**CHAPTER THREE**

**INSURANCE**

# DEFINITIONS OF INSURANCE

There is no single definition of insurance. Insurance can be defined from the viewpoint of individual, and social.

* **From an individual point of view**

Insurance is an economic device whereby the individual substitutes a small certain cost (the premium) for a large uncertain financial loss (the contingency insured against) that would exist if it were not for the insurance.

* **From the social point of view**

Insurance is an economic device for reducing and eliminating risk through the process of combining a sufficient number of homogeneous exposures into a group to make the losses predictable for the group as a whole

* **Functional Definition**

Insurance is a co-operative device to spread the loss caused by a particular risk over a number of persons, who are exposed to it and who agree to insure themselves against the risk.

* **Contractual Definition**

Insurance contract may be defined as a contract by which one party (the insurer/insurance company) agrees to pay to the other party (the insured) or his beneficiary. A certain sum upon a given contingency (the risk) against which insurance is sought.

According to the Commission on Insurance Terminology of the American Risk and Insurance Association, “Insurance is the pooling of fortuitous losses by transfer of such risks to insurers, who agree to indemnify insured for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk".

A1though this definition may not be acceptable to all insurance scholars, it is useful for analyzing the common elements of a true insurance plan.

**FUNCTIONS OF INSURANCE**

The functions of insurance can be studied into two parts;

* Primary functions
* Secondary functions

# PRIMARY FUNCTIONS

1. **Insurance provides certainty**

Insurance provides certainty of payment at the uncertainty of losses, the uncertainty of loss can be reduced by better planning and administration. But, the insurance relieves the person from such difficult task. There are different types of uncertainty in a risk. The risk will occur or not, when will occur?, how much loss will be there?, i**n**other words, there are uncertainty of happening of time and amount of loss. Insurance removes all these uncertainty and the insured is given certainty of payment of losses.

1. **Insurance provides protection**

Themain function of the insurance is to provide protection against the probable chances of loss. The time and amount of loss are uncertain and at the happening of risk, the person will suffer loss in the absence of insurance. The insurance guarantees the payment of loss and thus protects the insured from sufferings. The insurance cannot check (or) control the happening of risk but can provide for losses at the happening of the risk.

1. **Risk Sharing**

The risk is uncertain and therefore, the loss arising from the risk is also uncertain. When risk takes place, the loss is shared by all the persons who are exposed to the risk. The risk sharing in ancient times was done only at the time of damage or death. But, today, on the basis of Probability of risk, the share is obtained from each and every insured in the shape of premium without which protection is not guaranteed by the insurer.

# SECONDARY FUNCTIONS

1. **Prevention of loss**

The insurance joins hands with those institutions which are engaged in preventing the losses of the society because the reduction in loss causes lesser payment to the insured and so more saving is possible which will assist in reducing the premium. Lesser premium invites more business and more business cause lesser share to the insured.

Here, the insurance assists financially to health organizations, fire brigade, educational institutions and other organizations which are engaged in preventing the losses of the masses from death and damage.

1. **It provides capital**

The insurance provides capital to the society. The accumulated funds are invested in productive channels. The shortage of capital of the society is minimized to a greater extent with the help of investment of insurance. The industry, the business and the individual are benefited by the investment and loans of the insurers.

1. **It improves efficiency**

The insurance eliminates worries and miseries of losses at death and destruction of property. The carefree person can devote his body and soul together for better achievement. It improves not only his efficiency, but the efficiencies of the masses are also advanced.

1. **It helps economic progress**

The insurance by protecting the society from huge losses of damage, destruction and death, provides an initiative to work hard for the betterment of the masses. The next factor of economic progress, the capital, is also immensely provided by the masses.

**BASIC CHARACTERISTICS OF INSURANCE**

Insurance has several distinct characteristics. They are:

* Pooling of losses
* Payment of accidental losses
* Risk transfer
* Indemnification

1. **Pooling of losses**

The other names for pooling are sharing, spreading or combination. "Pooling is the spreading of losses incurred by the few over the entire group, so that in the process, average loss is substituted for actual loss". In addition, pooling involves the grouping of a large number of homogeneous exposure units so that the law of large numbers can operate to provide a substantially accurate prediction of future losses.

