

CHAPTER THREE

INSURANCE

Introduction

Devices resembling insurance are said to exist in the early period of human existence. At early 2000 a crude form of insurance designed to protect marine merchants, ship owners and marine traders in Babylonia who were exposed to risk of robbery, sea perils and capture for ransom were prevalent. Such risks caused heavy financial loss and distress to the shippers and marine traders there by curtailing their business ventures.

To deal with such risks the Babylonians were said to have devised the system that can provide some kind of protection to the ship owners, marine merchants and the creditors who advanced marine loans for the venture.

Under the system, the creditor and the ship owner or the merchant enter in to a contract whereby the creditor advanced the loans to the shipper or the merchant for the business venture. The loan is repayable only up on the safe arrival of the ship at the desired destination. The creditor collected the nominal interest plus some extra charge for assuming the risk, (risk premium). Due to such arrangements, ship owners and marine merchants were encouraged to conduct their venture without fear of financial loss. Ship owners and marine merchants were pledging their cargo as a security for marine loans.

Commercial insurance in its refined form is believed to have begun with marine insurance during the out grows of the Italian commerce in the 13th and 14th century. During this period, cities in Northern Italy were practicing banking and insurance. In fact the term policy insurance originated from Italian word pollizza, which means a promise. In subsequent periods insurance business spread to other parts of the world, the USA and Japan.

Marine insurance is considered to be the oldest branch of insurance. It is believed that merchants from Lombardy were known for their active role in marine contract, introduced marine insurance to Britain around 4th century.

Learning objectives of the Chapter

At the end of /after studying this chapter, students should be able to:

- ❖ Define and explain the development of insurance from different view points

- ❖ Identify the basic characteristics of insurance
- ❖ Describe and explain the function, role and importance of insurance
- ❖ Illustrate how insurance is different from Gambling and speculation
- ❖ List the requirements of insurable contracts/risks.

3.1. Definition of Insurance

Insurance can be defined in several ways and probably no one brief definition does justice to its many new features. It may be defined from economic, legal, business, social and mathematical point of view. In economic sense, insurance is a mechanism of providing certainty or predictability of loss with regard to pure risk. It accomplishes these by policy or charity of risk. By reducing uncertainty in the business environment, it will create peace of mind that enables business people focus on their primary activities instead of worrying about the existence of possibility of loss so that societies can grow more.

- From legal point of view, insurance is a contract whereby, a consideration (price) paid to a party adequate to the risk, becomes security to other that he shall not suffer loss, damage, or prejudice by the happening of risks specified in the contract from which he may be exposed to. The contracting parties are the insured, who is responsible to pay the price from obtaining the security (premium) and the insurer, who will assume the risk transferred. This makes insurance a means of transferring risks from a premium (price) from one party known as the insured to another called insurer.
- From business perspective insurance is defined as a cooperative device to spread the loss caused by particular risk over a number of persons who are exposed and who agree to ensue themselves against the risk. Every risk involves the loss of one or other kind. The function of insurance is to spread the loss over a large number of persons who agree to co-operate each other at the time of loss. The risk cannot be averted but loss occurring due to certain peril can be distributed amongst the agreed persons. They agree to share the loss because the chance of loss, the time and amount, to a person is not known. Any of the insured may suffer loss to a given risk: so, the rest of the persons who have agreed will share the loss. The larger the number of such persons, the easier the process of distribution of loss will be. In fact, they share the loss by payment of premium, which is calculated on the basis of probability of loss.

- From the social point of view, insurance is defined as a device to accumulate funds to meet uncertain losses of capital, which is carried at through the transfer of the risk of many individuals to one person or to group of persons.

Mathematically, insurance is the application of certain actuarial principles (insurance mathematics), law of probability, and statistical techniques used to achieve predictability.

In summary, insurance is an economic system for reducing uncertainty of loss through pooling of losses together, a legal method of transferring risks from insured to the insurer in a contract of indemnity, a business undertaking for profit that provides the many jobs in a free enterprise economy, a social device in which the loss of few is covered by the contribution of many, or an actuarial system of applied mathematics.

