# ***FAQ-BASICS OF INSURANCE –(SERIES -I)***

1. ***Define insurance.***
   ***Ans.*** *Insurance can be defined both from an economic perspective and from a legal perspective.*

   ***From an ECONOMIC PERSPECTIVE****, insurance is a financial intermediation function by which individuals exposed to a specific financial contingency each contribute to a pool from which covered events suffered by participating individuals are paid.*

   ***From a LEGAL PERSPECTIVE,*** *insurance is an agreement by which one party, the policy owner, pays a stipulated consideration called the premium to the other party called the insurer in return for which the insurer agrees to pay a defined amount of money or provide a defined service if a covered event occurs during the currency of the policy.*

2. ***What are the basic characteristics of insurance?***
   ***Ans:*** *The basic characteristics of insurance are.*
   - *Pooling of losses*
   - *The law of large numbers*
   - *Payment of fortuitous losses*
   - *Risk transfer*
   - *Indemnification*

   ***1. Pooling of losses*** *Pooling of risks, or the sharing of losses is the heart of insurance. Pooling is spreading of losses incurred by the few over the entire group, so that, in the process, average loss is substituted for actual loss.*

   *It implies.*
   *(i) the sharing of losses by the entire group; and*
   *(ii) prediction of future losses with some accuracy based on the law of large numbers.*

   ***2. The law of large numbers Many*** *lines of insurance risk reduction are based on the law of large numbers. It states that the greater the number of exposures, the more*

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*closely will the actual results approach the probable results that are expected from an infinite number of exposures.*

***3. Payment of fortuitous losses:*** *Payment is made for losses that are unforeseen and unexpected and occurs as a result of chance. This means the loss must be accidental.*

***4. Risk transfer*** *in this, a pure risk is transferred from the insured to the insurer who typically is in a stronger financial position and is willing to pay the loss than the insured (e.g., risk of premature death, poor health, destruction or theft of property)*

*5.* ***Indemnification*** *This means the insured is restored to his or her approximate financial position prior to the occurrence of the loss*

3. ***Write a brief note on the Law of Large Numbers***
   ***Ans:*** *Many lines of insurance risk reduction are based on the law of large numbers. The law states that the greater the number of exposures, the more closely will the actual results approach the probable results that are expected from an infinite number of exposures. If there are a large number of exposure units, the actual loss experience of the past may be a good approximation of future losses. To charge premium that will be adequate for paying all losses, expenses and margin for profit, this concept is important to insurer because he can predict future losses with a greater degree of accuracy as the number of exposures increases.*

4. ***What do you mean by Risk Transfer?***
   ***Ans.*** *In this, a pure risk is transferred from the insured to the insurer, who typically is in a stronger financial position and is willing to pay for the loss than the insured (e.g., risk of premature death, poor health, destruction or theft of property).*

5. ***What do you mean by Indemnification?***
   ***Ans.*** *Indemnification means the insured is restored to his or her approximate financial position prior to the occurrence of the loss.*

6. ***What are the requirements of an insurable risk?***
   ***Ans.*** *Insurers normally insure only pure risks. However, all pure risks are not insurable. From the viewpoint of the insurer, the requirements of an insurable risk are:*

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- *There must be a large number of exposure units;*
- *The loss must be accidental and unintentional;*
- *The loss must be determinable and measurable;*
- *The loss should not be catastrophic;*
- *The chance of loss must be calculable;*
- *The premium must be economically feasible.*

7. ***How does insurance differ from gambling?***

   ***Ans****. Insurance is often confused with gambling. But there are two important differences between them.*

   *1. Gambling creates a new speculative risk, while insurance is a technique for handling an already existing pure risk.*

   *2. Gambling is socially unproductive, because the winners gain comes at the expense of the loser. In contrast, insurance is always socially productive, because neither the insurer nor the insured is placed in a position where the gain of the winner comes at the expense of the loser. The insurer and the insured both have a common interest in the prevention of a loss. Both parties win if the loss does not occur.*

   *3. Gambling transactions never restore the losers to their former financial position. In contrast, insurance contracts restore the position of insureds financially in whole or in part if a loss occurs.*

8. ***How does insurance differ from speculation?***

   ***Ans.*** *Insurance is different from speculation. Insurers insure pure risks. Pure risk is defined as a situation in which there are only the possibilities of loss or no loss, while speculation deals with speculative risk. Speculative risk is defined as a situation in which either profit or loss is possible.*

   *2. The law of large numbers, which is the basic characteristic of insurance, can be applied more easily to pure risks than to speculative risks. Based on this, insurers predict future loss experience.*

   *3. Finally, society may benefit from a speculative risk even though a loss occurs, but it is harmed if a pure risk is present, and a loss occurs.*

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9. ***How does insurance differ from hedging?***

***Ans****. Though both insurance and hedging techniques are similar in that risk is transferred by a contract, and no new risk is created, there are major differences between them.*

***First, an insurance transaction*** *involves the transfer of insurable risks, because the requirements of an insurable risk can generally be met. Second, insurance can reduce the objective risk of an insurer by application of law of large numbers.*

***However, hedging is a technique of handling*** *risks that are typically uninsurable, such as protection against decline in the price of agricultural products and raw materials. In contrast, hedging typically involves only risk transfer, not risk reduction. The risk of adverse price fluctuations is transferred to speculators who believe that they can make a profit because of superior knowledge of market conditions. The risk is transferred, not reduced, and prediction of loss generally is not based on the law of large numbers.*

10. ***Differentiate between Life and Non-Life insurance.***

***Ans****. LIFE INSURANCE is a branch of private insurance and includes the following four classes of insurance coverage:*

*1.* ***Death****: called life insurance \ assurance*
*2.* ***living a certain length of time:*** *called endowments, pensions and annuities.*
*3.* ***incapacity:*** *called disability and long-term care*
*4.* ***injury or incurring a disease:*** *called health insurance, accident insurance, and medical expense insurance.*

