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Contents

Principles of Insurance – Let us understand the principle with story of Ramesh and his Warehouse 3

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Principles of Insurance – Let us understand the principle with story of Ramesh and his Warehouse

The Story of Ramesh and His Warehouse

“Ramesh was a **warehouse owner** who stored agricultural equipment worth ₹50 lakh. Worried about increasing risks due to floods and fires, he decided to **insure his warehouse**”

1. Utmost Good Faith (*uberrima fides*)

When filling the insurance proposal form, Ramesh **honestly disclosed** that his warehouse was near a river and had old electrical wiring. Because he told the **full truth**, the insurer assessed the risk correctly.

Lesson: Insurance works only when both sides speak the truth.

2. Insurable Interest

Ramesh could ensure the warehouse **only because he owned it**. His neighbour Mohan could not insure it, even though he lived nearby.

Lesson: Only the person who suffers **financial loss** can insure.

3. Certainty of Event

Ramesh knew that damage to the warehouse **may or may not happen**, but the **timing and extent were uncertain**.

Lesson: Insurance covers uncertain events, not sure losses.

4. Indemnity

Unfortunately, a fire broke out and caused damage worth ₹10 lakh. Even though the warehouse was insured for ₹50 lakh, the insurer paid **only ₹10 lakh**.

Lesson: Insurance restores loss; it does not create profit.

5. Proximate Cause

Investigation showed that the fire was caused by a **short circuit**—a risk covered in the policy. So the claim was **accepted**.

Lesson: The **dominant cause** of loss decides claim settlement.

6. Mitigation of Loss

During the fire, Ramesh immediately called the fire brigade and moved goods to a safer area.

Lesson: The insured must take **reasonable steps** to reduce loss.

7. Contribution

Ramesh had insured the warehouse with **two insurers**. Both insurers shared the ₹10 lakh loss **in proportion to their coverage**.

Lesson: Multiple insurers divide the loss fairly.

8. Subrogation

Later, it was found that the fire was due to **negligence of an electrical contractor**. After compensating Ramesh, the insurer **recovered the loss** from the contractor.

Lesson: Insurer steps into the shoes of the insured.

9. Risk Sharing

The insurer could pay Ramesh because **thousands of policyholders** paid small premiums.

Lesson: Loss of one is shared by many.

10. Certainty of Benefit (Life Insurance Link)

Ramesh also had a **life insurance policy**. While death is certain, **its timing was uncertain**, which justified insurance.

Lesson: Insurance is based on uncertainty, not inevitability.



Understanding with example

1. Utmost Good Faith (Uberrimae Fidei)

Meaning

Both insurer and insured must disclose **all material facts** affecting risk assessment.

Example (India)

- In **health insurance claims (post-COVID)**, insurers have rejected claims where **pre-existing diseases (diabetes, hypertension)** were not disclosed at proposal stage.
- IRDAI has reiterated that **non-disclosure = contract voidable**, even if disease is unrelated later.

Analogy - Like applying for a **bank loan**—if you hide an existing loan, the bank can cancel approval even after sanction.

- Applies **strongest in life & health insurance**
- Breach → Policy becomes **voidable, not automatically void**

2. Insurable Interest

Meaning

The insured must suffer a **financial loss** if the insured

event occurs. This means that **insurance is valid only when the insured has a financial stake** in the subject matter of insurance. If the insured event happens, the insured should **lose money or economic benefit**. Ensures insurance is a **risk-management tool**, not a profit tool

Example

- **Crop Insurance (PMFBY)**: Only the **farmer cultivating the land** has insurable interest, not a speculative trader.
- In life insurance, employer can insure a **key employee (Keyman Insurance)**.

Analogy

You lock **your own bike**, not your neighbour's—because only you will lose if it's stolen.

Timing Rule (Very Important)

- Life Insurance → At **policy inception**
- General Insurance → At **time of loss**

3. Indemnity

Meaning

Insurance compensates **actual loss only**, no profit.

Recent Example

- In **motor insurance**, if a 10-year-old car is damaged, claim is paid after **depreciation**, not new car value.

Analogy - Like a **repair reimbursement**—you get money to fix the damage, not to upgrade the house.

Exceptions

- Life Insurance
- Personal Accident (fixed benefit)

4. Contribution

Meaning - If same risk is insured with **multiple insurers**, loss is shared proportionately.

Example - Large **commercial properties** often insured by a **consortium of insurers**—each pays as per share in sum insured.

Analogy - Friends jointly paying a restaurant bill in the **same ratio** they ordered food.

