit 10 of the course analyses uses and types of evaluation of health insurance.Principles of underwriting of life and health insurance and group insurance are discussed here. Unit 11 of the chapter includes defination, types and importance of general insurance in a country’s economic development. Concept of short-term risk is also discussed in this chapter.Policy endorsements conditions and warranties; selection of risks; inspection of risks; rating and calculation of premiums; tariffs and non-tariffs; marketing of general insurance; technology development and general insurance are discussed in unit 12. Wealth accumulation and life cycle planning are discussed in unit 13.Insurance institutions in Indian capital market; regulations governing investments of insurance institutions in India;

While going through the units of the course, you will find that the unit is further divided into certain sections and sub-sections, wherever necessary, for your better understanding. Again, the units carry certain ‘activities’ after certain sections. These “ACTIVITIES” will provide you the opportunity to practically apply your own thoughts based on the knowledge gained from reading the text in a particular section. Besides, in order to give you additional information on certain relevant topics, you will find a category called “LET US KNOW” after the sections in each unit. Another category that has been included at the end of each section of a particular unit is “CHECK YOUR PROGRESS”. The purpose of this category is to help you to asses for yourself as to how thoroughly you have understood a particular section. You may then match your answers with “ANSWERS TO CHECK YOUR PROGRESS” given at the end of each unit. The section “FURTHER READING” in each unit contains the names of a few books which you might want to consult if you are intereted in learning more elaborately about the concepts discussed in a particular unit. Furthermore, the category titled “MODEL QUESTIONS” intends to provide you a hint of the type of questions you are likely to get in the examination.

UNIT 1 : INTRODUCTION TO INSURANCE

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Economic Security

1.3.1 The Concept

1.3.2 Ensuring Economic Security

1.4 Quest for Economic Security

1.4.1 The Basic and Work Related Securities

1.4.2 Income Security

1.4.3 Labour Market Security

1.4.4 Employment Security

1.4.5 Work Security

1.4.6 Skills Security

1.4.7 Job Security

1.4.8 Voice Representation Security

1.5 Exposure to Losses

1.5.1 Meaning

1.5.2 Types of Exposure

1.6 Insurance

1.6.1 Meaning and Definition

1.6.2 Principles of Insurance

1.6.3 Role of Insurance

1.6.4 Types of Insurance

1.6.5 Risk Pooling and Risk Transfer

1.6.6 Economic and Legal Perspectives

1.7 Let Us Sum Up

1.8 Further Reading

1.9 Answers to Check Your Progress

1.10 Model Questions

1.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- grasp the concept of economic security and how basic and work related securities aid in ensuring economic security
- comprehend the concept of exposure to losses and its role in insurance
- analyse the importance of insurance in an economy and the safeguards it provides to the insured.

1.2 INTRODUCTION

Every individual needs economic security and takes measures and steps to ensure the continuity of security. However, there are forces which try to curtail the security and as a result the individual slumps into economic insecurity. There may be multiple reasons of economic insecurity. Economic security is ensured when an individual has access to basic security which includes food, shelter and health care. In addition to these, one needs to have seven different work related securities.

The objective of insurance is to ensure economic security. It plays a constructive role in the economy and boosts the consumption factor. An entity having security through an insurance policy can have a sigh of relief in the event of a loss. The discussion in this unit will delve into economic security, loss exposure and the importance of insurance.

1.3 ECONOMIC SECURITY

In the following subsection let us discuss the concept of economic security:

1.3.1 The Concept

Economic security is not precisely defined (Hacker, 2006 cited in Weller and Logan, 2009). However, International Committee of the Red Cross highlights economic security as an individual's/ household's/communities' ability to manage their basic needs in

a sustainable manner (www.icrc.org). Economic insecurity is due to *risks* and *uncertainty*. Prof. Knight differentiated between the two as *"Uncertainty is an unknown risk, while Risk is a measurable uncertainty"*. As uncertainty is an unknown risk hence the outcome cannot be predicted. Conversely, for risk, the outcome can be predicted with some probability. Thus, risk is manageable whereas uncertainty is beyond control. Economic insecurity is the result of economic / income losses. Income losses are due to sudden unemployment, deteriorating health condition leading to higher medical expenditure, rising debts, divorce, etc. This economic insecurity may in extreme cases lead to an individual's insolvency. *Economic security* thus takes care of the problems arising out of economic losses.

The end of the Second World War witnessed a growing concern for economic and social security. Post-War economic growth and progression was built on security and these resulted in furtherance of security. This was the reason that the citizens of the industrialised countries started witnessing security in the form of social services, transfers and institutions providing an array of security in the nature of "from cradle to grave" approach. Although the developing countries recognised the importance of providing this kind of security yet it accepted that it was not possible to provide the same at a faster pace (ILO, 2004).

1.3.2 Ensuring Economic Security

Economic security is ensured when an individual has access to basic security which includes food, shelter and health care. In addition to these one needs to have seven different work related securities. An individual's work related securities tend to influence his/her basic securities. While work related securities concern a worker, basic securities affect both workers and non-workers (Dasgupta, 2002). Though a non-worker may not be directly influenced by the work related securities but he/she is dependent

on a worker for arranging the basic securities. Therefore, a non-worker is also influenced by the work related securities.



CHECK YOUR PROGRESS

Q 1: What is meant by economic security? (Answer in about 20 words)

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Q 2: What are the basic securities? (Answer in about 20 words)

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1.4 QUEST FOR ECONOMIC SECURITY

Let us quickly discuss the basic and work related securities as well as income security in this subsection:

1.4.1 The Basic and Work Related Securities

Every individual craves to have economic and social security for himself/herself and his/her dependants. This quest of having security is natural and time immemorial. As a social being humans look for opportunities to earn a livelihood which then takes care of the basic needs. Once an individual is directly or indirectly related to an organisation, the work related securities are also to be ensured. The seven work-related securities based on the International Labour Organisation (ILO) Socio-Economic Security Programme, 2004 is thus discussed here in detail. The following are the seven work related securities:

- Income Security
- Labour Market Security
- Employment Security
- Work Security
- Skills Security
- Job Security

- Voice Representation Security

1.4.2 Income Security

An individual has income security when his/her income is reasonable and satisfactory and has an assured continuation. The income is sufficient to fulfil the actual and perceived needs. The income is comparable to others engaged in the same type of profession and the same nature of work. Also, the income must be able to assist the individual when he or she is affected by an income crisis. The theory of income does not include only income in monetary terms but also other forms of income. The monetary incomes are in the form of salary, wages, rent, business profits and return from sales, etc. Non-monetary incomes are in the nature of pre-requisites and can be measured in terms of money. This genre includes rent free accommodation, subsidised food at work place, paid leave, health insurance coverage, free transportation, etc.

A person's income security depends on the following:

- what income he or she retains, not what he or she "earns";
- the assurance of that income lasting beyond today;
- the prospect of receiving adequate income in the future. Most poverty statistics measure what a person neither "earns" nor nominally "receives".Source: Economic Security for a better world, ILO Socio-Economic Security Programme, 2004

Public goods are also an important form of income security mostly provided by the government to the entire population. The basic objective of providing public goods is to reduce social inequality amongst the people. Some examples of public goods are education, health, water, power, post and telegraph, communication which includes roads, buses, trains and other government providing services. In addition, income security also includes government support for the people in general. Support to

specific group of people based on their specific needs. For example old age pension, monetary support for the parents rearing differently abled child, etc. The income security thus includes both monetary and non-monetary benefits.

Income security is vastly affected by inequality of income. It is debated that globalisation is a cause of inequalities of income. The inequalities of income are of four types as identified by ILO's Socio-Economic Security Programme, 2004.

- **Inter-regional and International Income Inequality:** The inequalities exist amongst the different nations of the world. As a result one country is richer than the other.
- **Functional Income Inequality:** The inequality is between the income of the labour and the return (profits) to the contributors of capital. In the recent past, the share of income as percentage of GDP has swung in favour of owners of capital while the labour income had declined.
- **Personal Income Distribution:** The income inequality is amongst the citizens of a country which may also be termed as intra-country inequality. One of the reasons for it is the uneven distribution of wealth amongst the people. Another dimension of the inequality is the pre-requisite received by one group of people and not by the other. These pre-requisites in most of the cases are either not measured while calculating the actual remuneration of an employee or partially considered. The intra-country inequality also occurs due to some group of people owing to their caste, creed, colour and religion earning lower levels of income.
- **Polarisation:** This form of inequality arises when a small percentage of the population amasses large amount of income/wealth.

1.4.3 Labour Market Security

In the present globalised era, labour market insecurity has

risen by manifold. Unemployment is one of the root causes of labour market insecurity. Even when a person is having a job he or she fears of losing the job and thus adds to level of unemployment. Labour market insecurity also considers those situations wherein a person searches for a job which is different than the work he or she intends to do.

Labour market security is robust when the workforce has the prospect of finding employment to earn livelihood. There is a feeling among the labours that the opportunities would further increase or at least maintain the status quo. Research indicates that migrant labours (whether skilled or unskilled) have a positive effect in the labour market security. Thus, migrant labours in most cases remain employed. The labour market security is adversely affected by three factors:

- **Agricultural Unemployment in Developing Countries:** Although agricultural and allied activities are the primary sources of job for rural youth, yet in reality it does not mean that the rural youth is engaged in a job. Admission of modern technology in agricultural activities has an inverse relationship with the employment scenario in agricultural and allied activities.
- **Informalisation:** The growth of labour supply needs a corresponding growth in the formal sector of the economy to absorb the labour. However, most of the developing countries do not witness this trend and the labours have to engage in the informal sectors to earn their livelihood. These informal sectors are devoid of any social security schemes of the government and/or necessary regulatory protection. It is further reported by the ILO that in the developing countries 50% to 70% of the labours are engaged in the informal sectors. The figures may be even higher for the countries like India and Bangladesh. Some of the labours are casual workers and they get work only when there is a requirement and during other time they remain unemployed. The labour

insecurity does not arise from the informal sector as such but from the extra working time, deteriorating health condition, inadequate welfare measures etc. of the informal sector. The inability to earn optimum level of income is a strong indication of *inadequate* employment. Thus, poorer families engage their children and women care providers women or the elderly person in the family into employment engagement.

- **Global De-Industrialisation:** The adverse affect of globalisation has been felt in the manufacturing sector. In many industrialised countries, there is a trend of declining job in the manufacturing sector. The era of 1990s and early 2000s has witnessed rapid job shrinkage. There was massive job loss in the manufacturing sector in economically powerful countries like China, Japan and South Korea resulting into massive unemployment.

1.4.4 Employment Security

An individual experiences employment security when he or she is guarded against unjust and arbitrary sacking from the job. The employment security is profound in those organisations where a grievance redressal mechanism exists for the employees against arbitrary dismissal. Risks and uncertainty in jobs are important factors in employment security. The ownership pattern of the organisation, the regulatory safeguards, agreements between the employers and the employees are important determinants in measuring employment security. Workers union plays a key role in ensuring employment security. The security is more in government controlled organisations in comparison to the private firms. Nevertheless this phenomenon is gradually changing even in countries like China. Moreover, privatisation of the government companies is eroding the employment security as also evident in India. The size of the firms also plays a significant role in employment security. Therefore, it is noticed that large

firms provide greater employment security than the small or mid-sized firms.

However, irrespective of all this, casual/temporary/part-time workers in any organisation have greater employment insecurity than the regular employees. The sense of insecurity has an adverse affect on the physical and psychological health of an employee which leads to depression, heart ailments, fatigue, etc.

Employment security is a phenomenon which the workers desire as it ensures income security. The employers conversely need flexibility and try to reduce employment security.

1.4.5 Work Security

Work security in an organisation ensures safety of the workers and their personal well-being. The protection of workers against occupational hazards at work place, injuries and diseases, stress, excess work load, *presenteeism* and harassment comes under the purview of work security. There are government regulations to ensure work security. Inspite of that, work insecurity in varying proportion exists all over the world, in different industries, work places and employment.

Agriculture is one of those sectors which has a high magnitude of work insecurity due to absence of social security and measures for workers' health. The sector records large number of accidents and fatal injuries. Women workforce in the agricultural sector faces more insecurity than men. They even suffer from sexual harassment from their pay master. The exposure to hazardous chemicals and pesticides even places an unborn child of a pregnant women worker at risk.

The insecurity is also present in the industrial sector. The industrially advanced countries are witnessing increasing numbers of workmen suicide and deteriorating mental health leading to depression. For example, Japan recorded growing cases of *Karoshi* (death from overwork).

In the present globalised world, the workers tend to work for long hours with minimal breaks in between. This is leading to physical ailments and injuries like Musculo-skeletal Disorders (MSDs) which is a big concern for the working class. Another growing concern of work insecurity is harassment which may be in the form of physical, mental or sexual. The ILO's Socio-Economic Security Programme, 2004 reported that in many countries women employees faces sexual harassment from their supervisors and colleagues. There is a need to frame guidelines by the countries to tide over this problem. In India, Sexual Harassment of Women at Workplace (Prevention, Prohibition and Redressal) Act, 2013 in the backdrop of Vishaka Guidelines was enacted for providing protection to women against sexual harassment at work place. To ensure work security it is important for the organisations to set up a department or committee to look after the health and safety of the work force.

1.4.6 Skills Security

A society ensures skills security when the people engaged in employment have the prospect to access training, apprenticeship, and education to augment their knowledge and skills. Skills security is associated with Millennium Development Goals of United Nations. Skills security not only aids in acquiring a job or earning more money but also ensures a better living. Skills security necessitates infrastructure for formal education and skills imparting facilities which one can access post the formal education. In skills security, it is also important that the person acquiring training can utilise the learned skills in his/her job and insure that in future there would be ample scope to acquire newer skills. Skills can be acquired in an infrastructural facilities or in the form of 'on the job' training. It is evident that better skills have prospect for better income generation or earning.

However, it is also pertinent that the acquired sills are

being utilised efficiently while performing the job. If it remain unutilised/underutilised than the objective of skills security remains unfulfilled. Moreover, an employee in a job who feels that his/her skills is inadequate in performing the job efficiently and effectively has a tendency to feel insecure in his/her job. Orientation Course and Refresher Courses for teachers are examples of skills security.

1.4.7 Job Security

Job security has to be studied from the context of inequality in an organisation. An employee has job security when he or she has expertise in her/his job and because of that he or she is not discriminated or shunned out of his or her place of work. Job security helps in developing a bond with the job being performed. It helps the employee to grow in his/her professional life. However, job security is different from employment security in the sense that an employee may have employment security due to long term contract with his/her employer but no job security. The employee may be discriminated against and transferred to other departments within the organisation. In that case, the employee has to adjust to the new department every time and may then suffer from stress and other kinds of physical or mental ailments.

Discrimination is one of the causes of job insecurity and it may arise because of race, colour, gender, religion, ethnicity, and migrant nature of labourer to name a few. In many organisations, women are not recruited as it is wrongly believed that their productivity at work may be less than the men recruits. The young women may ask for maternity leave during her pregnancy. Discrimination is there in regard to pay and perks as well. Even within the organisation some group of people may have easy ways of climbing the ladder of success than some others. Training for skill development may be imparted to some favourite employees and not to the others. Thus, it is believed that absence of unfair practice, partiality or discrimination aids in creating job security within an organisation.

1.4.8 Voice Representation Security

Voice is necessary to ensure the employees' rightful interests and entitlements in an organisation. Voice representation may be in the form of individual voice or collective voice. Trade unions are an example of collective voice in any organisation. However, we find most of the active trade unions in public sector organisations and composed of permanent employees.

Trade unions participate in collective bargaining with the management of the organisation. The unions play an important role in ensuring fair wages to the employees and thus engage in wage negotiation. For example, in Indian banking sector, United Forum of Bank Unions negotiates the employees' wages with Indian Banks' Association.

Unions also play major roles in eradicating discrimination amongst employees based on gender, colour, creed, religion, etc. The trade unions also see that the organisation is providing safe and healthy working conditions to the employees and takes care of the employees with regard to the happening of certain unfortunate event. An organisation without an active trade union fails to provide economic and social security to its employees. The voice representation security is important in ensuring the other work related securities; be it employment security, income security, employment security, work security, skills security or job security.

Trade unions also engage in strikes and lock-outs in an organisation and sometimes it has negative effect on the industrial sector of the economy. Owing to this sometimes there is a pressure even from the government to weaken the trade union movements. The casual workers/part time workers/contractual workers in the formal sector and workers in the informal sector are most often outside the purview of organised trade union. However, all groups of employees must be encouraged to take membership in the unions so as to have a strong 'voice' and to guarantee equitable rights in an organisation.



ACTIVITY 1:1

Q 1: Identify an organisation of your choice and study how the management is ensuring work related securities.

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CHECK YOUR PROGRESS

Q 3: What are the different types of inequalities of income? (Answer in about 20 words)

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Q 4: State one of the root causes of labour market insecurity. (Answer in about 20 words)

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Q 5: What are the problems addressed by work security in an organisation? (Answer in about 30 words)

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Q 6: How job security is different from employment security? (Answer in about 50 words)

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1.5 EXPOSURE TO LOSSES

In the following subsections we shall discuss the meaning of exposure and the types of exposure:

1.5.1 Meaning

The possibility of suffering loss due to one or more perils is known as exposure to losses. This is a financial loss an individual or business entity bears. This can be also discussed to the extent of 'risks' that one takes. Let us assume that an equity market investor invests Rs. 1,00,000 in equity stocks of company X Ltd. Due to the inherent risks associated with equity market investments the stock price may fall and in some extent may even plunge to zero. Thus, while making an investment of Rs. 1,00,000 the investor has a loss exposure to the extent of Rs. 1,00,000. However, there is a difference between risk and loss exposure. Risk may lead to unexpected gain or unexpected loss but loss exposure lead to loss only. The loss exposure thus comes under the domain of 'Risk Management'. To manage risks, the risk management process involves identifying, assessing and controlling the risks (or sources of threats).

It is important to calculate the value of the property (assets) one owns to calculate the extent of exposure to losses. Quantification aids in recovering the value of assets on the happening of certain unfortunate event. Insurance is one of the methods to protect ones property against economic / financial losses. The next section discusses in detail the role of insurance in mitigating losses.