*NON-LIFE INSURANCE is also a branch of private insurance and includes the following coverage:*

*1. property losses: damage or destruction of homes;*
*2. liability losses: payments due to professional negligence;*
*3. workers compensation and health insurance in some countries.*

11. ***What are the different uses of life and health insurance to individuals?***

***Ans.*** *The prime use of life and health insurance for individuals, families and businesses is to provide financial protection.*

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*The other uses are:*

- *Assists in making saving possible*
- *Furnishes a safe and profitable investment*
- *Encourages thrift*
- *Minimizes worry and increases initiative*
- *Furnishes an assured income in the form of annuities*
- *Helps preserve an estate.*

12. ***How does society benefit from the insurance?***

***Ans.*** *The major social and economic Benefits of insurance include the following:*

- *Indemnification for loss:*
- *Indemnification permits individuals, families and business firms to be restored to their former financial position after a loss occurs.*
- *The community also benefits because its tax base is not eroded.*
- *Less worry and fear: Worry and fear are reduced for a family and property owner both before and after a loss because the insureds know that they have insurance that will pay for the loss.*
- *Source of investment funds: The insurance industry is an important source of funds for capital investment and accumulation.*
- *Investments increase societies stock of capital goods and promote economic growth and full employment.*
- *Insurers also invest in social investments, such as housing, nursing homes and economic development projects.*
- *In addition, the total supply of loanable funds is increased by the advance payment of insurance premiums, the cost of capital to business firms that borrow is lower than it would be in the absence of insurance.*
- *Loss prevention: Society benefits with the involvement of insurance companies directly and indirectly in the loss prevention activities such as*
  - *i) Highway safety and reduction of automobile deaths*
  - *ii) Fire prevention*
  - *iii) Reduction of work-related disabilities*
  - *iv) Prevention and detection of arson losses*
  - *v) Prevention and defective products that could injure the user.*
  - *vi) Prevention of auto thefts*

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*vii) Prevention of boiler explosions*
*viii) Educational programmes on loss prevention.*

*Enhancement of credit: Insurance enhances a personal credit. And it makes a borrower a better credit risk because it guarantees the value of the borrowers collateral or gives greater assurance that the loan will be repaid.*

13. ***How might one assess the impact of the Life Insurance Industry on the general economy?***

***Ans.*** *The United Nations Conference on Trade and Development [UNCTAD] noted that an efficient insurance market can aid in overall economic development in the following ways:*

***i)*** *It can contribute to social stability by permitting individuals to minimize financial stress and worry.*
***ii)*** *It can reduce the financial burden on the state of caring for the aged and destitute.*
***iii)*** *It can benefit the economy by creating a source of financing for new businesses, housing and farming, etc.*
***iv)*** *It generates employment.*
***v)*** *It can permit more favourable terms to borrowers;*
***vi)*** *decrease the risk of default; and*
***vii)*** *minimize financial disruption due to death of key employee and owner.*
***viii)*** *It can promote better employee/employer relations and provide low-cost benefits to a broad spectrum of persons who may otherwise have been unable to obtain such protection.*

***Insurance and Economies****: A study by the Organization for Economic Cooperation and Development [OECD] observes that insurance provides at least three categories of services important to economies. These are:*

***i)*** ***Substitute for government security programmes****- The study of OECD countries found a significant negative relationship between social expenditures and life insurance premiums.*
***ii)*** ***Mobilizes savings*** *-Role of savings in economic development is crucial. Insurers act as financial intermediaries and reduce transaction costs between savers and borrowers, create liquidity and facilitate economies of scale.*

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***iii)*** ***Fosters a more efficient capital allocation.*** *Insurers gather substantial information to provide funds to the most attractive firms and projects, show continuing interest on them, monitor entrepreneurs and foster more efficient allocation of a country's scarce financial capital.*

***14. Insurance entails certain costs to Society Explain***

***Ans****:* ***The Costs of Insurance****: Although insurance offers societies great social and economic benefits, it also carries certain costs.*

*These are:*

*i) Costs of doing business*
*ii) Fraudulent claims*
*iii) Inflated claims*

*i)* ***Costs of doing business:*** *One important cost is the cost of doing business. An expense loading [the amount needed to pay all expenses, including commissions, general administrative expenses and an allowance for contingencies and profit] must be added to the pure premium to cover the expenses incurred by companies in their daily operations. However, these additional costs can be justified from the insured viewpoint of engaging in a wide variety of loss prevention activities. And from the industry viewpoint, it provides jobs to millions of workers.*

*ii)* ***Fraudulent claims:*** *A second cost of insurance encourages moral hazards like*

- *Faked auto accidents*
- *Fake slip and fall accident*
- *Phony burglaries, thefts, and vandalism*
- *False health insurance claims*
- *Murders, etc.*

*These social costs fall directly on society.*

***Inflated Claims:*** *Submission of inflated or "Padded" claims though loss is not intentionally caused by the insured like.*

- *Attorneys for Plaintiffs sue for high liability judgements than the true economic loss of the victim.*
- *Inflate the amount of damage in automobile collision claims.*

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● *Disabled persons often manage to collect disability income benefits for a larger duration.*

*In summary, the social and economic benefits of insurance generally outweigh the social costs. Insurance reduces worry and fear, contributes its service to economic and social stability and provides financial security to individuals and firms. So, the social costs of insurance can be viewed as the sacrifice that society must make to obtain these benefits.*

15. ***Explain the economic basis of life and health insurance.***

***Ans.*** *The economic basis of life and health insurance arises out of family purposes or from business purposes.*

***We can classify the FAMILY PURPOSES*** *as*

***i)*** *sources of the economic value of the human life;*
***ii)*** *preservation of family economic security;*
***iii)*** *moral obligation to provide protection.*

***BUSINESS PURPOSES***

***i)*** *Key person indemnification*
***ii)*** *Credit enhancement*
***iii)*** *Business continuation*
***iv)*** *Employee benefit plans.*

***NEEDS APROACH:*** *Under the concepts which influence demand for insurance this needs approach is having practical value. McGill segmented the needs into*

*i) Clean up Fund [hospital, doctors, nurses bills, burial expenses, legal fees, etc.] Readjustment shock [ to cushion the economic and emotional shock] Critical period income for children.*
*ii) Life income for surviving dependent spouse.*
*iii) Special needs [mortgage redemption, educational needs, emergency needs [illness, surgery, etc.]*
*iv) Retirement needs Hence the economic basis of insurance determines how much life and health insurance should be carried like any other product.*

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16. ***Explain Human Life Value Concept and its significance to life insurance***.

