

LESSON 5

UNIT 5: INSURANCE

Lesson Objectives:

Students should be able to:

- Acquire knowledge on various types of insurance
- Understand the principles of insurance

Definition

Risk management

Risk management is the process of measuring, or assessing, risk and developing strategies to manage it. Strategies include transferring the risk to another party, avoiding the risk, reducing the negative effect of the risk, and accepting some or all of the consequences of a particular risk. Traditional risk management focuses on risks stemming from physical or legal causes (e.g. natural disasters or fires, accidents, death, and lawsuits). Financial risk management, on the other hand, focuses on risks that can be managed using traded financial instruments.

Insurance, in law and economics, is a form of risk management primarily used to hedge against the risk of a contingent loss. Insurance is defined as the equitable transfer of the risk of a potential loss, from one entity to another, in exchange for a premium. **Insurer**, in economics, is the company that sells the insurance. **Insurance rate** is a factor used to determine the amount, called the **premium**, to be charged for a certain amount of insurance coverage.

Principles of insurance

- a. Utmost Good Faith
- b. Insurable interest
- c. Indemnity
- d. Subrogation
- e. Contribution
- f. Proximate cause

Types of insurance

Any risk that can be quantified can potentially be insured. Among the different types of commercially available insurance are:

- Automobile insurance, known in the UK as *motor insurance*, is probably the most common form of insurance and may cover both legal liability claims against the driver and loss of or damage to the insured's vehicle itself. Throughout most of the United States an auto insurance policy is required to legally operate a motor vehicle on public roads. In some jurisdictions, bodily injury compensation for automobile accident victims has been changed to a no fault system, which reduces or eliminates the ability to sue for compensation but provides automatic eligibility for benefits.

- Financial loss insurance protects individuals and companies against various financial risks. For example, a business might purchase cover to protect it from loss of sales if a fire in a factory prevented it from carrying out its business for a time. Insurance might also cover the failure of a creditor to pay money it owes to the insured. This type of insurance is frequently referred to as "business interruption insurance." Fidelity bonds and surety bonds are included in this category, although these products provide a benefit to a third party (the "obligee") in the event the insured party (usually referred to as the "obligor") fails to perform its obligations under a contract with the obligee.
- Liability insurance covers legal claims against the insured. For example, a homeowner's insurance policy will normally include liability coverage which will protect the insured in the event of a claim brought by someone who slips and falls on the property, and brings a lawsuit for her injuries. Similarly, a doctor may purchase liability insurance to cover any legal claims against him if his negligence (carelessness) in treating a patient caused the patient injury and monetary harm. The protection offered by a liability insurance policy is twofold: a legal defense in the event of a lawsuit commenced against the policyholder and indemnification (payment on behalf of the insured) with respect to a settlement or court verdict. Liability policies typically cover only the negligence of the insured, and will not apply to results of willful or intentional acts by the insured.
- Marine cargo insurance covers physical loss or damage to property while in transit via sea or inland waterways. Marine insurance typically refers to coverage of physical damage to the transporting vessel. Many marine insurance underwriters will include "time element" coverage in such policies, which extends the indemnity to cover loss of profit and other business expenses attributable to the delay caused by a covered loss. Marine insurance covers the loss or damage of goods at sea. Marine insurance typically compensates the owner of merchandise for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier.
- Purchase insurance is aimed at providing protection on the products people purchase. Purchase insurance can cover individual purchase protection, warranties, guarantees, care plans and even mobile phone insurance. Such insurance is normally very limited in the scope of problems that are covered by the policy.
- Life insurance provides a monetary benefit to a deceased's family or other designated beneficiary, and may specifically provide for burial, funeral and other final expenses. Life insurance policies often allow the option of having the proceeds paid to the beneficiary either in a lump sum cash payment or an annuity.
 - Annuities provide a stream of payments and are generally classified as insurance because they are issued by insurance companies and regulated as insurance and require the same kinds of actuarial and investment management expertise that life insurance requires. Annuities and pensions that pay a benefit for life are sometimes

regarded as insurance against the possibility that a retiree will outlive his or her financial resources. In that sense, they are the complement of life insurance and, from an underwriting perspective, are the mirror image of life insurance.