3.2. Basic characteristics of Insurance

An insurance plan or arrangement typically has certain characteristics. They include the following:

- ❖ Pooling of losses
- ❖ Payment of fortuitous losses
- ❖ Risk transfer
- ❖ Indemnification

Pooling of losses/sharing of losses: is the heart of insurance companies. It is the spreading of losses of an insured by the few over the entire groups, so that in the process the average loss is substituted for actual loss. Generally, pooling implies:

- a. The sharing of loss by the entire group and
- b. Prediction of future losses with some accuracy based on the law of large number.

The law of large numbers states that “As the number of exposure units (in other words, persons or objects exposed to risk) increases, the more certain it becomes that the actual loss experience will be equal to the probable loss experience. This law is stated based on assumption that the losses are accidental and occur randomly.

Payment of fortuitous losses: it is one that unforeseen and unexpected and occurs as a result of chance. For example a person may slip on a muddy side walk and break his leg. The loss would be fortuitous.

Risk transfer: refers to a pure risk is transferred from the insured to the insurer, who has a strong financial position to pay the loss than the insured.

Indemnification: means that the insured is restored to his/her approximate financial position prior to the occurrence of the loss. Let's see some examples of indemnification:

1. If you house burns in a fire, the home owners' policy will indemnify you or restore you to the previous position.
2. If you are sued because of the negligent operation of an automobile, your automobile liability insurance policy will pay those sums that you are legally obligated to pay.

3.3.The Functions of Insurance

The primary functions of insurance are the followings.

- I. **Providing certainty:** insurance provides certainty of payment at the uncertain of loss. Better planning and administration can reduce the uncertainty of loss. Insurance removes all uncertainties and assurance is given to payments of compensation at the time of loss. The insurer charges premium for providing the said certainty.
- II. **Protection:** the main function of insurance is to provide protection against the probable chance of loss. Insurance guarantees the payment of loss and this protects the assured from sufferings.
- III. **Risk sharing:** when the risk takes place, all persons who are exposed to the same risk share the loss.

In addition, insurance provides the following secondary functions.

- A. **Prevention of loss:** insurance is primarily concerned with the financial consequences of losses, but it would be fair to say that insurers have more than a passing interest of in loss control. It could be argued that insurers have no real interest in the complete control of loss, as this would inevitably lead to an end their business. This is a rather shortsighted view. Insurers do have an interest in reducing the frequency and the severity of loss. In a practical way, buyers of insurance will normally come into a contract with the loss control service offered by an insurer when they meet the surveyor. The insurer, or indeed the insurance broker may employ the surveyor, and part of his job is to give advice on loss control. Many insurers employ specialist surveyors in fire, security, liability and other types of risk.

Insurance assists financially to the fire brigade, educational institutions and other organizations, which are engaged in preventing the losses. In short, the function of insurance is not limited to merely compensating those who suffered from the losses at the time the risk materializes. However, insurance must make sure that adequate loss prevention and loss control mechanisms were implemented by the insured to minimize the probability and severity of loss.

- B. Providing capital:** insurance companies have, at their disposal, large amount of money. This arises due to the fact that there is a time gap between the receipt of a premium and the payment of a claim. A premium could be paid in January and a claim may not occur until December, if it occurs at all. The insurer has this money and can invest it. In fact, the insurer will have the accumulated premiums of all insured, over a long period of time.

The Role and Importance of Insurance

Insurance is a mechanism of collecting funds from those exposed to risk that would be paid out for those who suffered a loss at the time it materializes. The accommodated funds are invested in productive areas.

The existence of a sound insurance market is an essential component of any successful economy and the proof of this can be seen in many parts of the world.

The role and importance of insurance can be seen in three ways: uses to individuals, to special group of individuals, and to the society.

