PGCM S4 16 (FIN)

Risk Management and Insurance

(Finance Specialization)

SEMESTER - 4
MASTER OF COMMERCE
BLOCK - 1

KRISHNA KANTA HANDIQUI STATE OPEN UNIVERSITY

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MASTER OF COMMERCE

RISK MANAGEMENT AND INSURANCE

Block 1

DETAILED SYLLABUS

COURSE CODE 16 (FIN): 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. For the sake of convenience, this course has divided into two blocks.

Block 1 consists of introduction to risk and risk management, risk management applications, credit risk management, introduction to insurance, nature and scope of insurance and principles of insurance.

Block 2 encompasses with life and non-life insurance, function of insurer, insurance agent and salesmanship and regulation of insurance.

Each unit of these blocks 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-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.

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

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.

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 approach 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.

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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
2.7 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:



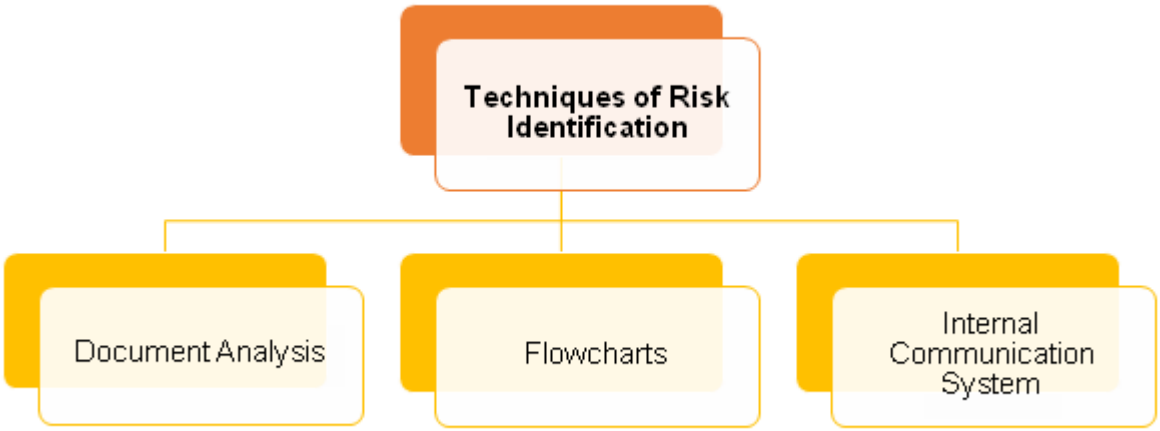
2.5.1.1 Setting the objectives

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

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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?

2.13 REFERENCES

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Websites

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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

4.5 Risk Financing

3.6 Risk management decision making

4.7 Risk management decision making in business

3.7 Let us Sum Up

3.7 Further Readings

3.9 Answers to Check Your Progress

3.10 Model Questions

3.1 LEARNING OBJECTIVES

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

- 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.

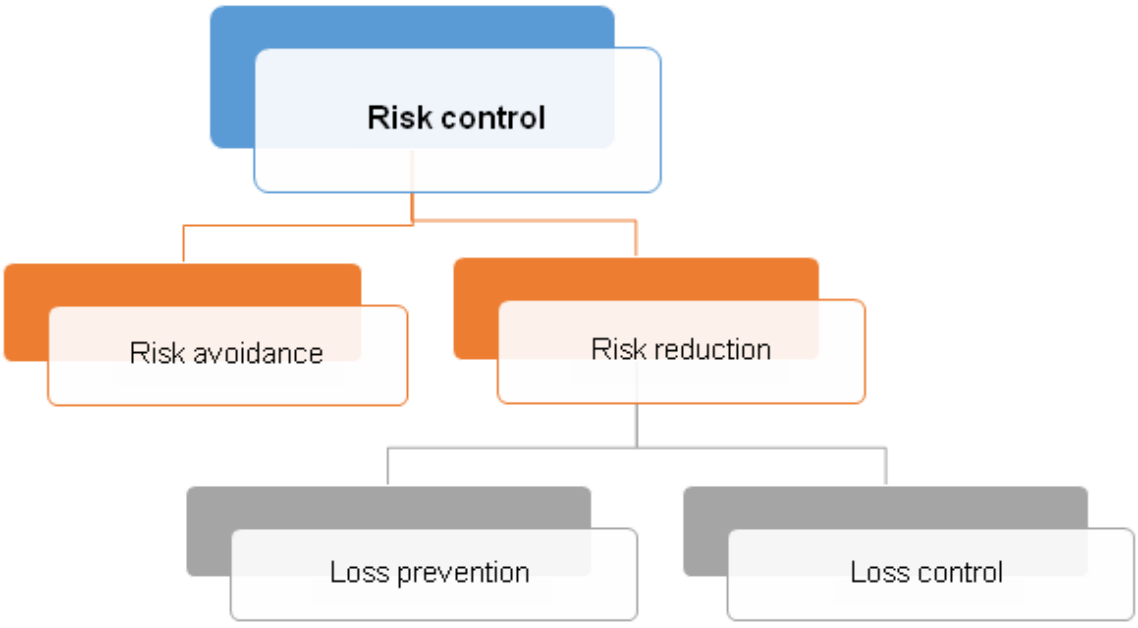
The second rule of risk management, "Consider the odds," suggests that the likelihood or probability of loss may be an important factor in deciding what to do about a particular risk. But which risks? Logically, consideration of the odds is limited to those situations in which the first rule, "Don't 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 financ-*

