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Chapter One

Students learning objectives
After studying this chapter you should be able to:
❖ Explain the meaning of risk
❖ Define the term “chance of loss,” “peril” and “hazard.”
❖ Classify the various types of risks in our society
❖ Describe the major pure risk that are associated with great financial and economic insecurity.

Introduction
Ever since, the human race came to this planet, its livelihood has been surrounded by diverse risks ranging from those that, to extent, are controllable to those that are uncontrollable. An anonymous person clearly stated this fact of life as follows: The whole of life is the management of risk, but not its elimination.

People understand risk from different perspective. For example a system analysts views risk from the point of view of system failure or breakdown. Insurers on the other hand, view it interm of suffering losses due to accidental misfortunes- focusing on pure risks, while in the field of finance, security investors view it interm of fluctuation in the performance of the investment portfolio (i.e in the return of the investment portfolio). These different perspective, however, have one thing in common is deviation from expactation.

The term risk is generally associated with an unfortunate incident that leads to undesirable outcome. It denotes something unpleasant and harmful. The fact is the risk becomes part of our day- to-day life. Each of us is faced with the possibility of sustaining an undesirable incident on any given day. The undesirable incident could lead to a loss – financial or non-financial.

1.1 Basic Concepts
1. Risk: - What is risk? There is no single definition of risk. Economics, Behavioral Scientists, Risk Theorists, Statician and Financial Managers each have their own definition of risk. Traditionally risk has been defined interm of uncertainty. Based on this concept risk is defined as uncertainty concerning the occurrence of a loss. Modern scholars define risk like this:
Risk is variability in future outcomes or the deviation of actual from expected (probable) outcome. Risk is then perceived as a deviation from what is expected or anticipated, (Houston (1964); Athearn, (1969) and Pritchett et al (1996)).

Risk is the possibility of an unfavorable deviation from expectations; that is the occurrence of an undesirable contingency. It is the possibility that something we do not want to happen will happen or that something we want to happen will fail to do so, Atheran’s (1969: 3).

2. Probability and chance of loss:- probability is understood as a measure of the likelihood for the occurrence of an event. Probability is an estimate of the proportion of outcomes in which a specific condition is expected to occur.

- “Chance of loss” is relative frequency occurring among a large numbers of possible events. As per the definition “chance of loss” is similar to “probability of loss.”

There are three types of probability:

i. prior probability:-- it is objective from the nature of the event (e.g the probability of getting a head or a tail in a toss of coin or the probability of getting a number in rolling a die).

ii. Statistical probability:-- determined empirically by examining and analyzing large observations from experience (e.g probability of motor vehicle accident in a given geographical area in a given time period).

iii. Estimated (judgment) probability:-- which cannot be established objectively, but estimated intuitively.

Note: - The first two probability fall under the definition of risk while the third one is described under uncertainty for which there is no valid basis of any kind for classifying instance. The implication is that adverse events having a feature of the first two probability are generally insurable, while, adverse events with a characteristic of the third type of probability are uninsurable.

3. Peril:-- is defined as the immediate cause of a loss. If your house burns because of a fire, the peril, or cause of loss, is the fire. If your car is damaged in a collision with another car,
collision is the perill or the cause of loss. Some common perils that cause property damage or loss include fire, lightning, windstorm, hail, tornadoes, earthquakes, theft and burglary.

4. **Hazard**:- a hazard is a condition that creates or increases the chance of loss. There are four major types of hazards:
   A. Physical hazard
   B. Moral hazard
   C. Morale hazard
   D. Legal hazard

   A. **Physical hazard**:- is physical condition that increase the chance of loss. **Example**: icy roads that increase the chance of an auto accident or the road of Abay desert (the road which is found between Dejen and Goha-Tsiyon) that increase the chance of car accident, which is the cause of the death of many people, defective wiring in a building that increase the chance of fire, and a defective product that increase the loss of customer.

   B. **Moral hazard**:- is dishonesty of character defects in an individual that increase the frequency or severity of loss. **Example**: faking an accident to collect insurance money, submitting a fraudulent claim, inflating the size of claim, and intentionally burning house that insured.

   Moral hazard is present in all forms of financial institution (especially in insurance company) and it is difficult to control. The difficulty of moral hazard or moral crime is positively related with the behaviour of individuals. Insurers attempt to control moral hazard by careful underwriting of applicants for insurance and by various policy provisions, such as deductible, waiting periods (elimination), exclusions and riders.

   ✨ **Activity**: what are another mechanism of controlling moral hazard exercised by the financial institution at current time?

   C. **Morale hazard**:- is carelessness or indifference of the insured to a loss because the existence of insurance. Example leaving a key in the ignition of an unlocked car and thus increasing the chance of theft, leaving a door unlocked that allows a burglar to enter and drinking alchol and deriving.

   ✨ **Activity**: what is the difference between moral and morale hazard?

   D. **Legal hazard**:- Legal hazard refers to characteristics of the legal system or regulatory environment that increase the frequency or severity of losses. Examples include adverse jury
verdicts or large damage awards in liability lawsuits, statutes that require insurers to include coverage for certain benefits in health insurance plans, such as coverage for alcoholism; and regulatory action by state insurance departments that restrict the ability of insurers to withdraw from the state because of poor underwriting results.

1.2 Risk Vs uncertainty
Some writers use the term risk and uncertainty synonymously. However the difference between the two terms must be noted. Generally, uncertainty denotes the fact that the individuals and organizations do not know when an event will occur and what its actual impact will be in case the event occurs.

➢ The practical difference between risk and uncertainty
- Risk is a combination of hazards and is measured by probability or the distribution of the outcome in a group of instances is known (either through calculation of a priori or from statistics of past experience). However, uncertainty is measured by a degree of belief or it is impossible to form a group of instances (assign probability).
- Risk is a state of the world (i.e. objective phenomenon) but uncertainty is the state of the mind (i.e. subjective phenomenon).
- Risk relates only future outcomes, while, uncertainty can relate to the past event, present realities and future outcomes.

➢ The relation between risk and uncertainty
- The relationship between risk and uncertainty is established in terms of cause and effect relationship. Because the knowledge of the existence of risk and appreciation of its significance creates a feeling of uncertainty. Therefore, risk may create uncertainty.
- When risk is present, outcome cannot be forecasted with certainty. As a result, risk gives rise to uncertainty.
- If risk were synonymous to uncertainty (state of the mind) then it would have been possible to handle risk that some one is exposed to by removing his uncertainty thorough psychological therapy.

When risk is defined as the uncertainty some authors make a careful distinction between objective risk and subjective risk.
Objective Risk: - is defined as the relative variation of actual loss from expected loss. For example, assume that a motor insurer has 100,000 automobiles insured over a long period and estimated on average 2% or 2000 automobiles damage each year. However, it would be rare for exactly 2000 automobiles damage. There is relative fluctuation of the numbers of the damaged cars in some years (i.e reducing in to 1900 or increasing in to 2100). Thus, there is a variation of 100 automobiles from the expected numbers of 2000 or the variation of 5 percent. This relative variation of actual loss from expected loss is known as objective risk.

Objective risk declines as the numbers of exposures increase. More specifically, objective risk varies inversly with the square root of the numbers of cases under observation. For example from the previous example, assume 20 million automobiles insured by the motor insurance company. The expected numbers of automobiles that will damage is now 4,000,000 but the variation of actual loss from the expected loss is 100. Objective risk is now 100/4,000,000 or 0.0025 percent. Thus the square root of the numbers of automobiles increased from 2000 in the fist example to 4,000,000 in the second example objective risk decline from 5 percent to 0.0025 percent.

Objective risk can be statistically measured by some measure of dispersion, such as the standared divation or coefficient of variation. Since objective risk can be measured, it is extremely useful concept for an insurer or corporate risk manager.

Since objective risk can be statistically measured, it is a very powerful method for managing risk. As the number of exposure increases, the insurer is able to predict its future loss experience more precisely. This phenomenon is based on the law of large numbers. The law states that as the number of exposure increase, the variation reduces; therefore the actual loss experience will approach the expected loss experience.

Subjective Risk: - As the term suggests, subjective risk can be defined as the degree of uncertainty perceived by an individual. It can therefore vary from one person to another. For example, a person who has consumed a large amount of alcohol at a party and intends to drive home will be uncertain if he will be booked by the police. This mental uncertainty is an instance of subjective risk.
Two persons in the same situation may have different perceptions of the risks and show markedly different attitudes and responses towards the risks. Further, perceptions of risk can be affected by prior experience. If, in the example above, the drinker had been booked previously for driving under the influence of alcohol, he will probably judge that the risk of being booked again is high and may not attempt to drive home.

- **Objective probability** refers to the long-run relative frequency of an event based on the assumptions of an infinite number of observations and of no change in the underlying conditions. Objective probabilities can be determined in two ways. First, they can be determined by deductive reasoning. These probabilities are called a priori probabilities. For example, the probability of getting a head from the toss of a perfectly balanced coin is 1/2 because there are two sides, and only one is a head. Likewise, the probability of rolling a 6 with a single die is 1/6, since there are six sides and only one side has six dots on it. Secondly, objective probabilities can be determined by inductive reasoning, rather than deduction reasoning. For example, the probability that a person age 21 will die before age 26 cannot be logically deduced. However, by a careful analysis of past mortality experience, life insurers can estimate the probability of death and sell a five-year term life insurance policy issued at age 21.

- **Subjective probability** is the individual’s personal estimate of the chance of loss. Subjective probability need not coincide with objective probability. For example, people who buy a lottery ticket on their birthday may believe it is their lucky day and overestimate the small chance of winning. A wide variety of factors can influence subjective probability, including a person’s age, gender, intelligence, education, and the use of alcohol. In addition, a person’s estimate of a loss may differ from objective probability because there may be ambiguity in the way in which the probability is perceived. For example, assume that a slot machine in a gambling casino requires three lemons to win. The person playing the machine may perceive the probability of winning to be quite high. But if there are 10 symbols on each reel and only one is a lemon, the objective probability of hitting the jackpot with three lemons is quite small. Assuming that each reel spins independently of the others, the probability that all three will simultaneously show a lemon is the product of their individual probabilities (1/10, 1/10, 1/10 and 1/1000). This knowledge is advantageous to casino owners, who know that most
gamblers are not trained statisticians and are therefore likely to overestimate the objective probabilities of winning.

1.3 Risk and probability
While some definitions of risk focus only on the probability of an event occurring, more comprehensive definitions incorporate both the probability of the event occurring and the consequences of the event. Thus, the probability of a severe earthquake may be very small but the consequences are so catastrophic that it would be categorized as a high-risk event.

Chance of loss can be distinguished from objective risk. Chance of loss is the probability that an event that causes a loss will occur. Objective risk is the relative variation of actual loss from expected loss. The chance of loss may be identical for two different groups, but objective risk may be quite different.

For example, assume that a property insurer company has 10,000 homes insured in Addis Ababa and 10,000 homes insured in Gondar and that the chance of loss in each city is 1 percent. Thus, on average, 100 homes should burn annually in each city. However, if the annual variation in losses ranges from 75 to 125 in Gondar, but only from 90 to 110 in Addis Ababa, objective risk is greater in Gondar even though the chance of loss in both cities is the same.

1.4 Basic Categories of Risk
Risk can be classified into several distinct categories. The four major categories are as follows:

1. Pure or/and static risk
2. Speculative or/and dynamic risk
3. Particular (Diversifiable, unsystematic) risk
4. Fundamental (Non diversifiable, systematic) risk

1. Pure Risks
Pure risk is defined as a situation in which there are only the possibilities of loss or no loss. The only possible outcomes are adverse (loss) and neutral (no loss). Examples of pure risks include premature death, job-related accidents, catastrophic medical expenses, and damage to property from fire, lightning, flood, or earthquake.

Types of pure Risk
The major types of pure risk that can create great financial insecurity include personal risks, property risks, and liability risks.

**Personal Risks:** - Personal risks are risks that directly affect an individual. They involve the possibility of the complete loss or reduction of earned income, extra expenses, and the depletion of financial assets. There are four major personal risks:

1. Risk of premature death
2. Risk of insufficient income during retirement
3. Risk of poor health
4. Risk of unemployment

**Risk of Premature Death:** - *Premature death* is defined as the death of a household head with unfulfilled financial obligations. These obligations can include dependents to support, a mortgage to be paid off, or children to educate. If the surviving family members receive an insufficient amount of replacement income from other sources or have insufficient financial assets to replace the lost income, they may be financially insecure.

Premature death can cause financial problems only if the deceased has dependents to support or dies with unsatisfied financial obligations. Thus, the death of a child age seven is not “premature” in the economic sense.

There are at least four costs that result from the premature death of a household head. First, the human life value of the family head is lost forever. The **human life value** is defined as the present value of the family’s share of the deceased bread winner’s future earnings. This loss can be substantial; the actual or potential human life value of most college graduates can easily exceed $500,000. Second, additional expenses may be incurred because of funeral expenses, uninsured medical bills, probate and estate settlement costs, and estate and inheritance taxes for larger estates. Third, because of insufficient income, some families may have trouble making ends meet or covering expenses. Finally, certain noneconomic costs are also incurred, including emotional grief, loss of a role model, and counseling and guidance for the children.

**Risk of Insufficient Income during Retirement:** - The major risk associated with old age is insufficient income during retirement. The vast majority of workers in the Ethiopia retire before age 65. When they retire, they lose their earned income. Unless they have sufficient financial assets on which to draw, or have access to other sources of retirement income, such as Social Security or a private pension, they will be exposed to financial insecurity during retirement. The
majority of workers experience a substantial reduction in their money incomes when they retire, which can result in a reduced standard of living.

**Risk of Poor Health:** - Poor health is another important personal risk. The risk of poor health includes both the payment of catastrophic medical bills and the loss of earned income. The costs of major surgery have increased substantially in recent years. Unless these persons have adequate health insurance, private savings and financial assets, or other sources of income to meet these expenditures, they will be financially insecure. In particular, the inability of some persons to pay catastrophic medical bills is an important cause of personal bankruptcy. The loss of earned income is another major cause of financial insecurity if the disability is severe.

In cases of long-term disability, there is a substantial loss of earned income, medical bills are incurred, employee benefits may be lost or reduced, savings are often depleted, and someone must take care of the disabled person.

**Risk of Unemployment:** - The risk of unemployment is another major threat to financial security. Unemployment can result from business cycle downswings, technological and structural changes in the economy, seasonal factors, and imperfections in the labor market. Several important trends have aggravated the problem of unemployment. To hold down labor costs, large corporations have downsized, and their workforce has been permanently reduced; employers are increasingly hiring temporary or part-time workers to reduce labor costs; and millions of jobs have been lost to foreign nations because of global competition.

Regardless of the reason, unemployment can cause financial insecurity in at least three ways. First, workers lose their earned income and employee benefits. Unless there is adequate replacement income or past savings on which to draw, the unemployed worker will be financially insecure. Second, because of economic conditions, the worker may be able to work only part-time. The reduced income may be insufficient in terms of the worker's needs. Finally, if the duration of unemployment is extended over a long period, past savings and unemployment benefits may be exhausted.

**Property Risks:** - Persons owning property are exposed to property risks; the risk of having property damaged or lost from numerous causes. Real estate and personal property can be damaged or destroyed because of fire, lightning, tornadoes, windstorms, and numerous other
causes. There are two major types of loss associated with the destruction or theft of property: direct loss and indirect or consequential loss.

**Direct Loss:** A direct loss is defined as a financial loss that results from the physical damage, destruction, or theft of the property. For example, if you own a restaurant that is damaged by a fire, the physical damage to the restaurant is known as a direct loss.

