

INSURANCE AND RISK MANAGEMENT EXAMINATION
SUGGESTED ANSWERS - MAY 2004
P1 - PRINCIPLES AND PRACTICE OF INSURANCE

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1. Do you agree that there is always a trade off between shareholders' needs and policyholders' needs in capital of an insurance company? Discuss in relation to capital management.

Ans. Yes, it is true that there needs to be a trade off between the shareholders' and policyholders with respect to capital. Shareholders prefer less capital and maximize Return on Equity (ROE), whereas policyholders want more capital to maximize solvency. An insurance company need adequate capital related to risk exposure, for its present operation and for future growth.

The company has to keep in mind the following three factors:

- (i) Regulatory needs
- (ii) Rating agency guidelines
- (iii) Solvency requirement

Regulators give guidelines on risk based capital. In this case the IRDA. The following factors are considered in this regard.

- (i) Risk characteristics based on size, nature of business, quality of investment etc.
- (ii) Risk weightage for different class of assets like investment in government securities, private equity etc.
- (iii) Total adjusted capital, which consist of statutory capital, asset valuation reserve etc.
- (iv) Capital derived from risk-weighted formulae as per (ii) above. The two capitals as per (iii) and (iv) above are compared to find out

whether the capital is adequate in relation to the risk of the company.

Rating for financial products like deposits, debentures etc., are very important to Insurance companies like any other company, to get policyholders loyalty and confidence.

Rating agency will look for adequate capital commensurate with risk, track record of claim settlement along with financial strength of insurance companies for rating purpose.

Solvency margin is the excess of asset value over the value of liabilities. The valuations are done as per IRDA regulations. It provides guidelines for valuation of assets, valuation of liabilities and determination of solvency margins.

2. Differentiate between co-insurance and re-insurance contracts.

Ans.

- (i) Co-insurance is a method by which more than one insurer shares a risk in agreed proportions. It also means in some cases that the loss is shared or borne by the insured. For eg., when a premium of Rs.50 lacs is paid for a property worth Rs.1000 lacs with insurers A, B, and C sharing 40%, 30% and 30% respectively, when a claim arises, it is paid in the same proportion.
- (ii) Under a Mediclaim policy, the insured may agree to bear 10% of loss (deductible) and the insurer will settle the balance loss. There can be compulsory or voluntary deductibles under some policies.
- (iii) The insured himself / herself becomes co-insurer when he / she under insurers the risk or property or the subject matter.

One important factor to be considered in Co-insurance is increase in value of property due to inflation, increase in inventory, increase in price etc. If the corresponding adjustments are not made, it may attract penalties.

In reinsurer, the insured does not share the risk, but the insurer transfers his risk amongst other insurers. A reinsurer is an insurer's insurer. The original insurer is called the primary insurer or the 'ceding company.' The amount reinsured with the reinsurer is called

'cession' and the balance is 'retention'. In case of reinsurance, the insurer can limit his liability to the extent of the insurer's financial capacity. It helps in stabilizing the profits of the insurer. The insurer can retire from underwriting and unearned premium reserve can be passed on to the reinsurer.

It must be clearly understood that the primary responsibility to settle the claim to the insured, when one arises, is that of the insurer and not that of the re-insurer. The lack of contribution from the reinsurer under the reinsurance agreement cannot be a basis for the non-payment of the claim.

3. Very briefly describe the IRDA (Assets, Liabilities and Solvency Margin of Insurance) Regulations, 2000.

Ans. IRDA (Assets, Liabilities and Solvency Margin of Insurers) deals with preparation of different statements by the insurers.

Valuation of Assets: Schedule I deals with valuation of assets. It has to be prepared in FORM IRDA Assets AA. It gives a list of assets whose value shall be placed zero. It also provides for the valuation of computer equipments and other assets.

Schedule II A: Deals with valuation of liabilities in life business. It defines the valuation date and Universal life contracts. It gives the method of determination of mathematical reserves, valuation parameters and the additional requirements that should be considered for linked business and provisions.

Schedule II B: Deals with the valuation liabilities in general insurance business. It has to be prepared in Form 4 G, which is required to be certified by an Auditor approved by the Authority.

