

## **INSURANCE - PRINCIPLES & PRACTICE**

### **STUDY GUIDE FOR MODULE ONE**

(A full 'Study & Training Guide' will accompany the Study or Training Manual(s) you will receive soon by airmail post).

This Study Guide - like all our Training Materials - has been written by professionals; experts in the Training of well over three million ambitious men and women in countries all over the world. It is therefore essential that you:-

- \* Read this **Study Guide** carefully and thoroughly BEFORE you start to read and study Module One, which is the first '**Study Section**' of a CIC Study or Training Manual you will receive for the Program for which you have been enrolled.
- \* Follow the **Study Guide** exactly, stage by stage and step by step - if you fail to do so, you might not succeed in your Training or pass the Examination for the CIC Diploma.

#### **\* STAGE ONE**

Learning how to **really STUDY** the College's Study or Training Manual(s) provided - including THOROUGHLY READING this **Study Guide**, and the full '**Study & Training Guide**' which you will soon receive by airmail post.

#### **\* STAGE TWO**

Studying in accordance with the professional advice and instructions given.

#### **\* STAGE THREE**

Answering Self-Assessment Test Questions/Exercises.

#### **\* STAGE FOUR**

Assessing - or having someone assess for you - the standard of your answers to the Self-Assessment Test/Exercises.

#### **\* STAGE FIVE**

Preparing for your Final Examination.

#### **\* STAGE SIX**

Sitting the Final Examination.

Remember: your CIC Program has been **planned** by experts. To be certain of gaining the greatest benefit from the Program, it is **essential** that you follow precisely each one of the **SIX stages** in the Program, as described above.

**STAGE ONE is your thorough reading of this 'Study Guide'**

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## **ABOUT CIC STUDY and TRAINING MANUALS**

A CIC Study or Training Manual (which comprises 4 or 6 Modules - the first Module of which follows) supplied by the College as part of your Course or Program is **NOT** simply a text book. It must therefore **not** be read simply from cover to cover like a text book or another publication. It **MUST** be **studied**, Module by Module, exactly as explained in the following pages. Each CIC Study or Training Manual has been designed and written by specialists, with wide experience of teaching people in countries all over the world to become managers, administrators, supervisors, sales and accounting personnel, business-people, and professionals in many other fields.

Therefore, it is in **your own best interests** that you use the Study or Training Manuals in the way CIC's experts recommend. By doing so, you should be able to learn easily and enjoyably, and master the contents of the Manuals in a relatively short period of time - and then sit the Final Examination with confidence. Every Study Manual and Training Manual is written in clear and easy to understand English, and the meanings of any "uncommon" words, with which you might not be familiar, are fully explained; so you should not encounter any problems in your Studies and Training.

But should you fail to fully grasp anything - after making a thorough and genuine attempt to understand the text - you will be welcome to write to the College for assistance. You must state the **exact** page number(s) in the Study or Training Manual, the paragraph(s) and line(s) which you do not understand. If you do not give full details of a problem, our Tutors will be unable to assist you, and your Training will be delayed unnecessarily.

Start now by reading **carefully** the following pages about Stages Two, Three and Four. Do **NOT**, however, start studying the first Study or Training Manual until you are **certain** you understand **how** you are to do so.

## **STAGE TWO - STUDYING A CIC MODULE**

### **STEP 1**

Once you have read page 1 of this document fully and carefully, turn to the first **study section** - called **Module One** - of **Study or Training Manual One**. (Note: In some Manuals the term "Chapter" is used instead of "Module").

Read the whole of Module One at your normal reading pace, without trying to memorise every topic covered or fact stated, but trying to get "the feel" of what is dealt with in the Module as a whole.

### **STEP 2**

Start reading the Module again from the beginning, this time reading more slowly, paragraph by paragraph and section by section. Make brief notes of any points, sentences, paragraphs or sections which you feel need your further study, consideration or thought. Try to absorb and memorise all the important topics covered in the Module.

### **STEP 3**

Start reading the Module again from its start, this time paying particular attention to - and if necessary studying more thoroughly - those parts which were the subject of your earlier notes. It is best that you do **not** pass on to other parts or topics until you are **certain** you fully understand and remember those parts you earlier noted as requiring your special attention. Try to fix everything taught firmly in your mind.

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**Note:** You may not wish to, or be able to, carry out Steps 1, 2 and 3 one after the other. You could, for instance, carry out Steps 1 and 2 and then take Step 3 after a break.

## **STAGE THREE - ANSWERING SELF-ASSESSMENT TESTS**

### **STEP 4**

When you feel that you have **fully understood and learned everything** taught in the whole Module (and if necessary after a further careful read through it) turn to the Self-Assessment Test set at the end of it, and read the Questions/Exercises in it carefully. You do not have to attempt to answer any or all of the Questions/Exercises in the Test, but it is **best** that you do so, to the best of your abilities. The reasons for this are:-

- ❁ By comparing your answers with the Recommended Answers printed in the Appendix at the end of the Module, you will be able to assess whether you **really have** mastered everything taught in the Module, or whether you need to study again any part or parts of it.
- ❁ By answering Questions/Exercises and then comparing your attempts with the Recommended Answers, you will gain experience - and confidence - in attempting Test and Final Examination Questions/Exercises in the future. Treat the Self-Assessment Tests as being “*Past Examination Papers*”.

### **Professional Advice on Answering Self-Assessment Test (and Examination) Questions and Exercises**

1. You may answer the Questions/Exercises in a Self-Assessment Test in any order you like, but it is best that you attempt **all** of them.
2. Read very carefully the first Question/Exercise you select, to be quite **certain** that you really **understand** it and what it requires **you to do**, because:
  - ★ some Questions/Exercises might require you to give full “written” answers;
  - ★ some Questions/Exercises (e.g. in English) might require you to fill in blank spaces in sentences;
  - ★ some Questions/Exercises (e.g. in bookkeeping) might require you to provide “worked” solutions;
  - ★ some Questions/Exercises (called “multiple-choice questions”) might require you only to place ticks in boxes  against correct/incorrect statements.

In your Final Examination you could **lose marks** if you attempt a Question/Exercise in the wrong way, or if you misread and/or misunderstand a Question/Exercise and write about something which is not relevant or required.

3. Try to answer the Question/Exercise under “**true Test or Examination conditions**”, that is, **WITHOUT** referring back to the relevant section or pages of the Module or to any notes you have made - and certainly **WITHOUT** referring to the Recommended Answers. Try to limit to about two hours the time you spend on answering a set of Questions/Exercises; in your Final Examination you will have **only two hours**.
4. Although you are going to check your Self-Assessment Test answers yourself (or have a friend, relative or colleague assess them for you) practise writing “written” answers:-

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★ in clear, easy-to-read handwriting;

and

★ in good, grammatical language.

The Examiner who assesses your Final Examination answers will take into account that English might not be your national or main language. Nevertheless, to be able to assess whether you really **have** learned what we have taught you, he or she will need to be able to read and understand what you have written. You could lose marks if the Examiner cannot read or understand easily what you have written.

5. Pay particular attention to neatness and to layout, to spelling and to punctuation.
6. When “written” answers are required, make sure what you write is **relevant** to the Question/Exercise, and concentrate on **quality** - demonstrating your knowledge and understanding of facts, techniques, theories, etc. - rather than on quantity alone. Write fully and clearly, but **to the point**. If you write long, rambling Final Examination answers, you will waste time, and the Examiner will deduct marks; so practise the **right** way!
7. When you have finished writing your answer, read through what you have written to see whether you have left out anything, and whether you can spot - and correct - any errors or omissions you might have made.  
**Warning:** some Questions/Exercises comprise two or more parts; make **certain** you have answered **all** parts.
8. Attempt the next Question/Exercise in the Self-Assessment Test in the same manner as we have explained in 1 to 7 above, and so on until all the Questions/Exercises in the Test have been attempted.

**Note:** There is no limit on how much time you spend on studying a Module before answering the Self-Assessment Test set on it, and some Modules are, of course, longer than others. You will, however, normally need to spend between twelve and fifteen hours on the thorough study of each Module - and that time may be spread over a number of days if necessary - plus approximately two hours on answering the Self-Assessment Test on each Module.

## **STAGE FOUR - ASSESSING YOUR ANSWERS**

### **STEP 5**

When you have answered all the Questions/Exercises set in Self-Assessment Test One to the best of your ability, compare them (or ask a friend, relative or a colleague/senior at work to compare them) with the Recommended Answers to that Test, printed in the Appendix at the end of the Module. In any case, you should thoroughly study the Recommended Answers because:-

★ As already explained, they will help you to assess whether you have really understood everything taught in the Module;

and

★ They will teach you how the Questions/Exercises in subsequent Self-Assessment Tests and in your Final Examination **should** be answered: clearly, accurately and factually (with suitable examples when necessary), and how they should be laid out for maximum effect and marks.

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## MARKS AND AWARDS

To assist in the assessment and grading of your answers, the **maximum number of marks** which can be earned for each answer to a Self-Assessment Test Question/Exercise is stated, either in brackets at the **end of each one**.

**The maximum number of marks for any one Test is 100.**

Your answers should be assessed fairly and critically. Marks should be awarded for **facts** included in your answer to a Question/Exercise, for presentation and for neatness. It is **not**, of course, to be expected that your answers will be identical to all those in the Appendix. However, your answers should contain the **same facts**, although they might be given in a different order or sequence - and any examples you give should be as appropriate to the Questions/Exercises as those given in the relevant "Recommended" Answers.

Add together the marks awarded for all your answers to the Questions/Exercises in a Self-Assessment Test, and enter the total (out of 100) in the "Award" column in the **Progress Chart** in the middle of the full '**Study & Training Guide**' when you receive it. Also enter in the "Matters Requiring Further Study" column the number(s) of any Question(s)/Exercise(s) for which you did not achieve high marks.

