

Materials online 001/3/2017

Risk Financing and Short Term Insurance RSK3701

Semester 1 and 2

Department of Finance,
Risk Management and Banking

IMPORTANT INFORMATION:

Please activate your *myUnisa* and *myLife* email addresses and ensure you have regular access to the *myUnisa* module site RSK3701-2017-S1 for Semester 01 and RSK3701-2017-S2 for Semester 02 as well as your group site.

Note: This is an online module, and therefore your module is available on myUnisa. However, in order to support you in your learning process, you will also receive some study materials in printed format.

Dear Student

1 ONLINE MATERIALS

The purpose of this Tutorial letter is to provide you with the online material available on the website of the module RSK3701. The material is provided as follows:

Annexure A: Welcome page

The welcome page as reflected on the module website is duplicated for your convenience in Annexure A.

Annexure B: Learning unit 1: Housekeeping

This learning unit sets out the aim and objectives of the module, the framework of the module, and provides information on the assessment, examination and lecturers of the module. Some frequently asked questions are also included under this learning unit.

Annexure C: Learning units 2-4: RSK3701

The various topics and study units representing the Unisa study material for this module are uploaded under the following learning units on the module website RSK3701-16-S1 for Semester 01 and S2 for Semester 02:

Learning unit number	Name of learning unit	Study units
2	Risk Management and insurance	1 -2
3	Short-term insurance	3 - 11
4	Self-funding and Alternative risk financing techniques	12

You should follow the guidelines provided in the Unisa study material to study the material in the prescribed book. Pay special attention to the additional notes provided in the Unisa learning units as some material is not reflected in the prescribed book and must be studied from the Unisa notes.

We wish you all of the best in studying this module. Please do not hesitate to call us if you need some assistance with your studies.

Kind regards

Cecile de Swardt
Jethro Godi
Lecturers: Finance, Risk Management and Banking

ANNEXURE A

RSK3701 WELCOME PAGE

Dear Students

I wish to give a warm welcome to all students registered for the module in Short-term Insurance, RSK3701.

This module is offered in an online format. For those students who have difficulty following the on-line method of studying, hard copies of the study material will be made available as in the past. Your online study material is uploaded under *Learning units* on the RSK3701 module site on *myUnisa*.

Please note that this module requires, and is also designed that students must dedicate at least 120 hours per semester to master the content and learning outcomes of this module. You may find the assignments and examination paper very difficult if you have not invested the required time in the subject.

Online Course outlay

Tuition will be in the format of 'Learning Units' posted on *myUnisa*. The various study units of the Unisa guide are uploaded under separate topics and study units under the following topics:

- Housekeeping*
- Risk management and Insurance
- Short-term insurance
- Self-funding and Alternative Risk Financing (ART)
- Assignments for 2017

*The housekeeping topic replaces the traditional Tutorial letter 101 and is divided into various sections dealing with the framework of the module, aims and objectives, assessment, examination, prescribed book and lecturer details. Tutorial letter 101 will however also be available in a printed format and uploaded on *myUnisa* as in the past.

Prescribed book

The compulsory prescribed textbook for this module is:

- Risk Financing and Short Term Insurance. 2017. (RSK3701) Published by and obtainable from the Insurance Institute of South Africa.

The prescribed book must be purchased from the Insurance Institute of South Africa in Johannesburg. Older versions of book cannot be used as the book was revised in 2016. Please note that the book is not available at any of the official bookstores of UNISA. The contact details of the Insurance Institute are as follows:

E-mail: info@iisa.co.za

Local Tel: 011 341 9480

Additional contact details are available under prescribed books on the RSK3701 site on *myUnisa* or in Tutorial letter 101.

Assignments

Formative assessment of the module in terms of multiple choice and written assignments are available under 'Learning Units' on *myUnisa*. The assignments are also available in Tutorial Letter 101 uploaded on *myUnisa*.