1.5.2 Types of Exposure

The exposure to losses in a business may be of different kinds. Some of the prevalent ones are discussed below (boltinsurance.com):

- **Liability Loss Exposure:** It causes due to intentional, civil or criminal accidents.
- **Income Loss Exposure:** The loss of income affecting the cash flow of an entity is known as income loss exposure. The major causes are loss of sales revenue and for an individual it may results into employment loss due to accident, sickness or partial or full disability.
- **People Loss Exposure:** The loss of personnel in an organisation due to death, retirement, disability or resignation is termed as people loss exposure.
- **Property Loss Exposure:** The most common exposure to loss is property loss. The loss may be for tangible or intangible assets of the business. For example, loss of building, furniture, automobile, equipments and intellectual property rights, etc.

The losses can be hedged by taking insurance policies. The study on exposure to loss is therefore the preliminary factor for studying insurance.



CHECK YOUR PROGRESS

Q 7: What is meant by understand by exposure to loss? (Answer in about 30 words)

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1.6 INSURANCE

Let us discuss the meaning and definition of insurance:

1.6.1 Meaning and Definition

Insurance is a financial instrument that comes to the rescue of an entity when it faces a financial loss due to the happening of a

certain unforeseen event. The entity may be an individual or a business set up. The insurance business is based on the concept of large number. Hence, in an insurance pool the entity contributes a small amount of money (known as premium) to mitigate the losses of a few. The entity must have an insurable interest on the insured. It means loss to the asset (which is insured) must lead to financial or other kind of loss to the person who has insured the asset. The insurance interest must be present both at the time of purchasing the insurance and also at the time of loss.

According to Hansell, "Insurance may be defined as a social device providing financial compensation for the effects of misfortune, the payment being made from the accumulated contributions of all parties participating in the scheme".

According to Riegel and Miller, "Insurance is a social device whereby the uncertain risks of individuals may be combined in a group and thus made more certain, small periodic contributions by the individuals providing a fund, out of which, those who suffer losses may be reimbursed".

According to Patterson, "Insurance is a contract by which one party, for a compensation called the premium, assumes particularly risks of the other party and promises to pay him or his nominee a certain or ascertainable sum of money on a specified contingency". The definitions indicate that insurance business thrives on the notion of uncertainties. It is a contract which is based on contributions of the party. The loss of few insured is being reimbursed by the contributions made by all.

1.6.2 Principles of Insurance

The contract of insurance is guided by the principles of insurance and those are discussed below:

- **Uberrimae Fidei (Utmost Good Faith):** The insured (policyholder) and the insurer (insurance company) must have good faith for each other while sealing the contract. It means

the prospective policyholder must disclose all relevant information to the company while proposing for the policy and the company also at the time of accepting the proposal must clearly state the terms and conditions.

- **Insurable Interest:** This part is already discussed under meaning and definition of insurance.
- **Causa Proxima:** A loss may occur because of one or many of the causes. All causes may not be covered by the insurance policy. The principle thus guides the parties in identifying the nearest cause which had led to the loss and then the compensation is paid.
- **Indemnity:** The company is liable to only compensate the loss of the insured. With the compensation the insured is brought back to the position he or she was before suffering the loss and so the insured cannot make any profit.
- **Subrogation:** It means transferring all rights and remedies of the asset (the insured object) by the insured to the insurer so that law suit can be filed by the insurer against the third party who has caused the loss to the insured.
- **Contribution:** An entity can have multiple insurance on the same object. In the event of a loss all the insurance companies will contribute proportionately for the loss of an object.
- **Loss Minimisation:** The principle entails that an insured has the responsibility to protect the insured object against any mishaps and must not resort to moral hazard.

1.6.3 Role of Insurance

Insurance serves a multifaceted role. From providing protection to the policy holders to accumulating fund for investing in different sectors or encouraging people for savings, to name a few. The different roles played by insurance sector are listed below:

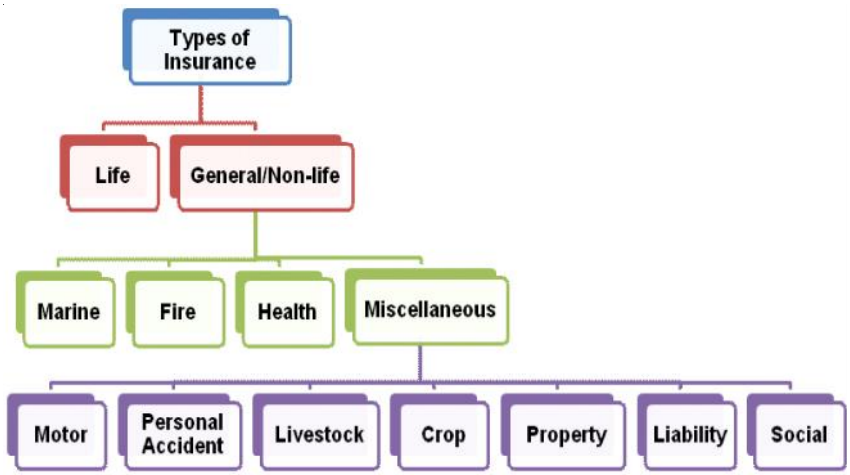
- Financial security to policy holders in the event of loss and thereby shifting the risks from the insured to the insurer.

- Encouraging savings habit of people.
- Generating funds from the policy holders with an objective to invest in different sectors of the economy.
- Investing funds in housing and infrastructural sectors, central and state government and other approved securities, approved investments, etc. thus helping in capital formation.
- Agent of economic development of a country by the process of generating funds from the one who has surplus and in investing in the sector which has a deficit.
- Insurance also acts as social security.

1.6.4 Types of Insurance

The origin of insurance can be traced back to marine insurance and is considered as the oldest form of insurance. Insurance sector has evolved considerably with the development of the global economy. A classification of different types of insurance is depicted below. The classification is not to be considered as an exhaustive one since in the evolving era of insurance business more and more types of insurance can be added to the following structure.

Figure 1:1



1.6.5 Risk Pooling and Risk Transfer

The contract of insurance is based on the tenet of risk

transfer. Purchasing an insurance policy by the insured by paying premium to the insurer is the method of transferring the risks of loss to the insurer. The insurer is now under a contractual obligation to indemnify the loss of the insured up to the sum insured or the value of loss whichever is less.

An even distribution of risks within a large group of contributors of the common cause is known as risk pooling in insurance. The bigger the size of the group of contributors, the more stable and predictable the premium is. However, in insurance business, risk pooling is a technique which is not a prerequisite for all insurance contracts. There may be a unique insurance contract between the insurer and the insured which is devoid of risk pooling. Risk pooling reduces the overall risks for the insurer but contracts can be signed without risk pooling.

1.6.6 Economic and Legal Perspectives

Insurance contributes immensely in a country's economy. By generating fund from the masses and investing in different sectors of the economy it contributes positively to the GDP of a country. History witnessed that insurance stabilises the economy even during the financial crises. Insurance acts as a catalyst in promoting social order and common good. Worker's compensation policies, motor insurance, health insurance are some examples of insurance which aims to maintain the social order. In today's globalised economy, with the advancement of technology there is increased interdependence amongst the markets and the nations and it has its effects in the supply chain. The commercial trade promotes production and consumption and thus advances the economic growth. The room of errors is thus minimal and hence failure has multiple consequences. The insurance sector plays a key role in absorbing the shocks of the business houses in the supply chain in the event of a loss. Moreover, insurance promotes savings habit amongst the people and aids in capital formation in

the economy. In case of annuity insurance, it even provides continuity in income to the retired people (Weisbart, 2018).

Globally, the countries enact laws to govern their insurance business. In India, the principal Act to regulate the insurance business is Insurance Act, 1938. The insurance sector has witnessed considerable changes post economic liberalisation of 1991. On the basis of the recommendation of the Malhotra Committee, 1994, Insurance Regulatory and Development Authority of India Act was passed in the year 1999 "to provide for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto and further to amend the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972". Accordingly, the Insurance Regulatory and Development Authority of India was established in April, 2000. Another remarkable step by the Government of India was setting up of the Institution of Insurance Ombudsman in 1999 for redressal of customer grievance and to protect the interests of the policy holders. At present there are 17 Ombudsmen in India. For an efficient insurance sector and for orderly growth of the insurance business, government enacts laws and also lays down various rules and regulations. This ensures that both the insured and the insurer interests are protected.



ACTIVITY 1:2

Q 2: Identify what are the new types of insurance services that are marketed by insurance company.

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CHECK YOUR PROGRESS

Q 8: State the meaning of insurance. (Answer in about 80 words)

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Q 9: What are the two basic types of insurance? (Answer in about 20 words)

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Q 10: What is the Principal Act to regulate insurance business in India? (Answer in about 20 words)

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1.7 LET US SUM UP

- International Committee of the Red Cross discusses economic security as an individual's/ household's/ communities' ability to manage their basic needs in a sustainable manner.
- Economic insecurity is the result of economic / income losses. Income losses are due to sudden unemployment, deteriorating health condition leading to higher medical expenditure, rising debts, divorce, etc.
- Economic security is ensured when an individual has access to basic security which includes food, shelter and health care. In addition to these, one needs to have seven different work related securities.
- ILO's Socio-Economic Security Programme, 2004 studied the seven work related securities which include income Security, labour market security, employment security, work security, skills security, job security and voice representation security.

- An individual has income security when his or her income is reasonable and satisfactory and has an assured continuation. The income is sufficient to fulfil the actual and perceived needs. The income is comparable to others engaged in same type of profession with same nature of work. Also, the income must be able to assist the individual when he or she is affected by an income crisis.
- Labour market security is robust when the workforce has the prospect of getting employment to earn livelihood. There is a feeling among the labourers that the opportunities will further increase or at least maintain the status quo.
- An individual experiences employment security when he or she is guarded against unjust and arbitrary sacking from the job. The employment security is profound in those organisations where a grievance redressal mechanism exists for the employees against the arbitrary dismissal.
- Work security in an organisation ensures safety of the workers and their personal well-being.
- A society ensures skills security when the people engaged in employment have the prospect to access training, apprenticeship, and education to augment their knowledge and skills.
- An employee has job security when he or she has expertise in his or her job and because of that he or she is not discriminated or shunned from his or her place of work.
- Voice is necessary to ensure the employees' rightful inter place of works rests and entitlements in an organisation. Voice representation may be in the form of individual voice or collective voice.
- The possibility of suffering loss due to one or more perils is known as exposure to losses. The loss is the financial loss an individual or business entity bears.
- Insurance is a financial instrument that comes to the rescue of an entity when it faces a financial loss due to the happening of a certain unforeseen event. The entity may be an individual or a business set up.

- The principles of Insurance are uberrimae fidei, insurable interest, causa proxima, indemnity, subrogation, contribution and loss minimisation.
- The contract of insurance is based on the tenet of risk transfer.



1.8 FURTHER READING

1) Head, G.L. (2009). *Risk Management- Why and How An Illustrative Introduction to Risk Management for Business Executives*. USA: International Risk Management Institute.

2) Vaughan, E.J. and Vaughan, T. (2008). *Fundamentals of Risk and Insurance* (10th Edition). USA: John Wiley & Sons, Inc.



1.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Economic security is individual's/household's/communities' ability to manage their basic needs in a sustainable manner.

Ans to Q No 2: Basic security includes food, shelter and health care.

Ans to Q No 3: Inter-regional and international income inequality, functional income inequality, personal income distribution and polarisation.

Ans to Q No 4: Unemployment is one of the root causes of labour market insecurity.

Ans to Q No 5: The protection of workers against occupational hazards at work place, injuries and diseases, stress, excess work load, presenteeism and harassment comes under the purview of work security.

Ans to Q No 6: Job security is different from employment security in the sense that an employee may have employment security due to long term contract with his/her employer but no job security. The employee may be discriminated against and transferred to other departments within the organisation.

Ans to Q No 7: The possibility of suffering loss due to one or more perils is known as exposure to losses. The loss is the financial loss an

individual or business entity bears.

Ans to Q No 8: Insurance is a financial instrument that comes to the rescue of an entity when it faces a financial loss due to the happening of a certain unforeseen event. The entity may be an individual or a business set up. The insurance business is based on the concept of large number. Hence, in an insurance pool the entity contributes a small amount of money (known as premium) to mitigate the losses of a few.

Ans to Q No 9: The basic two types of insurance are Life insurance and General/Non-life insurance.

Ans to Q No 10: In India, the Principal Act to regulate the insurance business is Insurance Act, 1938.



1.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: How risks and uncertainty is related to economic security?

Q 2: Write a brief note on employment security.

Q 3: State the importance of skills security.

Q 4: Define insurance. How principles of insurance guide the insurance business?

Q 5: How is risk transfer different from risk pooling in insurance? Discuss

Long Questions (Answer each question in about 300-500 words)

Q 1: What is income security? How it is important in ensuring economic security?

Q 2: What is the role of trade union in safeguarding the interests of employees in an organisation?

Q 3: Give a note on the relationship between risk and exposure to loss. What are the different types of exposure to loss?

Q 4: Discuss in detail the features of different types of insurance.

Q 5: Elucidate the contribution of insurance in a country's economy.

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UNIT 2 : TYPES OF INSURANCE

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Life Vs. Non-Life Insurance

2.4 Classification of Life, Health, and General Insurance

- 2.4.1 Life Insurance
- 2.4.2 Health Insurance
- 2.4.3 General Insurance

2.5 Social Vs. Private Insurance

2.6 Let Us Sum Up

2.7 Further Reading

2.8 Answers to Check Your Progress

2.9 Model Questions

2.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- explain the difference between life and non-life insurance
- classify the different insurance policies
- grasp the difference between social and private insurance.

2.2 INTRODUCTION

Humans are usually risk averse. Insurance was developed as a social device to reduce risk of life and property. Insurance is thus a scheme of economic cooperation amongst the members of a community sharing risks. It is defined as a legal contract between two parties i.e., the insurer and the insured. The insurer pays a fixed amount of money on the happening of particular events, while the insured pays an amount known as premium in exchange of the fixed amount. The document where the contract is embodied is called an insurance policy. The contract is based on the principles of good faith, indemnity, causa proxima, insurable interest

and doctrine of subrogation.

2.3 LIFE VS. NON-LIFE INSURANCE

Life insurance is an insurance cover which pays the sum assured as stated on the policy to the insured or their nominated beneficiaries by the insurance company, in the event of the premature death of the individual who is insured. In case, the insured person outlives the policy period, then there is a provision of maturity benefit, which is the returns of the premiums paid by the insured person plus a bonus.

Non life insurance policy covers the risk of an individual against the losses and damages other than those covered by life insurance policies. A non life insurance policy basically compensates the damages in case of unfortunate events or unavoidable circumstances, as per the policy terms and conditions, to the insured or their nominated beneficiaries by the insurance company. However, it has no savings or investment tangent, that means there is no provision of maturity benefit unlike the life insurance policy.

Life insurance is a long term contract between the insured person (policy holder) and the insurer (insurance company) and the policy holder of a life insurance policy requires to pay the periodic payments that is the premium of a policy to the insurance company either monthly or quarterly or annually for a long time until the policy reaches its maturity. On the other hand, non life insurance is a short-term contract between the insured person and the insurer. The coverage period for most of the non life insurance policies is usually one year and the policy holder of a non life insurance policy requires paying the entire premium up front to the insurance company premiums, that is, before the commencement of the policy.

The risks which are covered by the life insurance policy are premature death, income during retirement, illness etc. On the other hand, the risk which are covered by the non life insurance policy are property loss (due to theft and burns), liability arising from damage caused by an individual to a third party, accidental death or injury.

The main products of the life insurance include- whole life,

endowment, term, pension, ***unit linked investment plans (ULIPs)***, money back plans and life annuity plan. On the other hand, the main products of non life insurance include- motor insurance, fire insurance, home insurance, marine insurance, commercial insurance, personal accident insurance, medical and health insurance and travel insurance.



CHECK YOUR PROGRESS:

Q 1: Distinguish between life and non life insurance. (Answer in about 50 words)

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Q 2: Mention the products of life and non life insurance. (Answer in about 50 words)

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Unit linked Investment Plan (ULIP) is a multi-faceted life insurance product, which is the combination of life insurance and investment. That means a small portion of the money invested goes to securing the life of policy holders and the rest of the money is invested in the capital market.

2.4 CLASSIFICATION OF LIFE, HEALTH AND GENERAL INSURANCE

Insurance can be classified into Life, Health and General Insurance, the details for the same is discussed in the following sections:

2.4.1 Life Insurance

Life insurance is defined as the contract between two parties, the assured and the assurer. The assurer pays a fixed amount of money on the occurrence of particular events, while the assured pays an amount known as premium periodically in exchange of the fixed amount. Life insurance is a long-term contract

that provides a sense of security to the insured in the event of untimely death and old age as well. Life insurance also serves as a compulsory savings and improves the quality of life of the insured and his family members. We will study in details about the life insurance in the units 7 and 8 of this course.

2.4.2 Health Insurance

The Registration of Indian Insurance Companies Regulations, 2000, defines Health Insurance as the effecting of contracts which provide sickness benefits or medical, surgical, or hospital expense benefits, whether in-patient or out-patient, on an indemnity, reimbursement, service, prepaid, hospital or other plans basis, including assured benefits and long-term care. Both the public and private sector offers variants of health insurance policies. In the public sector, companies offer the following health insurance policies: Mediclaim Policy for the general public; Jan Arogya Policy for the economically weaker sections; Community-based Universal Health Insurance Scheme which is a group insurance scheme for people below the poverty line. Both life and non-life insurers which is registered with the Insurance Regulation and Development Authority (IRDA) can offer health insurance. We will study about the health insurance in details in unit 9 and 10 of this course.

2.4.3 General Insurance

General or non-life insurance is an insurance provided for a short-term coverage, usually a year. General Insurance provides security against loss arising out of damages to property or any other liabilities. General Insurance usually comprises Insurance of property against fire, theft, flood, earth quake etc; Personal Insurance such as Accident & Health Insurance; Liability Insurance i.e., legal liability arising out of third-party claims such as claim from a person injured in a motor accident etc. and other types of Insurances such as Credit Insurance, Crop Insurance, etc. General

Insurance is important as every person desires to cover himself of risk arising out of insecurities which can result in financial losses. General Insurance provides security to a person by covering the risks arising out of security. This in turn allows people to run their life smoothly. The major types of General Insurances are as follows :

Fire Insurance: It is a contract under which the insurer agrees to cover the insured/assured for the financial loss in return for a consideration (premium), which the Insured may suffer due to destruction of or damage to property or goods, caused by fire, during a specified period.

