UNIT III SERVICE BUSINESS - I

CHAPTER 15

INSURANCE

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Learning Objectives

To enable the students to

i. learn the concept of Insurance

ii. understand the meaning and principles of Insurance and its types

iii. know various risks in business

iv. legal protection through IRDA

Introduction

"Uncertainty is inherent in human life"

Every business is exposed to different types of risks such as fire, theft, accident etc. Some of the risks can be transferred to specialized institution known as Insurance Companies. Insurance substitute this uncertainty by providing financial compensation. Insurance is nothing but socialization of risks. Insurance companies indemnify the loss of the insured.

15.01 Meaning and Definition of Insurance

Insurance is a contract between the insurer and the insured under which the insurer undertakes to compensate the insured for the loss arising from the risk insured against, in consideration the insured agrees to pay premium regularly. The person whose risk insured is called the insured or assured. The person who agrees to compensate the loss arising from the risk is called the insurer or assurer (or underwriter)

Insurance is a means of providing monetary coverage against loss caused by natural or man-made factors

Definition

"Insurance is a plan by themselves which large number of people associate and transfer to the shoulders of all, risk that attacks to individuals"

- According to John Merge

15.02 Principles of Insurance

Insurance concept was started to distribute risk among group of people. Co-operation is the basic principle behind every Insurance contract. The following are the important principles of Insurance

1. Utmost Good Faith

According to this principle, both insurer and insured should enter into contract in good faith. Insured should provide all the information that impacts the subject matter. Insurer should provide all the details regarding insurance contract. Both the insurer and the insured should display good faith towards each other in regard to the contract.

Example: Mr. M is a heart patient. But he hides this fact to the LIC while taking a life policy. On his death due to a heart attack, LIC can refuse to pay compensation to his legal representative because a material fact was not disclosed by the insured.

2. Insurable Interest

The insured must have an insurable interest in the subject matter of insurance. Insurable interest means some pecuniary interest in the subject matter of the insurance contract. The insured must have an interest in the preservation of the thing or life insured, so that they will suffer financially on the happening of the event against which they are insured.

Example, a businessman has insurable interest in his stock of goods.

3. Indemnity

Indemnity means security or compensation against loss or damages. In insurance, the insured would be compensated with the amount equivalent to the actual loss and not the amount exceeding the loss. This principle ensures that the insured does not make any profit out of the insurance. This principle of indemnity is applicable to property insurance alone.

Example: A businessman gets his sock of goods insured for ₹ 5,00,000. If the goods are destroyed by the fire, the insurance company will be liable to pay compensation for the loss caused to the insured. However, maximum compensation shall be ₹5,00,000 even if loss is more than this.

"The principle of indemnity is not applicable to life insurance because one cannot estimate the loss due to the death of a person"

4. Causa Proxima

The word 'Causa proxima' means 'nearest cause'. According to this principle, when the loss is the result of two or more cause, the proximate cause, i.e. the direct. The direct, the most dominant and most effective cause of loss should be taken into consideration. The insurance company is not liable for the remote cause.

DO YOU KNOW?

Material Fact

A material fact is one which goes to the root of the insurance contract i.e., a fact is material if it can influence the insurer in accepting or declaring the risk or in fixing conditions of insurance or rate of premium.

In the previous example,where ‘fire’ is accepted as the proximate cause of loss and if there is no fire and goods are destroyed due to excessive heat, the insurance company would not be liable to pay compensation.

5. Contribution

The same subject matter may be insured with more than one insurer then it is known as ‘Double Insurance’. In such a case, the insurance claim to be paid to the insured must be shared on contributed by all insurers in proportion to the sum assured by each one of them. It may be noted that in case of multiple insurance, the insured can claim the loss from any of the insurers subject to the condition that the insured cannot recover more than the amount of actual loss from all taken together.

Example: A businessman gets his factory insured against fire for ₹10,00,000 with insurer A and ₹5,00,000 with insurer B. Due to fire, a loss of ₹1,50,000 occurred. Then, insurers A and B will contribute the loss in the ratio of 2:1. A will pay ₹1,00,000 and B will pay ₹ 50,000.