The suggested solutions for the the assignments will be provided under 'Learning Units' on *myUnisa*, or in Tutorial letters 201 and 202, two weeks after the respective due dates of the assignments.

Discussion forums

We shall initiate discussions on relevant items as per the structure or topics of the study guide. The purpose of the discussion forums is to give you the opportunity to discuss subject related matter and to make contributions where possible. I strongly recommend that you make an effort to contribute to the discussions as it will deepen your knowledge and insight into the subject.

Announcements

Special instructions and provision of relevant information will be shared via the *Announcement* tool under *myUnisa*. If you have not changed the default Unisa e-mail address to your work or home e-mail address, please ensure that you log on at least once a week to read the announcements.

Examination

The examination paper will comprise both multiple choice and written questions. Please be cautious when using previous examination papers as the format of this module has been revised. Additional information on the examination and format of the paper is available under the topic *Housekeeping* under *Learning units* on *myUnisa* and in Tutorial letter 101.

I wish you all the best with the module.

Regards

Mrs Cecile de Swardt

Primary Lecturer



ANNEXURE B

LEARNING UNIT: HOUSEKEEPING

AIM AND OUTCOMES

AIM OF THIS MODULE

The aim of this module is to enable students to study the principles and nature of short-term insurance, the structure and regulation of the short-term industry from a risk management perspective and the principles of alternative risk financing alternatives,.

MODULE OUTCOMES

At the end of the module, students should be able to

- demonstrate effective risk management skills by selecting appropriate short-term insurance cover for the financial consequences of risk
- demonstrate the ability to apply alternative risk-financing techniques to fund the financial consequences of risk, to describe these techniques, and to list their advantages and disadvantages compared to insurance products
- demonstrate a basic understanding of the operation of the short -term insurance market by identifying industry bodies and explaining their role
- providing arguments for and against regulating the short term insurance industry and the duties of short-term insurers, subject to insurance legislation
- explaining and applying the principles of underwriting, policy servicing and claims management

In addition to teaching students technical skills, this module also aims to achieve the following general goals of a broad-based education:

- To encourage critical thinking, including moral and ethical reasoning (This module examines a number of logical alternative choices which require critical thinking. A study of insurance invariably addresses a number of moral and ethical issues, ranging from the question whether the insurance industry should be regulated to how the Aids problem should be handled.)
- To aid the understanding of human behavior (The insurance transaction is the result of human interaction. Many risk management questions have psychological explanations such as the role human behaviour plays in preventing and causing losses.)
- To integrate knowledge across various disciplines (The study of risk management and insurance not only requires an understanding of business management, but also requires the application of some of the principles of economics, law and mathematics.)

FRAMEWORK AND CONTENT

1 FRAMEWORK OF THE MODULE

This module consists of the following topics:



2 CONTENTS OF THE VARIOUS TOPICS AND STUDY UNITS

TOPIC 1: RISK MANAGEMENT AND INSURANCE

Study unit 1: Risk management

- 1.1 Risk management as a concept
- 1.2 Risk identification
- 1.3 Risk evaluation
- 1.4 Risk control
- 1.5 Personal risk management

Study unit 2: The Short Term Insurance Market

- 2.1 The insurance device
- 2.2 The short-term insurance market
- 2.3 Market Associations

TOPIC 2: SHORT-TERM INSURANCE

Study unit 3: The Practice of Underwriting

- 3.1 Essential elements of a contract
- 3.2 Special legal characteristics of insurance contracts
- 3.3 The parts of the policy
- 3.4 Insurable interest
- 3.5 Insurable and Uninsurable risk
- 3.6 The Proposal form
- 3.7 The procedure
- 3.8 Premium collection

Study unit 4: Renewals

- 4.1 The renewal listing
- 4.2 The claims experience
- 4.3 Options
- 4.4 The survey
- 4.5 South African Special Risks Insurance Association (SASRIA)
- 4.6 Renewal