***Ans***. *Human life value: The human life value concept is one segment of the general theory of human capital. The relationship between life insurance and human capital has been acknowledged through the human life value concept. In 1924, the late Dr.S.S. Huebner proposed this concept. It measures the actual future earnings or value of services of an individual, i.e., the capitalized value of an individual's future net earnings after subtracting self-maintenance cost such as food, clothing and shelter.*

*In connection with life and health insurance, the economic value of a human life is derived from both (a) its earning capacity and (b) the financial dependence of other lives {or organizations} on that earning capacity.*

17. ***What are the fundamental principles related to General and Life Insurance Contracts?***

***Ans.*** *The most important fundamental principles related to General and Life Insurance Contracts are.*

*1. Utmost good faith*
*2. Indemnity*
*3. Insurable interest*
*4. Subrogation*
*5. Contribution*
*6. Proximate cause*

18. ***. Explain why an insurance contract is considered of utmost good faith and not of caveat emptor?***

***Ans.*** *An insurance contract is based on the principle of utmost good faith. The principle of utmost good faith is supported by three important legal doctrines:*

***i)*** *Representations concealment [intentional failure of the applicant for insurance to reveal a material fact to the insurer] and breach of warranty [promise made by the insured in the contract]. Each party [insured and insurer] to the contract is entitled to rely on good faith upon the representations of the other. The rule of caveat emptor [let the buyer beware] does not generally apply. The Insurer believes in the representations of the Insured. Representations of insured are statements of his or her age, weight, height occupation, state of health, family and personal history. And*

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*from the insurers side, it is intricate and highly technical. Here both the parties are under an obligation not to attempt to deceive or withhold material information from the other. The insurance contract is voidable at the insurers option if the representation is material, [if the insurer knows the true facts, the policy would not have been issued or would have been issued on different terms] false, reliance [the insurer relies on the misrepresentation in issuing the policy at a specified premium] and innocent or unintentional misrepresentation.*

19. ***Explain the principle of indemnity. And what are the exceptions to this principle of indemnity?***

***Ans.*** *It is one of the important legal principles in Insurance. The principle of Indemnity states that the insurer agrees to pay no more than the actual amount of the loss, which means the insured should not profit from a loss. And this principle has two fundamental purposes:*

*1). To prevent the insured from profiting from a loss; and*
*2). To reduce moral hazard.*

*This indemnity is different for different types of insurance. In property insurance, the basic method for indemnifying the insured is based on the actual cash value of the damaged property at the time of loss and this cash value can be determined through 3 major methods such as*

*1). replacement cost less depreciation,*
*2). fair market value, and*
*3). broad evidence rule.*

*In liability insurance, the insurer pays up to the policy limit.*
*In life insurance, the amount paid when the insured dies are the face value of the policy.*

***Life insurance is not a contract of indemnity.*** *In business income insurance, the amount is paid on the loss of profits and continuing expenses when the business is shut down because of loss from a covered peril.*

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***Exceptions:*** *The major exceptions to the principle of indemnity are*
*1). valued policy [pays the face amount ex. Payment for the loss of antiques];*
*2). valued policy laws [differ from state to state];*
*3). Replacement cost insurance [no deduction for depreciation];*
*4). Life insurance [ a valued policy].*

20. ***What problems might arise if life policies were contracts of indemnity and property, and liability policies were valued contracts?***
***Ans.*** *The principle of indemnity states that the insurer agrees to pay no more than the actual amount of the loss. In the case of life policies, the amount is paid when the insured dies. The actual amount of loss of human life value is capitalized through the face value of its policy. It is only a valued contract, and it cannot be a contract of indemnity.*

*If it is a contract of indemnity, the principle of paying actual amount of the loss cannot be operated.*

21. ***What is an insurable interest? Why is an insurable interest required in every insurance contract?***
***Ans.*** *It is an important legal principle. It states that the insured must be in a position to lose financially if a loss occurs, or to incur some other kind of harm if the loss takes place. To prevent gambling, to reduce moral hazard and to measure the amount of the insureds loss [in property insurance] all insurance contracts must be supported by an insurable interest. There is a difference between an insurable interest in property and liability insurance and life insurance.*

***IN PROPERTY AND LIABILITY INSURANCE***
***(****a) Ownership of property can support an insurable interest because he loses financially if his property is damaged.*
*(b) Potential legal liability also can support an insurable interest in the property of the customer because these firms are legally liable for damage to the customers goods caused by their negligence.*
*(c) Secured creditors also have an insurable interest in the property pledged to them.*
*(d) A contractual right also can support an insurable interest.*
*(e) In property insurance, the insurable interest must exist at the time of the loss.*

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***IN LIFE INSURANCE*** *there is no question of insurable interest if the life insurance is purchased on their own life. If the life insurance policy is purchased on the life of another person, this person should have an insurable interest on that persons' life. Close ties of blood or marriage or a pecuniary interest will satisfy the insurable interest requirement in life insurance. And this requirement must be met only at the inception of the policy and not at the time of death. Life insurance is not a contract of indemnity but is a valued policy that pays a stated sum upon the insureds death.*