6. Subrogation

Subrogation means ‘stepping the shoes on others’. According to this principle, once the claim of the insured has been settled, the ownership right of the subject matter of insurance passes on to the insurer. Otherwise, the insured will realize more than the actual loss which goes against the principle of Indemnity. This is because the insured cannot make any profit by selling the damaged property

Example: Mr. B gets his motor car insured. Some of its parts got damaged at a road accident. He gets the insurance claim and gets the damaged parts replaced with new ones. In this case the damaged parts will be taken by the insurance company. The insured has no right over the damaged parts since they had already got compensation for the damaged parts.

7. Mitigation

In case of a mishap, the insured must take off all possible steps to reduce or mitigate the loss or damage to the subject matter of insurance. This principle ensures that the insured does not become negligent about the safety of the subject matter after taking the insurance policy. Insured is expected to act in a manner as if the subject matter has been insured. If appropriate steps are not taken to save the property then the insured may not get the full compensation from the insurer.

Example: When a factory is insured against fire and theft by insured, insured must take all possible precautions and steps to prevent those from the risk.

15.03 Types of Insurance

Insurance covers different types of risks. All contracts of insurance can be broadly classified as follows:

1. Life Insurance (or) Life Assurance
2. Non-life Insurance (or) General Insurance

It can be further classified into: (i) Fire Insurance; (ii) Marine Insurance; (iii) Health Insurance and (iv) Miscellaneous Insurance.

1. Life Insurance

Life Insurance may be defined as a contract in which the insurance company called insurer undertakes to insure the life of a person called assured in exchange of a sum of money called premium which may be paid in one lump sum or monthly, quarterly, half yearly or yearly and promises to pay a certain sum of money either on the death of the assured or on expiry of certain period.

Importance of Life Insurance

a) Life insurance provides protection to the family at premature death of an individual.

b) It gives adequate amount at an old age when earning capacities are reduced.

c) Life insurance is not only a protection but is a sort of investment because a certain sum is returnable to the assured at the time of death or at the expiry of a certain period.

Types of Life Insurance Policies

Life insurance policies are of many kinds. Some of them are given below:

i) Whole Life Policy

In this kind of policy, the sum insured is payable only on the death of the assured to the beneficiaries or heir of the deceased. The premium is payable for a fixed period (20 or 30 years) or for the whole life of the assured. If the premium is payable for a fixed period, the policy will continue till the death of the assured.

ii) Endowment Life Assurance Policy

Under this type of policy, the insurer undertakes to pay the assured a specified sum, on the attainment of a particular age or on his death, whichever is earlier. In case of death of the assured before he attains the specified age, the sum is payable to his legal heir or the nominee. Otherwise, the sum is paid to the assured, when he attains a particular age. Thus, the endowment policy matures after a limited number of years.

iii) Joint Life Policy (JLP)

The policy is taken up jointly on the lives of two or more persons is known as Joint Life Policy. On the death of any one person, the assured sum or policy money is paid to the other survivor or survivors. The premium is paid jointly or by either of them in installments or lump sum.

Usually this policy is taken up by husband and wife jointly or by two partners in a partnership firm, where the amount is payable to the survivor on the death of either of the two.

iv) Annuity Policy

Under this policy, the assured sum or policy money is payable in monthly or annual instalments after the assured

DO YOU KNOW?

Life Insurance should more properly be called as “Life Assurance” because the risk insured here is certain and natural. Only the tie of occurrence is uncertain.

attains a certain age. In this case, either the whole amount of the premium is paid once or premium is paid in instalments over a certain period. This policy is useful to those who prefer a regular income after a certain age.

v) Children's Endowment Policy

This policy is taken to provide funds for the education or marriage of children. For example, Jeevan Anurag Policy. In this policy, the amount is payable by the insurer when the children attain a particular age. The premium is paid by the person entering into the contract. However, no premium will be paid, if he/she dies before the maturity of the policy.

2. Non – Life Insurance

It refers as the insurance not related to human but related to properties.