Formula (Exam-Favourite)

$$\text{Insurer's Share} = \frac{\text{Policy Amount}}{\text{Total Insurance}} \times \text{Loss}$$

5. Subrogation

Meaning - After paying claim, insurer gets the right to recover from **third party responsible**.

Recent Example - In **marine insurance**, if cargo damage is due to **port operator negligence**, insurer recovers from port authority.

Analogy - If your friend pays your hospital bill and later recovers money from the person who caused accident.

Key Rule - Subrogation arises **only after full indemnification**.

6. Proximate Cause (Causa Proxima)

Meaning - Claim is paid only if loss is caused by the **dominant, nearest cause insured against**.

Recent Example - Flood damages factory → fire breaks out due to short-circuit → fire claim payable if flood is insured peril.

Analogy - In a chain accident, **who hit you last** matters, not who started traffic jam.

7. Mitigation of Loss

Meaning - Insured must take **reasonable steps** to reduce loss.

Recent Example - During **cyclones/flood warnings**, failure to move goods to safer location can reduce claim amount.

Analogy - If water leaks at home, you close the tap first—don't wait for insurer.

Legal View - Negligence by insured can **reduce claim settlement**

8. Risk Sharing (Law of Large Numbers)

Meaning - Losses of few are spread over many policyholders.

Recent Example - **Ayushman Bharat / Health Insurance pools** spread medical costs across millions.

Analogy - Everyone contributes ₹10; only few face hospital bills—rest help indirectly.

Foundation Principle

- Basis of premium calculation

- Enables affordable insurance

9. Certainty of Event

Meaning - Insured event must be **uncertain**, not inevitable.

Recent Example

- Death is certain, but **timing is uncertain** → Life insurance valid
- Wear & tear excluded → certain loss

Analogy - Exam result is uncertain, but **exam itself is certain**.

10- In short

- **Good Faith** → Truth in application
- **Insurable Interest** → Financial relationship
- **Indemnity** → No profit
- **Contribution** → Many insurers share
- **Subrogation** → Insurer recovers
- **Proximate Cause** → Dominant cause
- **Mitigation** → Reduce damage

MCQ

Q1. Utmost Good Faith

An insurance contract is called a contract of uberrimae fidei because:

- A. It is based on mutual profit
- B. Both parties must disclose all material facts
- C. The insurer bears all risks
- D. The insured cannot cancel the policy
- E. The contract is enforceable without consideration

Answer: B

Q2. Insurable Interest

Which of the following best explains insurable interest?

- A. Emotional attachment to the subject matter
- B. Legal ownership at all times
- C. Possibility of financial loss to the insured
- D. Payment of premium by the insured
- E. Agreement between insurer and insured

Answer: C

Q3. Timing of Insurable Interest

Insurable interest must exist at the time of loss in:

- A. Life insurance
- B. Fire insurance
- C. Personal accident insurance
- D. Term insurance

E. Endowment insurance

Answer: B

Q4. Indemnity

The principle of indemnity aims to:

- A. Maximise compensation to the insured
- B. Ensure profit from insurance
- C. Restore the insured to the same financial position
- D. Fix a predetermined benefit
- E. Transfer ownership of the asset

Answer: C

Q5. Exception to Indemnity

Which of the following insurance contracts does NOT follow the principle of indemnity?

- A. Fire insurance
- B. Marine insurance
- C. Motor insurance
- D. Life insurance
- E. Burglary insurance

Answer: D

Q6. Contribution

The principle of contribution becomes applicable when:

- A. One insurer covers multiple risks
- B. Same risk is insured with more than one insurer
- C. Insured fails to disclose material facts
- D. Loss exceeds sum insured
- E. Policy is under-insured

Answer: B

Q7. Subrogation

Subrogation means:

- A. Transfer of policy ownership
- B. Sharing of loss among insurers
- C. Insurer's right to recover from third party
- D. Reduction of insured's claim
- E. Cancellation of insurance contract

Answer: C

Q8. Relationship Between Indemnity and Subrogation

Subrogation arises only:

- A. Before settlement of claim
- B. When premium is unpaid
- C. After full indemnification of insured
- D. When policy is over-insured

E. In life insurance contracts

Answer: C

Answer: C

Q9. Proximate Cause

The principle of proximate cause is applied to:

- A. Determine amount of premium
- B. Identify the dominant cause of loss
- C. Decide insurable interest
- D. Calculate depreciation
- E. Fix contribution ratio

Answer: B

Q10. Mitigation of Loss

The duty to mitigate loss implies that the insured:

