CHAPTER 3
THEORETICAL BACKGROUND OF THE STUDY

3.1 Introduction
The insurance is primarily a social device adopted by civilized society for mitigating the incidence of loss of income to families by unforeseen contingencies. In India, when life insurance companies started operating in the middle of 20th century the evil play natural to all business had its sway. There was a lot of cut throat competition as well as profiteering. The avowed social objective of insurance had been totally relegated to background. As a result Life Insurance Corporation of India (LIC) came into existence on 1st September, 1956 after nationalization of all the 245 companies engaged in life insurance business. From its very inception, the Corporation has made impressive growth always striving for further improvement. However, Government made a paradigm shift in the economic policy by adopting the process of liberalization, privatization and globalization at the end of previous decade. Consequently a committee was set up under the chairmanship of Mr. Malholtra, Ex-governor of RBI for undertaking various reforms in the insurance sector in the light of new economic policy. The Committee which submitted his report in 1993 recommended the establishment of a special regulatory agency along the lines of SEBI and opening of insurance industry for private sector. This was aggressively opposed by the various trade unions of then operating insurance companies which led to some delay in implementation of Malhotra Committee’s recommendations. However, the Government passed Insurance Regulatory and Development Authority (IRDA) Act in 1999 and established IRDA to regulate the insurance business in the country. As a
result, private sector was allowed entry both in general and life insurance sector in India. IRDA also allowed foreign participation up to 26 per cent in equity shareholding of private companies. As a result many companies (both in general and life insurance) got themselves registered with IRDA to operate in India. Presently, twenty life insurance companies (Annexure I) are operating in private sector in addition to LIC from public sector.

Insurance is a risk management technique primarily used to hedge against the risk of a contingent, uncertain loss that may be suffered by those individuals or entities who have an insurable interest in scarce resources, by transferring the possibility of this loss from one interested person, persons, or entity to another. The scarce resources referred to here fall into three divisions: human resources, financial resources, and capital, or tangible resources. In the context of insurance, scarce resources are also known as "exposures," because they are "exposed" to perils, those things, or forces, which cause destruction or reduction, in the usefulness, or value, of an exposed resource. Human resources are thus exposed to perils such as illness or death; financial resources to legal judgments that may result from negligent acts, and capital resources to physical perils such as fire, theft, windstorm, and vandalism, to name but a few. A hazard is the cause of a peril. It is that thing or condition which increases the likelihood of a peril. Thus perils and hazards are identified by the exposure that they threaten. For example a slippery roadway could be viewed as a financial hazard, capital hazard, or human hazard by automobile owners, and rightly so, since this condition increases the likelihood of an automobile accident that might result in an unfavorable legal judgement, automobile damage, and bodily injury.

In the context of commercial trade, insurance is further defined as the equitable transfer of the risk of a loss, from one entity to another, in
exchange for consideration, payment, in the form of a risk premium. The insurance premium develops at an actuarially-determined rate. This rate is a factor used to determine the amount of premium to charge for a certain limit, and type, of insurance on the scarce resource. The premium can further be viewed as a guaranteed, known, relatively small financial loss to the insured, paid to the insurer, in exchange for the insurer's promise to compensate (indemnify) the insured in the case of a loss to the insured resource(s). The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be indemnified.

3.2 History of insurance

In some sense we can say that insurance appears simultaneously with the appearance of human society. We know of two types of economies in human societies: natural or non-monetary economies (using barter and trade with no centralized nor standardized set of financial instruments) and more modern monetary economies (with markets, currency, financial instruments and so on). The former is more primitive and the insurance in such economies entails agreements of mutual aid. If one family's house is destroyed the neighbours are committed to help rebuild. Granaries housed another primitive form of insurance to indemnify against famines. Often informal or formally intrinsic to local religious customs, this type of insurance has survived to the present day in some countries where modern money economy with its financial instruments is not widespread.

Turning to insurance in the modern sense (i.e., insurance in a modern money economy, in which insurance is part of the financial sphere), early methods of transferring or distributing risk were practised
by Chinese and Babylonian traders as long ago as the 3rd and 2nd millennia BC, respectively. Chinese merchants travelling treacherous river rapids would redistribute their wares across many vessels to limit the loss due to any single vessel's capsizing. The Babylonians developed a system which was recorded in the famous Code of Hammurabi, c. 1750 BC, and practiced by early Mediterranean sailing merchants. If a merchant received a loan to fund his shipment, he would pay the lender an additional sum in exchange for the lender's guarantee to cancel the loan should the shipment be stolen or lost at sea.

Achaemenian monarchs of Ancient Persia were the first to insure their people and made it official by registering the insuring process in governmental notary offices. The insurance tradition was performed each year in Norouz (beginning of the Iranian New Year); the heads of different ethnic groups as well as others willing to take part, presented gifts to the monarch. The most important gift was presented during a special ceremony. When a gift was worth more than 10,000 Derrik (Achaemenian gold coin) the issue was registered in a special office. This was advantageous to those who presented such special gifts. For others, the presents were fairly assessed by the confidants of the court. Then the assessment was registered in special offices.

The purpose of registering was that whenever the person who presented the gift registered by the court was in trouble, the monarch and the court would help him. Jahez, a historian and writer, writes in one of his books on ancient Iran: "Whenever the owner of the present is in trouble or wants to construct a building, set up a feast, have his children married, etc. the one in charge of this in the court would check the registration. If the registered amount exceeded 10,000 Derrik, he or she would receive an amount of twice as much."
A thousand years later, the inhabitants of Rhodes invented the concept of the general average. Merchants whose goods were being shipped together would pay a proportionally divided premium which would be used to reimburse any merchant whose goods were deliberately jettisoned in order to lighten the ship and save it from total loss.

The Talmud deals with several aspects of insuring goods. Before insurance was established in the late 17th century, "friendly societies" existed in England, in which people donated amounts of money to a general sum that could be used for emergencies.

Separate insurance contracts (i.e., insurance policies not bundled with loans or other kinds of contracts) were invented in Genoa in the 14th century, as were insurance pools backed by pledges of landed estates. These new insurance contracts allowed insurance to be separated from investment, a separation of roles that first proved useful in marine insurance. Insurance became far more sophisticated in post-Renaissance Europe, and specialized varieties developed.

Lloyd's of London, pictured in 1991, is one of the world's leading and most famous insurance markets.

Some forms of insurance had developed in London by the early decades of the 17th century. For example, the will of the English colonist Robert Hayman mentions two "policies of insurance" taken out with the diocesan Chancellor of London, Arthur Duck. Of the value of £100 each, one relates to the safe arrival of Hayman's ship in Guyana and the other is in regard to "one hundred pounds assured by the said Doctor Arthur Ducke on my life". Hayman's will was signed and sealed on 17 November 1628 but not proved until 1633. Toward the end of the seventeenth century, London's growing importance as a centre for trade increased demand for marine insurance. In the late 1680s, Edward Lloyd
opened a coffee house that became a popular haunt of ship owners, merchants, and ships' captains, and thereby a reliable source of the latest shipping news. It became the meeting place for parties wishing to insure cargoes and ships, and those willing to underwrite such ventures. Today, Lloyd's of London remains the leading market (note that it is an insurance market rather than a company) for marine and other specialist types of insurance, but it operates rather differently than the more familiar kinds of insurance. Insurance as we know it today can be traced to the Great Fire of London, which in 1666 devoured more than 13,000 houses. The devastating effects of the fire converted the development of insurance "from a matter of convenience into one of urgency, a change of opinion reflected in Sir Christopher Wren's inclusion of a site for 'the Insurance Office' in his new plan for London in 1667." A number of attempted fire insurance schemes came to nothing, but in 1681 Nicholas Barbon, and eleven associates, established England's first fire insurance company, the 'Insurance Office for Houses', at the back of the Royal Exchange. Initially, 5,000 homes were insured by Barbon's Insurance Office.

The first insurance company in the United States underwrote fire insurance and was formed in Charles Town (modern-day Charleston), South Carolina, in 1732. Benjamin Franklin helped to popularize and make standard the practice of insurance, particularly against fire in the form of perpetual insurance. In 1752, he founded the Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. Franklin's company was the first to make contributions toward fire prevention. Not only did his company warn against certain fire hazards, it refused to insure certain buildings where the risk of fire was too great, such as all wooden houses. In the United States, regulation of the insurance industry is highly Balkanized, with primary responsibility
assumed by individual state insurance departments. Whereas insurance markets have become centralized nationally and internationally, state insurance commissioners operate individually, though at times in concert through a national insurance commissioners' organization. In recent years, some have called for a dual state and federal regulatory system (commonly referred to as the Optional federal charter (OFC)) for insurance similar to that which oversees state banks and national banks.