1. Uses to individuals:

- a) **Insurance provides security and safety:** Insurance reduces the physical and mental stress that insured face concerning the possibility of death, disability, and financial loss. Insured's, through transfer of their risk to the insurer reduce their worry about any financial loss they may face due to coincidental misfortune. This means that insured are to a large extent certain that the loss, if at all occurs will be recovered from the insurer.
- b) **Insurance affords peace of mind:** The knowledge that insurance exist to meet the financial consequences of certain risks provides a form of peace of mind. This is important for private individuals when they insure car, house, possessions, and, but it is also of vital importance in industry and commerce.
- c) **Insurance protects mortgage property:** At the death of the owner of the mortgaged property, or at the time of damage or destruction of the property, the insurer will provide

an adequate amount to the dependents at the early death of the owners to pay off the unpaid loans, or the mortgage gets a deflated amount at the destruction of the property.

2. Uses to business:

a) **Reduction of uncertainty:** why should a person put money in to a business venture when there are so many risks which could result in the loss of the money? Yet, if people did not invest in business, then there would be fewer jobs, less goods, the need for even higher imports and a general reduction in wealth. Buying insurance allows the entrepreneur to transfer at least some of the risks of being in business to an insurer. Uncertainty of business losses is reduced in the world of business.

b) **Increasing business efficiency:** Insurance also acts as a stimulus for the activity of business, which are already in existence. This is done through the release of funds for investment in the productive side of the business, which would otherwise require to be held in easily accessible reserves to cover any future loss. Business efficiency is increased with insurance when the owner of business is free from botheration of loss, hence, certainty devote much time to the business. The carefree owner can work better for maximization of profit. The uncertainty of loss, damage, destruction, or disappearance of a property, may affect the mind of the business people adversely. The insurance, removing the uncertainty, stimulates businesspeople to work hard.

3) Uses to society:

a) **Wealth protection:** with the advancement of the society, the wealth or the property of the society attracts more hazards resulting in the creation of new types of insurance invested top protect them against the possible losses. To present, future and potential property resources are well protected through insurance in which each and every member will have financial security against damage and destruction of wealth. Through prevention of losses, insurance protects the society against degradation of resources and ensure stabilization and expansion of business and industry.

b) **Economic growth:** Insurance provides strong hand and mind and protection against the losses of property. In addition to these, insurance companies accumulate large sum of money available for investment purpose. Such money accumulated may be invested by the insurance companies themselves or lent to produce more wealth. This will have its own contribution to economic growth of the country. The fact that the owner of the business has the

funds available to recover from the loss provides the stimulus to business activity. It also means that jobs may not be lost and goods or services can still be sold. The social benefit of this is that people keep their jobs, their sources of income are maintained and they can continue to contribute to the national economy.

3.4. Insurance, Gambling and Speculation

The essential feature about gambling is that it creates a risk where there existed none hitherto. The difference between insurance and gambling can be stated as follows.

The man who gambles creates risk, which did not exist before whereas the man who purchases insurance minimizes a risk which was already in being and which is not in his power to avoid.

The gambler with hope of gain goes out his way to bring me a risk in to being while the man, who insures, for the purpose of avoiding loss, goes out of his way to hedge against a risk which already exists.

The man who gambles accepts deliberately the risk of loss in exchange for the possibility of profit: the man who insures accepts deliberately the certainty of a small loss in exchange for the freedom from the risk of devastating catastrophic loss. The gambler bears the risk while the insured transfers the risk.

Speculation on the other hand involves doing some kind of activity with the expectation of profit in the future. For example, a person who purchases and sells goods, stocks and shares, etc with the risk of loss and hope of profit through changes in their market values is a clear case of speculation. Through speculation, individuals create a risk deliberately in the anticipation of profits. However, an insurance transaction normally involves the transfer of risks that are insurable, since the requirements of an insurable risk generally can be met. On the contrary, speculation is a technique for handling risks that are typically uninsurable, such as protection against a substantial decline in the price of agricultural products and raw materials.

The other difference between the two is that insurance can reduce the objective risk of insurer by application of the law of large number. In contrast, speculation typically involves only risk transfer, not risk reduction. The risk of an adverse price fluctuation if transferred to a speculator who feels he or she can make a profit because of superior knowledge of forces that affect

market price. The risk is transferred, not reduced, and the speculator's prediction of loss generally is not based on the law of large number.