Study unit 5: Short-term reinsurance practice

- 5.1 The reasons for and the importance of reinsurance
- 5.2 Classes of reinsurance
- 5.3 Proportional reinsurance
- 5.4 Quota share treaty
- 5.5 Surplus treaty
- 5.6 Non proportional reinsurance

Study unit 6: Claims procedures

- 6.1 Notification of a claim
- 6.2 The claims department
- 6.3 Valid claim
- 6.4 Indemnity
- 6.5 Methods of settling claims
- 6.6 Claims disputes
- 6.7 Prescription period
- 6.8 Post-loss action

Study unit 7: Regulation of the short-term industry

- 7.1 Short-term insurance business
- 7.2 The Short-term Insurance Act, 53 of 1998
- 7.3 Other statutes
- 7.4 Compulsory insurance

Study unit 8: The personal insurance policy

- 8.1 Personal Lines
- 8.2 Houseowners
- 8.3 Householders
- 8.4 All-risks insurance
- 8.5 Personal accident insurance
- 8.6 Personal liability
- 8.7 Small-craft insurance

Study unit 9: Commercial insurance

- 9.1 Multi-peril policies
- 9.2 Fire sections
- 9.3 Accident classes
- 9.4 Liability
- 9.5 Other types of cover

Study unit 10: Motor insurance

- 10.1 Compulsory motor insurance
- 10.2 Types of cover in motor insurance
- 10.3 First amount payable
- 10.4 Motor cycles
- 10.5 Commercial vehicles
- 10.6 Motor trade risks
- 10.7 Rating methods
- 10.8 Claims handling

Study unit 11: SASRIA, COID and miscellaneous short-term covers

- 11.1 South African Special Risks Insurance Association (SASRIA)
- 11.2 The Compensation for Occupational Injuries and Diseases Act (COID), 130 of 1993
- 11.3 Specialist insurance cover
- 11.4 Bank assurance and group schemes

TOPIC 3: SELF-FUNDING AND ALTERNATIVE RISK-FINANCING TECHNIQUES (ART)

Study unit 12: Self-funding and Alternative Risk Financing

- 12.1 Self-funding
- 12.2 Risk retention
- 12.3 Captives and rent-a-captive companies
- 12.4 Finite risk insurance and capital market instruments

ASSESSMENT

1 Assessment plan

Assignments are seen as part of the learning material for this module. As you do the assignments, study the reading texts, consult other resources, discuss the work with fellow students or tutors or do research, you are actively engaged in learning. Paying attention to the assessment criteria for each assignment will help you to understand what is required of you more clearly.

You may submit written assignments electronically via myUnisa. Assignments may not be submitted by fax or e-mail. For detailed information and requirements as far as assignments are concerned, see the brochure *my Studies @ Unisa* that you received with your study material.

Compulsory assignment

There are TWO compulsory assignments for this module per semester. Different assignments are set for semester 2. The compulsory assignments consist of multiple-choice questions. There are non-negotiable submission deadlines for each of the assignments of this module and you must submit Assignment 01 if you wish to gain entry to the examination. Both the compulsory assignments contribute to your year mark. A third assignment containing written questions is also included. This assignment is for self-assessment only and must not be submitted.

Year mark and Final mark

Your year mark, based on the mark obtained for the compulsory assignment, contributes 20% towards your final mark, while your examination mark contributes 80%.

The combined weighted average of your year mark and examination mark must be 50% or higher for you to pass the module. Should you however, obtain less than 40% in the examination, your year mark will not be taken into account and you will fail.

For example:

Assignment 01 mark = 50% Assignment 02 mark = 90%. These marks each contribute 50% towards the final 20% year mark.

Assignment no	Mark	Weight	Total
Ass. 01	50%	50%	25
Ass. 02	90%	50%	45
			70 x 20% of final = 14

Assume an examination mark of 45%
80% of the examination mark is 36

Final mark= (20% of the average assignment marks) + (80% examination mark)
= 14 + 36
= 50%

The example demonstrates that your year mark can help you to pass the module. To pass the module you need a final mark of at least 50% and to qualify for a supplementary examination you will need a final mark of above 40%.