ing. 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 con-

sequences 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 being 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

4.7.5 Provision

4.8 Let us sum up

4.9 Further readings

4.10 Answers to check your progress

4.11 Model questions

4.12 References

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.

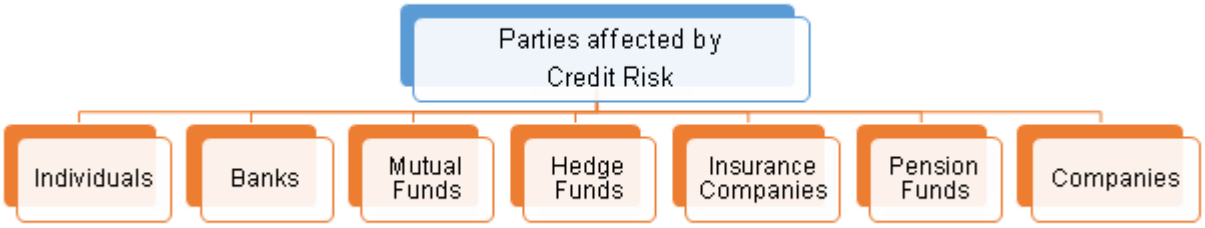
iv. **Buying prepaid goods and/or services:** Risk arises if the buyer doesn't receive the goods and/or services as per stipulated terms and conditions.

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 lending 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 administrative 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?

4.12 REFERENCES

- Brown, K. and Moles, P. (2008). *Credit Risk Management*. UK: Edinburgh Business School.
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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 Natura 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

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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

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5.18 Check Your Progress

5.19 Answers to Check Your Progress

5.20 Possible 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 NATURA 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 business 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 F URTHER 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)

UNIT 6: PRINCIPLES OF INSURANCE

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Principle of Utmost Good Faith

6.4 Principle of Indemnity

6.5 Principle of Insurable Interest

6.6 Principle of Subrogation

6.7 Principle of Loss Minimization

6.8 Principle of Contribution

6.9 Principle of Causa Proxima

6.10 Distinct Characteristics of Insurance Contracts

- 6.10.1 Aleatory Contract
- 6.10.2 Unilateral Contract
- 6.10.3 Conditional Contract
- 6.10.4 Personal Contract
- 6.10.5 Contract of Adhesion

6.11 Let Us Sum Up

6.12 Further Readings

6.13 Possible Questions

6.1 LEARNING OBJECTIVES

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

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

6.2 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.

6.3 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.

6.4 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.

6.5 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.

6.6 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.

6.7 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.

6.8 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'.

6.9 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.

6.10 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:

6.10.1 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.

6.10.2 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.

6.10.3 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.

6.10.4 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.

6.10.5 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.



6.11 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.
- Insurance contracts are different from other types of contracts as they have some distinguishing characteristics that define them as insurance documents.



6.12 FURTHER READINGS

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



6.13 POSSIBLE 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-7: INTRODUCTION TO RISK

UNIT STRUCTURE

7.1 Learning Objectives

7.2 Introduction

7.3 Role of Insurance in Financial System

7.4 Evolution of Insurance sector in India

7.4.1 Insurance in the Colonial Era

7.4.2 Nationalisation

7.4.3 Post Nationalisation and liberalization

7.4.4 FDI in Insurance Sector

7.5 Bancassurance in India

7.6 Let Us Sum Up

7.7 Further Readings

7.8 Answers to Check Your Progress

7.9 Possible Questions

7.1 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

7.2 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.

7.3 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.

7.3.1. 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.

7.3.2. 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.

7.3.3. 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.

7.3.4. 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.

7.3.5. 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.

7.3.6. 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.

7.4 GROWTH OF INSURANCE IN INDIA

7.4.1 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.

7.4.2 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?

7.4.3 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.

7.4.4 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?

7.5 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.



7.6 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.



7.7 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.



7.8 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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