3.5.Social and Economic Values of Insurance

Insurance is obviously desirable that we can enumerate several advantage or value to the social well-being and economic development of a nation. Some of the advantages are discussed below.

1. Risk transfer/Indemnification

The primary objective of insurance is to provide financial compensation to those insured who suffered accidental losses. Indemnification is made out of the fund established by the member's contribution or premium payment, who are exposed to the same risk. This means, the loss is spread to all members on equitable basis and the financial burden of the unfortunate is reduced and he is restored to his former financial position. By doing so insurance helps stabilize the financial situation of individuals, families and organizations.

2. Reduction of Uncertainty

Insurance reduces the physical and mental stress that insured's face concerning the risk of loss and provides peace of mind. It is a psychological benefit that may not be quantified but still of great importance. Insurance reduces worries and anxieties and help everyone work in a relaxed manner, which can make everyone to work more productive and perform his duties properly without anxiety. This has direct implication on the society because the society will be secured from unexpected loss and interruption of services from those who will face unexpected loss.

3. Encourages Savings

Insurance is a contractual agreement between the insurer and the insured, where the insured is expected to pay a premium for the risk he/she transferred to the insurer. This compulsory premium payment is a form of encouragement of the insured to make systematic saving. Particularly, this is possible in certain life insurance policies that have dual purpose, i.e., protection in the event of death and savings in the event of survival.

4. Help Businesses Continue Without Interruption of Operation

The insured firm will not be knocked out of business by fire or liability or other insurable risks. The insurer indemnifies the losses and restores the firm to its former position. This is also advantageous to the society because they can get uninterrupted services and goods of the firm. Moreover, insurance helps small businesses since they cannot bear all the risks by themselves. By transferring their risk, they can safely perform their operation and compete with larger firms.

5. Provide Funds for Investment

Premiums collected by insurance companies are not left stagnant. They are used to provide a big source long-term investment capital for the national economy. The loan is made available to investors through banks and it serve as a stimulant for the national economy to be healthier.

6. Keeps Families Together

Family can continue to live together after disastrous adversaries. For example, if a husband with life insurance dies, it may not force his family to disintegrate due to lack of income because they can receive the compensation from the insurer and can earn their live as it was before at least to some extent

It relieves pressure on social welfare system, thereby reserving government resources for essential social security activities.

7. Provides a Basis for Credit

Insurance policies are used as a guarantee for personal and business bank loans. This days banks lend money on the basis of the collateral security of insurance.

8. Promotes Loss Control Systems

In order to minimize their losses, insurance companies have tried and are continuing to introduce several kinds of loss reduction and prevention schemes. For example, health education, inspection, of elevators, and boilers, installation of fire extinguishers, burglar alarms, on vehicles or houses are risk control mechanisms developed and applied by insurance companies at different times. The introduction of this loss control programs can reduce losses to businesses and individuals and complement good risk management thereby benefiting society as a whole.

9. It provides Financial Stability to the Community

Insurance makes a remarkable contribution to the society as a whole. It creates certainty in the environment thereby stimulating competition among business enterprises in a certain region. Fair competition is a greater advantage to the society since it reduces price, encourage efficient utilization of scarce resources and produce quality products. Insurance also avoids or at least minimizes production stoppage that produces an economic wastage, and results in loss of profit to the insured, unemployment and loss of trade and services to the business community. So, insurance can minimize all these and other consequences of risk.

10. Stimulates International Trade and Commerce

Goods traded at the international market are highly vulnerable to risk of loss due to large number of perils. As a result, it is difficult to think of international trade without insurance. Insurance coverage may be a condition for engaging in international trade and commerce. Insurance serves as a "lubricant of trade", without it trade and commerce may stifle.

