Chapter I
INTRODUCTION

Each and every individual in the world has to deal with risks of various kinds and degrees which involve exposure to losses. To overcome this situation and to minimize the loss arising out of occurrence of these risks a device had been developed known as insurance.

Insurance is defined as a contract whereby one person, called the insurer, undertakes to make good for the loss of another, called the insured, on payment of a specific sum of money, called premium, to him on the happening of a specified event. Thus insurance is a cooperative device to spread the loss caused by a particular risk over a number of persons who are exposed to it and who agree to insure themselves against the risk.

The function of insurance is to spread the loss over a large number of persons who are agreed to cooperate each other at the time of loss. The risk cannot be averted but the loss occurring due to certain risk can be distributed amongst the agreed persons. They are agreed to share the loss because the chances of loss, i.e., the time, amount, to a person are not known. Anybody of them may suffer loss to a given risk, so, the rest of the persons who are agreed will share the loss. The larger the number of such persons, the easier the process of distribution of loss. In fact, the loss is shared by them by payment of premium which is calculated on probability of loss 1.

Different authors have defined the term insurance differently. Some of the important definitions of insurance are as follows:

Prof. D.S. Hansell: “A social device providing financial compensation for the effects of misfortune, the payments being made from the accumulated contributions of all parties participating in the scheme”.

Dr. W.A. Dinsdale: “Insurance is a device for the transfer of risks of individual entities to an insurer, who agrees, for a consideration (called the premium),

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to assume to a specified extent losses suffered by the insured”.

Prof. John H. Magee: “Insurance is a plan by which large number of people associate themselves and transfer, to the shoulders of all, risks that attach to individuals”.

A.H. Willett: “Insurance is a social device for making accumulations to meet uncertain losses of capital which is carried out through the transfer of risks of many individuals to one person or to a group of persons”.

Justice Lawrence: “Insurance is a contract by which the one party, in consideration of a price paid to him adequate to the risk, becomes security to the other that he shall not suffer loss, damage, or prejudice by the happening of the perils specified to certain things which may be exposed to them”.

Prof. Allan L. Mayerson: “Insurance is a device for the transfer to an insurer of certain risks of economic loss that would otherwise be borne by the insured”.

Professor Robert Mehr: “Insurance is a special device for reducing risk by combining a sufficient number of exposure units to make their individual losses collectively predictable. The predictable loss is then shared proportionately by all those in the combination”.

J.B. Maclean: “Insurance is a method of spreading over large number of persons a possible financial loss too serious to be conveniently borne by an individual”.

Riegel R and Miller J.S.: “Insurance is a social device whereby uncertain risks of individuals may be combined in a group and thus made more certain; small periodic contributions by the individuals providing a fund out of which those who suffer losses may be reimbursed”.

E.R. Hardy Iwamy: "Insurance is a contract whereby one person, called the “insurer” undertakes, in return for the agreed consideration, called the premium, to pay to another person called the assured a sum of money or its equivalent, on the happening of a specified event”.

Dictionary of Business and Finance: “A form of contract or agreement under
which one party agrees in return for a consideration to pay an agreed amount of money to another party to make good for a loss, damage, or injury to something of value in which the insured has a pecuniary interest as a result of some uncertain event”.

Dictionary of Commerce: “The payment of a sum of money by one person to another on the understanding that in specified circumstances the second person will make good any loss suffered by the first”.

Advanced Learner’s Dictionary: “Undertaking by a company, society or the State, to provide safeguard against loss, provision against sickness, death, etc., in return for regular payments”.

In the light of the above definitions, we may, therefore, define insurance, as a cooperative device to spread the loss caused by a particular risk over a number of persons who are exposed to it and who agree to insure themselves against that risk. The loss is shared willingly by contributing a small amount towards a common fund.

Functions of insurance:

Following are the main functions of insurance:

• The main function of insurance is to provide certainty of payment against the occurrence of sudden loss arising due to happening of uncertain event. Thus insurance removes uncertainty. The function of insurance is primarily to decrease the uncertainty of event.

• Insurance also provides protection against the probable chances of loss. The time and amount of loss are uncertain and at the happening of risk, the person will suffer loss in absence of insurance. The insurance guarantees the payment of loss and thus protects the assured from sufferings. Although insurance cannot check the happening of risk but can provide for losses at the happening of risk and thereby creates security to the insured.