22. ***Explain the principle of subrogation. Why is subrogation used?***

***Ans.*** *The principle of subrogation strongly supports the principle of indemnity. According to George E. Rejda, subrogation means substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance.*

***Example -*** *In an accident the insured victim gives legal rights to the insurer to collect damages from the negligent third party instead of collecting himself directly from the third party. The main purposes of subrogation are.*

a) *to prevent the insured from collecting twice for the same loss,*
b) *to hold the negligent person responsible for the loss and*
c) *to hold down insurance rates.*
d) *Insurer must pay before he claims subrogation.*
e) *The insured cannot impair the insurers subrogation rights.*
f) *The insurer can waive its subrogation rights in the contract either before or after the loss.*
g) *Subrogation does not apply to life insurance and to most individual health insurance contracts because life insurance is not a contract of indemnity and subrogation relates to only contracts of indemnity.*
h) *Finally, insurer cannot subrogate against its own insured because it defeats the basic purpose of purchasing insurance.*

23. ***What are the differences between subrogation and contribution?***

***Ans.*** *The principle of subrogation strongly supports the principle of indemnity. According to George E. Rejda, subrogation means substitution of the insurer in place of*

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*the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance. Subrogation and Contribution are corollaries to the principle of indemnity. Both these arise only in property insurance. Contribution arises with the liberty of double insurance which means the assured can insure the same property with more than one insurer and that too with over insurance. The conditions to satisfy this right of contribution are all the insurance must relate to the same subject matter, they should cover the same interest of the same insured, they should cover same peril, and all of them should be in force at the time of loss.*

*When all these conditions are satisfied then the insurer who has paid first in the full the assured, can claim contribution from the other co-insurers. And this claim amount depends on the aggregate of rateable clause or continental law. Though the doctrines of subrogation and contribution are important corollaries of indemnity, they differ with each other.*

***Subrogation***

- *The loss shifts from one person to another;*
- *It is against third party;*
- *It is in between insurers.*
- *One insurer and one policy*
- *The right of the insured is claimed.*

***Contribution***

- *The loss is distributed among insurers.*
- *It is in between insurers.*
- *More than one insurer*
- *The right of the insurer is claimed.*

24. ***What is the legal doctrine of proximate cause?***

***Ans.*** *The legal doctrine of proximate cause is based on the principle of cause and effect. And it does not concern itself with the cause of causes. The law provides the rule causa proxima non remota spectator" which means to be proximate, a cause must be immediate cause, which is effectual in producing that result but not the remote or*

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*distant one. And this cause has to be selected by applying common sense standards, i.e., the standards of a man in the street.*

*An insurance policy is designed to provide compensation only for insured perils [named in the policy as insured ex. fire, theft, etc.] but not for uninsured [not mentioned in the policy] and excepted or excluded [stated in the policy as excluded] perils. And the liability of the insurer arises only if the loss is caused by an insured. The selection of proximate cause is not an easy and simple task because loss may be caused by several events acting simultaneously or one after the other. It is necessary to differentiate between the insured peril, the excepted peril and the uninsured peril.*

***Application of the doctrine:*** *It is, not the latest, but the direct, dominant, operative and efficient cause that must be regarded as proximate.*

*❑ If there are concurrent causes, i.e., causes happening together and no excluded peril is involved, there is liability under the policy.*

*❑ When an insured peril and an excepted peril operate together to produce the loss, the claim will be outside the scope of the policy.*

*❑ If the results of the operation of the insured peril can be easily separated from the effects of the excluded peril, then there is liability under the policy.*

*❑ Where several events occur in unbroken sequence and no excepted peril is involved, the insurer is liable for all loss resulting from the insured peril.*

*❑ If an excepted peril precedes the happening of an insured peril, there is no claim*

*❑ If the insured peril is followed by an excepted peril, there is a valid claim for part, at least, of the loss.*

*❑ If the happening of an excepted peril is followed by the occurrence of an insured peril, as a new and independent cause, there is a valid claim for loss caused by the happening of an excepted peril.*

***Modification of the doctrine:*** *In the event of loss, the onus of proof [ or burden of proof] is on the insured. He has to prove that his loss is proximately caused by an insured peril. The onus is shifted to the insurer, if the insurer argues that the loss was caused by an excepted insurer will peril. They have to prove that the loss was proximately caused not by the insured peril, but by the excepted peril.*

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***Value of the doctrine:*** *This doctrine serves not only to define the scope of coverage under the contract but serves also to protect the relative rights of the parties to the contract.*

- ❑ *It maintains a balance between the rights of the insureds and insurers.*
- ❑ *In the absence of this rule, every loss could be claimed by the insured and every loss could be rejected by the insurer*
- ❑ *It allows for the application of common sense to the interpretation of an insurance contract to the mutual advantage of the parties.*

25. ***What is the nature of an Insurance Contract?***

***Ans.*** *The life insurance contract has distinguishing features with the contract law. An offer and acceptance, legal capacity, valid consideration and a lawful agreement are sufficient for any contract to be valid.*

*Apart from these requirements the insurance contract has some more characteristics like*

- ❑ *Adhesion*
- ❑ *Conditional*
- ❑ *Unilateral*
- ❑ *Aleatory*
- ❑ *Personal*

26. ***Give a brief note on***

- ❑ *Adhesion contract*
- ❑ *Valued policy*
- ❑ *Unilateral contract*
- ❑ *Conditional contract*
- ❑ *Aleatory contract*
- ❑ *Personal contract*

***Ans.***

***Adhesion Contract:*** *A contract of adhesion means that the insured must accept the entire contract, with all its terms and conditions which are fixed by the insurer. It is*

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*highly specialized and technical in nature and prevents it from being a bargaining contract.*

***Valued Policy:*** *Unlike property insurance, life insurance contract is a valued policy which means the insurer agrees to pay a stated sum of money irrespective of the actual economic loss which is opposite to the contract of indemnity applicable to property insurance.*