Marine Insurance: It is an Insurance against loss or damage or destruction of cargo, freight, merchandise acquired or held between the point of origin and point of destination.

Motor Vehicle Insurance: Motor Vehicle Insurance is a contract of Insurance under which the Insurer covers the Insured, who is the owner of a motor vehicle, against any loss that he may incur due to damage to the property (i.e., the motor vehicle) or any other person (i.e., Third Party) as a result of an accident.

Health Insurance Policy: It refers to the policies covering hospitalisation expenses for the treatment of illness or injury. These policies may also cover pre hospitalisation expenses and also post hospitalisation expenses as per the terms and conditions of the policy.

We will study in details about the general insurance in unit 11 and 12 of this course.

2.5 SOCIAL VS. PRIVATE INSURANCE

The concept of social insurance is associated with the intervention of government in the insurance market to ensure a group of individuals against emergencies that might lead to financial problems. The concept of social insurance is based on contributions by the individuals towards a common fund and the benefits are paid in the future. The risks of social insurance are pooled by a government organisation that requires certain benefits.

Thus, Social insurance can be described as a public insurance program that provides protection against various economic risks. The participation is usually compulsory and may be made by the insured's employer and the state as well as by the insured himself/ herself.

On the other hand, private insurance are plans purchased by individuals for oneself or family. Private insurance is not associated with an employer or other organisation. The costs of these plans may vary greatly, depending on what kind of plan the individual chooses and what benefits he/she will receive.

The difference between social and private insurance are found in its goals and objectives; the techniques of protection. Further, there is also difference in the legal form of the insurance bodies as private or public organisations. One of the foremost distinctions between social and private insurance is the manner in which risk is calculated and benefits are financed.



CHECK YOUR PROGRESS

Q 3: Define Insurance. (Answer in about 40 words)

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Q 4: Define a policy. (Answer in about 30 words)

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Q 5: What is meant by a Life Insurance? (Answer in about 40 words)

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Q 6: Define Health Insurance according to The Registration of Indian Insurance Companies Regulations, 2000. (Answer in about 50 words)

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Q 7: Define general Insurance. (Answer in about 30 words)

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2.6 LET US SUM UP

- Insurance was developed as a social device to reduce risk of life and property.
- Insurance is thus a scheme of economic cooperation amongst the members of a community sharing risks.
- Life insurance is an insurance cover which pays the sum assured as stated in the policy to the insured or their nominated beneficiaries by the insurance company, in the event of the premature death of the individual who is insured.
- In case, the insured person outlives the policy period, then there is a provision of maturity benefit, which is the returns of the premiums paid by the insured person plus a bonus.
- Non life insurance policy covers the risk of an individual against the losses and damages other than those covered by life insurance policies.
- A non life insurance policy basically compensates the damages in case of unfortunate events or unavoidable circumstances, as per the policy terms and conditions to the insured or their nominated beneficiaries by the insurance company, but has no savings or

investment tangent, that means there is no provision of maturity benefit unlike the life insurance policy.

- Life insurance is a long term contract between the insured person (policy holder) and the insurer (insurance company).
- Non life insurance is a short-term contract between the insured person and the insurer.
- The coverage period for most of the non life insurance policies is usually one year and the policy holder of a non life insurance policy requires paying the entire premium up front to the insurance company premiums, that is, before the commencement of the policy.
- The main products of the life insurance include- whole life, endowment, term, pension, unit linked investment plans (ULIPs), money back plans and life annuity plan.
- The main products of non life insurance include- motor insurance, fire insurance, home insurance, marine insurance, commercial insurance, personal accident insurance, medical and health insurance and travel insurance.
- Insurance can be classified into Life, Health and General Insurance. Further it can be classified into social and private insurance.
- The difference between social and private insurance are found in its goals and objectives; the techniques of protection. Depending on the necessity, an individual can choose from various forms of insurances.



2.7 FURTHER READING

1) Pathak, B. V. (2012). *The Indian Financial Sysytem*. Singapore: Pearson

2) Smith, P.F. (1971). *Economics of Financial Institutions & Markets*. Prentice Hall

3) Grabble, J.O. (2004). *International Financial Markets*. New York: Elsevier.

2.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Life insurance is an insurance cover which pays the sum assured as stated on the policy to the insured or their nominated beneficiaries by the insurance company, in the event of premature death of the individual who is insured. On the other hand non life insurance policy covers the risk of an individual against the losses and damages other than those covered by life insurance policies.

Ans to Q No 2: The main products of the life insurance include- whole life, endowment, term, pension, unit linked investment plans (ULIPs), money back plans and life annuity plan. On the other hand, the main products of non life insurance include- motor insurance, fire insurance, home insurance, marine insurance, commercial insurance, personal accident insurance, medical and health insurance and travel insurance.

Ans to Q No 3: Insurance is defined as a legal contract between two parties i.e., the insurer and the insured. The insurer pays a fixed amount of money on the happening of particular events, while the insured pays an amount known as premium in exchange of the fixed amount.

Ans to Q No 4: The document where the contract is embodied is called a policy. The contract is based on the principles of good faith, indemnity, causa proxima, insurable interest and doctrine of subrogation.

Ans to Q No 5: Life insurance is defined as the contract between two parties, the assured and the assurer. The assurer pays a fixed amount of money on the happening of particular events, while the assured pays an amount known as premium periodically in exchange of the fixed amount.

Ans to Q No 4: The Registration of Indian Insurance Companies Regulations, 2000, defines Health Insurance as the effecting of contracts which provide sickness benefits or medical, surgical, or

hospital expense benefits, whether in-patient or out-patient, on an indemnity, reimbursement, service, prepaid, hospital or other plans basis, including assured benefits and long-term care.

Ans to Q No 5: General or non-life insurance is an insurance provided for a short-term coverage, usually a year. General Insurance provides security against loss arising out of damages to property or any other liabilities.



2.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Distinguish between social and private insurance.

Q 2: State the meaning of non life insurance.

Q 3: Mention some examples of life insurance.

Long Questions (Answer each question in about 300-500 words)

Q 1: Discuss the major types of general Insurance.

Q 2: Write a short note on life insurance.

Q 3: Distinguish between life and non-life insurance.

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UNIT 3 : RISK AND INSURANCE

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 Fundamentals of Risk and Uncertainty

3.4 Pure Risk and Speculative Risk

3.5 Expected Utility and Demand for Insurance

3.6 Moral Hazard

3.7 Let Us Sum Up

3.8 Further Reading

3.9 Answers to Check Your Progress

3.10 Model Questions

3.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- define the fundamental concepts of risk and uncertainty
- learn about various types of risk
- differentiate between pure risk and speculative risk
- learn about demand for insurance using the expected utility theory
- grasp the problem of moral hazard existing in the insurance industry.

3.2 INTRODUCTION

When we study the theory of consumer behaviour, it is normally assumed that there is no risk or uncertainty involved in consumer's decision making. However, in the real world, all activities and decision making by individuals involve uncertain, risky and unknown circumstances. The existence of risk, affects individual's decision making and places constraints on optimal allocation of resources. Risk or uncertainty creates disutility to the consumers because of the unexpected loss that may occur and also due to the fear of future uncertainty. In order to protect

various assets like heath, wealth and assets from uncertain future shocks, people use several risk managements tools such as saving for such future probabilistic losses or purchasing insurance policies. Insurance has evolved due to uncertain and unknown future circumstances which are beyond the control of individuals. It is one of the ways to cope with the risk or uncertainty and is considered to be one of the major means of risk management. Especially for risks with negative consequences, there is a particular demand for insurance. According to Hax (1964), exchange of any uncertain future loss of unknown magnitude at the cost of a comparatively small magnitude of loss, which is the premium, is known as insurance.

3.3 FUNDAMENTALS OF RISK AND UNCERTAINITY

The word 'risk' might has evolved from the Arabic word 'risq' or the Latin word 'risicum'. The Commission on Insurance Terminology of the American Risk and Insurance approved the definition of the term 'risk' as "Uncertainty as to the outcome of an event when two or more possibilities exist". However, the concepts of 'risk' and 'uncertainty' are not completely same. The classification between the two terms has been introduced by Knight (1921). According to him, "the practical difference between the two categories, risk and uncertainty, is that in the former, the distribution of the outcomes in a group of instances is known (either through calculation a-priori or from statistics of past experiences), while in the case of uncertainty this is not true, the reason being in general that it is impossible to form a group of instances, because the situation dealt with is in a high degree unique." This definition refers that the basic difference between a 'risky' and an 'uncertain' situation arises from the issue of specification with regard to the probability of the various outcomes of an event. If these probabilities are known, then that situation is termed as a 'risky situation'. For example, when we toss a coin, the possible outcomes are either a head or a tail and the probability of each possible outcome is ½. Similarly, when investing in a stock, we are aware of the possible outcomes, which can be estimated from past experiences. On

the other hand, when there is no past information regarding the outcome of an event or the chance of happening, the various outcomes cannot be predicted, which is called uncertainty. The situation of uncertainty may arise because there are not adequate past information regarding the possible outcomes and the probability of the outcomes of an event. For instance, when oil drilling is done in a new field, the drilling party may not have any past information regarding the probable outcomes and their respective chances of occurring. This is a situation of uncertainty. However, in real economic situations, neither 'ignorance' nor 'complete' information of probabilistic situations is adequately available. Therefore, to use the available partial information in real economic decisions, there should be high degree of confidence in the estimates of probabilistic situations based on past experiences. In most cases, the estimates of probabilities of past experiences is a subjective phenomenon and therefore the difference between the two terminologies 'risk' and 'uncertainty' does not remain distinct.

Different people have different attitude towards risky and uncertain situation which affect their choices. In real life, most of the people try to avoid risk and are called risk averters. They have incentives to buy insurances and pay premiums to avoid risky situations. There are some other individuals who have preference towards risk and are called risk lovers. Some individuals are indifferent in their choice towards risky situations, and they are called risk neutral individuals.



CHECK YOUR PROGRESS

Q 1: What is meant by risk? (Answer in about 20 words)

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Q 2: Briefly discuss the concept of insurance. (Answer in about 30 words)

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Q 3: Briefly discuss the difference between risk and uncertainty. (Answer in about 40 words)

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3.4 PURE RISK AND SPECULATIVE RISK

There are two types of risks depending on the possible outcomes of the risky situation-pure risk and speculative risk. In case of pure risks, only two possible outcomes can occur loss or no loss. There is no possibility of any gain or any profit in pure risk. The results of pure risk events are either unfavourable or no change in the situation occurs after the event. Probabilities of partial loss, partial profit or full profit are not available in pure risk situation. There are two dimensions of pure risk- the degree of loss and the frequency of occurrence. Various risky situations might have varying combinations of these two aspects. For instance, the highest degree of loss occurs in case of 'death', because that is the ultimate severity of loss that can occur in the life of an individual, but its frequency of occurrence is low. On the other hand, the risk of loss of a pen has an extremely high frequency of occurrence. There are three types of pure risk situations that may arise in a person's life: a) personal risk b) property risk c) liability risk.

- **Personal Risk:** It includes those pure risk situations that have direct effect on a person's life, which hampers his capacity to work and earnings. Some examples of personal risks are:
  - **Premature Death:** When the primary or sole bread earner of a family dies prematurely at a young age, it affects the financial condition of the family of the deceased person because they have to bear all the financial responsibilities after his or her death.
  - **Health Crisis:** A person may face unexpected health deterioration leading to large medical bills, reduction of work

efficiency and loss of income. Permanent disability due to disease or accidents can end up in a person losing his job and career.

- **Unemployment:** This is another personal risk situation where a person may be jobless and living only on his past savings.

- **Property Risk:** Pure risk can also occur in case of property. Here, only two situations are possible. The property remains intact (no change or no damage) or there may be some possible loss or damage to the property owing to various causes, which is the unfavourable situation.
- **Liability** R**isk:** Liability risks arise out of negligence and carelessness or act of individuals which may create loss to a third party. It is the risk of injury, property loss, financial loss or even death of an individual created by an action of any other individual or business. For example, if any wrong treatment done by a doctor causes damage to another person, he is legally liable to face consequences for the wrong act, if found guilty.

Unlike pure risk, in case of 'speculative risk', profit or loss situation is possible. For example, if we purchase 1000 shares of a stock, we can earn a profit, if the price of the stock increases and again face losses, if price of the stock decreases involving speculative risks. Most of the investments made in stock market are classified as speculative risk. Some other examples of speculative risk are starting a business where both profit and loss can occur, investing in real estate, gain or loss from interest rate changes, profit or loss arising due to price changes of agriculture or other commodities etc.

Private insurance companies normally sell insurance to cover only pure risk, speculative risks are not typically insurable, although there are certain exceptions (e.g. some insurance companies provide insurance against losses for institutional portfolio investments, municipal bonds etc). This is one of the most crucial difference between pure and speculative risks. Another difference between the two risks is based on the ease of applicability of the law of the large numbers. The law of the large numbers has crucial importance for insurers because it enables the insurance companies to predict

future probable risks. The applicability of this law is easier in case of pure risks compared to speculative risks. In other words, compared to pure risk, the law of large numbers is difficult to apply to predict future losses arising due to speculative risks. Another difference between pure risk and speculative risk can be stated from the point of view of society's benefit when a loss occurs. A loss from speculative risk may even be beneficial for the society, but loss from pure risk is always harmful. For instance, if a competitor of computer manufacturing companies develops a new technology and produces computer at lower cost, this may lead to huge losses to the producers using old technology. Despite these losses, the overall society benefit increases because of the reduced cost of production of the computers. A loss from pure risk normally does not create any beneficial effect on the society. For example, loss from a flood, earthquake, and storm is always harmful to the society.



CHECK YOUR PROGRESS

Q 4: What is meant by systematic risk? (Answer in about 20 words)

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Q 5: Briefly discuss the concept of static and dynamic risks. (Answer in about 30 words)

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Q 6: Explain the difference between pure risk and speculative risk. (Answer in about 40 words)

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Q 7: Briefly discuss about the various types of pure risk. (Answer

in about 40 words)

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3.5 EXPECTED UTILITY AND DEMAND FOR INSURANCE

In most of the real-life situations, consumer's preference or choice is affected by uncertainty and the choice under such situation depends on the probability of each possible occurrences. The utility functions of the consumer under risky situation will therefore incorporate the probabilities of each possible outcome along with consumption levels at these outcomes. Suppose the consumer faces two uncertain situations 1 and 2 (e.g., loss or no loss, head or tail, rain or no rain, damage by fire or no damage etc) and these two cases are mutually exclusive. Let probability of occurrence of these two states be are p1 and p2 and level of consumption in the situations be c1 and c2 respectively. As we have assumed the two cases to be mutually exclusive, therefore p2=1-p1. The utility function of the consumer can be written as U (c1, c2, p1, p2). This utility function can take various forms. For example, we can have a Cobb-Douglas utility function which can be written as

$$U(c1, c2, p1, p2) = U(c1, c2, p1, 1-p1)$$
$$= c1^{p1}.c2^{(1-p1)}$$

Another form of utility function is expected utility function or average utility function. This can be represented as

$$U(c1, c2, p1, p2) = p1.v(c1) + p2.v(c2)$$

In this form, utility has been represents as a weighted sum of some function of consumption in each possible state, the weights being the respective probabilities. This expression represents average or expected utility of the consumption levels c1 and c2 in an uncertain situation with two possible outcomes having probabilities p1 and p2. Thus, when we represent consumer's preferences using the expected utility function,

the utility must be additive as shown in the above expression.

The expected utility representation is based on one important assumption which is called the 'independence assumption'. The different outcomes in an uncertain situation are normally independent of each other and this is why people's plan towards making one choice should not affect their plans of making choice of other alternatives. Suppose one consumer has plans to buy fire insurance to protect his property from the risk of fire damage. While making this decision, he or she will take into consideration three different situations: (i) present wealth (w0), (ii) wealth if there is a fire (w1) (iii) wealth if there is no fire (w2). If p1 and p2 are probabilities of occurrence of fire damage and no fire, the utility function of the individual can be represented as U (p1, p2, w0, w1, w2).

Here, the consumer's decision of buying insurance is not dependent on his wealth in case of no fire. Rather, he or she will decide to pay the premium depending on the extra money that he or she will get by sacrificing some money now, if there is in reality fire damage occurs. In other words, the level of consumption or wealth when something does not happen should not depend on the value of consumption when it actually happens. This is the 'independence assumption' which implies that choices made by people in one particular situation do not depend on their choices in another situation; and due to this, the contingent consumption utility function is normally additive in nature. For instance, if c1, c2 and c3 are values of consumption in three different situations with probabilities p1, p2 and p3, the expected utility function can be written as

$$U(c1, c2, c3) = p1U(c1) + p2U(c2) + p3U(c3)$$

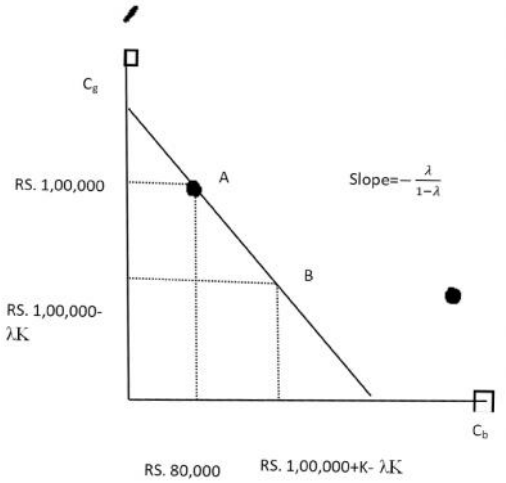
Consumer's demand for insurance policies can be illustrated using the expected utility representation. Consider a consumer with an initial asset of Rs. 1,00,000 with a possibility of loss of Rs. 20,000. Suppose the probability of loss of wealth is p%, which means that his asset will be Rs. 1,00,000 with (1-p)% probability and Rs. 80,000 with p% probability. To get rid of this possible loss of wealth, the person may choose to purchase insurance policy. If insurance policy is offered at a premium of Rs. 1 per Rs. 100 and the person decides to take full coverage of his

possible loss, his total cost in terms of premium will be Rs. 200. The person is faced with a gamble where his wealth is Rs 99,800 [Rs. 1,00,000 (initial wealth)- Rs.20,000 (loss)+ Rs.20000 (payment from insurance company)- Rs 200 (premium)] with p% probability or Rs 99,800 [Rs. 1,00,000 (initial wealth)- Rs. 200 (insurance premium)] with (1-p)% probability. Thus, at a nominal loss of Rs 200 paid as insurance premium, the wealth of the consumer remains the same at all situations. The insurance policy has enabled the person to cover his entire loss in this case. However, a person may choose to purchase insurance policy only to cover a part of his loss, instead of his whole expected loss. Generalising, if 'λ' is the rate of premium, then insurance cover for a wealth of 'K' rupees can be purchased at a premium of Rs. λK. The gamble faced by the individual has the following two situations:

Probability	Wealth
1-p	w1=Rs. 1,00,000- λK
p	w2=Rs 80,000+K- λK

The actual purchase of insurance will vary from person to person based on their preferences and also depending on the states of nature. The contingent consumption of one individual in case of insurance will depend upon various conditions of the insurance policy like the wealth in case of a loss and wealth if no loss occurs. The contingent consumption in these two states of nature is illustrated using the following figure.