- A. Must prevent the occurrence of loss
- B. Can neglect the insured property
- C. Must take reasonable steps to reduce loss
- D. Is not responsible after loss occurs
- E. Can claim full loss even due to negligence

Q11. Risk Sharing

The principle of risk sharing in insurance is based on

- A. Law of diminishing returns
- B. Law of large numbers
- C. Law of demand
- D. Law of supply
- E. Principle of indemnity

Answer: B

Q12. Certainty of Event

Insurance is possible because:

- A. The insured event is certain
- B. The loss amount is fixed
- C. The occurrence of event is uncertain
- D. Premium is compulsory
- E. Risk is transferable

Answer: C

Practice Descriptive Questions

Q1. Explain the fundamental principles of insurance. How do these principles ensure fairness, prevent moral hazard, and contribute to the stability and sustainability of the insurance system? Illustrate your answer with suitable examples. **(24 Marks / 300 words)**

Q2. "Insurance contracts are contracts of utmost good faith." Explain this statement. Discuss the importance of full disclosure of material facts by both the insurer and the insured, and examine the consequences of non-disclosure with suitable examples. **(7 Marks / 150 words)**

Q3. What is meant by the principle of insurable interest? Why is it essential for a valid insurance contract? Distinguish between the timing of insurable interest in life insurance and general insurance. **(7 Marks / 150 words)**

Q4. Explain the principle of indemnity in insurance. How does it prevent the insured from making a profit out of insurance? Mention the exceptions to this principle with suitable illustrations. **(7 Marks / 150 words)**

Q5. Define the principle of proximate cause in insurance. How is it applied in settling claims when multiple causes contribute to a loss? Support your answer with examples. **(7 Marks / 150 words)**

Q6. Explain the principle of contribution. Under what circumstances does it apply, and how does it ensure equity among insurers when the same risk is covered by multiple policies? **(7 Marks / 150 words)**

Q7. What is the principle of subrogation in insurance? Discuss how it protects the interests of insurers and prevents unjust enrichment of the insured. **(7 Marks / 150 words)**

Q8. Discuss the principle of mitigation of loss in insurance contracts. What duties does it impose on the insured, and how does it influence claim settlement? **(7 Marks / 150 words)**

Q9. Explain how the principle of risk sharing operates in insurance. Discuss the role of the law of large numbers in enabling insurers to spread risk and offer affordable premiums. (7 Marks / 150 words)

Q10. Explain the principle of certainty of event in insurance. Why are certain losses excluded from insurance contracts? Illustrate your answer with suitable examples. (7 Marks / 150 words)

SOLUTION

Explain the fundamental principles of insurance. How do these principles ensure fairness, prevent moral hazard, and contribute to the stability and sustainability of the insurance system?

Introduction

Insurance is a contractual mechanism for transferring and pooling risk, where uncertain losses of individuals are shared collectively. To ensure that insurance functions as a tool of **risk protection rather than profit-making or speculation**, certain fundamental principles govern insurance contracts. These principles promote **fairness**, prevent **moral hazard and fraud**, and ensure the **long-term stability and sustainability** of the insurance system.

Fundamental Principles of Insurance

1. Utmost Good Faith (Uberrimae Fidei)

Insurance contracts require **full and honest disclosure of all material facts** by both insurer and insured. Since insurers rely heavily on information provided by the insured for risk assessment, non-disclosure can distort pricing and coverage.

Example: Non-disclosure of a pre-existing disease in health insurance can lead to claim rejection.

Role: Prevents information asymmetry and moral hazard, ensuring fair underwriting.

2. Insurable Interest

The insured must have a **financial interest** in the subject matter of insurance and must suffer a **financial loss** if the insured event occurs.

Example: A farmer can insure his crop under PMFBY, but a third party cannot.

Role: Prevents gambling and speculative insurance, ensuring insurance remains a risk-mitigation tool.

3. Principle of Indemnity

Insurance compensates only the **actual loss suffered**, restoring the insured to the same financial position as before the loss, without allowing profit.

Example: In motor insurance, depreciation is deducted while settling claims.

Role: Prevents deliberate loss creation and discourages reckless behaviour.

4. Proximate Cause (Causa Proxima)

When multiple causes contribute to a loss, the claim is payable only if the **dominant cause** is a peril insured against.

Example: Fire caused by a covered electrical short circuit is payable even if flood preceded it.

Role: Ensures objective and consistent claim settlement.

5. Contribution

If the same risk is insured with multiple insurers, the loss is **shared proportionately** among them.