• Insurance involves sharing of risk which implies that insurance spreads the

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2 Theory and Practice of Insurance, M. Arif Khan, Page 8.
3 Insurance, Principles & Practice, Reigel & Miller, page 29 (1963)
financial losses of insured members over the entire community by compensating the unfortunate few from the funds built up from the contribution of all members.

- The insurance provides capital to the business houses and industrialists by way of lending the funds to them or making contribution to their share capital. In other words, the funds accumulated by insurance companies by way of premiums are invested in productive channels.

- The insurance minimizes the worries and miseries of losses arising due to death of insured or destruction of property. The carefree person can devote himself in a better manner towards the achievement of objectives which results in enhancing his efficiency and rapid economic growth.

**Socio-economic significance of insurance**

Socio-economic benefits of insurance are incalculable. Some of its benefits are as follows:

**Benefits of insurance**

1. Insurance policy is a suitable way for providing for the future of most of the people who find it difficult to save and accumulate funds for the evening of their lives.

2. Insurance plays an important role in the expansion and promotion of foreign trade.

3. Insurance helps in spreading education.

4. Insurance companies accumulate large funds which they hold as custodians and out of which claims and losses are met; a large portion of such resources are invested in various securities and social welfare purposes.

5. Confidence building and removal of fears from the minds of businessmen and individuals against sudden losses, is a job done by the insurance.

6. The spreading of the financial losses of insured members over the entire community in an equitable manner by compensation of the unfortunate few
from the funds built up from the contributions of all members is done by the insurance.

7. It helps businessman in facing the competition and in expanding the size of business units.

8. Insurance has considerable effect on the reduction of losses due to the loss-prevention measures of the insurers.

9. Insurance is an item of invisible exports and contributes significantly to the balance of trade.

10. Insurance also increases the credit of a man as money can be easily borrowed on the security of goods and property insured against fire or sea perils or on the basis of a life policy.

11. Insurance takes care of some of the social problems which beset a modern civilized society.

12. Insurance accelerates the process of economic growth in various ways. By providing for events which may be anticipated, the insurance acts as a stabilizer of economic growth.

**Kinds of insurance**

Insurance can broadly be categorized as follows:
(i) **Life Insurance**: Life insurance is the most popular insurance whereby the Insurance Company agrees to pay a specified sum of money to the insured, on the expiry of a certain period of time or on the death of the insured person, whichever is earlier. Thus life insurance relieves the widow, children and other dependents from the hardships of utter poverty, in case death of the bread-winner takes place.

Life insurance combines two elements simultaneously element of protection and element of investment. Element of protection provides the safeguard against the risk of early death by replacing the income of the deceased. Thus, if a person dies before the policy matures for payment, Life Insurance Company undertakes to pay the assured sum to the representatives and dependents of the deceased. It, therefore, extends the hand of protection to those who are left without support and help due to the sudden and premature death of their breadwinning. Element of investment implies that the small sums paid to the insurance company by way of premium over a long period of 10 to 20 years grow into a large sum and are paid back to the policyholder after the expiry of the term. In other words, if an insured person live up to the maturity of the policy, the insurance company undertakes to replace income to him and to his dependents in the evening of one’s life, when he is unable and unfit for physical hard work. Though, the protection aspect is present in other forms of insurance like fire and marine, the investment aspect is lacking in these forms. Thus life insurance is the only avenue that offers both the protection and investment benefits.

(ii) **General Insurance**

(a) **Fire Insurance**: Fire insurance covers the risks of fire. It is a contract whereby the insurer undertakes to indemnify the insured against any loss caused by fire to the property insured upto the extent agreed upon between the insurer and the insured. This kind of insurance is taken by the owners of the factories, shops, cinema houses, godowns and residential houses. In case of losses caused by fire, they get
compensation from the fire insurance company.

(b) Marine Insurance: Marine insurance provides protection against risk of marine adventures and perils up to an extent mentioned in the policy document. A particular ship may meet collision with another ship or it may be captured by enemy or thieves or it may sink in the sea. Marine insurance insures ship, cargo and freight. Marine insurance thus helps shipping companies and traders to insure their ships and cargo against risk of marine adventures.