Figure 3:1



Without any insurance purchase, the contingent consumption of the consumer is worth of Rs. 1,00,000 in the good state of nature with probability of '(1-p)' and Rs. 80,000 in the bad state of nature with a probability of 'p'. If he or she purchases insurance worth Rs. K, the person can move to point B from point A. In the good state of nature, his or her value of contingent consumption will reduce from Rs 1,00,000 to Rs (1,00,000- λK), λK being the amount of insurance premium. If a loss occurs, his consumption possibility is Rs. 1,00,000+K- λK. The consumer loses Rs. λK worth of consumption in the good state of nature to get extra consumption possibility worth Rs. (K- λK) in the bad state of nature. Thus, the slope of the consumer's budget line with insurance purchase is:

$$\text{Slope} = -\frac{\lambda}{k-\lambda} = -\frac{\lambda}{1-\lambda} \quad (1)$$

The condition of consumer equilibrium for insurance purchase will be determined by equality between marginal rate substitution and the slope of the budget line. Marginal rate of substitution between consumption in the two states of nature is

$$\text{MRS} = -\frac{p\Delta(w_2)/\Delta w_2}{(1-p)\Delta(w_1)/\Delta w_1} \quad (2)$$

The condition of consumer's optimal choice is

MRS = Slope of the budget line (Price ratio)

$$\text{Or } -\frac{p\Delta(w_2)/\Delta w_2}{(1-p)\Delta(w_1)/\Delta w_1} = -\frac{\lambda}{1-\lambda}$$

$$\text{Or } \frac{p\Delta(w_2)/\Delta w_2}{(1-p)\Delta(w_1)/\Delta w_1} = \frac{\lambda}{1-\lambda} \quad (3)$$

On the other hand, the insurance company gets an income of λK as premium in the two states of nature. They have to pay an amount K if the loss occurs with probability p and has to pay nothing with probability 1-p. The expected profit of the insurance company is

$$\text{Profit} = \lambda K - pK - (1-p).0 = K(\lambda - p)$$

If the insurance policy is offered at a fair rate, which implies the company offers policy at no profit no loss, then profit will be zero.

i.e. Profit=0

or K(λ-p) =0

or λ=p

Substituting λ with p. we get

$$\frac{p.\ \ (w_2)/\Delta w_2}{(1-p)\Delta\ \ (w_1)/\Delta w_1} = \frac{p}{1-p}$$

$$\text{Or} \qquad \frac{\Delta\ \ (w_1)}{\Delta w_1} = \frac{\Delta\ \ (w_2)}{\Delta w_2} \quad (4)$$

This equation shows that marginal utility of an extra rupee in case of loss should be equal to the marginal utility of an extra rupee if there is no loss. If we assume that marginal utility of money of the consumer decreases (i.e., the consumer is risk averse), then if w1>w2 it would imply that marginal utility of w1 wealth is less than w2 wealth. In equation 4 , we see that marginal utility of w1 and w2 amount of money are same, then this means that

$$w_1 = w_2$$

$$\text{or } 1{,}00{,}000 - \lambda K = 80{,}000 + K - \lambda K$$

$$0\text{r } K = 20000$$

This implies that if a risk averse person is offered a fair premium, maximisation of expected utility by the consumer will ensure that he will choose to get full coverage of insurance for any future probabilistic loss.

3.6 MORAL HAZARD

Moral hazard is a problem that arises in insurance markets as a result of careless behaviour of individuals after getting insured and this leads to an increase in the chance of occurring the event and insurance claims. Thus, the problem of moral hazard leads to an increase in the probability of theft, accidents, fire, illness and other incidents, which can be insured. For instance, when a person purchases car insurance, he feels that the cost of any damage to the car by accidents, or theft etc is now shifted from him/her to the insurance company. As a result, he or

she may engage in reckless driving or behave carelessly in locking the vehicle or may not take proper maintenance and care of the car, which increases the probability of damage and theft of the car. Similarly, when people purchase health insurance, they might not take proper health care, which results in the increase of the probability of sickness. Thus, when the risk is insured, people behave irresponsibly and take fewer precautions to avoid accidents, sickness, fire, theft or any other disasters. Such behaviour of persons after purchasing insurance policies raise the total cost of the insurance sellers due to increased claims. This is the problem of moral hazard, which leads to increased premiums charged by insurance companies to cover their increased cost due to higher number of claims as a result of irresponsible behaviour of the buyers.

As moral hazard is a problem in the insurance industry which affects the probability of an event and the insurance premium; it has also impact on insurance demand. Let us take the following example- the warehouse of a company is valued at Rs. 10 crores by an insurance company. The probability of fire in the warehouse varies depending on whether a fire prevention system is installed or not. Suppose the cost of a system is Rs. 1 Lakh and with its installation, the probability of fire is 0.5%. If no such system is installed, the probability rises to 1%. In usual situations, it is not possible for insurance company to always monitor the condition of fire installation system or whether it is continued to be installed after purchasing the policy or not. This creates a dilemma for the company providing insurance policies. Owing to this problem, the insurance policy cannot include a clause before selling the policy stating that the amount of claim, if any, will be paid only if there is a fire prevention system. If monitoring was possible and such systems were in place, the expected loss from the fire which is equal to 0.005 x 10,00,00,000= Rs. 5,00,000 would have been minimum insurance premium at which the warehouse could be insured. As such clauses are not feasible and there is every possibility that after purchasing the insurance policy, the owners may behave carelessly and no longer continue the fire prevention system. Owing to of this moral hazard, the expected loss to the insurance company

in case of a fire will be 0.1x10,000,0000=Rs.10,00,000. So, if they sell the insurance policy at a premium of Rs. 5 lakhs, they will have to incur a loss. This is how the moral hazard increases the insurance premiums due to inability of the insurance company to monitor behaviour of individuals and due to the increased prices of insurance policies, lesser people purchase policies implying lower demand for insurances.



CHECK YOUR PROGRESS

Q 8: Define the expected utility function. (Answer in about 20 words)

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Q 9: State the independence assumption of expected utility function. (Answer in about 20 words)

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Q 10: Discuss the problem of moral hazard that arises in the insurance market. (Answer in about 40 words)

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3.7 LET US SUM UP

- In the real world, all activities and decision making by individuals involve uncertain, risky, and unknown circumstances.
- In order to protect various assets like heath, wealth and wisdom from uncertain future shocks, people use several risk managements tools such as saving for such future probabilistic loses or purchasing insurance policies. Insurance has evolved due to uncertain and unknown future circumstances which are beyond the control of individuals. It is one of the ways to cope with the risk or uncertainty

and is considered to be one of the major means of risk management.

- The basic difference between a 'risky' and an 'uncertain' situation arises from the issue of specification of the probability of the various outcomes of an event. If these probabilities are known, then that situation is termed as a 'risky situation.
- Risks which arise due to participation in economic activity is known as economic risk. The existence of extra economic risk is not the result of any economic activity.
- Dynamic risks arise as a result of possible dynamic changes of economic conditions. Risks of losses which can occur even if there are no changes in the economic conditions are known as static risk.
- Systematic risk affects large number of assets or individuals. It is caused by a significant change in the political front or a major economic event which affect the entire market, not just a particular asset, stock, or industry. Unlike systematic risk, unsystematic risk shows its impact on specific assets only.
- There are two types of risks depending on the possible outcomes of the risky situation-pure risk and speculative risk. In case of pure risks, only two possible outcomes can occur- the loss or no loss. There is no possibility of any gain or any profit in pure risk. Unlike pure risk, in case of speculative risk profit or loss situation is possible.
- Expected utility function can be represented as U (C1, C2, P1, P2) = P1.v(C1) + P2. v(C2) where c1 and c2 are consumptions at two different states of nature with respective probabilities P1 and P2.
- The expected utility function is dependent on the 'independence assumption' which means that people's choice in one particular situation does not depend on their choices in another situation.
- If a consumer is offered insurance at fair premium rate, the consumer will choose to get full coverage for any future probabilistic loss by maximising his or her expected utility.
- Moral hazard is a problem that arises in insurance markets as a result of careless behaviour of individuals after getting insured and this leads to an increase in the chance of an event occurring and insurance claims.

- Moral hazard increases the insurance premiums due to inability of the insurance company to monitor behaviour of individuals and due to the increased prices of insurance policies, lesser people purchase policies implying lower demand for insurances.



3.8 FURTHER READING

1) Varian H.R (1996). *Intermediate Microeconomics*. New Delhi: Affiliated East-West Press.

2) Peter Z. & Eisen R. (2012). *Insurance Economics*. Springer

3) Willet, A.H (1901). *The Economic Theory of Risk and Insurance*. World Public Library.



3.9 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Risk refers to the uncertainty of future outcomes of any event.

Ans to Q No 2: Insurance has evolved due to uncertain and unknown future circumstances which are beyond the control of individuals. It is one of the ways to cope with the risk or uncertainty and is considered to be one of the major means of risk management.

Ans to Q No 3: If the probabilities of various future probable outcomes of an event is known, then it is called risk. On the other hand, when there is no past information regarding the outcome of an event and their probabilities are unknown, that is known as uncertainty.

Ans to Q No 4: The risk which affects a large number of assets or individuals is known as systematic risk.

Ans to Q No 5: Dynamic risks arise as a result of possible dynamic changes of economic conditions such as changes in price level, consumer consumption, saving, investment behaviour, changes in consumer's tastes, preferences etc. Risks of losses which can occur even if there are no changes in the economic conditions are known as static risk.

Ans to Q No 6: In pure risk, only two outcomes are possible loss or no loss but in case of speculative risk along with these two outcomes, profit or loss situation is also possible.

Ans to Q No 7: Pure risks can be of various types like personal risk, property risk and liability risk.

Ans to Q No 8: The utility function where utility is represented as weighted sum of consumption in each possible state of nature, weights being the respective probabilities is known as the expected utility function.

Ans to Q No 9: The independence assumption implies that choices made by people in one particular situation does not depend on his choice in another situation.

Ans to Q No 10: Moral hazard is a problem that arises in insurance markets as a result of careless behaviour of individuals after getting insured and this leads to an increase in the chance of occurring the event and insurance claims. Thus, the problem of moral hazard leads to an increase in the probability of theft, accidents, fire, illness and other incidents, which can be insured.



3.10 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words).

Q 1: Briefly discuss why people buy insurance policies?

Q 2: What are the different measures of risk?

Q 3: Write short note on the problem of moral hazard.

Long questions (Answer each question in about 300-500 words)

Q 1: Discuss the concept of pure risk and speculative risk.

Q 2: Illustrate consumer's demand for insurance using expected utility hypothesis.

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UNIT 4 : RISK MANAGEMENT AND RISK SHARING

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Concept of Risk Management

- 4.3.1 Risk
- 4.3.2 Types of Risk
  - 4.3.2.1 Static and Dynamic Risks
  - 4.3.2.2 Fundamental and Particular Risks
  - 4.3.2.3 Pure and Speculative Risks
- 4.3.3 Risk Management- The Meaning
- 4.3.4 Enterprise Risk Management

4.4 Essentials of Risk Management

- 4.4.1 The Process of Risk Management
  - 4.4.1.1 Setting the Objectives
  - 4.4.1.2 Risk Identification
  - 4.4.1.3 Risk Evaluation
  - 4.4.1.4 Evaluating the Alternatives and Deciding on the Technique
  - 4.4.1.5 Implementation
  - 4.4.1.6 Review

4.5 Elements of Risk Management

- 4.5.1 Risk Assessment
- 4.5.2 Risk Control
- 4.5.3 Risk Financing
- 4.5.4 World-Wide Risk Sharing

4.6 Let Us Sum Up

4.7 Further Reading

4.8 Answers to Check Your Progress

4.9 Model Questions

4.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- grasp the meaning of risk and how risk is managed in a business
- explain the process of risk management
- discuss how risk is assessed, controlled and financed in an organisation.

4.2 INTRODUCTION

Risk management is an important function in a business to manage risk and also to identify opportunities. The genesis of risk management was in corporate insurance but with a shift in the way business is carried out today, risk management has become a completely different field of study. There is a defined process and technique of risk management. The scope of risk management has widened in recent past. From managing only pure risk, the scope now includes managing speculative risk also under the domain of Enterprise Risk Management. The unit will thus delve into the different facets of risk management.

4.3 CONCEPT OF RISK MANAGEMENT

Let us discuss the meaning of risk and risk management in the following subsection:

4.3.1 Risk

The understanding of risk management must be preceded by learning the meaning of risk. Risk is the happening of certain event which can be either positive or negative. There is a probability of happening of the event. On the occurrence of the event, the magnitude of the result can also be evaluated. Hence, risk involves- the event (either positive or negative), probability of happening of the event and magnitude of the consequences.

Risk is different from uncertainty. As Prof. Knight points out "Uncertainty is an unknown risk, while Risk is a measurable

uncertainty". Therefore, predicting the outcome of an uncertain event is difficult whereas one can predict the outcome of a risky event with some probability. Thus, management is possible for risk but not uncertainty. It is also important to understand that risk management sometimes provide the business with surprising opportunities.

Vaughan and Vaughan define risk thus "Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for".

CIMA Official Terminology, 2005 defined risk as "Risk is a condition in which there exists a quantifiable dispersion in the possible outcomes from any activity. It can be classified in a number of ways".

Risk has been defined by International Federation of Accountants, 1999 as "Uncertain future events which could influence the achievement of the organisation's strategic, operational and financial objectives".

The definitions indicate that risk is seen from the perspective of a negative event which may affect the performance of the business.

4.3.2 Types of Risk

Risks are classified into various types. Classification of risk is important to understand the nuances of various risks. Let us discuss the various risks types in the following subsection:

4.3.2.1 Static and Dynamic Risks

Dynamic risks are unpredictable and arise due to economic changes like income and price level, technological changes or government regulations, etc. Static risks denote those risks arising out of perils of nature and dishonesty of individuals. The static risk leads to loss of assets and are predictable. Hence, insurance coverage can be opted for static risks than dynamic risks.

4.3.2.2 Fundamental and Particular Risks

The fundamental risks arise out of economic, social, political and physical reasons and affect the whole population. It is also termed as group risks. Some of the examples of fundamental risks are unemployment, drought, inflation, etc. Particular risks on the other hand affects individual and originate also due to acts of individuals. It may be either static or dynamic. Robbery at home, car accident are examples of particular risks.

4.3.2.3 Pure and Speculative Risks

The risks which beget the chance of both gain and loss are known as speculative risks and gambling is the best example of the same. Conversely, the risk where there is a chance of loss or no loss is known as pure risks. Theft of car is an example of pure risk. From insurance point of view, pure risks are insurable whereas speculative risks are uninsurable. Further classification of pure risk encompasses personal risks, property risks, liability risks, risks due to failure of another person.

4.3.3 Risk Management- The meaning

A scientific approach to prevent or minimise the risks which may affect an enterprise is known as risk management. The genesis of risk management is in 'corporate insurance'. However, now insurance is a part of risk management. During the last seven decades risk management has evolved as a distinct discipline by inculcating within itself the domain of decision theory, risk financing and risk control. Risk management deals with pure risk (as discussed earlier) and companies these days appoint specialised personnel known as Risk Managers to manage the risks of business.

Vaughan and Vaughan defines risk management thus "Risk management is a scientific approach to dealing with risks by

anticipating possible losses and designing and implementing procedures that minimise the occurrence of loss or the financial impact of the losses that do occur".

According to CIMA Official Terminology, 2005, risk management can be defined as "A process of understanding and managing the risks that the entity is inevitably subject to in attempting to achieve its corporate objectives. For management purposes, risks are usually divided into categories such as operational, financial, legal compliance, information and personnel. One example of an integrated solution to risk management is enterprise risk management".

Najjaar, Yasseen & Small defined risk management in the following words, "Risk management refers to the process designed to reduce or eliminate the risk of certain kinds of events happening or having an impact on the business - process for identifying, assessing and prioritizing risks".

Risk management is a continuous process of reducing risks in the corporate world. It is also seen as the process of analysing and accepting the type and level of risk for garnering profits in future. Collier and Agyei-Ampomah (2006) stated that in order to study risk management of an enterprise it is pertinent to understand the risk appetite and risk culture that a corporate carries. Risk appetite deals with the amount of risk a business is willing to assume for a return in future. Whereas, risk culture denotes the organisation’s reward or penalty policies either for assuming risk or evading risk in the day-to-day affairs of the business. Hence, Crouhy, Galai and Mark aptly opined that risk management and risk taking are two sides of the same coin and are not opposite to each other.

4.3.4 Enterprise Risk Management

The traditional form of risk management pertaining to managing only pure risk is giving way to a new form of risk management known as enterprise risk management (ERM). The

ERM encompasses all risks of a business, be it pure or speculative risks. The different risks under the ambit of ERM include:

- **Market Risk**- Market risk arises due to unexpected changes in the market prices like interest rate, prices of supplies required for production, etc.
- **Credit Risk**- The risk of bad debt for a business is a credit risk.
- **Liquidity Risk**- A business faces liquidity risk when its liquid assets are insufficient to discharge the current liabilities.
- **Operational Risk**- Operational risk is defined as the risk of failure of internal processes, people, systems or risks arising out of external events like earthquake, fire, etc.
- **Reputational Risk**- A negative publicity of the business may beget reputational risk.
- **Strategic Risk**- The probability of futile execution of the organisation's strategy.
- **Compliance Risk**- This risk takes place when a firm fails to adhere to the rules and regulations under which the firm needs to operate.