**Indirect or Consequential Loss:** An indirect loss is a financial loss that results indirectly from the occurrence of a direct physical damage or theft loss. Thus, in addition to the physical damage loss, the restaurant would lose profits for several months while the restaurant is being rebuilt. The loss of profits would be a consequential loss. Other examples of a consequential loss would be the loss of rents, the loss of the use of the building, and the loss of a local market. Extra expenses are another type of indirect, or consequential, loss. For example, suppose you own a newspaper, bank, or dairy. If a loss occurs, you must continue to operate regardless of cost; otherwise, you will lose customers to your competitors. It may be necessary to set up a temporary operation at some alternative location, and substantial extra expenses would then be incurred.

**Liability Risks:** Liability risks are another important type of pure risk that most persons face. Under our legal system, you can be held legally liable if you do something that result in bodily injury or property damage to someone else. A court of law may order you to pay substantial damages to the person you have injured.

Liability risks are of great importance for several reasons. First, there is no maximum upper limit with respect to the amount of the loss. You can be sued for any amount. In contrast, if you own property, there is a maximum limit on the loss. For example, if your car has an actual cash value of $10,000, the maximum physical damage loss is $10,000. But if you are negligent and cause an accident that results in serious bodily injury to the other driver, you can be sued for any amount $50,000, $500,000, or $1 million or more by the person you have injured.

Second, a lien can be placed on your income and financial assets to satisfy a legal judgment. For example, assume that you injure someone, and a court of law orders you to pay damages to the injured party. If you cannot pay the judgment, a lien may be placed on your income and financial assets to satisfy the judgment. If you declare bankruptcy to avoid payment of the judgment, your credit rating will be impaired.
Finally, legal defense costs can be enormous. If you have no liability insurance, the cost of hiring an attorney to defend you can be staggering. If the suit goes to trial, attorney fees and other legal expenses can be substantial.

2. Speculative risk

It is defined as a situation in which either profit or loss is possible. For example, if you purchase 100 shares of common stock, you would profit if the price of the stock increases but would lose if the price declines. Other examples of speculative risks include betting on a horse race, investing in real estate, and going into business for your self. In these situations, both profit and loss are possible.

It is important to distinguish between pure and speculative risks for three reasons. First, private insurers generally insure only pure risks. With certain exceptions, speculative risks generally are not considered insurable and other techniques for coping with speculative risk must be used. (One exception is that some insurers will insure institutional portfolio investments and municipal bonds against loss.)

Second, the law of large numbers can be applied more easily to pure risks than to speculative risks. The law of large numbers is important because it enables insurers to predict future loss experience. In contrast, it is generally more difficult to apply the law of large numbers to speculative risks to predict future loss experience. An exception is the speculative risk of gambling, where casino operators can apply the law of large numbers in a most efficient manner.

Finally, society may benefit from a speculative risk even though a loss occurs, but it is harmed if a pure risk is present and a loss occurs. For example, a firm may develop new technology for producing inexpensive computers. As a result, some competitors’ competitors may be forced into bankruptcy. Despite the bankruptcy, society benefits because the computers are produced at a lower cost. However, society normally does not benefit when a loss from a pure risk occurs, such as a flood or earthquake that devastates an area.

3. Particular risk

A particular risk is a risk that affects only individuals and not the entire community. Examples include car thefts, bank robberies, and dwelling fires. Only individuals experiencing such losses are affected, not the entire economy.
The distinction between a fundamental and a particular risk is important because government assistance may be necessary to insure a fundamental risk. Social insurance and government insurance programs, as well as government guarantees and subsidies, may be necessary to insure certain fundamental risks in the United States. For example, the risk of unemployment generally is not insurable by private insurers but can be insured publicly by state unemployment compensation programs. In addition, flood insurance subsidized by the federal government is available to business firms and individuals in flood-prone areas.

3. Fundamental Risks
A fundamental risk is a risk that affects the entire economy or large numbers of persons or groups within the economy. Examples include rapid inflation, cyclical unemployment, and war because large numbers of individuals are affected.

The risk of a natural disaster is another important risk. Hurricanes, tornadoes, earthquakes, floods, and forest and grass fires can result in billions of dollars of property damage and numerous deaths. More recently, the risk of a terrorist attack is rapidly emerging as a fundamental risk. Many countries have experienced a substantial increase in terrorism in recent years, resulting in substantial property damage and the loss of human lives.

1.5 Burden of Risk on Society
The presence of risk results in certain undesirable social and economic effects. Risk entails three major burdens on society:

- The size of an emergency fund must be increased.
- Society is deprived of certain goods and services.
- Worry and fear are present.

Larger Emergency Fund: - It is prudent to set aside funds for an emergency. However, in the absence of insurance, individuals and business firms would have to increase the size of their emergency fund to pay for unexpected losses. For example, assume you have purchased a $150,000 home and want to accumulate a fund for repairs if the home is damaged by fire, hail, windstorm, or some other peril. Without insurance, you would have to save at least $25,000 annually to build up an adequate fund within a relatively short period of time. Even then, an early loss could occur, and your emergency fund may be insufficient to pay the loss. If you are a middle-income wage earner, you would find such saving difficult. In any event, the higher the
amount that must be saved, the more current consumption spending must be reduced, which results in a lower standard of living.

**Loss of Certain Goods and Services:** - A second burden of risk is that society is deprived of certain goods and services. For example, because of the risk of a liability lawsuit, many corporations have discontinued manufacturing certain products. Numerous examples can be given. Some 250 companies in the world once manufactured childhood vaccines; today, only a small number of firms manufacture vaccines, due in part to the threat of liability suits. Other firms have discontinued the manufacture of certain products, including asbestos products, football helmets, silicone-gel breast implants, and certain birth-control devices because of fear of legal liability.

**Worry and Fear:** - A final burden of risk is that worry and fear are present. Numerous examples can illustrate the mental unrest and fear caused by risk. Parents may be fearful if a teenage son or daughter departs on a skiing trip during a blinding snowstorm because the risk of being killed on an icy road is present. Some passengers in a commercial jet may become extremely nervous and fearful if the jet encounters severe turbulence during the flight. A college student who needs a grade of C in a course to graduate may enter the final examination room with a feeling of apprehension and fear.

**1.6 Methods of Handling Risk**
As we stressed earlier, risk is a burden not only to the individual but to society as well. Thus, it is important to examine some techniques for meeting the problem of risk. There are five major methods of handling risk:

- **Avoidance:** - Avoidance is one method of handling risk. For example, you can avoid the risk of being mugged in a high-crime rate area by staying out of the area; you can avoid the risk of divorce by not marrying; and a business firm can avoid the risk of being sued for a
defective product by not producing the product. Not all risks should be avoided, however. For example, you can avoid the risk of death or disability in a plane crash by refusing to fly. But is this choice practical or desirable? The alternatives driving or taking a bus or train often are not appealing. Although the risk of a plane crash is present, the safety record of commercial airlines is excellent, and flying is a reasonable risk to assume.

➢ **Loss Control:** - Loss control is another important method for handling risk. Loss control consists of certain activities that reduce both the frequency and severity of losses. Thus, loss control has two major objectives: loss prevention and loss reduction.

➢ **Loss Prevention:** - Loss prevention aims at reducing the probability of loss so that the frequency of losses is reduced. Several examples of personal loss prevention can be given. Auto accidents can be reduced if motorists take a safe-driving course and drive defensively. The number of heart attacks can be reduced if individuals control their weight, give up smoking, and eat healthy diets.

Loss prevention is also important for business firms. For example, strict security measures at airports and aboard commercial flights can reduce hijacking by terrorists. Boiler explosions can be prevented by periodic inspections by safety engineers; occupational accidents can be reduced by the elimination of unsafe working conditions and by strong enforcement of safety rules; and fires can be prevented by forbidding workers to smoke in a building where highly flammable materials are used. In short, the goal of loss prevention is to prevent the loss from occurring.

➢ **Loss Reduction:** - Strict loss-prevention efforts can reduce the frequency of losses, yet some losses will inevitably occur. Thus, the second objective of loss control is to reduce the severity of a loss after it occurs. For example, a department store can install a sprinkler system so that a fire will be promptly extinguished, thereby reducing the loss; a plant can be constructed with fire-resistant materials to minimize fire damage; fire doors and fire walls can be used to prevent a fire from spreading; and a community warning system can reduce the number of injuries and deaths from an approaching tornado.

From the viewpoint of society, loss control is highly desirable for two reasons. First, the indirect costs of losses may be large, and in some instances can easily exceed the direct costs. For example, a worker may be injured on the job. In addition to being responsible for the worker’s medical expenses and a certain percentage of earnings (direct costs), the firm may incur sizable
indirect costs: a machine may be damaged and must be repaired; the assembly line may have to be shut down; costs are incurred in training a new worker to replace the injured worker; and a contract may be canceled because goods are not shipped on time. By preventing the loss from occurring, both indirect costs and direct costs are reduced.

Second, the social costs of losses are reduced. For example, assume that the worker in the preceding example dies from the accident. Society is deprived forever of the goods and services the deceased worker could have produced. The worker’s family loses its share of the worker’s earnings and may experience considerable grief and financial insecurity. And the worker may personally experience great pain and suffering before dying. In short, these social costs can be reduced through an effective loss control program.

➢ Retention: - Retention is a third method of handling risk. An individual or a business firm retains all or part of a given risk. Risk retention can be either active or passive.

Active Retention Active risk retention means that an individual is consciously aware of the risk and deliberately plans to retain all or part of it. For example, a motorist may wish to retain the risk of a small collision loss by purchasing an auto insurance policy with a $250 or higher deductible. A homeowner may retain a small part of the risk of damage to the home by purchasing a homeowners policy with a substantial deductible. A business firm may deliberately retain the risk of petty thefts by employees, shoplifting, or the spoilage of perishable goods. In these cases, a conscious decision is made to retain part or all of a given risk. Active risk retention is used for two major reasons. First, it can save money. Insurance may not be purchased at all, or it may be purchased with a deductible; either way, there is often a substantial saving in the cost of insurance. Second, the risk may be deliberately retained because commercial insurance is either unavailable or unaffordable.

Passive Retention Risk can also be retained passively. Certain risks may be unknowingly retained because of ignorance, indifference, or laziness. Passive retention is very dangerous if the risk retained has the potential for destroying you financially. For example, many workers with earned incomes are not insured against the risk of total and permanent disability under either an
individual or group disability income plan. However, the adverse financial consequences of total and permanent disability generally are more severe than the financial consequences of premature death. Therefore, people who are not insured against this risk are using the technique of risk retention in a most dangerous and inappropriate manner.

In summary, risk retention is an important technique for handling risk, especially in a modern corporate risk management program, however, is appropriate primarily for high-frequency, low-severity risks where potential losses are relatively small. Except under unusual circumstances, risk retention should not be used to retain low frequency, high-severity risks, such as the risk of catastrophic medical expenses, long-term disability, or legal liability.

- **Noninsurance Transfers:** Noninsurance transfers are another technique for handling risk. The risk is transferred to a party other than an insurance company. A risk can be transferred by several methods, among which are the following:
  - Transfer of risk by contracts
  - Hedging price risks
  - Incorporation of a business firm

- **Transfer of Risk by Contracts:** Unwanted risks can be transferred by contracts. For example, the risk of a defective television or stereo set can be transferred to the retailer by purchasing a service contract, which makes the retailer responsible for all repairs after the warranty expires. The risk of a rent increase can be transferred to the landlord by a long-term lease. The risk of a price increase in construction costs can be transferred to the builder by having a fixed price in the contract.
Finally, a risk can be transferred by a **hold harmless clause.** For example, if a manufacturer of scaffolds inserts a hold-harmless clause in a contract with a retailer, the retailer agrees to hold the manufacturer harmless in case a scaffold collapses and someone is injured.

- **Hedging Price Risks:** Hedging price risks is another example of risk transfer. Hedging is a technique for transferring the risk of unfavorable price fluctuations to a speculator by purchasing and selling futures contracts on an organized exchange, such as the Chicago Board of Trade or New York Stock Exchange.
For example, the portfolio manager of a pension fund may hold a substantial position in long-term U.S. Treasury bonds. If interest rates rise, the value of the Treasury bonds will decline. To hedge that risk, the portfolio manager can sell U.S. Treasury bond futures. Assume that interest rates rise as expected, and bond prices decline. The value of the futures contract will also decline, which will enable the portfolio manager to make an offsetting purchase at a lower price. The profit obtained from closing out the futures position will partly or completely offset the decline in the market value of the Treasury bonds. Of course, markets do not always move as expected, so the hedge may not be perfect. Transaction costs also are incurred. However, by hedging, the portfolio manager has reduced the potential loss in bond prices if interest rates rise.

❖ **Incorporation of a Business Firm:** - Incorporation is another example of risk transfer. If a firm is a sole proprietorship, the owner’s personal assets can be attached by creditors for satisfaction of debts. If a firm incorporates, personal assets cannot be attached by creditors for payment of the firm’s debts. In essence, by incorporation, the liability of the stockholders is limited, and the risk of the firm having insufficient assets to pay business debts is shifted to the creditors.

➢ **Insurance:** - For most people, insurance is the most practical method for handling a major risk. Although private insurance has several characteristics, three major characteristics should be emphasized. First, risk transfer is used because a pure risk is transferred to the insurer. Second, the pooling technique is used to spread the losses of the few over the entire group so that average loss is substituted for actual loss. Finally, the risk may be reduced by application of the law of large numbers by which an insurer can predict future loss experience with greater accuracy. Each of these characteristics is treated in greater detail in Chapter 3.

**Review Questions**
1. Briefly explain the meaning of risk.
2. How does objective risk differ from subjective risk?
3. Define chance of loss.
4. Distinguish between an objective probability and a subjective probability.
5. Define peril, hazard, physical hazard, moral hazard, morale hazard, and legal hazard.
6. Explain the difference between pure and speculative risk and between fundamental and particular risk.
7. Identify the major types of pure risk that are associated with great financial insecurity.
8. Why is pure risk harmful to society?
9. What is the difference between a direct loss and an indirect, or consequential, loss?
10. Describe briefly the five major methods of handling risk. Give an example of each method.

**Cases Practice**

Tyrone is a college senior who is majoring in journalism. He owns a high-mileage 1990 Ford that has a current market value of $1500. The current replacement value of his clothes, television set, stereo set and other personal property in a rented apartment total $5000. He wears disposable contact lenses, which cost $200 for a six-month supply. He also has a waterbed in his rented apartment that has leaked water in the past. An avid runner, Tyrone runs five miles daily in a nearby public park that has the reputation of being extremely dangerous because of drug dealers, numerous assaults and muggings, and drive-by shootings. Tyrone’s parents both work to help him pay his tuition. For each of the following risks or loss exposures, identify an appropriate risk management technique that could be used to deal with the exposure. Explain your answer.

a. Physical damage to the 1990 Ford because of a collision with another motorist
b. Liability lawsuit against Tyrone arising out of the negligent operation of his car
c. Total loss of clothes, television, stereo, and personal property because of a grease fire in the kitchen of his rented apartment
d. Disappearance of one contact lens
e. Waterbed leak that causes property damage to the apartment
f. Physical assault on Tyrone by gang members who are dealing drugs in the park where he runs
g. Loss of tuition from Tyrone’s father who is killed by a drunk driver in an auto accident
Chapter Two: Risk Management

Introduction
In the previous sections we have identified several types of pure risks that affect individuals and businesses. After sources of risks are identified and measured, a decision can be made as to how the risk should be handled. The process used to systematically manage pure risk exposures is known as risk management.

2.1 Risk Management Definitions
“Risk Management is defined as a systematic process for the identification and evaluation of pure loss exposures faced by an organization or individual and for the selection and implementation of the most appropriate techniques for treating such exposures”.

Risk Management is the culture, processes and structures that are directed towards realizing potential opportunities whilst managing adverse effects (AS/NZS ISO31000:2009).

Risk Management is the comprehensive process of assessing and responding to risks. It includes managing adverse impacts and realizing potential opportunities.

Risk Control is a process, policy, device, practice or other action that acts to modify or minimize risk. As a general rule, the risk manager is concerned with only management of pure risks, not speculative risks.

