PG CM S4-04 (DSC) (Finance)

TWO YEAR MASTER'S DEGREE COURSE

(CBCS in Accordance with NEP-2020)

SEMESTER-IV

RISK MANAGEMENT AND INSURANCE

COMMERCE

Maniram Dewan School of Management

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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MASTER OF COMMERCE
RISK MANAGEMENT AND INSURANCE
(Finance Specialization)

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COURSE INTRODUCTION

Risk Management and Insurance is the forth Course of 4th Semester under *Finance Specialization* and overall the sixteenth Course of M.Com. Programme. Risk management is an important process as it empowers a business with the necessary tools so that it can adequately identify and deal with potential risks. Once a risk has been identified, it is then easy to mitigate it. Thus, risk management encompasses the identification, analysis, and response to risk factors that form part of the life of a business. Effective risk management means attempting to control, as much as possible, future outcomes by acting proactively rather than reactively and it offers the potential to reduce both the possibility of a risk occurring and its potential impact. Insurance is an arrangement by which an individual, a company or a state undertakes to provide a guarantee of compensation for specified loss, damage, illness, or death in return for payment of a specified premium.

This course which starts with the unit discussing the concept of risk consists of fourteen units. Fourteen units covers introduction to risk and risk management, risk management applications, credit risk management, introduction to insurance, nature and scope of insurance, principles of insurance, life and non-life insurance, function of insurer, insurance agent and salesmanship and regulation of insurance.

Each unit of the course includes some along-side boxes to help you know some of the difficult, unseen terms. Some “EXERCISES” have been included to help you apply your own thoughts. You may find some boxes marked with: “LET US KNOW”. These boxes will provide you with some additional interesting and relevant information. Again, you will get “CHECK YOUR PROGRESS” questions. These have been designed to self-check your progress of study. It will be helpful for you if you solve the problems put in these boxes immediately after you go through the sections of the units and then match your answers with “ANSWERS TO CHECK YOUR PROGRESS” given at the end of each unit. At the end of each section, you will get “CHECK YOUR PROGRESS” questions to check yourselves.

UNIT DISTRIBUTIONS

This course encompusses with the following fourteen Units:

Unit-1 **:** Introduction to Risk

Unit-2 : Introduction to Risk Management

Unit-3 : Risk Management Applications

Unit-4 : Credit Risk Management

Unit-5 : Introduction to Insurance

Unit-6 : Nature and Scope of Insurance

Unit-7 : Principles of Insurance

Unit-8 : Life Insurance -I

Unit -9 : Life Insurance-II

Unit-10: Non-Life Insurance -I

Unit 11 : Non-Life Insurance-II

Unit- 12: Function of Insurer

Unit-13 : Insurance Agent and Salesmanship

Unit-14 : Regulation of Insurance

UNIT-1: INTRODUCTION TO RISK

UNIT STRUCTURE

1.1 Learning Objectives

1.2 Introduction

1.3 Concept of Risk

1.4 Uncertainty and Its relationship to Risk

1.5 Differences between Risk and Uncertainty

1.6 Types of risk

1.7 Degree of Risk

1.8 Risk Distinguished from Peril and Hazard

1.9 Burden of Risk

1.10 Method of Handling Risk

1.11 Let Us Sum Up

1.12 Answers to Check Your Progress

1.13 Possible Questions

1.1 LEARNING OBJECTIVES

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

- Explain the meaning of risk
- Discuss different types of risk
- Distinguished between risk and uncertainty
- Explain the concept of degree of risk
- Explain different methods of handling risk

1.2 INTRODUCTION

While traveling you might have witnessed the collision of two vehicles on the road. A fire fighting vehicle with its alarming siren, hurrying down the street. You are in utter shock to see a blazing fire in your neighbouring building or even an ambulance racing towards the hospital. Such tragic events arouse our interest and emotions. After all the noise and chaos dies out, somewhere in your heart you feel grateful thatsuch a loss or crisis did not happen to you and you may even feel sorry for whoever suffered the loss. Many people face such losses, while

others go along happily, without ever having to face any such tragic incident or misfortune.

The possibility that similar incidents or crisis could happen to you as well as the fact, that you cannot be too sure whether they would or would not occur in your life is a condition that can be referred to as risk. Risk is a pervasive conditionof human existence. In this chapterwe will examine the concept of risk and examine several related concepts.

1.3 CONCEPT OF RISK

Economists, behavioural scientists, risk theorists, statisticians, and actuaries each have their own concept of risk. Though there is no single definition of risk, it is historically defined in terms of uncertainty. Based on this concept, **risk** *is definedas uncertainty concerning the occurrence of a loss.* For example, the risk of being killed in a car accidentis present because uncertainty is present. The risk of liver diseases for a drinker is present becauseuncertainty is present. The risk of losing capital in the stock market is present because uncertainty is present.

Risk can be defined as the chance of loss or an unfavourable outcome associated with an action. Uncertainty is not knowing what will happen in the future. The greater the uncertainty, the greater the risk.

According to the International Organisation for Standardization (ISO), the risk would be defined as a “combination of the probability of an event and its consequences”.

Vaughan & Vaughan define risk as “a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for.”

1.4 UNCERTAINTY AND ITS RELATIONSHIP TO RISK

The term *uncertainty* is often used in connection with the term *risk.* Uncertainty refers to a doubtful thought. The most widely held meaning of *uncertainty*refers to a state of mind characterized by doubt,based on a lack of knowledge about what will orwill not happen in the future. It is the opposite ofcertainty, which is a conviction or certitude about a particular situation. A learner says “I am certain Iwill get first class in this course,” which means the sameas “I am positive I will get first class in this course.” Bothstatements reflect a conviction about the outcome.Uncertainty, on the other hand, is the opposite mentalstate. If one says “I am uncertain what grade Iam going to get in this course,”

the statement reflectsa lack of knowledge about the outcome. Uncertainty,then, is simply a psychological reactionto the absence of knowledge about the future. Theexistence of risk—a condition or combination of circumstancesin which there is a possibility of loss—creates uncertainty on the part of individuals whenthat risk is recognized.The individual's conviction or lack thereof (certaintyor uncertainty) about a specific fact or situationmay ormay not coincide with the conditions ofthe real world. Uncertainty varies with theknowledge and attitudes of the person. Different attitudesare possible for different individuals underidentical conditions of the real world.

1.5 KEY DIFFERENCES BETWEEN RISK AND UNCERTAINTY

1.The risk is defined as the situation of winning or losing something worthy. Uncertainty is a condition where there is no knowledge about the future events.

2.Risk can be measured and quantified, through theoretical models. Conversely, it is not possible to measure uncertainty in quantitative terms, as the future events are unpredictable.

3.The potential outcomes are known in risk, whereas in the case of uncertainty, the outcomes are unknown.

4.Risk can be controlled if proper measures are taken to control it. On the other hand, uncertainty is beyond the control of the person or enterprise, as the future is uncertain.

5.Minimization of risk can be done, by taking necessary precautions. As opposed to the uncertainty that cannot be minimized.

6.In risk, probabilities are assigned to a set of circumstances which is not possible in case of uncertainty.



CHECK YOUR PROGRESS

Q1: Define Risk_____

Q2: Mention on distinction between Risk and Uncertainty

_____

1.6 TYPES OF RISK

Risk can be classified into several distinct classes.

They include the following:

- Pure and speculative risk
- Static and dynamic risks
- Diversifiable risk and no-diversifiable risk
- Enterprise risk

1.6.1 Pure and Speculative Risk

Pure risk is defined as a situation in which there areonly the possibilities of loss or no loss. The only possibleoutcomes are adverse (loss) and neutral (no loss).Examples of pure risks include premature death,job-related accidents, catastrophic medical expenses,and damage to property from fire, lightning, flood,or earthquake.

Speculative risk*is defined as a situation in whicheither profit or loss is possible*. For example, if youpurchase 100 shares of common stock, you wouldprofit if the price of the stock increases but wouldlose if the price declines. Other examples of speculativerisks include betting on a horse race, investingin real estate, and going into business for yourself.In these situations, both profit and loss are possible.

1.6.2 Static and Dynamic Risks

Dynamic risksare those risk which results from changes in the economy. Changes in the price level, consumer tastes, income and output, and technology may cause financial loss to members of the economy. These dynamic risks normally benefit society over the long run, since they are the result of adjustments to misallocation of resources. For example, technological changes which brings about a more efficient way of mass producing a higher quality of product at a cheaper price than previous to consumers, has obviously benefited the society. Although these dynamic risks may affect a large number of individuals, but because they do not occur regularly, they are more difficult to predict than static risk.

Static risksinvolve those losses brought about by irregular action of nature (flood, storm etc.) and the dishonest misdeed or mistake of individuals (theft etc.). Static risksare present in an economy that is not changing. If we could hold consumer tastes, output and income, and the level of technology constant, some individuals would still suffer financial loss. These losses arise from causes other than the changes in the economy, such as the perils of nature and the dishonesty of other individuals. Unlike dynamic risks, static risks are not a source of gain

to society. Static losses involve either the destruction of the asset or a change in its possession as a result of dishonesty or human failure. For example, if the economic variables remain constant, some people with fraudulent tendencies would still go out steal, embezzle funds and abuse their position. Because they are predictable, static risks are more suited to treatment by insurance than are dynamic risks.

1.6.3 Diversifiable Risk and No-diversifiable Risk

Diversifiable riskis a risk that affects only individualsor small groups and not the entire economy. It is arisk that can be reduced or eliminated by diversification.For example, a diversified portfolio of stocks,bonds, and certificates of deposit (CDs) is less riskythan a portfolio that is 100 percent invested in stocks.Losses on one type of investment, say stocks, maybe offset by gains from bonds and CDs. Likewise,there is less risk to a property and liability insurer ifdifferent lines of insurance are underwritten ratherthan only one line. Losses on one line can be offsetby profits on other lines. Because diversifiable riskaffects only specific individuals or small groups, itis also called non-systematic risk or particular risk.Examples include car thefts, robberies, and dwellingfires. Only individuals and business firms that experiencesuch losses are affected, not the entire economy.In contrast, non-diversifiable risk is a risk thataffects the entire economy or large numbers of personsor groups within the economy. It is a risk that cannotbe eliminated or reduced by diversification. Examplesinclude rapid inflation, cyclical unemployment,war, hurricanes, floods, and earthquakes becauselarge numbers of individuals or groups are affected.Because non-diversifiable risk affects the entire economyor large numbers of persons in the economy, it isalso called systematic risk or fundamental risk.

Actuarial life table-An actuarial life table is a table or spreadsheet that shows the probability of a person at a certain age dying before their next birthday. It is used often by life insurance companies.

The distinction between a diversifiable andNon-diversifiable (fundamental) risk is important

because government assistance may be necessary toinsure non-diversifiable risks. Social insurance andgovernment insurance programs, as well as governmentguarantees or subsidies,may be necessary toinsure certain non-diversifiable risks. For example, the risks of widespread unemploymentand flood are difficult to insure privately.

1.6.4 Fundamental and Particular Risk

Fundamental risks involvelosses that are impersonal in origin and consequence.They are group risks, caused for the mostpart by economic, social, and political phenomena,although they may also result from physical occurrences.They affect large segments or even all of the

population. Particular risks involve losses that ariseout of individual events and are felt by individualsrather than by the entire group. They may be staticor dynamic. Unemployment, war, inflation, earthquakes,and floods are all fundamental risks. Theburning of a house and the robbery of a bank areparticular risks.

1.6.5 Enterprise Risk

Enterprise risk is a term that encompasses all major risks faced by a business firm. Such risks include pure risk, speculative risk, strategic risk, operational risk, and financial risk. We have already explained themeaning of pure and speculative risk. *Strategic risk* refers to uncertainty regarding the firm's financial goals and objectives; for example, if a firm enters a new line of business, the line may be unprofitable. Operational risk results from the firm's business operations. For example, a bank that offers online banking services may incur losses if "hackers" break into the bank's computer. Enterprise risk also includes financial risk, which is becoming more important in a commercial risk management program. Financial risk refers to the uncertainty of loss because of adverse changes in commodity prices, interest rates, foreign exchange rates, and the value of money. For example, a food company that agrees to deliver cereal at a fixed price to a supermarket chain in six months may lose money if grain prices rise. A bank with a large portfolio of Treasury bonds may incur losses if interest rates rise. Likewise, an American corporation doing business in Japan may lose money when Japanese yen are exchanged for American dollars.Enterprise risk is becoming more important incommercial risk management, which is a processthat organizations use to identify and treat majorand minor risks.

1.7 DEGREE OF RISK

Actuarial life table-An actuarial life table is a table or spreadsheet that shows the probability of a person at a certain age dying before their next birthday. It is used often by life insurance companies.

There are some situationsin which the risk is greater than in other situations.The most commonly acceptedmeaning of *degree of risk* is related to the likelihoodof occurrence. We intuitively consider those eventswith a high probability of loss to be "riskier" thanthose with a low probability. When risk is defined as the possibility of anadverse deviation from a desired outcome that isexpected or hoped for, the degree of risk is measuredby the probability of the adverse deviation.In the case of the individual, the hope is that noloss will occur, so that the probability of a deviationfrom what is hoped for (which is the measure ofrisk) varies directly with the probability that a losswill occur. In the case of the individual, we measurerisk in terms of the probability of an adverse deviationfrom what is hoped for. Actuarial tables tell us,for example, that the probability of death at age 60is approximately 1 percent and that at age 83 it isabout 10 percent. At age 96, the probability of deathincreases to nearly 30 percent. Using the probabilityof an adverse deviation from the outcome thatis hoped for, we view the risk of death at age 83 asgreater than that at age 60, but less than that at age96. The higher the probability that an event will occur,the greater the likelihood of a deviation from theoutcome that is hoped for and the greater the risk,as long as the probability of loss is less than one.

At times we use the terms *more risk* and *less risk* to indicate a measure of the possible size of theloss. Many people would say that there is more riskinvolved in a possible loss of Rs.1000 than in that ofRs.1, even though the probability of loss is the samein both cases. The probability that a loss may occurand the potential severity of the loss if it doesoccur contribute to the intensity of one's reactionto risk. It seems, therefore, that a measurement ofrisk should recognize the magnitude of the potentialloss. Given two situations, one involving a Rs.1000exposure and the other a Rs.1 exposure, and assuming the same probability in each case, it seems appropriate to state that there is a greater risk in the case ofthe possible loss of Rs.1000.



CHECK YOUR PROGRESS

Q3: Define pure risk. _____

Q4: What is meant by degree of risk?_____

1.8 RISK DISTINGUISHED FROM PERIL AND HAZARD

It is not uncommon for the terms peril and hazard tobe used interchangeably with each other and withrisk. However, to be precise, it is

important to distinguishthese terms.A peril may be defined as the cause of a loss. Peril means danger, and it has a connotation of imminent danger. A rockslide is a peril to anyone standing underneath the cliff when the rocks start sliding. Other examples of peril include falling, crashing your car, fire, wind, hail, lightning, water, volcanic eruptions, falling objects, illness, and death.

Hazard is a condition that increases the chances of a loss arising from a peril. For example, an accident may be the cause of a permanent and total disability. It is possible for something to be both a peril and a hazard. For instance, sickness isa peril causing economic loss, but it is also a hazardthat increases the chance of loss from the perilof premature death. Hazards are normally classifiedinto three categories:

Physical hazards consist of those physical propertiesthat increase the chance of loss from thevarious perils. Examples of physical hazards are the type of construction, the location ofthe property, the occupancy of the building etc.

Moral hazard refers to the increase in the probabilityof loss that results fromdishonest tendenciesin the character of the insured person. A dishonestperson, in the hope of collecting from the insurancecompany, may intentionally cause a loss ormay exaggerate the amount of a loss in an attemptto collect more than the amount to which he orshe is entitled. Fraud is a significant problem forinsurance companies and increases the cost ofinsurance.

1.9 BURDEN OF RISK

The greatest burden in connection with risk is that some losses will actually occur. When a house is destroyed by fire, or a vehicle is ruined in a crash, or a breadwinner dies or money is stolen or you negligently injure a person or damage his property, financial losses would be involved. In addition to the financial cost of losses brought about by risk, there is the pain of fears and worries resulting from the uncertainty as to whether or not loss would occur. All these underwrite the need why a prudent individual and society should prepare for a possible occurrence of loss. The greatest burden of risk, therefore is loss.

1.10 METHOD OF HANDLING RISK

We are living in a world of risk. Risk is all pervading. Risk is very disgusting. But no matter how disgusting risk is, and how much we try

to run away from it, we can never succeed in our desire to avoid exposing ourselves to risks.

For example, if you are afraid to travel in plane because of the fear of plane crash, you may decide to travel in a car. By doing so, you have merely decided not to expose yourself to the risk of plane crash and instead choose to expose yourself to the risk of car crash. This means that, if you must travel at all, you cannot avoid exposing yourself to one type of risk or the other, but you may have the opportunity to choose the type of risks to which you wish to expose yourself.

The existence of risk is a source of pain, anguish and misery to people and the accompanying uncertainty causes great anxiety and mental worry.

Because risk is unpleasant distasteful and therefore undesired, the rational nature of man has led him to attempt to finding effective ways of dealing with risks. There are many techniques of dealing with, the problem of risk.

The most important methods of dealing with risk includes:

- Risk avoidance
- Risk retention
- Risk transfer
- Insurance
- Transfer of risk through contracts
- Transfer of risk through the process of hedging
- Incorporation of a business firm

1.10.1 Risk Avoidance

Avoidance is a method for mitigating risk by not participating in activities that may cause damage. For example, if you do not want undertake the risk of divorce, you would have to refrain from marrying, if a company wants to avoid the risk of being sued for producing a defective product, then it would not engage in producing or manufacturing any product. If you want to avoid the risk associated with owing and running a business enterprise, you would simply refuse to establish one.

It is a negative method of dealing with risk because it hinders progress. As a result of this, risk avoidance is an unsatisfactory method of dealing with many risks.

1.10.2 Risk Retention or Risk Assumption

Retention is the acknowledgment and acceptance of a risk as given. Risk retention or risk assumption is the same. Usually, this accepted risk is a cost to help offset larger risks down the road, such as opting to select a lower premium health insurance plan that carries a higher deductible rate. The initial risk is the cost of having to pay more out-of-pocket medical expenses if health issues arise. If the issue becomes more serious or life-threatening, then the health insurance benefits are available to cover most of the costs beyond the deductible. If the individual has no serious health issues warranting any additional medical expenses for the year, then they avoid the out-of-pocket payments, mitigating the larger risk altogether.

Voluntary (Active) Risk Retention

A voluntary (Active) risk retention exists in a situation in which an individual knowingly retains risk to himself and assume the loss involved. This may be due to the fact that the individual has no alternative way of dealing with the risk. For example, if you insure your car, the insurer may impose an excess for small losses. In this case, you will be responsible and keep to yourself such small losses. Excess is the amount of loss under a policy which the insured retains with himself. A company may insure its stocks with a deductible imposed.

Involuntary (Passive) Risk Retention

Risk can be retained involuntarily (passively). This occurs when the individual exposed to the risk is not aware of the existence of the risk and unknowingly retains the risk in ignorance. Through his ignorance, laziness or sheer indifference, the individual retains the financial consequence of the possible loss. This could be very dangerous, if the risk that is retained is sufficiently high as to involve the individual in great financial loss that could possibly ruin him/her. For example, most of people in India are not aware of most of the risks to which they are exposed. As a result of this, they do nothing to take insurance cover and simply retain all risks to themselves. In the event of any misfortune, they suffer very heavily.

1.10.3 Risk Transfer

This is another technique for handling risk. Risk can be transferred from one person who is not willing to bear a risk to another person who is more willing and abler to bear the risk. The use of health insurance is an example of transferring risk because the financial risks associated with health care are transferred from the individual to the insurer.Risk can be transferred by different methods which include:

1.10.4 Insurance

Risk transfer is most often accomplished through an insurance policy. This is a voluntary arrangement between two parties, the insurance company and the policyholder, where the insurance company assumes strictly defined financial risks from the policyholder. In very simple terms, if a worker is injured, the insurance company pays the cost. If a building burns down, the insurance company pays to replace it. Insurance companies charge a fee, or an insurance premium, for accepting this risk. In addition, there are deductibles, reserves, reinsurance and other financial agreements that modify the financial risk the insurance company assumes.

1.10.5 Transfer of Risk through Contracts

Risk transfer can also be accomplished through non-insurance agreements such as contracts. These contracts often include indemnification provisions. An indemnity clause is a contractual provision in which one party agrees to answer for any specified and unspecified liability or harm that the other party might incur. An indemnity clause also can be termed a hold-harmless or save-harmless clause. Indemnification agreements are completely independent of insurance coverages and transfer the financial consequences of legal liability from one party, the indemnitee, to another, the indemnitor. In addition to direct financial losses, some contracts may also transfer legal defense or product recall costs.

1.10.6 Transfer of Risk through the Process of Hedging

Risk can be transferred through the process of hedging. Hedging is the method of transferring risk of unfavourable price fluctuations to a

speculator by purchasing and selling future contracts on an organized commodity market. You could buy a hedge or sell a hedge. Buying hedge is the forward purchase in order to avoid a possible future increase in the price of the commodity, while selling hedge is the forward sales of a commodity in order to avoid a possible future fall in the price of the commodity.

For example, A. a paddy producer receives an order worth Rs.100,000 to be delivered 90 days after receipt of the order. In this case, A runs the risk of rise in price of paddy at the time it is to be delivered. If A perceives that the risk is higher than what he is prepared to bear he can take step to protect himself against such future rise in price. This, he can do by buying the paddy now at a low price for delivery in 90 days' time. Under this arrangement A would be able to avoid future rise in price of paddy and still make his margin of profit by the difference between his current selling and purchase prices. As a result of this, potential losses would be avoided.

On the other hand, B, a rice merchant anticipates that price would fall in future and sells his stock of rice now at a high price and immediately enters into a purchase contract to buy rice in future at a lower price. If his judgment is correct, and price falls sufficiently well, he would have succeeded in avoiding making a loss. His profit per measure of rice would be his selling price now and his buying price in future and by this succeeds in handling the risk of potential loss by hedging.

1.10.7 Incorporation of a Business Firm

Establishment of a firm is a method of transferring risk from an individual or a sale proprietorship on to a corporate body. If a firm is a sole proprietor, the personal assets of the owners in addition to the assets of the firm can be attached by creditors in satisfaction of their debts. In this case the liability of the owners in unlimited. However, if the firm is incorporated, then it acquires a status of its legal personality which is distinct and separate from that of its legal personality which is distinct and separate from that of its owners. By this it can own properties, enters into contracts, sued and be sued. It becomes a separate legal entity.

Given the vast array of risks faced by individuals and businesses and the variety of possible ways to deal with them, a systematic ap-

proach is needed in dealing with risks. In the next chapter we will discuss risk management.



CHECK YOUR PROGRESS

Q5: Mention two methods of transferring risk.



1.11 LET US SUM UP

- Though there is no single definition of risk, it is historically defined in terms of uncertainty.
- Risk can be classified into several distinct classes such as Pure and speculative risk, Static and dynamic risks, Diversifiable risk and no-diversifiable risk, Enterprise risk etc.
- The most commonly accepted meaning of *degree of risk* is related to the likelihood of occurrence.
- The most important methods of dealing with risk includes: Risk avoidance, Risk retention, Risk transferetc.



1.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1. Risk is defined as uncertainty concerning the occurrence of a loss.

Ans to Q No.2.

a) The potential outcomes are known in risk, whereas in the case of uncertainty, the outcomes are unknown.

b) Risk can be controlled if proper measures are taken to control it. On the other hand, uncertainty is beyond the control of the person or enterprise, as the future is uncertain.

Ans to Q No.3. Pure risk is defined as a situation in which there are only the possibilities of loss or no loss.

Ans to Q No.4. The most commonly accepted meaning of *degree of risk* is related to the likelihood of occurrence.

Ans to Q No. 5 Transfer of risk through Insurance and contracts



1.13 MODEL QUESTIONS

Q.No.1. Define risk.

Q. No.2 Define diversifiable risk.

Q.No.3. Define pure risk.

Q.No.4. Define fundamental risk

Q.No.5. Define enterprise risk

Q.No.6. Distinguished between risk and uncertainty.

Q.No.7. Discuss different types of risk.

Q.No.8. Discuss different Methods of handling risk.

****

UNIT 2: INTRODUCTION TO RISK MANAGEMENT

UNIT STRUCTURE

2.1 Learning Objectives

2.2 Introduction

2.3 Meaning of Risk Management

2.4 Enterprise Risk Management

2.5 Essentials of Risk Management

2.6 Elements of Risk Management

2.6.1 Risk Assessment

2.7 Contribution of The Risk Management to Organization

2.8 World-Wide Risk Sharing

2.9 Let Us Sum Up

2.10 Further Readings

2.11 Answers to check your progress

2.12 Model questions

2.1 LEARNING OBJECTIVES

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

- understand the meaning of risk management
- explain the concept of enterprise risk management
- discuss the process of risk management
- know the elements of risk management
- know the contribution of risk management towards the organisation

2.2 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.

2.3 RISK MANAGEMENT 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'. But 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 as "*Risk management is a scientific approach to dealing with risks by anticipating possible losses and designing and implementing procedures that minimize 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. As Collier and Agyei-Ampomah (2006) stated that to study risk management of an enterprise it is pertinent to understand the *risk appetite* and *risk culture* 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 of each other.

2.4 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:

i. **Market risk**- Market risk arises due to unexpected changes in the market prices like interest rate, prices of supplies required for production, etc.
ii. **Credit risk**- The risk of bad debt for a business is a credit risk.
iii. **Liquidity risk**- A business faces liquidity risk when its liquid assets are insufficient to discharge the current liabilities.
iv. **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.
v. **Reputational risk**- A negative publicity of the business may beget reputational risk.
vi. **Strategic risk**- The probability of futile execution of the organisation's strategy.
vii. **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, still 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

Q1: Whatis risk management?

Q2: What are the different risks under the ambit of enterprise risk management?

2.5 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 gets intertwined while applying in an organisation setting.

2.5.1 The Process of risk management

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



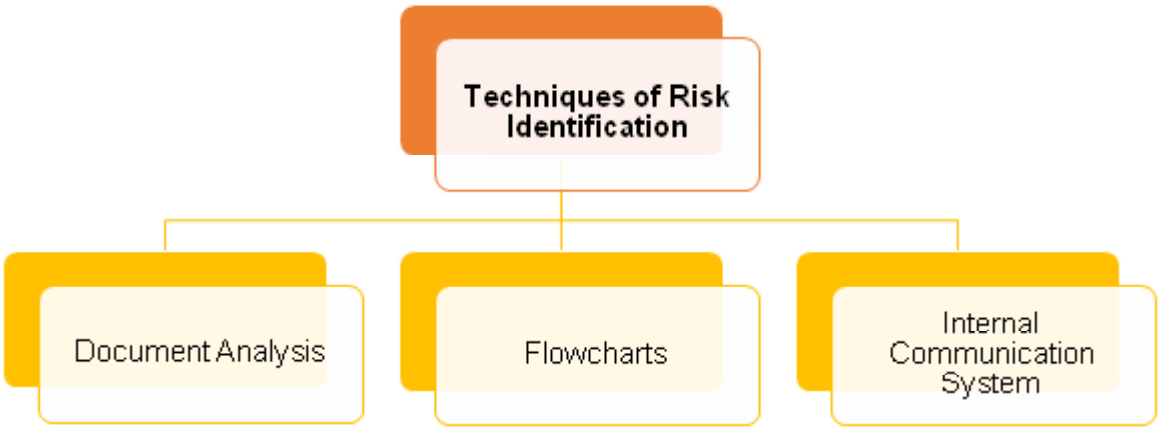
2.5.1.1 Setting the objectives

Setting the *objective* 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.

2.5.1.2 Risks 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:



i. 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 future.

ii. 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.

iii. 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.

2.5.1.3 Risks 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:

i. **critical risks**- the loss due to critical risks leads to bankruptcy of the firm

ii. **important risks**- the loss out of important risks has to be managed by borrowing external funds for continuity and survival, and

iii. **unimportant risks**- the losses suffered due to this type of risks can be managed with internal assets and resources.

2.5.1.4 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.

i. **accepting risks**- those risks need to be accepted whose returns are more than the costs.

ii. **avoiding risks**- if costs are more than the return.

iii. **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.

iv. **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.

2.5.1.5 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.

2.5.1.6 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 was 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

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



CHECK YOUR PROGRESS

Q3: What are the steps in risk management process?

_____

_____

Q4: What are the techniques of risk identification?

_____

_____

Q5: What do you mean by risk evaluation ?

_____

_____

2.6 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 also to an organisation. 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.

2.6.1 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.

i. 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.

ii. 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 tool for assessing the magnitude and probability of the risks.

iii. 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).

iv. Assessing risks interaction

An insignificant risk also has the ability to create havoc in an organisation since risks doesn't 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.

v. Prioritising risks

Prioritising risks is required to decide which risks to be responded 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.

vi. 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*).

2.7 CONTRIBUTION OF THERISK MANAGEMENT TO ORGANIZATION

By implementing a risk management plan and considering the various potential risks or events before they occur, an organization can save money and protect their future. This is because a robust risk management plan will help a company establish procedures to avoid potential threats, minimize their impact should they occur and cope with the results. This ability to understand and control risk enables organizations to be more confident in their business decisions. Furthermore, strong corporate governance principles that focus specifically on risk management can help a company reach their goals.

Other important benefits of risk management include:

- Creates a safe and secure work environment for all staff and customers.
- Increases the stability of business operations while also decreasing legal liability.
- Provides protection from events that are detrimental to both the company and the environment.
- Protects all involved people and assets from potential harm.
- Helps establish the organization's insurance needs in order to save on unnecessary premiums.

2.8 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.



2.9 LET US SUM UP

- Vaughan and Vaughan defines risk management as "*Risk management is a scientific approach to dealing with risks by anticipating possible losses and designing and implementing procedures that minimize 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.



2.10 FURTHER READINGS

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.



2.11 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No. 1: A scientific approach to prevent or minimise the risks which may affect an enterprise is known as risk management.

Ans to Q No. 2: Market risk, credit risk, liquidity risk, operational risk, reputational risk, strategic risk and compliance risk.

Ans to Q No. 3: 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. 4: The techniques of risk identification are- document Analysis, flowcharts and internal communication system.

Ans to Q No. 5: The *evaluation* step of the risk management process includes the ranking of different risks which may encounter a business.



2.12 MODEL QUESTIONS

Q1: Discuss in detail the concept of risk management.

Q2: What is enterprise risk management? Discuss in detail the different risks managed by ERM.

Q3: Write a detailed note on the risk management process.

Q4: How risks are evaluated and what needs to be done for implementing the technique of risk management in the organisation?

Q5: Discuss in detail the process of risk assessment.

Q6: How risk management contribute to the organisation?

UNIT 3: RISK MANAGEMENT APPLICATIONS

UNIT STRUCTURE

3.1 Learning Objectives

3.2 Introduction

3.3 The Rules of Risk Management

- 3.3.1 Don't Risk More Than You Can Afford to Lose
- 3.3.2 Consider the Odds
- 3.3.3 Don't Risk a Lot for a Little

3.4 Risk Control Techniques

3.5 Risk Financing

3.6 Risk management decision making

3.7 Risk management decision making in business

3.8 Let us Sum Up

3.9 Further Readings

3.10 Answers to Check Your Progress

3.11 Model Questions

3.1 LEARNING OBJECTIVES

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

- understand the rules of risk management
- discuss various risk control techniques
- know about risk financing

3.2 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 are certain rules and technique of risk management. The unit will discuss some rules and technique of risk management.

3.3 THE RULES OF RISK MANAGEMENT

One of the earliest contributions to the risk management field was the development of a set of "rules of risk management."[1] These rules are simply common sense principles applied to risk situations. They are:

1. Don't risk more than you can afford to lose.

2. Consider the odds.

3. Don't risk a lot for a little.

Simple as they appear, these three rules provide a basic framework within which risk management decisions can be made. Unfortunately, they are sometimes misunderstood and are often neglected.

3.3.1 Don't Risk More Than You Can Afford to Lose

The first of the three rules, "Don't risk more than you can afford to lose," is the most important. Although it does not necessarily tell us *what* should be done about a given risk, it does identify the risks about which *something* must be done. If we begin with the recognition that when nothing is done about a particular risk, that risk is retained, identifying the risks about which something must be done resolves into determining which risks cannot be retained. The answer is explicitly stated in the first rule. The most important consideration in determining which risks require some specific action is the maximum potential loss that might result from the risk. If the maximum potential loss from a given exposure is so large that it would result in an unbearable loss, retention is not realistic. The possible severity must be reduced to a manageable level or the risk must be transferred. If severity cannot be reduced and the risk cannot be transferred, it must be avoided. In decision theory terms, "Don't risk more than you can afford to lose" identifies the decisions for which the minimax cost or minimax regret strategy is appropriate.

(Footnotes)

[1] These rules appeared in the first edition of Robert I. Mehrand Bob A. Hedges, *Risk Management in the Business Enterprise* (Homewood, Ill.: Richard D. Irwin, 1963), pp. 16–26.

3.3.2 Consider the Odds

If an individual can determine the probability that a loss may occur, he or she is in a better position to deal with the risk than would be the case without such information. However, it is possible to attach undue significance

to such probabilities, since the probability that a loss may or may not occur is less important than the possible severity if it does occur. Even when the probability of loss is low, the primary consideration is the potential severity. This is not to say that the probability associated with a given exposure is not a consideration in determining what to do about that risk. Just as the potential severity indicates the risk about which something must be done (i.e., the risks that cannot be retained), knowing whether the probability that a loss will occur is slight, moderate, or quite high can assist the risk manager in deciding what should be done about a given risk (although not in the way that most people think).

A high probability is an indication that insurance is probably not an economical way of dealing with the risk. This is because insurance operates on the basis of averages. Based on past experience, the insurer estimates the amount that it must collect in premiums to cover the losses that will occur. In addition to covering the losses, the amount must cover the insurer's other expenses. Therefore, paradoxical though it may seem, the best buys in insurance involve those losses that are least likely to happen. The higher the probability of loss, the less suitable is insurance as a device for dealing with the exposure. The best buys in insurance are those in which the probability is low and the possible severity is high. The worst buys are those in which the size of the potential loss is low and the probability of loss is high. The most effective way to deal with those exposures in which the probability of loss is high is through loss prevention measures aimed at reducing the probability of loss.

The second rule of risk management, "Consider the odds," suggests that the likelihood or probability of loss may be an important factor in deciding what to do about a particular risk. But which risks? Logically, consideration of the odds is limited to those situations in which the first rule, "Don't risk more than you can afford to lose," does not apply. For decisions in which one of the possible states of nature is ruin, the minimax cost or minimax regret strategies are appropriate. Having limited our application of probability to situations in which ruin is not one of the possible outcomes or states of nature, it should be noted that even in this limited set of decisions, situations in which probability theory is useful abound. Among the more fertile fields for analysis are the selection of deductibles, and the decision to insure or retain moderate losses.

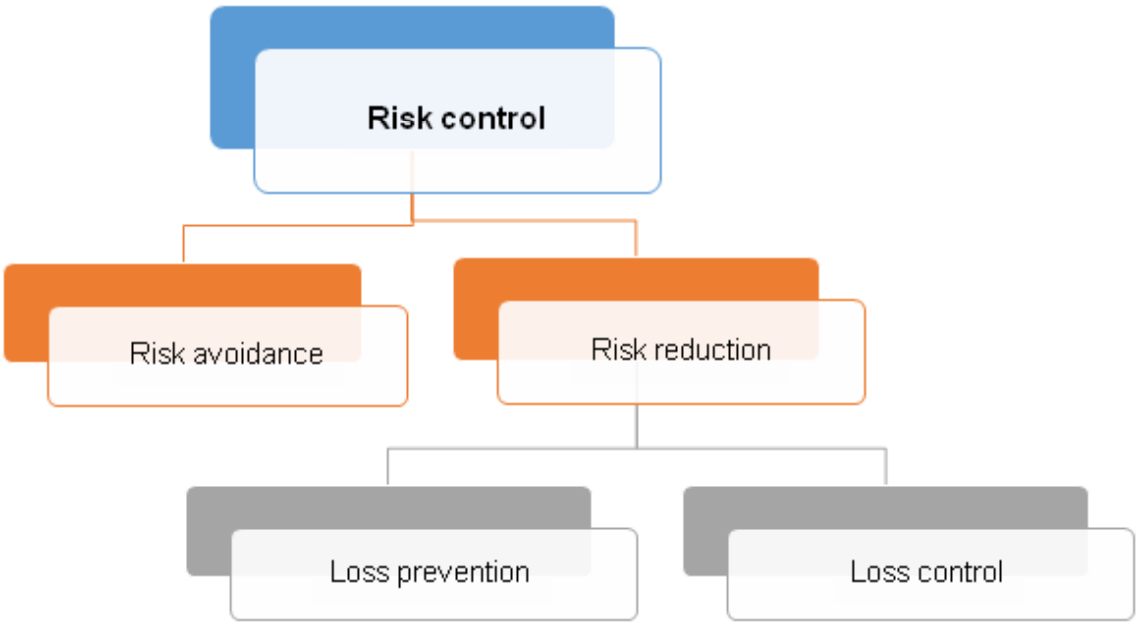
3.3.3 Don't Risk a Lot for a Little

Although the first rule provides guidance for those risks that should be transferred (those involving catastrophic losses in which the potential severity cannot be reduced), and the second rule provides guidance for those that

should not be insured (those in which the probability of loss is very high), a residual class of risks remains for which another rule is needed. The third rule dictates that there should be a reasonable relationship between the cost of transferring risk and the value that accrues to the transferor. The rule provides guidance in two directions. First, risks should not be retained when the possible loss is large (a lot) relative to the premiums saved through retention (a little). On the other hand, there are instances in which the premium that is required to insure a risk is disproportionately high relative to the risk transferred. In these cases, the premiums represent "a lot" while the possible loss is "a little." Although the rule "Don't risk more than you can afford to lose" imposes a maximum level on the risks that should be retained, the rule "Don't risk a lot for a little" suggests that some risks below this maximum retention level should also be transferred. The maximum retention level should be the same for all risks, yet the actual retention level for some exposures may be less than this maximum.

3.4 RISK CONTROL TECHNIQUES

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:



i. 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 it can be reduced. This technique must be resorted to by an organisation only as the last option and should not be opted at all the times.

ii. 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.

a. 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. Doing so, the business succeeds in preventing the number of losses and also able to save the costs it had to incur to cover the loss.

b. 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.

3.5 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.

i. 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 manager 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, reduce or avoid 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. But 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.

ii. 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.



CHECK YOUR PROGRESS

Q1: Mention two techniques of Risk control

_____

_____

Q2: What are the two techniques of risk reduction (Answer in about 15 words)

_____

_____

Q3: What are the common methods of risk transfer? (Answer in about 15 words)

_____

_____

3.6 RISK MANAGEMENT DECISION MAKING

Risk management is the process to identify risks and plan actions to manage the risks. The identified risks are assessed to determine significant risks. Significant risks are risks preventing firms from achieving business objectives or risks disrupting core business process. Firms then plan the best way to minimize the risks. Identifying significant risks enable firms not only to manage risks that matters but to efficiently allocate resources to manage the risks. A firm is exposed to many risks. Managing the risks involves many tasks. If the tasks are not structured firms will be overwhelmed by the number of actions to undertake to manage each risk. Risk management is a tool to structure the tasks. Risk management provides a step by step process to manage risks. The steps start with identifying risks firms are exposed to, assess the risks to determine significant risks and plan responses to the risks. Risk management is an iterative process. The process must be reviewed from time to time. New risks emerge, some risks do not materialize, venture into new market and the development of new risk response methods are some of the reasons firms needs to review risk management. The four steps (identify, assess, plan and review) are the basis to undertake risk management.

A key part of risk management is making decisions. Borge (2001) states the power of risk management lies in the ability of the risk manager to make good decisions. Risk management decision making is selecting the best

alternatives or ranking the alternatives for a specific risk management goal. For example, identifying risks face is risk management. Choosing the best method to identify risk with the aim to expedite the risk management process is risk management decision making. Determining significant risks affecting core business is risk management. Ranking the significant risks based on criteria such as is the risk transferable, does the risk have a long term effect on the firm or does the firm has the resources to manage the risk is risk management decision making. Techniques to implement risk management are well developed. Among the techniques to identify risks are Brainstorming, Delphi Technique and Scenario Analysis. Among the techniques to assess risks are risk mapping and risk matrix chart. The techniques enable firms to determine important risks and decide the best actions to manage the risk. However, the decisions are based on only one factor basically risks affecting business objectives or risks affecting core business process. In practical firm have to consider many factors and face with many alternatives in making decision in risk management. Risk management decisions rarely involve only one or two criteria or a yes and no answer.

Grunig and Kuhn (2005) states a complex problem has at least one of the following criteria; the problem has many dimensions, problem parameters are interdependent creating an unclear problem structure, more than one department in the company is included in the problem, a large number of possible solutions exist and environment where the decision is made is uncertain. If none of the criteria exist, the problem is a simple decision problem. Risk management decision problem fits the characteristics of a complex problem. Decision problems in risk management are unstructured with many criteria influencing the problem and solutions to the problem. Risks are interrelated and evolves requiring constant reviewing of the decisions. Decision making in risk management requires a tool able to handle conflicting multiple factors across different range of risk management situations. Risk management decision making consists of three areas:

Risk identification and assessment. How to identify risks? What is the best method to obtain a comprehensive list of risks? How to determine which risks are important? The central issue is to determine which risks are significant and what are the factors to use to determine the significance of the risks?

Risk responses. How much risk firms are willing to take? What is the best method to address the risks? How to choose the best method? How much

resources firms are willing to allocate to manage the risks? The central issue is to address the prioritized list of risks with a concrete risk response planning.

Risk review. The environment where the decision is made changes over time. New information or new alternative emerges forcing firms to consider previous decisions. The purpose of risk review is to monitor the effectiveness of the chosen risk response and to monitor new risks.

3.7 RISK MANAGEMENT DECISION MAKING IN BUSINESS

Businesses face decisions about risk nearly every day. From equipment purchases to new hires to acquisitions and closures, each business decision carries an element of risk. The key aspect of making the right business decisions comes from determining the balance between risk and reward. Companies that expose themselves to high risks with minimal rewards can gamble themselves right out of business. At the other extreme, firms that play it too safe can miss out on growth opportunities they need to survive and thrive in a competitive marketplace. Following steps can be followed by a business organisation while making risk management decisions:

Identifying Risks

Before a business can make a decision about risks, the company must identify those risks. The sources of these risks can be from the outside, such as weather events or market fluctuations, or they can be internal, such as capital acquisitions and training expenses. Companies must identify where those risks can occur, the conditions that can bring those risks into reality and the potential damage to the business for ignoring those risks.

Prioritizing Risks

When identifying risks, businesses should also determine the probability that those risks will occur. Businesses that face risks that carry heavy consequences and a high probability of occurring must protect themselves against those risks first. A company based in a desert is less likely to deal with blizzard conditions as a business risk than one in a location that sees snowfall every winter, so the firm would not focus its decision-making efforts on handling such a risk.

Developing Strategies

Another aspect of the decision-making process lies in the development of a strategic plan. This plan can give businesses the tools they need to prevent the risks that they can avoid and reduce the damage of those they cannot stop. A strategic plan also prevents the business owners from be-

ing caught by surprise by the consequences of foreseeable risks. This preparation eases much of the decision-making process and gives business owners the tools they need to make the right calls.

Measuring Progress

When potential risks become unwelcome facts, businesses must also measure and assess their decision-making processes. Business owners must measure the effectiveness of their methods, learn where mistakes were made and adapt their tactics as needed. As market conditions, legal regulations, technological innovations and customer tastes change, new risks will inevitably arise. These changes require the business to identify and prioritize these new risks, develop new strategies and reassess the strengths and weaknesses of these new processes.



CHECK YOUR PROGRESS

Q.4. Mention one technique of identify risks

Q.5. Mention one techniques of assessing risks.



3.8 LET US SUM UP

- 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 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.
- A key part of risk management is making decisions.



3.9 FURTHER READINGS

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.



3.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No. 1: Risk avoidance and risk reduction.

Ans to Q No. 2: Loss prevention and loss control

Ans to Q No. 3: Insurance, hedging, contractual arrangements are the common methods of risk transfer

Ans to Q No. 4: Brainstorming, Delphi Technique

Ans to Q No. 4: Risk mapping and risk matrix chart



3.11 MODEL QUESTIONS

Q1: Discuss the rules of risk management.