ERM's objective is to better manage the firm's different risks and thereby allocating the funds judiciously in mitigating those risks. ERM has not yet developed fully and it is mostly applicable in insurance and banking business. Moreover there is a disagreement whether it is advisable to manage all the risks by a single risk manager. This area of risk management is thus still under progress.



CHECK YOUR PROGRESS

Q 1: What is meant by the term risk? (Answer in about 30 words)

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Q 2: What are the different types of risk? (Answer in about 20 words)

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Q 3: What is meant by risk management? (Answer in about 20 words)

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Q 4: What are the different risks under the ambit of enterprise risk management? (Answer in about 20 words)

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4.4 ESSENTIALS OF RISK MANAGEMENT

As we have learnt from the previous section, that risk management is a scientific approach to manage risks, hence a business has to follow some steps to manage the risks. In this section, we will discuss the process of managing risks. The discussion will pertain to managing only pure risks whether insurable or uninsurable. The number of steps varies differently as suggested by different authors. Some authors discuss it under five steps, some under six steps and some suggest seven steps, to name a few. However, the basic components of the process remain the same. We will discuss the process of risk management under six steps. The processes may be discussed independently but in practice, they get intertwined when applied in an organisational setting.

4.4.1 The Process of Risk Management

The process of risk management can be discussed under the following steps:

Figure 4:1



4.4.1.1 Setting the Objectives

Setting the objectives is the first step in the risk management process. This is the most crucial step but also the most ignored one. Objectives guide how the risk management would act in the organisation. In the absence of its clear definition, the risk management programme becomes non-functional and therefore, runs into problem.

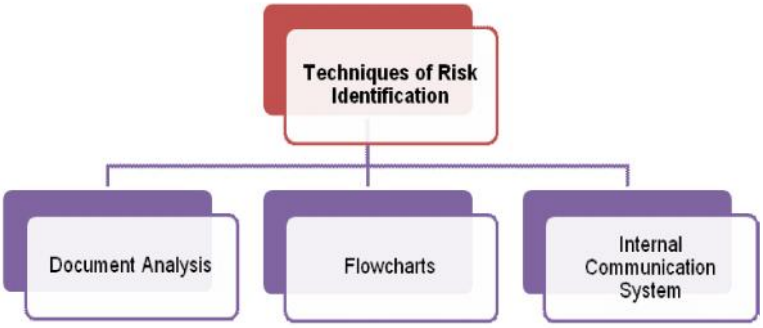
Risk management should be consistent with the value maximisation objective of a business (Doherty, 1985) and must ensure that the business has a perpetual existence. The foremost objective of risk management is to guarantee that due to pure risks of a business leading to a loss, the other goals of the business do not become unattainable. Hence, risk management programme must

be designed in such a way that the business can tide over the situation irrespective of the nature or amount of loss.

4.4.1.2 Risk Identification

A business is exposed to risks and identifying those risks is important for a business to manage it when it occurs. However, identifying the risks is not an easy task as different types of risks continuously penetrates a business. Risk management personnel should have the ability to differentiate amongst the risks which are apparent and the one which may have an adverse impact on the business. The businesses thus, apply some techniques to identify the risks. Those are discussed below:

Figure 4:2



- **Document Analysis:** Analysis of official documents is an important function in identification and analysis of risk. The documents like financial statements, contracts records, agreements entered into by the business, assets and inventory records, etc. are to be analysed in depth to identify the risk which may arise in the future.
- **Flowcharts:** Flowcharts consider the firm as a process and helps in identifying the obstacles which may disrupt the process. Hence, the risk managers

are to look for the possible disruptions due to breakdown of assets or other mishaps that may affect the functioning of the business.

- **Internal Communication System:** Information regarding all types of activities, be it procurement of assets, construction or alterations in the business, launching of new products or rendering a new service, etc. can be known by the internal communication. The internal communication system aids in understanding what the business is going to do in future and while doing it whether it would encounter any risk.

4.4.1.3 Risk Evaluation

The evaluation step of the risk management process includes the ranking of different risks which may encounter a business. The probable loss due to the risk must be evaluated for two factors. The first one is the magnitude of the loss and the second one is the probability of the occurrence of the loss. Due to varying magnitude of loss resulting from the risks, some risk needs be managed with far more concentration than the others. Hence, the risks can be classified under:

- **Critical Risks:** the loss due to critical risks leads to bankruptcy of the firm
- **Important Risks:** the loss out of important risks has to be managed by borrowing external funds for continuity and survival
- **Unimportant Risks:** the losses suffered due to this type of risks can be managed with internal assets and resources.

4.4.1.4 Evaluating the Alternatives and Deciding on the Technique

This is the decision making step of the process and hence the most problematic one. Under the guidance of the corporate risk management policy, the risk manager decides on the technique. In some organisation, the risk management programme is inflexible and in that case, the risk manager's job is to implement the programme without much scope of suggesting modifications. On the other hand, some organisations give flexibility to the risk manager in deciding about the alternatives and thus in those organisations the risk manager plays a role of a decision maker. For every alternative, the risk manager has to do a cost-benefit analysis before finalising on an alternative. The most common alternatives available to a risk manager can be summarised under four types.

- **Accepting Risks:** Those risks need to be accepted whose returns are more than the costs.
- **Avoiding Risks:** If costs are more than the returns.
- **Controlling / Mitigating Risks:** An attempt to minimise the chance of happening of the event. However, if the event occurs, an attempt needs to be made to minimise its impact on the business.
- **Transferring Risks:** One of the ways of transferring risks is 'insurance' whereby the business secures itself against any loss by paying premium to the insurance company (www.clearrisk.com).

4.4.1.5 Implementation

The finalisation of the technique calls for its implementation. The first step in this stage is to get the approval of the technique by the senior management

department. Once the approval is accorded, the risk manager will need the active participation of its own team and other departments and in some cases funds too for its proper implementation.

4.4.1.6 Review

Risk management is a process and not a project and hence the risk manager has to continuously monitor it to identify any gaps which may hinder the objective of the risk management process. Business is done in a dynamic environment and hence the risks which were there earlier may not exist today. In addition, new risks may also arise. Thus, it is important for a risk manager to constantly monitor these changes and to alter the techniques of risk management as per the need of the hour. Even, the technique decided on may not provide the desired result or the implementation may be improperly carried out. In those circumstances also, the process needs to have a relook. Hence, review is also considered as the control phase of the process.



ACTIVITY 4:1

Q 1: Identify an organisation of your choice and study their risk management process.

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CHECK YOUR PROGRESS

Q 5: What are the steps in risk management process? (Answer in about 30 words)

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Q 6: What are the techniques of risk identification? (Answer in about 20 words)

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Q 7: Which step is considered as the control phase of the risk management process? (Answer in about 20 words)

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4.5 ELEMENTS OF RISK MANAGEMENT

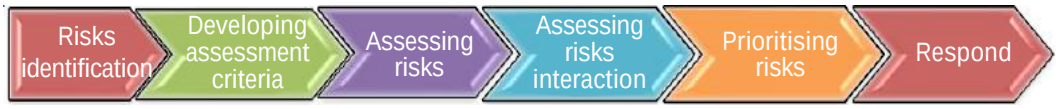
The sustainable development of business requires effective risk management. Value is dependent on risk and return and hence, risk is vital in the quest of value for an organisation. A business is bombarded with number of risks and it is thus a challenge to manage those risks which in some cases provide opportunities to an organisation as well. A business thus requires assessing the risks and taking steps to manage it. In this section, we will discuss about the elements of risk which is a crucial part in managing the risks.

4.5.1 Risk Assessment

Risk assessment follows a process starting from risk identification to responding to it. Assessment provides data relating to the size of the risk enabling the management to respond to it. Thereby, the management can identify the threats from the risk and/or seize the opportunities. To measure and prioritise is the basic objective of risk assessment. This aids the management in not only controlling the risks within an acceptable level but also grabbing the opportunities. Dynamic risks call for continuous monitoring and assessment. Conversely, static risks need continuous monitoring but periodic reassessment. The process of

risk assessment is depicted below. This process is depicted by Curtis and Carey in 2012.

Figure 4:3



- **Risks Identification:** Identification of risks precedes the risk assessment step and hence in some cases it is deemed to be outside the purview of risk assessment process. The identification helps in identifying the risks as a threat or opportunity. All the risks which may impact the business are put into a list by the risk manager in this stage.
- **Developing Assessment Criteria:** Assessment criteria need to be developed for understanding the magnitude and probability of happening of the event (risks). Five point rating scales are common assessment tools for assessing the magnitude and probability of the risks.
- **Assessing Risks:** The criteria developed at the preceding stage are used for assessing the risk. Assessing risks needs assigning values to each risk. This is done by quantitative and qualitative analysis technique. The quantitative analysis focuses on risk models and simulations which lead to assigning values to the risk. Monte Carlo Simulation is an example of quantitative analysis. In case of qualitative analysis, the personal judgement and experience enables the risk manager in building a theoretical risk model (www.investopedia.com).
- **Assessing Risks Interaction:** An insignificant risk also has the ability to create havoc in an organisation since risks does not act in isolation rather interacts with other variables of the organisation. As a result, business needs comprehensive techniques like risk interaction matrices, bow-tie diagrams, aggregated probability distributions, etc. for risks assessment.
- **Prioritising Risks:** Prioritising risks is required to decide

which risks one should respond urgently and which can be tackled after some time. Once profiling of all risks of the business is completed, it can be communicated to the stakeholders of the business. One of the common ways of prioritising risks is to put them into a hierarchy based on magnitude of the loss exposure and the probability of its occurrence.

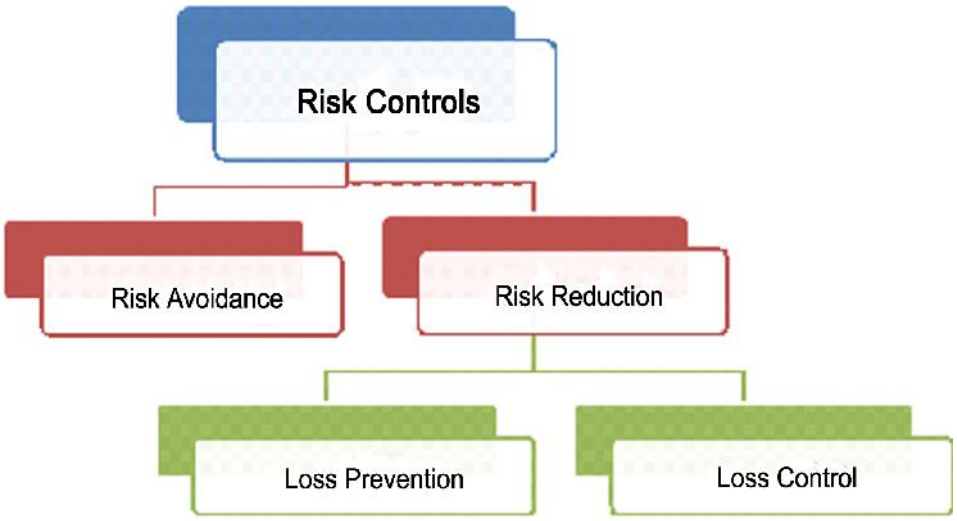
- **Respond:** Based on the results generated by the preceding steps, the business has to respond to the risks. The business can accept, avoid, control or transfer the risks. (Refer to the process of risk management for detail discussion).

All the risk management techniques can be grouped under two broad headings, viz., risk control and risk financing. Let us discuss the two in details in the following subsections:

4.5.2 Risk Control

The attempt to minimise risks a business is susceptible to comes under the domain of risk control. The different techniques under risk control are depicted below-

Figure 4:4



- **Risk Avoidance:** The attempt to completely eliminate the

chance of happening of a risky event is known as risk avoidance. This technique ensures that there is no accidental loss due to a risk exposure. Even if this is a technique of risk control, it is considered as a negative approach of risk management. We all know that to survive and grow, one has to take risk. Hence, this approach may be considered only when the business is convinced that the magnitude of the loss due to the risk will be severe. Also, the probability of happening of the risk is very high. Before finalising on this technique, the business has to be sure that the risk can neither be transferred not can it be reduced. This technique must be resorted by an organisation only as the last option and should not be opted at all the times.

- **Risk Reduction:** The attempt to minimise the possibility of loss or its magnitude due to the existence of a risk (event) is known as risk reduction. The two common techniques of risk reduction are loss prevention and loss control which are discussed below :
  - **Loss Prevention:** A risk leads to loss exposure and a business calculates the probability of occurrence of the risks (events) and the subsequent losses that it has to suffer. The technique aiming to lower the probability of loss due to the happening of the event is considered as loss prevention technique. In doing so, the business succeeds in preventing the number of losses and also enables or helps to save the costs it had to incur in order to cover the loss.
  - **Loss Control:** It is difficult for a business to be able to always prevent the loss due to the happening of a risky event. In that scenario, loss control techniques try to minimise the magnitude or the severity of the loss.

4.5.3 Risk Financing

If an enterprise in unable to completely avoid the occurrence of a risk; there exists a chance of exposure to losses due to the risk. Even if the magnitude of the loss is small the business should be in a position to arrange fund for mitigating the loss suffered by the business. This technique of arranging fund for managing the loss exposure is termed as risk financing. There are two types of risk financing. The first one is the risk retention whereby the business depends on its own fund to manage the loss. The other one is the risk transfer whereby the business depends on the funds outside the business. In some cases, a business, to manage its loss exposure due to a risk depends on a hybrid method. In this method a portion of the risk is retained by the business and the other part is transferred to a second party to manage the loss exposure. Let us discuss the two techniques in details.

- **Risk Retention:** The situation when the risk is neither transferred, reduced or avoided is by default retained by the business. Hence, it is treated as the most common way of managing risks. Retention may be intentional or unintentional and voluntary or involuntary. In case of unintentional risk retention, the business may either fail to recognise a risk or the coverage taken to finance the risk is inadequate. Unintentional risk retention is an improper technique of risk financing and the risk manger will be unable to rationally manage the loss due to the occurrence of the risk. On the other hand, when a business is conscious of the probability of the risk but neither transfers, reduces or avoids the risk, it is known as intentional risk retention.

  Another classification of risk retention is voluntary or involuntary. A condition wherein the business is unable to transfer, reduce or avoid the risk is known as involuntary risk retention. Conversely, the decision to retain the risk instead of

avoiding and transferring it to an insurance company is known as voluntary risk retention. The decision of a business to buy an insurance coverage of an amount which is less than the value of the asset is an example of voluntary risk retention.

In case of risk retention, the loss exposure of the business has to be managed by the internal resources. Hence, the business saves costs of buying an insurance policy to manage its risk. However, it may not be an all time advisable technique. In case of a catastrophic effect to the business due to a risk, the organisation may not be able to fully finance the loss from its own resources.

- **Risk Transfer:** The technique of risk transfer includes the method of managing the risks with the funds outside the business. Insurance, hedging, contractual arrangements are the common methods of risk transfer. In case of insurance, the business periodically pays an amount known as premium to the insurance company for covering the loss which may occur in future. To offset the loss to an asset by buying or selling another asset whose price moves in the other direction of the former asset is known as hedging. The contractual arrangements are not insurance and it is a harmless agreement between two parties. Under this agreement the transferee voluntarily assumes the probable loss of the transferor. For example, under a house rent agreement, the tenant may accept to indemnify the loss to the house caused due to its use by him/her.

4.5.4 World-Wide Risk Sharing

Risk sharing is also known as risk distribution. In a pool of insurance, every contributor contributes a share of money known as premium for safeguarding against the perils. In the event of any member suffering a loss due to the peril, other members indemnify the loss. This concept is known as 'risk sharing'. Social insurance

policies are designed in the backdrop of the concept of risk sharing. For detail study on social insurance refer to Unit-15 Economics of Insurance of block 2 of this course.



CHECK YOUR PROGRESS

Q 8: State an example of quantitative analysis. (Answer in about 10 words)

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Q 9: What are the two techniques of risk reduction? (Answer in about 15 words)

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Q 10: What are the common methods of risk transfer? (Answer in about 15 words)

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4.6 LET US SUM UP

- Risk is the happening of certain event either positive or negative. There is a probability of happening of the event. On the occurrence of the event the magnitude of the result can also be evaluated.
- CIMA Official Terminology, 2005 defined risk as "Risk is a condition in which there exists a quantifiable dispersion in the possible outcomes from any activity. It can be classified in a number of ways".
- The different types of risk are- static and dynamic risks, fundamental and particular risks and pure and speculative risks.
- Vaughan and Vaughan defines risk management thus "Risk management is a scientific approach to dealing with risks by anticipating possible losses and designing and implementing procedures that minimise the occurrence of loss or the financial impact of the losses that do occur".

- Risk management is a continuous process of reducing risks in the corporate world. Risk management and risk taking are two sides of the same coin and are not opposite of each other.
- Risk management has evolved as a distinct discipline by inculcating within itself the domain of decision theory, risk financing and risk control.
- Enterprise risk management manages both pure and speculative risks.
- The steps in risk management process are setting the objectives, risks identification, risks evaluation, evaluating the alternatives and deciding on the technique, implementation and review.
- Objectives guide how the risk management would act in the organisation. In the absence of its clear definition the risk management programme becomes non-functional and therefore runs into problem.
- Risks identification is not an easy task as different types of risks continuously penetrates a business.
- The evaluation step of the risk management process includes the ranking of different risks which may encounter a business.
- Evaluating the alternatives and deciding on the technique is the decision making step of the risk management process and hence the most problematic one.
- Implementation of the technique for risk management needs the approval of the senior management department.
- Risk management is a process and not a project and hence the risk manager has to continuously monitor it to identify any gaps which may hinder the objective of the risk management process.
- The process of risk assessment includes risks identification, developing assessment criteria, assessing risks, assessing risks interaction, prioritising risks and respond.
- The attempt to minimise risks that a business is susceptible to comes under the domain of risk control.

- This technique of arranging fund for managing the loss exposure is termed as risk financing.



4.7 FURTHER READING

1) Head, G.L. (2009). Risk Management- *Why and How An illustrative Introduction to Risk Management for business executives*. USA: International Risk Management Institute.