2.2 Objectives of Risk Management
Risk management is a responsibility of all, with specific risk responsibilities being allocated to different groups and levels within the organization. It is important to have complete and current risk information available as this information assists the manager to make more informed decisions around both strategic direction and operational objectives. Risk management is not a stand-alone discipline but requires integration with existing business processes such as business planning and internal audit, in order to provide us with the greatest benefits.
The objectives of a risk management framework are:

As mentioned in the above chart, the objectives of risk management can be broadly classified into two;

1) Pre-loss Objectives
2) Post-loss Objectives

(1) Pre-loss Objectives:

An organization has many risk management objectives prior to the occurrence of a loss. The most important of such objectives are as follows;

(a) The first objective is that the firm should prepare for potential losses in the most economical way possible. This involves an analysis of safety program expenses, insurance premiums and the costs associated with the different techniques of handling losses.
(b) The second objective is the reduction of anxiety. It is more complicated. In a firm, certain loss exposures can cause greater worry and fear for the risk manager, key executives and unexpected stockholders of that firm. For example, a threat of a lawsuit from a defective product can cause greater anxiety than a possible small loss from a minor fire. However, the risk manager wants to minimize the anxiety and fear associated with such loss exposures.
(c) The third pre-loss objective is to meet any externally imposed obligations. This means that the firm must meet certain obligations imposed on it by the outsiders. For example, government regulations may require a firm to install safety devices to protect workers from harm. Similarly, a firm’s creditors may require that property pledged as collateral for a loan must be insured. Thus, the risk manager is expected to see that these externally imposed obligations are met properly.

(2) Post-loss Objectives:

Post-loss objectives are those which operate after the occurrence of a loss. They are as follows;

(a) The first post-loss objective is survival of the firm. It means that after a loss occurs, the firms can at least resume partial operation within some reasonable time period.
(b) The second post-loss objective is to continue operating. For some firms, the ability to operate after a severe loss is an extremely important objective. Especially, for public utility firms such as banks, dairies, etc, they must continue to provide service. Otherwise, they may lose their customers to competitors.
(c) Stability of earnings is the third post-loss objective. The firm wants to maintain its earnings per share after a loss occurs. This objective is closely related to the objective of continued operations. Because, earnings per share can be maintained only if the firm continues to operate. However, there may be substantial costs involved in achieving this goal, and perfect stability of earnings may not be attained.
(d) Another important post-loss objective is continued growth of the firm. A firm may grow by developing new products and markets or by acquisitions and mergers. Here, the risk manager must consider the impact that a loss will have on the firm’s ability to grow.
(e) The fifth and the final post-loss objective is the social responsibility to minimize the impact that a loss has on other persons and on society. A severe loss can adversely affect the employees, customers, suppliers, creditors and the community in general. Thus, the risk manager’s role is to minimize the impact of loss on other persons.

Thus, there are the pre-loss and post-loss objectives of risk management. A prudent risk manager must keep these objectives in mind while handling and managing the risk.
2.3 Benefits of Risk Management
Risk management will support us in being able to meet our values and deliver upon our objectives. Application of a consistent and comprehensive risk management process will:

- Increase the likelihood of us achieving our strategic and business objectives;
- Encourage a high standard of accountability at all levels of the organisation;
- Support more effective decision making through better understanding of risk exposures;
- Create an environment that enables us to deliver timely services and meet performance objectives in an efficient and cost effective manner;
- Safeguard our assets – human, property and reputation; and
- Meet compliance and governance requirements.

2.4 Steps in Risk Management Process
Whether the concern is with a business or an individual situation, the same general steps can be used to analyze systematically and deal with risk. This is known as RISK MANAGEMENT PROCESS.

The Risk Management Process has seven steps to be implemented by the risk manager. They are shown in the following chart;
1. Establish the context (strategic & organizational)

The purpose of this stage of risk management enables to understand the environment in which the respective organization operates, that means to thoroughly understand the external environment and the internal culture of the organization. The analysis is undertaken through: establishing the strategic, organizational and risk management context of the organization, and identifying the constraints and opportunities of the operating environment.

The establishment of the context and culture is undertaken through a number of environmental analyses that include, e.g., a review of the regulatory requirements, codes and standards, industry guidelines as well as the relevant corporate documents and the previous year’s risk management and business plans. Part of this step is also to develop risk criteria. The criteria should reflect the context defined, often depending on an internal policies, goals and objectives of the organization and the interests of stakeholders. Criteria may be affected by the perceptions of stakeholders and by legal or regulatory requirements. It is important that appropriate criteria be determined at the outset.

Although the broad criteria for making decisions are initially developed as part of establishing the risk management context, they may be further developed and refined subsequently as particular risks are identified and risk analysis techniques are chosen. The risk criteria must correspond to the type of risks and the way in which risk levels are expressed. Methods to assess the environmental analysis are SWOT (Strength, Weaknesses, Opportunities and Threats) and PEST (Political, Economic, Societal and Technological) frameworks developed.

The variables to be considered when executing the risk management process, although often times it is not feasible to study all of these factors:

- Goals and Objectives
- Mission Space and Values
- Policies and Standards
- Scope and Criticality of the Decision
- Decision Makers and Stakeholders
- Decision Timeframe
- Risk Management Capabilities and Resources
2. Risk Identification (Identify Potential Losses)

Using the information gained from the context, particularly as categorized by the SWOT and PEST frameworks, the next step is to identify the risks that are likely to affect the achievement of the goals of the organization, activity or initiative. It should be underlined that a risk can be an opportunity or strength that has not been realized.

Key questions that may assist your identification of risks include:

➢ For us to achieve our goals, when, where, why, and how are risks likely to occur?
➢ What are the risks associated with achieving each of our priorities?
➢ What are the risks of not achieving these priorities?
➢ Who might be involved (for example, suppliers, contractors, stakeholders)?

Here, based on the above key questions the risk manager can identify several types of potential losses. These potential losses include the following:

- Property losses
- Business income losses
- Liability losses
- Death or inability of key people
- Job-related injuries or disease
- Fraud, criminal acts and dishonesty of employees
- Employee benefits loss exposures

The appropriate risk identification method will depend on the application area (i.e. nature of activities and the hazard groups), the nature of the project, the project phase, resources available, regulatory requirements and client requirements as to objectives, desired outcome and the required level of detail.

A risk manager; can use the following tools and techniques may further assist the identification of risks.

➢ Examples of possible risk sources,
➢ Checklist of possible business risks and fraud risks,
➢ Typical risks in stages of the procurement process,
➢ Scenario planning as a risk assessment tool ,
➢ Process mapping,
➢ Documentation, relevant audit reports, program evaluations and / or research reports.
➢ Physical inspection of company plant & machineries can identify major loss exposures.
➢ Extensive risk analysis questionnaire can be used to discover hidden loss exposures that are common to many firms.
➢ Flow charts that show production and delivery processes can reveal production bottlenecks where a loss can have severe financial consequences to the firm.
➢ Financial statements can be used to identify the major assets that must be protected.
➢ Departmental & historical claims data can be invaluable in identifying major loss exposures.

Risk managers must also be aware of new loss exposures that may be emerging. More recently misuse of the internet and e-mail transmissions by employees have exposed employers to potential legal liability because of transmission of pornographic material and theft of confidential information.

3. Analysis risk and risk management tools (frequency and severity)

Risk analysis involves the consideration of the source of risk, the consequence and likelihood to estimate the inherent or unprotected risk without controls in place. It also involves identification of the controls, an estimation of their effectiveness and the resultant level of risk with controls in place (Avoidance, Loss control, Retention Non-insurance transfers Insurance). Qualitative, semi-quantitative and quantitative techniques are all acceptable analysis techniques depending on the risk, the purpose of the analysis and the information and data available.

Often qualitative or semi-quantitative techniques can be used for screening risks whereas higher risks are being subjected to more expensive quantitative techniques as required. Risks can be estimated qualitatively and semi-quantitatively using tools such as hazard matrices, risk graphs, risk matrices or monographs but noting that the risk matrix is the most common.

Applying the risk matrix, it is required to define for each risk its profile using likelihood and consequences criteria. Typical definitions of the likelihood and consequence are contained in the risk matrix.
Using the consequence criteria provided in the risk matrix, one has to determine the consequences of the event occurring (with current controls in place). To determine the likelihood of the risk occurring, one can apply the likelihood criteria (again contained in the risk matrix). As before, the assessment is undertaken with reference to the effectiveness of the current control activities. To determine the level of each risk, one can again refer to the risk matrix. The risk level is identified by intersecting the likelihood and consequence levels on the risk matrix.

Complex risks may involve a more sophisticated methodology. For example, a different approach may be required for assessing the risks associated with a significantly large procurement. Methods typically used for risk analysis.
4. Evaluate Measure Risk (Ranked & Prioritised)

Once the risks have been analyzed they can be compared against the previously documented and approved tolerable risk criteria. When using risk matrices this tolerable risk is generally documented with the risk matrix. Should the protected risk be greater than the tolerable risk then the specific risk needs additional control measures or improvements in the effectiveness of the existing controls.

The decision of whether a risk is acceptable or not acceptable is taken by the relevant manager. A risk may be considered acceptable if for example:

- The risk is sufficiently low that treatment is not considered cost effective, or
A treatment is not available, e.g. a project terminated by a change of government, or
A sufficient opportunity exists that outweighs the perceived level of threat.

If the manager determines the level of risk to be acceptable, the risk may be accepted with no
further treatment beyond the current controls. Acceptable risks should be monitored and
periodically reviewed to ensure they remain acceptable. The level of acceptability can be
organizational criteria or safety goals set by the authorities. From this stage of the process of risk
management the appropriate risk management tools is selected. The following risk matrix shows
this situation.

Risk Management Matrix

<table>
<thead>
<tr>
<th>Type of Loss</th>
<th>Loss Frequency</th>
<th>Loss Severity</th>
<th>Appropriate Risk Management Technique</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Low</td>
<td>Low</td>
<td>Retention</td>
</tr>
<tr>
<td>2</td>
<td>High</td>
<td>Low</td>
<td>Loss Control &amp; Retention</td>
</tr>
<tr>
<td>3</td>
<td>Low</td>
<td>High</td>
<td>Insurance</td>
</tr>
<tr>
<td>4</td>
<td>High</td>
<td>High</td>
<td>Avoidance</td>
</tr>
</tbody>
</table>

In determining the appropriate method or methods of handling losses, the above matrix can be
used. It classifies the various loss exposures according to frequency and severity.

The first loss exposure is characterized by both low frequency and low severity of loss. One
eexample of this type of exposure would be the potential theft of a secretary’s Note pad. This type
of exposure can be best handled by retention, since the loss occurs infrequently and when it occurs
it does not cause financial harm.

The second type of exposure is more serious. Losses occur frequently, but severity is relatively
low. Examples of this type of exposure include physical damage losses to automobiles,
shoplifting and food spoilage. Loss control should be used here to reduce the frequency of losses.
In addition, since losses occur regularly and are predictable, the retention technique can also be
used.
The third type of exposure can be met by insurance. Insurance is best suited for low frequency, high severity losses. High severity means that a catastrophic potential is present, while a low probability of loss indicates that the purchase of insurance is economically feasible. Examples include fires, explosion and other natural disasters. Here, the risk manager could also use a combination of retention and insurance to deal with these exposures.

The fourth and most serious type of exposure is characterized by both high frequency and high severity. This type of risk exposure is best handled by avoidance. For example, if a person has drunken and if he attempts to drive home in that drunken stage, the chance of meeting with an accident is more. This loss exposure can be avoided by not driving at the drunken stage or by having a driver to drive his car.

5. **Treating Risk or Risk Administration (identify strategies)**

The next and the fifth step in the risk management process are implementation and administration of the risk management program. An unacceptable risk requires treatment. The objective of this stage of the risk assessment process is to develop cost effective options for treating the risks. Treatment options which are not necessarily mutually exclusive or appropriate in all circumstances are driven by outcomes that include:

- Avoiding the risk,
- Reducing (mitigating) the risk,
- Transferring (sharing) the risk, and
- Retaining (accepting) the risk.

- Avoiding the risk - not undertaking the activity that is likely to trigger the risk.
- Reducing the risk - controlling the likelihood of the risk occurring, or controlling the impact of the consequences if the risk occurs. Examples for the mitigation activity effectiveness are described in (Writhing 2006).
- Transferring the risk totally or in part - This strategy may be achievable through moving the responsibility to another party or sharing the risk through a contract, insurance, or partnership/joint venture. However, one should be aware that a new risk arises in that the party to whom the risk is transferred may not adequately manage the risk!
- Retaining the risk and managing it - Resource requirements feature heavily in this strategy.
The next step is to determine the target level of risk resulting from the successful implementation of the preferred treatments and current control activities. The intention of a risk treatment is to reduce the expected level of an unacceptable risk. Using the risk matrix one can determine the consequence and likelihood of the risk and identify the expected target risk level.

Factors to consider for this risk treatment strategy include:

- Can the likelihood of the risk occurring be reduced? (Through preventative maintenance, or quality assurance and management, change in business systems and processes), or
- Can the consequences of the event be reduced? (Through contingency planning, minimizing exposure to sources of risk or separation/relocation of an activity and resources).

This steps involves three important components;

(i) Risk management policy statement
(ii) Co-operation with other departments
(iii) Periodic review and evaluation

(i) **Risk management policy statement**: A risk management policy statement is necessary in order to have an effective risk management program. This statement outlines the risk management objectives of the firm, as well as company policy with respect to the treatment of loss exposures. It also educates top level executives in regard to the risk management process and gives the risk manager greater authority in the firm.

In addition, a risk management manual may be developed and used in the program. The manual describes the risk management program of the firm and can be a very useful tool for training new employees who will be participating in the program.

(ii) **Co-operation with other departments**: The risk manager has to work in co-operation with other functional departments in the firm. It will facilitate to identify pure loss exposures and methods of treating these exposures. The Accounting Department can adopt Internal Accounting Controls to reduce employee’s fraud and theft of cash. The Finance Department can provide information showing how losses can disrupt profits and cash flow. The Marketing Department can prevent liability suits by ensuring accurate packaging. Besides, safe distribution procedures can prevent accidents. The Production Department has to ensure quality control and effective
safety programs in the plant can reduce injuries and accidents. The Personnel Department may be responsible for employee benefit program, pension program and safety program.

(iv) **Periodic review & evaluation:** The risk management program must be periodically reviewed and evaluated to see whether the objectives are being attained or not. Especially, risk management costs, safety programs and loss preventive programs must be carefully monitored. Loss records must also be examined to detect any changes in frequency and severity. Finally, the risk manager must determine whether the firm’s overall risk management policies are being carried out, and whether the risk manager is receiving the total co-operation of the other departments in carrying out the risk management functions.

6. **Monitoring & Review the risk**

It is important to understand that the concept of risk is dynamic and needs periodic and formal review. The currency of identified risks needs to be regularly monitored. New risks and their impact on the organization may to be taken into account. This step requires the description of how the outcomes of the treatment will be measured. Milestones or benchmarks for success and warning signs for failure need to be identified.

The review period is determined by the operating environment (including legislation), but as a general rule a comprehensive review every five years is an accepted industry norm. This is on the basis that all plant changes are subject to an appropriate change process including risk assessment. The review needs to validate that the risk management process and the documentation is still valid. The review also needs to consider the current regulatory environment and industry practices which may have changed significantly in the intervening period.