Example: Large industrial assets insured through consortium arrangements.

Role: Prevents overcompensation and promotes equity among insurers.

6. Subrogation

After compensating the insured, the insurer acquires the right to recover the loss from a **third party responsible** for the damage.

Example: Insurer recovering damages from a negligent transporter after settling a marine claim.

Role: Prevents unjust enrichment and reduces overall claim burden.

7. Mitigation of Loss

The insured must take **reasonable steps** to minimise loss after the occurrence of the insured event.

Example: Moving goods to a safer location during flood warnings.

Role: Reduces avoidable losses and supports efficient claims management.

8. Risk Sharing (Law of Large Numbers)

Insurance spreads losses of a few among a large number of policyholders through premium pooling.

Example: Health insurance schemes spreading medical costs across millions.

Role: Enables affordability, predictability of losses, and financial sustainability.

9. Certainty of Event

Only **uncertain events** are insurable; certain or inevitable losses are excluded.

Example: Death is certain, but its timing is uncertain, making life insurance possible.

Role: Distinguishes insurance from savings or maintenance contracts.

How These Principles Ensure Fairness, Prevent Moral Hazard, and Promote Stability

- **Fairness:** Principles like indemnity, contribution, and subrogation ensure equitable compensation without profit.
- **Moral Hazard Prevention:** Utmost good faith, insurable interest, and mitigation discourage fraud, negligence, and speculative behaviour.
- **System Stability:** Risk pooling, objective claim settlement, and loss control maintain insurer solvency and public trust.
- **Sustainability:** By aligning incentives of insurers and insured, these principles support long-term viability of the insurance ecosystem.

Conclusion

The fundamental principles of insurance form the ethical and operational backbone of the insurance system. By ensuring transparency, fairness, and disciplined risk-sharing, these principles prevent misuse, protect stakeholders, and strengthen confidence in insurance as a vital instrument of financial stability and social security.

“Insurance contracts are contracts of utmost good faith.” Explain this statement. Discuss the importance of full disclosure of material facts by both the insurer and the insured, and examine the consequences of non-disclosure with suitable examples.

Introduction

Insurance contracts are described as contracts of **utmost good faith (uberrimae fidei)** because they are based on complete trust and honesty between the insurer and the insured. Unlike ordinary commercial contracts, insurance involves **information asymmetry**, where the insured has better knowledge about the risk to be covered. Therefore, both parties are legally and ethically bound to disclose all **material facts** that may influence the decision to enter into the contract.

Meaning of Utmost Good Faith

Utmost good faith requires that **all material facts**, whether asked or not, must be truthfully disclosed at the time of entering into the insurance contract. A material fact is one that would affect the insurer's **decision to accept the risk, fix the premium, or determine the terms of the policy**.

Disclosure Obligations of the Insured

The insured must disclose:

- Pre-existing diseases in health and life insurance
- Past losses or claims history

- Nature and usage of insured property
- Hazardous occupations or lifestyle risks

Example: Non-disclosure of diabetes while purchasing a health insurance policy may lead to rejection of a claim related to medical complications.

Disclosure Obligations of the Insurer

The insurer is equally bound to disclose:

- Policy terms, conditions, exclusions, and limitations
- Waiting periods, deductibles, and claim procedures
- Rights and obligations of the insured

Example: Failure to disclose a waiting period clause in health insurance can mislead the insured and violate the principle of good faith.

Importance of Full Disclosure

- Enables **accurate risk assessment and premium pricing**
- Prevents **adverse selection and moral hazard**
- Ensures **fairness and transparency** in insurance contracts
- Builds **trust and credibility** in the insurance system

Consequences of Non-Disclosure

- The insurance contract becomes **voidable at the option of the aggrieved party**
- Claims may be **repudiated** if non-disclosure is material
- Premiums already paid may be forfeited
- Legal disputes and loss of consumer confidence

Example: A life insurance claim can be denied if the insured concealed a serious illness at the proposal stage, even if death occurs due to another cause.

Role in Preventing Moral Hazard

By enforcing strict disclosure norms, the principle of utmost good faith discourages:

- Intentional concealment of risk
- Fraudulent claims
- Reckless or negligent behaviour by the insured

Conclusion

The principle of utmost good faith forms the **foundation of insurance contracts**. By mandating full and honest disclosure by both the insurer and the insured, it ensures fairness, prevents moral hazard, and sustains the integrity and stability of the insurance system. Without this principle, insurance would degenerate into speculation rather than a mechanism for risk protection.