For general information and requirements as far as assignments are concerned, see the brochure *my Studies @ Unisa*, which you received with your study material.

2 Unique assignment numbers

The assignment has been allocated a unique number in order to identify it in the Unisa assessment plans. Please ensure you always indicate the correct unique number when submitting assignments.

3 Due dates for Assignments

Semester	Semester 1	Semester 2
Assignment 01	Due date: 22 March 2017 Unique number: 821608	Due date: 21 August 2017 Unique number: 753262
Assignment 02	Due date: 10 April 2017 Unique number: 870344	Due date: 11 September 2017 Unique number: 878260

As indicated earlier, you should preferably submit your assignments at <https://my.unisa.ac.za> prior to the due date of the assignment. Do not wait until the day just prior to the due date. Technical problems with the computer servers of myUnisa may prevent you from submitting your assignment at the last minute.

Please ensure that your assignment reach the Unisa main campus by the due date should you not be able to submit your assignments at myUnisa and need to mail us your assignments in hard copy format. Requests for extension of due dates for assignments will not be granted. The due dates have been set to allow you sufficient time for the completion of other assignments and your preparation for the examination.

Information about whether Unisa has received your assignment and the mark attained for an assignment can be obtained from <https://my.unisa.ac.za>.

4 Submission of assignments

To submit an assignment **via myUnisa**:

- Go to myUnisa at <https://my.unisa.ac.za>
- Log in with your student number and password.
- Select the module.
- Click on assignments in the left-hand menu.
- Click on the assignment number you want to submit.
- Follow the instructions on the screen.

To submit multiple-choice assignment answers using the Unisa mobile application refer to Tutorial letter 101.

5 Feedback on assignments

The suggested solutions to the assignments and the self-assessment assignment will be posted on **myUnisa** after the due date of the respective assignments. Guidelines for the answering of the self-assessment assignment will also be uploaded on the discussion forum during the semester. The assignments form an important part of your learning experience and it is advisable to redo the assignment after you receive the feedback to make sure that you comprehend the learning outcomes and to prepare you for the examination.

Assignments are seen as part of the learning material for this module. As you do the assignment, study the reading texts, consult other resources, or do research (i.e. actively engage in learning), refer to the learning outcomes and assessment criteria given for each study unit in the study guide to determine what is required of you.

6 Other assessment methods

Students who fail modules in their final year and who need to pass only this module to qualify for the degree will be given the opportunity to either complete an alternative assessment in the form of a portfolio or to rewrite the examination in the next examination session. The examination section will identify and notify the specific students. Please note that the portfolio assignment comprises various questions, requiring both theoretical knowledge and practical application. All the questions must be passed to be granted an overall maximum pass rate of 50%. Contrary to beliefs under students, the portfolio assignment requires a lot of time and effort from students and is by no means an easy way out.

EXAMINATION

Examination admission will be granted to all students who submit Assignment 01. Students who do not submit the assignment will NOT be allowed to write the examination.

The provisional examination dates have been published at <https://my.unisa.ac.za>

The examination paper will consist of two sections A and B. Section A will consist of multiple choice questions of 1 mark each. Section B will consist of paragraph/essay questions. The duration of the examination paper is two-hours for a total of 70 marks. More details with regard to the format of examination paper as well as other examination guidelines will be provided with Tutorial letter 201.

A student must attain a mark of at least 40% in order to qualify for admission to the supplementary examination. Details about the procedure and cost for the re-marking of examination scripts may be found on myUnisa (<https://my.unisa.ac.za>).

LECTURERS

The lecturers for this module are:

Mrs Cecile de Swardt
Primary Lecturer

Mr Jethro Godi
Secondary lecturer

You are welcome to contact the primary lecturer via email to discuss any problems you may encounter in your academic study material. When the primary lecturer is not available, you may forward the enquiry to the secondary lecturer. To enable the lecturer to assist you, please be specific on enquiry and provide the following information:

- Topic
- Definition of the problem/concern
- Your suggested solution/understanding of the problem.