***Unilateral Contract:*** *Unlike commercial contracts which are bilateral in nature, insurance contracts are unilateral in nature. It means that only one party, the insurer, gives a legally enforceable promise and the insured cannot be legally forced to pay the premiums. But of course, the insurer is bound to accept them and provide protection to the insured when they pay premiums in timely manner.*

***Conditional Contract****: An insurance contract is a conditional contract. The insurers obligation to pay a claim depends upon the conditions which are inserted in the policy like payment of premiums, proof of death and in the case of property loss immediate notice of loss to the insurer, etc.*

***Aleatory Contract:*** *Unlike a commutative contract, an insurance contract is aleatory. It means that the values exchanged may not be equal but involve the element of chance or an uncertain event. In this, one party may receive more in value than the other. The insured may receive more than the amount he paid in premiums when the loss occurs immediately after the acceptance of a policy. And the insurer may receive more in value if the loss does not occur to the insured when the policy was in force.*

***PERSONAL CONTRACT:*** *Property insurance is a personal contract between the insurer and the insured. In this, insurer insures the owner of property against loss but not the property. Insured property is indemnified if there is any loss, and it cannot be assigned to another party without the insurers consent. But life insurance can be assigned to any one because the assignment does not alter the risk.*

27. ***What are the basic requirements of an Insurance Contract?***

***Ans****. The basic requirements of an insurance contract are:*

❑ *Offer and acceptance.*

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❑ *Consideration.*
❑ *Competent parties.*
❑ *Legal purpose.*

***Offer and acceptance:*** *An agent merely solicits or invites the prospective insured to make an offer. The applicant for insurance makes the offer, and the company accepts or rejects the offer. This accepting procedure is different for property, liability insurance and life insurance. In property insurance, the offer and acceptance can be oral or written and the agents have the power to bind their companies through the use of a binder which is a temporary contract. But in life insurance, the agent does not have the power to bind the insurer. The application for life insurance is always in writing and it should be approved by the insurer before it is in force.*

***Consideration:*** *It refers to the value that each party gives to the other. The insureds consideration is payment or a promise to pay the premium and an agreement to abide by the conditions in the policy. The insurers consideration is the promise to do certain things which are specified in the contract.*

***Competent parties:*** *Insane persons, intoxicated persons and minors are not legally competent to enter into insurance contracts.*

***Legal purpose:*** *All illegal activities which are contrary to the public interest are not enforceable. A contract should have a legal purpose.*

28. ***Describe the basic parts of an Insurance Contract****:*

***Ans.*** *Insurance contracts generally can be divided into*

❑ *Declarations*
❑ *Definitions*
❑ *Insuring agreement /Operative clause*
❑ *Exclusions*
❑ *Conditions*
❑ *Miscellaneous provisions Generally, most of the insurance contracts contain these parts:*

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***Declarations:*** *In the declaration part information regarding property or activity to be insured by the insurer is presented. It is useful for underwriting and rating purposes. It is generally found on the first page of the policy. In property insurance, the declaration page contains information regarding the identification of the insurer, name of the insured, location of the property, period of protection, amount of insurance, amount of the premium, etc. In life insurance, the declaration page contains the insureds' name, age, premium amount, issue date and policy number.*

***Definitions:*** *Insurance contracts generally contain a page of definitions. They are in either quotation marks or in bold face type. For ex. The insurer is always referred to as "we" "our" or "us" and the insured is referred to as "you" and "your".*

*These definitions make easy to determine the coverage under the policy.*

***Insuring Agreement:*** *It is the most important part in the contact. It summarizes the major promises and conditions to fulfil the promises by the insurer. In property and liability insurance there are two forms of an agreement.*
*1). Named peril policy and*
*2). all risk coverage.*

***In the named peril policy****: the policy covers only the specified perils, whereas under an all-risk coverage policy the policy covers all losses except those losses specifically excluded. All risks coverage is preferable to named perils coverage because of its broad coverage and also as the burden of proof to deny the payment is placed on the insurer unlike the insured in the named peril policy.*

*Life insurance is an example of all risks policy it covers all causes of death with some exceptions like suicide, aviation, war, etc.*

***Exclusions:*** *There are three types of exclusions in an insurance contract:*
*a). Excluded perils [ex. The peril of war is excluded in disability income policy]*
*b). Excluded losses [ex. Professional liability losses are excluded from personal liability section of homeowners policy]*
*c). Excluded property [ex. Cars and planes in a homeowners policy]*

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***Main REASONS for these exclusions are:***

❖ *Some perils are uninsurable like wars.*

❖ *Some perils are predictable declines [wear and tear and inherent vice]*

❖ *Some perils are extraordinary hazards [in cars and cabs - cabs are more prone to accidents than car]*

❖ *To avoid duplication of coverage [ ex. A car is excluded under homeowners policy because car is covered under the personal auto policy]*

❖ *To avoid moral hazard - If unlimited amount of money were covered fraudulent claims could increase.*

❖ *Finally exclusions are used because the coverage is not needed by the typical insured.*

***Conditions:*** *To meet promises by the insurer, the conditions section imposes certain duties on the insured. If the policy conditions are not met, the insurer can refuse to pay the claim.*

***Miscellaneous Provisions****: In property and liability insurance, miscellaneous provisions refer to cancellation, subrogation, and assignment of the policy; and in life insurance, grace period, reinstatement of a lapsed policy and misstatement of age, etc. Most of the policy owners make a common mistake of not reading policies and understanding the contractual provisions that appear in the policies which lead to controversies in the settlement.*

29. ***Identify the major types of exclusions typically found in insurance contracts. Why are exclusions used by insurers?***

***Ans. EXCLUSIONS*** *are basic part of any insurance contract. There are three types of exclusions in the insurance contract.*

*a). Excluded perils [ ex. The peril of war is excluded in disability income policy]*

*b). Excluded losses [ ex. Professional liability losses are excluded from personal liability section of homeowners policy]*