What is meant by the principle of insurable interest? Why is it essential for a valid insurance contract? Distinguish between the timing of insurable interest in life insurance and general insurance.

Introduction

The principle of **insurable interest** is a fundamental requirement of a valid insurance contract. It ensures that insurance is used as a **risk-management mechanism** rather than a means of speculation or gambling. An insurance contract is enforceable only when the insured stands to suffer a **financial loss** on the occurrence of the insured event.

Meaning of Insurable Interest

Insurable interest exists when the insured has a **legal or financial relationship** with the subject matter of insurance such that its loss, damage, or destruction would result in **financial loss** to the insured. In the absence of insurable interest, the insurance contract becomes **void**.

Example: A shop owner can insure his shop because damage to it would cause him economic loss, whereas a stranger cannot insure the same shop.

Why Insurable Interest Is Essential

1. **Prevents wagering contracts:** It ensures that insurance does not become a gambling arrangement.
2. **Reduces moral hazard:** The insured has an incentive to protect the subject matter rather than cause loss intentionally.
3. **Ensures legitimacy of claims:** Only genuine losses are compensated.
4. **Promotes fairness and stability:** It protects insurers from speculative or fraudulent policies and sustains trust in the insurance system.

Timing of Insurable Interest

Aspect	Life Insurance	General Insurance
Time when insurable interest must exist	At the time of taking the policy	At the time of loss
Reason	Life insurance is a long-term contract based on human life	General insurance covers property or liability subject to change
Example	A person can insure his own life or spouse's life at inception	Ownership of property must exist when loss occurs
Nature	Benefit-based contract	Indemnity-based contract

Illustration

In life insurance, a person must have insurable interest at the time of proposal, even if the relationship ends later. In contrast, in fire or motor insurance, insurable interest must exist at the time the loss occurs; otherwise, no claim is payable.

Conclusion

The principle of insurable interest is the cornerstone of a valid insurance contract. By requiring the insured to have a financial stake in the subject matter, it prevents misuse, discourages moral hazard, and preserves the insurance system as a tool for protection rather than speculation. The difference in timing between life and general insurance reflects the distinct nature and objectives of these contracts.

Explain the principle of indemnity in insurance. How does it prevent the insured from making a profit out of insurance? Mention the exceptions to this principle with suitable illustrations.

Introduction

The principle of **indemnity** is a fundamental principle of insurance that ensures insurance contracts serve as instruments of **risk protection rather than profit-making**. According to this principle, the insurer agrees to compensate the insured only to the extent of the **actual loss suffered**, thereby restoring the insured to the same financial position as before the occurrence of the loss.

Meaning of the Principle of Indemnity

Indemnity means **making good the loss**. Under an indemnity-based insurance contract, the insured is entitled to receive compensation equal to the **actual monetary loss**, subject to the sum insured and policy terms. The insured should neither gain nor suffer more loss because of insurance.

Example: If a factory insured for ₹50 lakh suffers fire damage of ₹10 lakh, the insurer will pay only ₹10 lakh, not the full sum insured.

How the Principle of Indemnity Prevents Profit

1. **Limits claim to actual loss:** Compensation is restricted to the value of the loss incurred.
2. **Depreciation and excess clauses:** Wear and tear are deducted while settling claims.
3. **Market value basis:** Assets are valued at current market value, not replacement cost (unless specified).

4. **Link with subrogation and contribution:** These principles further ensure that the insured does not receive more than the actual loss.

Illustration: In motor insurance, if a damaged car is 8 years old, the claim is settled after deducting depreciation, preventing profit from insurance.

Role in Preventing Moral Hazard

By denying profit from loss, the principle discourages:

- Deliberate destruction of insured property
- Negligent behaviour by the insured
- Over-insurance for gain

Thus, it aligns the interests of the insured with loss prevention.

Exceptions to the Principle of Indemnity

Certain insurance contracts do not strictly follow indemnity because **exact monetary loss cannot be measured** or the contract is benefit-based.

1. Life Insurance

Human life cannot be valued in monetary terms; hence, a **fixed sum** is paid on death or maturity.

Illustration: A life policy of ₹20 lakh pays the full sum irrespective of actual financial loss.

2. Personal Accident Insurance

Compensation is paid as a **fixed benefit** for death or disability, not based on actual loss.

Illustration: Loss of a limb results in payment of a pre-defined percentage of the sum insured.

3. Valued Policies

The value of the subject matter is **pre-agreed** between insurer and insured.

Illustration: Marine insurance policies where cargo value is fixed in advance.

4. New-for-Old Policies

Replacement is done on a **new-for-old basis** without deducting depreciation.