**Homogeneous exposure unit**means there is a large number of similar (e.g., houses), but not necessarily identical exposure units that are exposed to the same perils. Thus pooling implies:

* The sharing of losses by the entire group and
* The prediction of future losses with some accuracy based on the law of large numbers.

1. **Sharing of loss**

The concept of loss sharing can be explained with an example. Assume that there are 10, 000 houses in Burie. All the10, 000 households agree that if anyone of the house is damaged or destroyed by a fire, the other households will indemnify, or cover, the actual costs of the household who has suffered a loss. Also assume that each home is valued at 100,000 birr, and, on average, one house burns every year. In the absence of insurance, the maximum loss to each household is 100,000 birr, if the house burns. However, by pooling the loss, it can be spread over the entire group, and if one household has a total loss, the maximum amount that each household would have to pay only 10 birr (100,000/ 10,000). Thus, the pooling technique results in the substitution of an average loss of 10 birr for the actual loss of 100,000 birr.

1. **Prediction of future losses**

By pooling the loss experience of a large number of units, an insurer may be able to predict future losses with some accuracy. From the viewpoint of the insurer if future losses can be predicted, objective risk is reduced. Thus, another characteristic of insurance is risk reduction based on the law of large numbers.

**The law of large numbers** 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. For example, if you flip a balanced coin into the air, the chance of getting a head is 0.5. If you flip the coin only 10 times, you may get a head 8 times. Although, the observed probability is 0.8, the true probability still 0.5. If the coin were flipped 1 million times, however, the actual number of heads would be approximately 500,000. Thus, as the number of random tosses increases, the actual results approach the expected results.

1. **Payment of accidental losses**

An accidental loss is one that is unforeseen and unexpected and occurs as a result of chance. In other words, the loss must be accidental. For example, a person may slip on an icy sidewalk and break his or her leg. The loss would be accidental.

1. **Risk Transfer**

Risk transfer means that "a pure risk is transferred from the insured to the insurer, who typically is in a stronger financial position to pay the loss than the insured." Examples: Premature death, Poor health, Disability, Destruction, Theft of property, etc. With the exception of self insurance, a true insurance plan always involves risk transfer.

1. **Indemnification**

Indemnification means that the insured is restored to his or her approximate financial position prior to the occurrence of the loss. Examples of insurance which cover the loss are, Home owners policy, Automobile liability insurance policy, Disability income policy, etc.  

**ELEMENTS OR REQUIREMENTS OF AN INSURABLE RISK**

Insurers normally insure only pure risks. However, not all pure risks are insurable. Certain requirements usually must be fulfilled before a pure risk can be privately insured. From the view point of the insurer, there are ideally six requirements of an insurable risk.

1. There must be a large number of homogeneous exposure units
2. The loss must be accidental and unintentional
3. The loss must be determinable and measurable.
4. The loss should not be the catastrophic
5. The chance of loss must be calculable
6. The premium must be economically feasible
7. **Large number of Homogeneous** **Exposure units**

The purpose of the first requirement is to enable the insurers to predict losses based on the law of large numbers. If a sufficiently large number of homogeneous exposure units are present within a class, the insurer can accurately predict both the average frequency and the average severity of loss.

The items in an insurance pool, or the exposure units, need to be similar so that a fair premium can be calculated. The fire damage done to brick homes will ordinarily be less than that of suffered by wooden homes. It would be unfair to combine them is the same insurance pool and charge each insured the same premium rate based on the combined losses of the pool. If such as attempt were made, the rate developed would cause the owners of brick home (less susceptible to loss) to pay too high a premium and the owners of wooden structures (more susceptible to loss) to pay too low a premium.

1. **Accidental and unintentional loss**

The second requirement is that the loss should be accidental and unintentional; ideally, the loss should be accidental and outside the insured’s control. Thus, if an individual deliberately causes a loss, he or she should not be indemnified for the loss.

The requirement of an accidental and unintentional loss is necessary for two reasons. First, if intentional losses were paid, moral hazard would be substantially increased, and premiums would rise as a result. The substantial increase in premium could result in relatively fewer persons purchasing the insurance, and the insurer might not have a sufficient number of exposure units to predict future losses.