(a) Fire Insurance

Fire insurance is a contract whereby the insurer, in consideration of the premium paid, undertakes to make good any loss or damage caused by a fire during a specified period upto the amount specified in the policy.

A claim for loss by fire must satisfy the following two conditions:

(i) There must be actual loss; and

(ii) Fire must be accidental and non-intentional.

Essential elements of Fire Insurance Contract

1. The insured must have insurable interest both at the time of insurance and at the time of loss.
2. The contract is based on the principle of utmost good faith.
3. It is based on the principle of strict indemnity.
4. Fire must be the proximate cause of damage or loss.

(b) Marine Insurance

Marine insurance is a contract of insurance under which the insurer undertakes to indemnify the insured in the manner and to the extent thereby agreed against marine losses. The insured pays the premium in consideration of the insurer's (underwriter's) guarantee to make good the losses arising from marine perils or perils of the sea.

Marine perils can be collision of ship with the rock, fire, ship attacked by the enemies, etc. These perils cause damage, destruction or disappearance of the ship and cargo and non-payment of freight. Through marine insurance policy, the insurer undertakes to compensate the owner of a ship or cargo for complete or partial loss at sea.

Essential elements of Marine Insurance Contract

1. It is based on the principle of indemnity
2. The contract is based on utmost good faith.
3. The insurable interest must exist at the time of loss.
4. The principle proximate cause will apply to marine loss only.

Types of Marine Insurance Policies

The three different types of marine insurance policies are:

1. Hull or Ship Insurance:

When a ship is insured against any type of danger, it is known as hull insurance. This policy is taken to indemnify the insured for losses caused by damage to ship.

2. Cargo Insurance:

When a marine insurance policy is taken by the cargo owner to be compensated for loss caused to his cargo during the Voyage, it is known as cargo insurance. The cargo to be transported by ship is subject to many risks, like risk of theft, loss of goods in voyage, etc.

3. Freight Insurance:

When a marine insurance policy is taken to guard against non-recovery of freight, it is known as freight insurance. The shipping company is mainly interested in freight, which it gets either in advance or on the arrival of goods. However, it will not get the freight, if the goods are lost during transit. So, to insure the freight, it takes freight insurance.

A contract of marine insurance covers the ship, cargo and the freight.

(c) Health Insurance

In mid 80's, most of the hospitals in India were government owned and treatment was free of cost. With the advent of Private Medical Care, the need for Health Insurance was felt and various Insurance Companies introduced Health Insurance as a Product. Presently the health insurance exists primarily in the form of 'Mediclaim policy'.

Health insurance policy is a contract between an insurer and an individual or group, in which the insurer agrees to provide specified health insurance at an agreed upon price (premium).Disability resulting from illness or accident may be peril to family because it not only cuts off income but also creates large medical expenses. Health insurance is taken as safeguard against rising medical costs. It provides risk coverage against unforeseen health expenditure that may result in financial hardship.

Types of Health Insurance

There are mainly three types of Health Insurance covers:

1. Individual Mediclaim

It covers the hospitalization expenses for an individual up to the sum assured limit

2. Family Floater Policy

It covers the hospitalization expenses for entire family up to the sum assured limit.

3. Unit Linked Health Plans

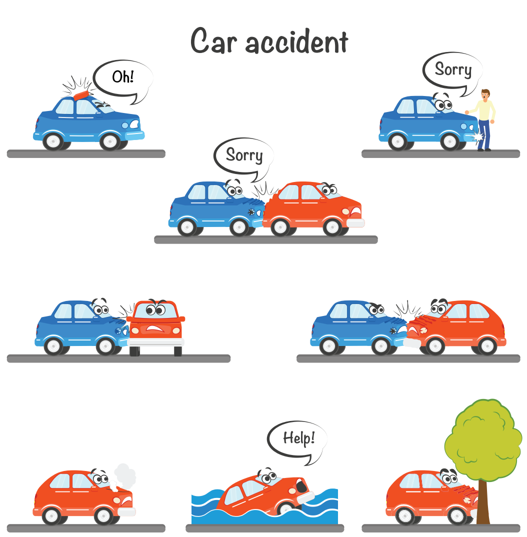
This policy combines health insurance with investment and pays back an amount at the end of the insurance terms.