You may also want to discuss certain topics with one another using the discussion forum on myUnisa (<https://my.unisa.ac.za>).

Please make a formal appointment beforehand for personal visits to the lecturers. Also note that lecturers can only help you with **academic** matters. The lecturers responsible for this module are as follows:

Mrs CJ de Swart: Primary Lecturer	Mr J Godi: SECONDARY LECTURER
AJH van der Walt 5-115	AJH van der Walt 5-112
dswarcj@unisa.ac.za	godinj@unisa.ac.za

ANNEXURE C

LEARNING UNITS 1-12

The following study units are uploaded as Learning Units on the RSK3701 site on myUnisa.

TOPIC 1

Risk management and insurance

AIM

The aim of this topic is to help you develop an understanding of the concepts “risk” and “insurance”, how insurance operates, and how the risk manager can use it to make provision for the financial consequences of risk.



Learning outcomes

After you have worked through Topic 1, you should be able to

- demonstrate your understanding of risk by critically analyzing different views and definitions of risk, and by categorizing different practical examples of loss-producing events correctly
 - identify situations in which insurance would be the most effective risk financing plan by demonstrating the skill to evaluate risk correctly and being able to relate the size and the frequency of the risk to the correct handling method.
 - demonstrate your understanding of the operation of insurance by explaining the essential features of insurance and the requirements of insurability
 - identify and describe the major players that operate within the short term insurance market
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TOPIC CONTENT

Study unit 1: Risk management

Study unit 2: The Short Term Insurance Market

STUDY UNIT 1

RISK MANAGEMENT

CONTENTS

Learning outcomes

Key concepts

Getting an overview

1.1 Risk management as a concept

1.2 Risk identification

1.3 Risk evaluation

1.4 Risk control

1.5 Personal risk management

Assessment

Summary



Learning outcomes

When you have worked through this study unit, you should be able to

- define and explain the meaning of “risk”
- differentiate between event and speculative risks
- describe the categories into which event risk may be subdivided
- identify and explain the principal methods of handling risk
- define and explain what is meant by “risk management”
- identify the techniques for managing risk
- explain how insurance fits into risk management
- list the steps in the risk management process
- demonstrate the skills required to identify risk
- demonstrate the ability to evaluate risk quantitatively and qualitatively

Key Concepts

Risk

Risk identification

Risk evaluation

Event risk

Risk financing – retention and transfer

Risk control – avoidance and reduction

GETTING AN OVERVIEW

This study unit addresses the first two outcomes of Topic 1.

A discussion of risk would logically precede the discussion of insurance itself. This study unit introduces the concept of “risk”, defines it, and discusses the different classifications of risk. The study unit also provides a broad overview of risk management and its two core activities, namely risk financing and risk control.

The risk financing specialty comes from the disciplines of finance and insurance, and the risk control specialty represents the merger between traditional safety management and loss prevention, as developed by the insurance industry, and systems safety from the military and aerospace industries.

Traditional approaches classify risk management techniques as risk control, focusing on minimising the risk of loss to which the organisation is exposed, and on risk financing, which concentrates on arranging the availability of funds to meet the losses that do occur.

The traditional approach offered the following classifications of risk control and risk financing techniques:

Risk control	Risk financing
Avoidance	Retention
Reduction	Transfer

Risk sharing is viewed as a special case of risk transfer, in which the risk is transferred from the individual to the group.

NOTE: Risks cannot really be transferred—only the financial consequences of risk are transferred to the insurance company.

As explained in numerous textbooks on risk management, the insurance manager’s job was to buy insurance, and he or she would rarely be criticized for doing so. The real threat to an insurance buyer’s career was uninsured losses, and insurance buyers protected themselves as well as the corporation by buying more rather than less insurance. This study unit explains how this situation has changed.