Q2: Explain various risk control techniques.

Q3: What is risk financing? Discuss the techniques of risk financing.

Q.4. What is risk management decision making?

****

UNIT 4: CREDIT RISK MANAGEMENT

UNIT STRUCTURE

4.1 Learning Objectives

4.2 Introduction

4.3 Credit Risk Management

4.4 Importance of Credit Risk Management

4.5 Credit Risk Assessment Methods

4.6 Expected Losses and Unexpected Losses

4.7 Controlling Credit Risk

- 4.7.1 Managing the Loss Given Default
- 4.7.2 Diversification
- 4.7.3 Convenants
- 4.7.4 Risk Pricing
- 4.7.5 Provision

4.8 Let us sum up

4.9 Further readings

4.10 Answers to check your progress

4.11 Model questions

4.1 LEARNING OBJECTIVES

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

- Understand the concept of credit risk management
- know the methods of assessing credit risk
- comprehend the technique for controlling credit risk

4.2 INTRODUCTION

Credit risk management is important for any lender to ensure that the obligation is repaid by the obligor on time. The obligor's failing to repay the money lead to the lender suffering monetary losses. It is very important for any lender to assess the ability of the borrower to repay the money. There are different assessment methods to do the same. Credit risk management is vital for any lender for its survival and profitability. However, in spite of all the measures undertaken to assess the credit risk of a potential

borrower there remains a risk of loss. The discussion in this unit will delve in detail the different facets of credit risk management.

4.3 CREDIT RISK MANAGEMENT

4.3.1 Meaning

Credit risk begins when one party owns a fund from the other party. If there remains a probability that the other party (also referred as counterparty) may fail to honour the liability as per the stated terms and conditions, credit risk arises.

According to Bouteillé and Coogan-Pushner, "*Credit risk is the possibility of losing money due to the inability, unwillingness, or non-timeliness of a counterparty to honour a financial obligation*". The counterparty having a liability to pay is also known as obligor. It is thus important to analyse the credit risk as it may affect the profitability of the business due to non-payment of the fund from the counterparty. Credit risk is also popularly known as *default risk*, *performance risk* and *counterparty risk*. Credit risk can be mathematically expressed as:

Credit Risk = Exposure X Probability of default (1 – Recovery rate), *where*

Exposure means the counterparty owing fund to the lender and has the chance to default;

Probability of default is the extent of possibility that the counterparty may fail to honour the obligation;

Recovery rate is the percentage of fund that can be recovered in the event of the failure to meet the obligation by the counterparty.

It is noteworthy to mention that higher the exposure and probability, higher is the credit risk. Conversely, higher the recovery rate; less is the credit risk (Brown and Moles, 2014). To reduce credit risk, it is important for a business to properly identify; measure and manage the risk. The credit risk also magnifies when the contract period is long as with every passing day there is a risk that the counterparty may fail to honour the obligation. Conceptually, credit risk is a part of market risk since due to the counterparties' inability to honour the obligation leads to the changes in the market value of financial portfolio of a firm. Being a part of market risk, credit risk is also influenced by the different types of asymmetric information problem. Empirical studies have proved that asymmetric information in the nature of adverse selection and moral hazard impacts the credit market.

4.3.2Adverse Selection and Credit Risk

The problem of adverse selection affects the 'credit businesses'. In case of a bank loan, the borrower is aware about his position whether s/he

will be able to return the principal amount of loan (credit) along with interest as per the terms and conditions of the credit or s/he will default. This information is private to the borrower and the bank in no way can know for certainty the credit worthiness of the borrower. Accordingly, it is for the bank to make a value judgement and has to correctly identify the good borrowers from the potential bad borrowers. If bank is unable to distinguish between the good borrowers and the bad borrowers, then bank may face the problem of adverse selection. To tide over this scenario banks in most cases either limit the access to credit or set the interest rate high so that it can filter out the bad borrowers from the good borrowers. As a result, the bad borrowers may still find it attractive to access the credit whereas the good borrowers may find it unattractive. If in the pool of borrowers, the good borrowers are more in numbers the bank can end up in having very less or no business at all due to the high interest rate. Hence, it is said that in credit business there remains the problem of adverse selection.

4.3.3 Moral Hazard and Credit Risk

The problem of moral hazard occurs when after acquiring the credit from the financial institution, the borrowers engage in some reckless activities which in turn may lead to the credit becoming bad debt. The problem is more prevalent in case of big credits being sanctioned to the borrowers. So as to have a check over this problem, the financial institution may restrict the access to credit to the borrowers who opt for large credit amount.

4.3.4 Types of credit risk

With the expansion of business and also the innovative financial dealings, there is a greater probability of credit risk. Even though the credit risks are common still we can identify some risks which are quite unique. In this section we will discuss the different types of credit risk:

i. **Lending activities:** In lending activities there is involvement of fund and thereby arises the credit risk since the counterparty is having a liability to repay the loan amount.

ii. **Lease business:** The lessor lends the asset to the lessee in return of periodical payment. If, the lessee fails to pay the lease rent, there is credit risk.

iii. **Credit sale of goods and/or services:** The risk arises if the buyer fails to pay for the goods and/or services.

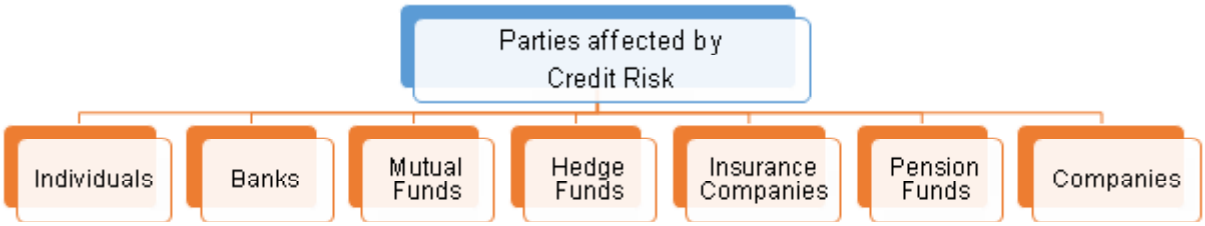
iv. **Buying prepaid goods and/or services:** Risk arises if the buyer doesn't receive the goods and/or services as per stipulated terms and conditions.

v. **Claim on asset kept with another party:** One of the examples of this is bank deposit. The depositors keep their money with the bank. Subsequently, banks lend the money to its counterparty. If due to some unforeseen circumstances, banks' lending turns to be bad debt, then the bank also will be unable to repay the bank deposits to its depositors. India has in recent past seen many banks finding it difficult to return the money to its deposit account holders. One of the recent examples is Punjab and Maharashtra Co-operative Bank.

vi. **Contingent liability:** Failure to honour the contract in the event of happening of certain event. For example, insurance company failing to indemnify the loss of the policyholder.

4.3.5 Credit Risk- Who is at risk?

Credit risk affects individuals, financial institutions and also non-financial institutions. Depicted below are the different parties affected by the risk of credit default.





CHECK YOUR PROGRESS

Q1: What do you understand by credit risk? (Answer in about 25 words)

Q2: State the parties at risk of credit default. (Answer in about 15 words)

Q3: What is recovery rate in the context of credit risk? (Answer in about 25 words)

4.4 IMPORTANCE OF CREDIT RISK MANAGEMENT

4.4.1 The factors

The primary issue in managing credit risk is to understand the nature of exposure that the company is dealing in. It is important to recognize that credit risk is manageable, provided the credit risk personnel have taken due diligence while sanctioning the credit. In the portfolio of credit there would be some credits turning bad. However, it has to be seen that the size of those credits are small and will not affect the company dearly. If, however, the management of credit is poorly done by the personnel leading to large proportion of credit losses in the portfolio, it may lead to a catastrophic blow to the organisation. It is thus important that the organisation has sufficient capital support to tide over the losses induced by bad credits. Moreover, it is of utmost important that the credit risk personnel assess the credit risk profile of the counterparty before extending the credit. Personal gain of the credit risk personnel and undue return for the shareholders should not be a consideration for extending credit to those counterparties whose credit worthiness is questionable. The credit risk personnel must also address the problem of adverse selection and moral hazard while assessing the credit risk profile of the counterparty. Credit risk management is important for the following three factors applicable to both financial and non-financial corporation (Bouteillé and Coogan-Pushner):

i. **Survival:** Improper management of credit risk may lead to bankruptcy of the corporation due to huge losses. If so happens then the company may not be able to sustain the business and have to close down. Hence, it is important for the companies to assess properly the obligors' credit worthiness.

ii. **Profitability:** Obligors failing to repay the money on the due date would definitely affect the profitability of the company. This happens since a percentage of profit is a component of the money owed by the obligor to the company.

iii. **Return on equity:** Return on equity is maximised when the business has a good debt-equity ratio. The companies must have optimum equity capital backed by efficient credit management.

4.4.2 Analysing Credit Risk

The importance of credit risk management depends on analysing the credit risk profile of the counterparty. The company extending the line of credit must have personnel efficient enough to analyse the credit risk pro-

file. The personnel must have the knowledge and understanding to analyse the data presented by the counterparty and must be bold enough to ask questions in times of need. The analysis is the base for deciding about extending the credit and also to set the limit of credit. The analysis must revolve around the internal and external environment of the counterparty in addition to gathering the internal credit ratings and ratings given by external agencies such as Moody's, Standard and Poor's, CRISIL, ICRA, etc. and past financial performances.

In regard to the financial performance the credit risk analyst has to look for the data from the financial statements which include the profit and loss account, balance sheet and cash flow statement. S/he must also give emphasis to the *'notes to the financial statements'* as bulk of the information are put therein. The audit reports are also read by the credit risk analyst while evaluating the credit worthiness of the counterparty. In addition to this the analyst may have to calculate different financial ratios like debt-equity, interest coverage, and other profitability and liquidity ratios to make a valued decision. The analysis must also include the corporate governance policy of the organisation. Also, the size of the business and its ability to generate revenue are important parameter for the credit risk analyst. Another pivotal factor in the analysis in regard to limited companies is the market capitalisation. Also known as "Market cap", it indicates the worth of the company. It is believed that, higher the market capitalisation better is the credit worthiness of the company. All things being equal, a company with higher market cap would have better financial position. Market capitalisation is calculated by multiplying the current value of one equity share with total number of outstanding equity shares in the stock market.

The internal environment of the business consists of the vision and mission of the business, management policies, etc. The external environment covers the political environment, regulatory environment, technological environment, to name a few. Hence, the job of credit risk personnel is not only to analyse the financial data but also to study the internal environment and the dynamic external environment of the counterparty. After garnering all the required data, the credit risk personnel have to prepare a credit report which needs to be submitted to the credit committee for deciding about sanctioning the credit and setting the credit limit. Thus, to produce a sound credit report, the credit analyst must have adequate knowledge of accounting and the accounting standards and GAAP of the counterparty's country. S/he must also be able to comprehend the macro-economic data and decipher the information of the internal and external environment. Also, s/he must be able to put queries to the officials of the counterparty for necessary clarifications.

Finally, it has to be understood that faulty credit risk analysis leads to loss for the business. If the business underestimates the risk, then it may suffer financial loss due to the inability of the counterparty to repay the obligation. Whereas, overestimation of the credit risk may result in losing the potential gains that the company would have earned by extending the line of credit.



CHECK YOUR PROGRESS

Q4: What are the three important factors in credit risk management? (Answer in about 15 words)

_____

_____

Q5: Name two credit rating agencies. (Answer in about 10 words)

_____

_____

Q6: How to calculate market capitalisation? (Answer in about 25 words)

_____

_____

4.5 CREDIT RISK ASSESSMENT METHODS

As discussed in the first section credit risk is determined by the amount of exposure extended to the counterparty, the probability of default and the recovery rate. Hence, for any business it becomes pertinent to calculate the credit risk both at the individual and portfolio level. It gives an impression to the business as to how much fund of the business is at risk. Accordingly, a business extending credit needs to focus on the following four indicators to assess the credit risk. These are:

i. Exposure
ii. Probability of default
iii. Recovery rate
iv. Tenure (Duration of credit)

The section would discuss in detail about the indicators so as to understand how these indicators aid in assessing the credit risk.

4.5.1 Exposure

The amount of money at risk of default is the exposure amount. It is difficult to quantify the exact amount of exposure and hence considered an imperfect indicator. But, then also it is taken as a useful input for measuring

credit risk. In the light of complex financial transactions, it becomes important to place to the credit committee the exposure report and also to indicate the exposures containing bulk of the amounts. The exposure report is the summary of the credit portfolio of a business. Even though it is easy for the committee to understand the exposure report but in most of the cases it is presented along with the fine prints. A lot of assumptions are being made while drafting the exposure report.

While deciding about the amount of exposure for an individual transaction the credit risk analyst faces the dilemma as to which amount to be considered? The obligor may have pledged some securities while taking the credit. Hence, should the analyst consider the total loan amount as the exposure or the amount should be net of the pledged securities. So as to tide over the situation, three figures are to be considered while deciding about the exposure amount. They are:

a. Gross exposure
b. Net exposure
c. Adjusted exposure

Let us discuss the above three items to understand their role in deciding about the exposure amount.

a. Gross exposure: Gross exposure is the total amount of money owed by the counterparty to the lender. This amount is ideally not considered by the credit risk analyst to calculate the exposure. This is because while extending the line of credit the lender may have taken some collateral to minimise the loss at the time of default. However, in worst case scenario this amount may become the actual exposure amount if the obligor faces acute fund shortage and becomes bankrupt and the collateral turns to be irrecoverable.

b. Net exposure: Net exposure is derived at by deducting the amount of collateral from the gross exposure. Thus, net exposure is a better figure than the gross exposure. However, the risk analyst have to satisfy the credit committee for the following queries regarding the collateral:

- Whether the collateral is pledged only to this company or it is pledged to other companies as well. If it is pledged to other companies also, then it can't be considered for calculating the net exposure.
- Whether the value of collateral is market driven? If so, then there needs to be some deductions from the collateral while taking it into consideration for calculating the net exposure.

- Whether in case of need the collateral can be liquidated easily? For example, a lender will get difficulties in liquidating a real estate to recover a sticky loan amount.

c. Adjusted exposure: There are some types of credit line where the borrower doesn't withdraw the whole sanctioned amount at one go. Rather the borrower withdraws as per need and repay a certain amount and again withdraws as required. The interest is charged on the outstanding loan amount. A good example of this is bank overdraft. Now, in this type of loans, the lender is aware that neither the whole gross exposure nor the net exposure is at risk of default. Accordingly, the net exposure is multiplied by the percentage of amount withdrawn by the borrower on an average. Thereby, the adjusted exposure amount becomes less than the net exposure and that amount becomes the exposure at risk of default.

However, there remains a risk for the lender. Since, the loan amount is already sanctioned hence the borrower may withdraw the whole loan amount without giving any prior information to the lender. If it happens, then suddenly there will be an increase in lender's exposure. Moreover, since this type of loan accounts have a long tenure hence; it becomes difficult for the lender to predict the behaviour of the borrower as to when s/he will withdraw more than the average withdrawal done earlier.

At the end it has to be understood that all the three figures have its own pros and cons. It is for the analyst and the credit committee to decide which figure will be considered as the exposure and for it due justification needs to be placed on record.

4.5.2 Probability of default

The probability of default is a statistical indicator indicating the extent of possibility that the counterparty may fail to honour the obligation. The probability of default is between 0 and 1. A borrower will always carry a probability of default even if it is financially and fundamentally strong. Hence, the probability of default for any counterparty is more than zero. Also, the lenders know that the probability of default for loans running for long period will have more default probability than a loan of shorter duration. Even, an obligor with two loans of different duration will account for two different default probabilities.

The importance thus lies in calculating or estimating the default probability rate. The lending companies rely on the organisations selling default probability rates. These are calculated for the borrowing companies based

on the data provided by it and also by making number of assumptions. Hence, these rates may not always hold good. The lenders thus follow a two stage process to determine the default probability rate.

Stage I: Assigning or generating credit ratings based on financial data of the counterparty

In the first stage the lending company intends to assign a credit rating for the counterparty. The rating is relative and not an absolute measurement of the financial position of the company. The rate may be assigned by the lending company itself (also known as internal ratings) or it may take the ratings provided by the credit rating agencies. The idea behind these rates is that the companies with better credit ratings will have less chance of making default than the companies with lower credit rates. The internal ratings may be generated by the big financial companies for their counterparties through their own personnel. But, it may not be possible for the smaller financial companies to do so as it involves huge financial and non-financial resources. The personnel who carry out the estimation depend on the publicly available data of the borrowing company and also some private information that they could find out during the process of study. After compilation of the data the team assign a credit rate for the borrowing company.

On the other hand, the lending companies may depend on the rating agencies for the credit rates. The agencies also assign the rate based on the study they have done for the borrowing companies. It is believed that the ratings are unbiased and ensures the credit quality of counterparty. However, in some cases this may not hold good. Because, the credit rating agencies are profit making businesses and they take fees from the counterparty to calculate their credit score. Hence, how far the agencies remain unbiased is questionable. In spite of this lacuna, the borrowing companies depend on the credit rating agencies rates for determining the default probability. However, it is important to mention that the agencies assess the big companies but for smaller counterparty the lending company has to depend on other scoring systems. A very common score for smaller companies is the Altman Z Score. The counterparty may have been assigned score by different credit rating agencies and also the lender may have made its own assessment. Hence, a hierarchical order of score needs to be placed. In that order the internal rate is at the top. If internal ratings are unavailable than the hierarchical order starting from the highest to the lowest score provided by different credit rating agencies will be placed. As per convention, the lowest credit score is adopted by the lending company and that score becomes the input for the next stage.

Stage II: Identifying the number of defaults of the companies with the identical credit score

In this stage the lending company takes into account the historical default probability rate of the companies having a similar credit rate as the lending company has adopted for the borrowing company. If a company had a credit score identical to the borrowing company experienced a default probability rate of 0.3 for a loan of duration five years, the lending company will assign the same default probability score of 0.3 for the borrowing company. Many of the credit rating agencies publish companies' data on defaults. The data aids the lending company in estimating the default probability rate of the counterparty. It also needs to be mention here that the probability of default varies with the business cycle. Hence, a company may have less chance to default when the economy is in rise in comparison to the period when the economy is down. Hence, the lending company needs to meticulously work out with the data for assigning a realistic default probability rate for the counterparty irrespective of the cycle of business.

4.5.3 Recovery rate

Recovery rate is the percentage of money that can be recovered in the event of a credit default. It is calculated upon the gross exposure. An obligor may have many creditors. In case of a default, some creditors may have prior right over the other creditors. Let us take the example of debentures and public deposits issued by a company. In case of a default, the debenture holders would be paid back the amount prior to anything is paid to the public depositors. Because, the debenture holders are secured creditors and the public depositors are unsecured creditors. It is therefore important for a lender to consider the following points while estimating the recovery rate:

a. The realisable value of assets, and
b. The nature of the credit extended, i.e., whether it is a secured, partly secured or unsecured credit.

The recovery rate is estimated at the time of sanctioning the credit. It is therefore important for any credit risk analyst to correctly estimate the recovery rate. For this, the analyst needs to gauge the past performance of the counterparty and also read the credit ratings issued by the external agencies. As discussed in the first section, credit risk is the function of: **Exposure X Probability of default (1 – Recovery rate)**; hence, it is pertinent to correctly estimate the recovery rate.

4.5.4 Tenure (Duration of credit)

The tenure of loan also plays an important role in assessing the credit risk. Longer the tenure of credit, higher the chances of credit default because of two reasons.

a. It is difficult for a lender to predict the long term financial performance of an obligor, and
b. The chance of default increases with passage of time.

Setting the optimum tenure for each credit is important because neither the tenure can be too short or too long.

The four indicators discussed in this section are to be understood in depth by the credit risk analyst to assess the risk of default. The assessment is not based on fully scientific connotation and hence, human subjectivity also comes into play while assessing the credit risk.



CHECK YOUR PROGRESS

Q7: What are the four indicators to assess the credit risk? (Answer in about 20 words)

Q8: How net exposure is derived? (Answer in about 20 words)

Q9: What are the two points in estimating the recovery rate? (Answer in about 35 words)

4.6 EXPECTED LOSSES AND UNEXPECTED LOSSES

Credit risk is always to be studied in the context of losses which are anticipated by the lender and the losses which are not. Popularly, this is known as expected losses and unexpected losses respectively.

4.6.1 Expected Losses

The expected losses can be anticipated by a lender. An expected loss rate is estimated by the lending business based on its historical data. Technically, expected loss rate is the average losses over a period of time. Hence, while extending the credit line a lending company takes into consideration the expected loss rate to estimate the present expected losses. This expected loss rate is also a part of the pricing done for a loan which the lender is planning to lend.

4.6.2 Unexpected Losses

Inspite of best of the calculations made, a business may not be able to correctly predict the expected losses. The situation whereby a lend-

ing company suffers more than the expected losses is known as unexpected losses. There is no way a business can predict the unexpected losses. This type of loss may occur due to various reasons ranging from sudden economic downturn, political unrest, problems in the industry in which the borrower company operates, etc.

4.6.3 Catastrophic Losses

Another type of loss which a business suffers is the catastrophic losses. The major reason for the lending company to suffer catastrophic loss is the concentration of credit to a particular industry or country or debtors. Sub-prime lending crisis which created havoc in the world economy originating in the United States in the year 2006 is an example of catastrophic loss. Lehman Brothers, one of the largest investment banks of the United States filed for bankruptcy in 2008 due to the impact of sub-prime lending induced financial crisis.



CHECK YOUR PROGRESS

Q10: How expected loss rate is estimated? (Answer in about 20 words)

Q11: Name a business which went bankrupt due to sub-prime lending crisis. (Answer in about 10words)

4.7 CONTROLLING CREDIT RISK

Controlling the credit risk is the pivotal role in credit risk management. There are different techniques of controlling credit risk. It is important for the risk manages to decide on the techniques as per the situation. The techniques depend heavily on the risk managers' assessment of the counterparty's ability to honour the obligation. Some of the techniques are discussed below:

4.7.1 Managing the Loss Given Default

The technique of managing the loss given default pertains to minimising the amount of loss in the event of an obligor failing to repay. The most common way of doing this is to take collateral while sanctioning the credit. In the event of the counterparty failing to honour the contract, the lender can liquidate the collateral to recover either partially or fully the credited amount.

Another method under this technique is to extending the credit based on the capital adequacy of the counterparty. If the counterparty fails to repay, the sufficiency of capital ensures that the counterparty would not get insolvent/bankrupt and there remains a chance that the amount would be repaid.

Third party guarantee for a borrower is also a method under this technique. In this method the lender takes a guarantee from a party either related or not related with the borrower that in the event of the borrower failing to honour the contract the third party have to make the repayment.

4.7.2 Diversification

Spreading of risk is one of the most efficient ways of controlling the credit risk. This can be done by diversifying the credit portfolio. A lender must not concentrate its credit activities in only one particular industry, or geographical area. If the credits are concentrated in only one particular industry, then any sudden downfall in the industry will lead to all the borrowers from that industry failing to repay the money. As a result, the lender will suffer huge losses.

4.7.3 Covenants

Covenant is a type of agreement between the lender and the borrower whereby the lender puts some restrictions on the borrower. A typical example of this may be asking the borrower to not make dividend payments, maintaining the level of capital and/or taking care of the collateral pledged as securities for taking the loan. This technique ensures that the borrower maintains its liquidity and solvency during the period of loan contract. There are three types of covenants.

a. **Affirmative:** Example of this is maintaining the capital level.

b. **Negative:** Example of this is not making dividend payment.

c. **Information:** Providing necessary information to the lender for ensuring that there is no breach of contract.

Any breach of contract by the counterparty allows the lender to take steps in recovering the credited amount prematurely.

4.7.4 Risk Pricing

In this technique the interest rate of loan is set in such a way that it compensates for the expected losses in addition to covering the adminis-

trative expenses and a percentage of return the lender intends to earn by extending the credit. The portion of interest which is fixed for covering the expected loss is known as the *risk premium*. Higher the credit risk, higher is the risk premium.

4.7.5 Provision

Inspite of all the steps undertaken to study the risk potential of a borrower before sanctioning a loan to ensure that it does not turn bad, there remains a probability of a loss in future. To tide over this situation, the lenders set aside a certain percentage out of its income to cover the anticipated loss. This technique in technical terminology refers to as provision.



CHECK YOUR PROGRESS

Q12: What is covenant? (Answer in about 20 words)

Q13: What is risk premium?(Answer in about 20words)



4.8 LET US SUM UP

- Credit risk is the possibility of losing money due to the inability, unwillingness, or non-timeliness of a counterparty to honour a financial obligation.
- Credit risk can be mathematically expressed as: Credit Risk = Exposure X Probability of default (1 – Recovery rate).
- Credit risk is a part of market risk since due to the counterparties' inability to honour the obligation leads to the changes in the market value of financial portfolio of a firm.
- Types of credit risk include lending activities, lease business, credit sale of goods and/or services, buying prepaid goods and/or services, claim on asset kept with another party and contingent liability.
- It is important to recognize that credit risk is manageable, provided the credit risk personnel have taken due diligence while sanctioning the credit.
- Credit risk management is important due to survival, profitability and return on equity aspects applicable to both financial and non-financial corporations.

- Analysis of credit risk involves evaluating the financial performance of the company coupled with studying the internal and external environment of the business.
- The four indicators to assess the credit risk are exposure, probability of default, recovery rate and tenure of credit.
- The amount of money at risk of default is the exposure amount. There are three different figures of exposure which a lender has to decide on. They are gross exposure, net exposure and adjusted exposure.
- The probability of default is a statistical indicator indicating the extent of possibility that the counterparty may fail to honour the obligation. It lies between 0 and 1. The default probability rate is estimated by two stage process.
- Recovery rate is the percentage of money that can be recovered in the event of a credit default. It is calculated upon the gross exposure.
- The chance of default increases with passage of time.
- The expected losses are anticipated by a lender based on the past data.
- The situation whereby a lending company suffers more than the expected losses is known as unexpected losses.
- Controlling the credit risk is the pivotal role in credit risk management.
- The techniques of controlling credit risk are managing the loss given default, diversification, Covenants, risk pricing, and provision.



4.9 FURTHER READINGS

- Duffie, D. and Singleton, K.J. (2005). *Credit Risk- Pricing, Measurement and Management*. India: New Age International (P) Ltd.



4.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No. 1: Credit risk is the probability of making default by the obligor to honour the liability as per the stated terms and conditions.

Ans to Q No. 2: Individuals, banks, mutual funds, hedge funds, insurance companies, pension funds and companies.

Ans to Q No. 3: Recovery rate is the percentage of fund that can be recovered in the event of the failure to meet the obligation by the counterparty.

Ans to Q No. 4: The three important factors in credit risk management are survival, profitability and return on equity.

Ans to Q No. 5: The two credit rating agencies are Moody's and CRISIL.

Ans to Q No. 6: Market capitalisation is calculated by multiplying the current value of one equity share with total number of outstanding equity shares in the stock market.

Ans to Q No. 7: The four indicators to assess the credit risk are: exposure, probability of default, recovery rate and tenure of credit.

Ans to Q No. 8: The net exposure is derived by deducting the amount of collateral from the gross exposure.

Ans to Q No. 9: The two points in estimating the recovery rate are (i) the realisable value of assets and (ii) the nature of the credit extended, i.e., whether it is a secured, partly secured or unsecured credit.

Ans to Q No. 10: Expected loss rate is estimated by averaging the losses over a period of time.

Ans to Q No. 11: Lehman Brothers went bankrupt due to sub-prime lending crisis.

Ans to Q No. 12: Covenant is a type of agreement between the lender and the borrower whereby the lender puts some restrictions on the borrower.

Ans to Q No. 13: The portion of interest which is fixed for covering the expected loss is known as the risk premium.



4.11 MODEL QUESTIONS

Short Questions (Answer each question in about 150 words)

Q1: Define credit risk and state the mathematical formula to calculate it.

Q2: State in brief how banks are affected by credit risk?

Q3: Why credit risk management is important?

Q4: What is the role or recovery rate in assessing credit risk?

Q5: State how net exposure is different from gross exposure.

Q6: What is catastrophic loss?

Q7: What do you understand by the technique managing the loss given default?

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

Q1:*"Credit risk is affected by asymmetric information problem"*. Elucidate this statement.

Q2: Explain the different types of credit risk.

Q3: What are the different aspects need to be studied by the credit risk analyst to evaluate the credit risk of counterparty?

Q4: Explain in detail the method to assess credit risk.

Q5: Explain how probability of default is estimated?

Q6: How is expected loss different from unexpected loss for a business?

Q7: Explain in detail the different techniques of controlling credit risk?

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UNIT-5: INTRODUCTION TO INSURANCE

UNIT STRUCTURE

5.1 Learning Objectives

5.2 Introduction

5.3 Meaning of Insurance

5.4 Nature of Insurance

5.5 Objectives of Insurance

5.6 Functions of Insurance

5.7 Characteristics of Insurance

5.8 Insurable Risks

5.9 Insurance and Gambling

5.10 Insurance and Hedging

5.11 Importance of Insurance

5.12 Business Insurance

5.13 Importance of Insurance in Business

5.14 Role of Insurance in Economic Development

5.15 How Insurance Works?

5.16 Let Us Sum Up

5.17 Further Readings

5.18 Check Your Progress

5.19 Answers to Check Your Progress

5.20 Model Questions

5.1 LEARNING OBJECTIVES

After going through this unit, the learners will able to:

- *State the meaning and nature of insurance*
- *Explain the objectives of insurance*
- *Understand the functions and characteristics of insurance*
- *Know the meaning and features of insurable risks*
- *Differentiate between insurance and gambling*

- *Differentiate between insurance and hedging*
- *Explain the importance of insurance*
- *Understand business insurance and its types and benefits*
- *Elaborate the importance of insurance in business*
- *Interpret therole of insurance in economic development*
- *Know about the working of insurance*

5.2 INTRODUCTION

Savings alone is not enough to achieve financial goals.Protection of our lives and assets from any unforeseen losses and contingencies by getting insurance is equally important. This unit will discuss about the meaning, nature,role and importance of various types of insurance.

5.3 MEANING OF INSURANCE

Insurance is a means of protection from any unforeseen losses and contingencies. It is a risk-management technique used for hedging against various uncertain losses. Insurance is a contractual agreement between two parties in which one party promise to protect another party from uncertainties and losses. The first party is insurance company or insurer who agrees to protect and compensate the other party for losses suffered by it. Another party is insured or insurance policy holder who gets protection under insurance policy in return for premium which he is required to pay regularly to insurer.

In simple terms, insurance is just the protection against the losses. By taking insurance policy, different insurance policy holders pool their interest together. Loss suffered by any of the insured property or life is paid out of premium amount paid by these policy holders to insurance company. Insurance is an effective tool to avoid losses by transferring or sharing it with other individual. It boosts confidence level of peoples and acts as supporting pillar by compensating them at time of emergencies.

Insurance helps in economic development of country by mobilising people's saving by attracting them for investment in insurance policies. Insurance companies reinvest the collected amount in different investment avenues for earning profit. There are generally three steps in insurance process: Firstly, select the insurance policy as per your needs, then you need to pay the premium amount regularly and at last claim your insured

amount with the help of supporting documents in case if any unfortunate event occurs.

5.4 NATURE OF INSURANCE

The concept of insurance was developed to mitigate the adverse effects of the risk associated with the probability of financial losses. Insurance is provided through a system which makes large financial losses more affordable by pooling the risk of individuals and business entities in returns for payments ofpremium. The nature of insurance may be discussed as under:

- Insurance is a devise of sharing risk by large number of people among the few who are exposed to risk by one or the other reason.
- Insurance provides facility of financial help in case of contingency. However, it depends on the value of insurance for which payment is made in case of contingency.
- Valuation of risk is determined as per predefined terms and conditions of the insurance policies.
- Insurance is a policy regulated under laws and therefore the amount of insurance can neither be paid as gambling nor as charity.

5.5 OBJECTIVES OF INSURANCE

Though the primary objective of insurance is to financially guard against unpredictable life occurrences there are also some other important objectives. The overall objectives of insurance are as follows:

1. Granting Security to People

Insurance primarily serves the purpose of granting security against losses and damages to people. It is an agreement enters into by two parties in which one promises to protect other from losses in return for premium paid by other party. One party is insurance company and other one is insured. Insurance companies guarantee the insured of compensation in case of any unfavourable contingencies. Insured need to pay premium to insurance companies in return for guarantee of compensation.

2. Minimisation of Losses

Insurance aims at minimisation of losses arising from future risks and uncertainties. It adds certainty of payments to people for happening of uncertain events. Insurance assures the individuals for compensation of

losses. It minimises the risk through proper planning and administration. Insurance companies suggest people for taking safety measures like installation of fire detection devices, alarm and cameras system etc. They also join hands with various organisations like fire brigade, health and various organisations which work for reducing losses and damages. This way, insurance works toward minimising the happening of various losses.

3. Diversifying the Risk

Insurance works towards diversifying the risk among large number of people. It aims at reducing the adverse effects of any future contingency by spreading the overall risk associated with it. It is medium through which people share their risk with others. Insurance companies compensate the insured for losses out of premium they charged from their different policy holders. The loss incurred by single individual is diversified among large peoples by insurance companies by utilising the collected premium amount for paying compensations.

4. Reduces the Anxiety and Fear

Insurance policies relieve the individuals of any tension and fear regarding the future risks and uncertainties. It guarantees them of compensation in occurrence of any unfavourable contingencies. Assurance of compensation is the most relieving factor for tensed and worried people. They are certain of payment on occurrence of various uncertain events. It makes them confident and they focus on their activities with full attention.

5. Mobilises the Saving

Mobilisation of savings is another important objective of insurance. It attracts people for investments by presenting them with numerous insurance policies guarantying of compensation for losses. Large number of people takes this insurance policy in order to insure them against losses and damages. Insurance companies are able to generate large amount of funds in the form of premium that they charged from their policy holders regularly. These funds are then invested by these companies into securities and stock in market and earn incomes. Ideal lying resources with public are employed by insurance companies towards income generating sources.

6. Generation of Capital

Insurance companies leads to capital generation by collecting large amount of funds from public. They regularly charge premium from their large customers for providing them protection against losses. These funds are invested for industrial development by subscribing to shares of compa-

nies. Companies are able to get their required capital through insurance industry as this invests in companies for earning dividends and other incomes. This boosts the industry performance and economic growth of country. Also, bigger investments lead to creation of various employment opportunities.

7. Tax Relief to the Insure

Another important objective of insurance is to provide tax benefit to the insured in life insurance and some health-related insurances. Under Section 80C and 10D of the Income Tax Act, there are provisions of getting income tax benefits on life insurance. Under section 80C, premiums that you pay towards a life insurance policy qualify for a deduction up to Rs. 1.5 lakh, while Section 10(10D) makes income on maturity tax-free if the premium is not more than 10% of the sum assured or the sum assured is at least 10 times the premium. But if the sum assured is less than 10 times the premium, for instance you pay Rs. 1 lakh as premium for a sum assured of Rs. 5 lakh, you will get a deduction on the premium up to 10% of the sum assured. In the example, your deduction will be Rs. 50,000 and not Rs. 1 lakh.



CHECK YOUR PROGRESS

Q. 1. Give the meaning of insurance.

Q. 2. Explain the objectives of insurance.

5.6 FUNCTIONS OF INSURANCE

1. Provides Protection

The primary function of insurance is to provide protection to insured in case of any uncertain event. Insurance guarantees the person to protect him from sufferings in case of damages and losses. Future risks and uncertainties cannot be controlled or reduce through insurance but it can only compensate for the losses caused by these uncertain events. Insurance policies help a person to recover back to its original position after incurring losses by compensating them.

2. Sharing of Risk

Sharing of risk is an important function played by insurance. It is a means of pooling risk of one person among a large number of persons. Compensation for losses suffered by one individual is paid out of premium paid by different policyholders. Risk is diversified and shared among differ-

ent persons. It reduces the adverse effect of uncertain events on only one person by sharing of risk.

3. Provides Certainty

Insurance provides reliability and certainty of payments to business. Happening of unexpected events is uncertain and cannot be determined. The uncertainties of these events can be minimized through proper planning and administration. Insurance helps in adding certainty to these uncertain events. It assures businessmen of certain payments on happening of unexpected events. It relieves them from large damages and losses.

4. Improves the Efficiency

Insurance has an effective role in improving the efficiency of the business. By providing the guarantee for compensation in case of any mishaps, it relieves the businessmen of worries and tension of risk. It boosts their confidence level and they work with full attention towards their roles. Insurance reduces the miseries and concern for losses or damages. This leads to better productivity of the organisation thereby increasing the overall efficiency.

5. Prevention of losses

It acts as a cover against the losses. Insurance guides business in taking appropriate corrective measures for reducing damages and losses. It suggests them for observing safety measures like installation of automatic fire detective devices, alarm systems etc. Insurance company's joins hand with institutions which help in avoiding losses like fire brigade, health organisations and other intuitions. It will help in reducing losses which will ensure lower payment of compensation to insured. This will also enable the insurer in reducing the amount of premium and will motivate more savings.

6. Helps in Earning Foreign Exchange

Insurance is an important means of earning foreign exchange. Several companies operate internationally with many branches in different countries. They need to take insurance policy as per the legal requirements of the country. Several countries earn foreign exchange by issue of insurance policies like marine insurance and many other different policies.

7. Promotes Economic Development

Insurance promotes the economic development of the country. It leads to generation of large amount of funds by insurance companies through the premium collected by them from insured. It utilises the ideal

lying money with people by attracting them for investment in various investment policies. All collected money by insurance companies is invested in shares of various companies and other investment avenues for earning profit. This leads to industrial development in the country thereby accelerating the rate of economic growth.

5.7 CHARACTERISTICS OF INSURANCE

1. Personal Contract

Insurance contracts are generally personal in nature. It is an agreement between the insurance company and insured and such agreement is bound by certain obligations. Both the party is required to fulfill their obligation to keep the contract legal. Insurance contract cannot be transferred to any other person without the consent of insurance policy holder. Insured is required to pay premium to insurer regularly as his part of obligation. Whereas insurer need to compensate insured in case of any losses as his part of obligation.

2. Pooling of Risk

Insurance are meant for pooling the risk of various policy holders. It helps in the reducing the adverse effect of heavy losses on single individual on occurrence of any contingency. Insurer compensates the insured for the losses incurred by him out of premium paid by different policy holders. Premium paid by different policy holders is used for recovering the losses incurred by insured individuals. This way risk of single individual is pooled among different individuals and its effect is minimized

1. Unilateral

Insurance contracts are unilateral. This means that both the parties(insurer and insured) who enter into insurance contracts are equally bound to perform their respective obligations. Insured need to pay the decided policy premium without any default. Policy premium is the cost for protection against losses provided by insurer. Insured is required not to pay any cost other than policy premium. Similarly, insurer has the right to compensate the insured for losses and damages arising out of contingency. It is their legal duty in exchange for the premium they are charging.

2. Cost of Risk

The cost of risk in insurance contract is the value of insurance object. Insurance companies before entering into contract properly evaluate the value of subject matter of insurance contract. Proper knowledge of in-

surance object enables the insurer in calculation of right premium amount to be paid by insured. Higher the risk associated with insurance object, higher will be premium charged. On the other hand, lower risk invited low premium by insurer from insured.

3. Assures of Compensation

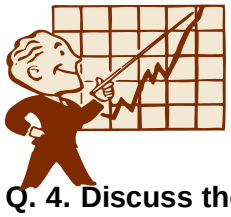
Insurance policies assure the policy holder of compensation in occurrence of losses and damages. These policies are taken by insured to seek protection from future risks and uncertainties. Insurance companies guarantee the people for compensating them for losses. They assure to bring them back in their original position in which they were before occurrence of such losses. Assurance for compensation by insurer motivates people for investment in insurance policies.

4. Executor

Insurance contacts are executory which means compensation is paid only on occurrence of the contingency. It is included in agreement done that insured is liable to claim for compensation from insurer only if he incurs losses. Insured cannot profit from the insurance policies and can be compensated for losses only. If any contingency do not occur then insurer is not liable to pay any compensation.

5. No misrepresentation or concealment

Insurance contract is assumed to be free from any misrepresentation and concealment of information. Any misrepresentation or concealment of facts from both insurer and insured side will make the insurance contract void. Insured is required to disclose full information regarding insurance object fairly to insurer. Similarly, insurance companies are required to explain clearly the terms and conditions of insurance contract to insured.



CHECK YOUR PROGRESS

Q. 3. Explain the functions of insurance.

Q. 4. Discuss the salient feature of insurance.

5.8 INSURABLE RISKS

A risk which can be easily insured and which follows the norms and specifications of insurance is called an Insurable Risk. In other words, insurable risks are those risks that insurance companies will cover. Insur-

able risks include a wide range of losses, including those from fire, theft, lawsuits etc. The most common example of insurable risks is property damage risk caused by floods, fires, earthquakes, and hurricanes. The losses covered under insurance policies differ among insurance companies. Insurers who do suffer losses may claim from the insurance company. However, no insurance company will cover every risk. Some losses are simply impossible to value or too costly, too probable, or too susceptible to manipulation. These are known as uninsurable risks.

Features of insurable risks:

i) The loss must be assessable, definite or can be measured in terms of time or money/financially measurable.

ii) The prime need for a risk to be insurable is that there must be a sufficiently large number of homogeneous/similar exposures units.

iii) The risk must be unexpected, unforeseeable and not intentionally caused by the insured.

iv) The insured must have an interest in the person or object being insured.

v) The insured object should be lawful and not against the public policy or public interest.

vi) The premium should be economically feasible.

5.9 INSURANCE AND GAMBLING

In insurance, risks are existing, they may occur at any time. Therefore, some people have their opinion that insurance is like gambling.Insurance and gambling were considered alike because there is an uncertainty of events and payment is made when the event occurs. However, buying insurance is actually distinctly different from gambling. When we enter into a gambling engagement, such as buying a lottery ticket or putting money in a slot machine, we create risk of loss that did not previously exist. In other words, there was no risk of losing money to gambling until we bought the lottery ticket or put the money in the slot machine. On the other hand, the risk of financial loss from other causes already exists whether we purchase insurance or not.

Differences between insurance and gambling

Sl. No.	Basis of difference	Insurance	Gambling
1	Security and risk	Insurance is done to provide security from risk.	Gambling is done to create risk.
2	Presence of risk	Insurance is done only in condition if risk exists.	Risk is emerged from gambling.
3	Measurement of risk	Measurement of risk in insurance is done in a scientific way.	Not possible to measure risk in gambling.
4	Objectives	Insurance is done to minimize the risk of future uncertainties.	Gambling is done for entertainment and for gaining profit.
5	Gains of insurance	An insurer can get insured benefits from insurance.	A gambler does not get insured benefits in gambling.
6	Validity	Insurance contracts are legal.	Gambling is not a legal contract.
7	Good faith	Utmost good faith is required to be exercised in insurance contracts.	It is not applicable to gaming.
8	Insurable interest	The principle of insurable interest applies to insurance contracts.	Not applicable to gambling.

5.10 INSURANCE AND HEDGING

Insurance is a form of risk managementwhich protects from financial losses. Entity which provides insurance is known as an insurer, i.e. insurance company. Hedge is an investment that protects finances from a risky situation. The concept of hedging is to transferring the risk to the speculator through purchase of future contracts. Hedging is done to minimize or offset the chance oflossof value of assets. It also limits the loss to a known amount if the asset does lose value.

Insurance and hedging both reduce exposure to financial risk, but they do so in different ways. Insurance typically involves paying someone else to bear risk, while hedging involves making an investment that offsets risk. Both insurance and hedges cost money; premiums in the case of insurance, and the price of the options in the hedging. But those costs are less than the losses protected. That's why the expense is considered worthwhile.Insurance shifts potential financial losses to someone else. Buying a home insurance policy protects the home against fire, but it does not guarantee that the home will not burn down. If the house burns down, the insurance company pays to replace.On the other hand, hedging reduces the risk of uncertainty.

Difference Between Insurance and Hedging

An insurance contract is not the same as hedging. Although both techniques are similar in that risk is transferred by a contract, and no new risk is created, there are some important differences between them.

Differences between Insurance and Hedge

Sl. No.	Basis of difference	Insurance	Hedging
1	Nature	Insurance Shifts Risk	Hedging Offsets Risk
2	Types of risks	An insurance transaction involves the transfer of insurable risks, because the requirement of an insurable risk generally can be met.	Hedging is a technique for handling risks that are typically uninsurable, such as protection against a decline in the price agriculture products and raw materials.
3	Reduction of risk	Insurance can reduce the objective risk of an insurer by application of the law of large numbers.	Hedging typically involves only risk transfer, not risk reduction.
4	Cost	premiums in the case of insurance	price of the options in the hedging
5	Involvement	Insurance typically involves paying someone else to bear risk.	Hedging involves making an investment that offsets risk.