3.3 Indian Insurance Market – History

Insurance has a long history in India. Life Insurance in its current form was introduced in 1818 when Oriental Life Insurance Company began its operations in India. General Insurance was however a comparatively late entrant in 1850 when Triton Insurance company set up its base in Kolkata. History of Insurance in India can be broadly bifurcated into three eras: a) Pre Nationalization b) Nationalization and c) Post Nationalization. Life Insurance was the first to be nationalized in 1956. Life Insurance Corporation of India was formed by consolidating the operations of various insurance companies. General Insurance followed suit and was nationalized in 1973. General Insurance Corporation of India was set up as the controlling body with New India, United India, National and Oriental as its subsidiaries. The process of opening up the insurance sector was initiated against the background of Economic Reform process which commenced from 1991. For this purpose Malhotra Committee was formed during this year who submitted their report in 1994 and Insurance Regulatory Development Act (IRDA) was passed in 1999. Resultantly Indian Insurance was opened for private companies and Private Insurance Company effectively started operations from 2001.
3.4 Insurance Market- Present:

The insurance sector was opened up for private participation ten years ago. For years now, the private players are active in the liberalized environment. The insurance market have witnessed dynamic changes which includes presence of a fairly large number of insurers both life and non-life segment. Most of the private insurance companies have formed joint venture partnering well recognized foreign players across the globe.

There are now 29 insurance companies operating in the Indian market – 24 private life insurers, nine private non-life insurers and six public sector companies. With many more joint ventures in the offing, the insurance industry in India today stands at a crossroads as competition intensifies and companies prepare survival strategies in a detariffed scenario.

There is pressure from both within the country and outside on the Government to increase the foreign direct investment (FDI) limit from the current 26% to 49%, which would help JV partners to bring in funds for expansion.

There are opportunities in the pensions sector where regulations are being framed. Less than 10% of Indians above the age of 60 receive pensions. The IRDA has issued the first license for a standalone health company in the country as many more players wait to enter. The health insurance sector has tremendous growth potential, and as it matures and new players enter, product innovation and enhancement will increase. The deepening of the health database over time will also allow players to develop and price products for larger segments of society.

State Insurers Continue to Dominate: There may be room for many more players in a large underinsured market like India with a
population of over one billion. But the reality is that the intense competition in the last five years has made it difficult for new entrants to keep pace with the leaders and thereby failing to make any impact in the market.

Also as the private sector controls over 26.18% of the life insurance market and over 26.53% of the non-life market, the public sector companies still call the shots.

The country’s largest life insurer, Life Insurance Corporation of India (LIC), had a share of 74.82% in new business premium income in November 2005.

Similarly, the four public-sector non-life insurers – New India Assurance, National Insurance, Oriental Insurance and United India Insurance – had a combined market share of 73.47% as of October 2005. ICICI Prudential Life Insurance Company continues to lead the private sector with a 7.26% market share in terms of fresh premium, whereas ICICI Lombard General Insurance Company is the leader among the private non-life players with a 8.11% market share. ICICI Lombard has focused on growing the market for general insurance products and increasing penetration within existing customers through product innovation and distribution.

Reaching out to Customers No doubt, the customer profile in the insurance industry is changing with the introduction of large number of divergent intermediaries such as brokers, corporate agents, and bancassurance.

The industry now deals with customers who know what they want and when, and are more demanding in terms of better service and speedier responses. With the industry all set to move to a detariffed
regime by 2007, there will be considerable improvement in customer service levels, product innovation and newer standards of underwriting.

Intense Competition: In a de-tariffed environment, competition will manifest itself in prices, products, underwriting criteria, innovative sales methods and creditworthiness. Insurance companies will vie with each other to capture market share through better pricing and client segmentation.

The battle has so far been fought in the big urban cities, but in the next few years, increased competition will drive insurers to rural and semi-urban markets.

Global Standards: While the world is eyeing India for growth and expansion, Indian companies are becoming increasingly world class. Take the case of LIC, which has set its sight on becoming a major global player following a Rs280-crore investment from the Indian government. The company now operates in Mauritius, Fiji, the UK, Sri Lanka, Nepal and will soon start operations in Saudi Arabia. It also plans to venture into the African and Asia-Pacific regions in 2006.

The year 2005 was a testing phase for the general insurance industry with a series of catastrophes hitting the Indian sub-continent.

However, with robust reinsurance programmes in place, insurers have successfully managed to tide over the crisis without any adverse impact on their balance sheets.

With life insurance premiums being just 2.5% of GDP and general insurance premiums being 0.65% of GDP, the opportunities in the Indian market place is immense. The next five years will be challenging but those that can build scale and market share will survive and prosper.
3.5 Principles

Insurance involves pooling funds from many insured entities (known as exposures) to pay for the losses that some may incur. The insured entities are therefore protected from risk for a fee, with the fee being dependent upon the frequency and severity of the event occurring. In order to be insurable, the risk insured against must meet certain characteristics in order to be an insurable risk. Insurance is a commercial enterprise and a major part of the financial services industry, but individual entities can also self-insure through saving money for possible future losses.

3.6 Types of insurance

Any risk that can be quantified can potentially be insured. Specific kinds of risk that may give rise to claims are known as perils. An insurance policy will set out in details which perils are covered by the policy and which are not. Below are non-exhaustive lists of the many different types of insurance that exist. A single policy may cover risks in one or more of the categories set out below. For example, vehicle insurance would typically cover both the property risk (theft or damage to the vehicle) and the liability risk (legal claims arising from an accident). A home insurance policy in the U.S. typically includes coverage for damage to the home and the owner's belongings, certain legal claims against the owner, and even a small amount of coverage for medical expenses of guests who are injured on the owner's property.

Business insurance can take a number of different forms, such as the various kinds of professional liability insurance, also called professional indemnity (PI), which are discussed below under that name; and the business owner's policy (BOP), which packages into one policy
many of the kinds of coverage that a business owner needs, in a way analogous to how homeowners' insurance packages the coverages that a homeowner needs.

**Auto insurance**

Auto insurance protects the policyholder against financial loss in the event of an incident involving a vehicle they own, such as in a traffic collision.

Coverage typically includes:

1. Property coverage, for damage to or theft of the car;
2. Liability coverage, for the legal responsibility to others for bodily injury or property damage;
3. Medical coverage, for the cost of treating injuries, rehabilitation and sometimes lost wages and funeral expenses.

Most countries, such as the United Kingdom, require drivers to buy some, but not all, of these coverages. When a car is used as collateral for a loan the lender usually requires specific coverage.

**Home insurance**

Home insurance provides coverage for damage or destruction of the policyholder's home. In some geographical areas, the policy may exclude certain types of risks, such as flood or earthquake that require additional coverage. Maintenance-related issues are typically the homeowner's responsibility. The policy may include inventory, or this can be bought as a separate policy, especially for people who rent housing. In some countries, insurers offer a package which may include liability and legal responsibility for injuries and property damage caused by members of the household, including pets.\(^{[19]}\)
Health insurance

Health insurance policies cover the cost of medical treatments. Dental insurance, like medical insurance, protects policyholders for dental costs. In the U.S. and Canada, dental insurance is often part of an employer's benefits package, along with health insurance.

Accident, sickness and unemployment insurance

Workers' compensation, or employers' liability insurance, is compulsory in some countries

- Disability insurance policies provide financial support in the event of the policyholder becoming unable to work because of disabling illness or injury. It provides monthly support to help pay such obligations as mortgage loans and credit cards. Short-term and long-term disability policies are available to individuals, but considering the expense, long-term policies are generally obtained only by those with at least six-figure incomes, such as doctors, lawyers, etc. Short-term disability insurance covers a person for a period typically up to six months, paying a stipend each month to cover medical bills and other necessities.

- Long-term disability insurance covers an individual's expenses for the long term, up until such time as they are considered permanently disabled and thereafter. Insurance companies will often try to encourage the person back into employment in preference to and before declaring them unable to work at all and therefore totally disabled.

- Disability overhead insurance allows business owners to cover the overhead expenses of their business while they are unable to work.
• Total permanent disability insurance provides benefits when a person is permanently disabled and can no longer work in their profession, often taken as an adjunct to life insurance.

• Workers' compensation insurance replaces all or part of a worker's wages lost and accompanying medical expenses incurred because of a job-related injury.

**Casualty**

Casualty insurance insures against accidents, not necessarily tied to any specific property. It is a broad spectrum of insurance that a number of other types of insurance could be classified, such as auto, workers compensation, and some liability insurances.

• Crime insurance is a form of casualty insurance that covers the policyholder against losses arising from the criminal acts of third parties. For example, a company can obtain crime insurance to cover losses arising from theft or embezzlement.

• Political risk insurance is a form of casualty insurance that can be taken out by businesses with operations in countries in which there is a risk that revolution or other political conditions could result in a loss.

**Life**

Life insurance provides a monetary benefit to a descendant's family or other designated beneficiary, and may specifically provide for income to an insured person's family, 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, are 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.