2) Vaughan, E.J. and Vaughan, T. (2008). *Fundamentals of Risk and Insurance (10th Edition)*. USA: John Wiley & Sons, Inc.



4.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: The probability of happening of a certain positive or negative event is known as risk. On the occurrence of the event the magnitude of the result can also be evaluated.

Ans to Q No 2: The different types of risk are- static and dynamic risks, fundamental and particular risks and pure and speculative risks.

Ans to Q No 3: A scientific approach to prevent or minimise the risks which may affect an enterprise is known as risk management.

Ans to Q No 4: Market risk, credit risk, liquidity risk, operational risk, reputational risk, strategic risk and compliance risk.

Ans to Q No. 5: The steps in risk management process are setting the objectives, risks identification, risks evaluation, evaluating the alternatives and deciding on the technique, implementation and review.

Ans to Q No 6: The techniques of risk identification are- document Analysis, flowcharts and internal communication system.

Ans to Q No 7: The step 'review' is considered as the control phase of the risk management process.

Ans to Q No 8: Monte Carlo Simulation is an example of quantitative analysis.

Ans to Q No 9: The two common techniques of risk reduction are loss prevention and loss control.

Ans to Q No 10: Insurance, hedging, contractual arrangements are the common methods of risk transfer.



4.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Define risk. How is risk different from uncertainty?

Q 2: How is pure risk different from speculative risk?

Q 3: How risk is identified in an organisation?

Q 4: State in brief the importance of review step in the risk management process.

Q 5: Write a note on risk reduction.

Q 6: State in brief the concept of risk sharing.

Long Questions (Answer each question in about 300-500 words)

Q 1: Discuss in detail the concept of risk management.

Q 2: What is meant by enterprise risk management? Discuss in detail the different risks managed by ERM.

Q 3: Write a detailed note on the risk management process.

Q 4: How risks are evaluated and what needs to be done for implementing the technique of risk management in the organisation?

Q 5: Discuss in detail the process of risk assessment.

Q 6: What is meant by risk financing? State in brief the different techniques of risk financing.

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UNIT 5 : REINSURANCE

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Concept of Reinsurance

5.4 Fundamentals of Reinsurance

5.5 Reinsurance Markets in Developing Countries

5.6 Let Us Sum Up

5.7 Further Reading

5.8 Answers to Check Your Progress

5.9 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit you will be able to –

- learn the concept and meaning of reinsurance
- grasp about the need and types of reinsurance
- discuss the aspect of reinsurance market in developing countries.

5.2 INTRODUCTION

Reinsurance means insuring again. It is the transfer of insurance risk from one insurer to another. The insurer is called the 'Principal' or 'Direct' or 'Ceding' or Original Office' and the office to which the business is transferred is called the 'Reinsurer' or 'Assuming' or Guaranteeing Office'. Reinsurance is a good method to diversify and distribute risk of the insurer. The reinsurer gives this facility of risk coverage for a premium which is called reinsurance premium. Reinsurance premium is an income to the reinsurer and expense to the insurer. In this unit, we will discuss the concept of reinsurance and reinsurance market in details.

5.3 CONCEPT OF REINSURANCE

Reinsurance is a process whereby one entity (the reinsurer) takes

on all or part of the risk covered under a policy issued by an insurance company in consideration of a premium payment. An insurance company transfers all or a portion of its risk exposure under an insurance policy to another company, in situations when the risk is high, as this helps the insurance company to put that excess risk to reinsurance company (one or more than one), in order to diversify the risk.

W.A. Dinsdale defines Reinsurance as, 'When the amount of any risk or risks from one hazard is such that it is beyond the limits, which it is prudent for one insurer to carry, it is necessary to effect reinsurance.'

Reinsurance as the term itself suggest, is insuring again. It is the transfer of insurance business from one insurer to another. Reinsurance is also a contract of indemnity. The original company must disclose all the material facts to the reinsurer.

The process in which insurance companies work is that if any claim is raised by the insured, the insurance company is liable to make the loss incurred by the insured, if the claim satisfies all the conditions, of the policy. In such case, the insurance company has to bear the financial burden. In order to share such burden, the insurance companies get themselves also insured against such financial burdens. Therefore in order to protect themselves the Insurance Companies enter into a contract with another company engaged in the business of reinsurance popularly known as third party. The contract made between insurance company and Reinsurance Company is known as Reinsurance. This contract makes provision for the insurance company, to get a certain sum of payment from the reinsurance company, for the losses incurred while fulfilling the original contract. This is done only after the insurance company makes the payment of the claim. That is, in other words, first the insurance company settles the claims and then seeks for reimbursement from the reinsurance company. The primary insurer, here, in fact, becomes the insured (known as reinsured) and the person or body or company giving him the protection becomes the insurer (known as reinsurer).

Insurance consists of two parties - the insurer company and the insured. However, in case of reinsurance, there is a third party involved

known as reinsurer. The original insurance company gets reinsured from the reinsurance company to cover its risk. The original policy holder does not enjoy any rights against the reinsurance company. The original policy issued by any insurance company is the basic issue for consideration of any re-insurance company. Reinsurance requires that the policy must be for an interest that specifies the involved interests. Such interests are pre-requisites for availing a reinsurance policy. After a reinsurance policy is issued such interests cannot be altered. The sum and amount of reinsurance cannot exceed the original amount specified in the reinsurance policy also the reinsurance policy cannot cover a period longer than the original policy.

An example explaining the concept of reinsurance is as given below:

Mr. X, a factory owner, approached an insurance company 'A' for an insurance of an amount of Rs. 40 crores. Company 'A' has two options before it. It can reject the risk or accept the entire risk and share a part of the risk with other insurer.

In case, the company 'A' decides to assume the risk, by retaining Rs. 20 crores worth of insurance with it and seeking assistance of other insurer for the excess of his own limit. i.e., for the balance of Rs. 20 crores. The excess for which the company 'A' is approaching the other insurer is called "Reinsurance".

Reinsurance is an entirely new contract, distinct from the original insurance contract entered into by the ceding company. The original insured is not a party to the reinsurance contract, and hence has no right against the reinsurer.



CHECK YOUR PROGRESS

Q 1: Explain the term Reinsurance? (Answer in about 60 words)

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Q 2: Briefly explain the process in which reinsurance companies work? (Answer in about 70 words)

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5.4 FUNDAMENTALS OF REINSURANCE

Every insurance company, whether life or non-life requires reinsurance to diversify and distribute risk. Every large size insurance companies need reinsurance because there are many risk which are too huge for any company to bear on its own. The need of reinsurance is as follows:

- Reinsurance of desired proportion of large risk enables a better spread of risk. It allows insurance companies to pass on risk greater than its size. The policy holder stands to get a higher degree of protection due to reinsurance.
- It helps to accommodate a valuable client by accepting a big business risk which the insurer could not otherwise entertain.
- Reinsurer provides insurance knowledge to a new insurer and even shares its experience to meet different needs of its client.
- The importance of reinsurance is immense in high risk areas like Marine/Aviation classes.
- Reinsurance helps protect against insolvency. It ensures that insurance companies are able to make payment on all claims, even in the case of a natural disaster or unexpected high number of expensive claims.

Reinsurance is basically a form of coverage intended for insurance providers. Generally speaking, this type of policy reduces the losses sustained by insurance companies by allowing them to recover all, or part, of the amounts they pay to claimants. Some of the major types of reinsurance policies are discussed below:

- **Facultative Coverage:** This is the oldest method of reinsurance. It is a type of reinsurance which covers a single risk. Under this method, the insurer offers each risk for reinsurance and it may be accepted or declined by the reinsurer. The procedure is to submit brief details of the risk to each reinsurer who will indicate the proportion that he would accept. The direct insurer (the ceding company) sends a copy of the original to the re-insurer who will then issue the reinsurance policy.

  The drawbacks of this method are:

  - Involves a lot of documentation
  - Delay in covering the risk

  In this method, the reinsurer cannot be forced to accept the risk. They have the 'option' or 'facility' to reject or accept the reinsurance of any amount they decide. And as such this method of reinsurance is called 'Facultative' reinsurance.

- **Reinsurance Treaty:** Treaty is a written agreement between the insured and the reinsurers in terms of which reinsurance offers and acceptance are automatic on the part of both the parties. It is applicable to all class of insurance. Unlike a facultative policy, a treaty type of coverage is in effect for a specified period of time, rather than on 'at per risk', or 'contract basis'. For the duration of the contract, the reinsurer agrees to cover all or a portion of the risks that may be incurred by the insurance company being covered.

- **Proportional Reinsurance:** Under this type of coverage, the reinsurer will receive a prorated share of the premiums of all the policies sold by the insurance company being covered. Consequently, when claims are made, the reinsurer will also bear a portion of the losses. The proportion of the premiums and losses that will be

shared by the reinsurer will be based on an agreed percentage. In a proportional coverage, the reinsurance company will also reimburse the insurance company for all processing, business acquisition and writing costs. Also known as ceding commission, such costs may be paid to the insurance company upfront.

- **Non-Proportional Reinsurance:** In a non-proportional type of coverage, the reinsurer will only get involved if the insurance company's losses exceed a specified amount, which is referred to as priority or retention limit. Hence, the reinsurer does not have a proportional share in the premiums and losses of the insurance provider. The priority or retention limit may be based on a single type of risk or an entire business category.
- **Excess-of-Loss Reinsurance:** This is actually a form of non-proportional coverage. The reinsurer will only cover the losses that exceed the insurance company's retained limit. However, what makes this type of contract unique is that it is typically applied to catastrophic events. It can cover the insurance company either on a per occurrence basis or for all the cumulative losses within a specified period.
- **Risk-Attaching Reinsurance:** Under this type of contract, all policy claims that are established during the effective period of the reinsurance coverage will be covered, regardless of whether the losses occurred outside the coverage period. Conversely, no coverage will be given on claims that originate outside the coverage period, even if the losses occurred while the reinsurance contract is in effect.
- **Loss-Occurring Coverage:** This is a type of treaty coverage where the insurance company can claim all losses that occur during the reinsurance contract period. The important factor to be considered is when the losses have occurred and not when the claims have been made.



CHECK YOUR PROGRESS

Q 3: Explain the Facultative Coverage type of Reinsurance. (Answer in about 30 words)

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Q 4: What is meant by reinsurance treaty? (Answer in about 20 words)

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5.5 REINSURANCE MARKETS IN DEVELOPING COUNTRIES

In the past decade, almost all the developing nations have established national insurance companies to cover their insurance needs, but their dependence on foreign reinsurance is still very high. Structural, financial and technical constraints such as undercapitalisation, the small size of markets and the lack of sufficient experience and know-how, limit the reinsurance capacity of these markets.

The challenges of reinsurance market in developing countries are both internal and external. The most obvious challenges are:

- **Lack of Skilled Manpower:** The sector will certainly need better trained better quality people to maintain the pace of growth so far achieved.
- **Slowing and Stunted Economic Growths:** The trends in the world economic, political and domestic priorities are changing at a very fast rate and in a manner that is unpredictable.
- **Changes in the Environment:** There have also been changes in the environment which are uncontrollable and these changes have given rise to the emergence and increase in the occurrences of natural catastrophes such as Earthquakes and Tsunamis, storms and floods etc. The frequent occurrence of these events is likely to

spell doom to most insurers and even reinsurers as they might not be adequately prepared for them.

- **Political Instability:** Another major challenge in developing countries is the political instability. This has led to slow growth in some sectors of the economy, and a general reduction in investments, which is the main operating area of the insurance and reinsurance sectors. The political instability also creates chaos which leads to losses and damages which would result in adverse claims experiences. In addition, the instability leads to other economic problems, which usually accelerate the incidences of crime, fraudulent claims and general normal hazards.



CHECK YOUR PROGRESS

Q 5: Mention some factors responsible for limiting the reinsurance capacity in developing markets? (Answer in about 20 words)

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Q 6: How does political instability pose a challenge for growth of reinsurance business in developing countries? (Answer in about 30 words)

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5.6 LET US SUM UP

- Reinsurance means insuring again. It is the transfer of insurance risk from one insurer to another. The insurer is called the 'Principal' or 'Direct' or 'Ceding' or Original Office' and the office to which the business is transferred is called the 'Reinsurer' or 'Assuming' or Guaranteeing Office'.

- The process in which insurance companies work is that if any claim is raised by the insured, the insurance company is liable to make the loss incurred by the insured, if the claim satisfies all the conditions, of the policy. In such case, the insurance company has to bear the financial burden. In order to share such burden the insurance companies get themselves, also insured against such financial burdens. The insurance companies therefore to protect themselves, enter into a contract with another company engaged in the business of reinsurance popularly known as third party. The contract made between insurance company and Reinsurance Company is known as Reinsurance.
- Reinsurance is an entirely new contract distinct from the original insurance contract entered into by the ceding company. The original insured is not a party to the reinsurance contract and hence has no right against the reinsurer.
- Reinsurance is a good method to diversify and distribute risk of the insurer. It also helps to accommodate valuable clients by accepting a big business risk which the insurer could not otherwise entertain. Reinsurer provides insurance knowledge to a new insurer and even shares its experience to meet different need of its client. In addition, the importance of reinsurance is immense in high risk areas like marine/aviation classes. Reinsurance also helps to protect against insolvency.
- The various methods of reinsurance are : (a) Facultative Coverage (b) Reinsurance Treaty (c) Proportional Reinsurance (d) Non-Proportional Reinsurance (e) Excess-of-Loss Reinsurance (f) Risk-Attaching Reinsurance (g) Loss-Occurring Coverage.
- Some factors responsible for limiting the reinsurance capacity of developing markets are structural, financial and technical constraints such as undercapitalisation, the small size of markets and the lack of sufficient experience and know-how, political instability etc.



5.7 FURTHER READING

1) Carter, L.R. (2014). *Reinsurance.* Netherlands: Springer

2) Gulati,C.N. (2007). Principles of Insurance Management: Excel Books.



5.8 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Re-insurance as the term itself suggest, is insuring again. It is the transfer of insurance business from one insurer to another. It is a process whereby one entity (the reinsurer) takes on all or part of the risk covered under a policy issued by an insurance company in consideration of a premium payment. An insurance company transfers all or a portion of its risk exposure under an insurance policy to another company, in situations when the risk is high, as this helps the insurance company to put that excess risk to reinsurance company (one or more than one), in order to diversify the risk.

Ans to Q No 2: The process in which insurance companies work is that if any claim is raised by the insured, the insurance company is liable to make the loss incurred by the insured, if the claim satisfies all the conditions, of the policy. In such case, the insurance company has to bear the financial burden. In order to share such burden the insurance companies get themselves also insured against such financial burdens. The insurance companies therefore to protect themselves enter into a contract with another company engaged in the business of reinsurance popularly known as third party. The contract made between insurance company and Reinsurance Company is known as Reinsurance.

Ans to Q No 3: It is a type of reinsurance which covers a single risk. Under this method, the insurer offers each risk for reinsurance

and it may be accepted or declined by the reinsurer. The procedure is to submit brief details of the risk to each reinsurer who will indicate the proportion that he would accept. The direct insurer (the ceding company) sends a copy of the original to the re-insurer who will then issue the reinsurance policy.

Ans to Q No 4: Reinsurance treaty is a written agreement between the insured and the reinsurers in terms of which reinsurance offers and acceptance are automatic on the part of both the parties. It is applicable to all class of insurance.

Ans to Q No 5: Some factors responsible for limiting the reinsurance capacity of developing markets are structural, financial and technical constraints such as undercapitalisation, the small size of markets and the lack of sufficient experience and know-how .

Ans to Q No 6: Political instability has led to slow growth in some sectors of the economy, and a general reduction in investments, which is the main operating area of the insurance and reinsurance sectors. The political instability also creates chaos which leads to losses and damages which would result in adverse claims experiences.



5.9 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Discuss the concept and meaning of reinsurance.

Q 2: Explain the need of Reinsurance.

Q 3: Briefly explain the facultative coverage method of Reinsurance and discuss the drawbacks of this method.

Long Questions (Answer each question in about 300-500 words)

Q 1: Briefly elaborate about Reinsurance contract with an example.

Q 2: Explain the various methods of Reinsurance.

Q 3: Discuss the challenges of Reinsurance market in developing countries.

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UNIT 6 : INSURANCE AND ECONOMIC DEVELOPMENT

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Concept and Significance of Insurance

6.4 Need for Insurance

6.5 An Overview of Risk Management

6.6 Role of Insurance in the Economic Development

6.7 Insurance Institutions as Financial Intermediaries

6.8 Insurance Institutions as Investment Institutions

6.9 Let Us Sum Up

6.10 Answers to Check Your Progress

6.11 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- explain the meaning and importance of insurance
- grasp the role of insurance in the economic development
- describe insurance institutions as financial intermediaries
- explain the insurance institutions as investment institutions.

6.2 INTRODUCTION

The future is always uncertain. This uncertainty gives rise to risk. Individuals, families, businesses, properties and assets are exposed to different types and levels of risks. A human life is also considered as an income generating asset, exposed to perils like sickness, disabilities or early death. Similarly, a businessman is worried if due to natural calamities like earthquake, flood, cyclone or accidental reasons like fire, his/her business activities may be disrupted and there may be loss of assets and properties. In order to have a safeguard against all these unforeseen

events one may opt for insurance to secure his future or secure the assets and properties. Insurance is a technique by which the loss likely to be caused by an uncertain event spread over a number of persons who are exposed to it and who propose to insure themselves against such event. The essence of insurance is mitigation of risk and substitution of certainty for uncertainty. Moreover, insurance generates significant impact on the economy by mobilising domestic savings. Insurance turn accumulated capital into productive investments. Insurance enables to mitigate loss, financial stability and promotes trade and commerce activities that results into economic growth and development.

6.3 CONCEPT AND SIGNIFICANCE OF INSURANCE

- **Concept:** There are no certainties or guarantees in life. There is no guarantee that the business will not suffer an unexpected loss or damages. While we cannot protect our interests against all risks, we can opt for some insurance. Insurance is defined as a contract, which is called a policy, in which an individual or organisation receives financial protection and reimbursement of damages from the insurer or the insurance company. At a very basic level, it is some form of protection from any possible financial losses.

  The basic principle of insurance is that an entity will choose to spend small periodic amounts of money against a possibility of a huge unexpected loss. Basically, all the policyholder pools their risks together. Any loss that they suffer will be paid out of their premiums which they pay.