CHECK YOUR PROGRESS

Q. 5.What is insurable risk? What are its features?

5.11 IMPORTANCE OFINSURANCE

1. Financially Security

No matter how much you are earning or how much you have saved; your financial position can be dented by an unexpected event in a moment. So, the best way to become financially secure is to cover yourself, your family, and your assets with insurance. You can buy or renew insurance online and receive a payout for financial support, in case there happens to be an unforeseen event.

2. Transfer of Risk

The contract of insurance works on the 'principle of transfer of financial risk from the insured to the insurer'. As an insured, you pay premiums to receive compensation from the insurer, in case of occurrence of an unforeseen event. So, having insurance reduces the financial burden on your shoulders.

3. Complete Protection for You and Your Family

Family is the most important asset that you have and your family also depends on you for financial support. This is why it is important to make sure that you and your family are completely secure to face any emergency.

4. No More Stress or Tension During Difficult Times

None of us can see the future or predetermine the future events. Any unforeseen tragedy can leave you physically, mentally, and financially strained. So, if you have insurance to take care of the outcomes of such tragedies such as illness, injury or permanent disability, even death- you save yourself and your family from tension and stress. With insurance in place, any financial stress will be taken care of, and you can focus on your recovery.

5. Some Types of Insurances are Compulsory

Insurance is necessary because sometimes it is mandatory as per the law. An example of this is motor insurance. As per the Motor Vehicle Act of 1988, it is compulsory to have at least a third-party motor insurance for every motor vehicle plying on road in India.

6. Peace of Mind

Having insurance offers you financial security and also peace of mind. No amount of money can replace your peace of mind. So, when you have insurance you know that you are secured against any unforeseen events in life, and this gives you complete peace of mind.

5.12 BUSINESS INSURANCE

An insurance cover to protect our business from unexpected events or fall during hard times is called business insurance. Business insurance offers end-to-end risk management services to provide to our business from different types of threats, perils, tragedies, etc. The entrepreneurs who have started new business with a motive to achieve various goals and success should purchase business insurance as this will help them from several risks like group life insurance, group Mediclaim, group personal accident insurance, insurance for resources, package for office, fire insurance, etc.

Business insurance is that provides coverage to the business against any damage such as natural calamities, thefts, income loss, employees' sickness, death or injuries, any type of judicial proceedings and sabotage. These events may cause severe regression in the ongoing business deals and may lead to huge losses. Even this may result in shut down the busi-

ness due to extreme income loss. Hence, it is necessary to buy an effective insurance plan to safeguard the business from any unexpected mishap.

Benefits of Business Insurance:

1. **Risk Management:** Business insurance provides cover against damage and losses to the business properties and assets due to many possible reasons.
2. **Third-Party Liability:** In the event when the business causes harm or any physical injuries to the third party this insurance will help to cover those expenses.
3. **Safeguard from Natural Hazards:** If any miserable incident takes place and the business suffers a big loss in the economy, this insurance will minimize the losses.
4. **Lawsuit Cover:** It offers coverage during legal proceedings against the business and takes care of the expenses related to it and settlements.
5. **Participate in Threats:** An important step towards the protection of the business against any losses and supports for sharing all the risks caused for continuous growth and operations to attain normalcy.
6. **Copyright Security:** Protection against liabilities for advertisements i.e. if a business breaks the copyright regulations of some other business, then this liability will defend the legal obligations towards those claims.

Types of Business Insurance Plans

1. **Professional Liability Insurance:** Professional liability insurance provides coverage to a business that is harmed due to carelessness i.e. any error caused by mistake or if the company fails to perform.
2. **Home-Based Businesses:** Many workers chose to start their business in their houses. But the commercial property or homeowner policy will not cover the home business. This insurance will provide coverage for the facilities and supplies in adverse situations.
3. **Product Liability Insurance:** Running a business to sell and manufacture goods and services in the market, opt for product liability insurance. This insurance will cover the expenses of the legal issues caused due to an impaired or loss of any one of the produced products.
4. **Vehicle Insurance:** In case of any accident with a vehicle of the business, this vehicle insurance utilized for business purposes can be used to cover for damages or loss, if any. The vehicle used in the event of an accident must have an insurance for safety.

5. **Worker's Compensation:** This type of insurance will protect the employees from any emergency and health conditions as well. Adding this compensation for the workforce will assure them for a secure future leading to a better output. The benefits of this plan are many, such as disability, death, therapeutic care, etc.

6. **Business Interruption Insurance:** Business interruption insurance will be efficient in the cases of unexpected hazard or devastating incidents that interrupts the activities of an ongoing business.

7. **Property Insurance:** Property insurance takes careof the expenseswhenthere is any loss, damage, or theft of property in a business. It covers all the appliances, furniture, or any other interior space during a natural calamity, theft, fire, storm, etc.

5.13 IMPORTANCE OF INSURANCE IN BUSINESS

The insurance has been useful to the business society also.In addition to protecting ourself, it's also important to have business insurance so we can **protect others**. In the case of a food business if a customer becomes ill after eating one of its products the business, or in the case of a delivery business if one of its vehicles hits a pedestrian, theyneed to be able to pay for the damage they have caused. Therefore, a business insurance is necessary. Fire and hazard insurance for businesses protect our company's assets in case of damaging and unpredictable circumstances.Some types of business insurance are required by our state government, such as workman's compensation insurance, which protects our workers if they're hurt on the job, and unemployment insurance, which helps workers make ends meet if they are laid off. The importance of insurance in a business are:

1. InsuranceReduces the Uncertainty of Business Losses

A huge number of properties are employed in the world of business, commerce, and industry.With a slight negligence, the property may be turned into ashes. The accident may be fatal not only to the individual or property but to the third party also. In absence of insurance, uncertainty will be in the maximum level and nobody would like to invest a huge amount in business.By purchasing a policy, businessman can be sure of his earning because the insurer will pay a fed amount at the time of death.

2. Business Efficiency is Increased with Insurance

The carefree businessman can work better for the maximization of the profit. The owner can devote much time to the business when he is free from the

botheration of losses.New, as well as old businessmen, are guaranteed payment of a certain amount with the insurance policies at the death of the person; at the damage, destruction or disappearance of the property or goods. The uncertainty of loss may affect the mind of the businessmen adversely. Insurance removes the uncertainty and stimulates the businessmen to work hard.

3. For Key Man Indemnification

Death or disability of some valuable lives whose capital, expertise, experience, energy, ability to control, goodwill and dutifulness make him the most valuable asset in the business may prove a more serious loss than that by fire or any hazard. Their absence will reduce the income of the employer tremendously and up to that time when such employee is not substituted.The potential loss to be suffered and the compensation to the dependents of such an employee requires an adequate provision that is met by purchasing adequate life-policies.The amount of loss may be up to the amount of reduced profit, expenses involved in the appointing of such persons and payment to the dependents of the key man. The Term Insurance Policy or Convertible Term Insurance Policy is more suitable in this case.

4. For Enhancement of Credit

Insurance is helpful in getting loans from banks. The business can obtain a loan by pledging the policy as collateral for the loan. The insured persons are getting more loans due to the certainty of payment at their deaths.In the case of death, this value can be utilized for setting the loan along with the interest.If the borrower is unwilling to repay the interest, the lender can surrender the policy and get the amount of loan and interest thereon paid.The insured properties are the best collateral and adequate loans are granted by the lenders.

5. Business Continuation

Many businessesespecially the partnership businesses may discontinue at the death of any partner.However, the surviving partners can restart the business.In both these cases the business will suffer economically.Insurance policies provide adequate assistance at the time of death. Moreover, with the help of property insurance, the property of the business is protected against disasters and the chance of disclosure of the business.

6. Welfare of Employees

The employees work for the employer.Therefore, the welfare of the employees is the prime responsibility of the employer.The employer has to look after the welfare of the employeesduring early death, disability and old

age.These requirements are easily met by the insurance. Insurance scheme especially group insurance is to be provided for the welfare of the employees.The premium for group insurance is generally paid by the employer. The employees will devote their maximum capacities to complete their jobs when they are assured of the above benefits. The struggle and strife between employees and employers can be minimized easily with the help of such insurance scheme.

5.14 ROLE OF INSURANCE IN ECONOMIC DEVELOPMENT

Insurance is one of the key and significant fields of the economy. It plays countless role in the development of the economy. Insurance contributes a lot to the general economic growth of the society by providing stability to the functioning of economic process. The insurance industries develop financial institutions and reduce uncertainties by improving financial resources. The main contributions of Insurance towards the economy are as follows:

1. **Insurance provides safety and security:**There is always a fear of sudden loss. Insurance provides a cover against any sudden loss. Insurance thus provides financial support and reduce uncertainties in business and human life. It provides safety and security against particular event.
2. **Insurance increases savings:** Insurance does not only protect against risks and uncertainties, but also provides an investment channel too. Insurance companies lead to economic development by mobilizing savings and investing them into productive activities. It encourages people's savings. It develops a habit of saving money by paying premium. As for example, Life insurance increases people's savings by collecting of regular premium. Insured get the lump sum amount at the maturity of the contract. Thus, life insurance encourages savings.
3. **Insurance spreads 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. With this process insurance spreads risk in life. In addition to eliminating risk for the individual through transfer, the insurance device reduces the aggregate amount of risk in the economy by substituting certain costs for uncertain losses.

4. **Insurance gives medical support to society:** A medical insurance considered essential in managing risk in health. Anyone can be a victim of critical illness unexpectedly. 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. Many companies insure their workers with medical insurance. Medical insurance always protects people from illness, and company's workers also can get treatment with medical insurance. With giving medical support insurance plays great role in society.

5. **Insurance is a source of collecting funds:**One of the main roles of insurance in the economy is that, it generates funds by collecting insurance premium. 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. This process increases development the economy of each country.

6. **Helps in Capital Formation:** Capital formation maybe defined as **increase in capital stock** of the country consisting of plant, equipment, machinery, tools, building, means of transport, communication, etc. The importance of Indian insurance industry is gauged by the fact that annual amount of investible funds of LIC and GIC and its subsidiaries are invested in nation building activities, housing and other infrastructural areas.

7. **Obligation to Rural and Social Sector:**In India, the insurance companies are required to fulfill their obligation towards rural and social sector. For this, Life insurers are required to have 5%, 7%, 10%, 12%, 15% of total policies in first five years respectively in rural sector. Likewise, General Insurers are required to have 2% 3% and 5% thereafter of total gross premium income written in first five financial years respectively in rural sector.

8. **Promotes Trade and Commerce:**Whether it is production of goods and services, domestic or international trade or venture capital projects, insurance dominates everywhere. Even banks demand insurance cover of assets while granting loans for purchase of assets. Thus, insurance covers, promotes specialization and flexibility in the economic system that play contributory role in healthy and smooth growth of trade and commerce.

9. **Encouraging Financial Stability and Reducing Anxiety:**Insurer promotes financial stability in economy by insuring the risks and

losses of individuals, firm and organizations. Moreover, it relieves the tensions and anxiety of individuals by securing the loss of their lives and assets.

10. **Reducing Burden on Govt. Exchequer:**Insurance companies, particularly life insurers provide a variety of insurance products covering needs of children, women, aged and all other categories of people under social security network and thereby reduce the burden on Govt. exchequer in providing these services. In this waythe Govt. saves expenditure on these items and amount can be utilized for more productive projects.

5.15 HOW INSURANCE WORKS?

Insurance is a contractual agreement whereby one party agrees, for a consideration called premium, to compensate another party for losses. The insurance sector is made up of companies that offer risk management in the form of insurance contracts. The basic concept of insurance is that one party, the insurer, will guarantee payment for an uncertain future loss. The other party, the insured or the policyholder, pays a smaller premium to the insurer in exchange for that protection on that uncertain future occurrence.

Insurance companies assess the risk and charge premiums for various types of insurance coverage. If an insured event occurs and the insured suffer damages, the insurance company pays him/her up to the agreed amount of the insurance policy. The way insurance companies work, they can pay this and still make a profit. The ways the insurance companies work may be discuss under the following heads:

1. **Evaluating Risk:** Insured persons or organisations that buy insurance policies transfer their risk to the insurance companies in return for paying their premiums. Therefore, the insurance companies have to evaluatethe insurance risk they are taking on. Depending on the risks associated the insurance companiesestimate premium. If the risk is higher than usual then the premium will be high.

2. **Shared Risk:** Insurance companies operate on the principle of shared risk. All the customers pay small amounts and share the risk that way. A fire or other covered events happens rarely. The insurance company has to calculate the premiums so the total premiums it receives from its many customers cover the few damage claims, with some money left over for administration and profit.

3. **Re-Insurance:** If an insurance company has a lot of policies in one area and there is a natural disaster, many customers will make a

claim. The insurance company may not have collected enough premiums to cover all those claims. To overcome such a problem, insurance companies pass on some of the risks to other large financial firms that offer re-insurance.The large firms take over the extra risk from the insurance company that holds the policies, and it pays for this service.

4. **Investment Income:** Insurance companies receive lots of small amounts in premiums and have to occasionally pay out large amounts over the time. Before paying out the damages, they may have large surpluses which they invest. They typically place this money in safe investments, but it still generates a substantial income. This income increases the revenue of the insurance companies, and they can use it to reduce the premiums they charge or to increase their profits.



5.16 LET US SUM UP

- Insurance is a contractual agreement between two parties in which one party promise, for a consideration called premium, to protect another party from uncertainties and losses. The first party is insurance company or insurer who agrees to protect and compensate the other party for losses suffered by it.Insurance helps in economic development of country by mobilising people's savings.
- Insurance is a form of risk managementwhich protects from financial losses. The primary objective of insurance is to financially guard against unpredictable occurrences.
- A risk which can be easily insured and which follows the norms and specifications of an insurance is called an Insurable Risk.
- An insurance cover to protect our business from unexpected events or fall during hard times is called business insurance. Business insurance offers end-to-end risk management services to provide to our business from different types of threats, perils, tragedies, etc.
- Insurance plays countless roles in the development of the economy. Insurance contributes a lot to the general economic growth of the society by providing stability to the functioning of economic process.



5.17 FURTHER READINGS

- **Principles & Practice of Insurance -By M Motihar**
- **Insurance: Principles and Practice -By M.N. Mishra & S B Mishra**



5.18 CHECK YOUR PROGRESS

Answer as directed:

a) The primary function of insurance is to provide protection to insured in case of any uncertain event. (Write True or False)

b) _____ is the regulator of insurance sector in India? (Fill in the gap)

c) A fixed amount of money collect by insurance companies from their clients is called _____.(Fill in the gap)

d) Write the full form of IRDA.



5.19 ANSWERS TO CHECK YOUR PROGRESS

(a) True(b) IRDA (c) Premium (d) Insurance Regulatory and Development Authority



5.20 Model QUESTIONS

1. Write short notes on the following:

a) Nature of insurance

b) Business insurance

c) Insurable risk

d) Insurance and gambling

2. Explain the functions of insurance.

3. Give the meaning of insurance. Explain its objectives.

4. Discuss the salient feature of insurance.

5. What is business insurance? Explain its types and benefits.

6. Distinguish between Insurance and gambling.

7. Mention the differences between insurance and hedging.

8. Write an analytical note on importance of insurance.

9. Explain the importance of insurance in business.

10. Describe the role played by insurance in economic development of a country.

11. Explain how insurance works.

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UNIT-6: NATURE AND SCOPE OF INSURANCE

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Role of Insurance in Financial System

6.4 Growth of Insurance in India

- 6.4.1 Insurance in the Colonial Era
- 6.4.2 Nationalisation
- 6.4.3 Post Nationalisation and liberalization
- 6.4.4 FDI in Insurance Sector

6.5 Bancassurance in India

6.6 Let Us Sum Up

6.7 Further Readings

6.8 Answers to Check Your Progress

6.9 Possible Questions

6.1 LEARNING OBJECTIVES

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

- Explain the Role of Insurance in Financial System
- Discuss Evolution of Insurance sector in India
- Know the concept of Bancassurance

6.2 INTRODUCTION

According to Swiss Reinsurance Company Ltd, commonly known as Swiss Re, in 2018 life insurance business India is ranked 10th among the 88 countries. India's share in global insurance market was 1.92 percent during2018 and share in global life insurance market was 2.61 percent during 2018. Strong economic growth in the last decade combined with a population of over one billion makes it one of the potentially largest markets in the future.

The measure of insurance penetration and density reflects the level of development of insurance sector in a country. While insurance penetration is measured as the percentage of insurance premium to GDP, insurance density is (per capita premium). During the rst decade of insurance sector liberalization, the sector has reported consistent increase in insurance penetration from 2.71 percent in 2001to 5.20 percent in 2009. Since then, the level of penetration was declining. However, there was a slight increase in the years 2015to 3.44 percent, in 2016 to 3.49percent, in2017to3.69 percent and in 2018 to 3.70 percent.

From being an exclusive state monopoly and restricted market to a competitive and open one, the insurance sector in India has experienced a paradigm shift in the last couple of years. The insurance sector in India has been marked by remarkable growth. In this unit we will discuss role of insurance in financial system and the evolution of insurance sector in India which is still evolving and expanding.

6.3 ROLE OF INSURANCE IN FINANCIAL SYSTEM

Insurance plays a very important role in financial system and contributes a lot to the general economic growth of the society by provides stability to the functioning of process. The insurance industries develop financial institutions and reduce uncertainties by improving financial resources.

6.3.1. Provide safety and security

Insurance provides financial support and reduce uncertainties in business and human life. It provides safety and security against particular event. There is always a fear of sudden loss. Insurance provides a cover against any sudden loss. For example, in case of life insurance financial assistance is provided to the family of the insured on his death. In case of other insurance security is provided against the loss due to fire, marine, accidents etc.

6.3.2. Generates financial resources

Insurance generate 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.

6.3.3. Life insurance encourages savings

Insurance does not only protect against risks and uncertainties, but also provides an investment channel too. 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 get the lump sum amount at the maturity of the contract. Thus life insurance encourages savings.

6.3.4. Promotes economic growth

Insurance generates significant impact on the economy by mobilizing domestic savings. Insurance turn accumulated capital into productive investments. Insurance 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.

6.3.5. 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.

6.3.6. 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.

6.4 GROWTH OF INSURANCE IN INDIA

6.4.1 Insurance in the Colonial Era

The insurance business in India started in the 19th century. At that time, only a few British insurance companies served the market and were lo-

cated in the larger cities of India. The first Life insurance company in the modern form was first set up in India through a British company called the Oriental Life Insurance Company in 1818, followed by the Bombay Assurance Company in 1823 and the Madras Equitable Life Insurance Society in 1829. All of these companies operated in India but did not insure the lives of Indians. They insured the lives of Europeans living in India. Some of the companies that started later did provide insurance for Indians, but they were treated as "substandard." Substandard in insurance parlance refers to life insurance for people with physical disability.

The General Insurance business was started late. The first general insurance company, Triton Insurance Company Ltd., was established in the year 1850. It was owned and operated by the British. In 1907, the first Indian general insurance company, namely Indian Mercantile Insurance was set up in Bombay.

During the early time there was no specific regulation or law for regulating insurance business in India. Insurers were subject to the Indian Companies Act of 1866, but the insurance industry was otherwise unregulated. After the start of the Swadeshi movement in 1905, indigenous enterprises sprang up in many industries. Not surprisingly, the movement also touched the insurance industry, leading to the formation of dozens of life insurers along with provident fund companies in India.

In 1912, two sets of legislation were passed- the Indian Life Assurance Companies Act and the Provident Insurance Societies Act. However, they did not apply to general insurance, because the government did not feel the necessity to regulate general insurance and they restricted activities of Indian insurers but not foreign insurers, even though the legislation was modelled after the British Act of 1909. Comprehensive insurance legislation covering both life and non-life business did not materialize for the next 26 years. The only significant legislative change before the Insurance Act of 1938 was Act XX of 1928. It enabled the government of India to collect information about (1) Indian insurers operating in India, (2) foreign insurers operating in India, and (3) Indian insurers operating in foreign countries. The Insurance Act, 1938 was the first comprehensive act that brought together and amended earlier legislations with a view to protecting the interests of the insurance public with provisions for effective control over the activities of insurers.

By 1956, there were 154 Indian life insurers. There were 16 non-Indian insurers, and 75 provident societies were issuing life insurance policies. Most of these policies were entered in the big cities of Bombay, Calcutta, Delhi, and Madras.

The Insurance Act of 1938

In 1937, the government of India set up a consultative committee. Sushil C. Sen, a well-known solicitor in Calcutta, was appointed the chair of the committee. He consulted a wide range of interested parties, including leaders within the insurance industry. It was debated in the legislative assembly, and, finally, in 1938, the Insurance Act was passed. This was the first comprehensive piece of legislation in India, covering both life and general insurers. This piece of legislation lost significance after life insurance was nationalized in 1956, and general insurance was nationalized in 1972.With the privatization in the late twentieth century, the Insurance Act of 1938returned as the backbone of current legislation of insurers. To implement the 1938 Act, an insurance department was established in the Ministry of Commerce by the government of India; later it was transferred to the Ministry of Finance. One curious element of the Act's classification of lines of insurance business was its inclusion of automobile insurance in the "miscellaneous" category. Later in the century, automobiles became the largest single item of general insurance.

6.4.2 Nationalisation

The Insurance Act 1938has been widely used as a reference by the insurance industry until the industry was nationalized. On 19th January, 1956, the management of life insurance business of 245 Indian and foreign insurers and provident societies then operating in India was taken over by the Central Government. The Life Insurance Corporation (LIC) was formed in September 1956 by the Life Insurance Corporation Act, 1956 (LIC Act), which granted LIC the exclusive privilege to conduct life insurance business in India. However, an exception was made in the case of company, firm or persons intending to carry on life insurance business in India in respect of the lives of "persons ordinarily resident outside India" provided the approval of the Central Government was obtained. The exception was however not absolute and a curious prohibition existed. Such company, firm or person would not be permitted to insure the life of any "person ordinarily resident outside India", during any period of their temporary residence in India. However, the LIC Act left outside its purview the Post Office Life Insurance Fund, any Family Pension Scheme framed under the Coal Mines Provident Fund, Family Pension and Bonus Schemes Act, 1948 or the Employees' Provident Funds and the Family Pension Fund Act, 1952.

The general insurance business was also nationalised with effect from 1st January, 1973, through the introduction of the General Insurance Business

(Nationalization) Act, 1972(GIC Act). Under the provisions of the GIC Act, the shares of the existing Indian general insurance companies and undertakings of other existing insurers were transferred to the General Insurance Corporation to secure the development of the general insurance business in India and for the regulation and control of such business. The GIC was established by the Central Government in accordance with the provisions of the Companies Act, 1956 (Companies Act) in November 1972 and it commenced business on 1st January, 1973. Prior to 1973, there were 107 companies, including foreign companies, offering general insurance in India. These companies were amalgamated and grouped into four subsidiary companies of GIC, viz. the National Insurance Company Ltd. (National Co.), the New India Assurance Company Ltd. (New India Co.), the Oriental Insurance Company Ltd. (Oriental Co.), and the United India Assurance Company Ltd. (United Co.). GIC undertakes mainly reinsurance business apart from aviation insurance. The bulk of the general insurance business of fire, marine, motor and miscellaneous insurance business is under taken by the four subsidiaries. Nationalisation was accomplished in two stages; initially the management of the companies was taken over by means of an Ordinance, and later, the ownership too was taken by means of a comprehensive bill. However, it was only in 1956 LIC was nationalised, with the objective of spreading life insurance much more widely and in particular to the rural areas with a view to reach all insurable persons in the country, providing them adequate financial cover at a reasonable cost. Today LIC is India's leading Insurance Company, with more than 2000 branches, which probably is the highest number of branches across India insurance sector.

Nationalization took place with the hope that with the economies of scale, the cost can be cut down and the lower premium can be offered to the market. In addition, the government can promote the life insurance products to the rural areas, which are not the interest of the private insurance companies due to non-profitability. The main purpose of nationalization of the life insurance industry is to meet the social objective of insurance and introduce it to the neglected rural areas.



Check your progress

Q. No. 1: Name the first Insurance company established in India.

Q. No. 2: In which year LIC was established?

6.4.3 Post Nationalisation and liberalization

After nationalization of the insurance industry, the Malhotra Committee was established in 1993. The Chairperson of this committee is R.N. Malhotra who is the retired Governor of the Reserve Bank of India. The aims of this committee are-

(a) to suggest the structure of insurance industry by assessing the strength and weakness of the industry, coverage of the insurance products, quality of insurance services, efficiency and variability,

(b) to recommend for changes in the structure of insurance industry and changes in general policy framework,

(c) to suggest LIC and GIC to improve their functioning,

(d) make recommendation on regulation and supervision of the insurance sector,

(e) to make recommendation on the role and functioning of the agents and

(f) to recommend on any matter for the development of the insurance industry in India.

This committee conducted a survey examining the impact of nationalisation and submit its report in 1994. Some of the recommendations of the committee are-

a. Government stake in insurance companies to be brought down to 50%.

b. the establishment of an independent regulatory authority (akin to Securities and Exchange Board of India);

c. allowing private sector to enter the insurance field;

d. improvement of the commission structure for agents to make it effective instrument for procuring business specially rural, personal and non-obligatory lines of business;

e. insurance plans for economically backward sections, appointment of institutional agents;

f. setting up of an institution of professional surveyors/loss assessors;

g. functioning of Tariff Advisory Committee (TAC) as a separate statutory body;

h. marketing of life insurance to relatively weaker sections of the society and specified proportion of business in rural areas;

i. provisions for co-operative societies for transacting life insurance business in states;

j. the requirement of specified proportion of the general business as rural non-traditional business to be undertaken by the new entrants;

k. welfare oriented schemes of general insurance;

l. technology driven operation of General Insurance Corporation of India (GICI); GIC to exclusively function as a reinsurer and to cease to be the holding company;

m. introduction of unlinked pension plans by the insurance companies;

n. Postal life insurance should be allowed to operate in the rural market;

o. Mandatory investment of LIC life fund in government securities to be reduced from 75% to 50%;

p. restructuring of insurance industry

In 1972, General Insurance Corporation (GIC) of India was incorporated under the Companies Act 1965 to control and operate the business of general insurance of India after nationalization. GIC is re-organized with four fully owned subsidiary companies: National Insurance Company Limited, New India Assurance Company Limited, Oriental Insurance Company Limited and United India Insurance Company Limited. The performance of GIC was criticized by the Malhotra Committee by pointing out the unavailability of complete and up-to-date data. In addition, with the amendment of the Motor Vehicles Act 1939, there as an increase in third party liability and hence, the premium should be higher. However, due to political pressure, the premium cannot be increased and thus it does not reflect the market price. Therefore, GLC incurred huge losses in motor insurance. This led to the abolishment of the Tariff Advisory Committee on 1st April 2006.Moreover, the efficiency of four subsidiaries is questioned and it has been suggested that these subsidiaries should be independent companies and GLC should not be the holding company and should focus solely on reinsurance. Interestingly, the report from Price Waterhouse Coopers was contrary to the suggestions of the Malhotra Committee. Price Waterhouse Cooper's recommended merging the four subsidiaries for greater efficiency. These companies came out with the "voluntary retirement scheme" to reduce the number of staff since they were overstaffed.

From 1991 onwards, the Indian Government introduced various reforms in the financial sector paving the way for the liberalisation of the Indian economy. It was a matter of time before this liberalisation affected the insurance sector. A huge gap in the funds required for infrastructure was felt particularly since much of these funds could be filled by life insurance funds, being long tenure funds.

In 1995, the Mukherjee Committee was set up. The purpose of this committee is to provide a concrete plan for newly formed insurance companies. The report of this committee is not disclosed to the public. This committee also focuses on the transparent disclosure of the financial information. After the report from the Malhotra Committee, the political instability slowed the process to liberalize the insurance industry. The Indian Cabinet approved the Insurance Regulatory Authority (IRA) Bill on 16th March1999. The Insurance Regulatory and Development Authority Act(which is now called the Insurance Regulatory and Development Authority) was passed on 7th December 1999. The IRDA was incorporated as a statutory body in April, 2000. The key objectives of the IRDA include promotion of competition so as to enhance customer satisfaction through increased consumer choice and lower premiums, while ensuring the financial security of the insurance market and aimed at liberalizing the insurance industry. Starting from early 2000, private companies are given licenses for insurance, according to life, general and reinsurance.

The IRDA opened up the market in August 2000 with the invitation for application for registrations. Foreign companies were allowed ownership of up to 26%. The Authority has the power to frame regulations under Section 114A of the Insurance Act, 1938 and has from 2000 onwards framed various regulations ranging from registration of companies for carrying on insurance business to protection of policyholders' interests. In the first year of insurance market liberalisation (2001) as much as 16 private sector companies including joint ventures with leading foreign insurance companies have entered the Indian insurance sector. Of this, 10 were under the life insurance category and six under general insurance.

In December, 2000, the subsidiaries of the General Insurance Corporation of India were restructured as independent companies and at the same time GIC was converted into a national re-insurer. Parliament passed a bill de-linking the four subsidiaries from GIC in July, 2002.

Today there are 34 general insurance companies including the ECGC and Agriculture Insurance Corporation of India and 24 life insurance companies operating in the country. The insurance sector is a huge one and is

growing at a speedy rate of 15-20%. Together with banking services, insurance services add about 7% to the country's GDP. A well-developed and evolved insurance sector is a boon for economic development as it provides long- term funds for infrastructure development at the same time strengthening the risk taking ability of the country.

6.4.4 FDI in Insurance Sector

As a part of reform process foreign investment in insurance sector was permitted in the year 2000 by allowing FDI up to 26 per cent in an Indian insurance company. Later, in 2015, this limit was raised to 49 per cent. Furthermore, in the Union Budget for 2021-22 proposed to liberalize foreign direct investment (FDI) in Indian insurance companies to 74% from the existing 49%.

The FDI will immensely help the insurance sector which is extremely short in investments. Following are the key benefits of Foreign Direct Investment in Insurance Sector:

- **Increased Insurance Penetration**– With the population of more than 100 crores, India requires insurance more than any other nation. However, the insurance penetration in the country is only around 3 percent of our gross domestic product with respect to over-all premiums underwritten annually. This is far less as compared to Japan which has an insurance penetration of more than 10 percent. Increased FDI limit will strengthen the existing companies and will also allow the new players to come in, thereby enabling more people to buy life cover.

- **Level Playing Field –** With the increase in foreign direct investment to 49 percent, the insurance companies will get the level playing field. So far the state owned Life Corporation of India controls around 70 percent of the life insurance market.

- **Increased Capital Inflow** – Most of the private sector insurance companies have been making considerable losses. The increased FDI limit has brought some much needed relief to these firms as the inflow of more than 10,000 crore is expected in the near term. This could go up to 40,000 crore in the medium to long term, depending on how things pan out.

- **Job Creation –**With more money coming in, the insurance companies will be able to create more jobs to meet their tar-

gets of venturing into under insured markets through improved infrastructure, better operations and more manpower.

- **Consumer Friendly –** The end beneficiary of this amendment will be common men. With more players in this sector, there is bound to be stringent competition leading to competitive quotes, improved services and better claim settlement ratio.



CHECK YOUR PROGRESS

Q. No. 3: In which year IRDA Act was passed?

Q. No. 4: From which year FDI is permitted in insurance sector in India?

6.5 BANCASSURANCE IN INDIA

Bancassurance is a French term referring to the selling of insurance through a bank's established distribution channels. In other words, we can say Bancassurance is the provision of insurance products by a bank. The usage of the word picked up as banks and insurance companies merged and banks sought to provide insurance, especially in markets that have been liberalised recently. It is a controversial idea, and many feel it gives banks too great a control over the financial industry. In some countries, bancassurance is still largely prohibited.

Bancassurance is the selling of insurance and banking products through the same channel, most commonly through bank branches. Selling insurance means distribution of insurance and other financial products through Banks. Bancassurance concept originated in France and soon became a success story even in other countries of Europe. In India a number of insurers have already tied up with banks and some banks have already flagged off bancassurance through select products. In 2002, the IRDAI passed a notification on "Corporate Agency" regulations. According to the guidelines, banks can act as an agent of one life and one non-life insurer and are allowed to sell insurance products to their customers.

With a middle-class population greater than 200 million, and a vast banking network covering urban as well as rural areas with the largest depositor base, bancassurance is particularly expected to be a win-win for India, which is known to be a high-saving society.

With the passes of time Bancassurance has become significant. Banks are now major distribution channels for insurers, and insurance sales a

significant source of profits for banks. Banks can often sell insurance at better prices (i.e., higher premiums) than many other channels, and they have low costs as they use the infrastructure (branches and systems) that they use for banking.

Bancassurance primarily rests on the relationship that the customer has developed over a period of time with the bank. And pushing risk products through banks is a much more cost-effective affair for an insurance company compared to the agent route, while, for banks, considering the falling interest rates, fee-based income coming in at a minimum cost is more than welcome.

Government of India Notification dated August 3, 2000, specified 'Insurance' as a permissible form of business that could be undertaken by banks under Section 6(1)(o) of the Banking Regulation Act, 1949. Then onwards, banks are allowed to enter the insurance business as per the guidelines and after obtaining prior approval of Reserve Bank of India.

Guidelines for Banks for Entry of banks into Insurance business

1. Scheduled commercial bank would be permitted to undertake insurance business as agent of insurance companies on fee basis, without any risk participation. The subsidiaries of banks will also be allowed to undertake distribution of insurance product on agency basis.

2. Banks which satisfy the eligibility criteria given below will be permitted to set up a joint venture company for undertaking insurance business with risk participation, subject to safeguards. The maximum equity contribution such a bank can hold in the joint venture company will normally be 50 per cent of the paid-up capital of the insurance company. On a selective basis the Reserve Bank of India may permit a higher equity contribution by a promoter bank initially, pending divestment of equity within the prescribed period (see Note 1 below). The eligibility criteria for joint venture participant are as under: -

(a) The net worth of the bank should not be less than Rs.500 crore;

(b) The CRAR of the bank should not be less than 10 per cent;

(c) The level of non-performing assets should be reasonable;

(d) The bank should have net profit for the last three consecutive years;

(e) The track record of the performance of the subsidiaries, if any, of the concerned bank should be satisfactory.

3. In cases where a foreign partner contributes 26 per cent of the equity with the approval of Insurance Regulatory and Development Authority/Foreign Investment Promotion Board, more than one public sector bank or private sector bank may be allowed to participate in the equity of the insurance joint venture. As such participants will also assume insurance risk, only those banks which satisfy the criteria given in paragraph 2 above, would be eligible.

4. A subsidiary of a bank or of another bank will not normally be allowed to join the insurance company on risk participation basis. Subsidiaries would include bank subsidiaries undertaking merchant banking, securities, mutual fund, leasing finance, housing finance business, etc.
5. Banks which are not eligible as joint venture participant as above, can make investments up to 10% of the net worth of the bank or Rs.50 crore, whichever is lower, in the insurance company for providing infrastructure and services support. Such participation shall be treated as an investment and should be without any contingent liability for the bank. The eligibility criteria for these banks will be as under:

(i) The CRAR of the bank should not be less than 10%;

(ii)The level of NPAs should be reasonable;

(iii) The bank should have net profit for the last three consecutive years.

6. All banks entering into insurance business will be required to obtain prior approval of the Reserve Bank. The Reserve Bank will give permission to banks on case to case basis keeping in view all relevant factors including the position in regard to the level of non-performing assets of the applicant bank so as to ensure that non-performing assets do not pose any future threat to the bank in its present or the proposed line of activity, viz., insurance business. It should be ensured that risks involved in insurance business do not get transferred to the bank and that the banking business does not get contaminated by any risks which may arise from insurance business. There should be ‘arms length’ relationship between the bank and the insurance outfit.

Notes: -

1. Holding of equity by a promoter bank in an insurance company or participation in any form in insurance business will be subject to compliance with any rules and regulations laid down by the IRDA/Central Government. This will include compliance with Section 6AA of the Insurance Act as amended by the IRDA Act, 1999, for divestment of equity in excess of 26 per cent of the paid up capital within a prescribed period of time.

2. Latest audited balance sheet will be considered for reckoning the eligibility criteria.

3. Banks which make investments under paragraph 5 of the above guidelines, and later qualify for risk participation in insurance business (as per paragraph 2 of the guidelines) will be eligible to apply to the Reserve Bank for permission to undertake insurance business on risk participation basis.



Check your progress

Q.No.5: What is meant by Bancassurance?

The following Time line of Insurance provides us with bird eye view of various changes that took place in Insurance Industry in India :

- 1818 British introduced the life insurance to India with the establishment of the Oriental Life Insurance Company in Calcutta.
- 1850 Non-life insurance started with Triton Insurance Company.
- 1870 Bombay Mutual Life Assurance Society is the first India owned life insurer.
- 1912 The Indian Life Assurance Company Act enacted to regulate the life insurance business.
- 1938 The Insurance Act was enacted.
- 1956 Nationalization took place. Government took over 245 Indian and foreign insurers and provident societies and Life Insurance Corporation was set up.
- 1972 Non-life business nationalized, General Insurance Corporation (GIC) came in to being.
- 1993 Malhotra committee was constituted under the chairmanship of former RBI chief R. N. Malhotra to draw a blue print for insurance sector reforms.
- 1994 Malhotra committee recommended entry of private players.
- 1997 IRDA (Insurance Regulatory and Development Authority) was set up as a regulator of the insurance market in India.
- 2000 IRDA started giving license to private insurers. ICICI Prudential, HDFC and Max New York Life Insurance (now MAX LIFE) were first private players to sell insurance policies.

- As a part of reform process foreign investment in insurance sector was permitted in the year 2000 by allowing FDI up to 26 per cent in an Indian insurance company.



6.6 LET US SUM UP

- Insurance provides financial support and reduce uncertainties in business and human life.
- Insurance does not only protect against risks and uncertainties, but also provides an investment channel too.
- Life insurance company in the modern form was first set up in India through a British company called the Oriental Life Insurance Company in 1818
- On 19th January, 1956, the management of life insurance business of 245 Indian and foreign insurers and provident societies then operating in India was taken over by the Central Government.
- The Life Insurance Corporation (LIC) was formed in September 1956 by the Life Insurance Corporation Act, 1956 (LIC Act).
- Starting from early 2000, private companies are given licenses for insurance, according to life, general and reinsurance.
- As a part of reform process foreign investment in insurance sector was permitted in the year 2000.
- Bancassurance is the selling of insurance and banking products through the same channel, most commonly through bank branches.



6.7 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1. Oriental Life Insurance Company

Ans to Q No.2 September 1956

Ans to Q No.3 7th December 1999

Ans to Q No.4 In 2000

Ans to Q No.5 Bancassurance is the provision of insurance products by a bank.



6.8 MODEL QUESTIONS

1. How insurance sector supports the financial system? Discuss
2. Discuss the growth of insurance in India in colonial era.
3. Discuss the objectives and recommendations of Malhotra Committee.
4. Explain the role of FDI in insurance sector.
5. Discuss the norms to be fulfilled by banks for entering in to the business of Bancassurance.
6. Evaluate the growth of insurance sector of India in post liberalised period.
7. Discuss the evolution of insurance sector in India.

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UNIT 7: PRINCIPLES OF INSURANCE

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Principle of Utmost Good Faith

7.4 Principle of Indemnity

7.5 Principle of Insurable Interest

7.6 Principle of Subrogation

7.7 Principle of Loss Minimization

7.8 Principle of Contribution

7.9 Principle of Causa Proxima

7.10 Distinct Characteristics of Insurance Contracts

- 7.10.1 Aleatory Contract
- 7.10.2 Unilateral Contract
- 7.10.3 Conditional Contract
- 7.10.4 Personal Contract
- 7.10.5 Contract of Adhesion

7.11 Let Us Sum Up

7.12 Further Readings

7.13 Possible Questions

7.1 LEARNING OBJECTIVES

After going through this unit, the learners will able to:

- *Know the basic principles of insurance*
- *Explain the characteristics of insurance contracts*

7.2 INTRODUCTION

Insurance is a contract in which an individual or organisation receives financial protection and reimbursement of damages from the insurer or the insurance company. 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 policyholders pool their risks together. Any loss that they suffer will be paid out of their premiums which they pay. There are seven basic principles on which the business of insurance is based on.

7.3 PRINCIPLE OF UTMOST GOOD FAITH

The principle of 'Utmost good faith', also known by its Latin name *Uberrimae Fidei*, is a minimum standard, legally obliging all parties entering a contract to act honestly and not mislead or withhold critical information from one another. The principle of utmost good faith applies to many every-day financial transactions and is one of the most fundamental principles in insurance law. Utmost good faith is one of the first principles of an insurance contract. This principle states that the insurer and the insured must disclose all material facts before the policy inception. This means that both the parties have to be transparent with each other and material facts have to be disclosed both before the policy is signed.

Insurance contract being a financial contract needs to follow utmost good faith. Both the parties, the insurer and the insured must enter into a contract in good faith. They both should reveal all material information and facts regarding contract to each other accurately and honestly. Insured should tell the insurer all details truly so that insurance companies are able to calculate the right premium amount. Also, the insurer should provide all information regarding insurance contract with fairness to insured. Any misrepresentation of facts and figures will make insurance policy legally revoked or cancelled.

Section 45 of Insurance Act 1938 states that if within two years of commencement or revival of the insurance policy, the insurer get to know that there has been a non-disclosure or misrepresentation of material facts, then the insurer can call the policy null and void. It simply means that if within two years the Insurance Company finds out that the policy holder has not stated the complete truth or has lied while filling up the proposal form, then it can cancel the policy and decline the claim.

Example: If an alcoholic person had mentioned that he is non-alcoholic and he dies in a heart attack within two years of the policy commencement, then also the Insurance Company may repudiate or decline the claim on grounds of 'non-disclosure' or 'misrepresentation' of 'material facts', i.e., for not stating the complete truth or misstating information which is relevant for underwriting and risk assessment.

7.4 PRINCIPLE OF INDEMNITY

Indemnity means making compensation payments to one party by the other for the loss occurred.In a legal sense, it may also refer to an exemption from liability for damages. Indemnity is a comprehensive form of insurance compensation for damages or loss. The insurer promises to make the insured party whole again for any covered loss in exchange for premiums the policyholder pays. Principle of indemnity means insurance contracts are done to provide protection and compensate against uncertain losses, damages or injuries. Indemnity simply means protection, security and compensation for damages or losses. Insured cannot enter into an insurance contract for earning profit but it is meant for recovery of losses only. Insurance is meant to bring back the insured into the original position in which he was before happening of uncertainties. Principle of indemnity does not apply to the life insurance contract.

Example: The owner of a commercial building enters an insurance contract to recover the costs for any loss or damage in future. If the building sustains structural damages from fire, then the insurer will indemnify the owner for the costs to repair the building by way of reimbursing the owner for the exact amount spent on repair or by reconstructing the damaged areas using its own authorized contractors.

7.5 PRINCIPLE OF INSURABLE INTEREST

Insurable interest is an essential requirement for issuing an insurance policy that makes the entity or event legal, valid and protected against intentionally harmful acts. Insurable interest means that the subject matter for which the individual enters the insurance contract must provide some financial gain to the insured. However, a person or entity cannot purchase an insurance policy to cover themselves if they are not actually subject to the risk of financial loss. Therefore, it is said that people not subject to financial loss do not have an insurable interest.

The principle of insurable interest states that insurance policy holder must have insurable interest in the subject matter of insurance. He must have some vested interest in it and must be affected by existence and non-existence of object of insurance. It is not necessarily required by insured to be the owner of insurance object. Existence of an object should provide him some benefits and gains. Any damage to an insurance object should adversely affect the insured and provides him heavy losses.

Example: The owner of a vegetable cart has an insurable interest in the cart because he is earning money from it. However, if he sells the cart, he will no longer have an insurable interest in it.

7.6 PRINCIPLE OF SUBROGATION

Subrogation means one party stands in for another. Principle of subrogation states that after paying compensation, the ownership right of property will transfer from insured to insurer. This principle gives insurer right to recover amount from third party who is responsible for happening of uncertainties and losses to insurer. Principle of subrogation allows insurer to pursue legal methods against that third party to recover the amount of losses. However, insurer can claim amount only to the extent of amount paid by him to insured as compensation.Subrogation gives the right to the insurance company to claim the amount of loss from the third-party responsible for the same.