The organization, competencies and effectiveness of the safety management system should also be covered. The plant management systems should have captured these changes and the review should be seen as a ‘back stop’. The assumptions made in the previous risk assessment (hazards, likelihood and consequence), the effectiveness of controls and the associated management system as well as people need to be monitored on an on-going basis to ensure risk are in fact controlled to the underlying criteria. For an efficient risk control the analysis of risk interactions is necessary. This ensures that the influences of one risk to another is identified and assessed. The usual method for that purpose are a cross impact analysis, Petri nets or simulation tools. A framework
needs to be in place that enables responsible officers to report on the following aspects of risk and its impact on organizations´ operations:

✓ What are the key risks?
✓ How are they being managed?
✓ Are the treatment strategies effective? – If not, what else must be undertaken?
✓ Are there any new risks and what are the implications for the organization?

7. Communication and reporting

Clear communication is essential for the risk management process, i.e. clear communication of the objectives, the risk management process and its elements, as well as the findings and required actions as a result of the output. Risk management is an integral element of organization´s management. However, for its successful adoption it is important that in its initial stages, the reporting on risk management is visible through the framework. The requirements on the reporting have to be fixed in a qualified and documented procedure, e. g., in a management handbook.

Documentation is essential to demonstrate that the process has been systematic, the methods and scope identified, the process conducted correctly and that it is fully auditable. Documentation provides a rational basis for management consideration, approval and implementation including an appropriate management system.

A documented output from the above sections (risk identification, analysis, evaluation and controls) is a risk register for the site, plant, equipment or activity under consideration. This document is essential for the on-going safe management of the plant and as a basis for communication throughout the client organization and for the on-going monitor and review processes. It can also be used with other supporting documents to demonstrate regulatory compliance.

Activity: Renaissance Dam Risk Management System

Take the Renaissance Dam of Ethiopia as an example and develop the risk management system for this Dam.
Chapter Three: Insurance

Definition:
According to the Commission on Insurance Terminology of the American Risk and Insurance Association, “Insurance is the pooling of fortuitous losses by transfer of such risks to insurers, who agree to indemnify insured for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk”. Although this definition may not be acceptable to all insurance scholars, it is useful for analyzing the common elements of a true insurance plan.

- Insurance is a financial institution that helps in curbing down the risk of loss or total loss of property or individuals by providing a cover in line before the occurrence of the risk. Therefore, when the insured is taking an insurance policy, it should be specific and on the suspected matter.

- Insurance is a co-operative device to spread lost course by a particular risk over a number of persons, who are expose to it and agree to insured’s themselves against the risk.

3.1 Basic Characteristics of Insurance
An insurance plan has typically certain characteristics. They include the following;

(i) Pooling of losses
(ii) Payment of fortuitous losses
(iii) Risk transfer
(iv) Indemnification

(i) Pooling of losses: - Pooling is the spreading of losses incurred by the few over the entire group, so that in the process, average loss is substituted for actual loss. Thus, pooling implies (a) the sharing of losses by the entire group, and (b) prediction of future losses with some accuracy based on the law of large numbers.

(a) Sharing of losses: - The concept of loss sharing can be explained with an example. Assume that there are 10000 houses in Mizan. All the 10000 households agree that if any one of the house is damaged or destroyed by a fire, the other households will indemnify, or cover, the actual costs of the household who has suffered a loss. Also assume that each home is valued at 100,000 birr, and, on average, one house burns every year. In the absence of insurance, the maximum loss to each household is 100,000 birr, if the house burns. However, by pooling the loss, it can be spread over the entire group, and if one
household has a total loss, the maximum amount that each household would have to pay only 10 birr (100,000 / 1,000). Thus, the pooling technique results in the substitution of an average loss of 10 birr for the actual loss of 100,000 birr.

(b) Prediction of future losses: - By pooling the loss experience of a large number of units, an insurer may be able to predict future losses with some accuracy. From the viewpoint of the insurer, if future losses can be predict, objective risk is reduced. Thus, another characteristic of insurance is risk reduction based on the law of large numbers.

The law of large numbers states that the greater the number of exposures, the more closely will the actual results approach the probable results that are expected from an infinite number of exposures. For example, if you flip a balanced coin into the air, the chance of getting a head is 0.5. If you flip the coin only 10 times, you may get a head 8 times. Although, the observed probability is 0.8, the true probability still 0.5. If the coin were flipped 1 million times, however, the actual number of heads would be approximately 500,000. Thus, as the number of random tosses increases, the actual results approach the expected results.

(ii) Payment of Fortuitous Losses: - A fortuitous loss is one that is unforeseen and unexpected and occurs as a result of chance. In other words, the loss must be accidental. The Law of Large Numbers is based on the assumption that losses are accidental and occur randomly. For example, a person may meet with an accident and break a leg. The loss would be fortuitous.

(iii) Risk transfer: - Risk transfer means that a pure risk is transferred from the insured to the insurer, who typically is in a stronger financial position to pay the loss than the insured. From the viewpoint of the individual, pure risks that are typically transferred to insurers include the risk of premature death, poor health, disability, destruction and theft of property, etc.

(iv). Indemnification: - Indemnification means that the insured is restored to his or her approximate financial position prior to the occurrence of the loss. Thus, if your home burns in a fire, the house owner policy will indemnify you or restore you to your previous position.

3.2 Fundamentals of insurable risk
Generally a person can insure most things. However there are some exceptions and exclusions. For a risk to be insurable the following conditions must be present:
➢ There must be an insurable interest in the thing or person being insured.
➢ There must be a large number of similar risks being insured.
➢ Any losses incurred must be accidental
➢ The risk must not be too catastrophic for the insurance company i.e. the possible loss should not be so great as to ruin the insurance company
➢ It must be possible to calculate the risk of a loss occurring.

Note:- In the absence of any of these five conditions the risk is uninsurable

3.3 Insurance & Gambling:
Insurance is often confused with gambling. There are two important differences between them. They are as follows;

(i) Gambling creates a new speculative risk, while insurance is a technique for handling an already existing pure risk. Thus, if you bet 1000 birr on a horse race, a new speculative risk is created, but if you pay the same 1000 birr to an insurer for fire insurance, the risk of fire is already present and it is transferred to the insurer by a contract. Now, new risk is created by the transaction.

(ii) Gambling is socially unproductive, since the winner’s gain comes at the expense of the loser. In contrast, insurance is always socially productive, since neither the insurer nor the insured is placed in a position where the gain of the winner comes at the expense of the loser. The insurer and the insured both have a common interest in the prevention of a loss. Both parties win if the loss does not occur.

3.4 Insurance & Speculation:
An insurance contract is not the same thing as speculation. There are some important differences between them. They are as follows;

(i) An insurance transaction involves the transfer of insurable risks, since the requirements of an insurable risk generally can be met. However, speculation is a technique for the handling risks that are typically uninsurable, such as protection against a decline in the price of agricultural products and raw materials.

(ii) Insurance can reduce the objective risk of an insurer by application of the law of large numbers. As the number of exposure units increases, the insurer’s prediction of future losses improves, since the relative variation of actual loss from expected loss will decline. Thus, many insurance transactions reduce objective risk. In contrast, speculation typically involves only risk transfer, not risk reduction. The risk of
adverse price fluctuations is transferred to speculators who believe they can make a profit because of superior knowledge of market conditions. The risk is transferred, not reduced, and the speculator’s prediction of loss generally is not based on the law of large numbers.

3.5 Benefits and Cost of Insurance (reading assignment)

1. Benefits of insurance to the society

The insurance has become an integral part of business and human life. The following are the Advantage of insurance:

❖ **Providing Security**: There is always a fear of sudden loss. There may be a fire in factory, storm in the sea or loss of life. In all these cases it becomes difficult to bear the loss. Insurance provides a cover against any sudden loss.

❖ **Spreading Risk**: The basic principal of insurance is to spread risk among a large number of peoples. A large number of persons get the insurance policies and pay premier to the insurer. Whenever a loss occurs, it is compensated out of fund to the insurer.

❖ **Source for collecting funds**: The premium is received regularly in instalments. Large funds are collected by way of premium. It helps in collecting saving from a large number of persons. The funds can be gainfully employed in industrial development of a country.

❖ **Encourage savings**: Insurance does not only protect the risks but it provides the investment channel too. Life insurance provides a mode of investment. In case of fixed time policies, the insured gets lump sum amount after the maturity of the policies.

❖ **Less worry and fear** (read more)

❖ **Enhancement of credit** (read more)

2. Cost of insurance to society (take your notes)

➢ Cost of doing business
➢ Fraudulent claims
➢ Inflated claims
Chapter Four: General Principles of Insurance

4.1 Insurable Interest:
The principle of insurable interest states that the insured must lose financially if a loss occurs, or must incur some other kind of harm if the loss takes place. For example, a person has an insurable interest in his automobile, television or VCR have been damaged or stolen.

Why Insurable Interest? Insurable interest is essential in an insurance contract for the following reasons;

First, an insurable interest is necessary to prevent gambling. If an insurable interest were not required, the contract would be a gambling contract and would be against the public interest. For example, one could insure the property of another and hope for an early loss. In the same way, one could insure the life of another and hope for an early death.

Second, an insurable interest reduces moral hazard. If an insurable interest is not required, a dishonest person could purchase a property insurance contract on some one’s property and then deliberately cause a loss to receive the insurance claims. But, if the insured person stands to lose financially, nothing is gained by causing the loss. Thus, moral hazard is reduced.

Finally, an insurable interest measures the amount of the insured’s loss. In property insurance, most contracts are contracts of indemnity. Thus, the measure of recovery is the insurable interest of the insured. The amount of indemnification is measured by calculating the insurable interest in monetary terms. For example, if a person’s property worth 1 million Birr is insured and it was destroyed totally after some time, his insurable interest on that property depends on the financial loss met by him. Here, as the entire property is destroyed, his insurable interest tends to be 1 million Birr on that property. Thus, he will be indemnified the 1 million Birr.

When must an insurable interest exist? In property insurance, the insurable interest must exist at the time of loss. There are two reasons for this requirement.

First, most property insurance contracts are indemnity contracts. If an insurable interest did not exist at the time of loss, financial loss would not occur. For example, if Mr. X sells his car to Mr. Y, and it was stolen before the insurance on the car is cancelled, Mr. X cannot collect since he has no insurable interest on the car. Also Mr. Y cannot collect as he is not named as an insured under the policy.
Second, one may not have an insurable interest in the property when the contract is first written, but may expect to have an insurable interest in the future, at the time of possible loss. For example, in a marine insurance, it is common to insure a return cargo by a contract entered into prior to the ship’s departure. However, the policy may not cover the goods until they are boarded on the ship as the insured’s property. Although an insurable interest does not exist when the contract is first written, one can still collect the claims if he has an insurable interest in the goods at the time of loss.

In life insurance contracts, the insurable interest requirement must be met only at the inception of the policy, not at the time of death. Life insurance is not a contract of indemnity, but it is valued policy that pays a stated sum upon the death of the insured. Since the beneficiary has only a legal claim to receive the policy proceeds, he need not show that a loss has been incurred by the insured’s death. For example, if Mrs. X has taken a policy on her husband Mr. Y and later gets a divorce, she is entitled to the policy proceeds upon the death of her former husband if she has kept the insurance in force.

4.2 Utmost Good faith

Utmost good faith means that a higher degree of honesty is imposed on both parties to an insurance contract than is imposed on parties to other contracts. This principle has its historical roots in marine insurance. The marine insurer had to place great faith in statements made by the applicant for insurance concerning the cargo to be shipped. The property to be insured may not have been visually inspected. The principle of utmost good faith is supported by three important legal principles;

(i) Representations

(ii) Concealment

(iii) Warranty

(i) Representations:

Representations are statements made by the applicant for insurance. For example, if a person wants to apply for life insurance, he may be asked questions concerning his age, weight, height, occupation, state of health and other relevant questions. The answers given by that person are called representations.

The legal importance of a representation is that the insurance contract is voidable at the insurer’s option if the representation is (a) material, (b) false, and (c) relied on by the insurer.
Material means that if the insurer knew the true facts, the policy would not have been issued, or would have been issued on different terms. False means that the statement given by the insured is not true or it is misleading. Reliance means that the insurer relies on the misrepresentation in issuing the policy at the specified premium.

For example, Mr. X may apply for life insurance and state in the application form that he has not visited a doctor within the last 5 years. But, he may have undergone surgery six months earlier. In this case, he has made a statement that is both false & material and the policy is voidable at the insurer’s option.

Finally, an innocent or unintentional misrepresentation of a material fact, if relied on by the insurer also makes the contract voidable.

(ii) Concealment:

Concealment is intentional failure of the applicant for insurance to reveal a material fact to the insurer. Here, the applicant for insurance deliberately withholds material information from the insurer. The legal effect of a material concealment is also voidable at the insurer’s option.

To deny a claim based on concealment, an insurer must prove two things; (a) the concealed fact was known by the insured and (b) the insured intended to defraud the insurer. For example, Mr. Joseph DeBellis applied for a life insurance policy on his life. 6 months after the policy was issued, he was murdered. The death certificate named the deceased as Joseph De Luca, his true name. Thus, the insurer denied payment on the ground that Joseph had concealed a material fact by not revealing his true identity, and he had also an extensive criminal record. Thus, the court held that intentional concealment of his true identity was material and the insurer need not pay the claim.

(iii) Warranty:

The doctrine of warranty also reflects the principle of utmost good faith. A warranty is a statement of fact or promise made by the insured, which is part of the insurance contract and which must be true if the insurer is to be liable under the contract. For example, in order to pay a reduced premium, the owner of a shop may warrant that an approved burglary and robbery alarm system will be operational at all times. The conditions describing the warranty become part of the contract.

A warranty is a harsh legal principle. Any breach of the warranty allows the insurer to deny payment of a claim. However, the courts have softened and modified the harsh common law of doctrine of warranty.
4.3 Indemnity

The principle of indemnity is one of the most important legal principles in the field of insurance. The principle of indemnity states that the insured should not profit from a covered loss but should be restored to approximately the same financial position that existed prior to the loss. Most of the property insurance contracts are indemnity contracts. If a covered loss occurs, the insured should not collect more than the actual amount of the loss.

The principle of indemnity has two fundamental purposes. The first purpose is to prevent the insured from profiting from insurance. The insured should not profit if a loss occurs, but should be restored to approximately the same financial position that existed before the loss. For example, if Mr. X has insured his house for 100,000 birr and a loss amounted to 10,000 birr occurs, the principle of indemnity would be violated if 100,000 birr were paid to him, because he would be profiting out of insurance.

The second purpose is to reduce moral hazard. If dishonest insured can profit from a loss, they may deliberately cause a loss with the intention of collecting the insurance. Thus, if the loss payment does not exceed the actual amount of the loss, the temptation to be dishonest is reduced. **Actual Cash Value:**

- In property insurance, the standard method of indemnifying the insured is based on the actual cash value of the damaged property at the time of loss. The Courts have used three major methods to determine actual cash value;

(i) Replacement cost less depreciation

(ii) Fair market value

(iii) Broad Evidence rule

(i) **Replacement cost less depreciation:**

Under this rule, actual cash value is defined as replacement cost less depreciation. This rule has been traditionally used to determine the actual cash value of property in property insurance. It takes into consideration both inflation and depreciation of property values over time. Replacement cost is current cost of restoring the damaged property with new materials of some kind and quality. Depreciation is a deduction for physical war and tear, age and economic obsolescence.

For example, machinery has been insured against fire. It burnt out of a fire. Assume that the machinery was bought 5 years ago, and that machinery is 50% depreciated. The similar machinery would cost 10,000 birr. Under the actual cash value rule, the insured will collect only 5,000 birr for the loss of the
machinery, because the replacement cost is 10,000 birr, but depreciation is 5,000 birr or 50%. If the insured were paid the full replacement value of 10,000 birr, the principle of indemnity would be violated, because the insured would be receiving the value of new brand machinery instead of one 5 years old. In short, 5,000 birr payment represents indemnification for the loss of 5 year old machinery. This can be summarized as follows;

Replacement Cost = 10,000 birr

Depreciation = 5,000 birr (Machinery is 50% depreciated)

Actual Cash Value = Replacement Cost – Depreciation

∴ Actual cash value = 10,000 birr – 5,000 birr

= 5,000 birr.