1.1 RISK MANAGEMENT AS A CONCEPT

Study the following sections in Chapter 1 of the prescribed book:

- Risk defined
- The concept of “risk management”
- The risk management process
- Insurance involvement
- The three steps

Activity1.1

Consult other literature on risk management and insurance to help you form your own view on the most appropriate definition of risk. For example:

Vaughan, EJ & Vaughan, TM. 2001. *Essentials of risk management and insurance*. (2nd ed). New York: Wiley.

Feedback

Vaughan and Vaughan (2001:4) define risk as “a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for”.

These authors argue that this definition immediately suggests that the role of insurance in the management of risk is to address the deviation from the desired outcome. They also argue that defining risk as “a condition” seems to be both semantically and intuitively appropriate. It delineates the essence of the thing being defined and helps to emphasise the notion that risk is a state of the world created by a combination of circumstances. In addition, it more or less coincides with the intuitive notion of risk. Their objections to a definition such as “risk is the uncertainty of loss” are that risk exists (as a condition of the real world) even when the danger is not perceived and when there is no uncertainty. Moreover, uncertainty may exist in situations where there is no risk (ie where the possibility of loss does not exist).

Note that the authors of your prescribed book identify three phases in the risk management process:

- (1) risk identification
- (2) risk evaluation
- (3) risk control

1.2 RISK IDENTIFICATION

Study the following sections on risk identification in Chapter 1 of your prescribed book:

- The risk manager
- Physical inspection
- Aids to identification
 - Organisational charts

These charts show the basic organizational structure of the company. They show the relationships between the personnel at the business level. The charts also highlight weaknesses in the structure that may cause problems for the risk manager.

Example

Works managers have to report all accidents or near accidents to six different managers. This means that they have to complete six copies of the report form. Doing so wastes valuable time that could have been used to improve safety standards.

- Flow charts

- Flow chart interpretation
- Checklists

1.3 RISK EVALUATION

Study the following sections on risk evaluation in Chapter 1 of your prescribed book:

- Introduction
- Quantitative measurement - The exact details of losses that occurred are available (eg five burglaries at a maximum cost of R10 000).
- Qualitative analysis - Exact figures are not available, and qualitative analysis therefore has to be used to calculate the probability of an event and how severe the effect of the loss would be.
- Computer technology
- Conclusion

1.4 RISK CONTROL

1.4.1 Physical risk control

Study the following sections on risk control in Chapter 1 of your prescribed book:

- Elimination
- Minimisation
 - Pre loss minimisation
 - Post-loss minimisation

1.4.1 Financial risk control

Study the following sections on financial risk control in Chapter 1 of your prescribed book:

- Retention
- Self-insurance versus non-insurance
- Risk transfer
- Insure the whole risk

Note that a franchise, which is referred to in this section, differs from an excess. An excess is an amount the insured has to pay each and every time a loss occurs. A franchise is an amount that applies to each and every claim. However, if the claim exceeds this amount, the insured's claim is paid in full. (Also refer to a discussion of these concepts under "Alternative risk financing" – Topic 3 in this guide.)

The difference between a franchise and an excess is further explained with the example below.

Example

Type of deductible	When the claim amount is	The deductible amount is	The client is paid
Excess	R500	R500	R0
Franchise	R500	R500	R0
Excess	R1 000	R500	R500
Franchise	R1 000	R500	R1 000

- Catastrophe cover

1.5 PERSONAL RISK MANAGEMENT

Study the section on personal risk management in Chapter 1 of your prescribed book.

ASSESSMENT

- (1) Answer the questions on Chapter 1 in the prescribed book.
- (2) Define risk, and state the relationship between risk and uncertainty.
- (3) List three ways in which risk may be classified.