## GRADES

Here is a guide to the grade your Self-Assessment Test Work has achieved, based on the number of marks awarded for it:

50% to 59%	PASS	60% to 64%	HIGH PASS
65% to 74%	MERIT	75% to 84%	HIGH MERIT
85% to 94%	DISTINCTION	95% to 100%	HIGH DISTINCTION

## STEP 6

Study again **thoroughly** the section(s) of the Module relating to the Question(s)/Exercise(s) to which your answers did not merit high marks. It is important that you understand where or why you went wrong, so that you will not make the same mistake(s) again.

## STEP 7

When you receive the complete Study or Training Manual One\*\* from the College by airmail post, '**revise**' - study again - Module One printed in it, and then turn to **Module Two** and proceed to **study it thoroughly** in exactly the same way as explained in Steps 1, 2 and 3 in this '**Study Guide**'.

When you have completed your **thorough study**, follow steps 4, 5 and 6 for the **Self-Assessment Test on Module 2**.

Continue in the **same way with each of Modules 3, 4, 5 and 6** until you have attempted and assessed your work to Self-Assessment Test 6, and have completed the study of Study or Training Manual One. But - and this is **important** - study the Modules **one by one**; complete Steps 1 to 6 on **each** Module **before** you proceed to the next one (unless during the course of your reading you are referred to another Module).

**\*\*Note:** When you receive Study or Training Manual One by airmail post, it will be accompanied by a 20-page '**Study & Training Guide**' (containing a '**Progress Chart**') which you **MUST read very carefully** before starting your study of Module Two.

TRAINING ON  
**INSURANCE -  
PRINCIPLES & PRACTICE**

**Module One**

**CONTENTS**

<i>Foreword</i>	page 8
<i>Nature and Purpose of Insurance</i>	page 10

**Risk:**

- what risk might involve
- losses from risks
- increased risks
- what insurance seeks to achieve
- the mathematical law of average
- the nature of risk
- types of risks:
  - fundamental risks
  - particular risks
  - pure risks
  - speculative risks
- risk and insurance:
  - controlling the financial aspects of the unknown
  - reducing risks
  - problems with moral hazard

**The main function of insurance:**

- compensation or indemnity:
  - forms which indemnity may take

**How insurance differs from wagers:**

- the legal position
- insurable interest
- utmost good faith
- indemnity
- likelihood of the event occurring

**Insurable risks:**

- examples
- tests of insurability

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**Uninsured risks:**

risks which cannot be insured, examples  
why some risks are not insured

**Means of reducing risks:**

risk control methods

**Subsidiary benefits of insurance:**

reducing fear of the future  
encouraging confidence to undertake new ventures  
assisting people to save  
investments  
reducing demands on social services

**Insurance and the law:**

practical example

**Contracts:**

definition of a contract  
agreements which are not contracts  
the six essentials for a genuine contract:  
intention that it is to be legally binding  
unrevoked offer  
unqualified acceptance  
consideration  
legality  
capacity of the parties

**Insurance contracts**

<b><i>Self-Assessment Test One</i></b>	<b>page 26</b>
<b><i>Recommended Answers to Self-Assessment Test One</i></b>	<b>page 28</b>
<b><i>Contents of Modules 2 to 12 - What you will Learn</i></b>	<b>page 29</b>

## FOREWORD

Everything which exists, whether it is a human being, an animal, a building, a piece of machinery or equipment or furniture, or any other “material” item, including money, is constantly exposed to **danger** of some kind. A person or animal might suddenly die or be injured in an accident. A piece of equipment or furniture might be broken, damaged or destroyed by fire or by water. Money, stocks of goods or other valuable items might be lost or stolen.

The very large number of dangers which can do harm to humans, to animals and to non-living things - and which can result in **‘losses’** - are called **‘risks’**. Insurance is concerned with **risk**, and its **primary purpose** is to eliminate or to *reduce* the harmful **‘effects of risk’**, or the **‘fears’** which arise from the *existence of risk*.

In every kind of society, most people and most organizations need some sort of **protection** - or **‘cover’** - against losses or the harmful effects or consequences of losses. There might be exceptions, such as devoutly religious people who take vows of poverty and chastity, and who as a result have no property and no dependants. But all other people and all organizations have possessions or potential losses and liabilities which need to be protected.

Contracts of insurance, which we consider in Module 1, are only one way in which people can guard against misfortune. Some tribal societies, for instance, developed systems of **‘mutual’** aid or help to their respective “members”. If one member suffered a setback - such as the loss of a hut by fire or the loss of cattle - the other members would act together to repair the damage, restore or rebuild the hut, or to search for or even replace the lost animals. Such mutual aid does not work well unless all members of a community are exposed to roughly the same risks, and will be unfair if some members have the potential for greater and more frequent losses than do other members. The need will then arise for a more equitable or fairer system, such as is provided by insurance.

Insurance developed in the distant past when societies found themselves unable to support trading and manufacturing activities which involved risks of significantly increased size and/or frequency of losses. Just as the ancient civilizations of the past: the Sumerians, Egyptians, Greeks, Romans, Chinese and others, could not gain empires and “greatness” without what we would recognise as bankers and banking services, so too did they need what we would today recognise as insurers and insurance cover. For example, what we today call “marine insurance” was developed some 3,000 years ago by a race of people called the Phoenicians, who were great seafaring traders, around the Mediterranean Sea in particular.

Many other types of property insurance date back to the *“Industrial Revolution”* in Britain, with its growth of manufacturing enterprises using comparatively expensive buildings and machinery and employing mass-production techniques. For example, private property insurance (initially to protect against damage by fire) did not appear in England until after the *“Great Fire of London”* in 1666 AD, which destroyed a large number of buildings.

The “roots” of modern-day insurance principles and practice extend back over thousands of years. They have been developed, modified, codified and honed over many years, both in the light of experience and also to meet prevailing circumstances from time to time in different countries or regions of the world. Some countries have developed their own principles and practice of insurance independently, without “outside” influences. In other countries the principles and practice of insurance reflect past influences from other countries, although those might have subsequently been modified in the light of national needs or circumstances.

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But the world of the 21st Century is “shrinking”; international trade and “globalization” are the order of the day. More and more the need arises to “standardise” insurance practice, if not even some long-held principles, between different countries. Similarly, computerisation, rapid communications, the Internet, and new marketing methods have enormous impact on insurance practice in many countries.

It must also be borne in mind that new Statutes or Laws are enacted by the parliaments or other legislatures of various countries from time to time, whilst older Statutes are amended or abolished. Rules and regulations relating to insurance business in different countries also change over time.

In no way can insurance in practice be seen as being “static”; it is constantly adapting and evolving to meet changing circumstances and customer demands. And it is customers who **pay** for insurance cover, so their attitudes towards and requirements from insurance are very important.

It is therefore essential that any insurance practitioner:

\* Adapts as necessary what is taught in this Program to the conditions prevailing in his or her country from time to time.

and

\* Keeps constantly abreast of any changes which occur from time to time which might affect insurance practice in his or her country.

Of necessity, the major Case References and Case Studies and Acts of Parliament mentioned in these Manuals, on which many of the recognised principles of insurance are based - are from British - and frequently English - Law, or are as extended by European Community (EC) Directives. Similarly, for the reasons already explained, there might be small or significant differences between insurance practice as described in these Manuals between different countries.

Some of the “precedents” which still hold good today were set in Legal Cases and Acts of Parliament as long ago as 200 years; and the language (English) in which they were written appears to us today to be very old-fashioned. In the interests of accuracy, we have reproduced sections of judgements and Acts as they were written at the time, and have explained in modern-day English any difficult to understand wording.

Many principles or maxims used in insurance were originally set down in a language called Latin; when we have quoted them (and many are still used in Latin to this day, although the language is not widely spoken) we have translated them for you into English.

Finally, do not hesitate to refer to the **Glossary at the end of Manual One** when necessary; that special Alphabetical Section is designed as a “quick reference check” to help your further understanding of many: “technical” words and terms used in insurance; words and terms which have “specialised” meanings when used in insurance; words and terms whose meanings in insurance differ from their “everyday” meanings; which are introduced and explained in the twelve Modules comprising this Program.

# **RISK AND THE NATURE AND PURPOSE OF INSURANCE**

## **Introduction**

Every human being, every business or other organization, every nation, and every item (whether living or not) on which a **'monetary value' can be placed**, is "exposed to" or "faces" dangers, which we collectively refer to as **'risks'**. Amongst very many, risks which might be faced include:-

- \* The **risk** of a person being injured in or by a motor vehicle, aeroplane, railway train, ship or boat.
- \* The **risk** of the premises of a business or any of its "contents" (money, furniture, machines, equipment, stocks of materials or goods for sale) being damaged or destroyed by fire or water.
- \* The **risk** of farm or domestic animals falling sick, being injured or killed or stolen.
- \* The **risk** of money, machines, equipment, motor vehicles, stocks of raw materials or goods for sale, or some other valuable item(s) being stolen.
- \* The **risk** of injury to a person due to an accident in the work-place. That person might be an employee, a customer, or some other person permitted access to the premises or other area, or even a person who was not authorised to enter a work-place, such as a building site.
- \* The **risk** of ill health necessitating medical expenses, the loss of life or limb, the loss of a family's "bread winner".
- \* The **risk** of "malicious" damage to property due to vandalism or for some other reason.

## **Losses from Risks becoming 'Reality'**

The variety of possible risks is very wide indeed. However, as you can see from the examples we have given above, they all have one feature in common. If a risk becomes **'reality'**, that is, a harmful incident actually occurs, something on which a monetary value can be placed is **lost** which it is not intended should be lost. That which is lost might be money or other property, life, limb or health.

