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CLASS : IX-X Financial Literacy

UNDERSTANDING INSURANCE AND RISK MANAGEMENT

Concept of Insurance

Insurance is a means of protection from financial loss. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss.

An entity which provides insurance is known as an insurer, insurance company, or insurance carrier. A person or entity who buys insurance is known as an insured or policyholder. The insurance transaction involves the insured assuming a guaranteed and known relatively small loss in the form of payment to the insurer in exchange for the insurer's promise to compensate the insured in the event of a covered loss. The loss may or may not be financial, but it must be reducible to financial terms, and must involve something in which the insured has an insurable interest established by ownership, possession, or preexisting relationship.

The insured receives a contract, called the insurance policy, which details the conditions and circumstances under which the insured will be financially compensated. The amount of money charged by the insurer to the insured for the coverage set forth in the insurance policy is called the premium. If the insured experiences a loss which is potentially covered by the insurance policy, the insured submits a claim to the insurer for processing by a claims adjuster.

Premium: It is the required amount required to be paid by an insured person to get cover under a given insurance plan for a definite period of time. It is paid by the insured to the insurer. This enable an insured party to get compensation in the event of loss.

Insurance Policy: A insurance policy is a contract in which an individual or entity receive financial protection against losses from an insurance company.

Difference between Pure risk and Investment Risk

Pure Risk: Any risk in which there is no possibility of gain, only the avoidance of loss. For example, if a company car is stolen, the company endures a loss, but if it is not stolen, the company does not make a gain. Individuals and companies purchase insurance to mitigate the potential damage from a loss from pure risk. It is also called absolute risk

Investment risk: can be defined as the probability or likelihood of occurrence of losses relative to the expected return on any particular investment. Stating simply, it is a measure of the level of uncertainty of achieving the returns as per the expectations of the investor. It is the extent of unexpected results to be realized.

Basis	Pure Risk	Speculative/ Investment Risk
Meaning	Pure risk involves no possibility of gain; either a loss ocurrs or no loss ocurrs	Speculative Risk involves three possible outcomes: loss, gain or no change
Example	An example of pure risk is the risk of becoming disabled as a result of illness or injury.	Trading in stock market may result in making either a profit or loss or neither a profit nor loss i.e. no change in the investment value.
Insurance	Pure risk - the risk of loss without the possibility of gain- is the only type of risk that can be insured.	Speculative Risk cannot be insured

Ways of Managing Risk

There are four main ways to manage risk: risk avoidance, risk transfer, risk reduction and risk retention. Each is applicable under different circumstances. Some ways of managing risk fall into multiple categories. Multiple ways of managing risk are often utilized simultaneously.

Risk Avoidance (elimination of risk)

Completely avoiding an activity that poses a potential risk. While attractive, this is not always practical. By avoiding risk we forfeit potential gains, be it in life, in business or in with investments.

Risk Transfer (insuring against risk)

Most commonly, this is to buy an insurance policy. The risk is transferred to a third-party entity (in most cases an insurance company). To be more clear, the financial risk is transferred to a third-party. For example, a homeowner's insurance policy does not transfer the risk of a house fire to the insurance company, it only transfers the financial risk. A house fire is still just as likely as before. Risk sharing is also a type of risk transfer. For example, members assume a smaller amount of risk by transferring and sharing the remainder of risk with the group.

Risk Reduction (mitigating risk)

This is the idea of reducing the extent or possibility of a loss. This can be done by increasing precautions or limiting the amount of risky activity. For example, installing a security alarm, smoke detectors, wearing a seat belt or wearing a helmet are ways of employing risk reduction. Diversification of assets and hedging are forms of risk reduction with investments. Investments in information are a way of mitigating risk because you are better informed, thus reducing the uncertainty. Another way of employing risk reduction is the safety in numbers approach. When discussing risk transfer, we spoke briefly about risk sharing. The larger the number of people sharing risk, the less severe the shared effects will be. Statistically, only a small number of individuals in the group will experience an unfortunate event. Insurance companies exist based on this concept.

Risk Retention (accepting risk)

Risk retention simply involves accepting the risk. Even if the risk is mitigated, if it is not avoided or transferred, it is retained. Retention is effective for small risks that do not pose any significant financial threat. The financial status of the family or individual will determine the acceptability of a risk. A couple of examples of risk retention: A billionaire may not have to worry about insuring his car. An individual may not be able to afford or obtain health insurance. Both individuals are retaining risk, one is because they're able to, the other is because they have to. Risk retention augments risk transfer through deductibles. With a deductible, we retain or 'self-insure' small, frequent occurrences and only utilize insurance for needs over a particular dollar threshold, our deductible limit.

Diversification of Risk

Allocation of proportional risk to all parties to a contract, usually through a risk premium. Also called risk allocation

Term Life Insurance

Term life insurance or term assurance is life insurance that provides coverage at a fixed rate of payments for a limited period of time, the relevant term. After that period expires, coverage at the previous rate of premiums is no longer guaranteed and the client must either forgo coverage or potentially obtain further coverage with different payments or conditions. If the life insured dies during the term, the death benefit will be paid to the beneficiary. Term insurance is the least expensive way to purchase a substantial death benefit on a coverage amount per premium dollar basis over a specific period of time.