Certain life insurance contracts accumulate cash values, which may be taken by the insured if the policy is surrendered or which may be borrowed against. Some policies, such as annuities and endowment policies, are financial instruments to accumulate or liquidate wealth when it is needed.

In many countries, such as the U.S. and the UK, the tax law provides that the interest on this cash value is not taxable under certain circumstances. This leads to widespread use of life insurance as a tax-efficient method of saving as well as protection in the event of early death.

In the U.S., the tax on interest income on life insurance policies and annuities is generally deferred. However, in some cases the benefit derived from tax deferral may be offset by a low return. This depends upon the insuring company, the type of policy and other variables (mortality, market return, etc.). Moreover, other income tax saving vehicles (e.g., IRAs, 401(k) plans, Roth IRAs) may be better alternatives for value accumulation.

**Burial insurance**

Burial insurance is a very old type of life insurance which is paid out upon death to cover final expenses, such as the cost of a funeral. The Greeks and Romans introduced burial insurance circa 600 AD when they organized guilds called "benevolent societies" which cared for the
surviving families and paid funeral expenses of members upon death. Guilds in the middle Ages served a similar purpose, as did friendly societies during Victorian times.

**Property**

This tornado damage to an Illinois home would be considered an "Act of God" for insurance purposes. Property insurance provides protection against risks to property, such as fire, theft or weather damage. This may include specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, inland marine insurance or boiler insurance. The term *property insurance* may, like casualty insurance, be used as a broad category of various subtypes of insurance, some of which are listed below:

- Aviation insurance protects aircraft hulls and spares, and associated liability risks, such as passenger and third-party liability. Airports may also appear under this subcategory, including air traffic control and refuelling operations for international airports through to smaller domestic exposures.
- Boiler insurance (also known as boiler and machinery insurance, or equipment breakdown insurance) insures against accidental physical damage to boilers, equipment or machinery.
- Builder's risk insurance insures against the risk of physical loss or damage to property during construction. Builder's risk insurance is typically written on an "all risk" basis covering damage arising from any cause (including the negligence of the insured) not otherwise expressly excluded. Builder's risk insurance is coverage that protects a person's or organization's insurable interest in materials, fixtures and/or equipment being used in the construction
or renovation of a building or structure should those items sustain physical loss or damage from an insured peril.[20]

- Crop insurance may be purchased by farmers to reduce or manage various risks associated with growing crops. Such risks include crop loss or damage caused by weather, hail, drought, frost damage, insects, or disease.[21]

- Earthquake insurance is a form of property insurance that pays the policyholder in the event of an earthquake that causes damage to the property. Most ordinary home insurance policies do not cover earthquake damage. Earthquake insurance policies generally feature a high deductible. Rates depend on location and hence the likelihood of an earthquake, as well as the construction of the home.

- Fidelity bond is a form of casualty insurance that covers policyholders for losses incurred as a result of fraudulent acts by specified individuals. It usually insures a business for losses caused by the dishonest acts of its employees.

- Flood insurance protects against property loss due to flooding. Many insurers in the U.S. do not provide flood insurance in some parts of the country. In response to this, the federal government created the National Flood Insurance Program which serves as the insurer of last resort.

- Home insurance, also commonly called hazard insurance, or homeowners insurance (often abbreviated in the real estate industry as HOI), is the type of property insurance that covers private homes, as outlined above.
• Landlord insurance covers residential and commercial properties which are rented to others. Most homeowners’ insurance covers only owner-occupied homes.

• Marine insurance and marine cargo insurance cover the loss or damage of vessels at sea or on inland waterways, and of cargo in transit, regardless of the method of transit. When the owner of the cargo and the carrier are separate corporations, marine cargo insurance typically compensates the owner of cargo for losses sustained from fire, shipwreck, etc., but excludes losses that can be recovered from the carrier or the carrier's insurance. 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.

• Supplemental natural disaster insurance covers specified expenses after a natural disaster renders the policyholder's home uninhabitable. Periodic payments are made directly to the insured until the home is rebuilt or a specified time period has elapsed.

• Surety bond insurance is a three-party insurance guaranteeing the performance of the principal.

• Terrorism insurance provides protection against any loss or damage caused by terrorist activities. In the U.S. in the wake of 9/11, the Terrorism Risk Insurance Act 2002 (TRIA) set up a federal Program providing a transparent system of shared public and private compensation for insured losses resulting from acts of terrorism. The program was extended until the end of 2014 by the Terrorism Risk Insurance Program Reauthorization Act 2007 (TRIPRA).
• Volcano insurance is a specialized insurance protecting against
damage arising specifically from volcanic eruptions.
• Windstorm insurance is an insurance covering the damage that can
be caused by wind events such as hurricanes.

Liability

Liability insurance is a very broad superset that covers legal claims
against the insured. Many types of insurance include an aspect of liability
coverage. For example, a homeowner's insurance policy will normally
include liability coverage which protects the insured in the event of a
claim brought by someone who slips and falls on the property; automobile insurance also includes an aspect of liability insurance that
indemnifies against the harm that a crashing car can cause to others' lives,
health, or property. 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.

The subprime mortgage crisis was the source of many liability
insurance losses
• Public liability insurance covers a business or organization against
claims should its operations injure a member of the public or
damage their property in some way.
• Directors and officers liability insurance (D&O) protects an
organization (usually a corporation) from costs associated with
litigation resulting from errors made by directors and officers for
which they are liable.
• 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.

• Errors and omissions insurance is business liability insurance for professionals such as insurance agents, real estate agents and brokers, architects, third-party administrators (TPAs) and other business professionals.

• Prize indemnity insurance protects the insured from giving away a large prize at a specific event. Examples would include offering prizes to contestants who can make a half-court shot at a basketball game, or a hole-in-one at a golf tournament.

• Professional liability insurance, also called professional indemnity insurance (PI), protects insured professionals such as architectural corporations and medical practitioners against potential negligence claims made by their patients/clients. Professional liability insurance may take on different names depending on the profession. For example, professional liability insurance in reference to the medical profession may be called medical malpractice insurance.

Credit
Credit insurance repays some or all of a loan when certain circumstances arise to the borrower such as unemployment, disability, or death.

• Mortgage insurance insures the lender against default by the borrower. Mortgage insurance is a form of credit insurance, although the name "credit insurance" more often is used to refer to policies that cover other kinds of debt.
• Many credit cards offer payment protection plans which are a form of credit insurance.

Other types

• All-risk insurance is an insurance that covers a wide-range of incidents and perils, except those noted in the policy. All-risk insurance is different from peril-specific insurance that cover losses from only those perils listed in the policy. In car insurance, all-risk policy includes also the damages caused by the own driver.

• Bloodstock insurance covers individual horses or a number of horses under common ownership. Coverage is typically for mortality as a result of accident, illness or disease but may extend to include infertility, in-transit loss, veterinary fees, and prospective foal.

• Business interruption insurance covers the loss of income, and the expenses incurred, after a covered peril interrupts normal business operations.

• Collateral protection insurance (CPI) insures property (primarily vehicles) held as collateral for loans made by lending institutions.

• Defense Base Act (DBA) insurance provides coverage for civilian workers hired by the government to perform contracts outside the U.S. and Canada. DBA is required for all U.S. citizens, U.S. residents, U.S. Green Card holders, and all employees or subcontractors hired on overseas government contracts. Depending on the country, foreign nationals must also be covered under DBA. This coverage typically includes expenses related to medical treatment and loss of wages, as well as disability and death benefits.
• Expatriate insurance provides individuals and organizations operating outside of their home country with protection for automobiles, property, health, liability and business pursuits.

• Kidnap and ransom insurance is designed to protect individuals and corporations operating in high-risk areas around the world against the perils of kidnap, extortion, wrongful detention and hijacking.

• Legal expenses insurance covers policyholders for the potential costs of legal action against an institution or an individual. When something happens which triggers the need for legal action, it is known as "the event". There are two main types of legal expenses insurance: before the event insurance and after the event insurance.

• Locked funds insurance is a little-known hybrid insurance policy jointly issued by governments and banks. It is used to protect public funds from tamper by unauthorized parties. In special cases, a government may authorize its use in protecting semi-private funds which are liable to tamper. The terms of this type of insurance are usually very strict. Therefore it is used only in extreme cases where maximum security of funds is required.

• Livestock insurance is a specialist policy provided to, for example, commercial or hobby farms, aquariums, fish farms or any other animal holding. Cover is available for mortality or economic slaughter as a result of accident, illness or disease but can extend to include destruction by government order.

• Media liability insurance is designed to cover professionals that engage in film and television production and print, against risks such as defamation.

• Nuclear incident insurance covers damages resulting from an incident involving radioactive materials and is generally arranged
at the national level. (See the nuclear exclusion clause and for the U.S. the Price-Anderson Nuclear Industries Indemnity Act.)