In insurance that which is lost is called a **'loss'** - plural **'losses'**. Those words used in an insurance context differ from when they are used in a normal business context, in which a "loss" is the opposite of a "profit", and is made when the total expenditure (payments) of a business exceeds the total income (receipts) generated by its commercial activities. An insurance "organization" (business, company or corporation) can, as we discuss in Module 10, also make a "business loss" for various reasons, but here we are concerned with losses arising from harmful happenings - risks.

## **Common Features of Risks**

Because there are so many different risks which might be faced - and we have already described a wide variety of risks - what exactly constitutes a **'risk'** is not easy to define; and for that reason there is no one universally accepted definition. However, we shall base our study in this Program on this definition:

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***'Risk is the inability to accurately predict the effects of future events which might result in losses.'***

Despite the great diversity of risks - some of which we have already described - apart from the inevitability of a loss if an undesirable event occurs, we can identify certain other common features:

- \* There is the **possibility** - not a certainty - of an undesirable event occurring.
- \* There is **unpredictability**; that is, it is not known when the undesirable event will occur, or indeed whether it will occur at all.
- \* There is **uncertainty** as to or the extent (or value) of the loss which will arise should the undesirable event actually occur.

We consider these features of risks further later in this Module. We also consider how different people have differing attitudes towards risks, and why some risks which could be insured against are not insured.

## **Increased Risks**

Not all people or organizations or animals or items are necessarily exposed to the same risks. Furthermore, some people or organizations or animals or items might be exposed to **greater risk** than are others. To put it another way, in their particular cases, the chances of risks becoming '**reality**' are greater.

For example, a racing driver clearly faces greater risk of being seriously injured in a motoring accident than does the average motorist. Similarly, a business selling paints and other inflammable materials faces greater risk of fire than do businesses selling, say, machines or metal filing cabinets. Cash is more "exposed" to risk by theft - because it is so much more portable (easily carried) and is "negotiable" or easy to exchange - than is, say, a large and heavy piece of machinery.

Fortunately, **not** every person or business actually has to face the *consequences of the risks* to which they are exposed. For example, most businesses '**insure**' their business premises and stocks of goods, etc, against the losses which they would incur if the premises or stocks were destroyed by fire. However, relatively few businesses do actually experience such a disaster. The problem is that it is **impossible to state in advance** which businesses will be caused financial loss by fire - and which will not suffer loss from that particular risk.

## **Insurers**

If we stay with the example of the risk of fire, we can explain very simply for you at this early stage, that organizations (which we shall refer to as '**insurers**' or '**underwriters**') offering insurance cover against fire:-

- \* Collect sums of money - called '**premiums**' - from those businesses which (and people who) require protection against the consequences of fire.
- \* They '**pool**' the premiums they collect to create a '**fund**'.
- \* Out of the monies in a fund, they '**compensate**' or '**reimburse**' - that is, "make good" the losses of - those businesses which (or people who) DO experience the disaster of fire.

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The above - simplified - example illustrates to you that insurance **spreads the risk** over as large a body of people and/or organizations *as it is possible to obtain*. In that way, the premium paid by any one **'insured party'** - often called an **'insured'** or a **'policyholder'** - is relatively small compared to the financial loss which that "party" might suffer in the event of the risk becoming **'reality'**, that is, loss actually occurring. (Certain factors might make insurers vary the amount of the premiums which some insured parties must pay; the reasons for this variation are discussed in Module 6.)

In order to achieve their aims adequately, insurers make use of a mathematical principle called the **'law of average'** or the **'law of large numbers'**. Under this mathematical principle, if a sufficiently large number of cases is considered, the more likely will the result be equal to the **average** of all possible cases. All insurers must maintain accurate statistics and study them, so that the premiums charged (the "selling price") can be just that little ahead of the amounts paid to policyholders who do incur loss, plus selling expenses (the "cost price") so that a reasonable overall gain - or "profit" - is made by an insurance organization.

Computers greatly assist the compilation and maintenance and analysis of statistics in all classes of insurance, because they can store vast quantities of data, can rapidly sort and retrieve it, they are accurate and, what is most important, they produce results and "reports" literally at the *"touch of a key"*. Accurate risk assessment is therefore that much quicker and more complete today than ever before.

Nevertheless, even in its most modern form, insurance really involves:

- (1) Gathering together into a "group" many people and/or organizations who are exposed to the **same risk**.
- (2) Collecting a prearranged sum of money - a **premium** - from each of them, thereby creating a **fund**.
- (3) Using monies in the fund to **compensate** or reimburse those in the group who meet with the misfortune insured against. This process is called paying or settling **'claims'** because policyholders who suffer loss must **'claim'** the amounts due to them from the insurers.

Contemporary insurance not only "shares" the values of losses amongst groups of individuals and organizations, it also spreads them over **'time'**. This is possible because in years when the total value of losses are lighter than expected, insurers can build up **'reserves'** out of the funds created from premiums collected, and also "earnings" from interest on their investments. Those reserves can be used later in years in which the value of outgoings to compensate for losses is as great as or greater than income received.

All these various matters and the words and terms used will be explored, considered and explained further in the Modules in this Program; remember to refer to the Glossary for the meanings of words or terms with which you are not familiar, or whose meaning (in insurance) is not entirely clear to you. In this Module we look further at risk.

## **The Nature of Risk**

Risk or danger is present whenever human beings are unable to control or foresee the future with certainty. For example, the risks to a homeowner arise because neither he nor she - nor anyone else - can know for certain whether or not his or her particular house will be flooded, burned down, struck by lightning, burgled or vandalised. No matter how "safety conscious" the owner might be, the house cannot be completely protected from all those risks. In the same way, there is risk in running a business, because no business person can guarantee that he or she will make profits rather than lose

money from the activities of the business.

Although no-one can foresee the future, it can to some extent be measured. For example, if we “toss a coin” we don’t know what will happen; whether it will land on its “head” or its “tail”, but we can make a very good guess as to which it will be. In this case we have an equal chance: 50 percent or 50% or “50-50”, of the result being either a “head” or a “tail”.

In relation to insurance, we use the term ‘**risk**’ when:

\* Although the precise future outcome is unknown, the possible alternatives can be listed; such as “heads” or “tails”.

and

\* The chances associated with those possible alternatives are also known; such as a 50% (50 percent) chance of either “heads” or “tails”.

The term ‘**uncertainty**’ is used in insurance when future alternatives and chances are **not** known, such as in ‘**speculative ventures**’. Examples include the outcome of medical or space research or the impact and possible sales volumes of new inventions or technological advances.

## Types of Risk

There are several different ways of looking at risk, and different kinds of risks can be categorised by considering their **effects**.

### Fundamental Risks

These tend to affect large numbers of people, perhaps areas of countries, or whole countries, or even a number of countries or a geographical region. Their affects are either on the community in general or on groups of people, and they **cannot be controlled** - even partially - by any one person. Such a risk is present in the “forces of nature”; the weather, for example, cannot be controlled or influenced by individual action. Incidences of volcanic eruption, tidal waves and tsunami, floods, earthquakes, and similar “natural” phenomena cannot be controlled, and the extent of damage or devastation which they might - or might not - cause, cannot be predicted.

Another example of fundamental risk is the economy of a country. That is because the **effects** of, say, “inflation” (increases in costs, prices, etc - see Module 8) or mass unemployment, are beyond the influence of individuals.

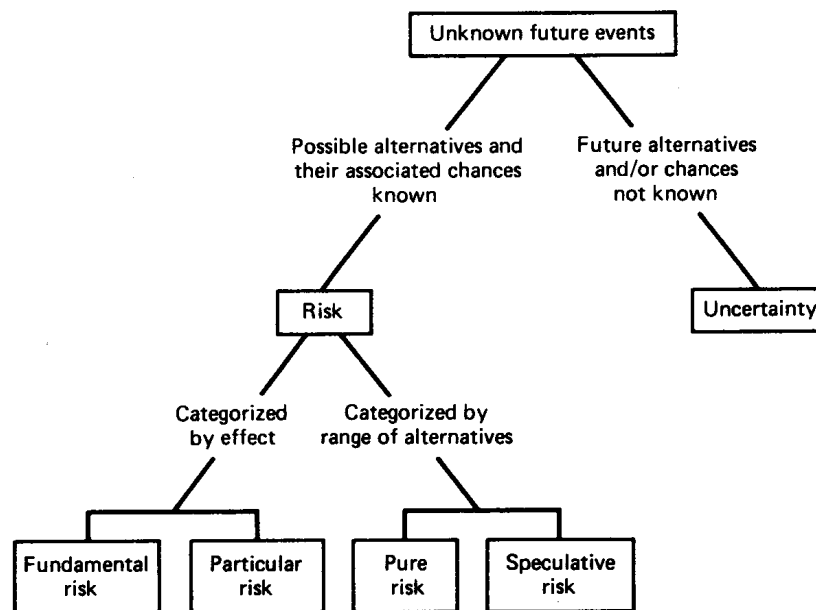
In many countries today fundamental risks are regarded as being the domain of society and government, and the State undertakes to deal with the consequences of events such as unemployment, retirement, or riot. Such risks as war, earthquakes, famines, etc, are generally dealt with by the governments of the country or countries concerned, or by international organizations.

### Particular Risks

In contrast, these refer to risks whose future outcomes or effects **can be partially controlled** (although not predictably) by individuals or groups of people . They arise, for example, from an individual’s decision to drive a motor vehicle, or to own property, or even to cross a road. Much depends on the individual’s action and level of care (or lack of care and attention). Because particular risks are the responsibility of individuals, each person must live with their consequences, although in many cases the effects can be alleviated by insurance; we say that such risks are ‘**insurable**’.