Example: If Mr 'A' gets injured in a road accident, due to irresponsible driving of a third party, the company with which Mr.'A' took the accidental insurance will compensate the loss occurred to Mr.'A' and will also sue the third party to recover the money paid as claim.

7.7 PRINCIPLE OF LOSS MINIMIZATION

This principle states that insured should always take all necessary steps to avoid losses and damages to insured property. It is his obligation to minimize the losses to insured property in case of any uncertainties like blast or fire outbreak. Insured should not be negligible or act irresponsible towards the property only because it is insured for losses. Therefore, insured should try to protect insured property and avoid any losses.

Example: If a fire breaks out in a factory, the owner of the factory should take reasonable steps to put out the fire. He cannot just stand back and allow the fire to burn down the factory because he knows that the insurance company will compensate for it.

7.8 PRINCIPLE OF CONTRIBUTION

Principle of contribution states that insured cannot make profit by insuring the property with more than one insurance company. The insured in case of any uncertainties can claim only the actual amount of loss. Insurance companies will compensate to insured on basis on 'principle of contri-

bution'. All Insurance companies will share the losses to extent of sum insured with them. In case if only one insurance company pays the full amount of loss it can demand contribution from other insurance companies.

Example: A property worth Rs. 5 Lakhs is insured with Company 'A' for Rs. 3 lakhs and with company 'B' for Rs.1 lakh. The owner in case of damage to the property for 3 lakhs can claim the full amount from Company 'A', but he cannot claim any amount from Company 'B'. Now, Company'A' can claim the proportional amount reimbursed value from Company 'B'.

7.9 PRINCIPLE OF CAUSA PROXIMA

Causa proxima means the 'direct cause' or 'nearest cause'. The principles of Causa proxima are applicable when there are series of causes for losses or damages to insured property. According to this, the nearest and most dominant cause for losses and damages is considered for calculating the liability of insurer.

Example: Due to fire, a wall of a building was damaged, and the municipal authority ordered it to be demolished. While demolition the adjoining building was damaged. The owner of the adjoining building claimed the loss under the fire policy. The court held that fire is the nearest cause of loss to the adjoining building, and the claim is payable as the falling of the wall is an inevitable result of the fire.

In the same example, the wall of the building damaged due to fire, fell down due to storm before it could be repaired and damaged an adjoining building. The owner of the adjoining building claimed the loss under the fire policy. In this case, the fire was a remote cause, and the storm was the proximate cause; hence the claim is not payable under the fire policy.



CHECK YOUR PROGRESS

Q. 1.Explain the basic principles upon which a contract of insurance is based.

7.10 DISTINCT CHARACTERISTICS OF INSURANCE CONTRACTS

Insurance contracts are legal agreements between insurance companies and their clients. These agreements come in the form of insurance policies, or contracts. Though, insurance contracts are similar to most other legal contracts but, certain features of insurance contracts differentiate them

from most other legal contracts. Insurance contracts are different from other types of contracts as they have some distinguishing characteristics that define them as insurance documents. Though all contracts share fundamental concepts and basic elements, insurance contracts typically possess a number of characteristics not widely found in other types of contractual agreements. The most common of these features are listed here:

7.10.1 Aleatory Contract

Most of the time, contracts between two parties represent an agreement for certain services in exchange for an amount of money that corresponds to the services rendered, which is generally fair to both parties. If one party to a contract might receive considerably more in value than he or she gives up under the terms of the agreement, the contract is said to be aleatory. Insurance contracts, by contrast, are aleatory. The term *aleatory* means that one party to the contract can potentially profit from the agreement much more than the other party. Insurance contracts are of this type because, depending upon chance or any number of uncertain outcomes, the insured may receive substantially more in claim proceeds than was paid to the insurance company in premium dollars. On the other hand, the insurer could ultimately receive significantly more money than the insured party if a claim is never filed.

For example, if an insured never files a claim, the insurer receives all the premiums and profits from the agreement. If he files a large claim, however, he can potentially receive much more than he ever paid in premiums, so heprofits greatly.

7.10.2 Unilateral Contract

Another unique characteristic of insurance contract is unilateral insurance. A contract may either be *bilateral* or *unilateral*. In a bilateral contract, each party exchanges a promise for a promise. However, in a unilateral contract, the promise of one party is exchanged for a specific act of the other party. Insurance contracts are unilateral. A unilateral insurance contract is based on the premise that a particular party makes a promise and in exchange will receive a specific act from another party. This is the opposite of a bilateral insurance contract, which is where each specific party will trade promises. When it comes to insurance contracts, a policyholder is responsible for paying the premiums while the company is responsible for paying back the policyholder for any covered losses that happen. The poli-

cyholder has no additional requirements to fulfil on their end once they have paid the premium on the policy.

7.10.3 Conditional Contract

A *condition* is a provision of a contract which limits the rights provided by the contract. Insurance contracts are conditional. Even when a loss is suffered, certain conditions must be met before the contract can be legally enforced. For example, the insured individual or beneficiary must satisfy the condition of submitting to the insurance company sufficient proof of loss, or prove that he or she has an insurable interest in the person insured. There are two basic types of conditions: conditions precedent and conditions subsequent. A condition precedent is any event or act that must take place or be performed before the contractual right will be granted. For instance, before an insured individual can collect medical benefits, he or she must become sick or injured. Further, before a beneficiary will be paid a death benefit, the insured must actually become deceased. A condition subsequent is an event or act that serves to cancel a contractual right. A suicide clause is an example of such a condition. Typical suicide clauses cancel the right of payment of the death benefit if the insured individual takes his or her own life within two years of a life insurance policy's effective date.

7.10.4 Personal Contract

Insurance contracts are usually personal agreements between the insurance company and the insured individual.Life insurance is a personal contract or personal agreement between the insurer and the insured. The owner of the policy has no bearing on the risk the insurer has assumed. For this reason, people who buy life insurance policies are called policy owners rather than policyholders. Policy owners actually own their policies and can give them away if they wish. This transfer of ownership is known as assignment. To assign a policy, a policy owner simply notifies the insurer in writing. The company will then accept the validity of the transfer without question. The new owner is granted all of the rights of policy ownership.

7.10.5 Contract of Adhesion

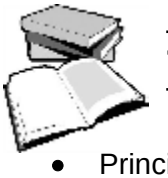
In a contract of adhesion, one party draws up the contract in its entirety and presents it to the other party on a 'take it or leave it' basis; the receiving party does not have the option of negotiating, revising, or deleting

any part or provision of the document. Insurance contracts are of this type, because the insurer writes the contract and the insured either 'adheres' to it or is denied coverage. In a court of law, when legal determinations must be made because of ambiguity in a contract of adhesion, the court will render its interpretation against the party that wrote the contract. Typically, the court will grant any reasonable expectation on the part of the insured (or his or her beneficiaries) arising from an insurer-prepared contract.



7.11 LET US SUM UP

- There are seven basic principles on which the business of insurance is based on.
- Utmost good faith is one of the first principles of an insurance contract. This principle states that the insurer and the insured must disclose all material facts before the policy inception.
- Principle of indemnity means insurance contracts are done to provide protection and compensate against uncertain losses, damages or injuries.
- The principle of insurable interest states that insurance policy holder must have insurable interest in the subject matter of insurance. He must have some vested interest in it and must be affected by existence and non-existence of object of insurance.
- Principle of subrogation states that after paying compensation, the ownership right of property will transfer from insured to insurer.
- Principle of loss minimization states that insured should always take all necessary steps to avoid losses and damages to insured property.
- Principle of contribution states that insured cannot make profit by insuring the property with more than one insurance company.
- The principles of Causa proxima are applicable when there are series of causes for losses or damages to insured property. According to this, the nearest and most dominant cause for losses and damages is considered for calculating the liability of insurer.
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7.12 FURTHER READINGS

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7.13 MODEL QUESTIONS

1. Discuss the meaning and importance of the Principle of Indemnity.
2. Explain doctrine of subrogation.
3. Explain the meaning of doctrine of Causa Proxima.
4. Explain how insurance contracts are different from other types of contracts.
5. What are the distinguishing characteristics of insurance? Explain.

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7.10.5 Contract of Adhesion

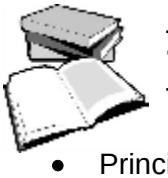
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7.11 LET US SUM UP

- There are seven basic principles on which the business of insurance is based on.
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7.13 MODEL QUESTIONS

1. Discuss the meaning and importance of the Principle of Indemnity.
2. Explain doctrine of subrogation.
3. Explain the meaning of doctrine of Causa Proxima.
4. Explain how insurance contracts are different from other types of contracts.
5. What are the distinguishing characteristics of insurance? Explain.

UNIT 8: LIFE INSURANCE-I

UNIT STRUCTURE

8.1 Learning Objective

8.2 Introduction

8.3 Meaning of Life Insurance

8.4 Characteristics of Life Insurance

8.5 Advantages of Life Insurance

8.6 Classification of policies prevailing in market

8.7 Children Policies

8.8 Pension Plans

8.9 Group Insurance

8.10 Non Traditional Products

8.11 Postal Life Insurance

8.12 Let Us Sum Up

8.13 Answer to Check your Progress

8.14 Further Readings

8.15 Model Questions

8.1 LEARNING OBJECTIVE

- To understand the important aspects of the different types of policies available in the market.
- To know the significance of mortality tables in helping insurance agencies.
- To identify the role of Life Insurance Corporation of India in life insurance industry.

8.2 INTRODUCTION

Life is a roller coaster ride and is full of twists and turns. The whole idea of insurance has developed on the fact that human life is full of uncertainties and the life of a person itself is very uncertain. Eventualities cast their shadows, and therefore one has to equip oneself with possible means so as to

face the unforeseen. Insurance policies are a safeguard against the uncertainties of life. It is one of the important tools of risk management which ensures family's financial security.

In this unit we will discuss the life insurance, its advantages, disadvantages, different types of life insurance policies and postal life insurance.

8.3 MEANING OF LIFE INSURANCE

Life Insurance contract may be defined as the contract, whereby the insurer in consideration of a premium undertakes to pay a certain sum of money either on the death of the insured or on the expiry of a fixed period.

In simple words, it means an agreement in which one party agrees to pay a given sum of money upon the happening of a particular event contingent upon duration of human life in exchange of the payment of a consideration. The person who guarantees the payment is called Insurer, the amount given is called Policy Amount, the person on whose life the payment is guaranteed is called Insured or Assured. The particular event on which the payment is guaranteed to be given may be Death or Life. The consideration is called the Premium. The document evidencing the contract is called Policy.

Thus, the scheme of life insurance provides an assurance that if an unforeseen event happens, the person or his dependents would get financial assistance to bear the loss.

According to Sec 2(ii) of the Insurance Act, 1938 life insurance business means "a business of effecting contracts upon human life. It includes

a) Any contracts whereby the payment of money is assured upon death(except death by accident) or the happening of any contingency dependent on human life;

b) Any contract which is subject to the payment of premiums for a term dependent on human life;

c) Any contract which include the granting of disability and double or triple indemnity, accident benefits, the granting of annuities upon human life and the granting of superannuation allowances.

8.4 CHARACTERISTICS OF LIFE INSURANCE

The following are the characteristics of life insurance:

1. **Offer and acceptance:** The life insurance contract is the outcome of an offer made by the insured and its acceptance by the insurer.

2. **Maturity value:** The insurance company agrees to pay a certain sum of money either on the death of the insured or on the maturity of the policy, whichever is less. As such, in life insurance payment is must.
3. **Payment of premium:** In life insurance, the insured is under an obligation to pay periodically the amount of payment till the death of the insured or expiry of policy, whichever is earlier.
4. **Type of contract:** The contract of life insurance is not a contract of indemnity because financial loss caused by a death cannot be calculated in monetary value. Secondly payment of money cannot be a compensation for loss of one's life. In this only financial protection is granted to the insured if he survives up to the date of maturity of policy or to his claimant if insured dies before date of maturity of policy.
5. **Insurable interest:** In case of life insurance, the person taking out a life policy must have a pecuniary insurable interest in the life of the insured person at the time of taking of the policy.
6. **Financial protection:** Life insurance extends the hands of financial protection to the claimants in case of death of insured before the date of maturity and to the insured if he survives up to the death of maturity of policy.
7. **Habit of saving:** Under the life insurance contract, the insured has to pay a definite premium compulsory which leads to curbing of unnecessary expenses and create the habit of saving.
8. **Meet various needs:** A suitable insurance plan or a combination of different plans can be taken out as life insurance to meet the specific needs that are likely to arise in future such as children's education, medical needs, marriage provision, housing needs, etc.

8.5 ADVANTAGES OF LIFE INSURANCE

The following are the advantages of life insurance:

1. **Superior saving plan:** Life insurance is considered to be the best saving plan in comparison to other plans because it guarantees full protection against risk of death of the saver.
2. **Encourage savings habits:** Life insurance encourages saving habits.
3. **Social security tool:** It acts as a social security tool when the breadwinner dies, to that extent, the family's income dies.
4. **Suitable for raising loan:** Life insurance policy can be given as security to raise a loan without any delay.
5. **Protection against creditors:** The maturity value of life insurance policy can be protected against the claims of the creditors of the life assured by valid assignment of a policy.
6. **Tax relief:** The income tax relief is available for amounts paid by way of premium for life insurance subject to the income tax rates in force.
7. **Helpful to the government:** Life insurance provides long term funds to the government for different development schemes. This helps the government to develop infrastructure and serve the society.

8.6 CLASSIFICATION OF POLICIES PREVAILING IN MARKET

A. Policies according to duration:

The life insurance policies according to the duration may be

I. **Whole-life policies:** Whole-life policies are issued for life. It means that the policy amount will be paid at the death of the life assured. The life assured, thus, cannot get the policy amount during his life time; only his dependents will get the advantages of this policy.

Benefits of Whole Life Insurance Policy

a) **Cover for life**: The insured will get cover for his entire life unlike other life insurance plans that is fixed for a certain period.

b) **Assurance of coverage, periodic payments and tax benefits**: The survival benefits will be built over time which keeps increasing over time. One will get lifetime coverage along with guaranteed level premiums for a limited premium payment term. Tax benefits are also available to the insured under Section 80C and Section 10(10D) of the Income Tax Act, 1961.

c) **Serves as a source of cash**: A whole life plan serves as a source of cash to help fund certain expenses or meeting certain financial obligations at the end of the premium payment term.

d) **Loan option available**: The surrender value of the policy increases over time and one can avail a loan against the policy's surrender value at any time.

e) **Dependents benefitted**: The return will prove to be an additional financial source in the family. This plan is ideal for estate planning individuals who want to pass on their estate to their legal heir as it helps create wealth.

II. **Term Insurance policies:** Term insurance is a kind of life insurance plan that provides death coverage to policyholders for a specific time limit. That is, if the policyholder dies during the policy tenure, then the insurance amount is given as a lump sum to the nominee Term insurance policies are the cheapest policies.

It may be of the following types:

i. **Straight-Term (Temporary) Insurance*:*** The Corporation issues term insurance for two years, which is also called as two-year temporary assurance policy.

ii. **Renewable Term Policies:** These policies are renewable at the expiry of term for an additional period without medical examination; but the premium rate will be altered according to the age attained at the time of renewal.

iii. **Convertible Term Policy:** Under this policy, option to convert it into whole life or endowment policy is available.

Benefits of Term Life Insurance

a) **Term Insurance Plans are very simple to understand:** Simplicity is one of the reasons for the growing popularity of term insurance.

b) **Term insurance plans are supremely affordable:** The premium for a term life insurance plan is as low as 0.1 per cent of the total sum insured.

c) **Death benefit:** In the unfortunate event of death of life insured during policy term, the nominee shall receive the total pay-out as a lump sum amount or a combination of lump sum and monthly amount.

d) **Tax benefit:** Term plans come with a host of tax benefits.

e) **Critical illness coverage:** In case optional critical illness coverage is included in the term insurance plan, one will get a lump sum pay-out upon diagnosis of any critical illness that is covered in the plan.

f) **Accidental death benefit:** One can add the accidental death benefit rider to the term insurance plan. This will offer protection against any mishaps in the future.

III. Endowment Policies: An endowment policy is an insurance plan designed to offer protection with life coverage and the chance to grow wealth through systematic savings. It encourages the policy holder to save money regularly so that he may have a large corpus of money waiting for him in the future. There is also the prospect of capital growth over a long term.

The endowment policies can be several, of which important endowment policies are discussed below:

1. **Pure Endowment Policy:** A pure endowment policy is affected for a stipulated term of years, but under such contract no sum assured is payable if the life assured dies during the term
2. **Ordinary Endowment Policy:** This policy provides an ideal combination of both the family protection and investment. The sum assured is payable either on the life assured's death during the period or on his survival to the end of the period.
3. **Joint Life Endowment Policy:** This policy covers more than one life under a single policy. Sum assured is payable on

the expiry of the term or on the death of one of the assured lives during the endowment period.

4. **Double Endowment Policy:** Under this policy, if the life assured dies during the endowment period, the basic sum assured is payable and if he survives to the end of the term, double of the sum assured is paid.
5. **Marriage Endowment Policy:** Under this policy, sum assured is paid in lump sum at the end of the term. If the death of the policy holder occurs earlier, then the policy will remain fully paid up but the premiums ceases.
6. **Educational Annuity Policy:** This policy is taken for the education needs of the children. The sum assured is payable in equal instalments over a period of five years, in half-yearly instalments.
7. **Triple-Benefit Policy:** This is a combination of the whole life limited payment and a pure endowment policy with guaranteed annual increase of sum assured during the endowment terms.
8. **Anticipated Endowment Policy:** The sum assured is paid at certain interval before death within maturity of the policy and balance of the sum assured is payable at maturity**.**
9. **Progressive Protection Policy with Profits:** The sum assured increases automatically by half the initial sum assured at the end of five years and again by half the initial sum assured at the end of 10 year without considering health of the policy holder at that time.
10. **Anticipated Whole Life Policy with Profits:** This policy provides two types of benefits under one policy-whole-life limited payment policy and anticipated payments at five years interval.

Benefit of Endowment Policy

a) **Incentive to save:** This is an effective plan to save compulsorily. Inspite of having good income, large section of people never saves. But through endowment insurance policy, they are bound to save in the form of payment of life insurance premium against the policy.

b) **Protection against contingencies:** The savings are protected by insurer against the contingency of the premature death of the policy

holder. If after the payment of even first instalment of premium the policy holder dies, the full amount of sum assured is paid to his heirs.

c) **Helpful for old age:** The policy holder is to get the maturity value of the policy after the term of the policy expires. This sum to the policyholders is a kind of financial support for him at the old age.

d) **Build corpus:** Endowment policy not only provides financial protection to the family of the policyholder but also helps policyholder build corpus for the future.

e) **Avail additional riders:** Policyholder can take additional riders like critical illness and personal accident and disability benefit.

f) **Tax benefits:** Policyholder gets benefits under Section 80 C and Section 10 (10) D.

B. Policies according to premium of payment:

Life insurance policies can also be divided according to mode of payment of premium as follows:

1. **Single premium policy:** In this policy, the whole premium is paid at the beginning of the policy. It is costlier for the insured and can be afforded by only those who have got very high income and they do not expect to continue these returns in coming years. But it is not useful to the people because of chances of death where after the subsequent premiums are not required to be paid.

2. **Level premium policy:** In these type of policies, equal and regular payments are made at regular intervals. The premium is lesser than the single premium. The equal instalments may be made monthly, quarterly, half-yearly and annually. This, suits the requirement of different types of policyholders according to convenience.

C. Policies according to participation in profits:

1. **With Profit Policies:** Under these policies, the policyholders share the profit of the insurer. They do not share the loss. Policyholder gets the bonus only if there is profit. The amount of bonus depends on the profit after deducting provision of taxes, etc. Thus the amount of bonus added to each year is not constant. They only follow the

law that the company has to distribute 95 per cent of its profits among the policyholders.

2. **Without Profit Policies:** The holders of without profit policies are not entitled to share the profits of the insurer. These policyholders get only the sum assured and no bonus is given to them.

D. Policies according to number of persons insured:

On the basis of number of persons insured under a single policy, the policy may be divided into:

1. **Single Life Policies:** Under these policies, only one person is insured. It is not necessary that the policy should be issued on one's own life, it may be issued on other's life too. The policy amount is payable when the death of the life assured occurs.
2. **Multiple Life Policies:** These policies may further be divided into:
   a) **Joint Life Policy:** This policy is to cover the risk of life of two or more persons and the amount of policy is payable on the first death. This is taken by the married couple or by the partners of a firm.
   b) **Last Survivorship Policy:** Under this policy, amount is payable at the last death only and not as long as any one of the insured is alive.

E. Policies according to the method of payment of policy amount:

1. **Lump Sum Policies**: Lump sum policies are those policies in which the sum assured is paid in lump sum at the events insured against.
2. **In Instalments:** These policies are also called as Annuity Policies in which the policy amount is payable in instalments. It is beneficial for those whose earning capacities are reduced to minimum in old age. He may continue to get up to a fixed period or up to death or both.

8.7 CHILDREN POLICIES

Children policies provide financial security to manage the future requirements of the child. As part of the policy, the child gets a fixed amount of money at certain intervals that helps meet various financial needs of the

child like paying fees for higher education, etc. Thus, it helps to build capital for important events in a child's life.

Most child plans provide one time pay-out or annual payments after the child reaches 18 years of age. In case the parent passes away during the policy term, payment is made to the child or family. Some insurance companies waive off the premiums in case of death of the policyholder and make the payment after maturity period.

In these plans, risk on the life of the insured child will begin only when the child attains a specified age. Practices vary widely. The time gap between the date of commencement of the policy and the commencement of risk is called the 'Deferment Period'. If the child is 6 years old when the policy is taken and the insurance is to begin when the child is 15 years old, the deferment period is 9 years. The date on which the risk will commence at the end of the deferment period is called the 'Deferment Date'. The deferred date will be a policy anniversary. Ages are reckoned as next birthday, nearest birthday or last birthday, as per the practice of the insurer.

Examples: LIC's Jeevan Ankur, Bajaj Allianz Young Assure

8.7.1 Benefits of Children Policies

The key benefits of children plans are discussed below:

1. **Protection with waiver of premium:** A children insurance plan, like other life insurance policies provide life insurance coverage to dependents. In this case, the protection is meant for the child. The life insurance amount from the child plan can be used to meet the immediate and regular needs besides meeting future needs of the child in the event of the untimely demise of the insured parent.

2. **Providing for immediate needs:** To provide for the child's regular needs, the life insurance coverage from children plans provides the money to help the family meet regular expenses such as those related to school education.

3. **Addressing future needs:** A children future plan also provides money for higher education. In case of the untimely demise of the insured parent, many child plans have what is a called premium waiver feature that ensures that the child plan remains in force for the remaining part of the policy term. The policy premium is paid by the life insurance company. The money invested so far, remains

invested till the end of the policy term and then money is paid to the child which can take care of higher education expenses.

4. **Regular investment for child's higher education:** One can opt for a child investment plan in the unit linked insurance plan (ULIP) category where a portion of the premium is invested in buying units of a fund, money growth may well be high. This typically takes place when you invest in ULIP equity funds. Over the long tenure of the ULIP, the value of the units grow well since equity investments typically provide high returns over 8-10 years, or more.

5. **Tax benefits:** This is the icing on the cake. Besides the protection benefits and helping one save substantial amounts, a children education plan helps one to save tax.

8.8 PENSION PLANS

Pension plans are retirement oriented life insurance plans. They aim to create a retirement corpus and provide one with a source of regular income even after one have stopped working. A pension plan is a retirement plan that requires an employer to make contributions to a pool of funds set aside for a worker's future benefit. The pool of funds is invested on the employee's behalf, and the earnings on the investments generate income to the worker upon retirement.

In addition to an employer's required contributions, some pension plans have a voluntary investment component. A pension plan may allow a worker to contribute part of his current income from wages into an investment plan to help fund retirement. The employer may also match a portion of the worker's annual contributions, up to a specific percentage or dollar amount.

Pension or retirement plans offer the dual benefit of investment and insurance cover. By investing a certain amount regularly towards your pension plan, you will accumulate a considerable sum in a phase-by-phase manner. This will ensure a steady flow of funds once you retire. Public Provident Fund is one of the most popular retirement planning schemes in India.

8.8.1 Features of Pension Plans

1. **Guaranteed Pension/Income:** One can get a fixed and steady income after retiring (deferred plan) or immediately after investing (immediate plan), based on investment. This ensures a financially independent life after retiring.

2. **Tax-Efficiency:** Some pension plans provide tax exemption specified under Section 80C. If one wish to invest in a pension plan, then the Income Tax Act, 1961, offers significant tax respite under Chapter VI-A. Section 80C, 80CCC and 80CCD specify them in detail. For instance, Atal Pension Yojana (APY) and National Pension Scheme (NPS) are subject to tax deductions under Section 80CCD.

3. **Liquidity:** Retirement plans are essentially a product of low liquidity. However, some plans allow withdrawal even during the accumulation stage. This will ensure funds to fall back on during emergencies without having to rely on bank loans or others for financial requirements.

4. **Accumulation Duration:** An investor can either choose to pay the premium in periodic intervals or at once as a lump sum investment. The wealth will simultaneously accumulate over time to build up a sizable corpus (investment + gains). For instance, if you start investing at the age of 30 and continue investing until one turn 60, the accumulation period will be 30 years. One's pension for the chosen period primarily comes from this corpus.

5. **Payment Period:** Investors often confuse this with the accumulation period. This is the period in which you receive the pension post-retirement. For example, if one receives a pension from the age of 60 years to 75 years, then the payment period will be 15 years. Most plans keep this separate from accumulation period, though some plans allow partial/full withdrawals during accumulation periods too.

8.8.2 Types of Pension Plans

There are various types of pension plans offered by a host of companies operating in the financial sector. Following are the various types of pension plans:

A. Traditional Pension Plan

This type of pension plan comes with four options – a regular pension plan, a pension plan with life cover, a pension plan with immediate annuity payments and a pension plan with deferred annuity payments.

- **The regular pension plan** invests all the money that is set aside and one get a corpus at the end of the term including interest earned. In this plan, if one does not survive the policy term, the nominee would receive the corpus along with interest earned until the time of the policyholder demise.

- **The pension plan with life cover** takes out a portion of the money set aside by the policyholder to pay a premium for covering his life through a term policy for a sum assured. Typically, the premium is low for term insurance. Thus, in this plan, the nominee would receive the sum assured in case of demise of the policyholder, before the end of the policy term. They would also be entitled to the sum accumulated from the start of the policy till the time of demise.

- **The pension plan with immediate annuity payments** allows the policyholder to start earning an income from the month following the month of investment. This is akin to earning monthly interest income from a fixed deposit in a bank.

- **The pension plan with deferred annuity payments** allows the policyholder to accumulate a corpus by paying premiums during the policy term. At the end of the term, the premiums paid and interest earned, together become a sizeable corpus. This allows the policyholder to buy an annuity and earn a regular pension. Typically, pension plans with deferred annuity payments come with a life insurance cover.

These pension plans are known as traditional pension plans because the premiums one pay are invested in conservative government and debt securities which are considered to be safe. These are offered by various life insurance companies.

B. Unit-Linked Pension Plans

Traditional pension plans invest the premiums received from the policyholder in safe investments such as government and debt securities. For those with a more aggressive outlook (high risk appetite), there are pension plans that invest a substantial portion of the premiums in high return-high risk investments such as money markets, non-government securities, bonds and stocks. These plans are known as Unit Linked Insurance Plans (ULIP). The main feature of these plans is that the investment com-

ponent is represented by investing the funds in equity instruments. These plans provide opportunities for policyholders with different risk profiles – low, medium and high. One can switch between plans during the policy term at one's discretion, subject to certain terms and conditions.

ULIPs do have a life assured component to cover the risk of premature death. The returns in these are not guaranteed, but one can expect a reasonable return consistent with the vagaries of the stock market.

8.8.3 Benefits of Pension Plans

Pension plans promise the following benefits to policyholders –

a) They create an earmarked corpus for retirement savings which comes in handy after retirement.

b) Deferred pension plans are also offered as unit-linked insurance plans. Through these plans, a substantial retirement corpus can be created.

c) Premiums paid towards pension plans are allowed as a deduction under Section 80CCC of the Income Tax Act.

d) Immediate annuity plans pay guaranteed incomes lifelong to meet expenses after retirement.

e) Joint life annuities are also available under immediate annuity plans which pay annuities for self and spouse too.

f) Deferred annuity plans give 1/3rd of the accumulated corpus as cash when the plan matures.

8.9 GROUP INSURANCE

Group life insurance is offered by an employer or another large-scale entity, such as an association or labour organization, to its workers or members. It is fairly inexpensive, may even be free, and is pretty common nationwide. It has a relatively low coverage amount and is typically offered as a piece of a larger employer or membership benefit package.

Group life insurance is a single contract for life insurance coverage that extends to a group of people. By purchasing group life insurance policy coverage through an insurance provider on a wholesale basis for its mem-

bers, companies are able to secure costs for each individual employee that are much lower than if they were to purchase an individual policy.

That receiving group life insurance coverage may not have to pay anything out of pocket for policy benefits. People who choose to take more-advanced coverage alongside it may elect to have their portion of the premium payment deducted from their pay check. Just as with regular insurance policies, insured parties are required to list one or more beneficiaries before the policy comes into effect. Beneficiaries can be changed at any point during the coverage period.

The typical group policy is for term life insurance, often renewable each year with a company's open-enrolment process. This is in contrast to whole life insurance, which provides coverage no matter when you die. Whole life insurance policies are permanent, have higher premiums and death benefits, and constitute the most popular type of life insurance.

With group life insurance, the employer or organization purchasing the policy for its staff or members retains the master contract. Employees who elect coverage through the group policy usually receives a certificate of coverage, which is needed to provide to a subsequent insurance company in the event that an individual leaves the company or organization and terminates their coverage.

8.9.1 Requirements for Group Life Insurance

Group life insurance policies generally come with certain conditions. Some organizations require group members to participate for a minimum amount of time before they are granted coverage. For instance, an employee may need to pass a probationary period before being allowed to take part in employee health and life insurance benefits.

Coverage is normally only valid for as long as a member is part of the group. Once the member leaves, whether through resignation or firing, the coverage ends. Group life insurance policies remain intact until insured parties are terminated or leave the group.

8.9.2 Features of Group Insurance

The important features of Group Insurance are as under:

1) **Risk of individual lives:** The risk of individual lives is not assessed in a group insurance scheme. The insurer is not concerned with the health, morals or habits of any particular person in a group.

2) **Minimum Number:** The minimum number of individuals in a group should be at least 25 persons.

3) **Existence of a group:** The group should be in existence and no new groups have to be formed for obtaining insurance cover.

4) **Amount of cover:** The individual member does not have any choice about the amount of cover. The amount of insurance depends upon the terms and conditions of the scheme.

5) **Other considerations:** The amount of insurance is determined by a formula or a schedule. It also depends upon salary grade, designation or the length of service of the employees in a group.

8.9.3 Importance of Group Insurance

1. **Boost Employee Retention -** People value jobs that give them a sense of security. A group health insurance will not only give the employees and their families enough financial security, but an overall sense of satisfaction that their employer actually cares about them.
2. **Financial security during unusual circumstances**- Amid unusual circumstances like the pandemic, financial security has become of utmost importance given the downfall in the economy and increasing pay cuts across sectors. Protecting the employees from treatment expenses that could arise out of the virus is the least one can do to ensure they are both financially and medically secure.
3. **Strengthen Employee Motivation -** Happy employees make happy workspaces and evidently successful companies! It's no surprise that the safer and satisfied employees feel, the happier and more motivated they're likely to be!
4. **Protect them from Severe Health Conditions -** More than 61% of illness hospitalization and death in India are due to lifestyle-related diseases. Safeguard your employees from the same, amongst other diseases; the earlier these issues are diagnosed, the earlier they can be treated and resolved.
5. **Enhance their Mental Wellbeing -** Many employees are often affected by stress due to either financial pressure or other personal issues which can lead to lower productively levels at work too. Our group health insurance plan will not only safeguard their savings but, also enhance their overall mental wellbeing with the right support.



CHECK YOUR PROGRESS

1. What is meant by Children Policies?

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2. What are Pension Plans?

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3. State the various types of pension plans.

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4. What is the full form of NPS?

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5. What is the full form of ULIPs?

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6. What is Group Insurance?

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8.10 NON TRADITIONAL PRODUCTS

Life insurers provide an array of plans for customers depending upon their specific requirements. These plans often vary a lot in terms of coverage offered, investment opportunities, policy term, benefits, etc. In the broad sense, life insurance policies can be categorised into traditional and non-traditional plans.

1. **Traditional life insurance:** Traditional products are low-risk insurance covers that offer guaranteed maturity returns for policyholders. These policies typically invest in bonds and other low-risk investment instruments to provide guaranteed maturity proceeds for policyholders.

Traditional insurance policies are of two types — participating and non-participating.

Participating policies are partially guaranteed policies that have some uncertainties. These policies offer guaranteed maturity proceeds along with additional bonuses and profits.

In a non-participating plan, the benefits are clearly guaranteed at the outset. For bonus, one should opt for a participating policy. Those who prioritize certainty should opt for a non-participating policy

2. **Non-traditional life insurance policies:** One of the major aspects of non-traditional life insurance coverage is the combination of insurance and investment under one single policy. These policies offer both components and appeal to customers who have the appetite for high-risk coverage. These plans invest in the market and there is a certain level of uncertainty associated with them. Due to the high-risk nature of these plans, there is a potential to earn higher returns from these plans as well. ULIPs are the most common form of non-traditional policies, and they are relatively new compared to other types of life insurance products. Most of the top companies in the market provide ULIPs to customers who look for high-risk, high-return insurance plans.

   Compared to other insurance products, ULIPs have various flexible options for policyholders. For instance, policyholders can decide what types of investments can be made with their fund based on the level of risk they are willing to take. This is not possible in other life insurance products available in the market. Insurance companies in the market offer different types of ULIPs based on the specific requirements of policyholders.

8.10.1 Traditional Vs. Non-traditional Life Insurance Policies

The major difference between traditional and non-traditional life insurance policies are listed as follows:

Features	Traditional plans	Non-traditional plans
1. Type of coverage	They are low-risk plans that offer insurance coverage and guaranteed maturity benefits.	They are high-risk plans that offer a combination of insurance as well as investment.
2. Maturity proceeds	The maturity proceeds are fixed at the predetermined sum assured amount. Additional bonuses and profits may vary from plan to plan.	The maturity proceeds are variable and they cannot be predetermined by the company. Any fluctuations in the market will have an impact on the fund value of these plans.
3. Flexibility	Investors cannot choose the specific funds in which their money is invested. Companies disclose the investment plan in the policy document and investments are made as per the company's discretion.	Investors can choose the avenues in which they can invest their funds. Based on their risk profile, investors can choose among debt, equity, or hybrid instruments in the market.
4. Transparency	Tracking individual portfolio is not possible in traditional plans. The accumulated fund value will be disclosed only at the end of the maturity term.	Investors can track and make changes to their portfolio anytime they want. If there are any fluctuations in the market, investors can transfer funds accordingly and prevent any losses to their funds.
5. Switching facility	Since investors do not have any control over the investments made under these plans, they cannot switch from one fund to another.	Since investors are allowed to track their funds, they can switch from one fund to another anytime.
6. Withdrawal	No partial withdrawal is allowed till the end of the lock-in period. The minimum policy term for most traditional policies is five years.	Most plans allow for partial withdrawal as long as the fund value does not drop below a certain minimum value.
7. Surrender	Endowment policies can be surrendered after three years of continuous premium payment. The surrender value obtained may differ based on the fund value and charges.	After the initial lock-in period, these plans can be surrendered anytime and the full fund value can be obtained by policyholders.

Traditional and non-traditional life insurance covers serve very different purposes based on the requirements of a person. Even within traditional plans, policies differ a lot based on their types. For instance, the coverage offered under a term plan is extremely different from that of an endowment policy. While the risk is evident in ULIPs, there is also a potential to get high returns that is not seen in other insurance plans. One thing that is common to both types of plans is that they offer tax relief to policyholders under Section 80C of the Income Tax Act.

8.11 POSTAL LIFE INSURANCE

Postal Life Insurance (PLI) was introduced on 1st February 1884 with the express approval of the Secretary of State (for India) to Her Majesty, the Queen Empress of India. It was essentially a scheme of State Insurance mooted by the then Director General of Post Offices, Mr F.R. Hogg in 1881 as a welfare scheme for the benefit of Postal employees and later extended to the employees of Telegraph department in 1888. In 1894, PLI extended insurance cover to female employees of P & T Department at a time when no other insurance company covered female lives. It is the oldest Life insurer in this country.

In the beginning, the upper limit of life insurance was only Rs. 4000/- which has now increased to Rs. 50 lacs (Rupees Fifty Lacs) and it will be effective as and when notified through a Gazette notification for all schemes combined - Endowment Assurance and Whole Life Assurance. Over the years, PLI has grown substantially from a few hundred policies in 1884 to more than 46 Lacs policies as on 31.03.2017. It now covers employees of Central and State Governments, Central and State Public Sector Undertakings, Universities, Government aided Educational institutions, Nationalized Banks, Local bodies, autonomous bodies, joint ventures having a minimum of 10% Govt./PSU stake, credit cooperative societies etc. PLI also extends the facility of insurance to the officers and staff of the Defence services and Paramilitary forces. Apart from single insurance policies, Postal Life Insurance also manages a Group Insurance scheme for the Extra Departmental Employees (Gramin Dak Sevaks) of the Department of Posts.

PLI is an exempted insurer under Section 118 (c) of the Insurance Act of 1938. It is also exempted under Section 44 (d) of LIC Act, 1956.

8.11.1 Benefits of Postal Life Insurance

1. PLI is the only insurer in the Indian Life Insurance market today which gives the higher return (bonus) with the low premium charged for any product in the market.

2. A PLI policy holder may also get following facilities :-

a) Change of nomination.

b) The insurant can take loan by pledging his/her policy to Heads of the Circle on behalf of President of India, provided the policy has completed 3 years in case of Endowment Assurance and 4 years in case of Whole Life Assurance. The facility of assignment is also available.

c) Assignment of Policy to any Financial Institution for taking loan.

d) Revival of his/her lapsed policy. Policy lapses after 6 unpaid premiums if it remained in force for less than 3 years and after 12 unpaid premiums if it remained in force for more than 3 years.

e) Issue of Duplicate Policy Bond in case the original Policy Bond is lost, burnt or torn/mutilated.

f) Conversion from Whole Life Assurance -Gram Suraksha to Endowment -Gram Santosh Assurance and from Endowment Assurance -Gram Santosh to other Endowment Assurance-Gram Santosh with reduced sum assured or reduced term as per rules.

8.11.2 Insurance Plans in Postal Life Insurance

Postal Life Insurance offers the following six types of policies:

1. Whole Life Assurance (Suraksha)

2. Endowment Assurance (Santosh)

3. Convertible Whole Life Assurance (Suvidha)

4. Anticipated Endowment Assurance (Sumangal)

5. Joint Life Assurance (Yugal Suraksha)

6. Children Policy (Bal Jeevan Bima)



CHECK YOUR PROGRESS

7. What are traditional life insurance policies?

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8. What are non-traditional life insurance policies?

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9. Which is the most common form of non-traditional policies?

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8.12 LET US SUM UP

In this unit we have discussed about the life insurance as well as annuity. The main points discussed in this unit are:

- Life Insurance is a contract, whereby the insurer in consideration of a premium undertakes to pay a certain sum of money either on the death of the insured or on the expiry of a fixed period.
- A child insurance plan helps to build capital for important events in a child's life such as higher education, overseas studies, marriage, etc.
- Pension plans are retirement oriented life insurance plans aimed to create a retirement corpus and provide one with a source of regular income even after one have stopped working.
- NPS is a pension program implemented by the Government of India which acts as a social security scheme aiding employees of all sectors to the age of 60 years.
- ULIPs are pension plans that invest a substantial portion of the premiums in high return-high risk investments such as money markets, non-government securities, bonds and stocks.
- Group life insurance is a single contract for life insurance coverage that extends to a group of people.

- Postal Life Insurance (PLI) is the only insurer in the Indian Life Insurance market today which gives the higher return (bonus) with the low premium charged for any product in the market.



8.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1: Children policies provide financial security to manage the future requirements of the child.

Ans to Q No.2 : Pension plans are retirement oriented life insurance plans aimed to create a retirement corpus and provide one with a source of regular income even after one have stopped working.

Ans to Q No.3: The various types of pension plans are: National Pension Scheme, Traditional pension plan and Unit-linked pension plans.

Ans to Q No.4: National Pension Scheme

Ans to Q No.5: Unit-Linked Pension Plans

Ans to Q No.6: Group life insurance is a single contract for life insurance coverage that extends to a group of people.

Ans to Q No.7: Traditional products are low-risk insurance covers that offer guaranteed

maturity returns for policyholders.

Ans to Q.No.8: Non-traditional life insurance coverage is the combination of insurance

and investment under one single policy.

Ans to Q.No.9: ULIPs are the most common form of non-traditional policies.



8.14 FURTHER READING

1. Insurance: Principles and Practices
   - M.N.Mishra
   - Dr.S.B.Mishra
2. Principles and Practice of Insurance

- Ghanashyam Panda
- Monika Mahajan



8.15 MODEL QUESTIONS

1) Write down the definition and nature of life insurance.
2) What do you mean by life insurance? What are the advantages?
3) What are the various kinds of life insurance policies?
4) Describe the different types of endowment and term policies.
5) What is meant by non-traditional life insurance policies? State the difference between traditional and non-traditional life insurance policies.
6) What is Mortality Table? Discuss its sources and also briefly describe it.

(7) Discuss the Postal Life Insurance along with its benefits.

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UNIT 9: LIFE INSURANCE-II

UNIT STRUCTURE

9.1 Learning Objective

9.2 Introduction

9.3 Concept of Annuity

9.4 Classification of Annuities

9.5 Difference between Annuity Contract and Life Insurance Policies

9.6 Mortality Tables-The Measurement of Mortality

9.7 Sources of Mortality Tables

9.8 Description of a Mortality Table

9.9 Life Insurance Corporation of India

9.10 Government Schemes for life insurance

9.11 Let Us Sum Up

9.12 Further Readings

9.13 Answers to Check Your Progress

9.14 Model Questions

9.1 LEARNING OBJECTIVE

After going through this unit, the learners will able to:

- Know the concept of annuity
- Know the different types of annuities
- Distinguished Annuity Contract and Life Insurance Policies
- Explain the concept Mortality Table
- Discuss the functions and objectives of Life Insurance Corporation of India
- Get an idea of Government Schemes for life insurance

9.2 INTRODUCTION

If you're worried about making your savings last throughout your entire retirement and think you may need more income you may want to consider purchasing an annuity. With discontinuation of pensions, annuities are filling the retirement income gap by allowing you to convert your savings into a stream of income guaranteed to last for the remainder of your lifetime. In

addition, some types of annuities offer a safe place for your money to grow, allowing you to avoid the downturns that come with investing in the stock market. In this unit we will discuss the annuity, mortality table and also about the LICI.

9.3 CONCEPT OF ANNUITY

It's a contract between an individual and an insurance company for which you pay a premium just like life or health insurance premiums to receive regular payments over a certain time frame, potentially the rest of your life. An annuity is an insurance-based retirement product that can create a stream of income in retirement, somewhat like a pension. Receiving an annuity payout as a series of periodic payments, as opposed to withdrawing one lump sum, is referred to as annuitization. The recipient is usually an annuitant. Not all annuity owners choose to annuitize their payments. Instead, they keep their money in an annuity for a lengthy accumulation, or growth, phase and eventually withdraw it as a lump sum. As insurance products, annuities protect against the biggest risk in retirement: outliving your savings. This insurance against living long is the mirror image of life insurance, which ensures that your dependents are financially compensated upon your death. With an annuity, your benefit is in living longer and receiving more payments.

Annuities are the best alternative to pensions, which are fast becoming a thing of the past. Many people have savings that are earmarked for retirement. Some or all of the money in these accounts can be turned into a steady stream of guaranteed income to supplement Social Security checks and ensure a comfortable retirement.

9.4 CLASSIFICATION OF ANNUITIES

The annuities can be classified as follows:

A. Annuities according to Commencement of Income

1. **Immediate Annuity:** This style of annuity features the payment of lump sum as premium in order to subscribe to the scheme. Once this lump sum payment is made, annuity pays outs to the subscriber start immediately as per the applicable pay out criteria.