- Pet insurance insures pets against accidents and illnesses; some companies cover routine/wellness care and burial, as well.
- Pollution insurance usually takes the form of first-party coverage for contamination of insured property either by external or on-site sources. Coverage is also afforded for liability to third parties arising from contamination of air, water, or land due to the sudden and accidental release of hazardous materials from the insured site. The policy usually covers the costs of cleanup and may include coverage for releases from underground storage tanks. Intentional acts are specifically excluded.
- 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.
- Title insurance provides a guarantee that title to real property is vested in the purchaser and/or mortgagee, free and clear of liens or encumbrances. It is usually issued in conjunction with a search of the public records performed at the time of a real estate transaction.
- Travel insurance is an insurance cover taken by those who travel abroad, which covers certain losses such as medical expenses, loss of personal belongings, travel delay, and personal liabilities.

3.7 Insurance financing vehicles

- Fraternal insurance is provided on a cooperative basis by fraternal benefit societies or other social organizations.\textsuperscript{[23]}
No-fault insurance is a type of insurance policy (typically automobile insurance) where insureds are indemnified by their own insurer regardless of fault in the incident.

Protected self-insurance is an alternative risk financing mechanism in which an organization retains the mathematically calculated cost of risk within the organization and transfers the catastrophic risk with specific and aggregate limits to an insurer so the maximum total cost of the program is known. A properly designed and underwritten Protected Self-Insurance Program reduces and stabilizes the cost of insurance and provides valuable risk management information.

Retrospectively rated insurance is a method of establishing a premium on large commercial accounts. The final premium is based on the insured's actual loss experience during the policy term, sometimes subject to a minimum and maximum premium, with the final premium determined by a formula. Under this plan, the current year's premium is based partially (or wholly) on the current year's losses, although the premium adjustments may take months or years beyond the current year's expiration date. The rating formula is guaranteed in the insurance contract. Formula: retrospective premium = converted loss + basic premium \times tax multiplier. Numerous variations of this formula have been developed and are in use.

Formal self insurance is the deliberate decision to pay for otherwise insurable losses out of one's own money. This can be done on a formal basis by establishing a separate fund into which funds are deposited on a periodic basis, or by simply forgoing the purchase of available insurance and paying out-of-pocket. Self insurance is
usually used to pay for high-frequency, low-severity losses. Such losses, if covered by conventional insurance, mean having to pay a premium that includes loadings for the company's general expenses, cost of putting the policy on the books, acquisition expenses, premium taxes, and contingencies. While this is true for all insurance, for small, frequent losses the transaction costs may exceed the benefit of volatility reduction that insurance otherwise affords.

- Reinsurance is a type of insurance purchased by insurance companies or self-insured employers to protect against unexpected losses. Financial reinsurance is a form of reinsurance that is primarily used for capital management rather than to transfer insurance risk.

- Social insurance can be many things to many people in many countries. But a summary of its essence is that it is a collection of insurance coverages (including components of life insurance, disability income insurance, unemployment insurance, health insurance, and others), plus retirement savings, that requires participation by all citizens. By forcing everyone in society to be a policyholder and pay premiums, it ensures that everyone can become a claimant when or if he/she needs to. Along the way this inevitably becomes related to other concepts such as the justice system and the welfare state.

- Stop-loss insurance provides protection against catastrophic or unpredictable losses. It is purchased by organizations who do not want to assume 100% of the liability for losses arising from the plans. Under a stop-loss policy, the insurance company becomes liable for losses that exceed certain limits called deductibles.
3.8 Closed community self-insurance

Some communities prefer to create virtual insurance amongst themselves by other means than contractual risk transfer, which assigns explicit numerical values to risk. A number of religious groups, including the Amish and some Muslim groups, depend on support provided by their communities when disasters strike. The risk presented by any given person is assumed collectively by the community who all bear the cost of rebuilding lost property and supporting people whose needs are suddenly greater after a loss of some kind. In supportive communities where others can be trusted to follow community leaders, this tacit form of insurance can work. In this manner the community can even out the extreme differences in insurability that exist among its members. Some further justification is also provided by invoking the moral hazard of explicit insurance contracts.

In the United Kingdom, The Crown (which, for practical purposes, meant the civil service) did not insure property such as government buildings. If a government building was damaged, the cost of repair would be met from public funds because, in the long run, this was cheaper than paying insurance premiums. Since many UK government buildings have been sold to property companies, and rented back, this arrangement is now less common and may have disappeared altogether.

3.9 Insurance companies

Insurance companies may be classified into two groups:

- Life insurance companies, which sell life insurance, annuities and pensions products.
- Non-life, general, or property/casualty insurance companies, which sell other types of insurance.
General insurance companies can be further divided into these sub categories.

- Standard lines
- Excess lines

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.

In the United States, standard line insurance companies are "mainstream" insurers. These are the companies that typically insure autos, homes or businesses. They use pattern or "cookie-cutter" policies without variation from one person to the next. They usually have lower premiums than excess lines and can sell directly to individuals. They are regulated by state laws that can restrict the amount they can charge for insurance policies.

Excess line insurance companies (also known as Excess and Surplus) typically insure risks not covered by the standard lines market. They are broadly referred as being all insurance placed with non-admitted insurers. Non-admitted insurers are not licensed in the states where the risks are located. These companies have more flexibility and can react faster than standard insurance companies because they are not required to file rates and forms as the "admitted" carriers do. However, they still have substantial regulatory requirements placed upon them. State laws generally require insurance placed with surplus line agents and brokers not to be available through standard licensed insurers.
Insurance companies are generally classified as either mutual or stock companies. Mutual companies are owned by the policyholders, while stockholders (who may or may not own policies) own stock insurance companies. Demutualization of mutual insurers to form stock companies, as well as the formation of a hybrid known as a mutual holding company, became common in some countries, such as the United States, in the late 20th century.

Other possible forms for an insurance company include reciprocals, in which policyholders reciprocate in sharing risks, and Lloyd's organizations.

Insurance companies are rated by various agencies such as A. M. Best. The ratings include the company's financial strength, which measures its ability to pay claims. It also rates financial instruments issued by the insurance company, such as bonds, notes, and securitization products.

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 product 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.

The financial stability and strength of an insurance company should be a major consideration when buying an insurance contract. An insurance premium paid currently provides coverage for losses that might arise many years in the future. For that reason, the viability of the insurance carrier is very important. In recent years, a number of insurance companies have become insolvent, leaving their policyholders with no coverage (or coverage only from a government-backed insurance pool or other arrangement with less attractive payouts for losses). A number of independent rating agencies provide information and rate the financial viability of insurance companies.

### 3.10 Complexity of insurance policy contracts

Insurance policies can be complex and some policyholders may not understand all the fees and coverages included in a policy. As a result, people may buy policies on unfavorable terms. In response to these issues, many countries have enacted detailed statutory and regulatory regimes governing every aspect of the insurance business, including minimum standards for policies and the ways in which they may be advertised and sold.
For example, most insurance policies in the English language today have been carefully drafted in plain English; the industry learned the hard way that many courts will not enforce policies against insureds when the judges themselves cannot understand what the policies are saying. Typically, courts construe ambiguities in insurance policies against the insurance company and in favor of coverage under the policy.

Many institutional insurance purchasers buy insurance through an insurance broker. While on the surface it appears the broker represents the buyer (not the insurance company), and typically counsels the buyer on appropriate coverage and policy limitations, it should be noted that in the vast majority of cases a broker's compensation comes in the form of a commission as a percentage of the insurance premium, creating a conflict of interest in that the broker's financial interest is tilted towards encouraging an insured to purchase more insurance than might be necessary at a higher price. A broker generally holds contracts with many insurers, thereby allowing the broker to "shop" the market for the best rates and coverage possible.

Insurance may also be purchased through an agent. Unlike a broker, who represents the policyholder, an agent represents the insurance company from whom the policyholder buys. Just as there is a potential conflict of interest with a broker, an agent has a different type of conflict. Because agents work directly for the insurance company, if there is a claim the agent may advise the client to the benefit of the insurance company. It should also be noted that agents generally can not offer as broad a range of selection compared to an insurance broker.

An independent insurance consultant advises insured on a fee-for-service retainer, similar to an attorney, and thus offers completely independent advice, free of the financial conflict of interest of brokers.
and/or agents. However, such a consultant must still work through brokers and/or agents in order to secure coverage for their clients.

3.11 Limited consumer benefits

Economists and consumer advocates generally consider insurance to be worthwhile for low-probability, catastrophic losses, but not for high-probability, small losses. Because of this, consumers are advised to select high deductibles and to not insure losses which would not cause a disruption in their life. However, consumers have shown a tendency to prefer low deductibles and to prefer to insure relatively high-probability, small losses over low-probability, perhaps due to not understanding or ignoring the low-probability risk. This is associated with reduced purchasing of insurance against low-probability losses, and may result in increased inefficiencies from moral hazard.