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**Fig.1/1.** types of risk



## Pure Risks and Speculative Risks

Not all risks to which people or organizations or items are exposed are insurable, or are insured. The majority of insurable risks are what are called '**pure risks**' which include fire, accidents, theft, etc, which offer no prospect of gain, but only of loss if the risk becomes a reality. If it does not, then there is no change to the situation - what is called the "*status quo*" is maintained.

Such risks as trading risks are called '**speculative risks**' because they offer the possibility of loss or gain, and in general they are not insurable. Indeed, some business ventures positively encourage uncertainty.

The distinction between the two categories - pure and speculative - depends on whether the "unknown" future holds out prospects of both good and bad, or only the possibility of damage or hurt. In other words, we consider the outcomes or **effects** of risks as follows:-

♦ *Speculative risk* is present if **either** beneficial or adverse outcomes could arise from a specific event.

♦ If possible harm is the **only** alternative to the present "*status quo*", the situation is one of *pure risk*.

. For example, the possibilities of damage by fire or of accidental injury are pure risks, because the property-owner or the injured person concerned must **not gain** from such calamities (a principle of insurance which we discuss in detail in Module 3.) In contrast, the outcome of a business venture might be either profit or loss and, therefore, that is an example of speculative risk.

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## Risk and Insurance

Buying insurance - or taking out '**insurance cover**' as it is called - is one method of *controlling the financial aspects* of the unknown future. A person who takes out an insurance policy exchanges:

✱ A situation of *risk* - where different financial outcomes are **possible**.

for

✱ A situation of **financial certainty**, that is, with only one definite financial result.

That is because the insurers guarantee the insured, subject to certain provisos, that his or her financial position will **not** be affected by the occurrence or non-occurrence - as the case may be - of certain specified events. In effect, the risk is **transferred** from the insured to the insurer.

For example, an uninsured person's house burns down. In the first place he will have lost an asset possibly worth a considerable sum of money. In the second place, even if he was sufficiently wealthy, he might have difficulty in raising the cash, at short notice, to pay for the rebuilding of the house - because he did not know **when** (or if) the fire would occur. But had he been insured against the loss of his house by fire, his insurers would have provided the money necessary to rebuild the house as *and when* the cash was required to do that.

In some respects the risks faced by insurers are the same as those faced by everybody else; insurers are unable to foresee the future any more clearly than can their clients. Insurers must therefore consider the possibility that the values of their policyholders' losses - resulting in claims being made - will exceed the total value of claims that they have anticipated.

The risk for an insurer is much less than that for an individual policyholder, however, because the insurer knows far more about possible losses through having collected together a group of similar "exposure units", and as well as through data collection, analysis, and experience.

Whilst insurance controls risk mainly by transferring the responsibility for paying for losses from one person or group to another, it might also affect the risk directly, by influencing the chance of a loss occurring. This might happen in two opposing ways:

- ✱ By insurers encouraging policyholders to take more care, and by offering advice on how to reduce risks and prevent losses, as well as by "rewarding" (for example with "*no claim-bonuses*" - see Module 6) those policyholders who do not make "claims" for compensation, or whose losses are negligible.
- ✱ By policyholders either deliberately causing losses in order to obtain money from insurers, or by being less careful because of the insurance protection; for example by having the attitude of "*don't worry, it's insured*". This behaviour is termed '**moral hazard**'.

Moral hazard arises when the existence of insurance cover changes the behaviour of the insured such that either the size of any loss or the chance that a loss will occur is increased.

The problem with moral hazard is that insurers cannot know whether or not the insured is affected by the existence of the insurance cover. Past '**claims history**' might give valuable insight to insurers and, say, an insured who requires excessively large sums of life cover, would probably be treated with some initial suspicion. We discuss moral hazard further in Module 4.

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The standard response to the potential existence of moral hazard is for insurers to require the insured himself to “carry” some of the potential loss, by imposing an ‘**excess**’ (which we explain more about in Module 6).

## **The Main Function of Insurance**

The main function of insurance is to **compensate the ‘insured’** (the person or organization who “effected” or “took out” and paid for the insurance) for loss or damage caused by the risk insured against.

In many cases the ‘**compensation**’ by the insurers takes the form of ‘**indemnity**’, which involves:

***‘Placing the insured in the same position financially as he or she or it was in immediately before the loss or damage took place.’***

The insured should be **no better and no worse** off than he or she or it was **before** the loss or damage occurred.

We consider indemnity more fully later in Module 3, but you should note at this stage that the ‘**indemnity**’ might take the form of one or more of the following:-

- ◆ A *payment of money* (equal to the value of the item lost or damaged).
- ◆ The *replacement* of the lost or damaged item.
- ◆ The *repair* of a damaged item.
- ◆ *Restoration*, for example, rebuilding a house destroyed by fire.

It is obvious that indemnity **cannot** apply to personal accident insurance or to life insurance, as a lost limb cannot be replaced (except perhaps partially by an artificial limb) any more than a dead husband or wife or child can be replaced. In such cases the insurance (or what is sometimes still called “*assurance*” in the case of life) seeks to **alleviate** (to reduce) the suffering or hardships caused by the injury or death.

For example, the insurance will provide for the payment of medical bills, special equipment (a wheelchair for example) required by an injured person, and possibly provide an “income” if the injured person is no longer capable of undertaking employment and earning a salary or wage for any length of time, or permanently.

In cases of death, the payment made will seek to **reduce hardship**. For example, the payment made to a wife on the death of her husband might be intended to ensure that she can still maintain a reasonable standard of living despite having lost the “wage earner” or “bread winner” of the family, and that any children will still be properly fed, housed, clothed and educated, etc.

It is important to remember that the function of insurance is to **compensate** or **reimburse** an insured for loss or damage; but **not** to allow the insured the opportunity of gaining more than the value of the loss or damage. That is, he must **not** “profit” from his insurance.

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## **How Insurance Differs from Wagers**

In view of our previous statement, we must make clear to you the essential - and important - difference between insurance and “wagering” or “betting”. Far too many members of the general public or “laymen”, who know little or nothing about insurance, think that there is no difference between insurance and wagering. You must understand from the outset that there **are** many - and very important - differences, which include:-

### **The Legal Position**

A properly executed insurance contract is **legally binding** on both or all the parties to it. This means that such insurance contracts can be enforced by Courts of Law if necessary. Wagers are **not** enforceable at law and, in fact, in some countries certain types of wagers are against the law (illegal).

We look further at insurance contracts later in this Module.

### **Insurable Interest**

This means that an insured **must suffer loss** if the item insured is lost or damaged; he cannot legally insure anything in which he has **no** insurable interest. This is **not** required in a wager.

Insurable interest is dealt with in greater detail in Module 2.

### **Utmost Good Faith**

Both or all parties to an insurance contract must exercise ‘**utmost good faith**’, which means that the insured must disclose **all** material facts about the item or risk to be insured to the insurers, whilst the insurers must disclose to the insured the full details and terms of the insurance to be provided. With a wager, there is **no** obligation on either party to disclose any information which might be possessed.

Utmost good faith is also dealt with in greater detail in Module 2.

### **Indemnity**

As we have already explained, many types of insurance cover are designed to compensate the insured for loss or damage sustained, but do **not** permit him to make a profit. In the case of a wager, the winner of it will almost certainly profit in one way or another!

Indemnity is considered in greater detail in Module 3.

### **Likelihood of the Event Occurring**

With the exception of many types of life insurance, insurance contracts are designed to protect against events that **might or might not** occur; that is, the events are “*possibilities*” and **not** “*certainties*”. On the other hand, wagers usually concern a definite future event, such as a horse race for example, which is bound to be won by one horse or another. Another example is a football match, in which one team or the other will win or lose, or both teams might “draw”.

There are other differences too between insurance and wagers, which will become clear to you as you proceed with the study of this Program. However, we have given you sufficient information and examples so far to show you that there **are** important differences.

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We shall be looking more closely at the matters outlined above in later Modules, particularly at **good faith, insurable interest** and **indemnity**, which are three of the main principles of insurance. We also consider the **precautions** taken by insurers to try to prevent those who take out insurance - called '**policyholders**' or '**insureds**', remember - from making profits, that is, gaining more than they should, from their insurance.

## **Uninsured Risks**

It is important for any person involved in insurance - as a buyer or as a seller or provider or intermediary - to know which risks can normally be insured against (are "insurable") and which cannot be, and why; and also why many risks which could be insured against are not insured. He or she also needs to learn what action can be taken to reduce the likelihood of risks becoming reality, or to reduce the possible effects of risks.

Some action is taken automatically by people, like locking the doors and windows of their homes at night and when they go out, like looking both ways before they cross a busy road, like putting out fires and switching off electrical appliances at night, like using seat belts in motor vehicles, and so on.

### **Risks Which Cannot be Insured**

Not all risks are insurable, that is, can be insured against. Let us look at the main reasons why risks might not be insurable, and at some examples which will make clear to you the various reasons, which might differ between different types - or "classes" - of insurance.

#### **★ No 'Monetary Value'**

Anything which does **not** have a '**monetary value**' - which cannot be quantified in terms of money (with the exception of life) cannot usually be insured.

*Example:* Photographs of dead relatives might have great "sentimental" value, but they have little or no monetary value, and so cannot usually be insured against loss or damage.

#### **★ Rare or Unusual Risks**

Most "rare" or unusual risks cannot be insured. This is because, as we explained earlier, insurance is based on the mathematical "*law of large numbers*", which requires risks to be "spread" or "shared" as widely as possible.