Health Insurance provides following types of coverage:

Medical expenses – It covers the expenses of hospitalization/nursing home bills and doctors' services.

Disability income – It replaces the income lost while the insured is unable to work.

Claims Settlement



There are two ways by which health insurance claims are settled:

a. **Cashless:** The claim amount needs to be approved by the TPA and the hospital settles the amount with the TPA. (TPA or Third Party Administrator is a middleman between Insurer and the Customer)

b. **Reimbursement:** The insured avails himself or herslef of the treatment and settles the hospital bills directly at the hospital. The insured can claim reimbursement later on by submitting relevant bills/documents for the claimed amount to the TPA

(d) Miscellaneous Insurance

(i) Motor Vehicle Insurance

This is also known as 'Auto Insurance'. This policy comes under General Insurance. This insurance has become very popular and is gaining importance. In motor insurance the owner's liability to compensate people who were killed or injured through an accident is passed on to the insurance company. The premium rate under this policy is standardized.

(ii) Burglary Insurance

This policy comes under the category of insurance of property. Any loss of damage

DO YOU KNOW?

CASCO INSURANCE

The motor casco is a voluntary insurance. It covers the motor vehicle against various risks such as fire, natural disaster, theft of the motor vehicle or the equipment installed therein, a breakdown as a result of collision with another vehicle or object on the road etc.

due to theft, larceny, burglary, house-breaking and acts of such nature are covered by this policy. Compensation of actual loss is done.

i) Insurable interest need not exist at the time of policy but should be present at the time of theft.

ii) The principle of causa proxima is also applied to it. The insurance company would pay only if the proximate cause falls under the policy

(iii) Cattle Insurance

This is a bond in which a sum of money is secured to the insured in case of an event of death of animals like bulls, buffaloes, cows and heifers. The cause of death may be an accident, disease or pregnant condition, etc.

(iv) Crop Insurance

This policy is to provide financial support to farmers in case of a crop failure due to drought or flood. It generally covers all risks of loss or damages relating to production of rice, wheat, millets, oil seeds and pulses etc.

(v) Sports Insurance

This policy is a comprehensive cover for amateur sports persons regarding their sporting equipment, personal effects, legal liability and personal accident risks. If desired it can also be extended to a named member of the insured's family but it is not available to professional sports person. The cover is generally for following sports or more: Angling, badminton, cricket, golf, lawn tennis, squash and use of sporting guns.

(vi) Amartya Sen SikshaYojana

The General Insurance Company offers to secure the education of dependent children under this policy. If the assured parent/legal guardian goes through any bodily injury resulting solely and directly from accident due to external, violent and visible means and if such injury shall within twelve calendar months of its occurrences be the only direct cause of his/her death or permanent total disablement, the insurer shall indemnify the insured student in respect of all covered expenses to be incurred from the date of occurrence of such accident till the expiry of policy or completion of the duration of covered course whichever occurs first and such indemnity shall not exceed the sum assured as stated in the policy schedule.

(vii) Rajeswari Mahila Kalyan Bima Yojana

This policy envisages to provide relief to the family members of insured women in case of their death or disablement due to any kinds of accidents and/or death and / or disablement arising out of other factors incidental to women only.

Terms used in Insurance

I. Nomination

According to Sec 39 of the Insurance Act, 1938, nomination is the process of appointing or nominating a person or persons by the insured, to receive the payment of the policy, in the event of death. The person who is authorized to receive the payment of the policy is called nominee. If the policy matures by expiry of time, the policy amount is payable to the insured himself and not to the nominee.

ii. Surrender Value

The surrender value is the cash value of the policy which is payable to policyholder if he decides to terminate the contract. This surrender value is usually obtained from the paid-up-value by applying a percentage factor. This percentage factor will vary according to the plan of assurance, the original term of the policy and the duration elapsed since the commencement of the policy. The surrender value signifies the amount of premiums paid which is returned to the policyholder at the time of surrendering the policy.

iii. Re-Insurance

It is a contract of insurance, in which an insurer enters into a contract with another insurer to insure the whole or a part of risk covered by the first insurer. It happens when an insurance company feels that it cannot bear the entire risk alone by itself. In such case, it transfers a part of the risk to other insurance companies.

iv. Double Insurance

When more than one insurance policy is taken to cover the same subject matter i.e. risk, then it is known as Double Insurance.