Illustration: Household appliances insured under replacement value policies.

Conclusion

The principle of indemnity is central to maintaining fairness and discipline in insurance contracts. By ensuring that compensation is limited to actual loss, it prevents insurance from becoming a source of profit and discourages moral hazard. While certain exceptions exist due to practical limitations in valuation, the principle remains the cornerstone of indemnity-based insurance contracts.

Define the principle of proximate cause in insurance. How is it applied in settling claims when multiple causes contribute to a loss? Support your answer with examples.

Introduction

In insurance, a loss may occur due to a **chain of events** rather than a single cause. The principle of **proximate cause** (**causa proxima**) helps in identifying the **dominant and effective cause** of the loss in order to determine whether the claim is payable. This principle ensures objectivity and fairness in claim settlement.

Meaning of Proximate Cause

The principle of proximate cause states that when a loss results from more than one cause, the insurer is liable only if the **nearest, dominant, and effective cause** of the loss is a peril insured against. Remote or indirect causes are ignored.

In simple terms, **the cause that sets the chain of events in motion and is most responsible for the loss is considered the proximate cause.**

Application in Claim Settlement

When multiple causes contribute to a loss:

1. The insurer identifies all contributing causes.
2. The **dominant or operative cause** is determined.
3. If the proximate cause is a **covered peril**, the claim is payable.
4. If the proximate cause is an **excluded peril**, the claim is repudiated, even if insured perils are present.

Illustrations

Example 1: Claim Payable

A fire breaks out in a factory due to an electrical short circuit (insured peril). Heavy rain follows and aggravates the damage. Since **fire is the proximate cause**, the insurer is liable to pay the claim.

Example 2: Claim Not Payable

A ship sinks due to war-related activity (excluded peril), even though the cargo is insured against marine risks. Since **war is the proximate cause**, the claim is rejected.

Example 3: Chain of Events

A flood damages electrical wiring, leading to a fire. If flood is excluded but fire is insured, and fire is the dominant cause of loss, the claim may be payable based on policy wording.

Importance of the Principle

- Ensures **fair and consistent claim settlement**
- Prevents unjustified claim payments
- Helps insurers assess liability objectively
- Reduces disputes between insurer and insured

Role in Preventing Moral Hazard

By focusing on the dominant cause, the principle prevents insured persons from claiming compensation for losses arising primarily from **excluded or intentional causes**, thus discouraging misuse.

Conclusion

The principle of proximate cause plays a crucial role in insurance claim settlement by identifying the dominant cause of loss when multiple causes operate together. By linking liability to the insured peril that is the effective cause, it ensures fairness, clarity, and sustainability of the insurance system.

Explain the principle of contribution. Under what circumstances does it apply, and how does it ensure equity among insurers when the same risk is covered by multiple policies?

Introduction

The principle of **contribution** is an extension of the principle of indemnity. It ensures that when the same subject matter is insured with **more than one insurer** against the same risk, the loss is shared **proportionately** among the insurers. This principle prevents the insured from receiving more than the actual loss and promotes fairness among insurers.

Meaning of the Principle of Contribution

The principle of contribution states that **if multiple insurance policies cover the same risk**, each insurer is liable to pay **only its proportionate share** of the loss. The insured cannot recover the entire loss from one insurer when others are also liable for the same risk.

Circumstances in Which Contribution Applies

Contribution applies only when **all the following conditions are satisfied**:

1. **Same subject matter** is insured (e.g., the same property).
2. **Same risk or peril** is covered (e.g., fire).
3. **Same insured** is involved under all policies.
4. **Policies are in force at the time of loss**.

5. **Contracts are contracts of indemnity** (not applicable to life insurance).

How Contribution Ensures Equity Among Insurers

- Prevents **unjust enrichment** of the insured.
- Ensures **fair sharing of loss** among insurers based on their respective coverage.
- Avoids placing the entire burden on a single insurer.
- Supports **financial stability** of insurers and the insurance market.

Method of Contribution (Illustration)

A factory insured against fire for:

- ₹10 lakh with Insurer A
- ₹20 lakh with Insurer B

Total insurance = ₹30 lakh

Actual loss = ₹15 lakh

- Insurer A's share = $(10/30) \times 15 = ₹5$ lakh
- Insurer B's share = $(20/30) \times 15 = ₹10$ lakh

Link with Indemnity

Contribution operates only in indemnity contracts and reinforces the principle that the insured should **not profit** from insurance. Even if one insurer pays the full claim initially, it can later recover the proportionate share from other insurers.