Schedule III A: Deals with determination of solvency margins, in case of life insurers. Every insurer must determine the required solvency margin, available solvency margin and solvency ratio in Form K.

Schedule III B: Deals with determination of solvency margins in case of general insurers. The required margin, available margin and solvency ratio should be given in FORM KG.

The required solvency margin is 150% of the absolute solvency.

4. (i) P's husband 'H' took a policy on the life of 'W', who is the wife of an employee 'E' working for 'H'. He later on assigned this policy to 'P'. On the death of 'W', 'P' claimed the money from insurance company.

(ii) 'MS' is a school teacher drawing a salary of Rs.2,000 per month. He took a policy for Rs.3,00,000 and assigned the same in favour of 'BD', who paid the premium for 6 months. At this time 'MS' died and 'BD' claimed the amount from insurance company.

Briefly discuss the liability of the insurance companies under the above policies and indicate whether the claims are allowable. Give reasons for your answers.

Ans. An important factor for a valid contract is that it should not be expressly declared to be void by the Act. As per Section-30 of Contracts Act, "agreements by way of wager are void". A "wager" is a promise to give money or money's worth upon the determination of an uncertain even. An insurance contract in certain cases resembles a wager when it is not supported by 'insurable interest.' And therefore such contracts are void. In both the cases there is a lack of insurable interest and so they are void.

Insurance and wager differs in many respects :

	INSURANCE	WAGER
i)	Effectuated to cover an existing risk	No risk exists until the bet is made
ii)	The insured event say like fire can never happen(is a contingency)	The event is bound to happen at a fixed time
iii)	Varying degree of loss happens	Either won or lost
iv)	Happening of the event is not desired by either party	Desired by the party one way or other
v)	Insured get indemnity and not anything more	The winner wins the amount of bet as per agreement
vi)	It is a contract requiring extreme good faith by both parties	No such consideration in Wager
vii)	It is known which party is immune from loss	Who will win or lose will not be known until after event.

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5. Mr. A had applied to a House Building Society for a loan of Rs.5,00,000 on a mortgage of the house to be purchased. The insurance policy had to be taken in the name of the society and Mr.A. There is a question in the form, which required Mr.A to state "any other matters" which he wished to be taken into account to which Mr.A said 'none'. However, A had suffered a period of imprisonment of 12 years for conviction for a robbery in April, 1960. A fire broke out in the premises and the house was burnt down.

Discuss, stating reasons, whether A can enforce the claim against the insurance company.

Ans. A's claim with the insurance company will not be acceptable by the insurer. 'A' has not disclosed a material fact about his conviction for 12 years when he applied for insurance. This is a moral hazard. The criminal record of the insured is important information and has to be disclosed. Moral Hazard pertains to the human factor which may contribute to the occurrence of the event insured against. Not only the character or moral integrity of the insured but also his motive in seeking cover, his behaviour towards his employees and the behaviour of his employees all have a bearing on moral hazard.

Moral hazard is good where the insured is honest and careful in dealing with his property and others having any sort of connection with the subject matter are also safety conscious.

Moral hazards exist when the insured seek cover with fraudulent motives or is generally careless about the property or machinery being covered. Moral hazard is difficult to assess. Often it will reveal itself only when a claim arises when it will be too late to take appropriate remedial underwriting measures.

In the present case, due to a failure to disclose material particulars in the proposal form, A's claim will not be paid by the insurers.

6. There are some distinctive features/special principles in an insurance contract. What are these special principles? Explain each with an appropriate example.

Ans. The special principles of an insurance contract are:

- (i) Utmost good faith
- (ii) Insurable interest
- (iii) Indemnity
- (iv) Subrogation
- (v) Contribution
- (vi) Proximate cause

- (i) Utmost good faith: In a contract of insurance, the concerned contracting parties must rely on each other's honesty. Insurance products are intangible products. To decide on the terms of contract certain information is needed which is known only to the insured / proposer. The law imposes great duty and responsibility on the parties to an insurance contract to have utmost good faith, which implies full, complete and correct disclosure of all material facts by both the parties. These material facts are such that they have a bearing on the determination of risk involved and amount of premium (pricing) and the terms of coverage of policy. Any concealment of material facts will lead to negative repercussion on the functioning of the insurance company's normal business.