  Thus, a contract of insurance is a contract under which the insurer (i.e. insurance company) in consideration of a sum of money paid by the insured (called the premium) agrees.

  - To make good the loss suffered by the insured against a specific risk (for which the insurance is effected), such as fire or,
  - To pay a pre-fixed amount to the insured or his/her beneficiaries on the happening of specified event e.g. death of the insured.

- **Significance of Insurance:** We can highlight the significance of insurance, in terms of the following advantages offered by it thus,
  - **Concentration on Business Issues**: Insurance help businessmen to concentrate their attention on business issues, as their risks are undertaken by the insurance company. Insurance gives them peace of mind. Thus, due to insurance, business efficiency increases.
  - **Better Utilisation of Capital**: Businessmen, in the absence of insurance, will maintain funds for meeting future contingencies. Insurance does away with this need to maintain contingency funds by them. Thus businessmen can better utilise their funds for business purposes.
  - **Promotion of Foreign Trade**: There are many risks in foreign trade much more than involved in home trade. Insurance of risks involved in foreign trade gives a boost to its volume, which is a healthy feature of economic development.
  - **Feeling of Security to Dependents:** Life insurance provides a feeling of economic security to the dependents of the insured, on whose life insurance is affected.
  - **Social Welfare**: Life insurance also provides for policies with regard to education of children, marriage of children etc. Such special policies provide a sense of security to the poor who opt for these policies. Thus life insurance is a device for ensuring social welfare.
  - **Speeding up the Process of Economic Development**: Insurance companies mobilise the savings of community through collection of premiums and invest these savings in productive channels. This process speeds up economic development. Huge funds at the disposal of LICs (Life Insurance Corporations) are available for investment purposes support the above-mentioned point of advantage of insurance.
  - **Generation of Employment Opportunities**: Insurance companies provide plenty employment, opportunities in the

economy. This is due to the ever growing business done by insurance companies.

6.4 NEED FOR INSURANCE

Insurance plans are beneficial to anyone looking to protect their family, assets/property and themselves from financial risk/losses. Some of the benefits are as highlighted below:

- Insurance plans will help you pay for medical emergencies, hospitalisation, contraction of any illnesses and treatment, and medical care required in the future.
- The financial loss to the family due to unfortunate death of the sole earner can be covered by insurance plans. The family can also repay any debts like home loans or other debts which the person insured may have incurred in his/her lifetime.
- Insurance plans will help your family maintain their standard of living in case you are not around in the future. This will help them cover costs of running the household through the pay out of insurance lump sum. The insurance money will give your family some much needed breathing space along with coverage for all expenditure in case of death/accident/medical emergency of the policy holder.
- Insurance plans will help in protecting the future of your child in terms of his/her education. They will make sure that your children are financially secured while pursuing their dreams and ambitions without any compromises, even when you are not around.
- Many insurance plans come with savings and investment schemes along with regular coverage. These help in building wealth/savings for the future through regular **investments**. You pay premiums regularly and a portion of the same goes towards life coverage while the other portion goes towards either a savings plan or investment plan, whichever you choose based on your future goals and needs.
- Insurance helps protect your home in the event of any unforeseen calamity or damage. Your home insurance plan will help you get coverage for damages to your home and pay for the cost of repairs

or rebuilding, whichever is needed. If you have coverage for valuables and items inside the house, then you can purchase replacement items with the insurance money.

6.5 AN OVERVIEW OF RISK MANAGEMENT

Risk is the chance something harmful or unexpected could happen. This might involve the loss, theft, or damage of valuable property and belongings, or it may involve someone being injured. There is saying higher the risk more the profit. A risky proposal can on one hand bring higher profits but on the other hand looming losses. The risk can never be certain or predictable. Therefore, there is need for the risk management.

Risk management may be seen as the identification, evaluation, and prioritisation of risks followed by coordinated and economical application of resources to minimise, monitor, and control the probability or impact of unfortunate events or to maximise the realisation of opportunities. Risk management may be defined as a managerial function concerned with the protection of the firm's assets, earnings or profits, personnel against financial losses that may result from fortuitous events i.e. accidental happenings.

Risk management ensures that an organisation identifies and understands the risks to which it is exposed. Risk management also guarantees that the organisation creates and implements an effective plan to prevent losses or reduce the impact if a loss occurs. A risk management plan includes strategies and techniques for recognising and confronting the threats.

- **Benefits of Managing Risks:** Risk management provides a clear and structured approach to identifying risks. Having a clear understanding of all risks allows an organisation to measure and prioritise them and to take the appropriate actions to reduce losses.

  Risk management has other benefits for an organisation, including:

  - Protecting the reputation and public image of the organisation.
  - Saving resources
  - Preventing or reducing legal liability and increasing the stability

of operations.

- Protecting people from harm.
- Enhancing the ability to prepare for various circumstances.
- Reducing liabilities
- Assisting in clearly defining the insurance needs.

- **Risk Management Cycle/ Process/ Steps:** Risk management cycle is a process involving the steps such as identifying business functions, assets, vulnerabilities and threats; assessing the risks; developing a risk management plan; implementing risk management actions, and re-evaluating the risks.

  The Risk Management process involves the following important steps:

  - Identify all potential and significant risks.
  - Evaluate the cause, frequency and severity of losses.
  - Develop and select methods to manage the risk.
  - Implement the method chosen.
  - Monitor performance on an on-going basis.

  This general framework applies to individual risk management too.

  According to the standard ISO 31000, "Risk Management – Principles and guidelines on implementation, the process of risk management consists of several steps which have been briefly explained below:

  - **Establish Context:** Understanding the circumstances in which the rest of the process will take place. The criteria that will be used to evaluate risk should also be established and the structure of the analysis should be defined.
  - **Risk Identification:** Company identifies and defines potential risks that may negatively influence a specific company process or project.
  - **Risk Analysis:** Once specific types of risks are identified, the company then determines the odds of it occurring, as well as its consequences. The goal of risk analysis is to further

understand each specific instance of risk, and how it could influence the company's projects and objectives.

- **Risk Assessment and Evaluation:** The risk is then further evaluated after determining the risk's overall likelihood of occurrence combined with its overall consequences. The company can then make decisions on whether the risk is acceptable and whether the company is willing to take it on.
- **Risk Mitigation:** During this step, companies assess their highest-ranked risks and develop a plan to alleviate those using specific risks controls. These plans include risk mitigation processes, risk prevention tactics and contingency plans in the event the risk comes to fruition.
- **Risk Monitoring:** Part of the mitigation plan includes following up on both the risks and the overall plan to continuously monitor and track new and existing risks. The overall risk management process should be reviewed and updated accordingly.
- **Communicate and Consult:** Internal and external shareholders should be included in communication and consultation at each appropriate step of the risk management process and with regard to the process as a whole.

- **Risk Management Approaches:** After the company's specific risks are identified and the risk management process has been implemented, there are several different strategies companies can take in regard to different types of risks:
  - **Risk Avoidance:** While the complete elimination of all risk is rarely possible, a risk avoidance strategy is designed to deflect as many threats as possible in order to avoid the costly and disruptive consequences of a damaging event.
  - **Risk Reduction:** Companies are sometimes able to reduce the amount of effect certain risks can have on company processes. This is achieved by adjusting certain aspects of an overall project plan or company process, or by reducing its scope.

- **Risk Sharing:** Sometimes, the consequences of a risk is shared, or distributed among several of the project's participants or business departments. The risk could also be shared with a third party, such as a vendor or business partner.
- **Risk Retaining:** Sometimes, companies decide a risk is worth it from a business standpoint, and decide to keep the risk and deal with any potential fallout. Companies will often retain a certain level of risk if a project's anticipated profit is greater than the costs of its potential risks.

CHECK YOUR PROGRESS



Q 1: What is meant by insurance? (Answer in about 20 words)

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Q 2: Define Risk. (Answer in about 20 words)

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Q 3: State the meaning of Risk Management. (Answer in about 30 words)

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6.6 ROLE OF INSURANCE IN THE ECONOMIC DEVELOPMENT

Insurance plays a significant role in the economic development of a country. Insurance market contributes to the economic growth as a financial intermediary and also helps in managing risk more effectively. It may be described as a social device to reduce or eliminate risk of loss to life and property. Insurance contributes a lot to the general economic growth of the society by providing stability to the functioning of process. The insurance industries develop financial institutions and reduce

uncertainties by improving financial resources.

- **Provide Safety and Security**: Insurance provides financial support and reduces uncertainties in business and human life. It provides safety and security against unseen events. There is always a fear of sudden loss. Insurance provides a cover against any unexpected or sudden loss. For example, in case of life insurance financial assistance is provided to the family of the insured on his or her death. In case of other insurance security, they are providing against the loss due to fire, marine, accidents etc.
- **Generates Financial Resources**: Insurance generates funds by collecting premium. These funds are invested in government securities and stock. These funds are gainfully employed in industrial development of a country for generating more funds and utilised for the economic development of the country. Employment opportunities are increased by big investments leading to capital formation.
- **Life Insurance Encourages Savings**: Insurance does not only protect against risks and uncertainties, but also provides an investment channel as well. Life insurance enables systematic savings due to payment of regular premium. Life insurance provides a mode of investment. It develops a habit of saving money by paying premium. The insured receives the lump sum amount at the maturity of the contract. Thus, life insurance encourages savings.
- **Promotes Economic Growth**: Insurance generates significant impact on the economy by mobilising domestic savings. Insurance turn accumulated capital into productive investments. It enables to mitigate loss, financial stability and promotes trade and commerce activities those results into economic growth and development. Thus, insurance plays a crucial role in sustainable growth of an economy.
- **Medical Support**: A medical insurance considered essential in managing risk in health. Anyone can be a victim of unexpected critical illness. And rising medical expense is of great concern. Medical Insurance is one of the insurance policies that cater for different type of health risks. The insured gets a medical support in

case of medical insurance policy.

- **Spreading of Risk**: Insurance facilitates spreading of risk from the insured to the insurer. The basic principle of insurance is to spread risk among a large number of people. A large number of persons get insurance policies and pay premium to the insurer. Whenever a loss occurs, it is compensated out of funds of the insurer.
- **Source of Collecting Funds**: Large funds are collected by the way of premium. These funds are utilised in the industrial development of a country, which accelerates the economic growth. Employment opportunities are increased by such big investments. Thus, insurance has become an important source of capital formation.

Insurance is an important element of modern economic relations. It includes financial relations which perform specific functions in economy. In addition to playing great role in society, insurance effects macroeconomic indicators positively as it facilitates economic growth by investing the premium funds, by protecting individuals, industry and commerce, community and nation from economic impact of losses, removing anxiety of losses and promoting investment. The effects of insurance to macroeconomic indicators are discussed below:

- **Insurance Provides Increasing Employment in Economy:** One of the main problems in economy is unemployment. Many countries suffer from this problem nowadays. The number of unemployed people is increasing in developing countries. But insurance system helps to solve this problem in economy. So, an insurance company provides employment by hiring new workers.
- **Insurance Provides Increasing GDP:** One of the main macroeconomic indicators of each country is GDP. A lot of macroeconomic indicators are usually considered as determinants of profitability. The development level of each country is measured with volume of GDP. In modern period, insurance companies offer different insurance products to people. When people use these insurance products, they pay insurance premiums to insurance

companies. Insurance companies use these premiums in financial and investment activities of economy. So, this process increases GDP in economy.

- **Insurance Effects to Economic Growth Positively:** The insurance sector plays an important role in the financial services industry, contributing to economic growth, efficient resource allocation, creation of liquidity, facilitation of economics of scale in investment and financing. Insurance also helps to develop service, agriculture and industry sector of economy. It is known that, insurance provides employment in economy and it provides increasing GDP. With these advantages insurance also effects economic growth positively.
- **Insurance Effects Stability of Financial System Positively:** Insurance is one of the main fields of service sector. Insurance companies are primary part of financial system. Besides that, insurance companies play great role in forming state budget because they are big tax payers of the state (as we know the big part of the state budget is formed by taxes). For this reason, insurance sector plays great role in providing stability of tax and financial system.
- **Insurance Provides Prosperity of People:** Availability of insurance is a great advantage. Nowadays, people can use different types of insurance. For example, in modern period people use motor insurance, property insurance, life insurance, medical insurance or travel insurance. All these insurance types provide people's safety and security. It affects their life style positively. It is known that, insurance increases savings of people. When people use insurance for their property, their life immediately falls under a certain guarantee. These advantages provide prosperity of people.

6.7 INSURANCE INSTITUTIONS AS FINANCIAL INTERMEDIARIES

A financial intermediary is an institution or individual that serves as a middleman among diverse parties in order to facilitate financial

transactions. Common types include commercial banks, investment banks, stock brokers, pooled investment funds and stock exchanges. Financial intermediaries reallocate otherwise uninvested capital to productive enterprises through a variety of debt, equity, or hybrid stockholding structures.

When it comes to financial intermediaries, there is a long list to be discussed. However, in this unit we are going to study only about insurance institutions as a financial middleman. Although there are several different types of insurance organisations, almost all of them operate in the exact same way. Insurance companies are considered as financial intermediaries for several reasons. The first reason is that they receive funds from their clients for further investment. Many people use insurance companies as institutions in which they invest most of their savings. Another reason why these institutions can be found as financial intermediaries is that these institutions place invested assets of its clients in a series of investments that will make them some money. So, they take resources from one sector and invest them in another sector. Insurance companies deal with the risk-taking on behalf of their clients in exchange for compensation in the form of premiums. Insurance companies generate profits by charging insurance premiums that are designed to be sufficient to pay expected claims for damages and to obtain certain profits.

Thus, an insurance company ensures its customers against certain risks, such as the risk of having a car accident or the risk of a house catching fire. In return for this insurance, their customers pay them regular insurance premiums. Insurance companies manage these premiums by making suitable investments, thereby also functioning as financial intermediaries between customers and the channels that receive their money. For instance, insurance companies may channel the money into investments such as commercial real estate and bonds. Insurance companies invest and manage the premiums they receive from their customers for their own benefit. Insurance companies, however, are not part of a centralised clearing and payment system. This means that they

are not as susceptible to systemic contagion as banks are.

Insurance companies as financial intermediaries perform the function of channelising savings into domestic investment. They facilitate efficient allocation of capital resources, which in turn improve productivity and economic efficiency which result in reduced capital output ratio. Thus, the insurance companies perform extremely useful function in economy as financial intermediaries. These are as highlighted follows:

- **Source for Collecting Funds:** In lieu of an insurance cover, the insured pays premium to the insurer. The premium is received regularly in instalments. Large funds are collected by way of premium. These funds can be gainfully employed in industrial development of a country. Life insurance policies are purchased by persons from all walks of life. It helps in collecting savings from a large number of persons.
- **Reduction in Transaction Cost**: Insurers help in reducing transaction cost in economy by collecting funds from policyholders and investing the same in different projects scattered over different regions. It is a specialised and time consuming job.
- **Creating liability**: The policy holders, in case of loss, are not required to wait for a long period for the amount of claim. It improves their liquidity.
- **Facilitates Economies of Scale in Investment**: Insurers are in the position of financing large projects, railways power projects, etc. These large projects create economies of scale, facilitate technological innovation and specialisation and thus promote economic efficiency and productivity.

6.8 INSURANCE INSTITUTIONS AS INVESTMENT INSTITUTIONS

The insurance sector as a mobiliser of savings in the form of institutional investing is an integral part of the financial services sector of a national economy and it has an important influence on development of the financial market and performance of the entire economy. On the

other side, the development of the economy and financial market has a strong influence on the development of the insurance sector.The insurance sector has traditionally been regarded as a relatively stable segment of the financial system. There are three main reasons why insurers are important for the stability of the financial system. First, insurers are large investors in financial markets. Second, insurers often have close links to banks and other financial institutions, and problems confronting an insurer can therefore spread to the banking sector. Third, insurers contribute to the safeguarding of the stability of household and firm balance sheets by insuring their risks.

Insurance companies being part of the institutional investment community controll almost the same amount of funds as investment firms. These organisations, which include property and casualty insurers and life insurance companies, take in premiums to protect policy holders from various types of risk. The premiums are then invested by the insurance companies to provide a source of future claims and a profit, thereby also functioning as financial intermediaries between customers and the channels that receive their money. Most often life insurance companies invest in portfolios of bonds and other lower risk fixed-income securities.



CHECK YOUR PROGRESS

Q 4: How the insurance sector promotes economic growth of a country? (Answer in about 30 words)

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Q 5: What is meant by Financial Intermediary? (Answer in about 20 words)

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6.9 LET US SUM UP

- Insurance is a contract, represented by a policy, in which an individual or entity receives financial protection against future possible losses from an insurance company. Thus, it helps to reduce the financial consequences of adverse situations.
- Insurance is an agreement between two parties – the insured (a person or organisation covered by insurance) and the insurer (the party who agrees to pay for the losses).
- Risk Management is the process of identifying and analysing risk exposures faced by the companies and involves the purchasing of insurance to reduce the financial impact of adverse events on a company.
- Insurance sector is a boon for economic development of the country as it generates capital formation, provides financial stability and promotes trade and commerce activities. Thus, it results into economic growth and development.
- Insurance companies play the role of financial intermediaries by investing the premiums received from their customers in some profitable investment opportunities, thereby, also functioning as financial intermediaries between the customers and the channels that receive their money. Insurance companies may channel the money into investments such as commercial real estate and bonds.
- Globalisation of the insurance sector has resulted in increased competition amongst the players internationally and within the nation.



6.10 FURTHER READING

1) Carter, L.R. (2014). *Reinsurance*. Netherlands: Springer

2) Gulati,C.N. (2007). *Principles of Insurance Management*: Excel Books.



6.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: Insurance is defined as a contract, in which an individual or organisation receives financial protection and reimbursement of damages from the insurer or the insurance company

Ans to Q No 2: Risk is the chance something harmful or unexpected could happen. This might involve the loss, theft, or damage of valuable property and belongings, or it may involve someone being injured.

Ans to Q No 3: Risk management may be defined as a managerial function concerned with the protection of the firm's assets, earnings or profits, personnel against financial losses that may result from fortuitous events i.e. accidental happenings.

Ans to Q No 4: Insurance generates significant impact on the economy by generating funds. These funds are gainfully employed in industrial development of the country or invested into some productive investments. Thus, insurance plays a crucial role in sustainable growth of an economy.