3.10 Evolution of Insurance in India

India had the nineteenth largest insurance market in the world in 2003. Strong economic growth in the last decade combined with a population of over a billion makes it one of the potentially largest markets in the future. Insurance in India has gone through two radical transformations. Before 1956, insurance was private with minimal government intervention. In 1956, life insurance was nationalized and a monopoly was created. In 1972, general insurance was nationalized as well (endnote 1). But, unlike life insurance, a different structure was created for the industry. One holding company was formed with four subsidiaries. As a part of the general opening up of the economy after 1992, a Government appointed committee recommended that private companies should be allowed to operate. It took six years to implement the recommendation. Private sector was allowed into insurance business
in 2000. However, foreign ownership was restricted. No more than 26% of any company can be foreign-owned.

In what follows, we examine the insurance industry in India through different regulatory regimes. A totally regulation free regime ended in 1912 with the introduction of regulation of life insurance. A comprehensive regulatory scheme came into place in 1938. This was disabled through nationalization. But, the Insurance Act of 1938 became relevant again in 2000 with deregulation. With a strong hint of sustained growth of the economy in the recent past, the Indian market is likely to grow substantially over the next few decades.

The rest of the chapter is organized as follows. First, we study the evolution of insurance business before nationalization. This is important because the denationalized structure brought back to play important legal rules from 1938. Next we analyze the nationalized era separately for life and property casualty business as they were not nationalized simultaneously. Much of post-independence history of insurance in India was the history of nationalized insurance. In the following section, we examine the new legal structure introduced after the industry was denationalized in 2000. In the penultimate section, we examine the current state of play and projected future of the industry. The final section sets out conclusions.

3.12 Evolution of Insurance Before Nationalization

Insurance in the Colonial Era. Life insurance in the modern form was first set up in India through a British company called the Oriental Life Insurance Company in 1818 followed by the Bombay Assurance Company in 1823 and the Madras Equitable Life Insurance Society in 1829. All of these companies operated in India but did not insure the lives
of Indians. They were insuring the lives of Europeans living in India (endnote 2).


Some of the companies that started later did provide insurance for Indians. But, they were treated as “substandard”. Substandard in insurance parlance refers to lives with physical disability. In this case, the common adjustment made was a “rating-up” of five to seven years to normal British life in India. This meant, treating $q(x)$, the (conditional) probability of dying between $x$ and $x+1$, for an $x$ year old Indian male as if it was $q(x+5)$ or $q(x+7)$ of a British male. Therefore, Indian lives had to pay an ad hoc extra premium of 20% or more. This was a common practice of the European companies at the time whether they were operating in Asia or Latin America. The first company to sell policies to Indians with “fair value” was the Bombay Mutual Life Assurance Society starting in 1871.

The first general insurance company, Triton Insurance Company Ltd., was established in 1850. It was owned and operated by the British. The first indigenous general insurance company was the Indian Mercantile Insurance Company Limited set up in Bombay in 1907.

Insurance business was conducted in India without any specific regulation for the insurance business. They were subject to Indian Companies Act (1866). After the start of the “Be Indian Buy Indian Movement” (called Swadeshi Movement) in 1905, indigenous enterprises sprang up in many industries. Not surprisingly, the Movement also touched the insurance industry leading to the formation of dozens of life
insurance companies along with provident fund companies (provident fund companies are pension funds). In 1912, two sets of legislation were passed: the Indian Life Assurance Companies Act and the Provident Insurance Societies Act. There are several striking features of these legislations. First, they were the first legislations in India that particularly targeted the insurance sector. Second, they left general insurance business out of it. The government did not feel the necessity to regulate general insurance. Third, they restricted activities of the Indian insurers but not the foreign insurers even though the model used was the British Act of 1909.

Comprehensive insurance legislation covering both life and non-life business did not materialize for the next twenty-six years. During the first phase of these years, Great Britain entered World War I. This event disrupted all legislative initiatives. Later, Indians demanded freedom from the British. As a concession, India was granted “home rule” through the Government of India Act of 1935. It provided for Legislative Assemblies for provincial governments as well as for the central government. But supreme authority of promulgated laws still stayed with the British Crown.

The only significant legislative change before the Insurance Act of 1938, was Act XX of 1928. It enabled the Government of India to collect information of (1) Indian insurance companies operating in India, (2) Foreign insurance companies operating in India and (3) Indian insurance companies operating in foreign countries. The last two elements were missing from the 1912 Insurance Act. Information thus collected allows us to compare the average size face value of Indian insurance companies against their foreign counterparts. In 1928, the average policy value of an Indian company was 619 US dollars against 1,150 US dollars for foreign

Foreign insurance companies were doing well during that period. In 1938, the average size of the policy sold by Indian companies has fallen to 532 US dollars (in comparison with 619 US dollars in 1928) and that of foreign companies had risen somewhat to 1,188 US dollars (in 1928, the average size was 1,150 US dollars).

The Birth of the Insurance Act, 1938. In 1937, the Government of India set up a consultative committee. Mr. Sushil C. Sen, a well known solicitor of Calcutta, was appointed the chair of the committee. He consulted a wide range of interested parties including the industry. It was debated in the Legislative Assembly. Finally, in 1938, the Insurance Act was passed. This piece of legislation was the first comprehensive one in India. It covered both life and general insurance companies. It clearly defined what would come under the life insurance business, the fire insurance business and so on (see Appendix 1). It covered deposits, supervision of insurance companies, investments, commissions of agents, directors appointed by the policyholders among others. This piece of legislation lost significance after nationalization. Life insurance was nationalized in 1956 and general insurance in 1972 respectively. With the privatization in the late Twentieth Century, it has returned as the backbone of the current legislation of insurance companies. All legislative changes are enumerated in Table 1.
<table>
<thead>
<tr>
<th>Year</th>
<th>Significant Regulatory Event</th>
</tr>
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<tbody>
<tr>
<td>1912</td>
<td>The Indian Life Insurance Company Act</td>
</tr>
<tr>
<td>1928</td>
<td>Indian Insurance Companies Act</td>
</tr>
<tr>
<td>1938</td>
<td>The Insurance Act: Comprehensive Act to regulate insurance business in India</td>
</tr>
<tr>
<td>1956</td>
<td>Nationalization of life insurance business in India with a monopoly awarded to the Life Insurance Corporation of India</td>
</tr>
<tr>
<td>1972</td>
<td>Nationalization of general insurance business in India with the formation of a holding company General Insurance Corporation</td>
</tr>
<tr>
<td>1993</td>
<td>Setting up of Malhotra Committee</td>
</tr>
<tr>
<td>1994</td>
<td>Recommendations of Malhotra Committee published</td>
</tr>
<tr>
<td>1995</td>
<td>Setting up of Mukherjee Committee</td>
</tr>
<tr>
<td>1996</td>
<td>Setting up of (interim) Insurance Regulatory Authority (IRA) Recommendations of the IRA</td>
</tr>
<tr>
<td>1997</td>
<td>Mukherjee Committee Report submitted but not made public</td>
</tr>
<tr>
<td>1997</td>
<td>The Government gives greater autonomy to Life Insurance Corporation, General Insurance Corporation and its subsidiaries with regard to the restructuring of boards and flexibility in investment norms aimed at channeling funds to the infrastructure sector</td>
</tr>
<tr>
<td>1998</td>
<td>The cabinet decides to allow 40% foreign equity in private insurance companies-26% to foreign companies and 14% to Non-resident Indians and Foreign Institutional Investors</td>
</tr>
<tr>
<td>1999</td>
<td>The Standing Committee headed by Murali Deora decides that foreign equity in private insurance should be limited to 26%.</td>
</tr>
</tbody>
</table>
The IRA bill is renamed the Insurance Regulatory and Development Authority Bill

<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
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<tbody>
<tr>
<td>1999</td>
<td>Cabinet clears Insurance Regulatory and Development Authority Bill</td>
</tr>
<tr>
<td>2000</td>
<td>President gives Assent to the Insurance Regulatory and Development Authority Bill</td>
</tr>
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### 3.13 Functions Of Insurance

#### Concept of Insurance

Insurance can be defined as a contract between two parties, where one promises the other to indemnify or make good any financial loss suffered by the latter (the insured) in consideration for an amount received by way of ‘premium’. In other words, the party agreeing to pay for the losses is the ‘insurer’. The party whose loss makes the ‘insurer’ pay the claim is the ‘insured’. The consideration involved in the contract or what the insured pays to the ‘insurer’ is called premium. The contract of insurance is referred to as the ‘policy’. Losses cannot be determined before hand, but certainly can be reimbursed if and when they occur, by insurance. For this, people facing common risks come together and contribute a fixed amount towards a pool, out of which they are reimbursed if and when loss occurs.