Conclusion

The principle of contribution plays a vital role in ensuring fairness and equity in insurance contracts involving multiple policies. By proportionately distributing liability among insurers, it prevents overcompensation of the insured and protects insurers from disproportionate losses, thereby strengthening the efficiency and sustainability of the insurance system.

What is the principle of subrogation in insurance? Discuss how it protects the interests of insurers and prevents unjust enrichment of the insured.

Introduction

The principle of **subrogation** is an important principle of insurance that supports the principle of **indemnity**. It comes into operation after the insurer has compensated the insured for the loss. Under this principle, the insurer acquires the legal right to recover the amount of loss from any **third party** responsible for causing the damage.

Meaning of the Principle of Subrogation

Subrogation means "**substitution**." After settling a claim, the insurer steps into the shoes of the insured and enjoys all the rights and remedies that the insured had against the third party who caused the loss. The insured cannot retain compensation from both the insurer and the third party for the same loss.

Example: If goods insured under marine insurance are damaged due to the negligence of a transporter, the insurer, after paying the claim, can recover the loss from the transporter.

Conditions for Subrogation

- The insurer must have **paid the claim in full**.
- Subrogation applies only to **contracts of indemnity**.
- It does not apply to **life insurance or personal accident insurance**.

How Subrogation Protects the Interests of Insurers

1. **Right of recovery:** Enables insurers to recover losses from negligent third parties.
2. **Reduces claim burden:** Helps control overall claim costs and stabilise premiums.
3. **Encourages accountability:** Ensures third parties responsible for loss are held liable.

Prevention of Unjust Enrichment of the Insured

Subrogation ensures that the insured does not receive **double compensation**—once from the insurer and again from the third party.

Illustration: If an insured receives insurance compensation and also recovers damages from the wrongdoer, retaining both would amount to unjust enrichment. Subrogation prevents this.

Relationship with the Principle of Indemnity

Subrogation is closely linked to indemnity, as both aim to ensure that insurance only compensates actual loss and does not become a source of profit for the insured.

Conclusion

The principle of subrogation safeguards the financial interests of insurers while maintaining fairness in insurance contracts. By preventing double recovery and ensuring that losses ultimately fall on the party responsible, it reinforces the principle of indemnity and contributes to the stability and sustainability of the insurance system.

Discuss the principle of mitigation of loss in insurance contracts. What duties does it impose on the insured, and how does it influence claim settlement?

Introduction

The principle of **mitigation of loss** is an important principle governing insurance contracts, particularly contracts of indemnity. It requires the insured to take **reasonable and prudent steps** to minimise the loss after the occurrence of the insured event. Insurance does not absolve the insured from responsibility; rather, it expects cooperative behaviour to reduce avoidable damage.

Meaning of the Principle of Mitigation of Loss

According to this principle, once a loss occurs or becomes imminent, the insured must act as a **reasonable uninsured person** would act under similar circumstances. The insured should not behave negligently or passively on the assumption that the insurer will bear the entire loss.

Example: If a fire breaks out in a warehouse, the insured must immediately call the fire brigade and attempt to save undamaged goods.

Duties Imposed on the Insured

The principle of mitigation imposes the following duties on the insured:

1. **Take reasonable care:** Act prudently to reduce the extent of loss.
2. **Avoid negligence:** Failure to act reasonably can reduce or nullify the claim.
3. **Preserve damaged property:** Prevent further deterioration after the loss.
4. **Cooperate with the insurer:** Provide timely information and assistance during claim investigation.

Example: During flood warnings, shifting stock to a safer location is expected from the insured.

Influence on Claim Settlement

- Losses caused by **insured perils** are compensated.
- Losses arising due to **negligence or inaction** by the insured are not fully payable.
- Claim amount may be **reduced proportionately** if mitigation measures were ignored.
- Ensures objective and fair assessment of claims.

Role in Preventing Moral Hazard

By imposing a duty to mitigate loss, this principle discourages:

- Careless behaviour after loss
- Deliberate inaction to increase claim amount
- Dependence on insurance for avoidable losses

Illustration

If an insured fails to repair a damaged roof after a storm, leading to further damage from rain, the insurer is liable only for the **initial storm damage**, not the additional loss caused by negligence.

Conclusion

The principle of mitigation of loss plays a crucial role in maintaining discipline and fairness in insurance contracts. By requiring the insured to act responsibly, it prevents moral hazard, reduces unnecessary claims, and supports efficient claim settlement, thereby contributing to the sustainability of the insurance system.