2. **Deferred Annuity:** Unlike in case of immediate annuity, deferred annuity pay outs feature an interval between the time premium payments are initiated and the annuity pay outs begin. The period dur-

ing which the subscriber makes premium payments is termed as the accumulation phase of the scheme. On completion of the accumulation phase, the accrued amount is utilised for purchase of annuities which provides the future pay outs to the subscribers.

3. **Annuity Due:** Under this annuity, the payment of instalment starts from the time of contract. The first payment is made as soon as the contract is finalised. The premium is generally paid in single amount; but can be paid in instalments.

B. Annuities according to the Number of Lives

1. **Single Life Annuity:** Under this annuity one single person following is contractor. This annuity is most beneficial to those who have no dependent and want to use all this saving during his life-time.

2. **Multiple Life Annuities:** In this annuity more than one life is contracted. The annuity is also of two types:

    a. Joint Life Annuity where payment of annuity stops at the first death.

    b. Last survivor annuity where payment continues up to the death of the last person of the group.

C. Annuities according to Mode of Premium:

1. **Level Premium Annuities:** For availing the annuity, the annuitant can deposit some amounts periodically so that, at the end, he can get sufficient amount of annuity in equal instalments.

2. **Single Premium Annuities:** The annuity in this case is purchased by payment of a single premium. Generally, the life insurance amount is utilised for purchasing this annuity.

D. Annuities according to the disposition of proceeds

1. **Life Annuity:** This annuity offers a regular income to the annuitant throughout his life-time. No payment is made after his death. When the annuity dies before receiving all the amounts of the purchase price he is at loss. But, if he survives for a longer period than expected, he is benefitted by this annuity.

2. **Guaranteed Minimum Annuity:** Annuity payment up to a period is guaranteed by the insurer. If the annuitant dies before the specified

period, annuity will continue up to the unexpired period. This annuity may be of two types-

i. **Immediate Annuity with Guaranteed Payment:** To safe-guard the loss in case of early death of the annuitant, this annuity is issued where payment for a fixed number of years will continue, irrespective of death.

ii. **Deferred Annuity with Guaranteed Payment:** During the deferment period, there is no difference between this annuity and ordinary deferred annuity. After deferment period, the payment under this policy will continue for a fixed period and up to life thereafter.

3. **Temporary Life Annuity:** Under this plan, annuity payments cease at the end of a specified period or at the death whichever is earlier.

4. **Retirement Annuity Policy:** This annuity is useful for employees at the time of retirement. It promises lifetime guaranteed monthly or annual income for a retiree until their death.

9.5 DIFFERENCE BETWEEN ANNUITY CONTRACT AND LIFE INSURANCE POLICIES

Following are the differences between Annuity Contract and Life Insurance Policies:

Sl. No.	Basis	Annuity	Life Insurance
1.	Purpose	It is mainly for securing an income after one retires.	It is a plan for the future, to cater for what is not known.
2.	Payment of Benefits	Matured annuity is paid only when the policy holder is alive	A matured Life insurance can only be paid once the policy holder is dead.
3.	Mode of Payment	Benefits are paid in regular allotments for deferred annuity.	Whether term or whole life insurance, the benefits are paid out by the insurance company as a lump sum.
4.	Calculation of Premium	The premium in an annuity contract is calculated on the basis of longevity of the annuitant.	The premium in life insurance is based on the mortality of the policy-holder.
5.	Protection	An annuity is a protection against living too long.	The life insurance contract is protection against living too short.

6.	Accumultaion of Fund	The annuity contract liquidates gradually the accumulated funds.	The life insurance contract provides gradual accumulation of funds.

9.6 MORTALITY TABLES-THE MEASUREMENT OF MORTALITY

A mortality table is a diagram that shows the death rate for a defined population within a specific rate of time. Also known as a life table or an actuarial table, mortality tables are used in business by insurance companies to price insurance products and schemes for individuals.

Also, mortality tables can be used to develop complex mathematical models that represent the survival rates of different populations. They are also useful in the study of biology and medicine. The tables can help in the development of diagnostic criteria for certain drugs, as well as the type of treatment an individual should receive.

Mortality tables are based on characteristics, such as gender and age. A mortality table gives probabilities based on deaths per thousand, or the number of people per 1,000 living who are expected to die in a given year. Life insurance companies use mortality tables to help determine premiums and to make sure the insurance company remains solvent.

9.6.1 Types of Mortality Tables

There are two main types of mortality tables – the period life table and the cohort life table.

A) Period life table

The period life table determines mortality rates for a specific population during a defined period of time, such as a single year or a group of years. It also assumes that mortality rates apply throughout the remainder of a person's life, and as such, it does not take into consideration any future developments or changes to mortality rates.

B) Cohort life table

Also known as a generation life table, the cohort life table determines the overall mortality rate of a group of people with the same year of birth (a cohort). It shows the probability for an individual from the given cohort dying at each age over the course of their lifespan.

The cohort life table is based on age-specific probabilities of one dying, which are determined using a combination of mortality data for the specific

cohort from past years long with estimates about mortality rates for the cohort in the future.

9.6.2 Uses of Mortality tables

A) Using Mortality Tables in Business: In business, mortality tables are generally used by insurance agencies to determine prices for insurance products. It requires a thorough process involving not only insurance agents but also actuaries who need to develop projections of future insured events, such as death, sickness, and disability.

Actuaries are responsible for developing mathematical models of the rates and timings of events, such as death or sickness, by studying historical data of the occurrence of such events in the past.

Actuaries also take into account how expectations will evolve, as well as age and other population characteristics to derive expected rates of deaths, sickness, and disability for the future. It enables them to form a comparison between people at risk of death and those that actually die to determine the probability of death at each age.

As mentioned previously, mortality tables play a significant role in helping insurance agencies determine the prices of various insurance products. The collection and accurate use of data are pivotal in developing such tables to be deployed in the insurance industry, as the more accurate data one can find, the stronger the actuarial structure of the insurance company will be.

B) Mortality Tables as Projections – Uses in Public Health: Mortality tables serve as actuarial resources to make projections on matters of public health, which are used to generate policy and epidemiological strategy. The mathematical tools help to determine disease and survival outcomes that help to better educate doctors and patients involving health concerns and diseases they may have contracted.

The tables lead to better-educated patients who can help make more informed decisions that determine professional care and treatment options. It is important, as often, individuals find themselves in positions where they have to make difficult decisions regarding which types of treatment they are to receive when they are unexpectedly diagnosed with a potentially life-threatening disease.

9.7 SOURCES OF MORTALITY TABLES

For construction of mortality table, number of living of the beginning of each age and the number of deaths during the age are required. The mortality table should be constructed to represent the past experience as accurately as possible. So the figures of mortality construction should be as accurate as possible and based on a large number of persons. The sources of mortality construction can be obtained either from (1) population statistics, and (2) records of life insurers.

1. **Population Statistics:** The insurer gets number of living at each age from the census records and the number of deaths from municipal and other death records. The population statistics will reveal how many persons have died at what age. So, with the radix of total number of persons at the beginning, it can be calculated how many died in a particular age. The calculation of mortality table on this basis is not very easy and correct.

2. **Records of Insurers:** The records of insurer give a correct figure because the death rates can be correctly recorded. No death will go unrecorded, correct number of persons living and dead for each age can be known. Collection of figures is done from the records of as many insurers as possible in large numbers but is not more than 10 years covering, favourable and unfavourable years. Generally, 10-year period may be quite sufficient. The abnormal years are excluded from the sample. Separate mortality tables may be prepared for standard lives, sub-standard lives, female and male lives. Subclassification according to sex, marital status, occupation, geographical area, class may be made and tables are constructed separately.

   Year wise aggregation of number of deaths and number of living persons is done from the information of all insurers. Mortality rate at every age will be counted by dividing the number of expired lives by number of exposed lives.

9.8 DESCRIPTION OF A MORTALITY TABLE

The amount of premium charged depends considerably upon the mortality assumption can be well explained by the following mortality table.

Age	Number living at age	Number dying during year following attainment of age	Number dying out of every 1,000
1	2	3	4
20	10,000	42	4.20
30	9,577	45	4.77
40	9,055	75	8.31
50	8,050	161	20.42
60	6,033	259	45.99
70	3,274	271	82.88
80	1,026	152	147.76
90	116	31	268.99

The second column given the number of persons living at the commencement of ages shown in column one, out of 10,000 starting at age 20; whereas the third column shows the number of persons dying out of those shown in second column, during one year after they attain the specified age. The fourth column shows the number of persons dying out of every 1000 within one year after they attain the specified age.

The above table can be used to compute the “premium” for a one-year policy at various ages. Assume that we insure each of the 9,577 persons living at age 30 for a sum of Rs.1, 000.Such out of this 45 will die during the year, the total claims we have to pay amount of Rs. 45000. The “premium “to be paid at the beginning of the year should be such as to divide these expected claims equally between the 9,577 insured. In other words, the premium will be 45,000/9,577=Rs.4.77. It will thus be seen that the last column of the Table also gives the premium for one-year term assurance for Rs.1, 000 at the respective ages. It will also be seen that the premium increases with age. The increase in premium is slow at early ages but accelerates with advancing age. This is the basic method of computing risk premiums under various types of policies. The premium rates will, of course, differ materially depending upon the mortality tables which are used.



CHECK YOUR PROGRESS

Q.1. What is an Annuity?

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Q.2. What is a mortality table?

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Q.3. What are the two sources of mortality tables?

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9.9 LIFE INSURANCE CORPORATION OF INDIA

Life Insurance Corporation of India (LIC) is the largest insurance company in India with an association of over 245 insurance companies and provident societies. It was incorporated in 1956 and has its headquarter in Mumbai, India. The company has completed 64 years and today, it stands proud of the fact that it has become what was envisioned way back at the time of its establishment.

The Life Insurance Corporation of India came into being on 1st September, 1956 and nationalized on 19th January, 1956 to carry on life business in India with capital of Rs.5 crores contributed by the Central Government.

The Corporation is a body corporate having perpetual succession with a common seal with powers to acquire, hold and dispose of property and may by its name sue and be sued. The functions of the Corporation shall be to carry on and develop life insurance business to the best advantage of the community.

9.9.1 Role/Functions of LIC

1. To carry on capital redemption business, annuity certain business or reinsurance business in so far as such reinsurance business relating to life insurance business;
2. To invest the funds of the Corporation in such manner as the Corporation may think fit and to take all such steps as may be necessary or expedient for the protection or realisation of any investment; including the taking over of and administering any property offered as security for the investment until a suitable opportunity arises for its disposal;
3. To acquire, hold and dispose of any property for the purpose of its business;

4. To transfer the whole or any part of the life insurance business carried on outside India to any other person or persons, if in the interest of the Corporation it is expedient so to do;
5. To advance or lend money upon the security of any movable or immovable property or otherwise;
6. To borrow or raise any money in such manner and upon such security as the Corporation may think fit;
7. To carry on either by itself or through any subsidiary any other business in any case where such other business was being carried on by a subsidiary of an insurer whose controlled business has been transferred to and vested in the Corporation by this act;
8. To carry on any other business which may seem to the Corporation to be capable of being conveniently carried on in connection with its business and calculated directly or indirectly to render profitable the business of the Corporation; and
9. To do all such things as may be incidental or conducive to the proper exercise of any of the powers of the Corporation.
10. In the discharge of any of its functions the Corporation shall act so far as may be on business principles.

9.9.2 Objectives of LIC

1. Spread Life Insurance widely and in particular to the rural areas and to the socially and economically backward classes with a view to reaching all insurable persons in the country and providing them adequate financial cover against death at a reasonable cost.
2. Maximize mobilization of people's savings by making insurance-linked savings adequately attractive.
3. Bear in mind, in the investment of funds, the primary obligation to its policyholders, whose money it holds in trust, without losing sight of the interest of the community as a whole; the funds to be deployed to the best advantage of the investors as well as the community as a whole, keeping in view national priorities and obligations of attractive return.
4. Conduct business with utmost economy and with the full realization that the moneys belong to the policyholders.

5. Act as trustees of the insured public in their individual and collective capacities.
6. Meet the various life insurance needs of the community that would arise in the changing social and economic environment.
7. Involve all people working in the Corporation to the best of their capability in furthering the interests of the insured public by providing efficient service with courtesy.
8. Promote amongst all agents and employees of the Corporation a sense of participation, pride and job satisfaction through discharge of their duties with dedication towards achievement of Corporate Objective.

9.10 GOVERNMENT SCHEMES FOR LIFE INSURANCE

Governments all over the world work towards providing good quality healthcare for their people. Whether it is creating awareness about health issues, ensuring strong infrastructure, and promoting health insurance are productive activities conducted by the authorities for people's welfare. In recent time, the Indian Government also undertakes such measures from time to time. Below a few of such measures and initiatives taken by the Government has been listed down.

1. Ayushman Bharat Yojana: The Pradhan Mantri Jan Arogya Yojana (PMJAY) popularly known as Ayushman Bharat Yojana Scheme is the flagship scheme by the Government of India. It was launched in September 2018 providing health insurance coverage of a maximum sum insured amount of Rs.5 lakh. It is essentially a health insurance scheme to cater to the poor, lower section of the society and the vulnerable population making quality healthcare accessible to the poorest of poor families in India. The scheme offers financial protection in case of hospitalization due to medical emergencies this plan came into existence because of recommendations made by the National Health Policy. Ayushman Bharat Yojana is designed keeping in mind Universal Health Coverage. Benefits of this scheme are portable across the country and a beneficiary covered under this scheme will be allowed to take cashless benefits from any public/private empanelled hospital across the country.

2. PMJAY Scheme Awaz Health Insurance Schemes: This is a health insurance cover initiated by the Government of Kerala and covers migrant workers. This is a first of its kind scheme intended for migrant labourers working in a state in India. It also offers insurance for death by accident for

labourers. The scheme was launched in the year 2017 and targeted 5 lakh inter-state migrant labourers working in Kerala. This scheme provides coverage of INR 15000, while the cover for death is INR 2 lakh. This policy can be obtained by labourers between the ages of 18 to 60 years. They shall be provided with an awaz Health Insurance card, post submitting and processing of enrolment details pertaining to biometric information and other worker related health insurance.

3. Aam Aadmi Bima Yojana: The Aam Admi Bima Yojana was launched on 2nd October 2007. It is a social security scheme that is targeted toward the low-income families of India. The Aam Aadmi Yojana is meant for people who are involved in certain vocations such as carpentry, fishing, handloom weaving, etc. There are 48 such defined vocations. The premium to be charged under this scheme will be INR 200 per annum per member for a cover of INR 30000, out of which 50% will be subsidized from the Social Security Fund. The member buying this insurance should be the head of the family or one earning member of the Below Poverty Line (BPL) family or marginally above the poverty line under identified vocational group/rural landless households.

4. Central Government Health scheme: The Central Government Health Scheme (CGHS) was started in 1954 with the objective of providing comprehensive medical care to the Central Government employees, both existing and former employees of the Central Government of India. The medical facilities are provided through Wellness centres (previously referred to as CGHS Dispensaries)/polyclinics under allopathic, Ayurveda, Yoga, Unani, Sidha, and Homeopathic systems of medicines.

5. Chief Minister's Comprehensive Insurance Scheme: The Chief Minister's Comprehensive Health Insurance Scheme Tamil Nadu (CMCHISTN) is a health insurance scheme designed for the underprivileged residents of Tamil Nadu. The scheme was launched in 2012 in Tamil Nadu, to provide health insurance benefits to economically backward sections of the society. It is a family floater plan for quality health care where the coverage limits are applicable on a floater basis. Spouse, dependent parents, and dependents children can be covered under the floater plan cover. One can claim for hospitalization expenses up to INR 5 lakhs under this scheme.

6. Employees State Insurance Scheme (ESIS): *ESIC scheme* was inaugurated *in* Kanpur on 24th February 1952 (*ESIC Day*) by then Prime Minister Pandit Jawaharlal Nehru. The promulgation of *Employees' State Insurance Act,* 1948 (*ESI Act*), by the Parliament was the first major legislation on social Security for workers *in* independent India. It is a self-financ-

ing social security and health insurance scheme for Indian workers to protect against the impact of incidences of sickness, maternity, disablement due to employment injury and to provide medical care to the insured person and their families. Contributions are raised from covered employees and their employers as a fixed percentage of wages. The State Governments, as per the provisions of the Act, contribute 1/8th of the expenditure of medical benefit within a per capita ceiling of INR 1500 per person per annum.

7. Pradhan Mantri Suraksha Bima Yojana: The *Pradhan Mantri Suraksha Bima Yojana launched* in 2015, is a one-year accidental death and disability cover which could be renewed annually. It is also known as the PM Rs. 12 Insurance Scheme. This social security scheme is to be administered through both public and private sector insurance companies in tie-up with scheduled commercial banks, regional rural banks and cooperative banks. The scheme is designed to ensure that people with permanent total as well as impartial disability could avail the benefits of this particular insurance coverage. The insurance premium of Rs 12 for the policy shall be deducted from the registered bank account of the policyholder. People in the age group of 18 to 70 can avail the benefits of PMSBY by providing their Aadhaar card as a Know Your Customer (KYC) document.

8. Rashtryia Swashthya Bima Yojana: It is a government-run health insurance programme for the Indian poor. The scheme aims to provide health insurance coverage to the unrecognised sector workers belonging to the BPL category and their family members shall be beneficiaries under this scheme. It provides for cashless insurance for hospitalisation in public as well as private hospitals. The scheme started enrolling on April 1, 2008 and has been implemented in 25 states of India.



CHECK YOUR PROGRESS

4. What is LICI?

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5. When was LICI incorporated?

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6. When was LICI nationalised?

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7. Name few government schemes for life insurance.

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9.11 LET US SUM UP

- An annuity is a contract aimed at generating steady income during retirement, where in lump sum payment is made by an individual to obtain certain amounts immediately or at some point of future.
- A mortality table is a diagram that shows the death rate for a defined population within a specific rate of time.
- The Life Insurance Corporation of India came into being on 1st September, 1956 and nationalized on 19th January, 1956 to carry on life business in India.
- Certain schemes and initiatives taken by the Government of India for promoting quality healthcare to the people are Ayushman Bharat Yojana, Awaz Health Insurance Schemes, Aam Aadmi Bima Yojana, Central Government Health scheme, etc.



9.12 FURTHER READINGS

1. Insurance: Principles and Practices
    - M.N.Mishra
    - Dr.S.B.Mishra
2. Principles and Practice of Insurance
    - Ghanashyam Panda
    - Monika Mahajan



9.13 ANSWER TO CHECK YOUR PROGRESS:

Ans to Q.No.1: An annuity is a contract aimed at generating steady income during retirement, where in lump sum payment is made by an individual to obtain certain amounts immediately or at some point of future.

Ans to Q. No.2: A mortality table is a diagram that shows the death rate for a defined population within a specific rate of time.

Ans to Q.No.3: The sources of mortality construction can be obtained either from (1) population statistics, and (2) records of life insurers.

Ans to Q No.4: Life Insurance Corporation of India (LICI) is the largest insurance company in India.

Ans to Q No.5: LICI was incorporated in 1st September 1956.

Ans to Q.No.6: LICI was nationalized in1956.

Ans to Q No.7: Ayushman Bharat Yojana, Awaz Health Insurance Schemes, Aam Aadmi

Bima Yojana, Central Government Health scheme, etc. are some of the government schemes for life insurance.



9.14 Model Questions

1) What is Annuity? State the differences between annuity contracts and life insurance policies.
2) State the classification of Annuities.
3) Discuss the functions of Life Insurance Corporation of India.
4) Discuss the objectives of Life Insurance Corporation of India.
5) Elaborate the government schemes for life insurance by the Government of India.

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UNIT 10: NON-LIFE INSURANCE-I

UNIT STRUCTURE

10.1 Learning Objective

10.2 Introduction

10.3 Meaning of Non-Life Insurance

10.4 Importance of Non-Life Insurance

10.5 Fire Insurance

10.6 Marine Insurance

10.7 Burglary Insurance

10.8 Motor Insurance

10.9 Transit Insurance

10.10 Health Insurance

10.11 Let Us Sum Up

10.12 Further Readings

10.13 Answers to Check Your Progress

10.14 Possible Questions

10.1 LEARNING OBJECTIVE

After going through this unit, the learners will able to:

- know the various non-life insurance available in the market.
- discuss the fire insurance
- discuss marine insurance
- get the concept of Burglary Insurance
- know the motor insurance and transit insurance
- discuss health insurance

10.2 INTRODUCTION

In today's age of consumerism, insurance requirements have expanded to keep pace with the increasing risks. Today we have a wide assortment of risk coverage commencing from health insurance to transit insurance to burglary insurance. With affluence and spending capacity on the surge there

is a growing trend to fulfil needs, deal with responsibilities and secure one's possession. General insurance companies have willingly catered to these increasing demands and have offered a plethora of insurance covers.

10.3 MEANING OF NON-LIFE INSURANCE

Non-Life Insurance is a policy that provides compensation for losses incurred from a specific financial event. This type of policy is also known as general insurance, or property and casualty insurance. Examples of non-life insurance policies include automobile policies, home-owners policies, damage cover from fire, marine accidents, travel, theft and any catastrophe etc. Since the probability of occurrence of these risks is very difficult to ascertain, it thereby is an extremely difficult task to measure the amount of damage they would do, on their incidence.

10.4 IMPORTANCE OF NON-LIFE INSURANCE

Insurance has become synonymous with safeguarding the interest of people and property from loss and uncertainty. A suitable non-life insurance cover is an absolute essential for every family. This is a necessity to overcome uncertainties and risks prevalent in life. Insurance is very important for businesses as they provide compensation for lost or damaged property. Property insurance in India provides safety against most risks such as Fire, theft and certain types of weather damage. Besides minimizing losses, insurance helps in industrial development as the premium which is collected is utilized for the economic development of the country.

10.5 FIRE INSURANCE

Fire Insurance is a device to compensate for the loss consequent upon destruction by fire. It is an agreement between an insurance company and an individual or company where the insurer agrees to compensate the policyholder in case of loss or damage due to fire. The policy holder can be an individual or a company. The policy holder pays premiums to the insurance company on a regular basis for certain period of time in exchange for compensation in the event of loss of property due to a fire.

Thus the fire insurer shifts the burden of fire losses from their actual victims over to all the members of the society. It is a cooperative device to

share the loss. It relieves the insured from the horror of the fire losses to which he is exposed.

10.5.1 Fire Insurance Contract

Fire insurance contract may be defined as “an agreement, whereby one party in return for a consideration undertakes to indemnify the other party against financial loss which the latter may sustain by reason of certain defined subject-matter being damaged or destroyed by fire or other defined perils up to an agreed amount”. The party responsible to indemnify the loss is called the insurer, the party who is to be indemnified is called the insured, the consideration for the contract is termed ‘the premium’, the defined subject-matter is termed ‘the property insured’, the sum set forth in the contract is called the assured sum and the document containing the terms and conditions of the contract is known as ‘the policy’.

10.5.2 Features of Fire Insurance Contract

1. **Indemnity:** The contract of fire insurance is a contract of indemnity in which the insured will be compensated for the loss up to a certain limit subject to the maximum sum insured.
2. **Offer and Acceptance:** The contract of insurance is the outcome of offer made by the insured and acceptance by insurer or insurance company. As such the contract of fire insurance is the result of an offer made by insured and its acceptance by insured.
3. **Consideration:** Fire insurance policy is issued for a lawful consideration i.e. premium.
4. **Insurable Interest:** In case of fire insurance, the insured must have insurable interest in goods or properties insured against fire, both at the time when policy is taken and also at the time when loss occurs and the claim is filed for compensation.
5. **Policy Tenure:** Fire insurance policies come with one year tenure. The policy lapses automatically after one year unless it is renewed.
6. **Scrap value**: The scrap or whatever is left of goods or properties after damages or destroyed by the automatically fall to the hands of insurer after the payment of claim under fire insurance.

10.5.3 Principles of Fire Insurance Contract

1. **Insurable Interest:** In fire insurance, the insured must have insurable interest in the subject matter of the insurance. Without insurable interest the contract of insurance is void. In case of fire insurance, unlike life insurance insurable interest must be present both at the time of insurance and at the time of loss. For Example, a person has insurable interest in the property he owns, a businessman has insurable interest in his stock, plant, machinery and building, an agent has an insurable interest in the property of his principal, a partner has an insurable interest in the property of a partnership firm and a mortgagee has insurable interest in the property which is mortgaged.

2. **Utmost Good Faith:** In fire insurance contracts, the legal doctrine of utmost good faith applies. The insured has the duty to disclose all material facts, which have a bearing on the insurance. A breach of this duty may make the contract void or voidable. The duty of disclosure continues throughout the policy period. The fire proposal form also includes a declaration by the insured saying that the statements declared by him are true, and that they can form the basis of the insurance contract. These principles also expect the insured to act as if he is uninsured all the time, and takes care and safeguards his assets from the perils. Following a loss, he is then expected to salvage as much of the property as possible. Thus, the utmost good faith in fire insurance has two aspects-first, disclosure of material facts and second, preservation of the property insured.

3. **Indemnity:** The principle of indemnity means the insured is indemnified only to the extent of his loss, no profit or undue benefit is extended. The indemnity is subject to the sum insured and other terms of the policy. The sum insured can be fixed on the basis of Reinstatement Value or Market Value.

4. **Doctrine of Subrogation:** Subrogation means the right of one person to stand in the place of another and to avail himself of the latter's rights and remedies**.** The principal of subrogation is the corollary of the principle of indemnity. If the loss suffered by the insured can be recovered from third parties who are responsible for the loss, the insured's rights of recovery are transferred or subrogated to the insurers, when they indemnify the loss.

5. **Warranties:** Warranty is that by which the assured undertakes that some particular thing shall or shall not be done, or that some conditions shall be fulfilled or whereby he affirms or negatives the existence of a particular state of facts. Warranties which are mentioned in the policy are called express warranties and those warranties which are not mentioned in the policy are called implied warranties.
6. **Proximate Cause:** It is the primary cause of a loss or injury. The insurer always takes the proximate cause while paying the claim. Proximate cause produces particular, foreseeable consequences without the intervention of any independent or unforeseeable cause. It is the active, direct, and efficient cause of loss in insurance that sets in motion an unbroken chain of events which bring about damage, destruction, or injury without the intervention of a new and independent force. It is also called legal or direct cause.

10.5.4 Types of Policies

Under fire insurance there are different types of fire insurance policies which are discussed below:

1. **Valued Policy:** Under this policy the policy holder can only recover a fixed amount of money that is agreed upon at the time the insurance policy is taken. This means that only a fixed amount of money is compensated for in the event of a loss regardless of the actual amount lost. . Valued policy is taken for those goods whose value becomes difficult to calculate in case of loss by fire. This types of policy can be taken for art work, paintings, etc. where the value of the damaged articles become difficult to assess/measure.
2. **Valuable Policy:** The valuable policy is that policy where the claim amount is to be determined at the market price of the damaged property. The amount of loss is not determined at the time of commencement of risk but is determined at the time and place of loss. This policy is truly representing the doctrine of indemnity.
3. **Specific Policy:** According to this policy, the property is insured for a definite sum irrespective of the market value. If there is a loss, the stated amount will have to be paid to the policy holder. The actual value of the property is not taken into consideration when determining indemnity.

4. **Comprehensive Policy:** Comprehensive policy undertakes full protection not only against the risk of fire but combining within the risk against burglary, riot, civil commotion, theft, damage from pest, lightning. This policy is also termed as all-in-one policy.

5. **Floating policy:** A floating policy is a fire insurance policy that covers properties or goods located in different places or godowns or warehouses. Since the quantity of goods lying at different places fluctuate from time - to time, it becomes difficult for the owner to take specific policy so businessmen and traders take floating policy. Such a policy is usually taken for one sum and one premium for goods lying at different places but under the same name and premiums. Such a policy is always subject to average clause.

6. **Replacement or Re – instatement policy:** In this type of policy, the insurance company chooses either to pay cash for any property lost by fire or reinstate it. By reinstating, the insurer pays for the replacement of the property lost or destroyed by fire. The rate of premium is higher in Reinstatement Policy.

7. **Average Policy**: It is a policy which contains an average clause. If the subject matter is not insured as per the exact market value or undervalued, then the insurer is liable to pay that percentage of the loss for which it is insured. e.g. If a policy is taken for Rs 50,000 against the market value of Rs 100,000, the loss incurred due to re is Rs 40,000, then the insurance company will pay Rs 20,000 (50% of Rs 40,000).

8. **Excess Policy**: Excess policy is taken when the value of the stock in the market constantly fluctuates. In such an instance it is not advisable to take one policy of certain sum, but instead two policies can be taken.

   (a) One policy is for a minimum amount below which value of the stock never falls known as First Loss Policy.

   (b) Another policy known as Excess Policy for a difference/excess amount (for a maximum amount of stock) by which price fluctuates. E. g. if the value of stock ranges between Rs 100,000 and Rs 130,000, then one policy is taken for Rs 100,000 and another policy for excess amounti.e.Rs.30, 000.

9. **Blanket Policy**: Blanket Policy covers all fixed and current assets of the assured in one policy. Under this policy all the assets

lying at different places are covered under one premium and one policy.

10. **Declaration Policy:** Under the declaration policy, the insured takes out insurance for the maximum amount that he considers would be at risk during the period of the policy. On a fixed date of every month or a specific period, the insured furnishes a declaration of the amount. The premium is provisionally paid to 75% of the annual premium amount.

11. **Adjustable Policy:** This policy is nothing but an ordinary policy on the stock of the businessman with the liberty to the insured to vary in his opinion; the premium is adjustable pro-rata according to the variation of the stock. In the case of declaration policy, since the excess premium is refundable at the end of the year, the insured may put fire to the property. This danger is avoidable in an 'Adjustable Policy'. This is issued for a definite term on the existing stock.

10.5.5 Importance of Fire Insurance

The most popular form of property insurance in India is Fire insurance. It is a form of insurance coverage to protect assets from losses occurring due to fire. Fire Insurance aids business men to feel secure and carry on their businesses with confidence as fire accidents are unexpected and cause massive destruction which can bring a flourishing business to an impasse. Fire insurance protects enterprises in the following ways:

1. Covers the cost of the property damage due to fire.

2. Provides medical expenses to employees who sustained injuries from the fire incident.

3. Provides compensation for loss of life as well.

Apart from businesses, personal assets can also be insured against fire damage under a fire insurance policy. It provides monetary compensation in case of loss or damage to personal property such as flats, furnishings, clothes etc. It also provides maintenance price for the electronic items which are damaged by fire like television, computer, air coolers etc. Modern technologies like smoke detectors and alarms do alert in and provide the time to run back to safety, but as far as safeguarding of property is concerned they can do little as fire spreads at a rapid pace. Hence fire insurance is a critical protective measure which one cannot ignore at any cost.

10.5.6 Procedure of Effecting a Fire Insurance Policy

The following procedure is adopted whenever a person wants to get his property insured against the risk of fire:

1. **Proposal Form:** An intending person must fill up the printed proposal form which is distributed by the insurance company free of cost. The proposal form solicits, in addition to the name and address of the proposer, other particulars concerning the object to be insured and the physical and moral hazards involved in it.
2. **Proof of Respectability:** Evidence of respectability is required if necessary, as the insurance policy covers a high degree of moral hazards.
3. **Assessing of the Proposal**: On receipt of the proposal, the underwriter assesses the possible loss involved in the proposal. A surveyor may be sent to assess the proposal if the subject matter is of very high value.
4. **Acceptance:** The insurance company accepts the proposal of the risks deem insurable after the assessment of the survey report and the evidence of respectability. Accordingly, a letter of acceptance is written to the proposer instructing him to pay the premium.
5. **Cover Note:** Sometimes a cover note is issued immediately and the policy is sent later on. A cover note binds the insurer to indemnify the risk. The risk coverage starts on the payment of premium.
6. **Insurance Policy:** The insurance company prepares and issues a legal and formal document of insurance along with the terms and conditions after the issuer of cover note. This policy serves as evidence of insurance between the insured and the insurer.

10.5.7 Procedure for Settlement of Claims

The following procedure is adopted while claiming the compensation of fire loss:

1. **Notice of Fire:** As soon as the occurrence of fire, the insured must send a notice of loss in writing to the insurance company. If possible, the evidences of loss and the evidence done to mitigate the loss must be provided along with the notice.

If deliberate person is suspected, an FIR must be lodged with the police and a copy of FIR must be submitted along with the notice.

2. **Receipt of claim intimation:** On receipt of a claim intimation the insurance company takes the following steps:

   a. The policy is in the force.

   b. The items of goods affected are the same as covered under the policy.

   c. The location involved is the same as covered in the insurance policy.

3. **Entering in the Claim Register:** The claim is registered after verification of the policy along with the allotment of a claim number for future reference.

4. **Claim Form:** Once the claim has been registered, the insurance company sends a claim form to the insured. The insured should carefully fill the form as the details given in the form can affect the amount of the claim. Any wrong information can result in the refusal of the claim.

5. **Survey:** The insurance company will appoint a surveyor for scrutiny of the situation if the amount of loss is large.

6. **Discharge Voucher:** A discharge voucher is sent to the insured for his acceptance and on return of the same; a cheque in settlement is sent.

7. **Recording:** The payment is recorded in the claim register before the release of the cheque.

10.6 MARINE INSURANCE

Marine Insurance insures all types of risks which can occur during transit. It is a contract whereby the insurer undertakes to indemnify the assured, in a manner and to the extent thereby agreed, against marine losses.

Section 2(13) of the Insurance Act 1938,defines marine insurance as “marine insurance business means the business of effecting contracts of insurance upon vessels of any description, including cargoes, freights and other interests which may be legally insured, in or in relation to such vessels, cargoes and freights, goods, wares, merchandise and property of

whatever description insured for any transit by land or water, or both, and whether or not including warehouse risks or similar risks in addition, or as incidental to such transit, and includes any other risks customarily included among the risks insured against in marine insurance policies".

Marine insurance has been designed to provide coverage for the transportation of goods either on the ocean or by land as well as damage to the waterborne instrument of conveyance and to the liability for third parties arising out of the process. The two branches of marine insurance are ocean marine (primarily water-based exposures) and inland marine (primarily land-based exposures).

10.6.1 Features of Marine Insurance

1. **Offer & Acceptance:** It is a prerequisite to any contract. Similarly, the goods under marine (transit) insurance will be insured after the offer is accepted by the insurance company.
2. **Payment of premium:** An owner must ensure that the premium is paid well in advance so that the risk can be covered.
3. **Period of marine Insurance:** The period of insurance in the policy is for the normal time taken for a transit. Generally, the period of open marine insurance will not exceed one year.
4. **Deliberate Act:** If goods are damaged or loss occurs during transit because of deliberate act of an owner then that damage or loss will not be covered under the policy.
5. **Claims:** To get the compensation under marine insurance the owner must inform the insurance company immediately so that the insurance company can take necessary steps to determine the loss.

10.6.2 Elements of Marine Insurance Contract

1. Insurable Interest: Marine insurance is based on the insurable interest in the property. It is not essential for the insured to have an insurable interest at the time of affecting the insurance. Instead, he/she should have such an interest in due course of time otherwise; he will not become entitled to indemnification. Thus a marine insurance will be valid if the person is having insurable interest at the time of loss.

2. Utmost good faith: According to this principle, both the parties to the insurance contract must disclose all facts material to the risk

voluntarily to each other. Any breach of this duty shall render the contract voidable at the option of the aggrieved party, i.e., the party who has suffered as a result of this breach.

3. Contract of Indemnity: Marine insurance is an agreement whereby the insurer undertakes to indemnify the assured in the manner and the extent agreed upon. Under no circumstances, an insured is allowed to make a profit out of a claim the insurance company. It is liable only to the extent of actual loss suffered.

4. Contribution: If a person insures his goods with two insurance companies, then in case of marine loss both the insurance companies will pay the loss to the owner proportionately.

5. Warranties: The principle of warranties applies to a marine insurance contract. Warranties are the statements according to which insured persons promises to do or not to do a particular thing or to fulfil or not to fulfil a certain condition. It may be expressed or implied.

6. Proximate Cause: The fundamental principle underlying every contract of marine insurance is that a loss must be one which was proximately caused by a peril insured against Proximate cause is used to examine how loss occurred and how many may have played a role in causing the loss. It refers to the initial action that caused a loss. The starting point in the chain of events that led to a loss.

10.6.3 Subject Matter of Marine Insurance

There are four types of marine insurance that provide different protections:

1. Hull Insurance: The hull insurance offers protection for physical damages to the boat or vessel along with its operating equipment, including machinery. It covers the applicant from any mishap to the ship and is generally taken by ship owners.

2. Cargo Insurance: Cargo owners are exposed to the risk of mishandling of the cargo at the terminal and during the voyage of the ship. It might get damaged, lost or misplaced. Hence, to protect the cargo owner from the financial losses arising out of such cases, marine cargo insurance is issued against appropriate premium payment. It comes with a third-party liability insurance which covers any damage done to the port, railway track, ship, other cargo or humans due to the cargo.

3. Liability Insurance: The ship may be exposed to crash, collision or piracy attack. Under such situations, the valuable cargo is exposed to a high risk. Moreover, the life of crew members and others on the ship is also

in danger. The appropriate liability insurance indemnifies the ship owners out of any such liabilities due to events not under his control.

4. Freight Insurance: This section covers the loss of freight. In case the freight is lost or damaged or the ship is lost, the shipping company will not have to bear the loss. They can be compensated for the loss through this insurance.

10.6.4 Types of Marine Insurance Policies

1. **Voyage Policy:** The validity of the insurance policy is limited to the specified voyage; hence, such policy is also known as voyage policy.
2. **Time Policy**: Many a times, customers want coverage for a particular period. Such coverage is called time policy.
3. **Mix Policy:** When the marine insurance policy extends the insurance cover for a particular voyage and for the desired duration of time, it is called mix policy. It gives flexibility to customers to handle various uncertainties related to the movement of the ship and the cargo inside the ship.
4. **Single Vessel Policy:** For ship owners who own only one ship, this policy is ideal, considering the cost and coverage. For ship-owners having a fleet of ships, single vessel policy for each ship is not cost effective.
5. **Fleet Policy:** If the ship-owners have multiple ships (fleet of ships), the fleet policy is cost effective and easy to administer.
6. **Floating Policy:** The floating policy is issued to the shipping line on an on-going basis. The only specified detail is the maximum sum insured in the policy. All other details are informed to the insurance company when the ship starts its voyage. For regular cargo owners, who need frequent transportation of goods through shipping line, this is the best policy, to save time and money.
7. **Unvalued Policy:** The value of the cargo is usually mentioned while taking the marine cargo policy. However, when the value of the goods and consignment is not defined before uploading the cargo, the unvalued policy is issued. It is also called open policy. The value is mentioned in case of claim after due verification and validation of the facts related to the consignment under the claim.
8. **Valued Policy:** When there is no ambiguity regarding the value of the consignment, it is mentioned during issuance of the cargo marine

policy. In case of any claim, the amount of reimbursement is limited to value mentioned in the policy, subject to other terms and conditions of the policy.

9. **Block Policy:** This policy also comes under maritime insurance to protect the cargo owner against damage or loss of cargo in all modes of transport through which his/her cargo is carried i.e. covering all the risks of rail, road, and sea transport.

10.6.5 Importance of Marine Insurance

The importance of marine insurance is manifold. The development of international trade is closely linked with marine insurance. Increase in the volume of trade is also closely linked with marine insurance as it assures to indemnify the insured against loss, damages and expenses occasioned in connection with ship, cargo and freight. Marine insurance is not like fire insurance in which only one risk of fire is covered. It covers many perils of sea which may include sinking of ship, fire, collusion, etc. It protects all the parties engaged in the business like ship owner, cargo owners and the shipping company.

Through marine insurance, ship owners and transporters can be sure of claiming damages especially considering the mode of transportation used. Of the four modes of transport – road, rail, air and water – it is the latter most which causes a lot of worry to the transporters not only because there are natural occurrences which have the potential to harm the cargo and the vessel but also other incidents and attributes which could cause a huge loss in the financial casket of the transporter and the shipping corporation.

Incidents like piracy and possibilities like cross-border shoot-outs also pose a major threat when it comes to water transportation and therefore in order to avoid any loss because of such events and happenings, in the interest of the corporation and the transporter, it is always beneficial to have a back-up like a marine insurance.

Another important aspect of having marine insurance is that a transporter can choose the insurance plan as per the size of his ship, the routes that are taken by his ship to transport the cargo and many such minor points which could go a great length in affecting the transporter majorly.

10.6.6 Marine Losses and its Classification

During voyage there are number of perils in the sea. If the loss takes place on account of any of the perils insured against with the insurer, the

insurer will be liable for it and shall have to make good the losses to the assured.

Marine losses may be divided into two broad categories:

A. Total Loss

B. Partial Loss

A. Total Loss: When the subject matter of the insured material is completely destroyed or lost is known as total loss. It can be either of the following:

a) Actual Total Loss: When the subject matter is completely destroyed or damaged that it ceases to be a thing of a kind insured or when the insured is deprived of the possession of the subject matter which cannot be recovered, such loss is called the actual total loss. Example, a ship is entirely destroyed by fire, foodstuff badly damaged by sea water became unfit for human consumption, where a ship is missing for a very long time and no news of her is received after the lapse of a reasonable time, etc.

b) Constructive Total Loss: A constructive total loss occurs when the ship or cargo is abandoned for certain reasons because its actual total loss seems unavoidable or when its subject matter cannot be preserved from its total loss by incurring more expenditure, which would be more than its actual value. Example, suppose a ship has to run on a rock and is badly damaged. If arrangements are made to send other ship to save and bring it back and repair it, the total expenses involved will be greater than the value of the ship so damaged. In this case the ship may be justifiably abandoned and will be deemed as a constructive loss.

B. Partial Loss When the subject matter of the kind insured is partially destroyed or damaged or lost, it will be case of partial loss. Partial loss is of two types:

a) Particular Average Loss: Particular average loss is partial and unforeseen loss which is accidentally incurred by sea perils. It is not caused voluntarily. Example, if some of the tins of refined oil are shipped and few of the tins are destroyed by sea water in the course of voyage.

b) General Average Loss: A general average loss is one in which is caused by an extraordinary sacrifice or expenditure

voluntarily and reasonably made or incurred under special circumstances for the only purpose of preserving the common interest from impending peril. Example, if a ship is sinking and some of the cargo is thrown out in the sea with a purpose to save the ship.

10.6.7 Procedure to insure under marine insurance

The following is the procedure for obtaining marine insurance policy:

1. **Selecting the Insurance Company:** General insurance business in India is the monopoly of General Insurance Corporation (GIC) of India and its four subsidiaries. However, if an exporter intends to insure with a foreign company, then prior permission of the RBI must be obtained.
2. **Deciding Appropriate Type of Policy:** There are various types of marine insurance policies issued by the GIC to suit the requirements of exporters. The exporter should decide the appropriate type of policy as per his requirements.
3. **Application to the Insurance Company:** When the goods are ready for despatch the exporter should apply to the insurance company in the prescribed 'Declaration Form' giving the following details:
    a) Address of the exporter and importer.
    b) Description of goods;
    c) Marks, numbers and kind of packages.
    d) Value of packages.
    e) Transportation from the warehouse to its final destination.
    f) Risk to be covered for insurance.
4. **Payment of Premium:** The insurance premium charges may vary from company to company and country to country. Payment on marine insurance policy can be made in rupees provided exporter certifies that insurance charges on the shipment in question have to be borne by him.
5. **Issue of the Insurance Policy:** After the completion of all the formalities, the exporter has to produce the Bill of Lading and the name of the ship to the insurance company. The insurance company issues the insurance certificate (in triplicate) as per the declaration given by the exporter. The policy generally contains the following details:

a) Name and address of the exporter.

b) Type of policy and description of the risks covered.

c) Description of the goods insured.

d) Amount of sum assured and premium paid.

e) Date of issue and the period of policy.

f) Special conditions and warranties.

g) Special instructions regarding procedure to be followed in the event of loss.

6. **Processing of the Policy:** The exporter submits the original policy to the bank with his other documents. The second copy of the policy is sent to the importer and the third copy is retained by the exporter for his own information.

10.6.8 Steps involved in filing marine insurance claim

Following procedure should be followed in the event of occurrence of marine loss:

1. **Intimation of Loss**: Intimating insurance company about the loss or damage of goods is the first step to be taken by the insured under claim of marine insurance. In the event of claim arising, the marine insurance company or its nearest office or its overseas agent as mentioned in the policy should be intimated about the loss without delay. The claim on carriers, customs and bales should be filed within the prescribed time limit under registered post with an acknowledgement due.
2. **Appointment of the Surveyor:** On receiving the intimation, the insurance company appoints a surveyor to determine the cause and extent of loss. The following details are necessary in the Survey Report:

    a) Whether the packing was sufficient? If not,

    b) What improvements are recommended?

    c) How claim could have been minimised?

    d) Was there failure of insured to protect interest by not taking measures to avoid or minimise loss or not protecting the rights of recovery from carriers/ Port, etc.?