BUSINESS RISKS

Insurance covers various risks of traders and others. Therefore the concept of risk need to be studied. The term 'business risk' refers to the possibility of inadequate profits or even losses due to uncertainties or unexpected events. Risk is different from uncertainties.

Nature of Business Risks

Business risks can be understood in terms of their peculiar characteristics:

(i) Business Risks Arise Due to Uncertainties

Uncertainty refers to the lack of knowledge about what is going to happen in the future. Natural calamities, change in demand and prices, changes in government policy, improvement in technology, are some of the examples of uncertainty which create risks for business because the outcome of these future events is not known in advance.

(ii) Risk is an Essential Part of Every Business

Every business has some risk. No business can avoid risk, although the amount of risk may vary from business to business. Risk can be minimized, but cannot be eliminated.

(iii) Degree of Risk Depends Mainly Upon the Nature and Size of Business

Nature of business (i.e. type of goods and services produced and sold) and size of business (i.e., volume of production and sale) are the main factors which determine the amount of risk in a business. For example, a business dealing in fashionable items has a high degree of risk. Similarly, a large-scale business generally has a higher risk than what a small scale business has.

(iv) Profit is the Reward for Risk Taking:

'No risk, no gain' is an age-old principle which applies to all types of business. Greater the risk involved in a business, higher is the chance of profit. An entrepreneur undertakes risks under the expectation of higher profit. Profit is thus the reward for risk taking.

Types of Business Risks

The business risks may be classified as

i) Speculative Risks

Speculative risks are the kind of risks which have the possibility of gain as well as the possibility of loss. Such risks are the result of market conditions. Favourable market conditions result in gains whereas unfavourable market conditions result in losses.

Example: Use of better technology helps to produce better quality products at cheaper prices. This may increase the demand and thus result in higher profits.

ii) Pure Risks

Pure risks are the type of risks where business suffers loss only if the risk occurs. Non-occurrence of such risks leads to absence of loss.

Example: Business may suffer loss only if fire, theft or strike occurs.

iii) Insurable Risks

Insurable risks are the type of risks where business can insure the probable losses by paying a predetermined premium to an insurance company. At the time of loss the insurance company pays compensation on the basis of agreed terms and conditions. Loss arising from natural and physical risks can be insured as the probability of risk can be determined.

Example: Company can insure its stock against fire or theft and if it loses its stock due to fire or theft in office, the insurance company pays compensation only upto a extent of the value lost.

iv) Uninsurable Risk

Losses arising from unforeseen natural events, political changes or trade cycles are called uninsurable risks. Loss due to earthquake or flood or cyclone cannot be estimated and their probability cannot be calculated. Government directly takes care of the affected persons. Losses to businesses due to policy decisions of ruling political parties in a country, or due to economic depression cannot be insured. These uninsurable risk events

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are called uncertainties. The concept of risk is different from uncertainty. During uncertain events decisions cannot be taken.

Causes of Business Risks

Business risks arise due to a variety of causes, which are classified as follows:

(i) Natural Causes

Human beings have little control over natural calamities like flood, earthquake, lightning, heavy rains, famine, etc. These result in heavy loss of life, property, and income in business.

(ii) Human Causes

Human causes include such unexpected events like dishonesty, carelessness or negligence of employees, stoppage of work due to power failure, strikes, riots, management inefficiency, etc.

(iii) Economic Causes

These include uncertainties relating to demand for goods, competition, price, collection of dues from customers, change of technology or method of production, etc. Financial problems like rise in interest rate for borrowing, levy of higher taxes, etc., also come under this type of causes as they result in higher unexpected cost of operation of business.