3.6. Costs and Limitations of Insurance

3.6.1 Disadvantages/ Costs of Insurance

Insurance is not without some problems. It has the following major problems:

1. It encourages fraud to collect dishonest claims (**moral hazard problems**). When individuals are insured against a particular risk, they may intentionally increase the chance of loss, or exaggerate the claim.
2. Increases carelessness in life (**morale hazard problem**): it is a condition that causes to be less careful than they would otherwise be. Some individuals do not consciously seek to bring about a loss, but the fact that they have insurance causes them to take more risks than they would if they had no insurance coverage. This manner may result in excessive losses in the community.
3. **Cost of Insurance:** insurers incur operating expenses such as loss control costs, loss adjustment expenses, expense involved in acquiring insured, (advertisement cost), state premium taxes, and general administrative costs. In addition to these expenses, the insured is expected to cover a reasonable amount for profit and contingencies.

3.4.2 Limitations of Insurance

Insurance is clearly a useful device for handling risk, but some risks cannot safely be handled by insurance. It is a device used to deal with pure risks only. Even not all pure risks are insurable. That means, insurance does not provide protection against a wide range of risks. It has a limited application. You may question: what types of risks are insurable? To give an answer to this question, it is necessary to discuss the characteristics of insurable risks. In other words, for insurance to be used as a risk transfer mechanism the following conditions must be met to identify the insurable risks from those which cannot be commercially insurable.

Characteristics of Insurable Risks

1. A large number of independent units should be exposed to the same risk. This requirement follows from the law of large numbers, a mathematical principle which states that a risk that is not predictable for one person can be forecasted accurately for a sufficiently large groups of people with similar characteristics. Insurance operation is safe only when the insurer is able to predict fairly and accurately its expected losses. If the pool of policy holders is small, volatility in number of claims can lead to unexpected increase in claim and hence bankrupt the plan the insurance company.

Therefore, there must be a sufficiently large number of risks of a similar class being insured so as to predict accurately the average loss experience.

2. It must be possible to calculate/measure the chance of loss in monetary terms.
3. The loss should be definite, in time, place, cause and amount; otherwise claim adjustment will be difficult.
4. the loss should be accidental from the view point of the insured as distinguished from the expected loss. For example, losses on account of depreciation cannot be insured, as there is nothing accidental about their occurrence.
5. The possible loss must not be catastrophic. The risks covered by insurance should affect only a relatively small portion of the total insured population at a given time. If a risk is likely to cause similar damage to a large proportion of policy holders at the same time, a single occurrence of the risk would bankrupt the insurance companies. Therefore, with

certain exceptions, it is usual to find exclusions regarding fundamental risks such as war and earthquake in all insurance contracts.

6. There must be an insurable interest. An insurance contract provides security against the consequences of a loss and is basically concerned with preserving the interest of the insured, one who possesses insurable interest (financial relationship) in the subject matter of insurance can avail the insurance protection.
7. The potential loss must be large. The risk should not be very minor one and the peril must be capable of causing a loss so large that the insured cannot bear it himself without economic distress.
8. The cost of insurance should not be prohibitive. The cost of insuring (premium) must be economically feasible and within the reach of nearly everyone; otherwise it will be confined to a very small section of the society. For instance, who would be willing to pay Birr 1,000 or 2,000 to insure the risk of losing a 100 Birr property? If you are rational person, the answer is definitely "no" The premium should be reasonable.
9. The risk must be consistent with public policy. The insurance contract should not be against the public policies, for example, insurance effected by terrorists for fines imposed for the offences.
10. The insured must be subject to real risk whatever may be the subject matter of insurance for which the insured seeks protection, the subject matter must be adversely affected on the happening of the event, i.e., the subject matter must be potentially exposed to the risk.

Insurable Risk

The following are generally insurable risks.

1. Pure risks: property (direct and indirect property losses; personal and legal liability losses).
2. Non-catastrophic losses
3. Risk with low probability of occurrence

Uninsurable risks

1. Speculative risks such as market risks,
2. Fundamental risks (war, earthquake, political and economic losses).
3. Wear and tear of goods, eg. Depreciation.
4. Risk that are against public policy.