3. **Landing Remarks:** The insured should also obtain landing remarks from the Port Authorities.

4. **Submission of Claim:** The insured should submit the following documents to finalise claim properly:

   a) Original insurance policy

   b) Original invoice and packing list.

   The following documents, inter alia, are required to be submitted by the exporter to the insurance company:

   a. Claim bill in duplicate.

   b. Original Insurance policy duly discharged.

   c. Original Invoice.

   d. Copy of Bill of Lading.

   e. Copy of packing list showing weight specification.

   f. Ship Survey Report.

   g. Insurance Survey Report.

   h. Port Trust Landing Remark Certificate.

   i. Copy of claim lodged with carriers, customs and bales.

   j. Reply received from carriers or Port Trust Authorities and/or correspondence exchanged.

   k. Any other documents required by the Insurance Company.

5. **Finalisation of the Claim:** On verification, if the insurer is satisfied with the claim, it pays the amount of claim to the insured or the person authorised to receive the claim as per the policy. If the claimant is of Indian origin, the claim is paid in Indian rupees irrespective of the currency in which relative policies have been issued. Where the clamant is not the resident of India, the may settle the claim in foreign currency.

CHECK YOUR PROGRESS



1. What is Non-Life Insurance?

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2. What is Fire Insurance?

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3. What is Valued Policy under a fire insurance contract?

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4. What is Marine Insurance?

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5. State the meaning of Hull Insurance.

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10.7 BURGLARY INSURANCE

Burglary is defined as an act of forceful entry into the house or business premises with an illegal intention of theft. The term burglary represents the act of entering any property illegally or unlawfully with the purpose of committing a crime and this might not always involve theft.

Lloyds Association introduced the scheme of burglary insurance in 1887 for the first time. The first company to issue policies was the 'Mercantile Accident and Guarantee Company of Glasgow.

Under the burglary insurance, the insurance company agrees to indemnify the financial losses caused to property and valuable items due to theft, dacoit, burglary, house-breaking, etc. during a certain period of time, as may be determined under the contract of insurance. The insured is required to pay a certain amount periodically or in lump sum by way of premium

Burglary Insurance is an add-on to other insurance policies. The policy is specifically designed to cover the losses arising as a result of burglary. The burglary or housebreaking insurance policies are meticulously designed to provide monetary reimbursement in case of loss or damage to a property in the premises by acts of housebreaking and or burglary.

10.7.1 Features of burglary insurance

Burglary insurance policies have the following salient features –

1. They can be bought by homeowners, tenants as well as business organisations to cover the financial loss suffered due to burglary

2. A burglary insurance policy can also cover theft and robbery. That is why the plans are also called burglary and theft insurance plans.
3. There are different types of burglary insurance plans available in the market
4. One can avail different types of burglary insurance policies for covering different types of assets which are exposed to the risk of theft.
5. A standard burglary insurance policy can be extended to cover losses suffered due to burglaries committed during riots, strikes, fire, etc.

10.7.2 Importance of Burglary Insurance

Every one of us stock up valuable goods and or documents at our home and office premise. If somebody breaks into your house and steals your expensive gems, jewellery, or stones you will have no other way left but to face a financial loss. Similarly, you will go helpless if an intruder manages to enter your office premise unlawfully and steal your important data or business plan. We'll have no option in our hands if somebody steals all that.

As a result of which, the financial loss we will have to suffer would add up to our anguish. But you need not worry since there is a simple, convenient and hassle-free way by which you can safeguard the security of your property. And the all-in-one solution is to buy burglary insurance. Burglary insurance policies are generally formulated to shield you against such losses or damages. A burglary insurance policy provides you with monetary support in the event where you face hard and tough times as mentioned above.

10.7.3 Types of Burglary Insurance

There are basically three types of burglary insurance policies.

1. **Stock Declaration Insurance:** This plan is the best and perfect when a large number of stocks often vary during a financial year. The Sum Insured is fixed at the highest stock value that is projected by the policyholder.
2. **First Loss Insurance:** In the event of an implausibility of total loss, this plan provides a policyholder to select a percentage of the stocks that can be insured.
3. **Full Value Insurance:** This plan offers full value of the insured property.

10.7.4 Exclusions under Home Burglary Insurance

The insurer will not accept burglary insurance claim under the following circumstances:

1. Loss or damage where the burglary happened due to the involvement of the insured's family member or any of the business staff or any other person that was lawfully present on the premises where the burglary took place.
2. Any loss or damage involving bonds, deeds, promissory notes, bills of exchange, cash, cheques, treasury, bank notes, books of accounts, securities for money, stamp collections, stamps, manuscripts, medals, coins, documents of any type unless specially mentioned in the policy documents.
3. Any damage resulting due to weapons, nuclear bombs, etc.
4. Any damage due to the invasion, war, the act of foreign enemy, etc.
5. Any loss or damage incurred due to confiscation by government authorities and nationalisation.
6. Any type of consequential loss or damage is also not covered.
7. Any damage caused by riots, strikes, civil, commotion, etc.

10.7.5 Types of burglary insurance policies

Burglary insurance policies can be of different types based on the type of coverage as well as the assets that they cover. Here are some of the commonly found burglary insurance policies in India –

1. **Money in Transit Insurance**: Under this policy, the insurance company agrees to indemnify the losses of cash, postal orders, bank drafts, cheques, money orders, stamps and bills of exchange of the insured while in transit. As such, it secures the insured against the risks of theft, dacoit, robbery and burglary, etc. relating to money or other forms of money in transit. The policy is relevant for businesses where the movement of physical cash is involved.
2. **Business Premises Insurance**: This policy covers the risk of burglary and theft in the place of business. The following properties or goods are covered under business premises burglary policy:
    a) Personal assets and properties, etc. of the insured.
    b) Articles of decoration and displays installed in the business premises.

c) Goods or properties kept under the contract of bailment, trust or in consideration of payment of commission or rent, etc.

d) Valuable and cash kept in the locked safe or security boxes or strong rooms, etc.

e) Stock-in-trade lying in the business premises or godowns of the business premises.

3. **Dwelling Insurance:** Insurance companies provide burglary insurance policies especially for residential buildings under which owner's or occupier's personal belongings, personal effects, property articles, jewellery, ornaments, etc. are secured against the risks of theft, dacoits, burglary and house-breaking, etc. Under this policy, the residential house is covered against burglary and theft.

4. **Jewellery and Valuable Policy**: This policy specifically covers precious jewellery, valuable, works of art and other valuables against burglary.

5. **Cash in Safe Policy**: This burglary insurance policy covers the risk of theft of the cash which is kept in a safe at the house or at the business premises.

10.7.6 Procedure of claiming Burglary Insurance

1. **Police Complaint:** All losses are required to be reported to the police authorities through formal written complaint, a copy of which has to be given to the insurer along with F.I.R. No. /Diary Entry No.by which police registers the case.

2. **Intimation to the insurance company:** The insured must give immediate written notice of the loss to the insurance company.

3. **Registration of claim:** The claim is then registered by the insurance company and a claim form is issued to the insured to be filled by him. Claim form includes:

   a) The description and value of the property stolen.

   b) Allowances have to be made for depreciation and wear and tear to arrive at the amount of the claim.

   c) Details are required in respect of date and time of loss.

4. **Furnish claim form:** The claim form must be duly completed by the insurer and submitted to the insurance company.

5. **Evidence:** There must be evidence of a broken lock, broken window, broken roof, etc.to substantiate the claim. These would be violent and forcible entry.

6. **Scrutiny:** The claim is processed on the basis of the claim form, survey report, the policies report and the various vouchers, proof of ownership and other evidence submitted by the insured. The same are scrutinised by the insurer to decide upon the admissibility of the claim and the amount payable.

7. **Finalisation of claim**: Burglary claim up to Rs.2500 are generally settled by the insurer on the basis of the completed claim form and copy of the First Information Report, provided the insurer is satisfied about the genuineness of the claim. Burglary claim over Rs.2500 are required to be surveyed by an independent surveyor. If need arises the matter may also be entrusted to a professional investigator for a thorough investigation.

8. **Payment of claim**: On payment of the claim, the sum insured gets automatically reduced by the amount of claim paid. The sum insured may be reinstated on payment of pro-rata additional premium on the amount to be reinstated.

10.8 MOTOR INSURANCE

Motor Insurance is a type of insurance policy which covers one's vehicles from potential risks financially. It is a contract by which the insurer assumes the risk of any loss the owner or operator of a car may incur through damage to property or persons as the result of an accident. It is generally a combined insurance which insures the damage to the motor vehicle and its accessories, liability for damage to property, death of, or injury to the assured himself or spouse and it also insures the motor vehicle against the risk of liability for injury to, or the death of third parties caused by the drivers' negligence.

Thus, the policyholder is provided financial security against damages arising out of accidents and other threats. There are many specific forms of motor vehicle insurance, varying not only in the kinds of risk that they cover but also in the legal principles underlying them.

The major benefit of having one is that it ensures higher level of protection against losses incurred due to road accidents. It also protects us against complications arising from third party liability. It acts as a financial cushion in case the vehicle is damaged due to accident, earthquake,

lightning, floods, etc. Also, vehicle insurance reimburses expenses incurred in suffering of bodily injuries because of an accident. In other words, it compensates for hospitalisation expenses due to an accident involving one's vehicle.

10.8.1 Types of Motor Insurance Policies

1. Third Party Policy: The Motor Vehicles Act make mandatory to avail a third party insurance policy failing which would result in a penalty and/or fine. This policy indemnifies the insured against his legal liability in respect of damage to property of third parties. It covers injury or death caused to a third person by one's vehicle along with damage caused to a property.

2. Own Damage Car Insurance Policy: Own damage is any kind of damage that is caused to the insured car. The cause of damage can be of multiple types; thus own damage is not limited to accidents. This policyhelps one stay covered against the damages caused to the car due to natural calamities, accidents like fire, theft, etc.

3. Comprehensive Policy: Comprehensive Policy is an extensive motor insurance plan that covers the insured person against both, own damages and any third party liabilities. It offers complete protection to both the parties involved in an accident. So, the damages to self, car, as well as the other party involved in the accident are covered by the comprehensive policy, up to the maximum coverage amount. Comprehensive insurance covers a number of perils such as vandalism, fire damage, floods, damage due to natural calamities like tornado, wind storm etc., glass breakage (e.g. windshield), and damage due to falling objects like trees and so on.

10.8.2 Importance of Motor Insurance

Vehicle insurance is an integral part of vehicle ownership and getting it insured will protect this investment thus making motor insurance policy a must for every car owner in India. . Motor vehicle insurance is perhaps the most important amongst the General Insurance and its importance is increasing immensely as road transport hazards and risks are also increasing day by day.

1. **Takes care of third-party liability:** It takes care of third-party liability arising due to damages suffered by a third party involving one's vehicle, thus protecting from legal litigations.
2. **Mandatory by law:** Any vehicle running on Indian roads has to have motor insurance, especially third-party liability cover. Not having

insurance cover can lead to a severe penalty. On the other hand, having a motor insurance gives the peace of mind as it acts as a backup in case the vehicle sustains damages of any kind.

3. **Coverage in case of death:** Death is perhaps the worst possible outcome after an accident. In case of the sole breadwinner of the family, untimely demise can throw the family in a financial insecurity. However, the pay-out from a motor insurance policy can help the family stay financially independent and take care of its day-to-day expenses.

4. **Add-ons:** One can enhance the protection by opting for Add-on covers to insure for risks that are not covered under a standard policy. Some of the common add-on covers include zero depreciation, no-claim bonus protection, accidental hospitalization, etc.

10.8.3 Motor Policy Conditions

The usual conditions incorporated in the motor policy are as follows:

1. **Notice of Accident:** Immediately after occurrence of accident, the same has to be brought to the knowledge of the insurer by serving a notice of accident.

2. **Supply of data:** The insured should provide all necessary information to the insurer whenever needed.

3. **Inspection:** It is the duty on the part of the insured to keep his vehicle in good condition and permit the insurer to inspect the vehicle at any time.

4. **Cooperation of insured and subrogation:** The insured cannot pay damages to the third party without consent of the insurer.

5. **Cancellation of Policy:** The insured may cancel the policy at seven days' notice and demand the return of the proportionate premium, provided that no claim has arisen during the then current period of insurance.

6. **Renewal of policy:** When a policy is renewed, bonus in the form of reduction of renewal premium will be allowed, provided that there was no claim under that policy in the previous year.

10.8.4 Procedure for effecting Motor Vehicle Insurance

The following procedure is followed for effect ting motor vehicle insurance:

1. **Filling and submission of proposal form:** First of all, the person who is interested in taking a motor policy known as proposer will

have to submit a proposal form with the insurer. Proposal form covers information required to be furnished by the insured relating to motor vehicle and occupier or owner of the vehicle such as registration number of vehicle, model, chaises, c.c. power, year of manufacture or make, etc.

2. **Determining the rate of premium:** After having received the proposal form, the insurer evaluates the volume of hazards before deciding consideration (rate of premium) and acceptance. While considering proposal, generally model of the vehicle, position and history of past claims, accidents and information about the proposer are examined.

3. **Cover Note, Certificate of Insurance and Policy:** As soon as the amount of premium to be charged on the proposer is determined, the same will be conveyed to the proposed by the insurer. On receipt of the letter from the insurer, the proposer will pay the amount of premium and the insurer will, after receiving the premium, issue a cover note along with a certificate of insurance. The cover not serves as an evidence of the acceptance of the risk by the insurer till the final policy is issued. The certificate of insurance can be produced before the Regional Transport Authority as a proof of insurance.

4. **Insurance Policy:** Finally, the insurer prepares the motor policy (to replace the cover note) and sends the same to the insured. The motor policy is generally issued for one year. In case, the insured wants to sell his insured motor vehicle and replace it by a new one, the policy can be transferred to the new vehicle. The amount of premium, if necessary, can be adjusted proportionately.

10.8.5 Procedure of Claiming Motor Insurance

The following procedure is adopted for the settlement of claim under motor vehicle insurance

1. **Receipt of claim intimation:** A notice of claim must be filed with the insurer as soon as the occurrence of damages. On receiving the claim intimation, insurance company checks the main contents of insurance policy.

2. **Entering it in the Claim Register:** On verification of the insurance policy, the claim is registered in the claim register along with a claim number.

3. **Letter to Motor Accident Claims Tribunal (MCAT):** If claim is received from MCAT, a letter is issued to MCAT to get details of the claim information necessary for the case.
4. **Claim Form:** Next, the claim form is sent to the insured person or claimant for completing and returns it to the insurance company. Information like name of the insured, policy number, address of the insured, details regarding loss, etc. needs to be mentioned.
5. **Additional information:** Additional information like driver's statement and statement of witness, driver's record of past prosecutions, charges, etc. is needed to determine the liability of the insured and liability under policy to insurer.
6. **Quantum of damages**: Certain factors are taken into consideration for determining the amount of damages for death/injury.
7. **Advocates opinion:** The opinion of advocate is obtained and files a written statement.
8. **Inspection of claims:** After the receipt of claim form, the insurance company investigates the relevant facts to determine its liability.
9. **Settlement of claims:** On the basis of investigation, the insurance company determines the extent of its liability and loss is indemnified.

10.9 TRANSIT INSURANCE

Transit insurance or transportation insurance policy is a safe and secured way of covering the risk arising due to loss or damage caused to goods or personal belongings while in transit. Transit insurance is an insurance plan which covers the risks faced by goods when they are being transported from one place to another. The policy covers being transported by air, water, road or rail.

A transit insurance policy is suitable for businesses and individuals who are involved in regular transportation of goods. The policy can be bought by the following types of parties:

1. Manufacturers of goods
2. Importers and exporters of goods
3. Custom house agents
4. Traders
5. Transporters or aggregators

10.9.1 Transit Insurance Coverage

Transit insurance coverage includes common perils which might cause damage to the goods which are being transported. These perils against which transit insurance protects the goods are as follows:

1. Earthquakes
2. Explosion
3. Fire
4. Lightning
5. Any type of natural or man-made calamity
6. Overturning of the transport vessel
7. The collision of the vessel which damages the goods con tained therein
8. The derailment of the vessel
9. The sinking of the vessel
10. Risks faced while loading and unloading the goods
11. Risks faced in packing and unpacking of goods
12. Accidental damages
13. Malicious damages
14. Impact damage
15. Theft, etc.

10.9.2 Types of Transit Insurance for Goods

Transit insurance policies can be offered in multiple variants. These variants are as follows –

1. **Single transit policy**: This policy covers one particular journey and is suitable for businesses that do not transport their goods frequently. The policy would cover the goods which are being transported on a particular journey only.
2. **Customised policy**: This policy is a flexible transit insurance policy which can be customised for businesses to suit their coverage re-quirements.
3. **Open policy:** This policy covers multiple transits occurring within a given period of time which is, usually, one year. So, if businesses transport their goods frequently, they can buy this policy and ensure

coverage for multiple trips without buying a different policy for each one.

4. **Overnight vehicles' insurance policy:** If the goods are to be stored overnight in a vehicle, this policy is suitable as it covers the goods in such cases.
5. **Goods in transit (carrier's) cover:** If the goods are transported using the transport vessel of a third party carrier, the carrier might not undertake the risks of damage to the goods. Therefore, this policy helps to cover the damages when the goods are being transported using another carrier service.
6. **Goods in transit (own vehicle) cover**: If one's own vehicle is being used for transporting the goods, this cover would insure the goods against possible damages.
7. **Multiple vehicles cover**: If multiple vessels are used in the transportation of goods, this policy can be taken to cover the goods being transported through different vehicles. The policy would cover multiple vehicles under a single plan.

10.9.3 Importance of Transit Policy

A transit insurance policy proves to be a boon for businesses because of the various benefits it provides. Here are some of the benefits of transit insurance policies which make them a must-buy –

1. Coverage under transit insurance plans is provided on globally standard terms. Thus, in the event of transporting the goods internationally, one can meet the coverage requirements of the country to which the goods are headed.
2. Transit insurance coverage provides financial support to businesses which might face considerable losses if their goods are damaged during transit. The policy, therefore, helps keep the business finances stable even after a loss.
3. Since any possible loss is covered under the transit insurance policy, businesses can also maintain their profitability even when any contingency damages their goods. This profitability also helps businesses maintain their solvency and their market value
4. The policy can be customised as per the requirements of the business and is, therefore, suitable for all types of businesses

10.10 HEALTH INSURANCE

Health insurance has been realised as an instrument for the health of the economy. If the people of the country are healthy, they can contribute significantly in the economic development of the country. The health insurance industry would provide protection to social development. Health insurance is a type of insurance coverage that covers the cost of an insured individual's medical and surgical expenses. It is the coverage that provides for the payments of benefits as a result of sickness or injury. It includes insurance for losses from accident, medical expense, disability, or accidental death and dismemberment.

10.10.1 Benefits of Health Insurance

1. **Ambulance expenses:** One of the benefits of having health insurance by side is that it covers for ambulance expenses incurred on the transportation of insured. Thus, the need for arranging a vehicle during an emergency situation gets eliminated.
2. **Cashless Benefits:** Today all the health insurance organization are tied up with network of hospitals or nursing homes. These plans make work easier during crucial period with no hassle for claim resolution and documentation. There is no cash payment in such benefits. By filling the policy number with valid documents the work on behalf of insured person is completed and rest will be taken care by the insurer up to the coverage amount. If the expenses go beyond the sub-limit or are not mentioned by the insurance company, then the coverage will have to be settled by the individuals directly in the hospital. The person should consider the point of not getting treatment in any other hospital that is not a part of their hospital network for cashless benefit.
3. **Wellness Care:** This facility provided by the health insurance make a lot of additional benefit to the insured. The wellness care section provides with regular health check-ups. Some firm also provide free medical check-up provided one has no claim bonus in record in his past history.
4. **No Claim Bonus (NCB) :** NCB is an advantage for the insured who have previous claim free year and no break in policy. The person will be subjected to a cumulative bonus or a discount in

the cost. This privilege is provided to the insured during next renewal period.

5. **Pre & Post Hospitalization:** Health insurance policies provide coverage for pre & post hospitalization expenses for a specific number of days depending on plan of purchase.
6. **Hospitalization Medical Expenses:** - The health insurance policy also provides reasonable and customary charges for medical expenses that are incurred during the hospitalisation of the insured person for medically necessary treatment required due to an illness or injury sustained by the insured person during the policy period.
7. **Tax-Benefit from health insurance:** Health Insurance provides a tax benefits under section 80D of income tax act, 1961. The premium an insurer pay towards health plan for self or family get a tax rebate. The tax benefit one offered from health insurance is subjected to which age group the insurer belongs to.

10.10.2 Types of Health Insurance Policies in India:

1. **Individual Health Plan:** The health insurance plan for individuals suffering from illness and are offers with advantages like cashless benefits and add –on. This facility is provided to the insured depending upon the age at entry.
2. **Family Floater Health plan:** This Health insurance policy covers or includes the entire family member against diseases under one roof. In family benefit, the sum as specified can be availed by ay one or all the members for one or more claims during the tenure of the policy.
3. **Plan for Critical Illness:** This policy is used for the treatment of various critical illnesses such as heart attack, paralysis, open heart surgery etc. These policies provide a lump-sum benefit if a person get diagnosed by any critical illness.
4. **Cancer Care plan:** Health Companies todays provide special cancer care coverage plan. Cancer treatment requires lots of medication treatment and the plan covers lots of benefit for such critical illness.

5. **Health plan For Senior Citizen:** This health insurance plan is specifically for age group above 60years, and offering maximum health benefits plan during old age.



Check your Progress

6. What is Burglary Insurance?

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7. What is Motor Insurance?

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8. What are the three types of Motor Insurance Policies?

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9. Name the parties who can purchase a Transit Insurance.

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10.11 LET US SUM UP

In this unit we have discussed about the different non-life insurance available in the market to suit the requirements of varied number of people. The main points discussed are:

- Non-Life Insurance is a policy that provides compensation for losses incurred from a specific financial event and this type of policy is also known as general insurance, or property and casualty insurance.
- Fire Insurance is a device to compensate for the loss consequent upon destruction by fire. It is an agreement between an insurance company and an individual or company where the insurer agrees to compensate the policyholder in case of loss or damage due to fire.
- Marine Insurance insures all types of risks which can occur during transit.

- ❖ Marine losses may be divided into two broad categories: Total Loss and Partial Loss.
- ❖ Burglary insurance policies can be of different types based on the type of coverage as well as the assets that they cover like Money in Transit Insurance, Business Premises Insurance, Dwelling Insurance, etc.
- ❖ Ambulance expenses, cashless banefits, wellness care, No Claim Bonus, pre and post hospitalisation, hospitalisation medical expenses and tax deductions are some of the benefits of health insurance.
- ❖ Crop insurance is a device under which the insurance company agrees to indemnify the loss caused due to the occurrence of uncertain events, to the standing of crops of the farmers.
- ❖ The objective of National Agriculture Insurance Scheme (NAIS) was to protect the farmers against the crop losses suffered on account of natural calamities, such as, drought, flood, hailstorm, cyclone, pests and diseases.
- ❖ Weather Based Crop Insurance Scheme (WBCIS) was launched in 2007.
- ❖ Protection of low income people, low premium, low coverage limits are some of the characteristics of micro insurance.



10.12 FURTHER READING:

1. Insurance: Principles and Practices
    - M.N.Mishra
    - Dr.S.B.Mishra
2. Principles and Practice of Insurance
    - Ghanashyam Panda
    - Monika Mahajan
3. Fundamentals of Insurance
    - Inderjit Singh
    - Rakesh Katyal
    - Surjeet Kaur
    - Sanjay Arora

10.13 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1 Non-Life Insurance is a policy that provides compensation for losses incurred from a specific financial event.

Ans to Q No.2 Fire Insurance is a device to compensate for the loss consequent upon destruction by fire.

Ans to Q No.3 Under the valued policy the policy holder can only recover a fixed amount of money that is agreed upon at the time the insurance policy is taken.

Ans to Q No.4 Marine Insurance is a contract whereby the insurer undertakes to indemnify the assured, in a manner and to the extent thereby agreed, against marine losses.

Ans to Q No.5 The hull insurance offers protection for physical damages to the boat or vessel along with its operating equipment, including machinery.

Ans to Q No.6: Burglary Insurance indemnifies the financial losses caused to property and valuable items due to theft, dacoit, burglary, house-breaking, etc. during a certain period of time.

Ans to Q No.7: Motor Insurance is a type of insurance policy which covers one's vehicles from potential risks financially.

Ans to Q No.8: The three types of Motor Insurance policies are:

(a) Third Party Policy (b) Own Damage Car Policy and (c)Comprehensive Policy

Ans to Q No.9: The parties who can purchase a Transit Insurance are:

1. Manufacturers of goods
2. Importers and exporters of goods
3. Custom house agents
4. Traders
5. Transporters or aggregators



10.14 MODEL QUESTIONS

1. Explain the different types of fire insurance policies.
2. Discuss the procedure of effecting and settlement of a claim under a fire insurance policy.
3. Define the marine insurance and explain its features.
4. Discuss the procedure for making any marine insurance claim.
5. Discuss the various types of burglary policies and the procedure of claiming money under burglary policy.
6. What is Health Insurance? Discuss the products of health insurance.
7. Discuss the types and significance of Transit Policy.
8. Discuss the growth and status of Crop Insurance in India.
9. Discuss the development of Micro Insurance in India.

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UNIT 11- NON-LIFE INSURANCE-II

UNIT STRUCTURE

11.1 Learning Objective

11.2 Introduction

11.3 Crop Insurance

11.4 Micro Insurance

11.5 Let Us Sum Up

11.6 Further Readings

11.7 Answers to Check Your Progress

11.8 Possible Questions

11.1 LEARNING OBJECTIVE

After going through this unit, you will be able to

- know the importance and objectives of crop insurance.
- discuss various crop insurance schemes
- know the evolution of crop insurance in India
- discuss importance and objectives of micro insurance

11.2 INTRODUCTION

Agriculture remains the primary sector of the Indian economy. While it accounts for merely 16 percent of the country's GDP, approximately 43.9 percent of the population depends on it for their livelihood. Agricultural is varied, diversified and prone to variety of risks like natural disasters such as drought, floods, cyclone, storm, landslide, earthquakes. Susceptibility of agriculture to these disasters is compounded by the outbreak of epidemics and man-made disasters such as fire, sale of spurious seeds, fertilizers and pesticides, price crashes, etc. All these events severely affect farmers through loss in production and farm income, and are beyond the control of farmers as most of them are small and marginal farmers.

Government of India focused on crop insurance as a mechanism to mitigate risks on natural perils on farm production. Crop insurance was intended to provide farmers with insurance coverage and financial support against failure of any notified crop as a result of agricultural calamities.

On the other hand, a huge section of population living in the society remains untapped and undeserved by mainstream commercial and social insurance schemes and, hence, the importance of micro insurance is undeniable.

In this unit we will discuss crop insurance and micro insurance

11.3 CROP INSURANCE

Crop insurance is a device under which the insurance company agrees to indemnify the loss caused due to the occurrence of uncertain events, to the standing of crops of the farmers. Such a measure proves to be a great boost to the farmers in case natural calamities destroy their standing crops. It is a type of protection policy that covers agricultural producers against unexpected loss of projected crop yields or profits from produce sales at market

Crop insurance is divided into two categories: crop-yield and crop-revenue. Crop-yield insurance protects the expected revenue due to unexpected yields, which is the volume of a crop's harvest. Crop-revenue insurance covers expected revenue from loss owing to market fluctuations of crop selling prices. Both types of insurance are a means to aid in disaster recovery for producers due to unexpected events.

Some of the insurance companies offering crop insurance in India are:

- Agricultural Insurance Company of Indian Ltd.,
- ICICI Lombard General Insurance Company Ltd.,
- IFFCO Tokio General Insurance Company Ltd.,
- Reliance General Insurance Company Ltd.,
- Royal Sundaram Alliance Ltd.,
- Tata AIG General Insurance Ltd.,
- Cholamandalam MS General Insurance
- HDFC ERGO General Insurance
- Future Genrali Indian Insurance Company Ltd.,
- L&T General Insurance Company Ltd.

11.4 NEED OF CROP INSURANCE

Every year, in one part of India or the other food crops are affected by natural calamities. The need for protecting the farmer from natural hazards arises for the following reasons**:**

1. Farming is more hazardous than any other enterprise. The weather can make all the difference between success and failure. The fickleness of weather conditions in different parts of the country upsets the whole agricultural economy making one part bountiful while the other part starves. Nature has always been moody.
2. Besides droughts and floods, locusts, plant diseases have always been a serious enemy to our agriculture by destroying standing crops and thereby reducing farmers' income.
3. Majority of the holdings are tiny, form which the farmers get marginal surplus in good years and incur heavy deficits in the bad ones.
4. Many farmers, particularly the small ones, feel shy of adopting new techniques.

11.5 CROP INSURANCE COVERAGE

Following stages of the crop loss are covered under crop insurance:

1. **Localised calamities:** It covers localised calamities and risks like hailstorm, landslide affecting isolated farms in the notified area
2. **Sowing/Planting/Germination risk**: Any problem in planting or sowing because of deficit rainfall or adverse seasonal conditions
3. **Standing crop loss:** Comprehensive risk insurance to cover yield losses because of non-preventable risks, such as dry spells, flood, hailstorm, cyclone, typhoon.
4. **Post-harvest losses**: It covers losses for up to a maximum period of two weeks from harvesting.

11.6 IMPORTANCE OF CROP INSURANCE

Crop insurance is the primary risk management tool farmers use to financially recover from natural disasters and volatile market fluctuations. It is a way to reduce farmers distress and to promote their welfare. The significance of crop insurance has been discussed below:

1. **Stability in Income:** It protects the farmers against losses caused by crop failure. It acts like a tool that allows farmers to manage their yield and price risks.
2. **Minimal Debts:** It minimizes the problem of rural indebtedness, which is traceable to the frequent failure of crops. Farmers are able to repay their loans even during the time of crop failure with the support of the right insurance partner.
3. **Technological Advancement:** Insurance companies work along with Agri platforms that use IOT to enhance agriculture practices and reduce farmers' losses. This helps farmers to understand latest technological advancement and improve their crop production.
4. **Yield Protection:** Crop Insurance protects farmers against production loss for crops. It also offers preventive planting and replant security.
5. **Provides Awareness:** Insurance companies provide awareness campaigns to help farmers understand the effect of natural calamities and also protect their farms.
6. **Reduces Government Expenditure:** It also reduces, to some extent, government expenditure incurred on relief measures extended to meet the havoc caused by natural calamities.

11.7 SCHEMES OF CROP INSURANCE

1. **National Agricultural Insurance Scheme (NAIS):** The Scheme was introduced during Rabi 1999-2000 season replacing Comprehensive Crop Insurance Scheme (CCIS). The main objective of the Scheme was to protect the farmers against the crop losses suffered on account of natural calamities, such as, drought, flood, hailstorm, cyclone, pests and diseases. The Scheme was implemented by the Agriculture Insurance Company of India Ltd. (AIC). The Scheme was available to all the farmers both, loaner and non-loaner irrespective of the size of their holding. The Scheme envisages coverage of all crops including cereals, millets, pulses, oilseeds and annual commercial and horticultural crops in respect of which past yield data is available.
2. **Modified National Agriculture Insurance Scheme (MNAIS):** The Scheme before incorporation in NCIP was piloted from Rabi 2010-11 to Kharif 2013. The modified version has many improvements

viz., Insurance Unit for major crops are village Panchayat or other equivalent unit; in case of prevented / failed sowing claims up to 25% of the sum insured is payable, post-harvest losses caused by cyclonic rains are assessed at farm level for the crop harvested and left in 'cut & spread' condition up to a period of 2 weeks in coastal areas; individual farm level assessment of losses in case of localized calamities, like hailstorm and landslide; on-account payment up to 25% of likely claim as advance, for providing immediate relief to farmers in case of severe calamities; threshold yield based on average yield of past seven years, excluding up to two years of declared natural calamities; minimum indemnity level of 80% is available (instead of 60% in NAIS); and premium rates are actuarial supported by up-front subsidy in premium, which ranges from 40% to 75%, equally shared by Centre and States. To improve further and make the Scheme easier and more farmer friendly, a proposal on Modified National Agricultural Insurance Scheme (MNAIS) was prepared and was approved by Government of India for implementation on pilot basis in 50 districts from Rabi2010-11 season.

3. **Weather Based Crop Insurance(WBCIS):** With the objective to bring more farmers under the fold of Crop Insurance, a Pilot Weather Based Crop Insurance Scheme (WBCIS) was launched in 20 States in 2007.Apart from Agriculture Insurance Company of India, some private companies have also been allowed to implement the Scheme. The WBCIS is intended to provide insurance protection to the farmers against adverse weather incidences, such as deficit and excess rainfall, high or low temperature, humidity etc. which are deemed to impact adversely the crop production. It has the advantage to settle the claims within shortest possible time. The WBCIS is based on actuarial rates of premium but to make the Scheme attractive, premium actually charged from farmers has been restricted at par with NAIS.

   Weather Based Crop Insurance that was introduced in 2011-12 on a pilot basis with an aim to make it more convenient for the farmers to avail crop insurance appeared to have received good response from the farmers.

4. **Pradhan Mantri Fasal Bima Yojana (PMFBY):** Pradhan Mantri Fasal Bima Yojana promises to take care of the loopholes of earlier schemes. It was launched in 2016 and replaces all the prevailing

yield insurance schemes in India. The scheme has been launched with an impetus on crop sector. It was implemented to ensure transparency, availability of real-time data and an accurate assessment of yield loss. The scheme has extended coverage under localized risks, post-harvest losses etc. and aims at adoption of technology for the purpose of yield estimation. Through increased farmer awareness and low farmer premium rates the scheme aims at increasing the crop insurance penetration in India.

Features of the PMFBY:

The following are the features of the scheme:

1. *Coverage of Farmers:* The scheme covers loanee farmers (those who have taken a loan), non-loanee farmers (on a voluntary basis), tenant farmers, and sharecroppers.
2. *Coverage of Crops:* Every state has notified crops (major crops) for the Rabi and Kharif seasons. The premium rates differ across seasons.
3. *Premium Rates:* The PMFBY fixes a uniform premium of two percent of the sum insured, to be paid by farmers for all Kharif crops, 1.5 percent of the sum insured for all Rabi crops, and five percent of sum insured for annual commercial and horticultural crops or actuarial rate, whichever is less, with no limit on government premium subsidy.
4. *Area-based Insurance Unit:* The PMFBY operates on an area approach. Thus, all farmers in a particular area must pay the same premium and have the same claim payments. The area approach reduces the risk of moral hazard and adverse selection.
5. *Coverage of Risks:* It aims to prevent sowing/planting risks, loss to standing crop, post-harvest losses and localised calamities. The sum insured is equal to the cost of cultivation per hectare, multiplied by the area of the notified crop proposed by the farmer for insurance.
6. *Innovative Technology Use:* It recommends the use of technology in agriculture. For example, using drones to reduce the use of crop cutting experiments (CCEs), which are traditionally used to estimate crop loss; and using mobile phones to reduce delays in claim settlements by uploading crop-cutting data on apps/online.

7. *Cluster Approach for Insurance Companies:* It encourages L1 bidding amongst insurance companies before being allocated to a district to ensure fair competition. A functional insurance office will be established at the local level for grievance redressed, in addition to a crop insurance portal for all online administration processes.

Objective of Pradhan Mantri Fasal Bima Yojana (PMFBY)

PMFBY aims at supporting sustainable production in agriculture sector by way of:

1. Providing financial support to farmers suffering crop loss/ damage arising out of unforeseen events
2. Stabilizing the income of farmers to ensure their continuance in farming
3. Encouraging farmers to adopt innovative and modern agricultural practices
4. Ensuring flow of credit to the agriculture sector; which will contribute to food security, crop diversification and enhancing growth and competitiveness of agriculture sector besides protecting farmers from production risks?

11.8 EVOLUTION AND STATUS OF CROP INSURANCE IN INDIA

After the attainment of Independence in 1947, crop insurance gradually started to find mention more often. The Central Legislature discussed the subject in 1947 and the then Minister of Food and Agriculture, Dr. Rajendra Prasad gave an assurance that the government would examine the possibility of crop and cattle insurance, and a special study was commissioned for this purpose in 1947-48.

The study reported in favour of a 'homogenous area' approach, as various agro-climatically homogenous areas treated as a single unit and the individual farmers in such cases pay the same rate of premium and receive the same benefits, irrespective of their individual fortunes. The Ministry of Agriculture circulated the scheme, for adoption by the State governments, but the States did not accept.

In October 1965 the Government of India decided to introduce a Crop Insurance Bill and a Model Scheme of Crop Insurance in order to enable the States to introduce crop insurance if they so desired. In 1970, the draft Bill

and the Model Scheme were referred to an Expert Committee headed by Dr. Dharm Narain.

First ever Crop Insurance scheme - 1972

From beginning of the seventy's decade, different experiments on crop insurance were undertaken on a limited, ad-hoc and scattered scale. The first crop insurance program was introduced in 1972-73 by the 'General Insurance' Department of Life Insurance Corporation of India on H-4 cotton in Gujarat. Later, the newly set up General Insurance Corporation of India took over the experimental scheme and subsequently included Groundnut, Wheat and Potato and implemented in the states of Gujarat, Maharashtra, Tamil Nadu, Andhra Pradesh, Karnataka and West Bengal.

This experimental scheme was based on "Individual Approach". It continued upto 1978-79 and covered only 3110 farmers for a premium of Rs 4.54 lakhs against claims of Rs 37.88 lakh.

It was realized that crop insurance programs based on the individual farm approach would not be viable and sustainable in this country.

Pilot Crop Insurance Scheme (PCIS) - 1979

Professor V. M. Dandekar, often referred to as the "Father of Crop Insurance in India", suggested an alternate "Homogeneous Area approach" for crop insurance in the mid-seventies.

Based on this Area approach, the General Insurance Corporation of India (GIC) introduced a Pilot Crop Insurance Scheme (PCIS) from 1979. Participation by the State Govts. was voluntary. The scheme covered cereals, millets, oilseeds, cotton, potato, gram and barley. The risk was shared by GIC and the respective State Govt. in the ratio of 2:1. The insurance Premium ranged from 5 to 10 per cent of the Sum Insured.

This PCIS ran till 1984-85 by which 13 States had participated. The scheme covered 6.27 lakh farmers for a Premium of Rs 1.97 crore against Claims of Rs 1.57 crore.

Comprehensive Crop Insurance Scheme (CCIS) - 1985

Based on the learnings from PCIS, the Comprehensive Crop Insurance Scheme (CCIS) was introduced with effect from 1st April 1985 by the Government of India with the active participation of State Governments. The Scheme was optional for the State Governments. The CCIS was implemented on Homogeneous Area approach and was linked to short-term crop credit, that is, all crop loans given for notified crops in notified areas were compulsorily covered under the CCIS.

The salient features of the Scheme were:

1. It covered farmers availing crop loans from Financial Institutions for growing food crops & oilseeds on compulsory basis. The coverage was restricted to 100% of crop loan subject to a maximum of ‘ 10,000/- per farmer.
2. The Premium rates were 2% for Cereals and Millets and 1% for Pulses and Oil seeds. 50% of the Premium payable by Small & Marginal farmers was subsidized by Central and State Governments in equal proportion.
3. Premium & Claims were shared by Central & State Government in 2:1 ratio.
4. The Scheme was optional to State Governments.
5. The maximum Sum Insured was 100% of the crop loan, which was later increased to 150%.
6. CCIS was a multi-agency scheme, involving Government of India, Departments of State Governments, Banking Institutions and GIC.

   15 States and 2 UTs had participated in the CCIS during its tenure from Kharif 1985 to Kharif 1999. These were Andhra Pradesh, Assam, Bihar, Goa, Gujarat, Himachal Pradesh, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Meghalaya, Orissa, Tamil Nadu, Tripura, West Bengal, Andaman & Nicobar Islands and Pondicherry. The States of Rajasthan, Uttar Pradesh, Jammu & Kashmir, Manipur and Delhi had initially joined the Scheme but opted out after few year

   In this entire period, the Scheme covered 7.63 crore farmers under an area of 12.76 crore hectares, for a Sum Insured of Rs 24,949 crore at a premium of Rs 403.56 crore. Correspondingly, the total claims outgo was Rs 2303.45 crore, thus having a Claim Ratio of 1 : 5.71. About Rs 59.78 lakh farmers were benefitted, and the majority of the claims were paid in the States of Gujarat - Rs 1086 crore (47%); Andhra Pradesh - Rs 482 Crores (21%); Maharashtra - Rs 213 Crores (9%); & Orissa - Rs 181 Crores (8%).

   CCIS was eventually discontinued after Kharif 1999, to be replaced by the improved and expanded “National Agriculture Insurance Scheme” (NAIS), which is being continued till date.

Experimental Crop Insurance Scheme (ECIS) - 1997

While the CCIS was being implemented, attempts were made to modify the existing CCIS from time to time as demanded by the States. During the

Rabi 1997-98 season, a new scheme, viz. Experimental Crop Insurance Scheme (ECIS) was introduced in 14 districts of 5 States. The Scheme was similar to CCIS, except that it was meant only for all small / marginal farmers with 100% subsidy on Premium. The Premium subsidy and Claims were shared by the Central and respective State Governments in the ratio of 4 : 1. The Scheme was discontinued after one season due to its many administrative and financial difficulties.

During its one season, the ECIS covered 4,54,555 farmers for a Sum Insured of Rs 168.11 crore at a Premium of Rs 2.84 crore against which the Claims paid were Rs 37.80 crore.

Pilot Scheme on Seed Crop Insurance (PSSCI) - 2000

A Pilot Scheme on Seed Crop Insurance (PSSCI) was introduced in Kharif 2000 season in 11 States to provide financial security & income stability to the Seed Growers in the event of failure of seed crop.

It was also the objective to provide stability to the infrastructure established by the State owned Seed Corporations and State Farms, and to give a boost to the modern seed industry by bringing it under scientific principles.

All seed-producing organizations, under Govt. or private control, producing certain classes of seed for identified Crops/States/Areas were eligible. All farmers growing the Foundation & Certified seed crops in the identified States /Areas, who had offered the seed crop for certification and had got registered with the concerned Certification Agency were eligible for coverage.

Farm Income Insurance Scheme (FIIS) - 2003

NAIS protects the farmers only against the yield fluctuations. The price fluctuations are outside the purview of this scheme. Farmers' income is a cumulative function of yield and market prices. In other words, a bumper harvest tends to bring down the market prices of grains and vice versa.

Therefore, despite normal production, farmers often fail to maintain their income level due to fluctuations in market prices. To take care of variability in both the yield and market price, the government introduced a pilot project, viz. Farm Income Insurance Scheme (FIIS) during Rabi 2003-04 season.

The objective of the scheme was to protect not only the income of the farmer, but also to reduce the government expenditure on procurement at Minimum Support Price (MSP).

FIIS was implemented on the basis of 'homogeneous area' approach in respect of rice and wheat crops only. The scheme was compulsory for

loanee farmers and voluntary for non-loanee farmers. The premium rates were actuarial, determined for each State at the District level, to be subsidised by the Govt. of India.

The Scheme was implemented during 2 seasons only, viz. Rabi 2003-04 season in 18 Districts of 11 States for wheat/rice, and Kharif 2004 season in 19 Districts of 4 States for rice alone. In all, the scheme covered Rs 4.15 lakh farmers for an area of 4.02 lakh hectares for a Sum Insured (i.e. guaranteed income) of Rs 420 crore, collecting a premium of Rs 28.5 crore and paid claims of Rs 28.75 crore.

Parallelly, the implementation and administration of crop insurance schemes, which were being done by General Insurance Corporation of India (GIC), was taken over by Agriculture Insurance Company of India Ltd. (AIC) since its commencement of business from 1st April 2003. Agriculture Insurance Company of India Ltd. (AIC) was incorporated on 20 December 2002 as a government owned agricultural insurance company and development financial institution. The AIC offers yield-based and weather-based crop insurance programs in almost 500 districts of India covering almost 20 million farmers.

11.9 MICRO INSURANCE

The term “micro insurance” typically refers to insurance services offered primarily to clients with low income and limited access to mainstream insurance services and other means of effectively coping with risk.

Micro insurance is specifically designed for the protection of low-income people, with affordable insurance products to help them cope with and recover from common risks. It is a market-based mechanism that promises to support sustainable livelihoods by empowering people to adapt and withstand stress.