*Example:* If the fund from which compensation is to be paid was made up of contributions (premiums) from just a few people and/or organizations, the contribution from each would have to be very high; probably unacceptably high for the few concerned. That is because the risk is not being shared widely enough.

#### **★ Insufficient Statistical Information**

Another reason why a risk might not be insurable is that there is insufficient statistical information available to enable a reasonably accurate prediction of the extent of loss.

*Example:* Risks due to losses from changes in fashion or from competition or from new inventions or medical or technological advancements, cannot be insured because there is as yet no data on which their likely effects can be predicted.

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### ★ *Expected Losses*

Usually, risks from which losses are **expected** cannot be insured. From the view point of the insured, losses must be accidental or unintentional.

*Example:* It is unlikely that insurers would be prepared to effect “new” or additional insurance on the life of a person once it becomes known that he or she is suffering from an incurable disease. Losses from risks must be reasonably **unexpected**. (Note, however, that in these circumstances, any insurance taken out on that person’s life **prior to** the illness or disease being diagnosed is likely to be unaffected.)

### ★ *Catastrophic Risks*

Many types of “catastrophic” risks cannot be insured against.

*Examples* include war, earthquake and volcanic eruption.

### ★ *Cover Might Cause Harm*

Some risks might be uninsurable in certain countries, because the “protection” afforded by the insurance cover might be harmful to the general public, or to sections of the community.

*Example:* If motorists could insure against the risks of being fined or otherwise punished for traffic offences, they might take less care to avoid committing those traffic offences, which could result in an increase in motor accidents, injury and death.

### *Tests of Insurability*

The answers to the following questions are often a useful guide as to whether or not a particular risk is insurable. If the answers to these questions are in the positive, it is likely that the risk is insurable:-

- ★ Is the occurrence of the event *uncertain*?
- ★ Would the only possible outcome of the event be *unwanted*?
- ★ Would the occurrence of the event be due to the *action of a person or people*?
- ★ Would the occurrence of the event result in a *measurable financial loss*?
- ★ Is there a *legal relationship* between the proposer and the potential financial loss? (See Module 2 on “Insurable Interest”.)
- ★ Does the event occur in *sufficient numbers* for an accurate premium to be calculated, using the “law of large numbers”?
- ★ Would the event be *legal* and concur with *public policy*? Insurers must not cover risks which are of a criminal nature, such as arson (deliberate fire razing) or deliberate damage to a person’s or a business’ own property.

It is emphasised that the answers to the “test questions” should be looked upon as a “guide”. The insurance market continues to develop to keep pace with requirements in the modern world, and the boundaries of insurability do not, and cannot, remain constant.

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## **Why Some Risks are Not Insured**

Now let us consider why some risks which could be insured against are not, in fact, insured against by some people or organizations.

### ★ **Lack of Awareness**

People might be unaware of some risks which they face.

*Example:* A trader might be unaware that he is '**liable**' (responsible) for injury sustained by customers or employees whilst they are on the premises of his business; for instance, they might slip on a wet floor or trip over something and might be hurt. He might not realise that legally he or his business will be liable to pay any medical and other bills incurred as the result of the injury unless he has insured against the risk.

### ★ **Likely Loss Small**

If the extent of a loss is likely to be very small, people might not find it worthwhile or cost-effective to insure items of little value against loss by fire or theft. Insurance covering, say, "household contents" might cover a wide range of "personal" items, clothing, furniture, domestic machines, etc, on an "inclusive" basis, so that individual items - often of relatively minor value - do not have to be itemised. (Any items of particular value, for instance a computer or a digital camera, might have to be declared separately; see Module 8.) Statistics indicate that on average only about a third of people actually insure their "household contents".

### ★ **Enjoyment of Risks**

There are some people who enjoy and relish "taking" - or exposing themselves to - risks. Such people might not take out insurance or, indeed, be able to obtain cover, for their "dangerous" sports or pastimes.

*Examples:* Racing drivers, mountain climbers, parachutists, etc.

### ★ **Cost**

Some people might not be able to afford to pay the premiums necessary to insure against certain risks to which they are exposed. People take out insurance because they are "averse to" or wish to avoid taking risk; they are said to be '**risk-averse**'. A house-owner will buy home insurance because, in effect, he prefers the certain "loss" or payment of the premium, as against the risk of either losing nothing or losing all or part of the value of his property.

However, people's dislike of risk has to be "balanced" against the price they are prepared to pay to "remove" it or to "transfer" it to insurers.

*Example:* House-owner A might pay the premium required to insure his house against fire. House-owner B next-door might refuse to pay the same or similar sum of premium required for fire insurance on his similar property. That does not necessarily mean that B prefers risk; it might simply be that he feels the "asking" premium is too high a price to pay for certainty. He might well buy insurance if it costs less: this simply means that he dislikes risk less than A does; that is, that he is less risk-averse than is A.

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## ★ *Lack of Understanding*

There are some people who do not realise the value or the benefits of insurance. Some other people do not bother to insure on the basis that “*it will never happen to me!*”. Yet others honestly believe - wrongly - that it is “unlucky” or “tempting fate” to take out life insurance, in particular.

## *Risk Control*

One of the “secondary functions” of insurance is to advise people and organizations on ways and means of reducing the likelihood of risks becoming reality, and of reducing the effects of risks. In other words, encouraging the development and use of appropriate and cost-effective means of “risk control”.

There are many ways in which this can be done, depending on the particular risk. An example is if insurers advise a ‘**proposer**’ - a person or organization wishing to take out insurance - or an existing policyholder, that suitable fire extinguishers should be located in strategic positions in business or other premises. Another example is the advice to motorists to wear seat belts.

In some cases, when the advice of insurers is heeded, reductions in premiums might be offered. On the other hand, when steps are **not** taken by proposers or policyholders to reduce risks, higher than usual premiums might be asked for. We deal with these matters in greater depth in Module 6.

Insurers frequently arrange for inspections and/or surveys of premises, complexes or compounds, and/or machinery or plant housed in them, on which insurance is ‘**proposed**’, that is, required. Furthermore, their specially trained staff often make recommendations for increasing safety, etc.

A major consideration in risk control is that the action taken by the insured should not cost more than the value of the potential loss should the insured event occur. For example, there is no benefit to an insured who spends, say, 30,000 units (of currency) on fire precautions, such as fire extinguishers, sprinkler system, etc, to protect a storehouse which never holds goods valued at more than 30,000 units. Similarly, the best way to prevent losses from pilfering - or “shoplifting” - would be to stop potential customers entering the premises; but that would be very costly for “high street” shops and stores.

The main ways of exercising risk control can be summarised as follows:-

- ★ **Risk avoidance**, which involves ceasing the activity causing the risk, or finding a way to “remove” the ‘**peril**’ - the sources or causes of the risk (see Module 4).
- ★ **Risk reduction**, which involves reducing the frequency and/or sizes of losses through one or more of:-
  - ❖ Education and training, such as holding regular “fire drills” for employees, or ensuring adequate training of drivers, forklift operators, and so on.
  - ❖ Environmental changes, such as improving “physical” conditions, e.g. better locks on doors, bars or shutters on windows, installing burglar or fire alarms.
  - ❖ Changes to dangerous or hazardous operations in using machinery and equipment and in the performance of other tasks.
- ★ **Risk retention**, which involves paying for any losses as they occur.

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\* **Risk transfer**, which involves transferring the responsibility for losses to another party. Insurance is one of the major forms of risk transfer, and it permits uncertainty to be replaced by certainty.

## Other 'Subsidiary Benefits' of Insurance

What are often referred to as being 'subsidiary' or 'secondary' benefits arising from the availability of insurance include the following:-

### \* **Reducing Fear of the Future**

We can say that insurance contributes to '**peace of mind**'. For example, life insurance provides a measure of relief to a husband or father in that he knows that in the event of his death, his wife and/or family will be provided for. Without such comfort provided by life insurance, many people might be "haunted" by what might happen to their wives and/or children in the event of their untimely death. Although this benefit of insurance is "intangible" and cannot actually be seen or felt, it is nevertheless very **real**.

The same applies to many other risks insured by individuals, and examples include fire, burglary, motor accidents, etc.

### \* **Encouraging Confidence to Undertake New Ventures**

Many businesses would not be started, and much research and development (R & D) would not be embarked upon, unless the people concerned had confidence in the protection against losses from risks provided by insurance. Of course, insurance cannot provide for losses arising from poor management, competition, etc, but people would hardly risk time and money in new ventures unless they had the protection provided by insurance against risks of losses by fire, water damage, theft, accidents, injury, etc.

The alternative to insurance would be to maintain large "reserves" of money to meet any large losses which might (or might not) occur. Another secondary function of insurance is therefore "releasing" money which would otherwise be "tied up" in reserves; such money can instead be put to more practical use in the purchase of machinery, or raw materials, or in modernisation, research and development, etc.

### \* **Assisting People to Save**

Certain types of life insurance - whilst insuring against the risk of death - also assist people to save for the future. Such '**endowment insurance**' (which is dealt with in Module 9) provides for the payment of a sum of money if the person whose life is insured survives to a certain age agreed in advance, whilst still providing payment to his dependants if he dies before reaching that agreed age.

This can be very useful for people who find it difficult to save money by other methods: with banks or building societies, for example.

### \* **Investment**

Insurance organizations build up large "reserves" in funds created from premiums paid by those for whom they provide insurance cover. A proportion of those reserves is invested by insurance organizations with government or in private enterprises, often assisting greatly in the economic development of a country.

