**CHAPTER THREE**

**INSURANCE**

* 1. **Definition of Insurance**

Sometimes it is difficult to define certain terms. However, it is possible to describe them. Some definition, though not comprehensive by themselves may provide reasonably sufficient explanations about the term insurance. The following are some of the definitions given by different scholars.

Insurance may be defined in economic, legal business, social, and mathematical point of view as follows:

1. ***In economic sense***: insurance is an important tool that provides certainty or predictability aiming at reducing uncertainty in regard to pure risks. It accomplishes this result by pooling or sharing of risk.
2. ***Legal point of view:*** insurance is a contract by which one party, in consideration of the price paid to him adequate to the risk, becomes security to the other that he shall not suffer loss, damage or prejudices by the happening of the perils specified in the policy.

***Article 654(1) of the commercial code of Ethiopia*** states insurance as follows:

"A contract whereby a person called the insurer undertakes against payment of one or more premiums to pay a person, called the beneficiary, sum of money where a specified risk materializes.

From these definitions of law we can learn that insurance is contractual agreement between two parties: the person (Insured) and Insurance companies. When a person buys private insurance, she/he is entering into a contract with the insurer that entitles the person (Insured) to certain advantages but also imposes certain responsibilities such as payment of a premium and satisfying certain conditions specified in the policy.

1. ***Business Point of views:*** as a business institution, insurance has been defined as a plan by which large number of people associate themselves and transfer risks of individuals to the shoulders of all members of the policy.
2. ***Social View Point:*** insurance is defined as a social device for making payment for the accumulation of fund to meet uncertain losses of capital which is carried out through the transfer of risk of many individuals to one person or a group of persons. It is advice through which few unfortunates are paid by many who are member of the policy.
3. ***Mathematical viewpoint:*** insurance is the application of actuarial (Insurance mathematics) principles. Laws of probability and statistical techniques are used for achieve predictable results.

Williams and Heins defines insurance as "a device by means of which the risks of two or more persons or firms are combined through actual or promised contributions to a fund out of which claimants are paid."

Dinsdale and McMurdie also defined insurance as "a device for transfer of risks of individual entities to an insurer, who agrees, for a consideration (called the premium), to assume to a specified extent losses suffered by the insured".

From the definitions, it can be learned that:

1. Insurance is a system used to transfer risk of individual for payment of premium.

The insured considers insurance as a transfer device where as from the point of view of the insurer (Insurance Company), it is regarded as retention and combination device. Of course, one may ask, "Why the insurer accepts risks that other people try to avoid?" Insurance companies /Insurers accept the risks of others because, as compared to individual insured’s:

* 1. They have the knowledge and the skill to apply various risk reduction and risk control measures;
	2. Combination or pooling of similar risks will enable the insurer to predict the actual loss experience with a reasonable accuracy.
	3. They have financial capacity to assume/ take risk
	4. They are in a position to enforce certain loss reduction and prevention measures
	5. For losses that are beyond their capacity, insurers arrange a reinsurance mechanism.

From this we can say that risk in the business of insurance companies. The insured is required to pay some amount of money in relation for the transfer of his/her risk to the insurer. They do this because they want to remain secured financially and/or mentally.

1. It is a scheme (plan) that establishes a common fund out of which financial compensation is made to those who faces accidental losses.
2. It is a pooling of risks of many people who are exposed to the same risk.
3. It is a device used to spread the loss suffered by an individual or firm to the members in the group.
4. It is a method to provide security to the insured person against the probable loss.
	1. **Basic characteristics of insurance**

There are four characteristics of an insurance plan/arrangement

1. Pooling of losses
2. Payment of fortuitous losses
3. Risk transfer
4. Indemnification
5. **Pooling of losses**

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.

* Key mechanism is “law of large number”.
* Future losses are predicted based on law of large number.

**Principal of loss pooling**

“There should be a large number of similar, but not necessarily identical, exposure units that are subject to the same peril”, which can be concluded as polling implies:

1. The sharing of losses by the entire group.

2. Prediction of future losses with some accuracy based on the law of large numbers

Ex: assume that 1,000 farmers in a village of Cheman Embecho (kebelle) agree that if any farmer’s home is damaged or destroyed by a fire, the other members of the group will indemnify the actual costs of the unlucky farmer who has a loss. Further assume that each home is worth

20,000 Birr, and, on average, one home burns every year.

In the absence of insurance, the maximum loss to each farmer is 20,000 Birr, if the home should burn. With the pooling of loss, the maximum loss for each farmer is 20 Birr for the actual loss of 20,000 Birr.

In reality, the actuary seldom knows the true probability and severity of loss. Therefore, estimates of both the average frequency and the average severity of loss must be based on previous loss experience (objective risk). As the number of exposures increases, the relative variation of actual loss from expected loss will decline.

**Note:**

1. Pooling of loss 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.

2. The primary purpose of pooling, or then sharing of losses, is to reduce the variation in possible outcomes as measured by the standard deviation or some other measure of dispersion, which reduces risk

Assume two business owners each own an identical storage building valued at Birr 50,000.

Assume there is a 10% chance in any year that each building will be destroyed by a peril, and that a loss to either building is an independent event. If the two owners decide to pool their loss agreeing to pay an equal share of any loss that might occur. Do risk pooling help reduce risk of the two owners?

From the last problem, if there is another owner joins the pool, what is the level of risk?

1. **Payment of fortuitous losses**

A fortuitous loss is one that is unforeseen and unexpected and occurs as a result of chance.

Law of large number is based on the assumption that losses are accidental and occur randomly. Insurance policies do not cover intentional losses.

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.

1. **Indemnification**

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

* 1. **Fundamentals of insurable risk**

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. We may question a: what types of risks are insurable? To give an answer, 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.

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.

1. It must be possible to calculate/measure the chance of loss in monetary terms.
2. The loss should be definite, in time, place, cause and amount; otherwise claim adjustment will be difficult.
3. 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.
4. 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.
5. 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.
6. The potential loss must be large. The risk should not be very minor one and the penil must be capable of causing a loss so large that the insured cannot bear it himself without economic distress.
7. 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.
8. 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.
9. 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 risk.

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

##### Un insurable 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.
	1. **Insurance and gambling compared**

The essential feature about gambling is that it creates a risk where there existed none hitherto. When a gambler buys a lottery ticket, for instance, or places a bet on a horse, he puts money at risk that was not in jeopardy before. The difference between insurance and gambling can be illustrated as follows.

* The man who gambles creates a risk, which did not exist previously 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 a risk into 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 risk of devastating catastrophic loss.
* The gambler bears the risk while the insured transfers the risk.

Considering the many risks we are exposed to in our daily life, such as fire, motor accident, etc there is certainly no complete escape from the hazards, and the man who gamble, by not insuring against them is gambling against frightful odds. The man who insures pays a fixed, certain and relatively small loss (the premium), and in doing so, doesn’t gamble which would have been ruinous to his and his family.

* 1. **Insurance and speculation compared**

*Speculation* on the other hand involves doing some kind of activity with the expectation of profit in the future. For instance, a businessman who purchases and sells goods, stocks and shares, etc with the risk of loss and hope of profit through changes in their market value 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 material.

The other difference between the two is *that insurance* can reduce the objective risk of an insurer by application of the law of large numbers. In contrast*, speculation* typically involves only risk transfer, not risk reduction. The risk of an adverse price fluctuation is 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 numbers.

* 1. **Benefits and costs of insurance**
		1. **Benefits 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 members 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 every one 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 payments are 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.

**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.

* + 1. **Cost of insurance to society**

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.