(ii) Fair Market Value

Fair market value is the price a willing buyer would pay a willing seller in a free market. The fair market value of a building may be below its actual cash value based on replacement cost less depreciation. This may be due to poor location, bad neighborhood or economic obsolescence of the building.

For example, in a big city, large homes in older residential areas often have a market value well below the replacement cost less depreciation. If a loss occurs, the fair market value may be used to determine the value of the loss. In one case, a building valued at $170,000 based on the actual cash value rule had a market value of only $65,000 when a loss occurred. The court ruled that the actual cash value of the property should be based on the fair market value of $65,000 rather than $170,000.

(iii) Broad Evidence Rule

The broad evidence rule means that the determination of actual cash value should include all relevant factors an expert would use to determine the value of the property. Relevant factors include
replacement cost less depreciation, fair market value, and present value of expected income from the property, comparison sales of similar property, opinions of appraisers and other factors.

Although the actual cash value is used in property insurance, different procedures are followed for other types of insurance. In liability insurance, the amount paid for a loss is the actual damage the insured is legally obligated to pay because of badly injury or property damage to another. In business income insurance, the amount paid is usually based on the loss of profits plus continuing expenses incurred when the firm is shut down because of a loss from a covered period. In Life insurance, the amount paid upon the insured’s death is the face amount of the policy.

Exception to the principle of indemnity: The important exceptions to the principle of indemnity are as follows;

(i) Valued policy
(ii) Valued policy laws
(iii) Replacement cost of insurance
(iv) Life Insurance

(i) **A valued policy** is one that pays the face amount of insurance regardless of actual cash value if total loss occurs. They are used to insure fine arts & rare paintings. Because of difficulty in determining the actual cash value of the property at the time of loss, the insured and insurer both agree on the value of the property when the policy is first issued. (E.g. Old clock)

(ii) **Valued policy laws** are another exception to the principle of indemnity. The specified perils to which a valued policy law applies vary among the states. Some states cover only fire and others cover fire, lightning, wind storm and tornado. In addition, the laws generally apply only to real property and the loss must be total. For example, a building insured for 200,000 birr may have the actual cash value of 175,000 birr. If a total loss from a fire occurs, the face amount of 200,000 would be paid. Thus, the principle of indemnity would be violated.

(iii) **Replacement cost of insurance** means no deduction is taken for depreciation in determining the amount paid for a loss. For example, assume the roof on your home is 5 years old and has a useful life of 20 years. The roof is damaged by a tornado, and the current cost of replacement is 10,000 birr. Under the actual cash value rule, you would receive only 7,500 birr (10,000 – 2,500 = 7,500 birr). Under a replacement cost policy, you would receive the full 10,000 birr. Since you receive the value of a brand new roof instead of one that is 5 years old, the principle of indemnity is technically violated.
(iv) **Life insurance** is another exception to the principle of indemnity. A life insurance contract is not a contract of indemnity but it is a valued policy that pays a stated sum to the beneficiary upon the insured’s death. The indemnity principle is difficult to apply, because the historical actual cash value rule is meaningless in determining the value of a human life.

4.4 **Subrogation**

Subrogation means substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance. This means that the insurer is entitled to recover from a negligent third party, any loss payments made to the insured.

For example, assume that a negligent motorist smashes into Mr.X’s car, causing damages of 5,000 Birr. If Mr.X has the collision insurance on his car, his insurance company will pay 5,000 Birr and then attempt to collect from the negligent motorist who caused the accident. Alternatively, if Mr..X directly collect from the negligent motorist, the principle of subrogation does not apply. Because, the loss payment is not made by the insurance company. However, to the extent that a loss payment is made, the insured gives to the insurer legal rights to collect damages from the negligent third party.

**Why Subrogation?** Subrogation has three basic purposes;

1. Subrogation prevents the insured from collecting twice for the same loss. In the absence of subrogation, the insured could collect from the insurer and from the person who caused the loss.
2. Subrogation is used to hold the guilty person responsible for the loss. By exercising its subrogation rights, the insurer can collect from the negligent person who caused the loss.
3. Subrogation tends to hold down insurance rates. Subrogation recoveries can be reflected in the rate making process, which tends to hold rates below where they would be in the absence of subrogation.

**Importance of Subrogation**

1) The general rule is that by exercising its subrogation rights, the insurer is entitled only to the amount it has paid under the policy. Some insured may not be fully indemnified after a loss because of insufficient insurance. Many policies currently have a provision stating how a
subrogation recovery is to be shared between the insured and the insurer. However, in the absence of any policy provision, the courts have used different rules in determining how a subrogation recovery is to be shared. One commonly held view is that the insurer is entitled to any remaining balance up to the insurer’s interest, with any remainder going to the insured. For example, Andrew has home insured for only Birr 80,000 under a home owner’s policy. Assume that the house is totally destroyed in a fire because of faulty wiring by an electrician. The insurer would pay Birr 80,000 to Andrew and then attempt to collect from the negligent electrician. After exercising its subrogation rights against the electrician, the insurer has a net recovery of 50,000 Birr. Thus, Andrew would receive 20,000 Birr and the insurer can retain the balance of 30,000 Birr.

2) The insured cannot impair the insurer’s subrogation rights; The insured cannot do anything that prejudices the insurer’s right to proceed against a negligent third party. For example, if the insured waives the right to sue the negligent party, the right to collect from the insurer for the loss is also waived.

3) The insurer can waive its subrogation rights in the contract; This may be to meet the special needs of some insured. For example, in order to rent an apartment house, a land lord may agree to release the tenants from potential liability if the building is damaged. If the land lord’s insurer waives its subrogation rights, and if a tenant negligently starts a fire, the insurer would have to reimburse the land lord for the loss, but could not recover from the tenant since the subrogation rights were waived.

4) Subrogation does not apply to life insurance and to most individual health insurance contracts; Life insurance is not a contract of indemnity, and subrogation has relevance only for contracts of indemnity. Individual health insurance contracts usually do not contain subrogation clauses.

5) The insurer cannot subrogate against its own insured; - If the insurer could recover a loss payment for a covered loss, the basic purpose of purchasing the insurance would be defeated.

4.5 Contribution
Contribution is the right of the insurer who has paid under a policy, to call upon other insurers equally or otherwise liable for the same loss to contribute to the payment. Where there is overinsurance because a loss is covered by policies affected with two or more insurers, the principle
of indemnity still applies. In these circumstances the insured will only be entitled to recover the full amount of his loss and if one insurer has paid out in full, he will be entitled to nothing more. Like subrogation, contribution supports the principle of indemnity and applies only to contracts of indemnity. Therefore there is no contribution in personal accident and life policies under which insurers contract to pay specific sums on the happening of certain events. Such policies are not contracts of indemnity, except to the extent that they may incorporate a benefit by way of indemnity, for example, payment of medical expenses incurred, in which respects contribution would apply.

It is important to understand the difference between contribution and subrogation. Subrogation is concerned with the rights of recovery against third parties or elsewhere in respect of payment of indemnity, and need not involve any other insurance, although it frequently does. Contribution necessarily involves more than one insurance each covering the interest of the same insured.

*Basis of Contribution:* - At the time of a claim, insurers usually inquire whether any other insurance exists covering the loss, where other insurances do exist and each policy is subject to a valid claim, contribution will apply so that the respective insurers share the loss ratably. This term allows two constructions, both of which are found in insurance;

(i) Contribution according to Independent Liability:
This means that the amount payable by each insurer is assessed as if the other insurances do not exist. If the aggregate of the amounts so calculated exceeds the loss, each insurer’s contribution is scaled down proportionately, so that an indemnity is provided. This method is usually found where for some reason one or more policies will not cover the loss in full. This happens particularly in many fire policy contributions.

(ii) Contribution according to the Sums Insured:
This is the normal method of contribution. Insurers will pay proportionately to the cover they have provided, in accordance with the following formula; Sum insured with the particular insurer

\[
\frac{\text{Each amount of premium}}{\text{Total sums insured with all insurers}} \times \text{Loss} = \text{Contribution}
\]

Eg: Assume that Mr.X has insured his house, which is worth 80,000 Birr against fire with three insurers namely A, B & C for 60,000 Birr, 40,000 Birr, and 20,000 Birr respectively. Mr.X’s
house was completely destroyed by a fire caused by Mr.Y’s negligence. The amount of indemnity that Mr.X will be entitled to receive would be 80,000 Birr, the value of the actual loss or the amount of insurance covered.

Solution:

The amount that each insurer is entitled to contribute would be as follows;

\[
\text{Br.60,000} \\
A's \text{ share of loss} = \frac{\text{X} \times \text{Br.80,000}}{\text{Br.120,000}} = \text{Br.40,000} \\
\text{Br.40,000} \\
B's \text{ share of loss} = \frac{\text{X} \times \text{Br.80,000}}{\text{Br.120,000}} = \text{Br.26,667} \\
\text{Br.20,000} \\
C's \text{ share of loss} = \frac{\text{X} \times \text{Br.80,000}}{\text{Br.120,000}} = \text{Br.13,333} \\
\text{Total Indemnity} \quad \text{Br.80,000}
\]

4.6 Proximate Cause

The rule is that immediate and not the remote cause is to be regarded. The maxim is “sed causa proxima non-remota spectatutuere”, i.e., see the proximate cause and not the distant cause. The
real cause must be seen while payment of the loss. If the real cause of loss is insured, the insurer is liable to compensate the loss; otherwise the insurer may not be responsible for loss.

The efficient cause of a loss is called the proximate cause of the loss. For the policy to cover, the loss must have an insured peril as the proximate cause of the loss. The proximate cause is not necessarily the cause that was nearest to the damage, but is rather the cause that was actually responsible for loss. (Eg) In marine insurance, sea water. Determination of proximate cause:

(i) If there is a single cause of the loss, the cause will be the proximate cause and further if the peril (cause of loss) was insured, the insurer will have to indemnify the loss.

(ii) If there are concurrent causes, the insured perils and excepted perils have to be segregated. The concurrent causes may be separable or inseparable. Separable causes are those which can be separated from each other. The loss occurred due to a particular cause may be distinguishing known. In such a case, if any cause is excepted peril, the insurer will have to pay up to the extent of loss which occurred due to insured perils. If the circumstances are such that the perils are inseparable, then the insurers are not liable at all when there exists any excepted peril.

(iii) If the causes occurred in form of chain, they have to be observed seriously.

(a) If there is unbroken chain to excepted and insured perils have to be separated. If an excepted peril precedes the operation of the insured peril so that the loss caused by the insured peril is the direct and natural consequences of the excepted peril, there is no liability. If the insured peril is followed by an excepted peril there is valid liability.

(b) If there is a broken chain of events with no excepted peril involved, it is possible to separate the losses. The insurer is liable only for that loss which is caused by an insured peril; when there is an excepted peril, the subsequent loss caused by an insured peril will be a new and indirect cause because of the interruption in the chain of events. Similarly, if the loss occurs by an insured peril and there is subsequently loss by an excepted peril, the insurer will be liable for loss occurred due to the insured peril.
CHAPTER FIVE: Major Insurance Policies

5.1 Life Insurance Policies
Life Insurers pay death benefits to designated beneficiaries when the insured dies. The death benefits are designed to pay for funeral expenses, uninsured medical bills, estate taxes, and other expenses due to death.

Premature Death: - can be defined as the death of a family head with outstanding unfulfilled financial obligations, such as dependents to support, children to educate, and a mortgage to pay off.

Costs of Premature Death

1. The family's share of the deceased bread winner's future earnings is lost forever.
2. Additional expenses are incurred because of funeral expenses, uninsured medical bills, estate settlement costs,
3. Because of insufficient income, some families will experience a reduction in their standard of living.

Certain non-economic costs are incurred, such as emotional grief, loss of a parental role model, and counseling and guidance for the children.

Documents Needed for Policy (contract)

The documents needed to issue the insurance contract include the proposal form, the Policy form, the Medical Report and any other supplementary contracts. The Medical Report is used to assess insurability. Other factors to assess insurability include age, sex, physical condition, medical history, family history, occupation, habits and like.

5.1.1 Types of Life Insurance

Life insurance policies can be classified as either term insurance or cash value life insurance. Term insurance provides temporary protection, while cash value life insurance has a savings component and builds cash values.

1. Term Insurance: - First, the period of protection is temporary, such as 1, 5, 10, or 20 years. Unless the policy is renewed, the protection expires at the end of the period.
Most term insurance policies are **renewable**, which means that the policy can be renewed for additional periods without evidence of insurability. Most term insurance policies are also **convertible**, which means the term policy can be exchanged for a cash value policy without evidence of insurability. Finally, term insurance policies have no **cash value or savings element**. Although some long term policies develop a small reserve, it is used up by the contract expiration date.

**2. Whole Life Insurance:** In contrast to term insurance, which provides short term protection, Whole life insurance is a cash value policy that provides lifetime protection. The followings are the two types of whole life insurance:

- Ordinary life insurance
- Limited payment life insurance

**Ordinary Life Insurance:** Ordinary Life insurance (also called straight life and continuous premium whole life) provides lifetime protection to age 100, and the death claim is a certainty. If the insured is still alive at age 100, the face amount of insurance is paid to the policy owner at that time.

In addition, premiums do not increase from year to year but remain level throughout the premium paying period.

Ordinary life insurance also has an investment or savings element called a cash surrender value. The cash values are due to the overpayment of insurance premiums during the early years. For example, in many ordinary life policies, a $100,000 policy issued at age 20 would have at least $50,000 of cash value at age 65.

Finally, ordinary life insurance contains cash surrender or non forfeiture options (if participating), and settlement options that can be used to meet a wide variety of financial needs and objectives.

**Limited payment life insurance:** A limited payment policy is another type of traditional whole life insurance. The insurance is permanent, and the insured has lifetime protection. The premiums are level, but they are paid only for a certain period. For example, Yonnas, age 35, may purchase a 20 year limited payment policy in the amount of $25,000. After 20 years, the policy is completely paid up, and no additional premiums are required even though the coverage remains in force throughout his life.
3. **Endowment Insurance**: Endowment insurance is another traditional form of life insurance. An endowment policy pays the face amount of insurance if the insured dies within a specified period, if the insured survives to the end of the endowment period; the face amount is paid to the policy owner at that time. For example, if Ato kebede, age 35, purchased a 20 year endowment policy and died any time within the 20 year period, the face amount would be paid to his beneficiary. If he survives to the end of the period, the face amount is paid to him.

4. **Modified Life Insurance**

A modified life policy is a whole life policy in which premiums are lower for the first three to five years and higher thereafter. The initial premiums is slightly higher than for term insurance, but considerably lower than for an ordinary life policy issued at the same age.

5. **Juvenile Insurance**

Juvenile insurance: - refers to life insurance purchased by a parent or adult on the lives of children younger than a certain age, such as age 14 or 15. Insurers generally require the child to be at least one month old before he or she can be insured. Some insurers, however, will insure a child as young as one day old.

6. **Industrial Life Insurance**

   Industrial life insurance - (some called debit insurance) is a class of life insurance that is issued in small amounts, and the premiums are payable weekly or monthly. In the past, the premiums were collected at the insured's home by an agent of the company. More than nine out of ten such policies were cash value policies.

   In recent years, industrial life insurance has also been called home service life insurance, reflecting the fact that individual policies are serviced by agents who call at the policy owner's home to collect the premiums.

7. **Group Life Insurance**

   Group life insurance is a type of insurance that provides life insurance to a group of people in a single master contract.
5.1.2 Life Insurance Underwriting

1. Underwriting definition: - The following definition is given by life management institute “Underwriting is the process of assessing an individual’s anticipated mortality—that is the relative incidence of death among a given group of people—or morbidity—that is the relative incidence of sickness or disease among a given group of people in order to determine

(1) Whether to approve that person for insurance coverage and if so

(2) The risk classification to which the proposed insure should be assigned”

The risk is, therefore, to be assessed or evaluated by the underwriter before he makes a decision to accept the proposal of the proposed insured. In life insurance underwriting the process involves the examination of certain factors pertinent to the person seeking an insurance protection.