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## \* **Reducing Demands on Social Services**

An “indirect” benefit of insurance to society is the way in which it reduces “demands” on the social services provided by a country. A good example of this is the large amounts of money paid as compensation by insurers to victims of motor accidents. Very few motorists would themselves be able to pay compensation to victims for injury or death caused as the result of their negligent driving, and if it was not for insurance, heavy demands would be made on governments to compensate or to assist road traffic accident victims. In fact it is for this very reason that certain motor insurance is **‘compulsory’**, that is, it **must** be paid for by every motorist in most countries.

In many countries, **‘private health insurance’** is taken out by both individuals and by organizations on behalf of some or all of their employees. Such insurance not only provides for the payment of medical bills arising from ill health and injury, but it also substantially **reduces** the “demands” made on often overworked “national health or social services” provided by government (and funded by tax payers).

## **Insurance and the Law**

At this time we shall give you only a brief “introduction” to matters which we deal with more fully at a later stage in the Program. To do so we shall use an example of a very common “practical” situation.

Let us assume that Mr & Mrs Wise have bought a house and have sensibly decided that they need to insure it against loss by fire. They contact an **‘insurance broker’** (whose range of duties we discuss in Module 10) who after taking note of all the necessary particulars - of the house-owners and of their property - recommends appropriate insurance organizations which were asked to quote their premiums for the cover required. Having accepted one of the quotations - which constitutes an “offer” - they buy what may be called a **‘householder’s policy’** or a **‘home insurance policy’** from the insurer chosen, and jointly become the policyholder.

At a later date their house was damaged by fire. They submitted a **‘claim’** to the insurers for compensation for their financial loss which had arisen as the result of the damage caused by the risk insured against, which in this example is fire. The insurers paid the value of the claim for compensation.

“The Law” appears in this simple example in several different ways:-

- \* Firstly, Mr & Mrs Wise contacted an insurance broker to arrange their insurance. In doing that, they formed a “*legal relationship*” with the broker, who in turn formed a “*legal relationship*” with the insurer selected. The law governing such relationships is known as the **‘law of agency’** and is discussed in a later Module.
- \* Mr & Mrs Wise then formed an agreement with an insurer. That agreement was governed by the normal **‘laws of contract’**. But special additional rules applied, because the contract was one of insurance, and we explain these matters in the next Section.
- \* Before paying the claim made - or “submitted” - by Mr & Mrs Wise for fire damage, the insurer had to decide whether the **cause** of the fire was covered by their policy. The decision reached was governed by the **‘doctrine of proximate cause’**, which we discuss in Module 4.
- \* All the foregoing events took place within the laws enacted by the government of the country concerned to ensure that both the broker and the insurer conduct their business properly, fairly and ethically.

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At a later stage we examine the law governing agreements between the “sellers” and “buyers” of insurance. Here we first look at the **‘law of contract’** which governs **all** agreements between buyers and sellers. Then we examine the **special** rules applying to insurance contracts.

## Contracts

For a risk to be insured, the person or organization wishing to take out the insurance - the “proposer” - must enter into a **‘contract’** with an insurance organization. A contract is:

***‘A legally binding agreement between two or more parties.’***

In this context a **‘party’** refers to one of the “participants”, that is, one of the people or organizations making the agreement. There might be only two parties to a contract, or there might be three or more.

Provided that a contract meets with certain **basic essentials** - which we describe below - the failure of one “party” to fulfil or honour the obligations of that party under the contract, enables the other party or parties to seek enforcement - or **‘redress’** - through the Courts of Law and/or to institute action for **‘damages’**, which term means:

***‘The financial reparation or compensation due for loss or injury or harm sustained by one ‘party’ (person or organization) through the fault or negligence of another ‘party’ (person or organization).’***

Not all “agreements” made between people and/or organizations are legal contracts. For example, a person might agree to lend a friend his motor vehicle, on condition that the friend replaces the fuel (petrol or gasoline or diesel) he uses. If the friend fails to replace the fuel, the owner of the vehicle has no “legal redress”.

Let us return to Mr & Mrs Wise. They had looked through the “houses for sale” columns in their local newspaper and found one which they liked. They made an **‘offer’** of a “certain sum” (of money) to the owner of the house to buy it from him, with the curtains and carpets included in the price. The owner agreed to the “deal” and the sale was duly completed.

Before the Wise’s purchase of the house could go ahead, it was important that they and the present owner agreed the **‘terms’** of the offer. In this context, “terms” are those facts or conditions contained in the contract - in this case the agreed price, and the inclusion of curtains and carpets. Clearly, a contract cannot be completed if the parties **disagree** over the terms. In some cases the parties might “negotiate” - to discuss or correspond - about the terms before agreement is reached between them.

The eventual agreement might be in the way of a “compromise” between the two “parties”. For example, the “asking price” of the house might have been 70,000 units (of money) for the “empty” house. The Wises might have offered to pay 65,000 units for the house, including the curtains and carpets. The eventual “compromise” between the seller and buyer - on which the agreement was based - might have been, say, 68,000 units including the curtains and carpets.

In contracts of insurance, the insurer and insured must agree “details” such as the premium (in effect the “price” to be paid); the extent and nature of the cover to be provided; the period of the cover, and so on. These “terms” are usually set out or “embodied” by the insurer in a document called the **‘policy’**, which we discuss in detail in Module 5.

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## Essentials of a 'Genuine' Simple Contract

There are six essentials for a genuine "simple" contract:-

1. The **intention** that the agreement is **legally binding** must be present. In our example of the friends and the motor vehicle, there was no intention or understanding that their agreement would be legally binding in that the borrower **had** to replace the fuel, or else be "taken to Court".
2. An **unrevoked offer** must be made, either in writing or orally. An "offer" is a communication of the contract terms. "Unrevoked" means that it is **not** withdrawn. For example if Mr & Mrs Wise had "second thoughts" about buying the house, and had withdrawn or cancelled the offer they had earlier made, their offer will have been **revoked**.
3. The offer must be **accepted in precisely the terms submitted** - which is called an "*unqualified acceptance*" - either in writing or orally. In this case "acceptance" means an agreement of the terms of the offer.

As soon as these three essentials have been satisfied, the parties are said to be "*of one mind*", and this is the fundamental requirement of any agreement if it is to be **enforceable legally**.

4. A '**consideration**' is required from both parties. A "consideration" refers to the gain or benefit received by one party in return for a promise or the performance of an act of another party. In insurance, the insured's "consideration" is the premium which is paid to the insurer, whilst the consideration from the insurer to the insured is the undertaking to compensate or to make payments to the insured on the occurrence of a certain event or events within a specified period.
5. The contract must be **legal**, *according to the laws of the country in which it is made*. A contract must not be *illegal*, that is, it will be invalid if it is forbidden by statute or is against public policy. Examples of illegal contracts include contracts which impede justice; contracts with an enemy of the State; contracts to commit a crime (such as tax evasion); contracts which involve sexual immorality.
6. Both or all parties must have the legal '**capacity**' to make the agreement. Minors (under, say, 18 or 21 years of age, depending on the Law of the country concerned), drunkards, drug addicts, and insane people may not have this legal capacity, and contracts made by them might be "set aside" by the Courts.

## Insurance Contracts

Simple contracts do not need to be "in writing" (which term includes typing and printing, for example by computer output) but it is very rare for an insurance contract not to be in writing. What are called "speciality" contracts are comparatively rare in insurance, and we shall not consider them at this stage.

You should learn by heart this definition:-

A contract of insurance is one:

***'Whereby one person, called the insurer, undertakes, in return for the agreed consideration, called the premium, to pay to another person, called the insured, a sum of money or its equivalent on the happening of a specified event.'***

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A contract of insurance is usually “embodied” or set down in a written (typed or printed) document known as a ‘**policy form**’ or simply a ‘**policy**’. However, it is important for you to note that the policy itself is **not** the contract; it is merely **evidence** of the contract, that is, it is **written proof** that the contract has been made. The contract is actually the “invisible” agreement between the parties to that contract.

A good definition of an insurance policy is:

***‘A written or printed document formally setting out particulars of the concluded contract which has been made between the insured and the insurers.’***

We return to the consideration of contracts and insurance policies in Module 5.

## **SELF-ASSESSMENT TEST ONE**

Recommended Answers to these Questions - against which you may compare your answers - will be found on page 28. The maximum mark which may be awarded for each Question appears in brackets at the end of the Question. Do **NOT** send your answers to these Questions to the College for examination.

**No.1.** What is the main function of insurance? Describe briefly the “secondary” benefits which individuals, organizations or the community as a whole gain from insurance.  
(maximum 30 marks)

**No.2.** Describe in your own words what you consider to be the difference between insurance and a wager or bet.  
(maximum 30 marks)

**No.3.** Describe the differences between (a) fundamental risk and particular risk; (b) pure risk and speculative risk.  
(maximum 30 marks)

**No.4.** Place a tick in the box  against the **one correct** statement in each set.

(a) *An insurance organization collects premiums in a “fund”:*

1  to ensure that the maximum profits will be made by their endeavours.

2  so that a policyholder will be able to profit from his or her loss.

3  to reduce the chances of risks becoming reality.

4  so there will be sufficient money to compensate or to reimburse insureds who experience an insured disaster.