The principal distinction from traditional insurance is in the targeting of low income people, which leads to distinct characteristics and objectives, including addressing the particular risks of low income people, affordability and inclusiveness, simplicity and clarity in documentation, accessible processes, and building trust among target clients.

Micro insurance is a highly diversified sector, in terms of:

1. **Stakeholders**: Micro insurance is developed and offered by commercial insurers, mutual funds, microfinance institutions, NGOs, governments or semi-public bodies. Micro insurance ventures are

often joint efforts among several of these stakeholders, who can play roles ranging from market research and product design to selling, delivering, and servicing claims.

2. **Products**: Micro insurance products can cover any insurable risk, including death, illness, accident, property damage, unemployment, crop failure, or loss of livestock.
3. **Portfolio size**: Micro insurance can operate at any scale; a micro insurer may cover dozens of policyholders, or millions.

The death of a breadwinner, especially in a low-income household transcends into a financial catastrophe for the family and in some cases no food on the table. Therefore, the social need to provide insurance to this sector becomes even more critical. With a large percentage of the country's population living in the rural parts, micro-insurance makes insurance affordable and accessible. Many individuals in such households opt for loans from micro-finance institutions. It ensures protection to the family from financial liabilities in case something happens to the breadwinner or the life insured, reducing their chances of falling into extreme poverty.

Thus, the micro insurance serves as an important tool to reduce risks for the already vulnerable population. It is a shelter against the hazards of low-income people in exchange of a premium in proportion with the possibility and cost of risk associated. A micro-insurance policy may be a general or a life insurance and done through Non-Government organizations, Self-help groups and Micro-finance institutions.

11.9.1 Importance of Micro Insurance

A high proportion of socially and economically underprivileged sections of the society are concentrated in informal economic activities, and that the high levels of growth of the Indian economy during the past two decades are accompanied by increasing informalisation. This huge workforce in the informal sector remains untapped and undeserved by mainstream commercial and social insurance schemes and, hence, the importance of micro insurance is undeniable.

Micro insurance provides a critical safety net; preventing households from falling into poverty. It provides poor and low-income households with the means to protect themselves against the effects of risk. The role of micro insurance must therefore be viewed alongside government provision of basic health services, employment and education, etc., all of which go towards

alleviating poverty. Micro insurance can deliver many other benefits to low-income households like:

1. **Access to vital services:** Insurance can allow low-income people to access vital services like health care and agricultural services
2. **More productive decisions:** Evidence has shown that low-income workers invest more in their livelihoods, and get higher returns, if they are protected by insurance;
3. **Tangible benefits:** Insurance often also provides important tangible benefits, such as a hot line for medical advice or health camps that provide vaccinations;
4. **Reduced risk:** Insurers can play a critical role in reducing risk, since they have an incentive to prevent risks from occurring.

Micro insurance can also be a tool to extend social protection in the context of providing security to populations in developing countries and contributing to poverty alleviation. Overall, strategies and mechanisms should ensure that micro insurance is not approached in isolation, thereby maximising impact.

11.9.2 Characteristics of Micro Insurance

The main characteristics of micro-insurance are discussed below:

1. **Protection of low income people:** Micro insurance is the protection of low-income people against specific perils in exchange for regular premium payment proportionate to the likelihood and cost of the risks involved.
2. **Low premium:** The insured people pay considerably smaller premiums. The premium is very much affordable.
3. **Low coverage limits:** The coverage limits are typically low in micro insurance.
4. **Guaranteed of coverage:** It offers full guaranteed financial compensation for a number of risks, in line with a pre-defined benefits package.
5. **Product Design:** Microfinance providers in particular, in working with insurance companies to develop successful micro insurance products for the low-income market which are very simple and easy to understand.
6. **Physically accessible:** Through micro financing small loans are produced and accessible.

7. **Group micro insurance schemes:** It provides a comprehensive protection to the socially and weaker sections of the society by providing security to them and their families in case of any unfortunate event. It also provides flexibility in choosing cover options as per the needs and requirements of the members.

8. **Mechanism for women empowerment:** Two-thirds of human beings suffering in the most extreme poverty are women. They earn less than men, have less control of property, and face higher levels of physical vulnerability and violence. They are often caregivers, homemakers, and, increasingly, household resource managers and income earners. Considering this combination of vulnerability and responsibility for the welfare of their families, women have a unique and pressing need to manage risk. Micro Insurance can help poor women manage risks related to health, income generation, old age and death.

11.9.3 Development of Micro Insurance in India

In India development of micro insurance sector and related policy discussions has started few years back. For a long time, the poor, because of their economic circumstance, were considered non-bankable. However, the "micro-credit phenomenon" has shown that the poor can be made creditworthy if they are organized in small groups. This clearly has profound implications not just from a finance perspective but, more importantly, from the perspective of poverty alleviation. Within very short period, the sector has drawn attention of policy makers due to its importance both at household level and the economy as a whole.

Micro-credit in India really started in a big way in the early 90s with the recognition of self-help groups as conduit for providing credit to the poor. In the late 90s, numerous agencies involved in micro-credit operations in India started adding other financial services, including micro-insurance to its micro-credit operations. A few micro-insurance schemes were initiated, either by non-governmental organizations (NGO) due to the felt need in the communities in which these organizations were involved or by the trust hospitals. These schemes have now gathered momentum partly due to the development of micro-finance activity, and partly due to the regulation that makes it mandatory for all formal insurance companies to extend their activities to rural and well-identified social sector in the country (IRDA 2000). As a result, increasingly, micro-finance institutions (MFIs) and NGOs are negotiating with the for-profit insurers for the purchase of customized group

or standardized individual insurance schemes for the low-income people. Although the reach of such schemes is still very limited their potential is viewed to be considerable.

India has the most dynamic micro insurance sector in the world. Liberalization of the economy and the insurance sector has created new opportunities for insurance to reach the vast majority of the poor, including those working in the informal sector. Even so, market penetration is largely driven by supply, not demand. Micro insurance in India has valuable lessons for rest of the world, particularly in the regulation of the industry. In India, though government plays a proactive role in providing insurance cover to the poor through subsidized insurance schemes and other programmes. The size and potential of micro insurance market is enormous due a sizeable portion of poor and low-income population who live without any formal insurance.

The micro insurance business in India has made a continuous progress in both the sectors whether it is public sector companies or private sector companies. During the year, many life and group operations and new policies have been launched. Significantly, these policies of the distribution system have also been reinforced. Also, the micro insurance business has shown a satisfactory growth even though the corpus is still very low and indicates that there is a vast scope for Micro Insurance sector in India:

- As per the 2015 release of the Ministry of Finance, around 42% households in India are devoid of banking facilities.
- Around 45% of the rural households and 33% of urban households do not have accounts in banks.
- In the market the insurance infiltration in urban areas is around 65% but is less in the low-income areas where there is no banking segment.
- In the banking segment in rural areas, the life insurance dispersion is valued at 40%, and is on the edge in the non-banking sector.

India is one amid those countries who are developing and has a unique Micro Insurance Act. It is obligatory for the insurance company to devote a percentage of their business to the rural area and other diminished groups as per the Micro Insurance Regulation Act. Many micro insurance innovative products are emerged from India as there is a large market as well as large portion of individuals living in rural areas that needs to be educated about the benefits. Risk mitigation becomes an important aspect to the

poor people as their income is limited and their livelihood is equally dependent on their health as well as their future life being the recipients of majority of risk in life. Hence, a saving solution is directed towards the low income group with moderate premium. There are innumerable issues and challenges for a sustainable growth of micro insurance in India but yet the insurance sector is finding new methods in order to cover those rural people who still live amidst the poverty line.

Some challenges which the policy holder's faces are:

The most noticed inadequacy in the execution of a micro insurance plan is that:

1. Funds for the scheme depend upon the intensity of the risk which makes it difficult to decide the actual price of the products.
2. As most micro insurance schemes are state led, the insurance company and MFI's joins as partnership wherein the insurance company assumes the risks that arise and the MFI's acts as an intermediary.
3. Uncertainty of cash flow results to loss of income to the rural people and inability to adopt a micro insurance policy.
4. Non awareness of the benefits of government schemes that a rural household can avail.
5. Uncertainty of income due to disasters, fluctuations in the market which causes a threat to the rural people.
6. Employment remains unstable in certain areas leading to instability of income to the family.

Currently India has a huge protection gap, the impact of which is strongly felt in the lower income group that is the mass or rural market. Insurance Regulatory and Development Authority of India (IRDAI) and the insurance industry has taken cognisance of the same and is committed towards providing protection to the stratum of society that is financially most vulnerable. Thereby, both the regulator as well as the industry has a lot of interest in making micro-insurance a success.

In a bid to popularise the much-needed product, the regulator has prescribed a product design that is simple, pricing of which is very affordable and a conducive distribution structure to encourage sales and purchase of micro-insurance covers. The industry is also very keen and most of the big life insurers offer micro-insurance products. They have tied up with several micro-finance institutions to promote life insurance and cover the popula-

tion in that segment. If large insurance companies can adapt to the regional sensitivities and also provide awareness through the various schemes introduced by the Government to the poor section and also educate them about the benefits and premium payment, micro insurance will thus, aid and offer a huge opportunity for the insurers to penetrate into the new markets and also build a more flexible and better economy.



CHECK YOUR PROGRESS

1. What is Crop Insurance?

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.....

2. Name some schemes of Crop Insurance.

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3. In which year the PMFBY was launched?

.....

.....

4. What is Micro Insurance?

.....

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11.10 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No.1: Crop insurance is a device under which the insurance company agrees to indemnify the loss caused due to the occurrence of uncertain events, to the standing of crops of the farmers.

Ans to Q No.2: Some schemes of Crop Insurance are:

i. National Agricultural Insurance Scheme (NAIS)

ii. Modified National Agriculture Insurance Scheme (MNAIS)

iii. Weather Based Crop Insurance(WBCIS)

iv. Pradhan Mantri Fasal Bima Yojana (PMFBY)

Ans to Q No.3: The PMFBY was launched in the year 2016.

Ans to Q No.4: Micro insurance is specifically designed for the protection of low-income people, with affordable insurance products to help them cope with and recover from common risks.



11.11 LET US SUM UP

In this unit we have discussed about the different non-life insurance available in the market to suit the requirements of varied number of people. The main points discussed are:

- Non-Life Insurance is a policy that provides compensation for losses incurred from a specific financial event and this type of policy is also known as general insurance, or property and casualty insurance.
- Fire Insurance is a device to compensate for the loss consequent upon destruction by fire. It is an agreement between an insurance company and an individual or company where the insurer agrees to compensate the policyholder in case of loss or damage due to fire.
- Marine Insurance insures all types of risks which can occur during transit.
- Marine losses may be divided into two broad categories: Total Loss and Partial Loss.
- Burglary insurance policies can be of different types based on the type of coverage as well as the assets that they cover like Money in Transit Insurance, Business Premises Insurance, Dwelling Insurance, etc.
- Ambulance expenses, cashless banefits, wellness care, No Claim Bonus,pre and post hospitalisation, hospitalisation medical expenses and tax deductions are some of the benefits of health insurance.
- Crop insurance is a device under which the insurance company agrees to indemnify the loss caused due to the occurrence of uncertain events, to the standing of crops of the farmers.
- The objective of National Agriculture Insurance Scheme (NAIS) was to protect the farmers against the crop losses suffered on account of natural calamities, such as, drought, flood, hailstorm, cyclone, pests and diseases.
- Weather Based Crop Insurance Scheme (WBCIS) was launched in 2007.

- ❖ Protection of low income people, low premium, low coverage limits are some of the characteristics of micro insurance.



11.12 FURTHER READING

1. Insurance

   Principles and Practices

   - M.N.Mishra
   - Dr.S.B.Mishra

2. Principles and Practice of Insurance
   - Ghanashyam Panda
   - Monika Mahajan
3. Fundamentals of Insurance
   - Inderjit Singh
   - Rakesh Katyal
   - Surjeet Kaur
   - Sanjay Arora



11.13 MODEL QUESTIONS

1. Explain the different types of fire insurance policies.
2. Discuss the procedure of effecting and settlement of a claim under a fire insurance policy.
3. Define the marine insurance and explain its features.
4. Discuss the procedure for making any marine insurance claim.
5. Discuss the various types of burglary policies and the procedure of claiming money under burglary policy.
6. What is Health Insurance? Discuss the products of health insurance.
7. Discuss the types and significance of Transit Policy.
8. Discuss the growth and status of Crop Insurance in India.
9. Discuss the development of Micro Insurance in India.

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Unit- 12 FUNCTION OF INSURER

UNIT STRUCTURE

12.1 Learning Objectives

12.2 Introduction

12.3 Function of Insurer

12.4 Ratemaking

12.5 Production

12.6 Underwriting

12.7 Loss Adjustment

12.8 Reinsurance

12.9 The Investment Function

12.10 Let Us Sum Up

12.11 Further Readings

12.12 Answers to Check Your Progress

12.13 Possible Questions

12.1 LEARNING OBJECTIVES

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

- Know various functions of insurer
- Discuss the ratemaking function of insurer
- Know about ratemaking
- Know about production and underwriting
- Discuss about loss adjustment
- Know about reinsurance and investment function of insurer

12.2 INTRODUCTION

When we talk about functions of insurance one thing comes to our mind that after purchasing an insurance policy we need not to worry about our future. This is a wrong concept. Every insurance policy is subject to the

terms and conditions contained in the insurance agreement and therefore any insurance serves a limited purpose as agreed to between two parties the Insurer and the Insured.

Beside selling insurance products insurer perform some other related functions which are unique and do not exist in other business. In this unit we will examine some of the specialized activities of insurance companies.

12.3 FUNCTION OF INSURER

Although there are definite operational differences between life insurance companies and general insurance companies the major activities of all insurers may be classified as follows: Ratemaking, Production, Underwriting, Loss Adjustment, Investment Function and Reinsurance.

12.4 RATEMAKING

An insurance rate is the price per unit of insurance. Like any other price, it is a function of the cost of production. However, in insurance, unlike in other industries, the cost of production is not known when the contract is sold, and it will not be known until sometime in the future, when the policy has expired. One fundamental difference between insurance pricing and the pricing function in other industries is that the price for insurance must be based on a prediction. The process of predicting future losses and future expenses and allocating these costs among the various classes of insureds is called *ratemaking*.

A second important difference between the pricing of insurance and pricing in other industries

arises from the fact that insurance rates are subject to government regulation and virtually all states impose statutory restraints on insurance rates. State laws require that insurance rates must not be excessive, must be adequate, and may not be unfairly discriminatory. Depending on the manner in which the state laws are administered, they impose differing limits on an insurer's freedom to price its products. The ratemaking function in a life insurance company is performed by the actuarial department or in smaller companies, by an actuarial consulting firm. In the property and liability field, advisory organizations accumulate loss statistics and compute loss costs for use by insurers in computing final rates, although some large insurers maintain their own loss statistics. In the field of marine insurance and in-

land marine insurance, rates are often made by the underwriter on a judgment basis.

Actuary is a professional person trained in the technical aspects in insurance and related fields, particularly in mathematics of insurance

In addition to the statutory requirements that rates must be adequate, not excessive, and not unfairly discriminatory, there are certain other characteristics considered desirable. To the extent possible, for example, rates should be relatively stable over time, so that the public is not subjected to wide variations in cost from year to year. At the same time, rates should be sufficiently responsive to changing conditions to avoid inadequacies in the event of deteriorating loss experience. Finally, whenever possible, the rate should provide some incentive for the insured to prevent loss.

Regardless of the type of insurance, the premium income of the insurer must be sufficient to cover losses and expenses. To obtain this premium income, the insurer must predict the claims and expenses and then allocate these anticipated costs among the various classes of policyholders. The premium that the insured pays is called the gross premium. The gross premium is composed of two parts, one to provide for payment of losses is called pure premium (net premium) and a second called a loading to cover expenses of operation like- commission, administrative expenses, taxes, profit of insurer etc. Rates and premiums are determined by an actuary, using the company's past loss experience and industry statistics.

In general, the pure premium is determined by dividing expected losses by the number of exposure units. For example, if 100,000 automobiles generate 30000000 losses, the pure premium will be Rs=300, which is calculated as-

Losses

Exposure Units

30,000,000

100,000

= Rs. 300

12.5 PRODUCTION

The production department of an insurance company, sometimes called the *agency department*, is its sales or marketing division. This department supervises the external portion of the sales effort, which is conducted by

the agents or salaried representatives of the company. The internal portion of the production function is carried on by the production (or agency) department. It is the responsibility of this department to select and appoint agents and assist in sales. In general, it renders assistance to agents in technical matters. *Special agents,* or people in the field, assist the agent directly in marketing problems. The special agent is a technician who calls on agents, acting as an intermediary between the production department and the agent. This person renders assistance when needed on rating and programming insurance coverages and also attempts to encourage the producers.

Actuary is a professional person trained in the technical aspects in insurance and related fields, particularly in mathematics of insurance

With few exceptions, the marketing mechanism in the insurance industry revolves around the agent; however, his or her role varies in different lines of insurance. In the field of property and liability insurance, the *agent* is "an individual authorized to create, terminate, and modify contracts of insurance." In the area of life insurance, however, the agent's power is somewhat more limited. Life insurance agents are appointed with the authorization to solicit and deliver contracts of insurance; however, they cannot, as can the property and liability agent, "bind" the insurance company to risk. The insurance agent is first and foremost the representative of the insurance company. An insurance *broker,* in contrast, is a representative of the insured. Although serving as the agent of the insured, the broker normally receives compensation in the form of a commission from the company. The fact that the broker is not an agent of the insurer means that he or she does not have the power to bind the company. The broker merely solicits business from clients and then places the business with an insurer. Brokers represent an important segment of the insurance marketing mechanism, particularly in large cities, where they control large segments of the market. In some instances, agents also act as brokers, placing coverage through the agents of companies they do not represent. Historically, brokers rarely operated in the life insurance field, because most life insurers accepted business only from their own appointed agents. Today, there are many life insurance producers who operate as brokers, placing life insurance with a variety of insurers, rather than with a single company. Although life insurance agents do not have binding authority, the distinction between an agent and a broker can still be important in the life insurance field. Any information given to the agent of an insurance company is considered to have been given to the insurer, and the insurer is presumed to have knowledge of relevant facts known to its agent. This may have relevance in situations in which there is a question regarding the insured's disclosure of information pertinent to the underwriting decision. Because the broker is a

representative of the insured rather than the company, information provided to the broker is not imputed to the company.



Check your progress

Q. No. 1: What is ratemaking?

Q. No. 2: Can an *agent of* property and liability insurance create, terminate, and modify contracts of insurance?

12.6 UNDERWRITING

Underwriting is the process of selecting and classifying exposures. It is an essential element in the operation of any insurance program, for unless the company selects from among its applicants, the inevitable result will be selection adverse to the company. There must be the same proportion of good and bad risks in the group insured as there were in the one from which the basic statistics were taken. The tendency of the poorer-than-average risks to seek insurance to a greater extent than the average or better-than-average risks must be blocked. The main responsibility of the underwriter is to guard against adverse selection. It is important to understand that the goal of underwriting is not the selection of risks that will not have losses. It is to avoid a disproportionate number of bad risks, thereby equalizing the actual losses with the expected ones. In addition to this goal, there are certain other objectives. While attempting to avoid adverse selection through rejection of undesirable risks the underwriter must secure an adequate volume of exposures in each class. In addition, he or she must guard against congestion or concentration of exposures that might result in a catastrophe. Few factors are as important to the success of the insurance operation as the underwriting function, for it is directly connected with the adequacy of rates. Actuaries compute the rates. The underwriter must determine into which of the classes, if any, each exposure unit should go. Poor underwriting may wipe out the efforts of the actuary, rendering a good rate inadequate. For this reason, those who perform the underwriting function must develop a keen sense of judgment and a thorough knowledge of the hazards associated with various types of coverage. The underwriting process often involves more than acceptance or rejection. In some instances, an exposure that is unacceptable at one rate maybe written at a different rate. In the life insurance field, for example, applicants may be classified as standard, preferred, substandard, and uninsurable.

Standard risks are persons who, according to the company's underwriting standards, are entitled to insurance without a rating surcharge or policy restrictions. The *preferred-risk* classification includes those whose mortality experience, as a group, is expected to be above average, and to whom the insurer offers a lower-than-standard rate. The most common preferred class today consists of non-smokers, for whom many insurers now offer a preferred risk rate. *Substandard risks* are persons who, because of a physical condition, occupation, or other factors, cannot be expected, on average, to live as long as people who are not subject to these hazards. Substandard applicants are insurable, but not at standard rates. Policies issued to substandard applicants are referred to as *rated policies* (or *extra risk policies*) and require a higher-than-standard premium rate to cover the extra risk when, for example, the insured has impaired health or a hazardous occupation. Usually, substandard risks will pay a percentage surcharge, a flat additional premium, or in some cases receive a policy subject to restrictions not included in the policies for standard risks. Most life insurers use a numerical rating system under which a point value is assigned for each type of physical disability or negative influence. The total of all points represents the expected mortality increase over that which is expected for standard or normal risks. The surcharge may apply only for a period of time and then disappear, or it may continue throughout the policy. In some situations, the policies issued to substandard risks may limit the death benefit during the first few years to the premiums paid. Finally, there are some applicants who are simply *uninsurable.* The applicant may be uninsurable because of high physical or moral hazard, or if he or she suffers from a rare disease or has a situation unique for which the insurer does not have the experience to derive a proper premium.

12.7 LOSS ADJUSTMENT

One basic purpose of insurance is to provide for the indemnification of those members of the group who suffer losses. This is accomplished in the loss settlement process, but it is sometimes a great deal more complicated than just passing out money. The payment of losses that have occurred is the function of the claims department. Life insurance companies refer to employees who settle losses as *claim representatives* or *benefit representatives*. The nature of the difficulties frequently encountered in the property and liability field is evidenced by the fact that employees of the claims department in this field are called *adjusters*. It is obviously important that the insurance company pay its claims fairly and promptly, but it is equally important that the company resist unjust claims and avoid overpayment of

them. The view is rapidly increasing among insurers that prompt, courteous, and fair claim service is one of the most effective competitive tools available to a company.

12.7.1 Adjusters

Broadly speaking, an *adjuster* is an individual who investigates losses. He or she determines the liability and the amount of payment to be made. Adjusters include agents as well as staff, bureau, independent, and public adjusters. It is quite common for the agent to function as an adjuster in the case of small property losses. Many agents have been granted *draft authority* by their companies, which mean that they are authorized to issue company checks in payment of losses up to some stipulated amount. Even in cases in which the amount of the loss exceeds the draft authority, the agent may handle the settlement of the loss. Most insurers employ adjusters who are salaried representatives of the company. The use of a company staff adjuster in a given area is dictated by the amount of work available. In a locality where the company has a large volume of claims, it will use salaried staff adjuster in preference to an adjustment bureau or an independent adjuster. If the volume of claims is too small to support a full-time adjuster, the company will contract for adjusting service. It is not economically feasible to maintain an adjuster in every area in which the company writes insurance. Likewise, it would be too expensive to send an adjuster into a distant area simply for the purpose of adjusting one loss. As an alternative, the company may hire an *independent adjuster,* who does not work for a company but instead contracts services directly to the insurance company. These adjusters normally do not handle claims for a single company but work for any firm that is involved in the community and does not have a staff adjuster or adjusting bureau. The independent adjuster bills each company directly for the expense of adjustment.

12.7.2 Responsibilities of Loss Adjuster

Where a loss adjuster's report is required, the report must be obtained from a loss adjuster licensed by the Insurance Regulatory and Development Authority (IRDA). As part of the licensing procedure and in view of the statutory monopoly given to the loss adjusting profession, the loss adjuster assumes certain obligations. The adjuster must:

"*investigate, manage, quantify, validate and deal with losses (whether insured or not) arising from any contingency, and report thereon, and carry out the work with competence, objectivity and professional integrity by strictly*

adhering to the code of conduct expected of such surveyors and loss assessors."

This obligation covers insured and uninsured losses as part of the loss adjuster's overall obligation to manage losses.

In discharging his obligations, the loss adjuster must act "ethically, with integrity and objectivity and impartially". This includes declaring any specific interest in the loss. Following on from the requirement to act impartially, the loss adjuster must address questions raised by the insured and the insurer.

If a loss adjuster does not conduct himself or herself as expected, the IRDA may refuse to grant or renew a licence or may suspend or cancel an existing licence. This was recognized in *Ravindra Nath Fruit Canning Industries v United India Insurance* (National Commission, 2006).

If a loss adjuster is to be appointed, the IRDA requires him or her to be appointed within 72 hours of the notification of the loss and requires the loss adjuster to produce his or her report within 30 days of appointment (this timeframe may be extended up to a maximum of six months). If an insurer requires more information, this must be requested within 15 days of the first report and any additional report must be produced within three weeks thereafter.

The timing of the production of the loss adjuster's report is important because it ties in with the provisions regulating the settlement of claims. An insurer must offer settlement or reject a claim within 30 days of the loss adjuster's final report, as emphasized in *New India Assurance v Uppalati Veeraswamy* (2005).

12.7.3 Appointing a Second Loss Adjuster

In recent years the courts have had to deal with a number of issues arising out of the statutory requirement for a loss adjuster's report and, as a result, it is possible to discern rules relating to circumstances in which an insurer can instruct a second loss adjuster if it is unhappy with the first loss adjuster's report. In a line of cases commencing with *National Insurance Co Ltd v New Patiala Traders* (2002), the courts have stated that an insurer cannot instruct a second loss adjuster as a matter of course in the hope that the second loss adjuster's findings will be more in line with the insurer's views on the claim.

As a loss adjuster is duty bound to give an accurate report and the insurer is not bound by the loss adjuster's recommendations, the appointment of a second loss adjuster should be the exception rather than the rule, as was confirmed in *Bright Vision Pvt Ltd v National Insurance* (2006).

Before appointing a second loss adjuster, the insurer should explain to the first loss adjuster which aspects of the report were found wanting and the first loss adjuster should be given the opportunity to substantiate his or her findings. In *United India Insurance v Sanjay Kumar* (2006) the National Commission reiterated this process in a case where the insurer had consecutively appointed five loss adjusters in response to a $5,000 theft claim. The police investigated and confirmed there had been a theft. The first and second loss adjusters appointed by the insurer confirmed there had been a theft. However, the third, fourth and fifth loss adjusters were less certain and the insurer repudiated liability on the strength of the latter loss adjusters' reports. The commission held that whenever an insurer appoints a second loss adjuster, this necessarily reflects badly on the first loss adjuster appointed.

A sense of the frustration felt by the courts when dealing with such cases is apparent from the National Commission judgment of February 23 2007 in *Mullangie Spintex v New India*. This case involved a fire claim in which the insurer immediately appointed a loss adjuster who reported on the fire and provided an estimate of loss in line with the insured's expectations. The insurer then appointed a second loss adjuster and offered the insured just over 10% of the claim value on the strength of the second loss adjuster's report. The commission noted that the offer was made in circumstances where the insured had been placed in financial difficulties by the fire and described the offer as "nothing but exploitation of the situation by the insurance company". The commission set aside the second loss adjuster's report and relied on the first loss adjuster's report to assess quantum.

The courts have also had to consider whether an insurer can take account of the findings of professionals other than licensed loss adjusters. In *National Harjeet Rice Mills* (2005 6 SCC 45) the Supreme Court ruled in the insurer's favour. The insurer believed that the fire claimed for was caused by arson, while the loss adjuster concluded that the fire was caused by a short circuit. The insurer obtained a private investigator's report confirming arson and relied on this to reject the claim. The lower court held that as the private investigator was not a licensed loss adjuster, his report was inadmissible. The Supreme Court disagreed, although it did so on the grounds that the

statutory requirement for a loss adjuster's report could not be an obstacle to uncovering a fraudulent claim. It is unclear whether this decision is a green light to rely on reports other than those from licensed loss adjusters, although for the moment it is being treated as such.

The loss adjuster's obligation to provide a correct report has also been used by insureds to bypass insurers that they suspect have delayed settling claims on the grounds that the loss adjuster's report was unavailable. The regulations allow loss adjusters to represent insurers and insureds, which is consistent with the loss adjuster's obligation to act impartially. In *Shri Krishna Woolen Mills Ltd v United India* (2006) the loss adjuster appointed by insurers had not assessed the loss, citing insufficient documentation. The insured instructed a licensed loss adjuster to assess loss and submitted that the court should accept the recommendations of the insured's loss adjuster. The court agreed.

12.7.4 Adjustment Process

In determining whether to pay or contest a claim, the adjuster follows a relatively set settlement procedure with four main steps: (1) notice of loss, (2) investigation, (3) proof of loss, and (4) payment or denial of the claim. The details of these steps vary with the type of insurance.

Notice of loss

The first step in the claim process is the notice by the insured to the company that a loss has occurred. The requirements differ from one policy to another, but in most cases the contract requires that the notice be given "immediately" or "as soon as practicable."Some contracts stipulate that notice be given in writing, but even in these, the requirement is not strictly enforced. Normally, the insured gives notice that a loss has occurred by informing the agent, and this satisfies the contract.

Investigation

The investigation is designed to determine if there was actually a loss covered by the policy and, if so, the amount of the loss. In deciding whether there was a covered loss, the adjuster must determine first that there was in fact a loss and then whether the loss is covered by the policy. Determination as to whether there was a loss is the simpler of the two. There are, of course, instances in which the claimant attempts to defraud the insurer, and in some instances payment is undoubtedly made where there has not in fact been a loss. Once it has been determined that a loss has occurred, the adjuster must determine whether the loss is covered under the policy.

First, was the policy in effect at the time of the loss? If the policy is newly issued, did the loss take place before the policy became effective? Or at the other end of the time spectrum, did the policy expire before the loss took place? Once it has been established that the loss took place during the policy period, there is still the possibility that the insured might have violated a condition that caused the suspension or voidance of the contract. If it appears that the policy was in effect at the time of the event and there was a loss, was the peril causing the loss insured against in the policy? In the case of property insurance, does the property damaged or lost meet the definition of the property insured? The location of the property is still another question, because some contracts cover property only at a specific location or are applicable only in certain jurisdictions. Finally, the adjuster must decide if the person making the claim is entitled to payment under the terms of the policy. If the answer to all these questions is yes, the loss is covered. Yet to be determined is the amount of the loss, which in most cases can be far more complicated than the determination of whether coverage applied.

Proof of Loss

Within a specified time after giving notice, the insured is required to file a proof of loss. This is a sworn statement that the loss has taken place and gives the amount of the claim and the circumstances surrounding the loss. The adjuster normally assists the insured in the preparation of this document.

Payment or Denial If all goes well, the insurance company draws a draft reimbursing the insured for the loss. If not, it denies the claim. The claim maybe disallowed because there was no loss, the policy did not cover the loss, or the adjuster feels that the amount of the claim is unreasonable.



Check your progress

Q. No. 3: Who is a claim representative?

Q. No. 4: Who is an adjuster?

12.8 REINSURANCE

Reinsurance is an integral function of the insurance sector. Under this practice, the insurance companies are going to transfer a part of their portfolio to other companies. Doing this has allowed insurers to cede a portion of the risk they assumed to other companies and thereby reducing their overall liability and risk.

This has also provided them with a means to stay solvent even when they are liable to pay out a huge sum as a part of a claim filed by an insurer. Furthermore, insurers will maintain premiums lower for their customers or policyholders and thereby luring more individuals to avail their services.

By spreading risk, the insurance company takes on the client's premium whose coverage is too burdensome to handle for a single insurance company. Premiums paid by the policyholder will be shared by all the insurance companies involved in that process.

If one company assumes the risk on its own, then the cost would ruin financially, then the insurance company possibly will not cover the loss which the company has paid the insurance premium.

Insurers purchase reinsurance for the following four reasons:

1. To limit the liability on a specific risk
2. To stabilize loss experience
3. To increase capacity
4. To protect themselves and the insured



CHECK YOUR PROGRESS

Q. No. 5: What is main objective of reinsurance?

12.9 THE INVESTMENT FUNCTION

As a result of their operations, insurance companies accumulate large amounts of money for the payment of claims in the future. It would be a costly waste to permit these funds to remain idle, and it is the responsibility of the insurer's finance department or a finance committee to see that they are properly invested. Because a portion of their invested funds must go to meet future claims, the primary requisite of insurance company investments is safety of principal. In addition, the return earned on investment is an important variable in the rating process: life insurance companies assume some minimum rate of interest earnings in their premium computations. Increasingly, property and liability insurers are also required to include investment income in their rate calculations. It may be argued that even when investment income is not explicitly recognized, it subsidizes the underwriting experience and is therefore a factor in ratemaking in this field as well.



12.10 LET US SUM UP

- An insurance rate is the price per unit of insurance.
- The production department of an insurance company, sometimes called the *agency department*, is its sales or marketing division.
- The main responsibility of the underwriter is to guard against adverse selection.
- The payment of losses that have occurred is the function of the claims department.
- In reinsurance the insurance companies are going to transfer a part of their portfolio to other companies.



12.11 FURTHER READINGS

1. Insurance: Principles and Practices
    - M.N.Mishra
    - Dr.S.B.Mishra
1. Principles and Practice of Insurance
    - Ghanashyam Panda
    - Monika Mahajan



12.12 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q. No.1. The process of predicting future losses and future expenses and allocating these costs among the various classes of insureds is called ratemaking.

Ans to Q. No. 2. Yes

Ans to Q. No.3. Life insurance companies refer to employees who settle losses as *c*laim representatives.

Ans to Q. No.4. An adjuster is an individual who investigates losses

Ans to Q. No.5. transfer a part of risk and liability of the insurer



12.13 POSSIBLE QUESTIONS

1. What is ratemaking? Explain with example.
2. Discuss the process of performing production function by an insurer.
3. How underwriting helps insurer?
4. What is loss adjustment?
5. Discuss the process of loss adjustment.
6. Why reinsurance is important?

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Unit 13: INSURANCE AGENT AND SALESMANSHIP

UNIT STRUCTURE

13.1 Learning Objectives

13.2 Introduction

13.3 Reasons for Selling of Insurance

13.4 Essentials of Insurance Salesman

13.5 Insurance Agent

- 13.5.1 Definition of Insurance Agent
- 13.5.2 Qualifications of an Insurance Agent
- 13.5.3 Training of an Insurance Agent
- 13.5.4 Appointment of an Insurance Agent
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- 13.5.6 Minimum Amount of Business to Be Secured by an Insurance Agent
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- 13.5.9 Termination of Insurance Agency

13.6 Ombudsman

- 13.6.1 Institution of Insurance Ombudsman
- 13.6.2 Appointment of Ombudsman
- 13.6.3 Eligibility
- 13.6.4 Term of Office
- 13.6.5 Territorial Jurisdiction
- 13.6.6 Power and Functions of Insurance Ombudsman
- 13.6.7 Manner of Lodging Complaint
- 13.6.8 Recommendation of The Ombudsman
- 13.6.9 Award

13.7 Let Us Sum Up

13.8 Further Readings

13.9 Check Your Progress

13.10 Answers to Check Your Progress

13.11 Possible Questions

13.1 LEARNING OBJECTIVES

After going through this unit, the learners will able to:

- *State the reasons for selling of insurance*
- *Explain the essentials of insurance salesman*
- *Know the meaning and definition of an insurance agent*
- *Know the qualifications of an insurance agent*
- *Discuss the need and procedure of training of an insurance agent*
- *Know the appointment procedure of an insurance agent*
- *Explain the functions and duties of an insurance agent*
- *Understand the minimum amount of business to be secured by an insurance agent*
- *Elaborate the disqualification of insurance agent*
- *Explain the rights of an insurance agent*
- *Discuss the procedure of termination of insurance agency*
- *Know about the appointment, eligibility, area of jurisdiction of an Ombudsman*
- *Explain the power and functions of insurance Ombudsman*

13.2 INTRODUCTION

Salesmanship is an art of persuading people to buy goods or services. Insurance salesmanship is similar to other salesmanship but it requires extra efforts to pursue prospective customer to buy insurance services. A salesman in a grocery shop does not require much efforts and persuasion in comparison to a salesman selling insurance services. It is rightly said that 'Insurance must be sold'. It means that in an insurance business prospective customer will not come to your shop or office and if you wish to sell, you will have to approach him to pursue and satisfy. Thus, insurance agent has to find out the prospective buyer first and then persuade him to take insurance policy. Insurance has to be sold as people are not likely to come forward to buy insurance on their own.

13.3 REASONS FOR SELLING OF INSURANCE

An insurance salesman (agent) should know that why insurance is necessary. He should be ready to answer this first question in selling insurance. The following are the main reasons for selling of insurance:

1. **Hazards:** There is no guarantee of life, fire or other casualties. Any day may be a dark day when dreams of happy future may fail completely. Insurance provide safety against such unexpected happenings.
2. **Savings:** Insurance bring about compulsory savings. Life insurance proves to be a great saving tool as it not only fulfils the need for savings but it also provides protection to our loved ones during uncertainties.
3. **Government Rules:** In some cases, Government rules and regulations make it essential on the part of the insured to take insurance policy. For example, in the case of motor vehicle it is essential under the Motor Vehicle Act, 1939, for the vehicle owner to take insurance policy.
4. **Insurance protects mortgaged property:** A very easy way to provide for repayment of mortgage loan is life insurance. It assists an individual to keep other assets of the family intact.
5. **Insurance is a profitable investment:** Insurance is a profitable investment as it carries the elements of the investment namely regular saving, capital formation and return of capital. In India, insurance policies carry a special exemption from Income Tax and Estate Duty etc.
6. **Insurance serves as a source of savings:** Systematic savings is possible through paying regular and compulsory premium. Unlike bank deposits the deposited insurance cannot be withdrawn.
7. **Insurance reduces uncertainty of business losses:** Insurance reduces the uncertainty of facing losses or damages by fire, theft, accidents or other perils.
8. **Insurance provides financial help:** Insurance companies also provide financial help to the businessmen. They finance various capital projects such as building, plant and machinery etc. in the form of equity participation and by granting loans and advances to the business people.
9. **Security of employees:** Insurance runs various schemes like 'Employees State Insurance', 'Life Policies', 'Old Aged Pension' et. to provide security to the employees.
10. **Beneficial to trade and industry:** Insurance is a key of industrial and commercial development. Insurance policies cover almost all

types of business and trade risks like net profit, wages, taxes, work force etc.

13.4 ESSENTIALS OF INSURANCE SALESMAN

The personal quality of a successful salesman may be grouped various categories: a) Physical, b) Mental, c) Social, and d) Vocational.

1. **Physical Characteristics:** An insurance salesman should have various physical characteristics such as, personal appearance, manners, way of addressing, posture, voice, demeanour etc. for handling his/her customer freely and carefully.
2. **Mental Characteristics:** An insurance salesman should have mental qualities which include presence of mind, imagination, judgement, self-confidence, memory and general intelligence. While persuading the insurance prospects, a salesman should be very alert, attentive and active so that he/she may be able to answer all the questions put to him/her.
3. **Social Characteristics:** Insurance salesman has constantly to deal with all types of people and influence their minds. Tact is needed for the accomplishment of this task effectively. Different types of insurance prospects need different treatments and the insurance salesman must be able to provide it. An insurance salesman should be possessing and cultivate social traits such as being frank, straightforward, sincere. Earnest, and honest in his approach.
4. **Vocational Characteristics:** Salesmanship is highly skilled vocation demanding a special discipline. It is to be distinguished from routine, mechanical, centrally directed and controlled jobs. This demands a quality of leadership, imagination, creative and constructive thinking. It requires the desire and capacity to mix among people, understand and appreciate their feelings and help them in their efforts. A successful salesman is never contended with the present alone, he/she always strives and exerts for improvement. He/she aims high and works for it. Success in salesman also depends to great extents upon training in effective sales methods. A well-trained insurance salesman will always be able to make a mark.



CHECK YOUR PROGRESS

Q. 1. What do you understand by insurance sales-manship?

Q. 2. Discuss the essentials of an insurance sales-man.

13.5 INSURANCE AGENT

Agent is a person or organization who/that is authorized to act on behalf of another. An insurance agent is a person or organization who/that solicits, negotiates, or instigates insurance contracts on behalf of an insurer and can be independent or an employee of the insurer. Insurance agents are the legal representatives of insurers. Insurance agents work for the insurance companies and sell the insurance products of those companies. Insurance agents meet the prospective customers and motivate them to take insurance policies. An important aspect of working with an agent is that he/she sells insurance products of **one company only**. Typically, an insurance agent receives a salary paid by an insurance company, and he/she can also receive a sales-based commission or bonus. The role of insurance agent is very important in life insurance business. The success of insurance mainly depends on the performance of the agents. Agents are paid commission in consideration of their services.

13.5.1 Definition of Insurance Agent

According to section 182 of Indian Contract Act, 1872, “An agent is a person employed to do any act for another or to represent others in dealing with third person.”

According to section 2 (10) of Insurance Act, 1938, “insurance agent means an agent licensed under section 42who receives or agrees to receive payment by way of commission or other remunera-tion in consideration of his soliciting or procuring insurance business including business relating to the continuance, renewal or revival of policies of insurance.”

13.5.2 Qualifications of An Insurance Agent

The following are the qualifications of an Insurance agent:

1. A person cannot be appointed as agent unless:

   a) He has attained the age of 18 years.

b) He has obtained a valid insurance licence under section 42 of the Insurance Act, 1983.

c) The applicant shall possess the minimum qualification of a pass in 12th Standard or equivalent examination conducted by any recognised Board/Institution, where the applicant resides in a place with a population of five thousand or more as per the last census, and a pass in 10th Standard or equivalent examination conducted by any recognised Board/Institution if the applicant resides in any other place.

2. Any Society, Association, Panchayat or other body may be appointed as an agent if it holds a licence to act as an agent under section 42 of the Insurance Act.

3. An employee of the Corporation may also be appointed as an agent subject to the provision of LIC Staff Regulation Act, 1960.

13.5.3 Training of An Insurance Agent

According to Insurance Regulatory and Development Authority (Licensing of Insurance Agents) Regulations, 2000-

a) The applicant shall have completed from an approved institution, at least, one hundred hours practical training in life or general insurance business, as the case may be, which may be spread over three to four weeks, where such applicant is seeking licence for the first time to act as an insurance agent.

b) Provided that the applicant shall have completed from an approved institution, at least, one hundred fifty hours practical training in life or general insurance business, as the case may be, which may be spread over six to eight weeks, where such applicant is seeking licence for the first time to act as a composite insurance agent.

c) An applicant, who has been granted a licence after the commencement of these regulations, before seeking renewal of licence to act as an insurance agent, shall have completed, at least twenty-five hours practical training in life or general insurance business, as the case may be, from an approved institution.

13.5.4 Appointment of an Insurance Agent

Agents may be appointed in any place within India for the purpose of soliciting or procuring life insurance business including business relating to the continuance, renewal or revival of policies of insurance for the Corporation. In view of the promulgation of the Insurance Laws (Amendment) Ordinance, 2014 inter alia amending Section 42 of the Insurance Act, 1938, the following guidelines are exercise relating to appointment of Insurance Agents by an insurer:

1. An applicant seeking appointment as an Insurance Agent of an Insurer shall submit an application in Form I-A to the Designated Official of the Insurer
2. The Designated Official of the insurer, on receipt of the application, shall satisfy himself that the applicant:
    a) has furnished the Agency Application in Form I-A complete in all respects;
    b) has submitted the PAN details along with the Agency Application Form;
    c) has passed the insurance examination;
    d) does not suffer from any of the disqualifications;
    e) has the requisite knowledge to solicit and procure insurance business; and
    f) capable of providing the necessary service to the policyholders;
3. The Designated Official shall exercise due diligence in verifying the agency application and ascertaining that the applicant does not hold agency appointment for more than one life insurer, one general insurer, one health insurer and one of each of the mono-line insurers and is not in the centralised list of blacklisted agents.
4. The applicant so appointed as an insurance agent shall be provided an identity card, by the insurer which shall identify the agent with the insurer of which he/she is acting as an agent.

13.5.5 Functions And Duties of an Insurance Agent

1. **To solicit and procure new business:** Every insurance agent is bound to solicit and procure new business as required under the rules. He should always make effort in getting new insurance proposals beyond his prescribed limit.