- Nuclear incident insurance covers damages resulting from an incident involving radioactive materials and is generally arranged at the national level. (For the United States, see the Price-Anderson Nuclear Industries Indemnity Act.)
- Environmental liability insurance protects the insured from bodily injury, property damage and cleanup costs as a result of the dispersal, release or escape of pollutants.
- Property insurance provides protection against risks to property, such as fire, theft or weather damage. This includes specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler insurance.
- Travel insurance is an insurance cover taken by those who travel abroad, which covers certain losses such as medical expenses, lost of personal belongings, travel delay, personal liabilities, etc.

Types of insurance companies

Insurance companies may be classified as

- *Life* insurance companies, which sell life insurance, annuities and pensions products.
- *Non-life* or *general* insurance companies, which sell other types of insurance.

In most countries, life and non-life insurers are subject to different regulatory regimes and different tax and accounting rules. The main reason for the distinction between the two types of company is that life, annuity, and pension business is very long-term in nature — coverage for life assurance or a pension can cover risks over many decades. By contrast, non-life insurance cover usually covers a shorter period, such as one year.

Insurance companies are generally classified as either mutual or stock companies. This is more of a traditional distinction as true mutual companies are becoming rare. Mutual companies are owned by the policyholders, while stockholders (who may or may not own policies) own stock insurance companies.

Reinsurance companies are insurance companies that sell policies to other insurance companies, allowing them to reduce their risks and protect themselves from very large losses. The reinsurance market is dominated by a few very large companies, with huge reserves. A reinsurer may also be a direct writer of insurance risks as well.

Captive insurance companies may be defined as limited-purpose insurance companies established with the specific objective of financing risks emanating from their parent group or groups. This definition can sometimes be extended to include some of the risks of the parent company's customers. In short, it is an in-house self-insurance vehicle. Captives may take the form of a "pure" entity (which is a 100% subsidiary of the self-insured parent company); of a "mutual" captive (which insures the collective risks of members of an industry); and of an "association" captive (which self-insures

individual risks of the members of a professional, commercial or industrial association). Captives represent commercial, economic and tax advantages to their sponsors because of the reductions in costs they help create and for the ease of insurance risk management and the flexibility for cash flows they generate. Additionally, they may provide coverage of risks which is neither available nor offered in the traditional insurance market at reasonable prices.

The types of risk that a captive can underwrite for their parents include property damage, public and products liability, professional indemnity, employee benefits, employers liability, motor and medical aid expenses. The captive's exposure to such risks may be limited by the use of reinsurance.

Captives are becoming an increasingly important component of the risk management and risk financing strategy of their parent. This can be understood against the following background:

- heavy and increasing premium costs in almost every line of coverage;
- difficulties in insuring certain types of fortuitous risk;
- differential coverage standards in various parts of the world;
- rating structures which reflect market trends rather than individual loss experience;
- insufficient credit for deductibles and/or loss control efforts.

There are also companies known as 'insurance consultants'. Like a mortgage broker, these companies are paid a fee by the customer to shop around for the best insurance policy amongst many companies.

Similar to an insurance consultant, an 'insurance broker' also shops around for the best insurance policy amongst many companies. However, with insurance brokers, the fee is usually paid in the form of commission from the insurer that is selected rather than directly from the client.

Neither insurance consultants nor insurance brokers are insurance companies and no risks are transferred to them in insurance transactions.

Third party administrators are companies that perform underwriting and sometimes claims handling services for insurance companies. These companies often have special expertise that the insurance companies do not have.

Main references

Gabriel, V. (1996), *Management*, 2nd edition, Longman Publisher

Additional reading

Website: www.bized.ac.uk and www.tutor2u.com