*c). Excluded property [ ex. Cars and planes in a homeowners policy]*

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- *To avoid duplication of coverage [ ex. A car is excluded under homeowners policy because car is covered under the personal auto policy.]*
- *To avoid moral hazard - If unlimited amount of money were covered, fraudulent claims could increase.*
- *Finally exclusions are used because the coverage is not needed by the typical insured.*

30. ***Define the term "conditions" in an insurance contract. What is the significance of the conditions section to the insured?***

***Ans.*** *The conditions section is an important part of an insurance contract.*

***The CONDITIONS*** *are provisions in the policy that qualify or place limitations on the insurers' promise to perform. So, the conditions section imposes certain duties on the insured. If the policy conditions are not met, the insurer can refuse to pay the claim.*

31. ***How do you construct an insurance contract?***

***Ans.*** *Generally speaking, the construction of the insurance contract as to its validity will be governed by the law and usages of the place where the contract is made. Like any other legal contract, the construction of an insurance contract also depends on the agreement between competent parties, resulting from an offer and acceptance, must comply with legal requirements as to form and have for its purpose a legal object. There must be a valuable consideration, an insurable interest and the contract must be made with full knowledge of material facts and be free from fraud, mistake and misunderstanding.*

*And policy forms are necessarily general in character, since they are drawn to meet a general situation and not with reference to particular cases. But because of ambiguity in the wording and varying circumstances surrounding the loss, the chance of disputes*

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*as to the interpretation may occur. To avoid this there are certain legal principles underlying the interpretation of the application, as well as of policy provisions, that are kept in mind by the courts as guiding principles in their efforts to interpret the contract.*

***Examples***

*1. Courts consider fire insurance is a contract of indemnity whereas life insurance is not a contract of indemnity though the principle of indemnity is a fundamental legal principle of an insurance contract.*

*2. In the case of contract of adhesion and endorsement, generally the courts will give the benefit of the doubt to the insured on the ground that the contract is not a bargaining contract.*

*3. Finally, it is the purpose of the law and function of the court to enforce the contract when there is no conflict or ambiguity between the two competent parties insured and the insurer.*

32. ***Describe the schedule of an insurance policy***.

***Ans.*** *Life insurance policies are generally two types.*

❑ *Narration type and*

❑ *Scheduled type.*

***In the NARRATION TYPE:*** *the contract contains continuous details in a long narration which is not popular in modern times.*

***SCHEDULED TYPE*** *is popular in modern times. It contains.*

❖ *Date of execution or operation*

❖ *parties names*

❖ *Preamble or recitals [object of the deed]*

❖ *Operative clause or consideration [ insurers' promise to pay the sum assured to the insured on the condition of scheduled payments]*

❖ *Covenants of title and conditions [covenants like*

*a). right to convey,*

*b). for freedom from encumbrances,*

*c). for further assurance and conditions like declaration of age insurable interest, valuable consideration, etc.]*

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❖ *Schedule or parcels [ accurate description of the property in property insurance and Benefit Schedule [particulars of the assured, the event insured, the sum assured, the payees, etc..] and payable schedule [particulars of the payment of dates of first premium, renewal premium etc. in life insurance.]*

❖ *Habendum [the quantity of the interest or estate of the assignee].*

❖ *Execution [prescribed articles for execution of the deed].* ❖ *Attestation of signature.*

❖ *Delivery -unless a deed is delivered it will not be operative.*

*There should be a great care in drafting the policy. There should not be any ambiguity in the wording, and it should reflect the intention of the both the parties.*

33. ***What is an endorsement or rider? If an endorsement conflicts with a policy provision, how is the problem resolved?***

***Ans.*** *Insurance contracts generally contain endorsements and riders. The terms endorsements and riders are interchangeable.*

***Endorsements in property and liability insurance*** *modify, extend or delete provisions found in the original policy.*

*In life and health insurance, riders can be added that increase or decrease benefits, waive a condition of coverage present in the original policy or amend the basic policy. If an endorsement is contrary to a law or regulation, the policy is read and applied as if that endorsement did not exist.*

34. ***Why do deductibles appear in insurance contracts? Identify some deductibles that are found in insurance contracts***.

***Ans.*** *This provision is generally found in property, health and auto insurance contracts and not in life insurance contracts because the insureds' death is a total loss and deductibles reduce the face amount of insurance. According to "Rejda", a deductible is a provision by which a specified amount is subtracted from the total loss payment that otherwise would be payable.*

*Main purposes of these deductibles are.*

❖ *To eliminate small claims [expensive to handle and process].*

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❖ *To reduce premiums [larger deductibles are preferable to smaller deductibles].*

❖ *To reduce moral and morale hazard [because of it insured may not profit out of loss and it encourages insured to be careful of his property] Deductibles in property insurance are two types:*

❖ *Straight deductibles [applies to each loss]*

❖ *Aggregate deductibles [all covered losses are added together till they reach a certain level for a particular period.] Deductibles in health insurance generally are:*

❖ *Calendar year deductible [aggregate]*

❖ *Corridor deductible [it is a supplement plan to major medical expense plan]*

❖ *Elimination [waiting] period deductibles [disability income contract for the loss of work earnings]*

35. ***What is Coinsurance?***

***Ans****. It is a contractual provision in commercial property insurance. Under this clause the insured must insure the property for a stated percentage of its insurable value [actual cash value or replacement cost] to collect in full for a partial loss. If this coinsurance is not met at the time of loss, the insured must share in the loss as a co-insurer.*

***The coinsurance formula is =Amount of insurance carried/Amount of Insurance Required x loss = amount of recovery***

*Amount of insurance required Amount of insurance required is the actual cash value of the property x % coinsurance clause in the policy.*

*The precaution in applying this coinsurance formula is that the amount paid can never exceed the amount of the actual loss and should be limited to the face amount of the insurance.*