(iv) Other Causes

These are unforeseen events like political disturbances, mechanical failures such as the bursting of boiler, fluctuations in exchange rates, etc. which lead to the possibility of business risks.

15.04 Insurance Regulatory Development Authority of India (IRDAI)

IRDAI – Insurance Regulatory Development and Authority of India is the statutory, independent and apex body that governs, regulates and supervises the Insurance Industry in India. It was constituted in the year 2000 by Parliament of India Act called IRDAI Act, 1999. Presently IRDAI headquarters is in Hyderabad.

Organisational Setup of IRDAI

IRDAI is a ten member body consists of

i. One Chairman (For 5 years & Maximum age – 60 years)

DO YOU KNOW?

1. Employee Group Insurance in India.
2. Passengers (All transport) Insurance Scheme.

For future Learning

David beckham, the famous football player from the UK first insured his legs for about 100 million pounds. as he became one of the most populous soccer players in the world, he insured his whole body for $195 million to cover the risks of injury, illness, and disfigurement. This policy would cover him financially if he were to lose any of the endorsements that depended on his looks. $195 is approximately equal to $12,337.65 million.

ii. Five whole-time Members (Not 5 years and Maximum Age – 62)

iii. Four part-time Members (Not more than 5 years)

iv. The chairman and members of IRDA are appointed by ;the Government of India

Objectives of IRDAI

1. To promote the interest and rights of policy holders.
2. To promote and ensure the growth of Insurance Industry.
3. To ensure speedy settlement of genuine claims and to prevent frauds and malpractices
4. To bring transparency and orderly conduct in financial markets dealing with insurance.

Section 14 of IRDAI Act, 1999 lays down the duties and functions of IRDAI:

i. It issues the registration certificates to Insurance Companies and regulates them.

ii. It provides license to insurance to intermediaries such as agents and brokers after specifying the required qualifications and set norms/code of conduct for them.

iii. It promotes and regulates the professional organizations related with insurance business to promote efficiency in insurance sector

iv. It regulates and supervises the premium rates and terms of insurance covers.

v. It specifies the conditions and manners, according to which the insurance companies and other intermediaries have to make their financial reports.

vi. It regulates the investment of policyholder's funds by insurance companies.

vii. It also ensures the maintenance of solvency margin (company's ability to pay out claims) by insurance companies.

Key Terms

Uberrimaefidei, Indemnity, Causa Proxima, Subrogation, Mitigation, Surrender value

Student Activity

a) Sanjana insured her factory for ₹5 Lakh against fire. Due to fire she suffered a loss of ₹2 lakh. How much amount she can recover from the insurance company? Why?

b) A factory owner gets his stock of goods insured, but he hides the fact the electricity board has issued him a statutory warning letter to get his factory's wiring changed. Later on, the factory catches fire due to short circuit of wiring. Can he claim compensation?

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Exercise

I. Choose the Correct Answer

1. The basic principle of insurance is ________

   a) Insurable Interest

   b) Co-Operation

   c) Subrogation

   d) Proximate causa

2. ______ is not a type of general insurance

a) Marine Insurance

b) Life Insurance

c) Fidelity Insurance

d) Fire Insurance

3. Which of the following is not a function of insurance?

a)Lending Funds

b) Risk sharing

c) Capital formation

d) Protection of life

4. Which of the following in not applicable in insurance contract?

a) Unilateral contract

b) Conditional contract

c) Indemnity contract

d) Inter-personal contract

5. Which one of the following is a type of marine insurance?

a) Money back

b) Mediclaim

c) Hull insurance

d) Corgo insurance

Answers

1. a 2. b 3. d 4. c 5. d

II. Very Short Answer Questions

1. List any five important type of policies.
2. What is health insurance?

III. Short Answer Questions

1. Define Insurance.
2. Give the meaning of crop insurance
3. Write a note on IRDAI

IV. Long Answer Questions

1. Explain the various types of Insurance
2. Explain the principles of insurance.
3. Discuss the causes of risk.

Reference

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2. Nael G. Bunni, Risk and Insurance.