2. **To conserve the present business:** An agent should ensure the continuation of the policies already issued and prevent them from lapsing on account of default in the payment of premium.
3. **Assist in selection of suitable policy:** The agent should give proper guidance and help to the prospects in selection of a suitable policy, keeping in view the needs of the proposer by guiding him.
4. **To enquire into full details of prospects:** It is an important duty of the insurance agent to enquire into all the requisite information from the prospective insured.
5. **Inform the agency about the factors which can cause damage to insured:** It is the duty of an agent to inform the agency about all the related information which can influence the insurance policy by any means.
6. **Assuring the age of insured:** It is the duty of an agent to assure date of birth of an insured at the time of starting the policy.
7. **Motivating the policy holders to pay premium in time:** It is the duty of an agent to inform the insured to pay premium in time and get benefits of payments by avoiding penalties applicable in late payments.
8. **To prevent the policy from lapsing:** Agent should inform the disadvantages of policy lapse to the insured.
9. **Inform the insured for appointing nominee(s):** It is the duty of an agent to make sure that the nominee's column is filled by the insured.
10. **To prepare the necessary documents:** The agent can help the proposed to submit other important documents like birth certificate, medical certificate, etc.
11. **Other important duties of an agent:**

    i) Introducing himself as an insurance agent, and if asked, to show his I.D.

    ii) Inform about the policies to the insurer.

    iii) By knowing the requirements of prospects, providing him the best suitable policy.

    iv) Hard working with honesty.

    v) If asked by the insured, telling him about the rate of commission.

    vi) Calculating the amount of premium which is payable by the insured.

vii) Explaining the details of insurance application form to the prospect.

viii) Informing the prospects about the refusal of insurance application by the insurance agency.

ix) Following the rules and regulations of insurance authority.

x) Providing insurance bond to the insured within 45 days.

13.5.6 Minimum Amount of Business to be Secured by an Insurance Agent

An agent has to procure the new business in his first year of his appointment as follows:

1. If he is working in a city or a town with an ascertained population of five lakhs or above, proposals resulting into policies for not less than Rs. 75,000/- sum assured on at least twelve different lives, or
2. If he is working in a city or a town with an ascertained population of one lakh or above, but less than five lakhs, proposals resulting into policies for not less than Rs. 60,000/- sum assured on at least twelve different lives, or
3. If he is working in any other place with an ascertained population of less than one lakh, proposals resulting into policies for not less than Rs. 40,000/- sum assured on at least twelve different lives.

Subsequent Years

An agent shall bring in the following business each year subsequent to the first year:

1. Where population exceeds five lakhs or above, proposals resulting into policies for not less than Rs. 1,00,000/- sum assured on at least twelve different lives, or
2. Where population exceeds one lakh but does not exceeds five lakhs, proposals resulting into policies for not less than Rs. 75,000/- sum assured on at least twelve different lives, or
3. Where population does not exceed one lakh, proposals resulting into policies for not less than Rs. 60,000/- sum assured on at least twelve different lives.

An agent has been exempted from the above business limit if he has continually worked for the Corporation as an agent for a period of:

1. Not less than 21 years, or

2. At least 15 years and he is at least 55 years of age, or
3. 15 years and at any time subsequent thereto there is business in force in the books of the Corporation under his agency yielding a renewal premium income of not less than Rs. 40,000/- per annum.

13.5.7 Disqualification of Insurance Agent

According to the provision of Insurance Act, 1938 and LIC Agents Regulation, 1972 nay of the following persons cannot be appointed as Insurance Agents.

1. If he/she has not attained the age of 18 years.
2. If he/she is of unsound mind.
3. If he/she is guilty of misappropriation or criminal offence or criminal breach of trust or cheating or forgery.
4. If he/she is found to be knowingly participating in any fraud, dishonesty or misappropriation against the Corporation or any of its subsidiaries.
5. If he/she does not possess a valid licence in force.
6. If he/she is in employment of a state or central Government or public undertakings etc.
7. If he/she does not possess the requisite qualification.

13.5.8 Rights of an Insurance Agent

The following are the rights of an Insurance Agent:

1. **To receive Commission:** A remuneration for the discharge of his functions as an agent shall be paid by way of commission as set out in the schedule II of LIC Regulation Act, 1972.
2. **To receive Bonus Commission:** In addition to the commission an agent has the right to receive bonus commission as set out in the schedule III of LIC Regulation Act, 1972.

1. **To receive other benefits:** An agent is entitled for all other benefits and perquisites which the Corporation may extend from time to time to the agents.
2. **To appoint nominee to receive commission and other benefits:** An agent has the right to appoint nominee during his/her lifetime to receive commission and other benefits.

3. **Right to appeal:** The agent has a right to appeal before the competent authority in case his/her agency is terminated without sufficient cause.

13.5.9 Termination of Insurance Agency

1. **Termination on account of required business:** If an agent fails to bring in the required business his appointment shall be terminated at the end of such year. The agency so terminated can however be re-instated by the competent authority if he/she is satisfied with the reasons advance for such laps. The agency so re-instated shall be treated as continuation for all purposes.
2. **Termination on account of Licence:** If the licence of the agent is cancelled, or is not renewed as the case may be, the agency may be terminated from the date of the licence is cancelled or the date when the licence ceases to be valid.
3. **Termination on account of certain dis-qualifications:** An agent may be terminated if he/she:
   - i) Is found to be unsound mind by the Court of law.
   - ii) Is found to be guilty of criminal mis-appropriation or criminal breach of trust or cheating or forgery.
   - iii) Is found to be knowingly participated in any fraud, dishonesty or mis-appropriation against the Corporation or any of its subsidiaries.
4. **Termination on account of certain lapses:** The competent authority may terminate the appointment of an agent on the following grounds:
   - i) If he/she has failed to dis-charge his/her functions.
   - ii) If he/she acts in a manner prejudicial, to the interest of the Corporation.
   - iii) If he/she has been offering a rebate, of the whole or part of his/her commission.
   - iv) If any information in application form is found to be untrue.
   - v) If he/she becomes physically or mentally incapacitated to carry on his/her functions.

The competent authority may terminate the agency at any time giving one month's notice in writing. The agent may also by giving one month's notice in writing to competent authority discontinue his/her agency.



CHECK YOUR PROGRESS

Q. 3. Who is an insurance agent?

Q. 4. What are the requisite qualifications of an insurance agent?

13.6 OMBUDSMAN

13.6.1 Institution of Insurance Ombudsman

The institution of insurance ombudsman was established by the Government of India in November 1998. The purpose of this institution is to quick and systematic disposal of customers' grievances and mitigation of issues involved in the settlement of those complaints. The institution plays an important role in protecting the interests of customers and building trust in the system.The institution is of great importance and relevance for the protection of interests of policy holders and also in building their confidence in the system. The institution has helped to generate and sustain the faith and confidence amongst the consumers and insurers.

13.6.2 Appointment of Ombudsman

The governing body of insurance council issues orders of appointment of the insurance Ombudsman on the recommendations of the committee comprising of IRDA Chairman, LIC Chairman, GIC Chairman and a representative of the Government.

Insurance council comprises of members of the life insurance council and general insurance council formed under Section 40C of the Insurance Act, 1983. The governing body of insurance council consists of representatives of insurance companies.

13.6.3 Eligibility

Ombudsman are drawn from Insurance Industry, Civil Services and Judicial Services.

13.6.4 Term of office

An insurance Ombudsman is appointed for a term of three years or till the incumbent attains the age of sixty-five years, whichever is earlier. Re-appointment is not permitted.

13.6.5 Territorial Jurisdiction

The governing body has appointed seventeen Ombudsman in the different locations across the country allotting them different geographical areas as their areas of jurisdiction. The ombudsman may hold sitting at various places within their area of jurisdiction in order to expedite disposal of complaints. The offices of seventeen insurance Ombudsman are located at (1) Ahmedabad, (2) Bengaluru, (3) Bhopal (4) Bhubaneswr, (5) Chandigarh, (6) Chennai (7) Delhi, (8) Guwahati, (9) Hyderabad, (10) Jaipur, (11) Ernakulam, (12) Kolkata, (13) Lukcnow, (14) Mumbai, (15) Noida, (16) Patna, and (17) Pune.

13.6.6 Power and Functions of Insurance Ombudsman

Insurance Ombudsman typically has two types of functions -Conciliation and Award Making. The institution is authorised to receive and address the complaints of the customers. Such complaints may associate to any grievance against the insurance service provider like:

a) Any total or partial denial or refutation of claims by the insurance company

b) Disputes related to payable or paid premiums

c) Disputes related to the legal structure of the policy's wordings

d) Delay in the process of settling claims

e) Not issuing insurance documents related to the policy even after receiving the premium amount

However, the powers of insurance ombudsman are restricted to the insurance contracts value not more than Rs. 20 lakhs. The insurance companies are required to honour the awards passed by an Insurance Ombudsman within three months.

13.6.7 Manner of lodging complaint

The complaint by an aggrieved person has to be in writing, and addressed to the insurance Ombudsman of the jurisdiction under which the office of the insurer falls. The complaint can also be longed through the legal heirs of the insured. However, before lodging a complaint:

i) The complaint should have made a representation to the insurer named in the complaint and the insurer either should have rejected the complaint or the complaint have not received any reply within a period of one month after the concerned insurer has received his/her complaint or he/she is not satisfied with the reply of the insurer.

ii) The complaint is not made later than one year after the insurer had replied.

iii) The same complaint on the subject should not be pending with before any court, consumer forum or arbitrator.

13.6.8 Recommendation of the Ombudsman

When a complaint is settled through the mediation of the Ombudsman, he shall make the recommendations which he thinks fair in the circumstances of the case. Such recommendation shall be made not later than one month and copies of the same sent to complainant and the insurance company concerned. If the complaint accepts recommendations, he will send a communication in writing within 15 days of the date of receipt accepting the settlement.

13.6.9 Award

The Ombudsman shall pass an award within a period of three months from the receipt of the complaint. The awards are binding upon the insurance companies. If the policy holder is not satisfied with the award of the Ombudsman, he/she can approach other venues like Consumer Forums and Courts of law for redressal of his/her grievances.

As per the policy holder's protection regulations, every insurer shall inform the policy holder along with the policy document in respect of the insurance Ombudsman in whose jurisdiction his office falls for the purpose of grievances redressal arising if any subsequently.

Steady increase in number of complaints receive by various Ombudsman shows that the policy-holders are reposing their confidence in the institution of insurance Ombudsman.



13.7 LET US SUM UP

- An insurance agent is a person or organization who/that solicits, negotiates, or instigates insurance contracts on behalf of an insurer and can be independent or an employee of the insurer.
- The personal quality of a successful salesman may be grouped various categories namely Physical, Mental, Social and Vocational.
- An agent sells insurance products of **one company only**.
- The success of insurance mainly depends on the performance of the agents. Agents are paid commission in consideration of their services.
- To be appointed as insurance agent a person should have some requisitequalifications.
- Agents may be appointed in any place within India for the purpose of soliciting or procuring life insurance business including business relating to the continuance, renewal or revival of policies of insurance for the Corporation.
- Insurance Act, 1938 consigns some specific functions and duties tothe insurance agents.
- An insurance agent is to be maintained minimum amount of business to be secured his/her agency.
- Insurance Act, 1938 and LIC Agents Regulation, 1972 have mentioned some disqualifications of insurance agents.
- Insurance agency may be terminated as per the provisions laid down in the Insurance Act, 1938.
- The institution of insurance ombudsman was established by the Government of India in November 1998.
- Ombudsman plays an important role in protecting the interests of customers and building trust in insurance business.
- The purpose of Ombudsman is to quick and systematic disposal of customers' grievances and mitigation of issues involved in the settlement of those complaints.
- **An insurance Ombudsman is appointed for a term of three years or till the incumbent attains the age of sixty-five years, whichever is earlier. Re-appointment is not permitted.**



13.8 FURTHER READINGS

- Principles & Practice of Insurance -By M Motihar
- Insurance: Principles and Practice -By M.N. Mishra & S B Mishra



13.9 CHECK YOUR PROGRESS

Answer as directed:

a) An agent can sell insurance products of **one company only**. (Write True or False)

b) A person cannot be appointed as agent unless he attains _____ years of age.

(Fill in the gap)

c) An employee of the Corporation may also be appointed as an agent subject to the provision of LIC Staff Regulation Act, 1960.(Write True or False)

d) The institution of insurance ombudsman was established by the Government of India in November _____.(Fill in the gap)

e) An insurance Ombudsman is appointed for a term of _____ years. (Fill in the gap)



13.10 ANSWERS TO CHECK YOUR PROGRESS

a) True b) 18 c) True d) 1998 e) Three



13.11 MODEL QUESTIONS

1. "Insurance has to be sold". Explain this statement with regard to insurance salesmanship.
2. Explain the main reasons for selling of insurance.
3. Discuss the essentials of an insurance agent.

4. Mention the guidelines that are exercised to appointment of an Insurance Agents by an insurer.
5. Explain the functions and duties of an insurance agent.
6. Write a note on minimum amount of business to be secured by an insurance agent.
7. What are the disqualifications of an insurance mentioned in Insurance Act, 1938 and LIC Agents Regulation, 1972?
8. Discuss the rights of an insurance agent.
9. Discuss the conditions on which an insurance agent may be terminated.
10. Explain the role of an Ombudsman.
11. Discuss the functions and powers of an Ombudsman.

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UNIT 14: REGULATION OF INSURANCE

UNIT STRUCTURE

14.1 Learning Objectives

14.2 Introduction

14.3 Development of Insurance Legislation in India

14.4 Insurance Regulatory and Development Authority Act-1999

14.4.1 Objective of IRDA

14.4.2 Duties, Powers and Functions of the IRDA

14.5 Prerequisites for Registration of Insurance Company

14.6 IRDAI's Role as Regulator of Insurance Agents & Intermediaries

14.7 Regulations Issued by IRDA

14.8 Life Insurance Council and General Insurance Council

14.9 General Insurance Business (Nationalisation) Act, 1972 (GIBNA)

14.10 The Actuaries Act, 2006

14.11 FDI in Insurance

14.12 Let Us Sum Up

14.13 Further Readings

14.14Answers to Check Your Progress

14.15 Model Questions

14.1 LEARNING OBJECTIVES

After going through this unit, the learners will able to:

- Know the evolution of insurance legislation in India
- Know about IRDA
- State the Objective, Duties, Powers and Functions of the IRDA
- Explain the Prerequisites for Registration of Insurance Company
- Discuss the procedurefor Procuring IRDA Registration Certificate
- Know the Life Insurance Council and General Insurance Council
- Know the Actuaries Act, 2006
- Get an idea of FDI in Insurance

14.2 INTRODUCTION

Considering the various recommences the insurance industry provides to the society, economy, businesses and people on one side and considering the capital invested by the people through the instrument of insurance on other side, it is mandated to regulate insurancesector.

Though since ages, regulation exists for ensuring the maximum utilization of the insurance sectorfor the benefit of the society and for avoiding the probability of misuse of the insurance as an instrument related to finance and capital, yet the privatization of insurance sector in early 90s hasmade it compulsory to have stricter standards of laws and regulation over insurance sector.

In this unit we will discuss some regulatory provisions related to regulation of insurance business in India and also discuss Foreign Direct Investment in Indian insurance sector.

14.3 DEVELOPMENT OF INSURANCE LEGISLATION IN INDIA

Insurance law in India had its origins in the UnitedKingdom with the establishment of a British firm, the Oriental Life Insurance Company in 1818 inCalcutta, followed by the Bombay Life Assurance Company in 1823, the Madras Equitable LifeInsurance Society in 1829 and the Oriental Life Assurance Company in 1874. However, till theestablishment of the Bombay Mutual Life Assurance Society in 1871, Indians were charged an extrapremium of up to 20% as compared to the British. The first statutory measure in India to regulatethe life insurance business was in 1912 with the passing of the Indian Life Assurance CompaniesAct, 1912 (“Act of 1912”) (which was based on the English Act of 1909). Other classes of insurancebusiness were left out of the scope of the Act of 1912, as such kinds of insurance were still in nascent stage and legislative controls were not considered necessary.

General insurance on the other hand also has its origins in the United Kingdom. The first generalinsurance company Triton Insurance Company Ltd. was promoted in 1850 by British nationals inCalcutta. The first general insurance company established by an Indian was Indian MercantileInsurance Company Ltd. in Bombay in 1907. Eventually, with the growth of fire, accident and marineinsurance, the need was felt to bring such kinds of insurance within the purview of the Act of 1912.While there were a number of attempts to introduce such legislation over the years, non-lifeinsurance was

finally regulated in 1938 through the passing of the Insurance Act, 1938 ("Act of1938"). The Act of 1938 along with various amendments over the years continues till date to be the definitive piece of legislation on insurance and controls both life insurance.

On January 19, 1956, the management of life insurance business of two hundred and fort y five Indian and foreign insurers and provident societies then operating in India was taken over by theCentral Government. The Life Insurance Corporation ("LIC") was formed in Sept ember 1956 by theLife Insurance Corporation Act, 1956 ("LIC Act") which granted LIC the exclusive privilege to conductlife insurance business in India.

The general insurance business was also nationalised with effect from January 1, 1973, through the introduction of the General Insurance Business (Nationalisation) Act, 1972 ("GIC Act"). Underthe provisions of the GIC Act, the shares of the existing Indian general insurance companies andundertakings of other existing insurers were transferred to the General Insurance Corporation("GIC") to secure the development of the general insurance business in India and for the regulationand control of such business. The GIC was established by the Central Government in accordancewith the provisions of the Companies Act, 1956 in November 1972 and itcommenced business on January 1, 1973. Prior to 1973, there were a hundred and sevencompanies, including foreign companies, offering general insurance in India. These companies wereamalgamated and grouped into four subsidiary companies of GIC viz. the National InsuranceCompany Ltd., the New India Assurance Company Ltd, the OrientalInsurance Company Ltd., and the United India Assurance Company Ltd.

Following the recommendations of the Malhotra Committee report, in 1999, the Insurance Regulatory andDevelopment Authority (IRDA) was constituted as an autonomous body to regulate and develop theinsurance industry. The IRDA was incorporated as a statutory body in April, 2000. Beside IRDA Act and Insurance Act, 1938, there are some common Act/Regulation to regulate and manage the General and LifeInsurance Business in India and some Acts have been made for specific requirement of LifeInsurance/ General Insurance.

Acts/Regulations Governing Both Life & General Insurance Business in India

The following Acts regulate the Insurance Business in India:

- Insurance Act, 1938.

- IRDA Act, 1999 & Regulations passed thereunder.
- Insurance Amendment Act, 2002. ? Exchange Control Regulations (FEMA).
- Indian Stamp Act, 1899.
- Consumer Protection Act, 1986.
- Insurance Ombudsman Rules, 2017.
- Labour Law legislations.

Regulations Governing/Affecting Life Insurance Business in India

The following Acts govern/regulate the life insurance business in India:

1. LIC Act, 1956.

2. Amendments to LIC Act.

Regulations affecting General Insurance Business in India

The following Acts affect, circumscribe or regulate in some way or the other, some aspect of the GeneralInsurance Business in India:

- General Insurance Nationalization Act, 1972.
- Amendments to GIN Act, 1972.
- Multi-Modal Transportation Act, 1993.
- Motor Vehicles Act, 1988.
- Inland Steam Vessels Amendment Act, 1977.
- Marine Insurance Act, 1963.
- Carriage of Goods by Sea Act, 1925.
- Merchant Shipping Act, 1958.
- Bill of Lading Act, 1855.
- Indian Ports (Major Ports) Act, 1963.
- Indian Railways Act, 1989.
- Carriers Act, 1865.
- Indian Post Office Act, 1898.
- Carriage by Air Act, 1972.
- Public Liability Insurance Act, 1991.
- Employee State Insurance Act,1948
- Aircraft Act, 1934.



Check Your Progress

Q. No. 1. In which year the general insurance business was nationalised?

Q.No.2. In which year IRDA was incorporated?

14.4 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY ACT-1999

The Insurance Regulatory andDevelopment Authority (IRDA) is a statutory regulator. Government of India establish IRDA by passing The IRD Act in the parliament in the year 1999 to regulate and promote the insurance industry in India and to protect the interests ofholders of insurance policies. The IRDA was incorporated as a statutory body in April, 2000.

The Preamble of the IRDA Act states the objective of IRDA which is "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. IRDA Act led to amendment of the Insurance Act, 1938, the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972."

The IRD Act also carried out a series of amendments to the Insurance Act of1938 and conferred the powers of the Controller of Insurance on the IRDA.

14.4.1 Composition of IRDA

The IRDA consistsof the following members: -

- a chairperson;
- not more than five whole-time members and
- not more than four part-time members.

The members of the IRDA are appointed by the Central Government from amongst persons of ability,integrity and standing who have knowledge or experience in life insurance, general insurance,actuarial science, finance, economics, law, accountancy, administration or any other discipline which would, in the opinion of the Central Government, be useful to the Authority.

The Central Government shall, while appointing the Chairperson and the whole- time members, ensure that at least one person each is a person

having knowledge or experience in life insurance, general insurance or actuarial science respectively. The head office of IRDA is situated at Hyderabad.

14.4.2 Objective of Irda

As per mission statement the objectives of the IRDA can be summarised as: -

1. To protect the interest of Policyholders and to secure their fair treatment.

2. To bring about speedy and orderly growth of the insurance industry for the benefit of thecommon man, and to provide long term funds for accelerating growth of the economy.

3. To set, promote, monitor and enforce high standards of integrity, financial soundness, fair dealing and competence of those it regulates.

4. To ensure that insurance customers receive precise, clear and correct information about products and services and to make them aware of their responsibilities and duties in this regard.

5. To ensure speedy settlement of genuine claims, to prevent insurance frauds and other malpractices and put in place effective grievance redressal machinery.

6. To promote fairness, transparency and orderly conduct in financial markets dealing with insurance and build a reliable management information system to enforce high standards of financial soundness amongst market players.

7. To take action where such standards are inadequate or ineffectively enforced.

8. To bring about optimum amount of self-regulation in day to day working of the industry consistent with the requirements of prudential regulation.

14.4.3 Duties, Powers and Functions of the Irda

Section 14 of the IRDA Act, 1999 lays down the following duties, powers and functions of IRDA.

1. Subject to the provisions of this Act and any other law for the time being in force, the Authority shall have the duty to regulate, promote and ensure orderly growth of the insurance business and re-insurance business.

2. Without prejudice to the generality of the provisions contained in subsection (1), the powers and functions of the Authority shall include:

a) issue to the applicant a certificate of registration, renew, modify, withdraw, suspend or cancel such registration;

b) protection of the interests of the policy holders in matters concerning assigning of policy, nomination by policy holders, insurable interest, settlement of insurance claim, surrender value of policy and other terms and conditions of contracts of insurance;

c) specifying requisite qualifications, code of conduct and practical training for intermediary or insurance intermediaries and agents;

d) specifying the code of conduct for surveyors and loss assessors;

e) promoting efficiency in the conduct of insurance business;

f) promoting and regulating professional organisations connected with the insurance and re-insurance business;

g) levying fees and other charges for carrying out the purposes of this Act;

h) calling for information from, undertaking inspection of, conducting enquiries and investigations including audit of the insurers, intermediaries, insurance intermediaries and other organisations connected with the insurance business;

i) control and regulation of the rates, advantages, terms and conditions that may be offered by insurers in respect of general insurance business not so controlled and regulated by the Tariff Advisory Committee under Section 64U of the Insurance Act, 1938 (4 of 1938);

j) specifying the form and manner in which books of account shall be maintained and statement of accounts shall be rendered by insurers and other insurance intermediaries;

k) regulating investment of funds by insurance companies;

l) regulating maintenance of margin of solvency;

m) adjudication of disputes between insurers and intermediaries or insurance intermediaries;

n) supervising the functioning of the Tariff Advisory Committee;

o) specifying the percentage of premium income of the insurer to finance schemes for promoting and regulating professional organisations referred to in clause (f);

p) specifying the percentage of life insurance business and general insurance business to be undertaken by the insurer in the rural or social sector; and

q) exercising such other powers as may be prescribed



Check Your Progress

Q.No.3. Mention two objectives of IRDA.

Q. No.4. Mention the duties of IRDA

14.5 PREREQUISITES FOR REGISTRATION OF INSURANCE COMPANY

An insurance company seeking to carry out insurance business in India need to obtain a certificate of registration from the IRDA before commencing business. The company need to fulfil some preconditions before applying for such registration as per Insurance Act of 1938, IRDAAct and various regulations prescribed by IRDA.

14.5.1 General Requirements

Following are some general requirements that an applicant need to fulfil before applying for registration: -

a) The applicant would need to be a company registered under the provisions of the Indian Companies Act, 1956. Consequently, any person intending to carry on insurance business in India would need to set up separate entity in India.

b) The aggregate equity participation of a foreign company (either by itself or through its subsidiary company or its nominees) in the applicant company cannot exceed twenty six percent of the paid up capital of the insurance company. However, the Insurance Act and the regulations there under provide for the manner of computation of such twenty-six per cent.

c) The applicant can carry on any one of the life insurance business, general insurance business or re-insurance business. Separate companies would be needed if the intent were to conduct more than one business.

d) The name of the applicant needs to contain the words" insurance company" or "assurance company"

14.5.2 Capital Structure Requirements

The applicant would need to meet with the following capital structure requirements

a) A minimum paid up equity capital of rupees one billion in case of an applicant which seeks to carry on the business of life insurance or general insurance.

b) A minimum paid-up equity capital of rupees two billion, in case of a person carrying on exclusively the business of reinsurance.

In determining the aforesaid capital requirements, the deposits to be made and any preliminary expenses incurred in the formation and registration of the company would be included. A "promoter" of the company is not permitted to hold, at any time, more than twenty six percent of the paid up capital in any Indian insurance company. However, an interim measure has been permitted. Percentages higher than twenty six percent are permitted if the promoters divest, in a phased manner, over a period of ten years from the date of commencement of business, the share capital held by them in excess of twenty six per cent.

14.6 PROCESS FOR PROCURING IRDA REGISTRATION CERTIFICATE

Stage-1

A request for acquiring the Certificate of Registration should be made to the IRDA in Form prescribed under IRDA/R1. The application should be supported by the following documents:

- The certified copy of the Memorandum of Association and Articles of Association;
- The full profile including the name, address and occupation of all the directors and shareholders of the company;
- The statement regarding the class of insurance business proposed to be carried on.
- The statement regarding the sources of capital funds.

The primary appeal would be screened by IRDA and additional information may be asked for. Even a Principal Officer may be appointed by the Authority for seeking any information or clarification on their behalf.

Stage-2

After being contented about the instructions and documents supplied along with the Form IRDA/R1, the Authority may ask for an additional application in the prescriber Form IRDA/R2 which shall be accompanied with the following documents:

- Every entity shall deposit either in cash or in securities, partly in cash and party in securities, the following:
- In the previous year,3% of the total gross premium written in India, in case of the general insurance business, not exceeding INR 10 crore;

- A sum of INR 20 crores in case of reinsurance business;
- A sum of INR 1 lac/- only in case of marine business;
- The certificate showing the amount deposited with the Reserve Bank of India.

The statement showing declaration from the Principal Officer about fulfilment of Minimum Capital Requirement. For a reinsurance business the capital requirement shall be 20 crores and for the life insurance as well as General Insurance 10 crores.

- Actuary certificate regarding rate of interest.
- A deposit of INR 50,000/- for each class of business.
- If any foreign promoter is involved, then the certified copy of the MOU between the Indian and Foreign promoter.

14.6.1 Grant of Registration Certificate for Insurance business in India

Only after the receipt of application and on being contented about the following mentioned conditions, the Certificate of Registration shall be granted to the insurer by the IRDA. The conditions include the following:

- Sound financial condition and general character of the management;
- Adequate volume, capital structure and earning prospects of the applicant company;
- Fulfilment of the interest of the general public.

14.6.2 Refusal of Registration for insurance operations

The applicant may be refused of the registration of an insurer on the following grounds:

- Inadequate or improper information;
- Delay in providing information;
- Non-fulfilment of capital requirements;
- Improper conduct of the management;
- Any other as decided by the Authority.

In case, the aspirant is denied of the registration as an insurer, he can appeal before the Central Govt. within 30 days from the date on which a copy of the decision from the Authority is received

In case of the insurance registration, the decision of the government shall be final and cannot be appealed against in any court of law.

14.6.3 Cancellation of Registration

The IRDA, in case of repeated default of the grounds for suspension of a certificate ofregistration may impose a penalty in the form of cancellation of the certificate. The Authority is compulsorily required to cancel the registration of an insurer either wholly or in so far as it relates to a particular class of insurance business, as the case may be

- If the insurer fails to comply with the provisions to deposit; or
- If the insurer fails, at any time, to comply with the provisions relating to the excess of the value of his assets over the amount of his liabilities; or
- If the insurer is in liquidation or is adjudged an insolvent or
- If the business or a class of the business of the insurer has been transferred to any person or has been transferred to or amalgamated with the business of any other insurer or
- If the whole of the deposit made in respect of the insurance business has been returned to the insurer
- If, in the case of an insurer, the standing contract is cancelled or is suspended and continued to be suspended for a period of six months, or
- If the Central Government of India so directs.

In addition to the above, the IRDA has the discretion to cancel the registration of an insurer

- If the insurer makes default in complying with, or acts in contravention of, any requirement of the Insurance Act or of any rule or any regulation or order made or any direction issued there under, or
- If the Authority has reason to believe that any claim upon the insurer arising in India under any policy of insurance remain unpaid for three months after final judgement in regular course of law or
- If the insurer carries on any business other than insurance business or any prescribed business or
- If the insurer makes a default in complying with any direction issued or order made, as the case may be, by the Authority under the IRDA Act, 1999

- If the insurer makes a default in complying with or acts in contravention of, any requirement of the Companies Act, or the LIC Act, or the GIC Act or the Foreign Exchange Management Act, 2000.

14.6.4 Renewal of Registration

The registration shall only be renewed annually and the application for renewal shall be made before 31st December of the preceding year following which the renewal is sought for, along with the fees as below:

- The fees should not be less than 50,000/- for each class of insurance;
- 1/4th of the 1% of the premium received during the year in India, for reinsurance companies;
- The renewal fees shall be paid to the Reserve Bank of India.

14.7 IRDAI'S ROLE AS REGULATOR OF INSURANCE AGENTS & INTERMEDIARIES

IRDAI have been vested with the following powers under the IRDAI Act, 1999 to regulate the Distributors ofInsurance Policies:

1. Specification of requisite qualifications, practical training and code of conduct for insurance agentsand intermediaries.

2. Specification of code of conduct for survey or sand loss assessors.

3. Promoting efficiency in the conduct of insurance business.

4. Calling for information from or undertaking inspection of insurance companies, intermediaries andother organisations connected with insurance business.

5. Control and regulation of rates, advantages, terms and conditions that may be offered by generalinsurance companies.

6. Specifying the form and manner in which books of account shall be maintained by insurance

companies and intermediaries.

As a step in the above direction, IRDAI have framed regulations to regulate the various distributors who areengaged in selling insurance.

14.8 REGULATIONS ISSUED BY IRDA

In exercise of the powers under the Act the IRDA has in consultation with the Insurance Advisory Committee made various regulations and amended

them subsequently as per requirement. Some examples of the regulations are given below:

- Licensing of Insurance Agents Regulations, 2000
- Assets, Liabilities and Solvency Margin of Insurers Regulation, 2000.
- General Insurance – Reinsurance Regulations, 2000
- Obligations of Insurance to Rural Social Sector Regulations, 2000
- Insurance Surveyors and Loss Assessors (Licensing, Professional Requirements and Code of Conduct) Regulations, 2000.
- Third Party Administrator – Health Services Regulations, 2001.
- Protection of Policy holders' Interest Regulations, 2002.
- Insurance Brokers Regulations, 2000.
- Micro Insurance Regulations, 2005.



Check Your Progress

Q. No.5. Which institution's mission is to protect the interests of holders of insurance policies?

Q.No.6. Name two regulations issued by IRDA for regulation of insurance business.

14.9 LIFE INSURANCE COUNCIL AND GENERAL INSURANCE COUNCIL

Insurance Act, 1938 provides for establishment of Insurance council accordingly two Insurance Councils are formed under Section 64C of the Insurance Act, 1938.

14.9.1 The Life Insurance Council

It consists of all the members and associate members of the Association who carry on life insurance business in India.

Constitution of Executive Committee of Life Insurance Council

As per Section 64F(1) of the Insurance Act, 1938, an Executive Committee of the Life Insurance Councilshall be formed comprising of the following persons, namely: —

(a) two officials nominated by the Authority, one as the Chairman and the other as a member;

(b) eight representatives of members of the Insurance Association of India carrying on life insurance business elected in their individual capacity by the said members in such manner, from such groups of members and from such areas as may be specified by the Authority.

(c) One non official not connected with any insurance business, nominated by the Authority; and

(d) five persons connected with life insurance business, nominated by the Authority for the purpose of representing such groups of insurers carrying on life insurance business or such areas as have not been able to secure adequate representation on the Executive Committee of the Life Insurance Council or for any other purpose.

According to Section 64H of the Insurance Act, 1938, The duration of the Executive Committee of the Life Insurance Council or the General Insurance Council shall be three years from the date of its first meeting on the expiry of which it shall stand dissolved and a new Executive Committee constituted.

14.9.2 The General Insurance Council

It consists of all the members and associate members of the Association who carry on general insurance business in India.

Constitution of Executive Committee of General Insurance Council

As per Section 64F (2) of the Insurance Act, 1938, an Executive Committee of the Life Insurance Council shall be formed comprising of the following persons, namely: —

(a) two officials nominated by the Authority, one as the Chairman and the other as a member;

(b) eight representatives of members of the Insurance Association of India carrying on general insurance business elected in their individual capacity by the said members in such manner, from such groups of members and from such areas as may be specified by the Authority;

(c) one non-official not connected with any insurance business, nominated by the Authority; and

(d) five persons connected with general insurance business, nominated by the Authority for the purpose of representing such groups of insurers carrying on general insurance business or such areas as have not been able to secure adequate representation on the Executive Committee of the General Insurance Council or for any other purpose.

(e) If anybody of persons specified in (1) and (2) fails to elect any of the members of the Executive Committees of the Life Insurance Council or the General Insurance Council, IRDA may nominate any person to fill the vacancy, and any person so nominated shall be deemed to be a member of the Executive Committee of the Life Insurance Council or the General Insurance Council, as the case may be, as if he had duly elected thereto.

(f) No official nominated by the IRDA shall be entitled, whether as chairman or as a member , to vote in respect of any matter coming up before any meeting of the Executive Committee of the Life Insurance Council or the General Insurance Council, as the case may be, and subject thereto each of the said Executive Committees, may with the approval of the IRDA, make bye-laws for the transaction of any business at any meeting of the said committee and any such bye-law may provide that any member of the Committee who is interested in an matter for the time being before that Committee may not be present at or take part in any meeting thereof.

(g) The life Insurance Council or the General Insurance Council may form such other committees consisting of such persons as it may think fit to discharge such functions as may be delegated thereto.

(h) The Secretary of the Executive Committee of the Life Insurance Council and of the Executive Committee of the General Insurance Council shall in each case be an official nominated by the IRDA.

14.9.3 Functions of the Executive Committee of Life and General Insurance Councils

As per Section 64J, read with Section 64L of the Insurance Act, 1938, the following are the functions of theExecutive Committee of the Life and General Insurance Council:

(a) to aid, advise andassist insurers carrying on life/general insurance business in the matter of settingup standards of conduct and sound practice and in the matter of rendering efficient service toholders of life insurance policies;

(b) to render advice to the Authority in the matter of controlling the expenses ofinsurers in respect oftheir life/general insurance business in India, respectively; in addition in respect of general insurers,Executive Committee of General insurance council may also advise on Commission andotherexpenses;

(c) to bring to the notice of the Authority the case of any insurer acting in a mannerprejudicial to theinterests of holders of life/general insurance policies, respectively; and

(d) to act in any matter incidental or ancillary to any of the matters specified in Clauses (a) to (c) as,with the approval of the Authority, may be notified by theLife/General Insurance Council, as thecase may be, in the Gazette of India.For the purpose of enabling it effectively to discharge its functions,the Executive Committee of theLife/ General Insurance Council may collect such fees from Life/General insurance companies, as may bespecified in the bye-laws of the respective Councils.

14.9.4 Powers of Life & General Insurance Councils

For the efficient performance of its duties, the Life InsuranceCouncil or the General Insurance Council, asthe case may be, may

(a) appoint such officers and servants as may be necessary and fix the conditions oftheir service;

(b) determine the manner in which any prescribed fee may be collected;

(c) keep and maintain up-to-date, a copy of list of all insurers who are members of the either Council;

(d) make bye-laws for:(i)the holding of elections other than the first elections;(ii)the summoning and holding of meetings, the conduct of business thereatand the number ofpersons necessary to form a quorum;(iii)the submission by insurers to the Executive Committee of the Life Insurance Council, or theGeneral Insurance Council of such statements or information asmay be required of them and he submission of copies thereof by the insurers to the Authority;(iv)the levy and collection of any fees;(v)the regulation of any other matter which may be necessary for the purposeof enabling it tocarry out its duties under this Act.

Further, the Life Insurance Council or the General Insurance Council may authorise the ExecutiveCommittee concerned to exercise any of the powers conferred on the Life Insurance Council or the GeneralInsurance Council, as the case may be, under Clauses (a), (b) or (c) mentioned above.

14.10 GENERAL INSURANCE BUSINESS (NATIONALISATION) ACT, 1972 (GIBNA)

The General Insurance Corporation of India (GIC) was formed as a Government company under sub-section (1) of Section 9 of the General Insurance Business (Nationalisation) Act, 1972 and it commenced business from January 1, 1973. The purpose of establishment of GIC as a holding com-

pany of the four operating (subsidiary) companies, as stated in the General Insurance Business (Nationalisation) Act, was superintending, controlling and carrying on the business of general insurance.

Functions of GIC

The functions of GIC as enunciated in the said Act are as follows:

a) the carrying on of any part of general insurance business as deemed desirable;

b) aiding, assisting and advising the companies in the matter of setting up of standards of conduct and sound practice in general insurance business and in rendering efficient customer service;

c) advising the acquiring companies in the matter of controlling their expenses including the payment of commission and other expenses;

d) advising the acquiring companies in the matter of the investment of funds;

e) issuing directions to acquiring companies in relation to the conduct of general insurance business

14.11 THE ACTUARIES ACT, 2006

The Actuaries Act, 2006 was enacted on August 27, 2006 to control and advance the actuaries profession and other issues related with the actuaries. As provided under the Act actuary is the person engaged in deciding the current results of the potential contingent happenings or in the moulding of finance and determining of risk in various locations of insurance or computing the rate of life interest and possibilities in insurance etc. It shall also deal with formulation and fixing of rates for policies, calculating the profits, suggesting rates that are concerned with insurance industry, allowances, insurance and rates of pension according to the empirically related tables. It shall also consist of such other persons as specifically provided under the Act. By virtue of the Act, from the date specified by the Government of India, the name of the persons included in the record of the actuarial society during the initiation of the Act and the names of the persons added subsequent to the pioneering of the legislation and till their name persist to be present in the record are established as a body corporate under the Actuaries Institute and the names of the persons included in the record shall be members under the Actuaries Institute. The Institute shall have the status of a company with continuous succession and shall have the authority to deal with property and shall have the power to litigate.

As per provision under Section 3 of the Actuaries Act, 2006 the Institute of Actuaries of India constituted and the erstwhile Actuarial Society of India was dissolved. All the Assets and Liabilities of the Actuarial Society of India were transferred to, and vested in, the Institute of Actuaries of India. The obligations and balances due that are outstanding, the agreements concluded and the things that are to be performed by the Actuarial Society shall also be assigned to the Actuaries Institute. The litigations in which the society is engaged are also transferred to the Institute.

In addition, the fundamental motive of the Institute shall consist of the advancement, support and progression of professional learning, practical experience through training, awareness and activities between the actuaries, uplift the status of actuaries, control the activities of the persons engaged in the actuary's profession, to advance research and development on the subjects that are important to actuarial science etc. The persons whose name is entered as an associate or fellow shall have his name included in the records of the Institute. To be a member of the Institute, the person must have passed the assessment conducted by the Society of Actuary. He shall also conclude the training as per the guidelines of the Society or by the Council with some exemptions.

Objects of the Actuaries Institute:

The main objects of the Institute are (section 5 of the Actuaries Act, 2006);

- To promote, uphold and develop the standards of professional education, training, knowledge, practice and conduct amongst Actuaries;
- To promote the status of the Actuarial profession;
- To regulate the practice by the Members of the profession of Actuary;
- To promote, in the public interest, knowledge and research in all the matters relevant to Actuarial Science and its application; and
- To do all such things as may be incidental or conducive to the above objects or any of them.



Check Your Progress

Q. No.7. Mention one Functions of the Executive Committee of General Insurance Councils.

14.12 FDI IN INSURANCE

Indian insurance sector witnessed many changes during the courses of time. However, massive changes have taken place after the opening up of Indian economy. India allowed participation of private entity in insurance sector in 2000 and allowed FDI in insurance up to 26%. The limit of FDI was further increased to 49% in 2014 and further to 74% in 2021.

In addition, it was announced that under the new 2021 framework:

- foreign ownership and control would be allowed with safeguards;
- the majority of directors on an insurer's board of directors and key management persons would be required to be resident Indians;
- 50% of directors would need to be independent directors; and
- a specified percentage of the insurer's profits would have to be retained as a general reserve.

Amendment of Insurance Act

Allowing FDI in insurance sector need amendment in the Insurance Act. In order to allow 74% FDI in Insurance sector on 25 March 2021 the Insurance (Amendment) Act 2021 was notified, which introduced as follows:

- The amended Section 2(7A)(b) states that:
    - the limit of foreign investment allowed in Indian insurers cannot exceed 74% (previously 49%); and
    - foreign investment in insurers must be "subject to such conditions and manner, as may be prescribed".
- The amended Section 27(7) has omitted its previous requirement for insurers incorporated in India to hold assets in trust where at least:
    - 33% capital is owned by investors domiciled outside India; or
    - 33% of the members of the governing body are domiciled outside India.
- The amended Sections 2(7A) and 114(2)(aaa) have omitted the requirement for insurers to be Indian owned and controlled. It has been stipulated that the conditions and manner of foreign investment will be as prescribed.



14.13 LET US SUM UP

- Insurance law in India had its origins in the UnitedKingdom.
- Following the recommendations of the Malhotra Committee report, in 1999, the Insurance Regulatory andDevelopment Authority (IRDA) was constituted as an autonomous body to regulate and develop theinsurance industry.
- Beside IRDA Act and Insurance Act, 1938, there are some common Act/Regulation to regulate and manage the Insurance Business in India.
- Section 14 of the IRDA Act, 1999 lays down the duties, powers and functions of IRDA.
- An insurance company seeking to carry out insurance business in India need to obtain a certificate of registration from the IRDA before commencing business.
- Insurance Act, 1938 provides for establishment of Insurance council.
- The General Insurance Corporation of India (GIC) was formed as a Government company under sub-section (1) of Section 9 of the General Insurance Business (Nationalisation) Act, 1972.
- India allowed participation of private entity in insurance sector in 2000 and allowed FDI in insurance up to 26%. The limit of FDI was further increased to 49% in 2014 and further to 74% in 2021.



14.14 FURTHER READINGS

- **Principles & Practice of Insurance -By M Motihar**
- **Insurance: Principles and Practice -By M. N. Mishra & S. B. Mishra**



14.15 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q.No.1.1971

Ans to Q.No.2.2000

Ans to Q.No.3. Two objectives of IRDA-

1. To protect the interest of Policyholders and to secure their fair treatment.

2. To bring about speedy and orderly growth of the insurance industry for the benefit of thecommon man, and to provide long term funds for accelerating growth of the economy.

Ans to Q.No.4. The duty of IRDAis to regulate, promote and ensure orderly growth of the insurance business and re-insurance business.

Ans to Q.No.5.IRDA

Ans to Q.No.6. Two regulations of IRDA-

- Licensing of Insurance Agents Regulations, 2000
- Assets, Liabilities and Solvency Margin of Insurers Regulation, 2000.

Ans to Q.No.7.One Functions of the Executive Committee of General Insurance Councils.

(a) to aid, advise and assist insurers carrying on life/general insurance business in the matter of setting up standards of conduct and sound practice and in the matter of rendering efficient service to holders of life insurance policies;



14.16 MODEL QUESTIONS

Q.No.1. List the Acts/Regulations Governing Insurance Business in India.

Q.No.2. Mention the objectives and powers of IRDA.

Q.No.3. Discuss the process for procuring registration certificate from IRDA**.**

Q.No.4. Discuss the Functions of the Executive Committee of Life and General Insurance Councils.

Q.No.5. Discuss the powers and functions of the Life and General Insurance Councils.

Q.No.6. Mention the functions of GIC.

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