*The main PURPOSE of co-insurance is to achieve equity in rating [ the insured who makes co-insurance receives a rate discount and who is under-insured is penalized through application of the coinsurance formula] But practical PROBLEMS IN OPERATING COINSURANCE clause arise from changes in the actual cash value of the property due to inflation or with increase in inventory values with increase in stock, etc.*

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36. ***Describe a typical coinsurance clause [percentage participation clause] in a major medical policy****?*

***Ans.*** *Coinsurance in health insurance is technically known as Percentage Participation Clause. Under this the insured has to pay a certain percentage of medical expenses in excess of the deductibles. The PURPOSE to introduce this participation is.*

*1). To reduce premiums, and*

*2). To prevent overutilization of policy benefits like expensive medical services.*

37. ***Underwriting is said to be the heart of insurance operations. Explain the factors that are considered by insurance companies when underwriting vehicle exposures?***

***Ans:*** *Generally, insurers measure the desirability of a vehicle by analysing the characteristics of the insured drivers. Many systems are used for evaluating the loss potential of private as well as commercial automobile applicants. Some of the major underwriting factors that are considered for evaluating the loss potential are:*

*i) Age of operators;*
*ii) Age and type of automobile;*
*iii) Use of the automobile;*
*iv) Driving record;*
*v) Territory or radius of operation;*
*vi) Sex and marital status;*
*vii) Occupation;*
*viii) Personal characteristics;*
*ix) Physical condition;*
*x) Safety equipment.*

***Age of operators****: Usually, considerably higher rates are charged for young drivers. This is due to the greater involvement of young drivers in fatal accidents.*

***Age and type of automobile.*** *A correlation exists between the age of the vehicle and its mechanical condition. The type of automobile may also determine underwriting acceptability. Sports and luxury cars tend to produce higher losses than other models.*

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***Use of the automobile:*** *Underwriting of automobiles also takes into account the type of roads the automobile runs on (highways or city roads,) the distance covered by it on a daily basis, and the purpose for which the automobile is used (for business use, for pleasure, etc.)*

***Driving record:*** *The record or prior loss history of the driver is taken into account when evaluating a private passenger automobile applicant.*

***Territory or radius of operation****: Accident frequency depends not only on the territory in which the automobile is used but also on the distance travelled by the automobile.*

***Sex and marital status:*** *young female drivers are considered to be more careful drivers than young male drivers and are therefore considered better than male drivers in terms of loss exposure.*

***Occupation:*** *Some occupations require extensive driving. This increases the probability of loss.*

***Personal characteristics****: The credit information of applicants is often used by insurers to evaluate their financial stability. Underwriters have discovered a correlation between poor credit risk and poor insurance risk.*

38. ***What are the risk dimensions of underwriting in the insurance business as opposed to the securities business?***

***Ans.*** *Investors seek diversification of risks and commensurate market rates of return. Otherwise, it may lead to pile up of high price/earnings (P/E) multiple stocks. Therefore, generally, investors try to maintain a balance between the real risk and the perceived risk and desire to have a balance of higher and lower P/E stocks. P/E ratio measure risk adjusted rates of return. They indicate the degree of risk as well as the expectation of earnings and cash flows in the near term. Buyers of insurance want a stable and credit quality market, which provides them with a reasonable ability to forecast and budget related costs. The risk involved in the insurance business is the unexpected or fortuitous causes of loss defined in the policies. Underwriting firms, on a portfolio basis, focus on matching assets and liabilities. However, they maintain a reasonable degree of liquidity in order to pay claims.*

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*Further, in the insurance business, the insurer has got the responsibility towards its policyholders apart from the investment philosophy of maintaining safe high-credit quality (lower yields) fixed income investments. Generally, insurers maintain a rate of return between 6 and 10 per cent. Insurers more or less abide by the regulations of the regulatory authorities to avoid losses. As per the regulations, they hold stocks in their investment portfolios.*

*In the securities business, investors seek a balance of risk and slight tilt towards high risk and expect an array of returns. The capital market firms proclaim about the high returns in the market. But this is possible because their portfolios would have large inventories of higher risk investments. For example, there is big correction in the market in recent times with the bursting of Information Technology bubble. Therefore, those who invested heavily in such stocks are now correcting their book values to the lower of cost or market as required by generally accepted accounting principles (GAAP).*

39. ***A majority of insurance claims pertain to losses caused by fire. Underwriting of natural disasters also constitutes a major portion of insurance activities. What are the possible losses that can arise due to disasters? Suggest a broad framework for disaster management in order to minimize such losses?***

***Ans.*** *A natural disaster is defined as any natural phenomenon, which causes such widespread losses to live, property or the environment, from which the affected population cannot recover without external assistance. Cyclones, floods, storms, earthquakes, drought, forest fire, avalanches, etc. are some examples of natural disasters.*

*Disasters are mostly natural, but they can also be caused by man. The world is prone to natural disasters which are caused by the interplay of natural forces and human activities. A broad categorization of losses that arise due to natural disasters are:*

***Direct losses:*** *These losses are in the form of damage to buildings, its contents, infrastructure, loss of human lives, costs of clearing the debris, restoration, loss mitigation and disposal.*

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***Indirect losses:*** *These are losses that result due to business interruption and power failure, costs of transportation, detours, assistance, storage, accommodation, provision of essentials, and communications.*

***Intangible losses:*** *These include psychological trauma and impairments, losses of intangible values, and losses due to evacuation from areas under risk. A risk management plan consists of the following steps:*

***I)*** ***Risk Identification:*** *It involves identifying the extent and intensity of past events, areas that are hit by one event at the same time, potential risk areas, and climatic trends.*

***II)*** ***Risk Evaluation:*** *It involves assessing the probability of the occurrence of a disaster and the severity of the disaster.*

***III)*** ***Risk Control****: This step covers measures aimed at avoiding, eliminating or reducing the chances of occurrence of loss-producing events and eliminating the severity of the disasters that could happen.*