Examination of these factors would enable the underwriter to accept, postpone or reject an insurance proposal. Besides, underwriting will enable the insurer to equitably distribute in losses among the group of insured by charging appropriate premiums to each insured that is commensurate with the level of risk he/she brings to the group. Equitable distribution of loses among the group of insured is one of the basic principles of insurance. Thus, the underwriting process tries to consider the unique characteristics of the proposed insured to arrive at a decision.

2. Factors Considered In Life Insurance Underwriting

Quite often, life insurance coverage is aimed at protecting the dependents of the insured from suffering financial losses in case of his premature death. This means that the coverage are usually connected with the occurrence of death to the insured. As a result in life insurance underwriting the factors that are considered or examined are those that influence mortality. These include age, sex, current physical condition personal medical history, family medical history, occupation habits, avocation, marital status, and the like.

a.Age: - This is the most important factor to be considered in life insurance underwriting. The likelihood of death or illness generally increases with an increase in age. People develop physical problems as their age increases. The higher the age level, the greater will be the physical problems.

b.Gender: - Empirical studies indicate that women generally live longer than men. This may influence the underwriter to charge a lower premium payments for women for a given age level as their counterparts, men.
c. **Current Physical Condition**: This refers to the proposed insured’s current physical and health condition regarding pulse rate, heart condition, blood pressure, lungs, nervous system, body build, height weight, etc...

d. **Personal Medical History**: The insured’s past medical history is examined to check for any previous illness that may possibly reoccur in the future. From personal health history of the insured the underwriter wants to know whether the proposed insured had gone major medical treatments in the past.

e. **Family Medical History**: Here, the medical history for the insured family is examined to discover any possible hereditary diseased or deficiencies.

f. **Occupation**: Occupation is given as much equal importance as that of age in life insurance underwriting. Occupation can affect the insured’s chance of suffering accidents of premature death. For example a coal miner is much more exposed to risk of premature death or illness than a manager or an accountant.

g. **Insurable Interest**: There should be an insurable interest to be protected by purchasing life insurance policy. Absence of insurable interest could reflect the presence of wagering in the contract. The underwriter must make sure that there is an insurable interest in applying for life insurance cover. This involves identifying any relationship between the proposed insured and named beneficiary.

h. **Moral Hazard**: Moral Hazard is defined “...as the like hood that the proposed insured is making a deliberate attempt to conceal or misrepresent information that might result in an unfavorable underwriting decision”.

i. **Financial Position**: The proposed insured’s financial position or his level of income has become an important factor to consider in life insurance underwriting. The proposed insured’s financial position is examined to check the existence of speculation and lack of insurable interest. Particularly, close examination is to be made when the amount of cover is appreciable large.

j. **Habits**: Habits such as drug or alcohol consumption and smoking could lead to accidents by retarding a person’s judgment, reducing flexibility and damaging his reflex system.

**11. Avocation**: Avocation is an activity that the insured undertakes outside his ordinary occupation during his spare time. It includes certain hobbies like sport activities, gardening, etc...
3. **Sources of Information for Underwriting**: The assessment and evaluation of the risk is based on the information collected by the underwriter. Pertinent information needed for underwriting is obtained from the following sources:

- Proposal Form
- Medical Report
- Attending Physicians Statement
- Agent’s/ Salesman’s Report
- Questionnaires and Interview
- Underwriting Manuals
- Inspection Report

3.1 **Proposal Form**: This form represents the basis of the contract between the proposed insured and the insurer; it is to be completed by the proposed insured. Thus, the Proposal Form provides the underwriter with some facts needed in assessing the risk and establishing the appropriate premium charge. The proposed insured required to disclose all material facts. These are facts which the insurer regards as likely to influence the assessment and acceptance of the proposal for life insurances.

3.2 **Medical Report**: Life insurance underwriter would have to possess some degree of medical knowledge. Information on the medical aspect of the proposed insured is utmost necessary and mandatory when some life insurance policies are originally issued. The Medical Report in this circumstance is a basic source of information regarding the health condition of the proposed insured.

3.3 **Attending Physician’s Statement**: In some circumstances, the proposed insured may have private physician for medical consultation and diagnosis. The attending physician might have treated the proposed insured in the past or is currently treating him/her. The underwriter would then request the physician for information on some factors that may affect insurability.

3.4 **Agent’s /salesman’s Report**: The underwriter may also collect some relevant information from an insurance agent/salesman.

3.5 **Questionnaires and interview**: Some specific information is obtained by designing questionnaires. These questionnaires are designed to elicit information on certain aspects of the proposed insured and to generate factual information regarding the nature of activities avocation, aviation, sport and occupation of the proposed insured.
3.6. Underwriting Guidelines: - It is widely accepted that “one of the most important prerequisite to good underwriting is consistency”. This means that the underwriter must evaluate each proposed insured in line with a given framework of standard procedures of evaluation.

Life underwriters in assessing the risk brought by a proposed insured consider two guidelines: numerical rating system and underwriting manuals.

4. Underwriting Decisions: - On the basis of the information collected from the various sources and the quantitative analysis made, the Underwriting assesses and evaluates the risk and accordingly makes a decision as to accept the risk or decline the proposal.

There could be a number of options to the underwriter. The following four options are some of them.

1. To accept the risk and issue an insurance policy immediately, average (standard) risk
2. To accept the risk immediately but with an adjustment for substandard factors.
3. To postpone the underwriting decision until information ordered is received or until an extra risk of a temporary nature (pregnancy, child birth) is expected to lapse.
4. To decline the risk

5.1.3 Payment of Premium
Normally annual premium payments are made in advance. But, it is also possible to arrange for semi-annual, quarterly or monthly premium payments. A grace period of 30 days is given to the insured to make payment of renewal premium or installments of premiums. If the insured dies during this grace period, the sum Assured less the amount past due will be payable to his beneficiary. The Insurance policy shall lapse without notice being given to the assured if any renewal premium or installment premiums are not paid on the due date unless the policy remains in force under the provisions of automatic premium loan or extended term insurance.

In the case of whole life and endowment insurance there are three options to the insured if payment of premium is discontinued after making continuous premium payments for at least two years. These options are known as Non-Forfeiture Options.

Non-Forfeiture Options:

If a policy under whole life or Endowment insurance acquires Cash Value and the premium due is not paid within the grace period, the Insurer will first check whether or not the Insured has applied for the effect of the Automatic Premium Loan (APL) has supplied for the effect of the Automatic premium
Loan (APL) provision. If this provision is to take effect and the Cash value is equal or greater than the premiums due and unpaid, the Insurer will pay the premiums for the Insured under the APL Provision. This keeps the policy in force.

On the other hand, after the policy has acquired Cash Value and APL is no in effect, the following Non-Forfeiture Options are available to the policy holder.

1. After the policy acquired a Cash Value and if the Automatic premium Loan provision is not in effect, the insured can continue the policy as Extended Term Insurance. The amount of the policy under this case will be equal to the sum assured less any existing liability.

2. The Insured can surrender the policy for its Cash Value. The Surrender Value is payable to the policy holder. This value is less than the total premiums paid to date of policy discontinuance.

3. The Insured may select an option to continue the policy as Reduced Paid-up Insurance maturing on the due date. The Reduced-Sum Assured is determined on the basis of the premiums already paid.

The Insured will have to notify his choice to the Insurer within three months following the due date of the unpaid premium. If he fails to make such notification within the stated period, the original policy will be automatically converted into Extended Term Insurance.

**Activity: Underwriting Practice**

Take one of the Insurance company in your area and develop an article on how underwriting takes place. Write the weakness and strength of underwriters and the insurance policy.
Chapter Six: Non-Life Insurance Policies

6.1 Motor Insurance

Motor insurance is one of the major classes of insurance that bring sizable premiums to insurance companies. It is also relatively a complicated class of insurance due to the various types of motor vehicles involved. Generally two types of motor policies are issue: private vehicle policy and commercial vehicles policy. Furthermore, the policy provides two types of insurance cover. Comprehensive cover which indemnifies the insured for losses/damage caused by a wide range of perils; and third Party Cover which indemnifies the insured against third party liability- death or bodily injury to third party or/and damages caused to the property of such people in the event of an accident caused with the use of the insured motor vehicle.

Motor insurance policies can be extended to include other risks as well. These are:

- Personal Accident Benefits, (PAB)
- Bandits, Shiftas and Guerillas, (BSG)
- Earthquake/Flood

1. Private Vehicle Policy:

Motor vehicles covered by this policy are those that are exclusively used for private purposes: social, domestic, pleasure or professional. Motor vehicles used for hiring, racing, pace-making, speed testing and the like are excluded from this policy.

This policy indemnifies the insured against loss of or damage to motor vehicles resulting from any accidental collision or overturning due to mechanical breakdown, wear and tear, fire, external explosion, self-ignition, Lightening, burglary, housebreaking, and theft or by malicious act. The policy also gives cover against damages that could happen while the vehicle is transit-road, rail, waterways or lift-including losses arising from the process of loading and unloading during transit activities. The policy excludes accidental damages to tires canvas and batteries.

The policy also provides payment for liabilities to third parties, i.e. compensation for death or bodily injuries to any person caused by the use of the motor vehicle that is mentioned in the policy. Cover is also made for damages caused to the property of third parties by lawful use of any motor vehicle mentioned in the policy. Compensation for damaged property will not be made, however, if the property belongs to or held in trust by or the custody or control of the insured or a member of the insured’s
household. In addition the protection mentioned above, the policy provides cover for medical expenses incurred in connection with any bodily injury sustained by the insured or his driver or any occupant upon an accident caused with the use of the motor vehicle insured.

The policy also provides in case of accident in the form of medical expenses incurred in connection with any bodily injury sustained by the insured or his driver or any occupant of the motor vehicle insured.

The policy makes payment to cover the cost of protection and removal of any insured vehicle to the connection with any bodily injury sustained by the insured or his driver or any occupant of the motor vehicle insured.

The policy makes payment to cover the cost of protection and removal of any insured vehicle to the repair shops following an accident. Such payments however are limited to the extant of 20% of the agreed cost of repair.

The policy does not provide for payment to the insured in respect of:

➢ Losses or damages or liability arising outside the geographical area specified in the policy.
➢ Consequential losses
➢ Wear and tear or depreciation of any vehicle
➢ Mechanical or electrical breakdown of the vehicle
➢ Damages caused by overloading or strain
➢ Losses caused by catastrophes like flood, windstorm, earthquake, war, invasion, etc...
➢ Loss/damage or liability arising out of the use of the vehicle in racing, testing of reliability, speed testing or such other incidents as using the pirated vehicle for transport of goods or passengers for monetary consideration.
➢ Contractual liability
➢ Any loss/damage caused by such fundamental risks as: flood, windstorm earthquake, war, invasion, riots, etc.

The sum insured which includes cover for accessories is an estimate of the insured which may not reflect the true value of the vehicle to be insured in the event of a loss the insurer is label to pay the market value of the vehicle immediately before the loss or the sum insured, whichever is lower, irrespective of the cost price of the vehicle.
Relevant information contained in the schedule include: the policy number, premium amount, name of the insured and his occupation and the geographical area within which the vehicle is to be operated during the insurance period. The other data refer to the description of the vehicles to be insured which includes: the plate number, cubic capacity, year of manufacture, and the insured amount.

Also specified in the schedule are the limits concerning:

a. The insurer’s liability for death or bodily injury to third parties- per event and per person.
b. The insurer’s liability for damages caused to the property of third parties- per event
c. The insurer’s liability for medical expenses to the insured in the case of bodily injury caused by an accident upon using the insured vehicle-per event.
d. The maximum amount for which the insured is permitted to authorize repairs.

Cancellation of policy:- The policy may be canceled by the insurer at any time upon sending thirty days notice. Under this circumstance, the insurer will return the premiums applicable for the un-expired portion of the policy on a pro-rata basis. The policy may also be cancelled at the option of the insured upon notice at any time provided that no claim had arisen during the period in which the insurance policy has been in force. The insured is then entitled to a premium refund equal to the annual premium charge less the premiums applicable the expired period which are which are calculated using the short period rate.

2. Commercial vehicle Policy

Gives the same protection as with that of the private vehicle policy except that the vehicles insured under this policy are those used for commercial purposes. A wide range of vehicles used for transporting goods and passengers are covered by this policy. The motor vehicles under this policy are classified as follow:

1 Goods Carrying Vehicles: - These are vehicles primarily manufactured for carrying goods

2 Tankers: - These are vehicles that transport liquid substances:

3 Buses: - These include passenger-carrying vehicles including omnibuses and micro buses which accommodate more than 12 people including the driver. Buses are further classified as: public service buses and own service buses.

4 Taxis, Car-Hire, Motor Cycles, and
5 Special Type vehicles: - These include mobile cranes, earth moving equipments, ambulances, agricultural vehicles, dumpers, fire brigade vehicles, etc

The policy also covers damages made to third party-death or bodily injuries, but, liability for death or bodily injuries is excluded to:

✓ Any person in the employment of the insured
✓ A member of the insured’s household
✓ Any person being carried in the insured vehicle at the time of the occurrence of the accident

The same cancellation procedures as in the case of the private Motor Policy are followed in the case of commercial Motor Policy.

6.2 Burglary and Housebreaking Insurance

This is a policy to protect property from loss by theft and by actual forcible and violent breaking into or out of a building. The insured will, then, be indemnified either by payment reinstatement, replacement or repair which is at the option of the insurer.

This policy provides cover for two categories of risk private residence and business premises. It is also possible for the insured to take insurance against both risks in one policy. However, burglary insurance is accepted only in conjunction with fire insurance of the same risk and for the same sum. A careful examination of the risk is needed since the risk involves moral hazard, it is, therefore, important to first identify the insured’s character and habits. The policy may be issued for a maximum period of one year.

The policy will not cover losses, destruction or damages arising out of fundamental risks like invasion and warlike operations. Payments may not be effected in the case of alterations to the premises or change of safety measures without the consent of the insurer, upon fire and explosion and the like.

One of the conditions of the policy is that the insured shall take reasonable precautions to safeguard the property with the use of locks, bolts, fastenings, guards and such other means that may be necessary in securing the premises.

The property to be insured may include stocks and materials, goods held by the insured in trust or on commission, fixtures, fittings and equipments, precious items like gold, diamonds and the like.
Cancellation of Policy: The Policy may be cancelled by the insurer at any time by giving 15 days notice to the insured in writing. The insured will then return a proportionate part of the premium applicable to the un-expired period of the policy.

6.3 Fire and Lightning Policy
This policy provides indemnification to the insured for loss of or damages to property by fire or lightning at any time during the tenure of the policy. The conditions of this policy state that the insurer will not be liable for any misrepresentations, omissions or mis-description of the insured property. The policy is not normally insured on a long term basis. Moreover, the value at risk is declared and agreed beforehand. The insured is required to make monthly declaration to the insurer concerning:

a. The average value at risk on each day of the month
b. The average of the highest value at risk in each week of the month
c. The highest value at risk during the month
d. The value at risk on a specified day of the month

All insurance cover under this policy ceases immediately when there is a fall or displacement of a substantial part of the insured building or of any part thereof.

The policy does not cover:

- Losses arising out of theft during or after the occurrence of a fire
- Loss/Damage to property arising out of climatic conditions, inherent chemical reaction, etc
- Burring Of property by order of any public authority or subterranean fire
- Fundamental risks

Moreover, unless expressly stated in the policy, fire insurance policy does not give cover for goods held in trust or on commission, any world or art exceeding Birr 150 manuscripts, plans, drawings, models, securities, documents of any kind, stamps, coined or paper money, checks and the like.