 Second, the loss should be accidental because the law of large numbers is based on the random occurrence of events. A deliberately caused loss is not a random event because the insured knows when the loss will occur. Thus, prediction of future experience may be highly inaccurate if a large number of intentional or nonrandom losses occur.

1. **Determinable and Measurable loss**

Loss must be definite, measurable and of sufficient severity to cause economic hardship. This means the loss must be definite to cause, time, place, and amount. Life insurance in most cases meets this requirement easily. The cause and time of death can be readily determined in most cases. It is difficult to determine and measure the losses in some cases. E.g. Disability income policy; there are chances of dishonest claims, taking an illness or injury and collecting the insurance payment.

It is also important that the losses insured against be measurable. The company must determine whether the insured satisfies the definition of disability as stated in the policy, because sickness and disability are highly subjective. The basic purpose of this requirement is that the insurers must be able to determine if the loss is covered under the policy, and if it is covered, how much the company will pay.

1. **No Catastrophic Loss**

This means that ideally a large proportion of exposure units should not incur losses at the same time. The pooling technique breaks down if most or all of the exposure units in a certain class simultaneously incur a loss. Examples of catastrophic losses include, flood, storms, earth quakes, wild fire, tsunami etc. Insurers ideally wish to avoid all catastrophic losses, but still employ two approaches to handle this problem.

* **Reinsurance:**Insurance companies are indemnified by re-insurers for catastrophic losses. It is shifting of part or all of the insurance originally written by one insurer to another.
* **Dispersing coverage over a large geographical area:**This is a technique to reduce the burden of catastrophic losses by dispersing the coverage area to different geographic locations.

1. **Calculable Chance of Loss**

The insurer must be able to calculate both the average frequency and the average severity of future losses with some accuracy. This is necessary so that a proper premium can be charged that is sufficient to pay all claims and expenses and yield a profit during the policy period. Certain catastrophic losses, however, are difficult to insure because of the chance of loss cannot be accurately estimated.

1. **Economically Feasible Premium**

The insured must be able to afford to pay the premium. Premium should be substantially less than the face value, or amount, of the policy.

**INSURANCE AND GAMBLING**

Insurance is often confused with gambling. There are two important differences between them.

|  |  |
| --- | --- |
| Insurance | Gambling |
| A technique for handling an already existing pure risk | Creates new speculative risk that did not exist before |
| Socially productive. since neither the insurer nor the insured is placed in a position where gain of the winner comes at the expense of the loser | Socially unproductive. Since the winners gain comes at the expense of the loser |

   
The insurer and the insured have a common interest in the prevention or non occurrence of loss and the insurer indemnify the losses incurred by the insured. Whereas gambling transaction never restores the losses to his or her earlier financial position. A gambler presumably enjoys the risk of gambling and therefore would be unlikely to pay the premium needed for transferring the risk being enjoyed.

**INSURANCE AND SPECULATION**

Both are similar in that risk is transferred by a contract and no new risk is created. The main difference between insurance and speculation lies in the type of that each is designed to handle, and in the resulting differences in contractual arrangements. The main similarity lies in the central purpose behind each transaction. However, there are some important differences exist between them.

Insurance transaction normally involves the transfer of risks that are insurable since the requirements of an insurable risk generally can be met. While speculation is a technique for handling risks that are typically uninsurable. Insurance can reduce the objective risk of an insurer by application of the law of large numbers, but speculation only involves transfer of risks & not reduction of risk. The losses cannot be predicted based on the law of large numbers

**BENEFITS OF INSURANCE TO THE SOCIETY**

The existence of insurance results in great benefits to society. The major social - economic benefits of insurance include the following.