(c) Miscellaneous Insurance: Under this form of insurance risk cover is provided against number of uncertainties. This type of insurance includes twins insurance, fidelity insurance, accident insurance, burglary insurance, workmen’s compensation insurance, unemployment insurance, national health insurance, plate glass insurance, crop insurance, license insurance, sickness insurance, etc.

HISTORY OF INSURANCE

Marine insurance

The marine insurance is the oldest of all the types of insurance. Under the Bottomry bond the system of credit and the law of interest were well-developed and based on a clear appreciation of the hazard involved and means of safeguarding against it. In case the ship was lost, the loan and interest thereon were forfeited. As we all know that travellers by sea and land were very much exposed to the risk of loosing their vessels and merchandise because the piracy on the open seas and highway robbery of caravans were very common.

Many a time's ships might have been captured by the king’s enemies or robbed by pirates or get sunk in deep waters. The risk to owners of such ships were enormous and therefore to safeguard them the marine traders devised a method of spreading over them the financial loss which would not be conveniently borne by the unfortunate individual victims. The cooperative device was quite voluntary in the

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5 Theory & Practice of Insurance, M. Arif Khan, Page 31.
beginning, but now in modern times it has been converted into modified shape of premium\(^6\).

The marine policy of the present forms was sold in the beginning of fourteenth century by the Brugians. On the demand of the inhabitants of Burges, the court of Flanders permitted in the year 1310, the establishment of the Town of a charter of Assurance, by means of which the merchants could insure their goods, exposed to the risks of the sea. The insurance development was not confined to the Lombards and to the Hansa merchants; it spread throughout Spain, Portugal, France, Holland and England\(^7\).

**Fire insurance**

After marine insurance it was the turn of development of fire insurance. In sixteenth century for the first time it was observed in Germany’s Anglo-Section Guild Form, the victims of fire hazards were given personal assistance by providing necessaries of life. However, the fire insurance got momentum in England after the great fire of 1666 in which about 85 per cent of the houses were burnt to ashes and property worth of sterling ten crore were completely burnt off. This resulted in establishment of fire insurance office in England in the year 1681. With colonial development of England, the fire insurance spread all over the world in present form. However, the first fire insurance commercially transacted was the one started by an unsuccessful physician who became builder and the most successful rebuilders of London, after the Great Fire, Dr. Nicholas Barbon in 1667\(^8\).

**Life insurance**

Life Insurance made its first appearance in England in 16\(^{th}\) century. The first recorded life policy was issued in June 18, 1583 on the life of William Gibbons for “12 months”. Besides, in the sixteenth and seventeenth centuries evidences of the existence of short term policies are available, which covered the risk of death within a limited period only. These policies were particularly used for merchant and others on voyages or on the lives of debtors as security against loan. In seventeenth and


\(^7\) Insurance Principles & Practice, M.N. Mishra, Page 11.

\(^8\) Theory and Practice of Insurance, M. Arif Khan, Page 20, 1999.
eighteenth centuries Mutual Assurance Association were formed in order to subscribe
to a fund out of which payments were made at the death of a member, based on the
amount available in the fund. The amount payable on death varied according to the
number of members and number of deaths in that year.

In later years, with the compilation of mortality tables (in 1693 and 1755) and
the introduction of an actuarial science revolutionary changes took place in the whole
practice of life insurance.

India & life insurance

Life insurance in its modern form came to India from England way back in
1818. Oriental Life Insurance Company was the first insurance company on Indian
soil, which was started in Kolkata by Europeans to help widows of their community.

In the year 1870, the first Indian Insurance Company in the name of Bombay
Mutual Life Assurance Society came into existence. The basic objective of the
Company was to insure Indian lives at normal rates since in the earlier period Indian
lives were treated as subnormal and loaded with an extra premium of 15 to 20 per
cent⁹.

However, right up to the end of the 19th century, foreign insurance companies
in India had an upper hand in matters of Insurance business. Insuring Indian lives with
10 per cent of extra premium was a common practice prevalent during this period of
time.