All disclosures should be made at the time of entering into the insurance contract.

Example: The insurer in a particular contract had minor kidney problem and was advised by his doctor to take care. Later an X-ray showed lung infection, which would probably clear up with treatment. He also suffered from a heart attack. He did not disclose any of his ailments to the insurance company. These are material facts and the insurance company can repudiate claim, saying these are important for entering into contract and to assess risk and hence the premium.

- (ii) Principle of Insurable interest: Insurable interest means the policyholder must have a pecuniary or monetary interest in the property, which he has insured.

In life insurance contract insurable interest exist between husband and wife, parent and child.

- (a) This principle adds legal validity without which such contracts would be considered as 'Wager'
- (b) Presence of insurable interest prevents fraudulent practices
- (c) Insurable interest provides the right to secure insurance and claim a compensation
- (d) The owner of the property has an insurable interest.

(e) Insurable interest exist between :

- Employer and employees
- Creditor and Debtor
- Partners
- Guarantors

Example: Mr. G and his wife each signed a proposal form for a joint life policy on their lives and both contributed towards premium. After the policy was taken, the wife committed suicide and the husband claimed the sum assured. The court held that the insurable interest exists between a husband and wife and the insurer has to pay the claim.

(iii) The principle of Indemnity: The meaning of the word 'indemnity' is making good the loss on the happening of the insured event for which the insurance policy is taken up the insured should be paid the amount of loss.

1. This principle sets the rule according to which insurance companies undertake to compensate the insured, on fulfilling the terms of contract.
2. This principle ensures that the insurance is liable to pay up to the amount of loss and not more than that. All general insurance contracts are contracts of indemnity.

Example: Mr. A owns a clinic. He bought this about 5 years ago for Rs. 20 lakhs. He had bought fire insurance cover for Rs.16 lakhs, which is the present written down value of the asset. His clinic got fire and the loss suffered was worth Rs.9.00 lakhs. The amount of compensation to him would be : $\frac{16}{20} \times 9 = \text{Rs.7.2 lakhs}$

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(iv) Subrogation : Subrogation means the restitution of the rights of an assured in favour of the insurer against the third party for any damages caused by him in place of the assured after the insurer has indemnified him for the loss.

This principle is invoked when a third party is responsible for the loss. When the asset is damaged, the insured can sue the party who has caused the damage or can seek compensation from the insurance company.

In case he chooses to claim compensation from the insurance company, he cannot sue the third party who has damaged the property. Instead the insurance company gets the right to sue the party causing damage. In other words, the insurer steps into the

shoes of the insured in the matter of enforcing the claim against the third party.

Example: Mr. X was on his way to office in his car, when it was hit by a lorry from behind. X can claim damage from insurance company, and the insurer in turn can sue the lorry owner for damages.

- (v) The principle / doctrine of contribution: Insurance companies, while insuring a very high value asset, seek to diversify the risks with other insurance companies. That is part of value of the asset is taken up by a single insurer and the asset is insured by a group of two or more insurance companies.

As per this doctrine, the loss shall be shared proportionately among the insurers according to the ratable proportion of the loss.

- 1) the insured asset must be common to all the policies
- 2) the risk insured against must be common to all the policies
- 3) the insured owner of the asset must be the same person
- 4) All policies must be in force during the occurrence of loss.

Example: Two insurers A and B independently cover a risk. When the loss occurs A fully indemnifies the insured and claimed 50% from B. In this case both the policies have the usual ratable proportion clause that the insurer will not pay more than its share of loss.

When A pays the full loss to insured B need not pay to A as excess paid by A is voluntary.

- (vi) Doctrine of Proximate Cause: When an insurance policy is issued it relates to some peril, which may result in loss to the policyholder. No policy can cover all types of risks. Insurer is liable to indemnify only against the insured perils.

The term 'Proximate cause' means the nearest cause.

Each policy in general insurance will state the protection from the risks that are mentioned in the policy. All details related to proximate cause should be clearly mentioned at the time of entering into contract. Sometimes the causes not covered by the policy have to be expressly mentioned.