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- (b) *In insurance, the term “uncertainty” is used when:*
- 1  a person cannot decide whether or not to insure a particular risk.
  - 2  the insurers have not been able to calculate the premium to charge.
  - 3  future alternatives and chances are not known.
  - 4  any loss will be unintentional or accidental.
- (c) *The two parties to an insurance contract are “of one mind” when:*
- 1  all six essentials for a genuine simple contract have been met.
  - 2  they agree that it is legal according to the country in which it is made.
  - 3  they intend the contract will be legally binding, an unrevoked offer has been made and has been accepted without qualification.
  - 4  a consideration, in the form of a premium, has been paid.
- (d) *Insurers will not normally offer to insure a risk if:*
- 1  a person cannot afford to pay the premiums required.
  - 2  the loss to be insured is expected.
  - 3  a large number of policyholders is already exposed to that risk.
  - 4  to do so encourages too many people to embark on new ventures.
- (e) *“Utmost good faith” in insurance means that:*
- 1  an insured will trust the insurers implicitly to compensate him in the event of a loss occurring.
  - 2  both parties have agreed that a contract will be legally binding.
  - 3  the insurers trust the policyholder to pay the required premium at some time after the insurance cover commences.
  - 4  the insured must disclose to the insurers all facts about the risk to be insured, and the insurers must disclose to the insured full details and terms of the cover to be provided.

(2 marks for a statement correctly ticked - maximum 10 marks)

## RECOMMENDED ANSWERS TO SELF-ASSESSMENT TEST ONE

**No.1.** The main function of insurance is to eliminate or to reduce the effects of risk, or the fears which arise from the existence of risk. One of the secondary benefits gained from insurance is the advice given by insurers to people and organizations on ways in which they can reduce the likelihood of risks becoming reality, and also reduce the effects of risks. Another benefit is the “peace of mind” given by the existence of insurance cover; for instance, a husband or father knows that in the event of his untimely death, his wife and/or family will be provided for from the proceeds of his life insurance. Also, endowment insurance helps people to save for the future.

Instead of businesses having to keep money “tied up” in reserves against contingencies, the insurance cover they take out in effect “releases” money for those businesses to use in the purchase of machinery, or raw materials, or in modernisation, in research and development, and so on. Insurance organizations invest heavily in government and/or in private enterprises, which assists in the economic development of a country. Furthermore, insurance benefits the country as a whole by reducing demands on its social services, and national health service.

**No.2.**(a) Wagers are not enforceable at law and in some countries certain types of wagers are against the law, that is, are illegal. But a properly executed insurance contract is legally binding on both or all the parties to it, which means that insurance contracts can be enforced by the Courts.

(b) An insured must actually suffer loss if the item insured is lost or damaged, and he cannot legally insure anything in which he has no insurable interest, which is not the case with a wager.

(c) With a wager, there is no obligation on either party to disclose any information which might be possessed. But both or all parties to an insurance contract must exercise “utmost good faith”; a proposer must disclose all material facts about the item or risk to be insured to the insurers, whilst the insurers must disclose to the insured the full details and terms of the insurance to be provided.

(d) The winner of a wager will almost certainly make a profit, whereas many insurances are designed to compensate the insured for loss or damage, but do not permit him to make a profit.

(e) Whilst wagers usually relate to a definite future event, many insurance contracts are intended to protect against events which might or might not occur.

**No.3.** (a) Fundamental risks usually affect groups of people or the community in general, and they cannot be controlled even partially by any one person. Particular risks are those whose future outcomes or effects can be partially controlled, although not predictably, by individuals or groups of people.

(b) A speculative risk is one from which either beneficial or adverse outcomes could arise from a specific event. A pure risk is one from which the only alternative to the continuation of the “status quo” is possible harm.

**No.4.** The correct statement from each of the sets selected and ticked:

(a) 4 ✓ (b) 3 ✓ (c) 3 ✓ (d) 2 ✓ (e) 4 ✓

## WHAT YOU WILL LEARN IN MODULES 2 TO 12 OF THE PRINCIPLES & PRACTICE OF INSURANCE PROGRAM

### *Module 2 - Insurable Interest and Utmost Good Faith*

How insurance developed  
Classes of insurance business  
Categorisation by object or event  
Subject-matter:  
    what it may be in insurance  
    examples in the classes of insurance  
Insurable interest:  
    explanation and definition  
    the legal position  
    requirements for valid insurable interest  
    those who can have insurable interest  
    those with limited insurable interest  
    those who have no insurable interest  
    when insurable interest is necessary:  
        *the Life Assurance Act, 1774*  
    examples of insurable interest  
    insurable interest and life insurance:  
        insurable interests allowed in law  
    timing of insurable interest:  
        time of purchase  
        time of loss  
    assignment of insurable interest:  
        assignment of the proceeds of a policy  
        assignment of the policy itself  
    transfer and resale of life insurance  
    transfer and resale of non-life insurance:  
Utmost good faith:  
    what is involved  
    legal obligations  
    onus placed on the insurers and the proposer  
    material facts:  
        definition  
        legal rulings  
        facts which are material:  
            examples in classes of insurance  
        facts which need not be disclosed  
        timing of utmost good faith  
        facts which must be disclosed  
Void and voidable contracts:  
    nondisclosure  
    concealment  
    representations  
    fraudulent misrepresentation  
    innocent misrepresentation  
    warranties:  
        express warranties  
        implied warranties

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- declarations
- differences between representations and warranties
- contemporary thinking on disclosure:
  - unfair contract terms
  - statements of practice

### **Module 3 - Indemnity**

- The contract of indemnity:
  - the purpose of indemnity
- Forms of indemnity:
  - cash payments
  - replacement
  - repair
  - reinstatement
- Value at the time of loss
- Applications of the principal of indemnity:
  - variations between classes of insurance
  - total loss
  - partial loss:
    - examples
- Agreed value or valued policies
- Replacement or reinstatement policies
- Indemnity for partial losses:
  - difficulties in assessing value
  - betterment
  - large partial losses
  - cover after partial losses
  - modifications of indemnity:
    - contract conditions
  - underinsurance:
    - example
  - excess
- Subrogation:
  - definition and purpose
  - rights in damaged property:
    - practical example
  - effects of the doctrine of subrogation
  - subrogation in practice
  - timing of subrogation
  - two or more policies on the same subject-matter
  - intercompany agreements:
    - knock for knock
    - third party sharing
  - waiver of subrogation
- Contribution:
  - the same risk insured under two or more policies:
    - practical examples
  - the doctrine of contribution
  - conditions for the application of contribution:
    - differences between subrogation and contribution
    - the need for common interest
  - timing of contribution

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avoidance of contribution rights:  
non-contribution clause  
more specific clauses  
specific market agreements

#### **Module 4 - Proximate Cause, Physical and Moral Hazard**

Types of perils:

- insured perils
- excepted perils
- uninsured perils

Proximate cause:

- definition
- a "train" or "chain" of related causes, factors, or events
- concurrent causes
- non-concurrent unrelated causes
- meanings of:
  - proximate
  - remote

- practical examples
- general rules for applying proximate cause
- conditions for proximate cause
- application of proximate cause to claims
- consequential loss:
  - damage caused by thieves
  - damaged cause by fire-fighting
  - legal costs

Moral hazard:

- fraud
- carelessness
- circumstances
- steps to be taken to reduce bad moral hazard

Physical hazard:

- examples in different classes of business
- steps which can be taken to reduce bad physical hazard

#### **Module 5 - Proposal Forms and Policies**

Buyers and sellers of insurance:

- proposers and insurers

Methods of selling insurance

Stages in buying insurance

Proposal forms:

- the questionnaire
- their functions:
  - to obtain information
  - to make a legal offer
  - to elicit a quotation
  - to describe the cover available
- advertising/publicity
- to establish a warranty
- the declaration:
  - specimen

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layout and contents:

information required:

name, address, occupation, age  
insurance and claims history  
sum insured  
medical history

use of postal codes in claims analysis and statistics

When proposal forms are not used in different

classes of insurance

Offer and acceptance:

documents in which acceptance might be shown

The premium:

when premiums are paid  
deposits

Proof of insurance cover:

cover notes:

when and why they may be issued  
how they may be issued  
claims whilst they are valid

certificates of insurance:

when and why they may be issued  
how they differ from cover notes  
employers liability insurance certificates:  
information they contain  
motor insurance certificates:  
information they may contain  
green cards and bail bonds

Policies:

what they are  
their sections and what those contain:  
the preamble  
the operative clause  
exceptions and provisos  
the schedule  
the policy conditions  
the attestation clause

endorsements:

what they are  
why they are used

legal interpretation of policies:

meanings of the words  
typed or handwritten words  
benefits of reasonable doubt  
general and particular statements

## **Module 6 - Premiums, Renewals and Claims**

Underwriting:

underwriting factors  
average claims experience  
effects of underwriting factors  
proposer's characteristics  
premium versus claims value

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Premiums:

- rating the risk
- life insurance premiums:
  - why they can be rated accurately
- non-life insurance premiums:
  - bases of ratings

Reserves:

- why they need to be established and built up:
  - higher than anticipated losses
  - unearned income
  - unpaid claims
- one class of business must not subsidise another

Renewals:

- meaning and process
- no obligation to renew, or on the same terms
- considerations of the insured
- considerations of the insurers
- utmost good faith
- reasons why terms may be varied
- policies under which insurers may not come "off risk"
- renewal procedure:
  - the renewal notice:
    - its purpose
    - its contents:
      - renewal premium required:
        - alternative values and premiums
- days of grace:
  - when they may be allowed
  - claims arising during them
- when renewal premiums are not paid:
  - lapsing the policy
  - reviving policies

Return of premiums:

- no general entitlement
- when total refunds might be made
- when partial refunds might be made

No-claim bonuses:

- why they are offered
- transfers between insurers

Excess:

- what is involved
- advantages to insurers

Surrender value

Paid-up policies

Delay of premium payments

Claims:

- handling of claims by insurers
- conditions for claims
- notification to the insurers
- proof of loss
- claims forms:
  - their uses
  - information required
  - methods by which proof of loss may be provided