Several clauses are contained in the policy. The Rent clause provides cover against loss of rental income.

1 Architects, surveyors, consulting, Engineering and Legal Fee: The inclusion of this clause means that the sum insured on buildings would include architects, surveyors, consulting, engineers legal and other fees for estimates, plans, specifications, quantities, tenders and supervision incurred in the reinstatement of the building damaged by fire or any other peril insured against. Such payment, however, will not exceed a specified percentage of the amount of the loss.
3.2 Debris Removal Clause: - This clause extends the insurance to include costs and expenses necessarily incurred by the insured with the consent of the insurer concerning the removal of debris, dismantling or demolishing and shoring up or propping of the portion of the property damaged by fire or any other peril insured against

3.3 All Other Content Clause: - This would include money and stamps, documents, manuscripts and business records not exceeding a specified amount

3.4 Electrical Clause

Claim Notification and Settlement: - On the occurrence of any loss or damage, the insured shall make an immediate notification to the insurer about the incident within 15 days after the occurrence of the loss, the insured shall file a claim in writing stating the particular items damaged or destroyed, and their value at the time of the loss or damage. Moreover, the insured is requested by the insurer to present all relevant documents that substantiate the claim.

Indemnification can take the form of cash payment, reinstatement or replacement of the damaged property which is all at the option of the insurer. The sum insured constitutes the limit of liability. In any event, however, the amount to be paid to the insured will be equal to the value of the property at the time of the loss, but not exceeding the sum insured.

Cancellation of Policy: - The Policy may be terminated at any time upon request by the insured. Premiums for the expired period are then calculated using the short period rates. Un-expired premiums are remitted to the insured; the policy may also be cancelled at the option of the insurer at any time by giving-day notice. The insure will then remit the premium applicable to the un-expired term of the policy on a pro-rata basis.

The policy will also cease to be in force if the building insured or containing the insured property becomes unoccupied for more than 30 days; or if the property insured is removed to any place other than that mentioned in the policy or if title to the insured property insured is removed to any place other than that mentioned in the policy or if title to the insured property passes from the insured to another party by will of the insured or operation of the law.

6.4 All Risks Policy
Under all risks policy the insured protects his property from loss or damage by an accident or misfortune not specifically excluded in the policy. Insurance cover under all risk policy is not provided for property
other than personal effects and household items. All items to be insured are listed in the schedule including the specification and the sum insured for each item.

The properties mainly insured include gold and silver, furs, pictures, wearing apparels and other jeweler items. There is a careful analysis of the risk with special attention given to moral hazard. The analysis includes a close examination of the insured’s credit history and losses sustained by the insured in the past. The maximum period for the issuance of this policy is one year.

Although the name of the policy implies cover against all risks, there are exceptions that the insurer is not liable to the insured for losses or damages arising from certain perils. They include losses arising from climatic conditions or exposure to light mechanical or electrical breakdowns, theft or attempted theft by any relative of the insured fundamental risks, and the like.

**Claim Notification and settlement:** Upon the happening of a loss, the insured shall give an immediate notice in writing, and within seven days after the happening of the incident, he should deliver a detailed statement of the loss or damage and of the actual value of each property insured at the time of the loss. Moreover, the insured has to famish supporting documents to the insurer to substantiate the claim.

Indemnification to the insured can take the form of cash payment, reinstatement or replacement of the property.

**Cancellation of Policy:** The insurer may at any time terminate the policy by giving 15 days notice in writing and consequently will return to the insured the premium applicable to the un-expired term of the policy on a pro-rat basis.

The policy ceases to be in force if ownership of the insured property is transferred to other party by the will of the insured or by the operation of the law unless such matter has been agreed in advance with the insurer.

6.5 **Public Liability Policy**

This policy is to indemnify the insured against all payments the insured becomes legally liable to pay for compensation in respect of bodily injuries to or illness of any person, loss of or damage caused to the property of others. They also cover the insured from all costs and expenses of litigation recovered by any claimant against the insured. The policy is issued for a maximum period of one year.
The nature of risk to be covered by the policy is to be described in the schedule. Moreover, the limits of liability are specified thereupon to indicate the limit liability for any one accident and the limit for any one period accident for example; if the insured dies while the policy is in force, the insurer will indemnify the personal representative of the insured in respect of the liability incurred by the insured. In other words the representative is treated as though he were the insured.

Exceptions to this policy include:

- Liabilities arising out of agreements by the insured,
- Liabilities in respect of injuries or illness under a contract of employment, i.e occupational injuries or illness
- Loss of or damage to the property of the insured, or to the property under his control
- Liabilities in respect of loss of or damage to any property, land, building caused by vibration or weakening or support, and any liability in respect of injuries to persons caused by such factors.

Claim Notification and Settlement: - Upon the occurrence of any accident, the insured shall immediately give notice to the insurer. Within seven days after notice has been given to the insurer, the insured has to deliver a detailed particulars of the claim in writing accompanied by substantive evidence.

Cancellation of Policy: - The insurer may cancel the policy at any time by giving 15 days notice to the insured. Consequently, the insurer will remit to the insured the premium applicable to the un-expired period of the policy on a pro-rat basis. The insured will also have an option to terminate the policy at any time. Under this circumstance, premiums for the expired period will be adjusted using the short period rates. The difference between the annual premium and the short-term premium applicable to the expired period is, then, remitted to the insured.

6.6 Fidelity Guarantee Policy
This policy protects employers from all direct losses arising from any act or acts of fraud or dishonesty committed by any of the employees during employment. The name of each employee is listed in the schedule. The schedule, therefore, includes the name of the person employed, position of the employee, date of commencement of the risk and the amount guaranteed in connection with each employee.

The insured is, then, indemnified up to the amount guaranteed by the insurer, subject to the terms and conditions of the policy. The insurance coder shall not exceed one year.
Claim Notification and Settlement: - In the event of an act of fraud or dishonesty that gives rise to a claim, the employer shall give a written notice to the insurer. Besides, the employer shall furnish to the insurer all necessary information that would enable the insurer to sue the defaulting employee for reimbursement.

In the case of compensation to the employer, any amount which would have been payable to the defaulting employee, and any money of the employee in the hands of the employer is deducted from the amount payable to him/her. The amount payable, however, will not exceed the sum guaranteed in the policy. The sum guaranteed is the amount that appears in the schedule opposite to the name of each employee.

There will be no claims under the following conditions unless otherwise endorsed in the policy.

- Losses occurring prior to the commencement of the risk as stated in the schedule.
- Losses not discovered and reported within three calendar months of the death, retirement, resignation or dismissal of a defaulting employee.
- Losses that could not be discovered and reported within three calendar months after the termination of the policy of non-renewal.

6.7 Personal Accident Policy
Personal accident policy indemnifies the insured against bodily injuries caused by violent accidental external and visible means. The injuries shall be the direct cause of death, loss or disablement in the event of death of the insured. The benefit is to be given to his representative.

In the schedule, the insured specifies his occupation or profession and the policy remains valid for exposure to risk associated with the stated occupation or profession. If the insured engages himself in any occupation in which greater risk may prevail without informing the insurer, the policy becomes void and no claim would be paid. Occupational changes may necessitate premium adjustment; moreover, the accident is bound to take place within the geographical limit specified in the schedule.

Personal accident policy is issued for individuals or a group of individuals on named basis. On the other hand, group personal accident policy can be issued on unnamed basis. Group personal accident policy can also be provided to cover employees from off-duty accidents and can be extended to include illness and BSG cover. The policy is not granted to people under the age of 14 or over 65. However, the policy can be renewed up to age of 70 under certain conditions.
**Claim Notification and Settlement:** - Upon the occurrence of an accident, the insured shall immediately notify the insurer in writing. Full details of the injuries must be reported to the insurer. It is the condition of the policy that the insurer appoints a medical adviser to conduct an examination of the insured. In the case of death of the insured, the medical adviser shall be permitted to conduct a post mortem examination. The insurer will not be liable for any claim not reported within three months after the occurrence of the accident.

Compensation is based on the type of injury sustained by the insured. Thus, the payment can be for death, permanent total disablement, temporary total disablement, temporary partial disablement or medical, surgical or hospital expenses incurred in connection with the accident.

The compensation is given for injuries that can show up with 12 calendar months from the date of the accident.

**Cancellation of Policy:** - The insurer may at any time cancel the policy by giving 15 days notice to the insured. Consequently, the insurer will return a portion of the annual premium applicable to the unexpired term of the policy on a pro-rata basis.

**6.8 Workmen Compensation Policy**

This policy indemnifies the insured against all sums for which he is to be liable to pay compensation for any worker who sustains death or bodily injury by an accident or occupational diseases arising from his work and during the time of his work. The worker should be employed by the insured, and the category of work as signed to him and the pace of work should be specified in the policy.

The policy does not provide compensation for death or disablement resulting from suicide attempted suicide or intentional self-injury. Other exceptions for which no compensation is paid by the insurer include accidents occurred while the insured is in a state of insanity, or is under the influence of intoxicates or drugs. Moreover, the policy does not cover accidents suffered by the insured resulting from own criminal acts like provoked assault, dueling or lighting. In the case of women, the policy does not cover accidents originating from pregnancy or childbirth.

The premium is based on the estimated amount of wages, salaries and other earnings. The estimated total earnings would include the value of food, fuel, living quarters hand other benefits the worker is entitled to receive.
Claim Notification and Settlement:- In the event of any accident, the same procedures, as in the case of personal accident policy were followed to notify the insured about the incident that gives rise to a claim.

Insurance compensation could be for death, permanent total disablement, and temporary total disablement or for medical, pharmaceutical, hospital funeral and other expenses necessitated by the employee as a result of an accident or occupational diseases. In the case of death or permanent total disablement, the benefits are payable for such accidents occurring within 12 calendar months from the happening of the accident or occupational disease.

Cancellation of policy:- The insurer may cancel the policy by sending a 15 day notice to the insured. The policy will also be void if the worker is placed to perform in more hazardous occupation than the one stated in the policy.

6.9 Marine Insurance
Marine insurance indemnifies the insured for loss of or damages to the property insured arising out of sea perils such as storm, shipwreck, stranding, collision, jettison, fire, explosion, capsizing and the like, the policy contains such information as: name and address of the insured, name of the vessel, Period of insurance, the subject –matter insured, the agreed insurable value and the amount of premium. The various classes of insurance policy that are issued under marine insurance are: Hull Cargo and Freight.

Inland marine insurance protects the insured from losses or damages to the property while the insured property in transported from port to the desired destination on surface transport.

9.1 Types of Marine Policies

1. Time policy:- Time policy provides coverage for a specified duration. The contract begins at a specified date and terminates at a specified date. Thus protection is only for a given period of time.

2 Voyage policies: - This policy is issued to cover a specific voyage, i.e. to give protection to the insured from port of departure too port of destination. The voyage can be accomplished via a specific route or different routes. The policy terminates when the ship reaches the desired port safely. This –policy is in most cases issued to cover cargos.

3 Mixed Policies (Time and Voyage Policy):- It combines time and Voyage Policies.

4. Valued policy: - Under valued policy, the value of the subject-matter is specifically declared at the beginning of the policy, and this value becomes the basis for premium determination. The issuance of
valued policy eliminates the potential disagreement that may arise between the insured and the insurer as to the valued of the property when a loss occurs.

5 Unvalued Policy (open Policy): In the case of unvalued policy, the value of the subject-matter insured in note to be determined at the time of issuance of the policy. The value is left to be proved later upon the occurrence of a loss or damage. The insurable value is the basis for making compensation.

9.2 Marine insurance clauses

Cargo insurance incorporates all types of cargos transported by sea, air or inland water ways including land transportation by road or air incidental to sea or air cargo. It also includes cargos sent by ordinary or registered mail, mail, airmails or parcel post. The type cover to be provided is based on the current clauses published by the institute of London Underwriters only.

Several clauses are included in the policy of both types of cargo insurance- ship cargo and air cargo-as published by the institute of London underwriters.

1. Ship Cargo
   a. Risk clause: - It indicates the risks to cover by the marine insurance policy.
   b. General Average Clause: - This indicates the amount that the insurance policy covers, insurance cover, under this clause, is limited to general average salvage charges that is to be determined in accordance with the contract of affreightment refer page for the meaning of general average. The next four clauses specify exclusions from the policy, i.e risks that are not covered by the policy.
   c. General Exclusions Clause: - it lists a wide range of factors that can causeless or damage to the nature of the vessel that carries the properly insured however such loses are not to be covered by the insurer. The factors that can cause such losses include willful misconduct of the insured ordinary loss in weight or volume of the subject-matter insured, losses due to inadequate packaging, losses due to inherent shortcomings of the property itself, etc.
   d. Un-sea worthies and Unfitness exclusion clause: - this clause excludes payment for loses or damages to the subject-matter insured arising out of the nature of the vessel that carries the property, the appropriateness of the container etc where the insured had knowledge of the unfitness of the vessel or the container at the time the subject-matter insured is loaded. There is a problem. However, since the insured does not have control on the condition of the vessel.
   e. War Exclusion Clause: - This clause excludes any payment to be made to the insured for losses or damages caused by war and war like operation.
f. **Strike Exclusion clause:** - This clause excludes payments to the insured for losses or damages to the properly insured arising out of strikes, lock-outs, labor disturbances, riots, civil commotion and other similar acts. The duration of the insurance policy is specified by the clauses: transit clause, termination of contract of carriage clause and changeover voyage clause.

g. **Transit clause:** - This clause describes when and where transit activities begin and terminate normally, the policy will be in effect from the time the subject-matter insured leaves the warehouse or place or storage specified in the policy until it is delivered to the designated person or place of storage at the desalination mentioned in the policy. In some cases, however the insured may elect the goods to be transported to any other warehouse prior to the destination mentioned in the policy, or to any of the several warehouse of the insured at the destination mentioned in the policy. Under this situation the insurances terminate upon delivery of the goods at the desired place of storage.

If action is not taken in due firms to transport the goods to the final destination specified in the policy, the insurance policy terminates upon the expiry of 60 days after completion of unloading of unloading of the subject-matter from the oversea vessel the final port of discharge.

h. **Termination of contract or carriage clause:** - If the contract of carriages terminated due to circumstances beyond the control of the insured, before delivery of the goods at the destination specified in the policy, the insured under this clause will be allowed to continue with the insurance cover. But he will be subject to any additional premiums required by the underwriter. The insured is required to give prompt notice of the circumstances that are beyond his control.

i. **Change of voyage clause:** - This clause enables the insured to adjust the insurance cover when for Sumerians; he changes the destination that is mentioned in the policy. There will be adjustments to premium payments and prompt notice is to be given to the insurer concerning the route change.

j. **Insurable interest clause:** - This clause provides that the insured shall have an insurable interest in the subject-matter in subedit the time of the loss. This means that he must be financially affected by the occurrence of a loss. An insurance compensation is then required to bring the insured to his original position. The insured shall also be entitled to insurance compensation for losses occurring during the period covered by the in insurance even though the loss had occurred before the contract is completed and the insured was not aware of such loss at the time he purchased the insurance policy.

k. **Forwarding Charges Clause:** - This clause provides the insured with a reimbursement to be made to him where the transit is terminated prior to the destination initially mentioned in the policy. The underwriter will, then, reimburse the insured for any extra payments incurred in connection with
unloading, storing and forwarding the subject-matter to the destination specified in the policy. This clause, however, does not apply to cases of general average or salvage charges.

l. **Constructive Total Loss Clause**: This clause states that there will be no claim for constructive totally loss unless the subject-matter is by far greater than the value on its arrival at the specified destination.

m. **Increased Value clause**: An increased value insurance refers to a policy that incorporates profits, fright contingencies and customs in the insurable value of the contract

n. **Duty of Assured Clause**: This clause specifies what the insured and his agents have to do to minimize losses. The insured and his agents are bound to take such measures as may be necessary in order to avert or minimized the loss.
Chapter Seven: Reinsurance

Introduction

A significant part of an insurance organization is reinsurance. Reinsurance is a method created to divide the task of handling risk among several insurers. Often this task is accomplished through co-operative arrangements, called Treaties that satisfy the ways in which risks will be shared by members of the group.