Example: A person has insured his asset against fire occurring due to electric short circuit. If the actual fire occurs due to leak of LPG cylinder the insurance company is not liable to pay for the losses.

7. Mr. Ram got insured his life on 7.2.1988 for Rs.1 lakh. The commencement date of the policy was given as 7.4.87 to take advantage of lesser age premium. The yearly premium was Rs.6,870 and the second yearly premium was due on 7.4.88.

Mr. Ram and Mr. Shyam were partners in a business. Shyam also insured his life for a premium of Rs.1,657 per annum. Both of them issued a joint cheque dated 7.5.88 for Rs.8,531.50 towards combined premiums on their respective lives. The insurance company issued a stamped receipt on 25.5.88 and sent the cheque for collection.

The cheque was dishonoured and sent back by the bank on 8.6.88. The company sent the intimation of cheque dishonour dated 21.7.88 which was posted by it on 30.7.88. It was received at the residence of Ram on 1.8.88. The intimation required Mr. Ram to pay the premium with interest by 16.8.88. However Mr. Ram died on 28.7.88, in an accident. Mrs. Ram claimed the insurance money along with the accident cover also. She said that the insurance company's services were "deficient" in not intimating of the cheque dishonour in time. To strengthen this statement, she quoted the insurance company's circular that stated that all dishonour of cheques should be intimated immediately by the concerned staff by contacting the policyholder.

Required: State whether Mrs. Ram will get the insured money from the company, i.e. is her claim maintainable?

Discuss with reference to;

- (i) Deficiency
- (ii) Payment of premium and grace period
- (iii) Revival of discontinued policies
- (iv) Forfeiture

Ans. From the facts of the case it appears that, the fault lies with Mr. Ram. He did not pay the premium even within the grace period allowed under the policy.

Deficiency: It may be true that the insurance company did not intimate the cheque dishonour in time, say within 2 or 3 days of cheque return.

In fact the fact that the cheque was not honoured is not informed in time by the bank also. Date of cheque was 7.5.88, it was returned by bank on 8.6.88 almost after one month.

The delay was further added by the insurance company as it posted the intimation of cheque dishonour on 30.7.88 only after 50 + days. This in spite of the internal circular. But this deficiency is just an administrative lapse and not sufficient to warrant to pay the claim.

Premium and grace period: As per terms of a Life insurance policy and also the regulations specified by the IRDA for protection of policy holders, a grace period of one month (30 days) will be allowed for payment of yearly, half-yearly or quarterly premiums and 15 days for monthly premiums. If death occurs within this period and before the payment of the premium then due, the policy will be still valid and the sum assured will be paid after the deduction of the said premium.

In this case, the premium was due on 7.4.88. The cheque was paid on 7.5.88 after the lapse of the grace period. The company sent it for collection on 25.5.88 and it was returned on 8.6.88 which means that for 60 days as against the grace period of 30 days the premium was not paid. Both Ram and Shyam must definitely be aware that there were insufficient funds in the Bank. The policy lapsed as the premium was not paid in grace period.

Revival of discontinued policies: Revival of a lapsed policy is a privilege or concession granted to the policy holder by the insurance company. The insurance company reserves the right to accept or decline the revival of a discontinued policy. There are also certain limitations while reviving a policy they are :

- (i) Revival should be during the life time of the assured and not after his death
- (ii) Within a period of 2 years from the due date of the first unpaid premium
- (iii) Before the date of maturity
- (iv) The conditions relating to the payment of the premium due on the lapsed policies should be complied with

In this case the lapsed policy was not revived during the life time of Ram. It could not be revived after the death of Ram. In any case, it is the right of the insurance company to revive the policy even if Ram had paid the premium before he died after the grace period.

Forfeiture : In certain cases and under certain circumstances, the insurance company can forfeit the money paid by the insured. Non payment of premiums is one such circumstance. When forfeiture clause is invoked the claims under the policy shall cease and the money paid shall belong to the insurance company. In this case, this clause could very much be invoked by the insurance company.