* Indemnification of losses
* Less worry & fear
* Source of investment fund
* Loss prevention
* Enhancement of credit

1. **Indemnification for loss**

The indemnification function contributes greatly to family and business stability and therefore is one of the most important social & economic benefits of insurance. The following table lists the benefits to individuals and families and also to business firms through the indemnification function of insurance.  

|  |  |
| --- | --- |
| To individuals and families | To business firms |
| Permits individuals & families to be restored to their former financial position that existed prior to the loss occur. | Permits the firm to remain in business even after the loss occurs |
| The families maintain their economic security. | Employees of the firm would be able to keep their jobs |
| They are less likely to apply for public assistance or welfare. | Suppliers continue to receive orders |
| They are less likely to seek financial assistance from relatives & friends. | Customers can still receive the goods and services |

1. **Reduction of Worry and Fear**

A second benefit of insurance is that worry and fear are reduced. This is true both before and after a loss. For example, if family heads have adequate amounts of life insurance, they are less likely to worry about the financial security of their dependents in the event of premature death; persons insured for long-term disability do not have to worry about the loss of earnings if a series illness or accident occurs; and property owners who are insured enjoy greater peace of mind because they know they are covered if a loss occurs. Worry and fear are also reduced after a loss occurs, because the insured know that they have insurance that will pay for the loss.

1. **Source of Investment funds**

Insurance provide funds for capital investment and accumulation. Premiums are collected in advance of the losses and funds not needed to meet the immediate losses can be loaned to business firms. These investments:

* increases society's stock of capital goods
* promote economic growth
* promote full employment
* reduce cost of borrowings of business firm

1. **Loss prevention**

Insurance companies are actively involved in numerous loss prevention programs and also employ a wide variety of loss prevention personnel. (E.g. Safety Engineers, Specialists in fire prevention, Occupational Safety and Health, etc.) Some of the loss prevention activities are:

* High way safety & reduction of automobile death'
* Fire prevention
* Reduction of work related disabilities
* Prevention of automobile thefts
* Prevention and detection of arson losses
* Prevention of defective products that could injure the users
* Prevention of boiler explosions
* Educational programs on loss prevention

The loss prevention activities reduce both direct and indirect, or consequential losses. Society benefits since both types of losses are reduced.

1. **Enhancement of Credit**

Insurance makes a borrower a better credit risk, because its gives greater assurance that the loan will be repaid. For example,

* Property insurance is obtained while lending for purchase of houses. Property insurance protects the lender's financial interest if the property is damaged or destroyed.
* Temporary loan may obtained by insuring inventories of business firms.
* Insurance on automobile)s required to get a loan for purchasing any new automobile

  Thus, insurance can enhance a person's credit worthiness

**COST OF INSURANCE TO SOCIETY**

No institution can operate without certain costs. These are listed below so that one can obtain an impartial view of the insurance institution as a social device. The major social costs of insurance include the following:

* Cost of doing business
* Fraudulent claims
* Inflated claims

1. **Cost of doing the business**

The main social cost of insurance lies in the use of scarce of economic resources land, labor, capital, and organization to operate the business. In financial terms, an expense loading must be added to the pure premium to cover the expenses incurred by insurance companies. An expense loading is the amount needed to pay all expenses, including commissions, general administrative expenses, state premium taxes, acquisition expenses, and an allowance for contingencies and profit. The cost is justified from the insured's view point as follows:

* Uncertainty concerning the payment of a covered loss is reduced because of insurance.
* The cost of doing business is not necessarily wasteful, because insurers engage in a wide variety of loss prevention activities.
* The insurance industry provides jobs to millions of workers.

However, because economic resources are used up in providing insurance, a real economic cost is incurred.

1. **Fraudulent claims**

These are the claims made against the losses that one caused intentionally by people in order to collect on their policies. There always exists moral hazard in all forms of insurance. Arson losses are on the increase. Fraud and vandalisms are the most common motives for arson. Fraudulent claims are made against thefts of valuable property, such as diamond ring or fur coat, and ask for reimbursement. These claims results in higher premiums to all insured. These social costs fall directly on society.

1. **Inflated claims**

It is a situation where, the tendency of the insured to exaggerate the extent of damages that result from purely unintentional loss occurrences. Examples of inflated claims include the following.

a) Attorney for plaintiffs may seek high liability judgments - Liability insurance

b) Physicians may charge above average fees – health insurance

c) Disabled persons may malinger to collect disability income benefits for a longer duration.

These inflated claims must be recognized as an important social cost of insurance. Premiums must be increased to cover the losses, and disposable income that could be used for the consumption of other goods or services is thereby reduced.

The social costs of insurance can be viewed as the sacrifice that society must make to obtain the social benefits of insurance.