Reinsurance definition: Reinsurance may be defined as the shifting by a primary insurer, called the ceding company, of a part of the risk it assumes to another company, called the reinsurer. That portion of the risk kept by the ceding company is known as the line or retention, and the portion reinsured, the cession. The process by which a reinsurer passes on risks to another reinsurer is known as retrocession. In simple words, reinsurance is the shifting of part or all of the insurance originally written by one insurer to another insurer.

7.1 Types of Reinsurance

There are two important forms of reinsurance. They are;

1. Facultative Reinsurance: Facultative reinsurance is an optional, case-by-case method that is used when the ceding company receives an application for insurance that exceeds its retention limit. Before the policy is issued, the primary insurer shops around for reinsurance and contacts several reinsurers. The primary insurer is under no obligation to cede insurance, and the reinsurer is under no obligation to accept the insurance. But if a willing insurer can be found, the primary insurer and reinsurer can then enter into a valid contract.

Advantages: It has the advantage of flexibility, since a reinsurance contract can be arranged to fit any kind of case. It can increase the insurer’s capacity to write large amounts of insurance. The reinsurance tends to stabilize the insurer’s operations by shifting large losses to the reinsurer.

Disadvantages: The major disadvantage of facultative reinsurance is that it is uncertain. The ceding insurer does not know in advance if a reinsurer will accept any part of the insurance. There is also a further disadvantage of delay, since the policy will not be issued until reinsurance is obtained. In times of bad loss experience, the reinsurance market tends to dry up. Therefore, facultative reinsurance has the further disadvantages of being unreliable.
2. Treaty Reinsurance: Treaty reinsurance means the primary insurer has agreed to cede insurance to the reinsurer, and the reinsurer has agreed to accept the business. All business that falls within the scope of the agreement is automatically reinsured according to the terms of the treaty.

Advantages: Treaty reinsurance has several advantages to the primary insurer. It is automatic and no uncertainty or delay is involved. It is also economical, since it is not necessary to shop around for reinsurance before the policy is not written.

Disadvantage: Treaty reinsurance could be unprofitable to the reinsurer. The reinsurer generally has no knowledge about the individual applicant and must rely on the underwriting judgment of the primary insurer. The primary insurer may write bad business and then reinsure it. Also, the premium received by the primary insurer has a poor selection of risks or charges inadequate rates, the reinsurer could incur a loss.

There are several types of reinsurance treaties and arrangements. They are as follows;

i) Quota – Share Treaty: Under a quota-share treaty, the ceding insurer and reinsurer agree to share premiums and losses based on some protection. The ceding insurer’s retention limit is stated as a percentage rather than as a dollar amount.

For example, Awash Insurance Company and Ethiopian Insurance Corporation may enter into a quota-share treaty by which premiums & losses are shared 50% & 50%. Thus, if a Birr.10, 000 loss occurs, AIC pays Birr.10, 000 to the insured but is reimbursed by EIC for Br.5, 000.

Premiums are also shared based on the same agreed percentages. However, the reinsurer pays a ceding commission to the primary insurer to help compensate for the expenses incurred in writing the business. Thus, in the example given above, EIC receive 50% of premium less a ceding commission that is paid to AIC.

Advantages: The major advantage of quota-share reinsurance is that the unearned premium reserve is reduced. For smaller insurers & other insurers that wish to reduce a surplus drain, a quota-share treaty can be especially effective.

Disadvantages: The disadvantage is that a large share of potentially profitable business is called to the reinsurer.
ii) Surplus – Share Treaty: Under a surplus-share treaty, the reinsurer agrees to accept insurance in excess of the ceding insurer’s retention limit, up to some maximum amount. If the amount of insurance on a given policy exceeds the retention limit, the excess insurance is ceded to the reinsurer up to some maximum limit. The primary insurer & reinsurer then share premiums and losses based on the fraction of total insurance retained by each party.

For example, assume that NICE has a retention limit of Br.200,000 (called a line) for a single policy, and that four lines or Br.800,000 are ceded to reinsurer, NIC. Thus, NICE’s total underwriting capacity is Br.1,000,000 or any single exposure. Assume that a Br.500,000 property insurance policy is issued. NICE takes the first Br.200,000 of insurance (2/5th) and NIC takes the remaining Br.300,000 (3/5th). If a loss of Br.5,000 occurs, NICE pays Br.2,000 and NIC pays the remaining Br.3,000.

Under surplus-share treaty, premiums are also shared based on the fraction of total insurance retained by each party. However, the reinsurer pays a ceding commission to the primary insurer to help compensate for the acquisition expenses.

Advantages: The main advantage is that the primary insurer’s underwriting capacity is increased.

Disadvantages: The major disadvantage is the increase in administration expenses. It is more complex & requires greater record keeping.

iii) Excess-of-loss Treaty: An excess-of-loss treaty is designed largely for catastrophic protection. Losses in excess of the retention limit are paid by the reinsurer up to some maximum limit. The excess-of-loss treaty can be written to cover a) a single exposure, or b) a single occurrence, such as a catastrophic loss from a tornado, or c) excess losses when the primary insurer’s cumulative losses exceed a certain amount during some stated time period, such as a year.

For example, assume that Awash Insurance Company wants protection for all windstorm losses in excess of Br.1 million. Assume that an excess-of-loss treaty is written with National Insurance Company of Ethiopia to cover single occurrences during a specified time period. NICE agrees to pay all losses exceeding Br.1 million but only to a maximum of Br.10 million.

iv) Re-insurance Pool: A reinsurance pool is an organization of insurers that underwrites insurance on a joint basis. Reinsurance pools have been formed because a single insurer alone may not have the financial capacity to write large amount of insurance, but the insurers as a group can combine their financial resources to obtain the necessary capacity. For example, the loss expenses on a crash by Jet
can exceed Br.2500 million if the jet crashes, such high limits are usually beyond the financial capacity of a single insurer. However, a reinsurance pool for aviation insurance can provide the necessary capacity. Reinsurance pools also exist for nuclear energy exposures, oil refineries, marine insurance, etc. The method for sharing losses and premiums varies depending on the type of reinsurance pool. Pools work in two ways;

First, each pool member agrees to pay a certain percentage of every loss. For example, if one insurer has a policy owner that incurs a Br.100,000 loss, and there are 50 members in the pool, each insurer would pay 2% or Br.2000 of loss, depending on the agreement.

A second arrangement is similar to the excess of loss reinsurance treaty. Each pool member is responsible for its own losses below a certain amount. Losses exceeding that amount are shared by all members in the pool.

Advantages of Reinsurance:

There are four important advantages of reinsurance: they are as follows;

1. **Increase underwriting capacity**: Reinsurance can be used to increase the insurance company’s underwriting capacity to write new business. The primary insurer may be asked to assume liability for loss in excess of the amount that its financial capacity permits. Instead of accepting only a portion of the risk and thus causing inconvenience to its customer, the insurance company accepts all the risk, knowing that it can pass on to the reinsurer the part that it can not bear. Thus, reinsurance permits the primary insurance company to issue a single policy in excess of its retention limit for the full amount of insurance.

2. **Stabilize profits**: Reinsurance can be used to stabilize profits. An insurer may wish to avoid large fluctuations in annual financial results. Loss experience can fluctuate widely because of social & economical conditions, natural disasters, etc. Reinsurance can be used to level out the effects of poor loss experience. For example, reinsurance may be used to cover a large exposure. If a large, unexpected loss occurs, the reinsurer would pay the portion of the loss in excess of some specified limit.

Another arrangement would be to have the reinsurer reimburse the ceding insurer for losses that exceed a specified loss ratio during a given year. For example, an insurer may wish to stabilize its loss ratio at 70%. The reinsurer then agrees to reimburse the ceding insurer for part or all the losses in excess of 70% up to some maximum limit.
3. **Reduce the unearned premium reserve**: The unearned premium reserve is a liability item on the insurer’s balance sheet that represents the unearned portion of gross premiums on all outstanding policies at the time of valuation. In effect, the unearned premium reserve reflects the fact that premiums are paid in advance, but the period of protection has not yet expired. As time goes on, part of the premium is considered earned, while the remainder is unearned. It is only after the period of protection has expired that the premium is fully earned.

An insurer’s ability to grow may be restricted by the unearned premium reserve requirement. This is because the entire gross premium must be placed in the unearned premium reserve when the policy is first written. The insurer also incurs relatively heavy first-year acquisition expenses in the form of commissions, state premium taxes, expenses in issuing the policy & other expenses. These first year acquisition expenses must be paid by the insurer out of its surplus. For example, a one-year property insurance policy with an annual premium of Birr.2400 may be written on January 1. The entire Birr.2400 must be placed in the unearned premium reserve. At the end of each month, 1/12th of the premium, i.e., Birr.200 is earned and the remainder is unearned. On December 31, the entire premium is fully earned. However, assume that first year acquisition expenses are 20% of the gross premium, i.e., Birr.480. This amount will come from the insurer’s surplus. Thus, the more business it writes, the greater is the short-term drain on its surplus. Reinsurance reduces the level of the unearned premium reserve required by law and temporarily increases the insurer’s surplus position.

4. **Provide protection against a Catastrophic loss**: Reinsurance also provides financial protection against a catastrophic loss. Insurers experience catastrophic losses because of natural disasters, like earthquake, floods & droughts. Reinsurance can provide considerable protection to the ceding company that experiences a catastrophic loss. The reinsurer pays part or all of the losses that exceed the ceding company’s retention up to some specified maximum limit.

5. **Retiring from underwriting**: An insurer can use reinsurance to retire from the business or from a given line of insurance. Reinsurance permits the insurer’s liabilities for existing insurance to be transferred to another carrier. Thus, the policy owner’s coverage remains undisturbed.

**Activity: Re-insurance Practice Review**

*Surf for the web of insurance companies in Ethiopia. Then, develop a term paper on how the reinsurance take place in Ethiopia, write the existing gap compared to the reinsurance principles, and write your recommendation and conclusion.*
Chapter Eight: Insurance Business in Ethiopia

8.1 Origin & Development of Insurance in Ethiopia

The origin of insurance business in Ethiopia was in the year 1905. The major role was played by Bank of Egypt in establishing insurance business in Ethiopia. At that time, Bank of Egypt had been an agent of a foreign insurance company. The major concentration was on fire insurance & marine insurance. In 1954, a study was conducted to improve the insurance operations in Ethiopia. The study was conducted by Ministry of Trade & Industry. At that time, there were 19 insurance companies operating in Ethiopia. Out of 19, only Imperial Insurance Company was as Ethiopian insurance company established in 1951. The remaining 18 companies were acting as agents of foreign insurance companies. Moreover, these companies were concentrated on port towns.

Another study was conducted in 1960 by the Ministry of Trade & Industry. By that time, the number of insurance companies operating in Ethiopia increased to 33, of which 32 are foreign insurance companies. Of 32, only 9 companies had been registered as life insurance companies, and there were only 541 life insurance policies issued by these 9 companies.

Proclamation 1970: (No.:281)

In order to have an effective control over the insurance companies in Ethiopia, the government announced the declaration on October 8th 1970. This proclamation is also considered as one of these basic proclamations that had brought about a significant change in the insurance industry. It also laid for the first time, the basic principle that enables the government to control the insurance industry in an effective way.

Before this proclamation, the insurance has considered as one of the business in the country. There was no regulation with regard to the subscribed capital & paid-up capital which is required to set up an insurance company in the country. Besides, there is no control over the operations of insurance companies in the country. Thus, ultimately the authority to control the insurance companies was given to the Ministry of Trade & Industry.

As per the provisions of the proclamation, the Insurance Council was established. The council consists of Trade & Industry Ministry, Finance Ministry, Transportation Ministry, Planning Commission Head, National Environmental Development & Social Affair Ministry, as its member. The following are the important functions of the Insurance Council;
1. Controlling & encouraging insurance business in the country.
2. Developing & implementing policies/strategies that creates a favorable conditions for re-insurance & investments.

Apart from the Insurance Council, the government has set up the Insurance Controller Office, which represents the Ministry of Trade & Industry, in controlling the insurance business in Ethiopia. At that time, the Licensing Authority was with the Insurance Controller Office. It has given licenses for the following:

➢ 15 domestic Insurance Companies, 36 agents of insurance companies, 7 brokers, 11 loss adjustors and 3 actuaries.

After four years, i.e. in 1975, the Transitional Socialist Government of Ethiopia (later, the Ethiopian Socialist Government) had nationalized and united the then existing private insurance companies and thus Ethiopian Insurance Corporation was officially established on January 1, 1976. The EIC was monopoly for the past 19 years and the revenue earned by EIC had grown from Br.50 million (in 1976) to Br.254 million (in 1993/94).

**Proclamation No: 86/1994:**

Following the demise of the Communist regime and the adoption of the New Economic Policy in the country, a new proclamation, under Proclamation number 86/1994, was declared with the aim of encouraging the participation of domestic investors in the insurance business. According to this proclamation, the National Bank of Ethiopia is authorized and assigned to exercise basic duties regarding the operation of insurance in the country. Besides, the NBE started performing the following duties;

1. Giving recognition to any newly emerging insurance companies in the country, by way of issuing licenses to them.
2. Controlling the overall functions of the insurance companies in the country.
3. Devising & implementing the efficient strategies to develop the insurance services in the country.

Thus, since 1994, 8 insurance companies were set up in the country with the initial paid-up capital of Br.56.5 million. As per Article 201/1994, the paid-up capital of the EIC was increased to Br.61 million. By year 2000, the total capital of all insurance companies went up to Br.340.2 million. At present, there are about 1844 employees working in some 95 branches throughout the country.

In the past 5 years, the NBE has given licenses for;
➢ 554 insurance agents, 11 insurance brokers, 8 loss adjustors and 1 actuary.

8.2 Government Regulation of Insurance:
Government has laid down rules governing the conduct of business, and insurance is no exception. In the case of insurance (as one component of business activities) special attention was given by the government to restructure and organize it in a new form to satisfy social and economic interests of the general public through the **proclamation No. 68 of 1975**, to provide for the establishment of EIC with an initial capital of Br.11 million dollars. Thus, the insurance industry was challenged and stimulated by the government to do its best.

**Why insurance is regulated?**

1. Insurance is a commodity people pay for in advance and whose benefits are reaped in the future, often by someone entirely different from the insured and who is not present to protect self-interest when the contract is made.

2. Insurance is affected by a complex agreement that few lay people understand and by which the insurer could achieve a great and unfair advantage if disposed to do so.

3. Insurance costs are unknown at the time the premium is agreed upon, and there exists a temptation for unregulated insurers to charge too little or too much. Charging too little results in the long run in removing the very security the insured thought was being purchased; charging too much results in unwarranted profits to the insurer.

4. Insurance is regulated to control abuses in the industry. As in any line of business, abuses of power and violations of public trust occur in insurance. These include failure by the insurer to live up to contract provisions, changing up contracts that are misleading and that seem to offer benefits they really do not cover, refused to pay legitimate claims, improper investments of policy holder’s funds, false advertising, and many others.

The Ethiopian Insurance Corporation is the sole entity, which is responsible for all affairs and practices of the insurance industry in the country. The general objectives and functions of the corporation being the following;

1. To engage in all classes of insurance business in Ethiopia.
2. To ensure that insurance services reach the broad masses of the people.
3. To promote efficient utilization of both material and financial resources, subject to government regulations and provisions.

4. To enter into insurance contract.

5. To appoint agents or act as agent for others in matters related to its activities.

6. To manage, administer, supervise and direct all insurance business transactions.

7. To negotiate, arrange, underwrite and contract reinsurance treaties and with foreign reinsurers.