The Life Insurance Companies Act, 1912 was the first legislation for
regulating insurance business in India. However, the Insurance Act, 1912 was
replaced by a comprehensive insurance act of 1938. This act was again amended in
1950. Finally, the Government of India nationalized the entire life insurance business
in the year 1956 by passing the Life Insurance Corporation Act, 1956 and as such Life
Insurance Corporation was set up on 1st September, 1956. The LIC took over the
assets and liabilities of 245 insurers which were operating at the time of
nationalization. LIC thus gained monopoly power of transacting life insurance

⁹ Life Insurance Corporation of India: Challenges and need for dynamism in the current scenario, Dr
S.K. Shukla, p. 2.
After the economic crisis of 1991, the Narsimha Rao led government adopted the policy of deregulating all the sectors including the insurance sector from the clutches of the government and thereby promote the private players to prove their worth. In this sequence in April 1993, the Government of India appointed the Malhotra Committee to recommend on the reforms of Insurance sector under the chairmanship of Sri R.N. Malhotra, the former Governor of RBI. The Malhotra Committee submitted its report to the Government on 7th January, 1994 and made recommendations for the establishment of an effective Insurance Regulatory Authority (IRA) in the form of a statutory autonomous board. With reference to its recommendations for entry of private sector in insurance business, the committee viewed that allowing some foreign insurance companies could be useful. In December 1996, Government tabled the IRA Bill in the parliament as per the recommendations of Malhotra Committee, but due to strong opposition from the left parties the Government was forced to withdraw IRA Bill in parliament.

Again in the year 1998, in order to provide better insurance coverage to our citizens and also to augment the flow of long-term resources for financing infrastructure, it was proposed by the Government to open the insurance sector and to permit the entry of private Indian companies into the insurance sector. This time the legislature enacted the Insurance Regulatory and Development Authority Act, 1999 to provide for the establishment of an authority to protect the interest of insurance policyholders and to regulate, promote the insure orderly growth of insurance industry. This Act was assented by President of India on 29th December, 1999.

**Principles of insurance contract**

All types of insurance contracts *i.e.* life, fire, marine and miscellaneous insurance contracts are based on certain fundamental principles. The only exception is the principle of indemnity which is not applicable in case of life insurance contract because of its being a contingent contract. All the principles of insurance are discussed in detail as under:

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(i) Utmost good faith

Insurance contracts are based upon mutual trust and confidence between the insurer and the insured\textsuperscript{11}.

The doctrine of disclosing all material facts is embodied in the important principle ‘utmost good faith’ which applies to all forms of insurance\textsuperscript{12}.

Both the parties to the insurance contract must disclose all the material facts which are likely to affect the judgment of the other party. In case of insurance contract the legal maximum ‘\textit{Caveat Emplor}’ does not prevail, where it is regarded the duty of the buyer to satisfy himself of the genuineness of the subject matter and the seller is under no obligation to supply information about it. But, in insurance contract, the seller \textit{i.e.} the insurer will also have to disclose all the material facts. Utmost good faith thus requires each party to tell the other “the truth, the whole truth and nothing but the truth” about the proposed contract. Bad faith or failure to reveal vital information, even if not asked about it, gives the aggrieved party the right to regard the contract as void\textsuperscript{13}. As such it is said that the insurance contract is a contract of ‘\textit{uberrimae fidai}’ \textit{i.e.} of absolute good faith.

In life insurance policies where an acceptance or rejection of risk depends upon the state of health of the proposed insured a clear-cut distinction must be drawn between illness and simple disorder. Thus, in a case, non disclosure by the assured of having suffered from indigestion was held to be of suppression of a material fact which should affect the validity of the policy\textsuperscript{14}.

However, the policy cannot be called into question after it has run for two years except on the ground of false date of birth or fraudulent concealment of facts. In a case, the Supreme Court observed that the burden of proving the falseness of a statement made by the insured is on LIC\textsuperscript{15}. Thus LIC must place on record the material fact on the basis of which it chooses to repudiate the claim.