Term life insurance can be contrasted to permanent life insurance such as whole life, universal life, and variable universal life, which guarantee coverage at fixed premiums for the lifetime of the covered individual unless the policy owner allows the policy to lapse. Term insurance is not generally used for estate planning needs or charitable giving strategies but is used for pure income replacement needs for an individual. Term insurance functions in a manner similar to most other types of insurance in that it satisfies claims against what is insured if the premiums are up to date and the contract has not expired and does not provide for a return of premium dollars if no claims are filed. As an example, auto insurance will satisfy claims against the insured in the event of an accident and a homeowner policy will satisfy claims against the home if it is damaged or destroyed by, for example, a fire. Whether or not these events will occur is uncertain. If the policyholder discontinues coverage because he has sold the insured car or home, the insurance company will not refund the full premium. This is purely risk protection.

Types of Life Insurance

There are certain basic forms of life insurance. The different types of life insurance policies include:

1. Term Life Insurance
2. Whole Life Policy
3. Endowment Plans
4. Unit Linked Insurance Plans
5. Money Back Policy

What are the various types of life insurance?

There are two basic types of life insurance policies viz. Traditional Whole Life and Term Life Insurance. A whole life is a policy you pay till death of the policy holder and term life is a policy for a fixed amount of time.

The basic types of life insurance policies are:

Term insurance

Term plans are the most basic form of life insurance. They provide life cover with no savings / profits component. They are the most affordable form of life insurance as premiums are cheaper compared to other life insurance plans.

Online term insurance plans provide pure risk cover, which explains the lower premiums. A fixed sum of money - the sum assured – is paid to the beneficiaries if the policyholder expires over the policy term. If the policyholder survives, there is no pay out.

Endowment plans

Endowment plans differ from term plans in one critical aspect i.e. maturity benefit. Unlike term plans which pay out the sum assured, along with profits, only in case of an eventuality over the policy term, endowment planspay out the sum assured under both scenarios – death and survival. However, endowment plans charge higher fees / expenses – reflected in premiums – for paying out sum assured, along with profits, in either scenario – death or maturity. The profits are an outcome of premiums being invested in asset markets – equities and debt.

Unit linked insurance plans (ULIP)

ULIPs are a variant of the traditional endowment plan. They pay out the sum assured (or the investment portfolio if its higher) on death/maturity.

ULIPs differ from traditional endowment plans in certain areas. As the name suggests, performance of ULIP is linked to markets. Individuals can choose the allocation for investments in stock/debt markets. The value of the investment portfolio is captured by the NAV (net asset value). To that end, there are many similarities between ULIPs and mutual funds. ULIPs differ in one area, they are a combination of investment and insurance, while mutual funds are a pure investment avenue

Whole life policy

A whole life insurance policy covers a policyholder over his life. The main feature of a whole life policy is that the validity of the policy is not defined so the individual enjoys the life cover throughout his life. The policyholder pays regular premiums until his death, upon which the corpus is paid out to the family. The policy expires only in case of an eventuality as there is no pre-defined policy tenure.

Money back policy

A money back policy is a variant of the endowment plan. It gives periodic payments over the policy term. To that end, a portion of the sum assured is paid out at regular intervals. If the policy holder survives the term, he gets the balance sum assured. In case of death over the policy term, the beneficiary gets the full sum assured.

General Insurance: or non-life insurance policies, including automobile and homeowners policies, provide payments depending on the loss from a particular financial event. General insurance is typically defined as any insurance that is not determined to be life insurance

Vehicle Insurance

Vehicle insurance (also known as **car insurance**, **motor insurance** or **auto insurance**) is insurance for cars, trucks, motorcycles, and other road vehicles. Its primary use is to provide financial protection against physical damage and/or bodily injury resulting from traffic collisions and against liability that could also arise there from. The specific terms of vehicle insurance vary with legal regulations in each region. To a lesser degree vehicle insurance may additionally offer financial protection against theft of the vehicle and possibly damage to the vehicle, sustained from things other than traffic collisions, such as keying and damage sustained by colliding with stationary objects.

Medical or Health Insurance

Health insurance is a type of insurance coverage that pays for medical and surgical expenses incurred by the insured. Health insurance can reimburse the insured for expenses incurred from illness or injury, or pay the care provider directly. It is often included in employer benefit packages as a means of enticing quality employees. The cost of health insurance premiums isdeductible to the payer, and benefits received are tax-free.

Property Insurance

Property insurance provides protection against most risks to property, such as fire, theft and some weather damage. This includes specialized forms of insurance such as fire insurance, flood insurance, earthquake insurance, home insurance, or boiler insurance. Property is insured in two main ways—open perils and named perils.

Open perils cover all the causes of loss not specifically excluded in the policy. Common exclusions on open peril policies include damage resulting from earthquakes, floods, nuclear incidents, acts of terrorism, and war. Named perils require the actual cause of loss to be listed in the policy for insurance to be provided. The more common named perils include such damage-causing events as fire, lightning, explosion, and theft.

Disability Insurance

Disability Insurance: Often called **DI** or **disability income insurance**, or **income protection**, is a form of insurance that insures the beneficiary's earned income against the risk that a disability creates a barrier for a worker to complete the core functions of their work. For example, the worker may suffer from an inability to maintain composure in the case of psychological disorders or an injury, illness or condition that causes physical impairment or incapacity to work. It encompasses paid sick leave, short-term disability benefits (STD), and long-term disability benefits (LTD)