Ans to Q No 5: A financial intermediary is an institution or individual that serves as a middleman among diverse parties in order to facilitate financial transactions.



6.12 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Explain the importance of insurance.

Q 2: Write the benefits of Risk Management.

Q 3: Write a note on different Risk Management Approaches.

Q 4: How has the insurance sector affected the macroeconomic indicators of the economy?

Long Questions (Answer each question in about 300-500 words)

Q 1: What is meant by Risk Management? Explain the different steps in risk management process.

Q 2: Discuss how insurance and economic developments are related to each other.

Q 3: Explain the role played by the insurance sector in the economy as a financial intermediary.

Q 4: Explain the role played by the Insurance Companies as investment institutions.

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UNIT 7 : ESSENTIALS OF LIFE INSURANCE-I

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Fundamentals of Life and Health Insurance

7.4 Functions of Life Insurance

7.5 Plans of Life Insurance

7.6 Legal Aspects of Life Insurance

7.7 Functions of Health Insurance

7.8 Let Us Sum Up

7.9 Further Reading

7.10 Answers to Check Your Progress

7.11 Model Questions

7.1 LEARNING OBJECTIVES

After going through this unit, you will be able to-

- learn the basics of life and health insurance
- explain the functions, plans and legal aspects of life insurance
- describe the functions of health insurance.

7.2 INTRODUCTION

In present times, the cost incurred for daily survival and for meeting medical expenses is very high. Therefore, Life Insurance and Health Insurance, both play a vital role.

Life insurance provides financial protection to surviving dependents after the death of an insured. It is essential for applicants to analyse their financial situation and determine the standard of living needed for their surviving dependents before purchasing a life insurance policy.

Health insurance provides access to and financial protection against medical costs in the event of an accident, injury or diagnosis of the illness that requires ongoing treatment by a specialist. Medical

coverage also protects individuals who need immediate care for a broken leg, stroke, heart attack, cancer etc. In this unit we will discuss about life insurance in details.

7.3 FUNDAMENTALS OF LIFE AND HEALTH INSURANCE

- **Life Insurance:** Life insurance contract may be defined as 'a contract whereby the insurer, in consideration of a premium, undertakes to pay an annuity or a certain sum of money, either on the death of the insured or on the expiry of a certain number of years'. Under the contract the sum assured is paid to the assured if policy matures during his life time, or to the nominees of the assured in case of his death whichever is earlier. The policy-holder goes on paying to the insurer a pre-determined sum of money known as 'premium'. The premium may be annual, half-yearly, quarterly or monthly, but it must be paid regularly during the period of policy.

  Thus, in simple words, Life insurance is a form of insurance in which a person makes regular payments to an insurance company, in return for a sum of money to be paid to them after a period of time, or to their family in the event of their death.

  Life Insurance Business at present is regulated by the provisions of the Insurance Act 1938, Life Insurance Corporation Act 1956 and IRDA Act 1999.

  The Advantages of Life Insurance:

  - **Providing Security:** There is always a fear of sudden loss of life as human life is most uncertain. If a bread-earning member of the family dies prematurely, the family is provided with money to continue with its livelihood. So, insurance gives security to the individuals for their life or even after death to their family members.
  - **Spreading of Risk:** The basic principle of insurance is to spread risk among a large number of people. A large number of persons receive insurance policies and pay premium to the

insurer. Whenever a loss occurs, it is compensated out of funds of the insurer. The loss is spread among a large number of policy-holders.

- **Source for Collecting Funds:** In lieu of an insurance cover, the insured pays premium to the insurer. The premium is received regularly in installments. Large funds are collected by way of premium. These funds can be gainfully employed in industrial development of a country. Life insurance policies are purchased by persons from all walks of life. It helps in collecting savings from a large number of persons.

  In India, Life Insurance Corporation of India provides large funds to the industries for long-term investments. These funds are productively used in exploiting natural resources which accelerates industrial growth of a country. The employment opportunities are also increased by big investments made by insurance companies. So, insurance has become an important source of capital formation.

- **Encourage Savings:** Insurance does not only guard against risks but it provides an investment channel too. Life insurance provides a mode of investment. The insurance develops a habit of saving money by paying premium. The amount of policy is paid to the insured or to his nominees.

- **Health Insurance*:*** Health insurance is a type of insurance coverage that pays for medical, surgical, and sometimes dental expenses incurred by the insured. Health insurance can reimburse the insured for expenses incurred from illness or injury, or pay the care provider directly. Health insurance is a type of insurance coverage that pays for medical, surgical, and sometimes dental expenses incurred by the insured. Health insurance can reimburse the insured for expenses incurred from illness or injury, or pay the care provider directly.

  The Advantages of Health Insurance:

  - **Coverage Against Medical Expenses:** The main purpose of

medical insurance is to receive the best medical care without any strain on ones finances. Health insurance plans offer protection against high medical costs. It covers hospitalisation expenses, day care procedures, domiciliary expenses, and ambulance charges, besides many others.

- **Coverage Against Critical Illnesses:** Insurance providers nowadays offer critical illness insurance, either as a standalone plan or as a rider. Such an insurance policy provides coverage against life-threatening diseases e.g. kidney failure, bone marrow transplant, stroke and loss of limbs, among others.
- **Cashless Claim Benefit:** Many insurance providers offer cashless claim facility. The hospitalisation expenses are settled between the insurer and the hospital. To avail of this benefit, it is imperative to get admitted at any of the insurer's network hospitals.
- **Additional Protection Over and Above the Employer Cover:** Many organisations cover their employees with a group insurance plan. However, such policies are not suited according to the needs of every individual. Besides, one may be left uninsured in case of loss of job or change in employment. In order to protect oneself against such an event, it is important to purchase a health cover individually.
- **Tax benefits:** Health care plans provide tax benefits. Premiums paid towards health care policy are eligible for tax deductions under **Section 80D** of the Income Tax Act, 1961.



CHECK YOUR PROGRESS

Q 1: Fill in the blanks:

Premiums paid towards health care policy are eligible for tax deductions under **Section** _____ of the Income Tax Act, 1961.

7.4 FUNCTIONS OF LIFE INSURANCE

The functions of life insurance can be divided into two viz. the primary functions and the secondary functions. These are discussed as follows:

- **Primary Functions of Insurance**
  - **Insurance Provides Certainty:** Insurance provides certainty of payment at the time of uncertainty or loss. However, the insurance relieves the person from such a difficult task.The insurer charges the premium for providing the said certainty. The premium paid for Life Insurance is received at the end of the maturity period or death whichever is earlier.
  - **Insurance Provides Protection:** The main function of insurance is to protect the probable chances of loss. The time and amount of loss are uncertain and at the happening of risk, the person will suffer the loss in the absence of insurance.
  - **Risk-Sharing:** The risk is uncertain, and therefore, the loss arising from the risk. When risk takes place, the loss is shared by all the persons who are exposed to the risk. Incase of Life Insurance the risk is loss of life.
- **Secondary Functions of Insurance:** Besides the above primary functions, the insurance works for the following functions:
  - **It Provides Capital:** The insurance provides capital to society. The accumulated funds are invested in the productive channel.The death of the capital of the society is minimised to a greater extent with the help of investment in insurance. The industry, the business, and the individual are benefited by the investment and loans of the insurers.
  - **It Improves Efficiency:** Insurance eliminates worries and miseries of losses at death. The carefree person can devote his body and soul together for better achievement, it improves not only his efficiency but the efficiencies of the masses are also advanced.
  - **It Helps Economic Progress:** The insurance by protecting

the society from huge losses of damage, destruction and death, provides an initiative to work hard for the betterment of the masses.

7.5 PLANS OF LIFE INSURANCE

A life insurance policy could offer pure protection (insurance), another variant could offer protection as well as investment while some others could offer only investment. In India, life insurance has been used more for investment purposes than for protection in one's overall financial planning. Followings are the types of life insurance policy:

- **Term Life Insurance Policy:** The term life insurance policy is for a specified period. It depends on the length of time. It has one of the lowest premiums among insurance plans and also carries an added advantage of fixed payments that do not increase during the term of the policy. In case of the policy holder's untimely demise, the benefit amount specified in the insurance agreement goes to the nominees.
- **Whole Life Insurance Policy:** Whole life insurance policies do not have any fixed term or end date and is only payable to the designated beneficiary after the death of the policy holder. The policy owner does not get any monetary benefits out of this policy. Owing to the same, this type of insurance involves fixed known annual premiums, it's a good option to ensure guaranteed financial benefits for surviving family members.
- **Money Back Plan:** With a money back plan, policy holder receives periodic payments, which are a percentage of the entire amount insured, during the lifetime of policy. It's a plan that offers insurance coverage along with savings. These policies provide for periodic payments of partial survival benefits during the term of the policy itself. A unique feature associated with this type of policies is that in the event of death of the insured during the policy term, the designated beneficiary will get the full sum assured without deducting any of the survival benefit amounts, which have already been paid

as money-back components. Moreover, the bonus on such policies is also calculated on the full sum assured.

- **Pension Plan:** Pension plans are different from other types of life insurance because they do not provide any life insurance cover, but ensure a guaranteed income, either for life or for a certain period. The Policy holder makes the investment for a pension plan either with a single lump sum payment or through installments paid over a certain number of years. In return, he gets a specific sum every year, every half-year or every month, either for life or for a fixed number of years. In case of the death of the insured, or after the fixed annuity period expires for annuity payments, the invested annuity fund is refunded, usually with some additional amounts as per the terms of the policy.
- **Endowment Policy:** It is the most popular life insurance plan. This policy combines risk cover with objective of savings and investment. If the policy holder dies during the policy period, he/she will get the assured amount. Even if he/she survives he/she will receive the assured amount. The advantage of this policy is if the policy holder survives after the completion of policy tenure, he/she receives assured amount plus additional benefits like bonus from the insurance company. Designed primarily to provide a living benefit, along with life insurance protection, the endowment policy makes a good investment if policy holder wants coverage, as well as some extra money.

  There are two types of Endowment policy:

  - **Without Profit Endowment Plan:** These plans do not participate in the profits the insurance company makes each year. Apart from the sum assured, the policy holder could possibly get a loyalty bonus, which is a one-time payout.
  - **With-Profit Endowment Plan:** These plans share the profits the insurance company makes each year with the policy holder. So they offer more returns than without-profit endowment plans and are more expensive i.e. the premiums will be higher than without-profit endowment plans.
- **Unit-Linked Insurance Plan (ULIP):** Unit-Linked Insurance Plans

gives a policy holder greater control on where premium can be invested. The annual premium is invested in various types of funds that invest in debt and equity in a proportion that suits all types of investors. A policy holder can switch from one fund plan to another freely and can also monitor the performance of his plan easily. ULIP is suitable for those who understand the stock market well.



CHECK YOUR PROGRESS

Q 2: Fill in the blanks:

a) The _____ life insurance policy is for a specified period which depends on the length of time.

b) There are two types of Endowment policy. These are: _____ and _____.

7.6 LEGAL ASPECTS OF LIFE INSURANCE

Life assurance is a legal product. In legal terms, life insurance is a contract between an insurance policy holder known as the insured and an insurance company known as the insurer. Under this contract, the insurer promises to pay a pre-specified sum of money which is known as “Sum Assured” or “Cover Amount” upon the death of the insured person or after a certain period whichever is earlier. Life insurance is chosen according to the needs and goals of the insured. The main objective of insurance is to help the insured and his/her family members at the time of crisis. Life insurance covers various things like accidents, illness, or even death. On the happening of the event, the person who is to receive the benefit is required to send claim intimation form to the insurance company. The Claim intimation form should contain various details viz. Date, Place, and Cause of Death. On successful submission of the form, an insurance company can ask for additional information about regarding the certificate of death, copy of insurance policy, legal evidence of title in case insured has not appointed a beneficiary, deeds of assignment, etc. On successful submission of all the required documents, the insurance

company shall verify the claim and settle the same.

The issues that may arise with life insurance policies be they determining an insurable interest or applying the substantial compliance rule or determining the cause of death, demonstrate the importance of gathering and analysing all the facts surrounding the circumstances of the case.

Also, there is a suicide clause, in this case death benefit cannot be given to the policyholder's nominee. According to the suicide clause, the policy shall be void if the life assured commits suicide.

The Life Insurance Contract is same as other contracts i.e. the contract must meet the requirements laid down in the Indian Contract Act, 1872 and in compliance with Section 10 of that Act, which states:

"All agreements are contracts if it is made by the free consent of the parties competent to contract, for a lawful consideration and with a lawful object, and are not hereby expressly declared to be void".

However, an insurance contract is a special arrangement, where certain specific requirements apply to ensuring the agreement's validity. The additional provisions include the existence of an insurable interest and the duty of utmost good faith.

The Insurance Contracts Act 1984 regulates the Life Insurance Contract which aims at ensuring that a fair balance is struck between the interests of insurers, insured parties and other members of the public, so that the provisions included in such contracts, and the practices of insurers in relation to such contracts, operate in a fair manner.

Also the Insurance Regulatory and Development Authority (IRDA) Act, 1999 spells out the Mission of IRDAI as:"... to protect the interests of the policy holders, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto....."Section 14 of the IRDA Act, 1999 lays down the duties, powers and functions of IRDA. These are:

- Registering and regulating insurance companies.
- Protecting policy holders' interests.
- Licensing and establishing norms for insurance intermediaries.

- Promoting professional organisations in insurance.
- Regulating and overseeing premium rates and terms of non-life insurance covers.
- Specifying financial reporting norms of insurance companies.
- Regulating investment of policyholders' funds by insurance companies.
- Ensuring the maintenance of solvency margin by insurance companies.
- Ensuring insurance coverage in rural areas and of vulnerable sections of society.



CHECK YOUR PROGRESS

Q 3: Fill in the blanks:

a) The Insurance Contracts Act _____ regulates the Life Insurance Contract.

b) Section _____ of the IRDA Act, 1999 lays down the duties, powers and functions of IRDA.

7.7 FUNCTIONS OF HEALTH INSURANCE

A typical health insurance plan provides four primary functions: provisions for routine care, emergency medical assistance, chronic condition treatment and pharmaceutical care. Different health insurance plans pay for all of these functions in differing amounts, and the premiums differ as well. Health insurance can reimburse the insured for expenses incurred from illness or injury, or pay the care provider directly.

The functions of Health Insurance are discussed below:

- **Provides Financial Protection to Individuals with Catastrophic Health Events:** Catastrophic health events are rare and difficult to predict, and their costs are far beyond the means of most people. Health insurance, protects individuals from unpredictable and financially catastrophic diseases like cancer, stroke, heart attacks, surgeries, etc. Catastrophic health events are rare and difficult to predict, and their costs are far beyond the means of most people.

- **Provides Expenses for Routine Care:** Routine procedures include physical examinations, regular tests, vaccines, booster shots and care for minor illnesses. Depending on the level of health care offered by the insurance plan, there may be no, some or complete coverage for such routine visits within certain limitations.
- **Emergency Care:** Emergencies include sudden injuries, acute illnesses, drug overdoses and other unexpected medical calamities. The emergency coverage provided by health insurance typically exceeds that for more predictable illnesses because of the reduced chances of their occurrence. Emergency coverage can cover ancillary costs like ambulance fees as well.
- **Pharmaceuticals:** Pharmaceutical treatments, as long as they are prescribed by a doctor, are usually covered in large part by insurance plans. The deductible for pharmaceuticals can sometimes be quite high depending on the plan. As pharmacology is critical to the practice of modern medicine, almost every health insurance plan provisions for at least some pharmaceutical usage for plan holders.



CHECK YOUR PROGRESS

Q 4: Fill in the blank:

Health insurance can _____ the insured for expenses incurred from illness or injury, or pay the care provider directly.

Q 5: State whether True (T) or False (F)

Health Insurance provides financial protection to individuals with catastrophic health events (T/F)



7.8 LET US SUM UP

- Life insurance provides financial protection to surviving dependents after the death of an insured. It is also a form of investment.
- Health insurance provides access to and financial protection against medical costs in the event of an accident, injury or diagnosis

of a chronic illness that requires ongoing treatment by a specialist.

- The advantages of Life Insurance are providing security, spreading of Risk, source for collecting funds and encourages savings.
- There are different types of Life Insurance plans viz Term Life Insurance Policy, Whole Life Insurance Policy, Money Back Plan, Pension Plan and Endowment Policy.
- The advantages of health Insurance are Coverage against medical expenses, Coverage against critical illnesses, Cashless claim benefit, Additional protection over and above the employer cover and tax benefits.
- In legal terms, life insurance is a contract between an insurance policy holder known as the insured and an insurance company known as the insurer.
- Life Insurance Business at present is regulated by the provisions of the Insurance Act 1938, Life Insurance Corporation Act 1956 and IRDA Act 1999.
- The Insurance Contracts Act 1984 regulates the Life Insurance Contract which aims at ensuring that a fair balance is struck between the interests of insurers, insured parties and other members of the public, so that the provisions included in such contracts, and the practices of insurers in relation to such contracts, operate in a fair manner.



7.9 FURTHER READING

1) Mishra, M.N. & Mishra, S.B. (2016). *Insurance: Principles and Practice*. New Delhi: S. Chand Publishing.

2) Mishra, K. (2010). *Fundamentals of Life Insurance Theories and Applications*. New Delhi: PHI Learning Pvt Ltd.

3) Handbook on Health Insurance, *Issued by Insurance Regulatory and Development Authority* (IRDA)

7.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: 80D

Ans to Q No 2: a)Term b) Without profit endowment plan and with-profit endowment plan

Ans to Q No 3: a) 1984 b) 14

Ans to Q No 4: Reimburse

Ans to Q No 5: True

7.11 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q 1: Explain Life Insurance.

Q 2: Explain the concept of Health Insurance.

Q 3: Discuss in brief the functions of Health Insurance.

Q 4: Explain the advantages of Life Insurance.

Q 5: Explain the advantages of Health Insurance.

Easy type Questions (Answer each question in about 300-500 words)

Q 1: Give a detailed overview of Life and Health Insurance.

Q 2: Discuss in brief about IRDA.

Q 3: Discuss in details about the functions of Life Insurance.

Q 4: Discuss in details the legal aspects of Life Insurance.

Q 5: Explain the different plans of Life Insurance.

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