This point can be made clear with the help of the following example:

If there are 100 houses in a locality each of the value of Rs. 2,00,000 and every year one house gets burnt down or destroyed, then the 100 owners will have to contribute an amount of Rs. 2,000 each to create a pool in order to be able to reimburse the loss amounting to Rs. 2,00,000 faced by the one unfortunate owner amongst them.
An asset of any nature that is the outcome of the efforts of the owner has an economic value and any damage that occurs to the asset making it non-functional in turn leads to a loss where the owner cannot derive benefits that he was enjoying earlier. Thus, it becomes necessary to replace or repair such an asset for the continued benefit of the owner. Every individual is endowed with a potential to earn. If he is disabled he cannot enjoy the same level of earnings. In the event of his death, his family suffers loss of earnings. It is in this context insurance assumes importance. If the asset had been insured, or the individual’s life and earning capabilities are insured, then any loss or damage to the asset or to him would not affect the lifestyle of the owner or his dependents to a very great extent. The owner/individual may suffer a loss, but it is made good by the insurer as the owner/individual by getting his assets or himself

Insured, is transferring the loss to the insurer thus making him liable to reimburse it. Insurance is therefore, from the point of view of an individual, a financial arrangement whereby the individual can substitute a relatively small definite cost (premium) for a large uncertain financial loss. The predictability of a loss forms the base of insurance system.

**Basic functions of Insurance**

1. **Primary Functions**
2. **Secondary Functions**
3. **Other Functions**

**Primary functions of insurance**

- **Providing protection** – The elementary purpose of insurance is to allow security against future risk, accidents and uncertainty. Insurance cannot arrest the risk from taking place, but can for sure allow for the losses arising with the risk. Insurance is in reality a
protective cover against economic loss, by apportioning the risk with others.

- **Collective risk bearing** – Insurance is an instrument to share the financial loss. It is a medium through which few losses are divided among larger number of people. All the insured add the premiums towards a fund and out of which the persons facing a specific risk is paid.

- **Evaluating risk** – Insurance fixes the likely volume of risk by assessing diverse factors that give rise to risk. Risk is the basis for ascertaining the premium rate as well.

- **Provide Certainty** – Insurance is a device, which assists in changing uncertainty to certainty.

**Secondary functions of insurance**

- **Preventing losses** – Insurance warns individuals and businessmen to embrace appropriate device to prevent unfortunate aftermaths of risk by observing safety instructions; installation of automatic sparkler or alarm systems, etc.

- **Covering larger risks with small capital** – Insurance assuages the businessmen from security investments. This is done by paying small amount of premium against larger risks and dubiety.

- **Helps in the development of larger industries** – Insurance provides an opportunity to develop to those larger industries which have more risks in their setting up.

**Other functions of insurance**

- **Is a savings and investment tool** – Insurance is the best savings and investment option, restricting unnecessary expenses by the insured. Also to take the benefit of income tax exemptions, people take up insurance as a good investment option.
• **Medium of earning foreign exchange** – Being an international business, any country can earn foreign exchange by way of issue of marine insurance policies and a different other ways.

• **Risk Free trade** – Insurance boosts exports insurance, making foreign trade risk free with the help of different types of policies under marine insurance cover.

  Insurance provides indemnity, or reimbursement, in the event of an unanticipated loss or disaster. There are different types of insurance policies under the sun cover almost anything that one might think of. There are loads of companies who are providing such customized insurance policies.

3.14 **Malhotra Committee's Recommendations**

The committee submitted its report in January 1994 recommending that private insurers be allowed to co-exist along with government companies like LIC and GIC companies. This recommendation had been prompted by several factors such as need for greater deeper insurance coverage in the economy, and a much a greater scale of mobilization of funds from the economy for infrastructural development. Liberalization of the insurance sector is at least partly driven by fiscal necessity of tapping the big reserve of savings in the economy. Committee's recommendations were as follows:

1) Raising the capital base of LIC and GIC up to Rs. 200 crores, half retained by the government and rest sold to the public at large with suitable reservations for its employees.

2) Private sector is granted to enter insurance industry with a minimum paid up capital of Rs. 100crores.
3) Foreign insurance be allowed to enter by floating an Indian company preferably a joint venture with Indian partners.

4) Steps are initiated to set up a strong and effective insurance regulatory in the form of a statutory autonomous board on the lines of SEBI.

5) Limited number of private companies to be allowed in the sector. But no firm is allowed in the sector. But no firm is allowed to operate in both lines of insurance (life or non-life).

6) Tariff Advisory Committee (TAC) is delinked from GIC to function as a separate statutory body under necessary supervision by the insurance regulatory authority.

7) All insurance companies be treated on equal footing and governed by the provisions of insurance Act. No special dispensation is given to government companies.

8) Setting up of a strong and effective regulatory body with independent source for financing before allowing private companies into sector.

Government companies had to face competition to private sector insurance companies not only in issuing various range of insurance products but also in various aspects in terms of customer service, channels of distribution, effective techniques of selling the products etc. Privatization of the insurance sector has opened the doors to innovations in the way business can be transacted.

New age insurance companies are embarking on new concepts and more cost effective way of transacting business. The idea is clear to cater to the maximum business at the least cost.

While nationalized insurance companies have done a commendable job in extending volume of the business opening up of insurance sector to
private players was a necessity in the context of liberalization of financial sector. If traditional infrastructural and semi-public goods industries such as banking, airlines, telecom, power etc. have significant private sector presence, continuing state monopoly in provision of insurance was indefensible and therefore, the privatization of insurance has been done as discussed earlier. Its impact has to be seen in the form of creating various opportunities and challenges.

3.15 Opportunities

1. Privatization of Insurance eliminated the monopolistic business of Life Insurance Corporation of India. It helps to introduce new range of products which covered wide range of risks.

2. It resulted in better customer services and help improve the variety and price of insurance products.

3. The entry of new player has speed up the spread of both life and general insurance. It will increase the insurance penetration and measure of density.

4. Entry of private players will ensure the mobilization of funds that can be utilized for the purpose of infrastructure development.

5. The participation of commercial banks into insurance business helped to mobilization of funds from the rural areas because of the availability of vast branches of the banks.

6. Most important not the least tremendous employment opportunities were created in the field of insurance which is a burning problem of the presence day today issues.

There is low penetration in the market and there is great opportunity of more players to participate in this field to increase the life insurance market. LIC is a state owned enterprise. LIC emerged as a
dominant enterprise over a long period of time and in the 10 years of the opening of this sector, LIC has retained large market share. Also the industry has not been able to cover much percentage of people in the country. Out of approx. 3% of the population covered, LIC has a large percentage of people covered under it. It has been often said that state owned enterprise can have strong incentives to engage in anticompetitive activities that serve to expand the scale and scope of their operative activities.

3.16 Current Insurance Market Structure

General Insurance business in India was under complete control of four Government insurance companies for nearly three decade. After much deliberation finally the market was opened for competition from December 2000 and also Government has de-linked four Public sector companies from holding company GIC to operate as independent company. In addition to four Public Sector insurance companies the Insurance Regulatory and Development Authority (.IRDA.) has issued licenses to the eight Private General Insurance Companies.

It is important to understand the market structure of life insurance sector. LIC as a dominant player has gained an increase of 88% in new business premium income. Despite of uncertain environment, total premium of Life Insurance industry increase by 66% to Rs 62,361.34 crore in first six months of the current fiscal from Rs 39,046.59 crore in same period last fiscal. In 2010, life insurance companies witnessed new business premium collecting during first five months. According to LIC’s recent filing with IRDA the total value of its investments from policy holders funds, as at June 30 2010, stood at Rs 867,935 crore as agencies Rs. 717,002 crore on June,2009, the value of investments in equity share
has become 183,233 crore. Public sector Life Insurance Corporation of India (LIC) has clocked a robust 72.53 per cent jump in fresh premium collection in January 2009 leaving behind major private sector players, most of whom have posted negative growth in the month as compared to January 2008.

Data released by insurance sector regulator IRDA shows that the first year premium of the life insurers for the period of December, 2010 is again predominantly in favour of LIC.