Conclusion: In view of the all above factors, the insurance company is not guilty of "deficiency" in service and Mrs. Ram will not be eligible to get the insured money.

8. You are auditing the investments of a Life Insurance Company and observe the following percentage of investible funds:

(i)	Investment in 8% no I, 2012 bonds	10%
(ii)	Investment in 10% no I, marketable securities of Railways	5%
(iii)	12% TNSEB, 2006 securities (approved)	25%
(iv)	Loans for Golden quadrangle Road project	5%
(v)	Loans for National Housing project	7%
(vi)	Bonds rated 'A' of Public Limited Company MS Ltd.	22%
(vii)	Bonds issued by a Co-operative Society not rated By agencies	26%

Required to:

Examine the above pattern of investment and state whether the requirements of the IRDA (Investment) Regulations have been met.

Ans. As per IRDA (INVESTMENT) Regulation, there are specific limits prescribed for investments to be made by every Life Insurance Company.

- (i) As per the regulation, the investment in Government securities and other approved securities should be made of not less than 50% of the investible sum. In the present company, the investment in 8% GOI bonds and 10% GOI Railways bonds and the 12% approved bonds in TNSEB consist of only 40%. Hence there is a deviation from the required investment by 10%. This needs to be brought out in the Audit report.
- (ii) As per the regulation, the investment in Infrastructure and social sector should not be less than 15%. In this company, the investment for road project is 5% and Housing project is 7%.

Together they constitute only 12%. Hence in this segment also there is deviation from the prescribed norms by 3%.

- (iii) The regulation restricts the investment in “other than approved investments” subject to exposure norms can never exceed 35%. In the company’s case there is an over exposure of investment in substandard companies and substandard products to the extent of 48%.

Whereas, as per exposure norms the other investment can be only in ‘AA’ rated investment. In addition, the investment made in cooperative society amounting to 26% is totally unacceptable as it is related to an asset which is not rated at all.

Conclusion : The investment by the company in all fronts is not falling in line with the recommendations by the IRDA regulations.

9. Write short notes on any **two** of the following :

- (i) Insurable interest
- (ii) Insurance as a risk management technique
- (iii) Differences between a nomination and over assignment of a policy of insurance.

Ans. i. Insurable interest : All risks are not insurable. In order to be insurable, the risk must be quantitatively measurable in terms of money and then there should be an insurable interest in the property that is sought to be insured.

Insurable interest means that the policyholders must have a pecuniary interest in the property sought to be insured and any damage that must result in a financial loss to him.

In life contracts, insurable interest is presumed to exist in certain relationships - spouse, parent and child etc.

In the case of general insurance contracts, it has to be proved and the existence of this in many cases signifies this contract against a wager contract.

A non-owner of a property cannot take up an insurance policy on it even if its loss can affect him partially - like a taxi driver in the case of a vehicle he drives as a professional.

ii. Insurance is used as a risk management tool because of certain advantages. Since the insurer indemnifies losses to an insured, he is enabled to carry on the business without any undue interruption and loss of capital. Insurers have rich experience and expertise in loss prevention, loss control and risk management and the insured is able to implement effectively his business plan. The stable conditions generated in a business promote a sense of security among the employees and lead to industrial peace. The effective to the insured is much less, than the cost of the premium paid since payment is an allowable deduction for tax purposes.

High cost of premium, because of market conditions sometimes forces customers to seek self-protection measures. The delay in settlement of claims by certain insurers laid best the claim that insurance acts as replacement capital. Due to availability of covers from insurers, owners do not take loss prevention measures promptly.

iii. an assignment of a policy once made cannot be cancelled at the discretion of the assigner. The assignment creates a vested interest in the assignee. On the other hand, a nomination does not deprive the policyholder of his rights, privileges, options and benefits under a policy including the right to alter a beneficiary. The beneficiary receives the money under the policy only as an agent and is accountable to the legal heirs of the policy holder. The nominee does not acquire any vested right in the amount insured.

If a policy becomes voidable on account of breach of warranty by the assignor, assignee will be deprived of all benefits under the policy. The nominee can neither surrender the policy or make it paid up. An assignement can not be obligated even under a will.