Explain how the principle of risk sharing operates in insurance. Discuss the role of the law of large numbers in enabling insurers to spread risk and offer affordable premiums.

Introduction

The principle of **risk sharing** lies at the core of insurance. Insurance works by pooling the risks of a large number of individuals exposed to similar uncertainties and spreading the financial losses of a few among many. This collective sharing of risk ensures financial protection to individuals while maintaining the viability of insurers.

Principle of Risk Sharing in Insurance

Under the risk-sharing mechanism, each policyholder contributes a small amount called **premium** to a common pool. When an insured event occurs, compensation is paid from this pooled fund to those who suffer losses. Thus, the **loss of a few is borne by the many**, ensuring that no single individual faces catastrophic financial hardship.

Example: In health insurance, thousands of policyholders pay premiums, but only a small proportion require hospitalisation in a given year. Their medical costs are met from the pooled premiums.

Role of the Law of Large Numbers

The **law of large numbers** states that as the number of exposure units increases, the **actual losses tend to approximate the expected losses**. In insurance, this statistical principle enables insurers to predict the frequency and severity of losses with greater accuracy.

By insuring a large and homogeneous group of risks, insurers can:

- Estimate claim costs reliably
- Fix premiums scientifically
- Reduce uncertainty and volatility of losses

Example: Life insurers can predict mortality rates accurately when policies are issued to a large population, allowing stable premium pricing.

How Risk Sharing and the Law of Large Numbers Enable Affordable Premiums

- **Predictability of losses:** Large numbers reduce randomness in claims.
- **Lower per-person cost:** Losses are distributed over many policyholders.
- **Reduced risk load:** Insurers need to hold lower contingency margins.
- **Economies of scale:** Administrative costs per policy decline.

Illustration: Government-backed health schemes spread risk across millions, making coverage affordable even for low-income households.

Contribution to Stability and Sustainability

Risk sharing supported by statistical predictability:

- Enhances insurer solvency
- Prevents sharp premium fluctuations
- Encourages wider insurance penetration
- Builds long-term trust in the insurance system

Conclusion

The principle of risk sharing, reinforced by the law of large numbers, forms the statistical and financial foundation of insurance. By pooling risks across large populations and predicting losses accurately, insurers can spread risk efficiently and offer affordable premiums, thereby ensuring financial protection, stability, and sustainability of the insurance system.

Explain the principle of certainty of event in insurance. Why are certain losses excluded from insurance contracts?

Illustrate your answer with suitable examples.

Introduction

Insurance is designed to protect against **uncertain future events** that may cause financial loss. The principle of **certainty of event** states that only events whose **occurrence, timing, or magnitude is uncertain** can be insured. If a loss is certain or inevitable, it cannot be covered under insurance, as insurance is meant for risk protection and not for funding assured expenses.

Meaning of the Principle of Certainty of Event

According to this principle, the insured event must be **uncertain**, meaning it may or may not happen, or the time and extent of its occurrence are unknown. If the event is certain to occur, it does not constitute a risk and therefore cannot be insured.

Example: Death is certain for every individual, but the **time of death is uncertain**, making life insurance valid.

Why Certain Losses Are Excluded from Insurance Contracts

Certain losses are excluded because:

1. **Absence of risk:** Certain losses lack uncertainty and hence do not involve risk.
2. **Predictability:** If losses are inevitable, insurers cannot pool risk or calculate premiums sustainably.
3. **Prevention of moral hazard:** Covering certain losses may encourage negligence or misuse.
4. **Nature of insurance:** Insurance is meant to compensate for accidental or fortuitous losses, not planned or unavoidable expenses.

Examples of Certain and Uncertain Events

Insurable (Uncertain Events):

- Fire in a factory
- Accident causing injury
- Theft or burglary

Not Insurable (Certain Events):

- Normal wear and tear of machinery
- Depreciation of assets
- Routine maintenance expenses

Illustration

A vehicle owner cannot claim insurance for **regular engine wear and tear**, as it is certain and predictable. However, accidental damage due to a collision is uncertain and therefore insurable.

Role in Maintaining Stability of Insurance System

By excluding certain losses, insurers:

- Ensure accurate premium pricing
- Avoid guaranteed payouts that would undermine solvency
- Maintain fairness among policyholders
- Preserve insurance as a risk-sharing mechanism

Conclusion

The principle of certainty of event distinguishes insurance from savings or maintenance contracts. By covering only uncertain events and excluding inevitable losses, this principle ensures financial discipline, prevents misuse, and sustains the stability and long-term viability of the insurance system.