Herein mentioned are some statistics given by IRDA regarding the individual single premium of several life insurers in December 2010:

1. Bajaj Allianz - 77.26 crore
2. ING vyasa - 2.58 crore
3. Reliance Life - 80.26 crore
4. SBI life - 248.54 crore
5. Tata AIG - 14.02 crore
6. HDFC standard - 136.72 crore
7. ICICI prudential - 251.97 crore
8. Birla Sunlife - 9.73 crore
9. Aviva - 21.57 crore
10. Max New York - 25.15 crore
11. Met Life - 33.86 crore
12. Shriram Life - 44.90 crore
13. IDBI federal - 21.11 crore
14. Star Union Dai-ichi - 44.98 crore
15. LIC - 1774.43 crore

These are some top companies and there premium collected in December 2010 which clearly depicts that LIC has lucrative market dominance and other private players have a small market share. Such
figures explain that LIC is a dominant entity and can influence competition in market negatively due to the regulation of the regulatory body and the government.

www.irda.gov.in, brief monthly market- first year premium of life insurers for the period ended December, 2010

Talking about the number of lives covered under group single premium upto December, 2010 for some major companies are as follows according to the data released by IRDA on basis of data submitted by these insurance companies:

1. Bajaj Allianz - 105972
2. Reliance life - 508352
3. SBI Life - 239465
4. Tata AIG - 57543
5. HDFC Standard - 175291
6. ICICI Prudential - 1793883
7. Kotak Mahindra - 359582
8. Max New York - 1495603
9. Shriram Life - 216448
10. LIC - 27020588

Apart from these companies like Aegon Religare and Birla Sunlife has 959 and 995 lives covered upto December 2010. This is evident in itself to prove my point that knowing or unknowingly but the regulation in the insurance sector is giving an undue advantage to LIC and leading to unfair competition.

The top 5 life insurance companies in India control 85% of the market-share while the remaining dozen are still struggling to setup their operation. If we see the entire market amongst private players only
excluding LIC in life insurance sector we would see there is hardly any private player which has a grip over the market.

**Market split up of private life insurers only excluding LIC**

India has come a long way since the economic reforms in 1991, moving from the growth rates of 5% into the orbit of 7-9% growth rates. This growth has been structurally driven by economic reforms, private entrepreneurship and linkages to the global economic boom. A McKinsey study estimated that India is likely to emerge as the fifth largest consuming nation in the globe by 2025. Significant demographic changes over the next two decades should throw up major investment opportunities for businesses as well as investors.

Every year, around Rs. 600,000 crores (Rs. 6 trillion) of household savings is being invested into HH Financial assets. Around 18-20% of this income goes into insurance. Proposed Direct Tax code, aimed at a substantial increase in income tax limit and product efficiency, could also lead to higher contribution to insurance.

The Indian life insurance sector has been witness to varied phases witnessing a slew of changes in the past year. Since 1999, when the government opened up the insurance sector by allowing private
companies to solicit insurance and also allowing foreign direct investment of up to 26%, the insurance sector has been characterized by a booming market. Hence 2010, was a landmark year in the history of the Indian insurance industry as it celebrated a decade since the entry of the private sector into this business.

The figures show that LIC has gained market share in spite of new companies coming in the market which signifies the dominance of LIC in the market and the ineffectiveness on its strengthened position in market.

3.17 GLOSSARY: TERMS COMMONLY USED IN THE INSURANCE SECTOR

**Actuary**

Someone who uses applied mathematics (in particular, probability calculations) to provide solutions to insurance-related problems. Actuarial techniques are used to design new products and to assess the probability and risks of existing and new business

**Adverse Selection**

The tendency of persons who know they present high risks to enrol in an insurance plan covering these particular risks. For instance, people suffering from critical illnesses purchasing health insurance

**Agent**

An insurance company representative who sells insurance policies. Agents usually earn a commission or a fee for their advice or on the sale of a policy and can deal only with one insurance company

**Annuity**

An annuity is a regular payment designed to give the policyholder an income for life after retirement. It is paid for by a lump sum saved during the policyholder’s working lifetime in a pension product
Assignment

A policy which has been assigned by the policyholder with an institution as beneficiary in case a claim arises.

Beneficiary

The person who enjoys the rights, title and benefits under the policy that is being bought.

Bonus

Interest earned on the premium paid to an insurance company or an additional sum that the policyholder receives in addition to the basic sum insured on a yearly basis.

Broker

An intermediary between an insurance company and a policyholder. He is the representative of the insured, although he receives compensation in the form of a commission from the insurance company. Brokers must be registered as independent as per regulations and are authorized to deal with more than one insurance company.

Cancellation

A policy or proposal that is cancelled by the insurance company on account of reasons the information given by the potential customer or policyholder is found incorrect, inadequate or fraudulent.

Cashless services

A financial arrangement that allows a policyholder to access the covered health services without having to pay. The health provider sends the corresponding invoices to be settled to the insurance company.

Claim

A call by a policyholder to the benefits payable under the terms and conditions of a policy.
Claims Rate

The percentage of claims received viz the total number of policies in force during a given period.

Coinsurance

When different insurance companies share specified percentages of risks attached to a policy.

Commission

The amount as percentage of premium paid by the insurer to the agent for selling the insurance product.

Compulsory Cover

A policy that is made mandatory for the customer to buy.

Covariant Risk

Risks that affect simultaneously a great number of policyholders. Example of flood or earthquake for assets or life coverage.

Credit Life

An insurance cover that is linked with credit activities and aims to protect the credit.

Deductible

The amount that an insurance company is allowed to deduct from the amount to be paid for a claim. This co-payment mechanism aims to reduce moral hazard.

Deferred annuity

When the policy-holder chooses the date to take the first payment after a specified period, the purchase price (of the policy) can be paid back to the insurer either in lump sum or in installment.

Eligibility

Requirements imposed by the insurance company to the client allowing him/her to subscribe to a policy. One of the main requirements
is the age bracket within which one person can propose for insurance product

**Endowment**

A form of life insurance where the face value is payable either to the insured at the end of the contract period or to a beneficiary if the insured dies before the maturity period

**Exclusion clauses**

Specific situations, conditions or circumstances that are listed in the contract as not being covered. In such circumstances the policyholder or nominee does not get any benefit

**Face value**

Amount to be paid by the insurance company to the insured (or nominee) in case of any unfortunate incident occurs during the policy period or maturity of policy (in case of endowment policy). This amount does not include the additional bonus

**Grace period**

Period of time during which the policy remains in force with or without penalty in spite of non-receipt of premium. The risk is fully covered under such a period

**Guaranteed additions**

These are calculated at the rate (that is fixed by the respective insurance companies) for a sum assured. This is then added to the basic sum assured every year and are payable on admission of claim. The rate is guaranteed not to fall (or increase). For instance, the Life Insurance Corporation of India makes its guaranteed additions per every Rs. 1.000 of sum assured

**Health Insurance**

Insurance cover towards unexpected ill health
In force

An insurance policy is “in force” from its start date until the date it is terminated, till such time the insurance premium are regularly received when they are due

Insurable Risk

Risk for which an insurance cover can be provided

Insured

The policyholder who is covered by an insurance company

Lapse

Termination of contract when the premium is not paid within the grace period. The risk is not covered under such a period

Life Insurance

Insurance cover on the lives on human being

Life Savings

Savings which have been accumulated over the period of the policy tenure

Loyalty additions

Additional benefits available to policyholder on certain policies that are payable only on maturity of the policy and provided the policy has been kept in force. The respective insurance companies, on the basis of their experiences and performances, determine such rates

Lump sum

A method of settlement whereby the beneficiary receives the entire proceeds of a policy at once rather than in installments

Maturity

The date that an insurance product finishes or “matures”, and the proceeds of the policy, sometimes known as the maturity value, become payable
Moral Hazard

A dishonest predisposition or behaviour on the part of an insured that increases the risks attached to a policy

Mortality rate

The number of deaths in a group of people, usually expressed as deaths per thousand. It can be the rate for the total population, called the crude mortality rate, or it can be refined by factors such as age groupings or causes of death

Nominee

The person nominated by the policyholder to receive the sum assured in case of the death of the policyholder during the term period

Option

Choice that a potential customer has when h/she is willing to buy an insurance cover

Penalty

The charges levied on an insurance product on account of delay of premium from the due date

Policy

A written and stamped document established for the purchase of an insurance product that contains the terms and conditions of the contract between the insurer and the policyholder

Policyholder

The person on whose name the policy bond is issued

Premium

Payment made to the insurance company to buy a policy and to keep it in force. Usually paid monthly, quarterly, half yearly, annually or as a single lump sum
Recurring Premium

Regular premium to be paid to an insurance company during the policy period

Reinsurance

An insurance that an insurance company buys for its own protection. The net premium is the result after having paid for these reinsurance services (gross premium income less reinsurance costs)

Return on premium

A rider on a life insurance policy providing that, in the event of the death of the insured person within a specified period of time, the policy will pay, in addition to the face amount, an amount equal to the sum of all premiums paid to date. This is a form of Increasing Term Insurance and is used as a sales tool

Return of premium

The total premium on a term policy which is paid back to the policyholder on maturity of the policy

Rider

Agreement attached to a policy by which the conditions of the policy are expanded or an additional coverage added. In short, additional coverage / benefit added to a regular insurance contract on the payment of some additional premium

Risk Premium

The part of the premium which is allocated towards the payment of the claim – also known as pure premium