***IV)*** ***Risk Retention:*** *This step pertains to the ability of the country or the society in particular to withstand disasters. There are two aspects of risk retention psychological and financial. The psychological aspects have a lot to do with the involvement of government machinery and voluntary agencies and also to a great extent on the tenacity of the people.*

***V)*** ***Risk Transfer:*** *This is a risk financing method and provides a means for handling risk which have a high severity of losses and one cannot afford to retain such risks.*

*40.* ***What are the parameters to decide whether a particular risk is insurable or not?***

***Ans.*** *The key parameters to decide whether a particular risk is insurable or not are:*

*I)* ***Mutuality:*** *A large number of people exposed to risk must combine to form a risk community.*

*II)* ***Need:*** *The occurrence of the anticipated event must place the insured in a condition of financial need.*

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III) ***Assessability:*** *The expected loss burden must be assessable.*

IV) ***Randomness:*** *The time at which the event occurs must not be predictable and the occurrence of the event must be independent of the will of the insured.*

V) ***Economic Viability:*** *The community organized by the insured persons must be able to meet its future loss-related financial needs on a planned basis.*

VI) ***Similarity of threat:*** *The insured community must be exposed to the same threat.*

*Further, the occurrence of the anticipated event must create the need for funds in the same way for all those affected.*

41. ***In reinsurance transactions, what does retention mean? What are the steps being considered by the Insurance Regulatory and Development Authority to improve the retention capacity of domestic insurance companies?***

***Ans.*** *Reinsurance agreements involve a transfer of loss exposures assumed by the primary insurer to the reinsurer. However, the reinsurer does not assume all the exposures to which the primary insurer is exposed. The reinsurance agreement requires that a portion of the exposure, known as retention, be retained by the primary insurer.*

*Domestic insurance companies are facing low retention capacities owing to the increasing outflow of their premium income from the country. The outflow of premium is a result of the large amounts of reinsurance taken by private insurance companies, either with their parent company abroad or with other large reinsurance companies.*

*Private sector insurance companies have retained only a small part of the risk that they have insured and reinsured a major portion of the risk insured owing to under-capitalization. Further, reinsurers have hiked their premiums to close to one percent of the sum assured. With this, the low retention capacity of the private insurance companies will lead to an outflow of premiums to the extent of 40 percent of the gross domestic premium income of all general insurance companies. In contrast to the insurance companies in the private sector, insurance companies in the public sector have seldom taken large reinsurance cover. Even in the worst cyclical phase, the reinsurance taken by the four public sector insurance companies has hardly exceeded 7 percent of the gross domestic premium income.*

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*This has been possible because of the high retention capacity of public sector insurance companies with each company having an average capitalization of about Rs. 2,500 crore. Thus, in order to cap premium outflows from the country and improve the retention capacity of domestic insurance companies, the Insurance Regulatory and Development Authority is considering the following measures:*

❑ ***Coinsurance****: It is an arrangement between all domestic insurance companies identical to consortium financing by banks. In coinsurance, there will be one lead insurer with several other insurance companies. All the member companies in the arrangement will have a share in premium collections. They will share the claims on a pari passu basis (at an equal rate or in an otherwise fair way, with no person or group taking percent over another).*

❑ ***Syndicated insurance****: This is identical to coinsurance arrangement, except that the members of the syndicate have the option to exit the agreement.*

❑ ***Increased Capitalization:*** *Increasing the capitalization of the new private sector companies in the general insurance industry is likely to improve the retention capacity of private insurers.*

42. ***Discuss the objectives of ratemaking activities in an insurance organization.***

***Ans.*** *Ratemaking is one of the functions of actuaries. The basic objective of ratemaking is to develop a rate structure that will enable the insurer to compete effectively for business while earning a reasonable profit.*

*Apart from this primary objective, there are certain secondary objectives. They are.*

❑ *Corporate objectives;*

❑ *Regulatory objectives.*

***Corporate objectives*** *- Primary insurers prefer rates that are flexible, easy to apply, promote loss control and provide for contingencies. However, in reality, this is not possible to achieve. Primary insurers prefer stable rates because the process of fixing a rate is very expensive. In addition, frequent changes would lead to customer dissatisfaction. To promote loss control, the rating system should provide lower rates to those policyholders who undertake loss prevention measures. Apart from this, the*

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*rating system should be understandable to agents, brokers, underwriters and especially policyholders (who have little expertise regarding insurance matters).*

***Regulatory objectives:*** *According to regulatory objectives, rates*

- ❑ *Should be adequate*
- ❑ *Should not be excessive*
- ❑ *Should not be unfairly discriminatory*

*If the rate does not comply with regulatory norms, it may invite harsh regulatory actions and unfavourable legislation.*

43. ***A property-liability insurer basically operates two kinds of businesses. Comment on this statement and also explain the role of investment income in ratemaking.***

***Ans.*** *A property liability insurer basically operates two kinds of businesses:*

- ❑ *Insurance business*
- ❑ *Investment business.*

***INSURANCE BUSINESS:*** *Insurance business operations include writing policies, collecting premiums, and paying claims. This is the revenue generator for an insurance company. The success of an insurer depends on the success of his insurance business.*

***INVESTMENT BUSINESS:*** *This business includes the purchase of bonds, stocks and other investment vehicles for earning profit. In the investment business, profit is derived from three sources:*

I) *Investment income,*
II) *Realized capital gains, and*
III) *Unrealized capital gains.*

*Role of investment income in ratemaking Previously, investment income was not considered by insurers when calculating insurance rates. But, of late, in some countries, it is considered in the calculation of rates. Investment profits can be reflected in ratemaking by first estimating the realizable investment profit from a particular insurance line, and later deducting that amount from the expense loading used in the rates.*

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*The inclusion of investment profits in ratemaking may affect liability insurance rates more than property insurance rates because the amount of investment profit earned on an insurance line would largely depend on the loss reserve and the unearned premium reserves.*

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