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- claims settlement
- ex gratia payments
- reasons why claims may fail:
  - invalid contract
  - policy exclusions
  - proximate cause:
    - contract wording which overrules general application
- the amount of the claim:
  - considerations
- disputes over claims:
  - liability
  - quantum
  - negotiation and compromise, litigation
  - arbitration:
    - what is involved
    - why insurers prefer arbitration to litigation
- Average
  - different meanings in classes of insurance
  - the pro rata condition
  - the special condition
  - two conditions
- Who pays the claim:
  - underinsurance or partial insurance
  - more than one insurer involved:
    - possible complications
- Recipients of claim payments:
  - the insured
  - other parties
- Sympathetic treatment of claims

## **Module 7 - Transportation Insurance**

### **Marine Insurance:**

- the background
- hull insurance
- cargo insurance
- marine liability damage
- modern developments and trends
- time policies
- voyage policies
- building risk policies
- floating policies

### **Aviation Insurance:**

- extent of cover
- aviation liability insurance:
  - injured passengers
  - non-passenger third parties
  - aircraft manufacturers
  - airport owners and operators
- comprehensive policies
- personal accident policies
- cargo policies
- loss of service policies
- airport liability policies
- product liability policies

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**Transit Insurance:**

- overland transport
- liability of hired carriers
- floating policies

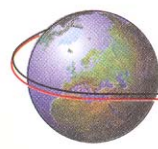
**Motor Insurance:**

- Road Traffic Acts:
  - types of vehicle used on the roads
- types of policies:
  - third party only
  - third party, fire and theft
  - comprehensive
  - act only
- motor cycle policies
- commercial vehicles policies
- fleet policies and premiums
- increased premiums
- excesses
- no-claim bonuses
- rebates

**Module 8 - Property, Accident, Pecuniary and Liability Insurances**

**Property Insurance:**

- the Great Fire of London:
  - developments thereafter
- definition of "fire"
- the standard fire policy:
  - insured perils:
    - fire, lightning, explosion
  - exclusions
  - additional special perils which can be covered
- combined or comprehensive policies
- period of cover
- inflation and property insurance:
  - indexing schemes
  - non-private property
- household comprehensive policies:
  - definitions of "buildings" and "contents"
  - personal possessions
  - new for old policies
- all-risks household policies:
  - scope of cover
- commercial theft insurance:
  - commercial or business combined policies:
    - scope of cover
  - office combined policies:
    - scope of cover
  - stock or inventory policies:
    - valuing "stock at risk"
  - business loss of profits policies:
    - scope of cover available
  - rent policies:
    - who may insure
  - excesses



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### **Accident Insurance:**

- overlap of fire and accident policies
- industrial all-risks policies:
  - scope of cover
- contractors all-risk policies:
  - scope of cover
- theft or burglary policies:
  - scope of cover
- glass policies
- money policies
- goods in transit policies
- contract policies
- rainfall and hail policies
- licence policies
- caravan policies
- small/pleasure boat policies
- travel insurance:
  - scope of cover
  - single trip policies and annual policies
- sports insurances:
  - scope of cover
- livestock insurances
- pet insurances
- engineering insurance
  - inspections
  - scope of cover:
    - extraneous perils
- computer insurances:
  - scope of cover

### **Pecuniary Insurances:**

- fidelity guarantee or suretyship:
  - commercial guarantees
  - court bonds
  - government bonds
- legal expenses policies
- credit policies
- business interruption policies:
  - scope of cover
- mortgage indemnity insurance:
  - scope of cover

### **Liability Insurances:**

- liabilities arising from:
  - negligence
  - nuisance
  - trespass
  - strict liabilities
  - statutory liabilities
  - contractual liabilities
- employers liability insurance:
  - compulsory in many countries
  - scope of cover
- public liability insurance:
  - scope of the wide variety of policies available

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### **Module 9 - Insurances of the Person**

Income, expenditure, wealth and purchasing power  
How the need for personal insurances can arise  
Social security or national insurance:

- common state benefits:
  - unemployment
  - sick pay and sickness/health care
  - disablement and disability
  - maternity leave
  - retirement pension

#### **Personal accident and sickness insurance:**

- scope of cover:
  - the policy schedule
- stand-alone policies
- specified benefits:
  - how and when they might be paid
  - deferred periods
- exclusions from policy cover

#### **Permanent health insurance (PHI):**

- scope of cover
- the long-term liability
- level premiums
- policy exclusions
- specified benefits:
  - how and when they might be paid
  - deferred periods

Long-term care insurance:

- scope of cover

#### **Private medical/health care insurance:**

- scope of cover
- policy exclusions
- factors which influence premiums quoted
- excesses

#### **Group insurance schemes:**

- employees personal accident schemes
- employees personal accident and sickness schemes
- schemes for clubs and other organizations

How personal insurances may be affected by:

- a person's occupation:
  - hazards associated with different occupations
- a person's age:
  - risk exposures at different ages
- a person's family circumstances:
  - number and ages of dependants
- a person's sex:
  - reasons why women's PHI premiums may be higher
- a person's health and medical history:
  - factors which influence insurers

Holiday travel insurance

Business travel insurance

Sports insurance

Debt repayment insurance

Mortgage protection payment insurance

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**Life Insurance:**

- special features
- types of life policies and scope of cover:
  - term policies
  - whole life policies
  - endowment policies
  - with profits policies
  - unit-linked endowment policies
  - flexible endowment policies
  - guaranteed insurability policies
  - unit-linked whole life policies
  - specialised life policies
- industrial life insurance:
  - how it differs from ordinary life insurance
- considerations in effecting life insurance:
  - family protection
  - educational fees protection
  - debt and mortgage protection
    - endowment house-purchase policies
  - sole business owner protection
  - key-personnel protection
  - providing an inheritance
  - savings for the future

**Pensions:**

- providing an income on retirement
- state retirement pensions
- occupational pension schemes
- personal pension plans

**Annuities:**

- types of annuities
- Tontines and capital redemption policies

**Module 10 - The Insurance Market**

Composition of the insurance market

**Buyers of insurance:**

- personal and business buyers

**Sellers of Insurance:**

- Lloyds underwriters:
  - the background
  - the Corporation of Lloyd's
  - the Lloyd's Acts
  - underwriting members
  - names
  - syndicates
  - Lloyd's brokers
  - stages in placing a risk at Lloyd's
  - shipping intelligence:
    - Lloyd's agents and sub-agents
  - publications:
    - Lloyd's list
- Insurance companies:
  - limited liability companies:
    - the meaning of limited liability
  - mutual companies

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captive insurance companies

bankassurance

Mutual indemnity associations

Collecting friendly societies

Tariff and non-tariff insurers

**Intermediaries - middlemen:**

insurance agents:

Law of Agency

types of agents:

cash, credit, bulk business

commission

insurance brokers:

professional conduct and expertise

brokerage

differences between agents and brokers

tour operators and travel agents

bank building societies and other lenders

large retailers

**Direct selling or writing:**

increasing use of telesales and the Internet

standardised cover

reductions in insurers' costs

savings on commission and brokerage

reductions in premiums

convenience for buyers

Third party administrators

**Reinsurance:**

the necessity for reinsurance

methods of reinsuring:

facultative reinsurance

treaty reinsurance:

fixed share/quota treaties

surplus treaties

excess of loss treaties

excess of loss ratio treaties

reinsurance pools

**Module 11 - Organisation & Management of Insurance Companies**

Centralised organisations:

advantages and disadvantages

Decentralised organisations:

advantages and disadvantages

Regional or zonal organisations

Semi-autonomous branches

Branches and claims

Executives of insurance companies:

the board of directors:

composition

duties and responsibilities

managing director

general manager

heads of departments

executive directors

non-executive directors

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- the chairman
- company secretary
- agency manager
- marketing manager
- investment and estates manager
- personnel and training:
  - the importance of training
- underwriting executives
- Organization charts:
  - what they show
  - organisation by function
  - organisation by division
- Branch staff
- Specialist staff
- Insurance funds:
  - the meaning of “funds” in insurance
  - types of funds
- Insurance reserves:
  - reasons why different reserves must be build up
- Investment of insurance company funds:
  - aims of the investment policy:
    - considerations in non-life business
    - considerations in long-term business
- Insurance and the economy:
  - how insurance funds can assist a country’s economy
  - ways in which insurance funds can aid a country’s development
  - insurance and the balance of payments:
    - visible and invisible imports and exports
    - possible positive and negative affects of insurance

## **Module 12 - Supervision and Regulation of Insurance**

- The “promissory” nature of insurance:
  - insurance as an intangible product
  - the effects of insolvency of insurers on:
    - policyholders
    - third parties
- The need for regulation
  - consumer protection:
    - areas of concentration:
      - financial standing and stability of insurers
      - buyers’ understanding of what they are buying
      - availability of insurance when and where needed
    - national and economic interests
    - aleatory nature of insurance
- Development of the regulation of insurance:
  - self-regulation
  - acts and statutes
  - EU Directives
  - authorisation of insurers:
    - requirements for authorisation
    - supervision of authorised insurers
  - solvency margins:
    - premium basis of calculation
    - claims basis of calculation

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- minimum guarantee funds
- examples of legislation enacted with regard to:
  - policyholders protection
  - insurance brokers
  - Lloyd's insurance brokers
  - financial services
  - insurance standards
  - the financial services authority
  - insurance ombudsman schemes:
    - the role of ombudsmen
- Conclusion:
  - the continuing evolution of regulation and supervision

### ***Glossary of Words and Terms Used in Insurance***

This Alphabetical Section (which is provided in the printed Manual One of the Program) is designed as a "quick reference check" to help further understanding of many: "technical" words and terms used in insurance; words and terms which have "specialised" meanings when used in insurance; words and terms whose meanings in insurance differ from their "everyday" meanings; which are introduced and explained in Modules 1 to 12