Screening

Process through which the insurance company verifies that its criteria are met before issuing a policy
Sub-standard life

Any individual who cannot be granted an insurance policy under the normal premium rates because of health grounds

Sum assured

The amount for which the insurer has agreed to pay in the event of death or maturity provided the policy is kept in force

Surrender value

The amount payable at the time when the policyholder terminates the contract at a specified period (this period varies between different insurance companies) from the date of commencement of the policy. The surrender value is equal to sum paid till date multiplied by the surrender value factor

Term insurance

Pure risk cover where full sum assured is payable only if death occurs during the policy term. The sum assured is not returned back to the policyholder in case s/he survives the term period

Third Party Administrator

A party that is employed by the insurance company to enable the insurance business by providing health services essential to the issuance of policies or the processing of claims. However, a TPA cannot sell insurance products. A TPA may work with several insurance companies

Total Insured Benefit

The total benefit an insured person will receive at the time of claim

Traditional products

Insurance products which are invested in a single fund and the policyholder has no way of tracking the fund performance of fund options
Underwriter

Someone who is willing to assume an insurance risk in exchange for payment of a premium. The term derives from the practice of the person who accepted the risk signing their name under the amount they insured (thereby entering into a contract)

Underwriting

The analysis of risks presented by a particular customer prior taking the decision to cover these risks

Unit linked products

Products where the risks and savings in an insurance product are clearly defined and the savings are invested in a unit trust fund. A unitised contract where the price of the units is directly related to the value of assets in the fund, or unit trust

Valuation

A periodical investigation to check the solvency of the insurer

Voluntary Cover

A policy that the potential customer is free to refuse, as opposed to a mandatory cover

Waiting period

The period between the purchase of a policy and the time when the coverage becomes effective. Often used for health insurance in order to reduce the risk of adverse selection

Whole life insurance

Insurance payable to a beneficiary at the death of the insured, whenever that occurs
3.18 Investment

Investment has different meanings in finance and economics. Finance investment is putting money into something with the expectation of gain that upon thorough analysis has a high degree of security for the principal amount, as well as security of return, within an expected period of time. In contrast putting money into something with an expectation of gain without thorough analysis, without security of principal, and without security of return is gambling. Putting money into something with an expectation of gain with thorough analysis, without security of principal, and without security of return is speculation. As such, those shareholders who fail to thoroughly analyze their stock purchases, such as owners of mutual funds, could well be called gamblers. Indeed, given the efficient market hypothesis, which implies that a thorough analysis of stock data is irrational, most rational shareholders are, by definition, not investors, but speculators.

Investment is related to saving or deferring consumption. Investment is involved in many areas of the economy, such as business management and finance whether for households, firms, or governments.

In finance, investment is the commitment of funds through collateralized lending, or making a deposit into a secured institution.

In contrast to investment; dollar cost averaging, market timing, and diversification are phrases associated with speculation.

Investments are often made indirectly through intermediaries, such as banks, credit unions, brokers, lenders, and insurance companies. Though their legal and procedural details differ, an intermediary generally makes an investment using money from many individuals, each of whom receives a claim on the intermediary.
Investment implies the production of new capital goods, plants and equipments. John Keynes refers investment as real investment and not financial investment.

**Definition of 'Investment'**

An asset or item that is purchased with the hope that it will generate income or appreciate in the future. In an economic sense, an investment is the purchase of goods that are not consumed today but are used in the future to create wealth. In finance, an investment is a monetary asset purchased with the idea that the asset will provide income in the future or appreciate and be sold at a higher price. In the financial sense Investments include the purchase of bonds, stocks or real estate property.

**3.19 Financial Instruments**

- **Equities**
  
  Equities are a type of security that represents the ownership in a company. Equities are traded (bought and sold) in stock markets. Alternatively, they can be purchased via the Initial Public Offering (IPO) route, i.e. directly from the company. Investing in equities is a good long-term investment option as the returns on equities over a long time horizon are generally higher than most other investment avenues. However, along with the possibility of greater returns comes greater risk.

- **Mutual funds**
  
  A mutual fund allows a group of people to pool their money together and have it professionally managed, in keeping with a predetermined investment objective. This investment avenue is popular because of its cost-efficiency, risk-diversification, professional management and sound regulation. You can invest as little as Rs. 1,000 per month in a mutual fund. There are various general and thematic
mutual funds to choose from and the risk and return possibilities vary accordingly.

- **Bonds**
  Bonds are fixed income instruments which are issued for the purpose of raising capital. Both private entities, such as companies, financial institutions, and the central or state government and other government institutions use this instrument as a means of garnering funds. Bonds issued by the Government carry the lowest level of risk but could deliver fair returns.

- **Deposits**
  Investing in bank or post-office deposits is a very common way of securing surplus funds. These instruments are at the low end of the risk-return spectrum.

- **Cash equivalents**
  These are relatively safe and highly liquid investment options. Treasury bills and money market funds are cash equivalents.

3.20 Non-financial Instruments

- **Real estate**
  With the ever-increasing cost of land, real estate has come up as a profitable investment proposition.

- **Gold**
  The 'yellow metal' is a preferred investment option, particularly when markets are volatile. Today, beyond physical gold, a number of products which derive their value from the price of gold are available for investment. These include gold futures and gold exchange traded funds.
3.21 Different Types of Investment:

Different types or kinds of investment are discussed in the following points.

- **Autonomous Investment**
  Investment which does not change with the changes in income level, is called as Autonomous or Government Investment.
  Autonomous Investment remains constant irrespective of income level. Which means even if the income is low, the autonomous, Investment remains the same. It refers to the investment made on houses, roads, public buildings and other parts of Infrastructure. The Government normally makes such a type of investment.

- **Induced Investment**
  Investment which changes with the changes in the income level, is called as Induced Investment.
Induced Investment is positively related to the income level. That is, at high levels of income entrepreneurs are induced to invest more and vice-versa. At a high level of income, Consumption expenditure increases this leads to an increase in investment of capital goods, in order to produce more consumer goods.

- **Financial Investment**

  Investment made in buying financial instruments such as new shares, bonds, securities, etc. is considered as a Financial Investment.

  However, the money used for purchasing existing financial instruments such as old bonds, old shares, etc., cannot be considered as financial investment. It is a mere transfer of a financial asset from one individual to another. In financial investment, money invested for buying of new shares and bonds as well as debentures have a positive impact on employment level, production and economic growth.

- **Real Investment**

  Investment made in new plant and equipment, construction of public utilities like schools, roads and railways, etc., is considered as Real Investment.

  Real investment in new machine tools, plant and equipments purchased, factory buildings, etc. increases employment, production and economic growth of the nation. Thus real investment has a direct impact on employment generation, economic growth, etc.

- **Planned Investment**

  Investment made with a plan in several sectors of the economy with specific objectives is called as Planned or Intended Investment.

  Planned Investment can also be called as Intended Investment because an investor while making investment make a concrete plan of his investment.
• **Unplanned Investment**

Investment done without any planning is called as an Unplanned or Unintended Investment.

In unplanned type of investment, investors make investment randomly without making any concrete plans. Hence it can also be called as Unintended Investment. Under this type of investment, the investor may not consider the specific objectives while making an investment decision.

• **Gross Investment**

Gross Investment means the total amount of money spent for creation of new capital assets like Plant and Machinery, Factory Building, etc.

It is the total expenditure made on new capital assets in a period.

• **Net Investment**

Net Investment is Gross Investment less (minus) Capital Consumption (Depreciation) during a period of time, usually a year.

It must be noted that a part of the investment is meant for depreciation of the capital asset or for replacing a worn-out capital asset. Hence it must be deducted to arrive at net investment.

### 3.22 Investment management

Investment management is the professional management of various securities (shares, bonds and other securities) and assets (e.g., real estate) in order to meet specified investment goals for the benefit of the investors. Investors may be institutions (insurance companies, pension funds, corporations, charities, educational establishments etc.) or private investors (both directly via investment contracts and more commonly via
collective investment schemes e.g. mutual funds or exchange-traded funds).

The term asset management is often used to refer to the investment management of collective investments, while the more generic fund management may refer to all forms of institutional investment as well as investment management for private investors. Investment managers who specialize in advisory or discretionary management on behalf of (normally wealthy) private investors may often refer to their services as wealth management or portfolio management often within the context of so-called "private banking".

The provision of 'investment management services' includes elements of financial statement analysis, asset selection, stock selection, plan implementation and ongoing monitoring of investments. Investment management is a large and important global industry in its own right responsible for caretaking of trillions of yuan, dollars, euro, pounds and yen. Coming under the remit of financial services many of the world's largest companies are at least in part investment managers and employ millions of staff and create billions in revenue.

Fund manager (or investment adviser in the United States) refers to both a firm that provides investment management services and an individual who directs fund management decisions.