\textsuperscript{11} Theory and Practice of Insurance, M. Arif Khan, p. 45.
\textsuperscript{12} Insurance, Principles & Practice, M.N. Mishra, p. 33.
\textsuperscript{13} Theory & Practice of Insurance, M. Arif Khan, p. 45.
\textsuperscript{14} LIC vs Shakuntala Bai, AIR, 1975.
\textsuperscript{15} Vijay Kumar Kohli vs LIC, AIR, 1992.
(ii) Insurable interest

Insurable interest implies that the assured must have an actual interest in the subject matter of insurance that he would benefit from its continued existence and suffer loss from its destruction. In life insurance, insurable interest must exist at the time of taking of policy. It may or may not exist at the time of death of the insured. In the case of the fire insurance, insurable interest is necessary to exist both at the time of taking the fire insurance policy as well as at the time when the loss is incurred and a claim is filed with the insurance company. In case of marine insurance the insured must have insurable interest in the insured object only at the time of loss i.e. on the happening of the event insured against.

(iii) Indemnity

The principles of Indemnity implies that the insurer undertakes to put the insured, in the event of occurring of insured risk resulting in loss to the insured, in the same position that he occupied immediately before the happening of the event insured against. However, there are some exceptions such as life insurance, personal accident and sickness insurance where the principle of indemnity does not apply. All the other insurance contracts are the contract of indemnity where indemnity is the controlling principle of insurance law. This implies that the assured in the case of loss against which the policy has been viewed shall be paid the actual amount of loss not exceeding the policy value. The insured is thus not allowed to make any profit out of his loss but will only be compensated. The assured will be fully indemnified but shall never be more than fully indemnified\(^{16}\).

(iv) Mitigation of loss

The principle of Mitigation of loss places a duty on the insured to make every effort and take all such steps, in the event of some mishap to the insured property, to mitigate or minimize the loss, as would has been taken by an uninsured person. The principle is included so as to check the insured to become careless and inactive in the event of the mishap merely because the property which is getting damaged is already insured. If the insured fails to take the reasonable steps to mitigate the loss, the insurer

\(^{16}\) Castellain vs Preston, 1883.
can avoid the payment of loss as it occurred due to the negligence of the insured.

(v) Causa proxima

*Causa proxima* means the nearest cause or the proximate cause or the most effective, dominant and efficient cause. It is the real or actual cause of loss. If the cause of loss is insured, the insurer will pay, otherwise the insurer will not pay. Insurer will not be liable for the losses caused by the expected perils or by the misconduct of the assured or where the insured peril is a distant cause of loss.

(vi) Subrogation

The doctrine of subrogation, which is the outcome of the principle of indemnity and applies only to fire and marine insurance, states that after the insurer has made good of the loss to the insured, he is entitled to succeed to all the ways and means by which the assured might have protected himself against the loss. Thus the insurer for his own benefit comes to possess all the rights of the insured against third persons as regards the subject matter once the claim is paid by the underwriter.

(vii) Contribution

When the subject matter has been insured with different insurers, the principle of contribution applies between different insurers. The main aim being to distribute losses equitably among different insurers, who are liable under various policies of the same subject matter. This doctrine applies only to contract of indemnity.

**PRINCIPLES OF INSURANCE**

There are two main principles of insurance:

**Principle of co-operation**

Insurance is based on the principle of cooperation. Co-operation was prevailing from the very beginning up to the era of Christ. Now it is the duty of insurer to obtain adequate funds from the members of society to pay them at the happening of the insured risk. The share of loss takes the form of premium. All the insured give a premium to join the scheme of insurance. In this way the insured are cooperating to share the loss of an individual by payment of a premium in advance.
Insurance is pre-eminently social in nature. It represents, in the highest degree cooperation for mutual benefit.\(^{17}\)

**Principle of probability**

The whole building of insurance science is based on the theory of probability, if we toss a coin we are certain that it will come head upwards or head downwards our common sense tell us that the probability of its coming up is half and of the tail coming upward is half the number of tosses. This probability increases with the number of tosses. The chances of loss are estimated in advance to affix the amount of premium. The loss in the shape of premium can be distributed only on the basis of the theory of probability with the help of this principle the uncertainty of loss is minimized. The insurer charges only so much of amount which is adequate to meet the losses. Pooling of a large number of risks is very necessary for the successful operation of the theory of probability. The law of large numbers is a sub principle of the principle of probability. According to the law of large numbers the greater the number of exposures, the more nearly will the actual results obtained approach the probable result expected with an infinite number of exposures.