FEEDBACK

- (1) Consult the suggested answers on Chapter 1 of your prescribed book.
- (2) "Risk" is defined as a condition in which there is the possibility of an adverse deviation from a desired outcome that is expected or hoped for. In simpler terms: there is a possibility of loss. This definition reflects the real world in which a possibility of loss exists, where as "uncertainty" is a state of mind characterized by doubt or insufficient knowledge of the outcome of an event. Risk can exist (in the real world), even when the danger is not perceived and where there is no uncertainty. Uncertainty can exist when there is no risk.
- (3) Risk may be classified as financial or non-financial, dynamic or static, fundamental or particular, and event or speculative. The distinction between financial and non-financial risks is self-explanatory. Financial risks have financial consequences, whereas non-financial risks do not. Dynamic risks arise from changes in the economy; static risks would exist even in the absence of economic change. Fundamental risks are impersonal in origin as well as consequences and are usually beyond the individual's control. Particular risks are personal in origin and consequences, and are generally considered the individual's own responsibility. Event risks are those in which there is a chance of loss or no loss. Speculative risks involve the chance of loss or gain.

SUMMARY

This study unit defined risk and explained the steps in the risk management process. It indicated that insurance can be used to address a negative deviation from an expected value by providing financially for such a deviation. In this sense insurance is sometimes described as a “risk transfer mechanism” because it provides a means of transferring some of the negative financial consequences of risk. The next unit deals with the insurance device and the short-term insurance market.

STUDY UNIT 2

THE SHORT-TERM INSURANCE MARKET

CONTENTS

Learning outcomes

Key concepts

Getting an overview

3.1 Buyers

3.2 Intermediaries

3.3 Insurers

3.4 Reinsurers

3.5 Other players

3.6 Self-insurance

3.7 Regulators

3.8 Market associations

3.9 Educational associates

3.10 The financial services sector charter

3.11 Addressing the low-income market

Assessment

Summary



Learning outcomes

After you have worked through this study unit, you should be able to

- describe the short-term insurance market
- list the participants in the short-term insurance market
- explain the relationship between the various participants (pictorially)
- describe the functions of the South African Insurance Association, and the Financial Intermediaries' Association
- explain the difference between noninsurance and self-insurance
- list the advantages and disadvantages of self-insurance

- describe a “captive insurance company”
- explain the operation of Lloyds in South Africa
- differentiate between a mutual indemnity association and a Protection and Indemnity club (P&I Club)
- describe the functions of the loss adjuster and the motor assessor
- describe the classes of cover available to different customers
- explain reinsurance and collective insurance

Key concepts

Captive insurance company	Lloyds
Mutual indemnity association	P&I Club
Collective insurance	

GETTING AN OVERVIEW

This study unit provides an overview of the short-term insurance market, its main participants, and their functions.

2.1 THE INSURANCE DEVICE

Study the following sections on buyers in the short-term insurance market in Chapter 2 of the prescribed book:

2.1.1 What is insurance

2.1.2 How does insurance work?

- Risk assumption
- Law of large numbers
- Adverse selection

2.1.3 Elements of an insurable risk

2.1.4 Self-insurance

2.1.5 Reinsurance

- The purpose of reinsurance
- The significance of reinsurance for the insured

2.2 THE SHORT TERM INSURANCE MARKET

Study the following sections on the short-term insurance market in Chapter 2 of the prescribed book:

2.2.1 The Buyers

Study the following sections on buyers in the short-term insurance market in Chapter 2 of the prescribed book:

- Private individuals
- The commercial client
- The corporate client
- Public bodies
- Type of cover available
- Policy wording
- Multi-peril policies
- The sections
- Asset all risks

2.2.2 The Intermediaries

Study the following sections on intermediaries in the short-term insurance market in Chapter 2 of the prescribed book:

- The broker
- The underwriter manager
- The agent
- The Lloyd's broker
- Other distribution channels

2.2.3 Insurers

Study the following sections on insurers in the short-term insurance market in Chapter 2 of the prescribed book:

- Proprietary companies
- Public or mutual companies
- Captive insurance companies
- Lloyd's
- Mutual indemnity associations
- Protection and indemnity associations (P&I Club)

2.2.4 Reinsurers

Study the following sections in Chapter 2 of the prescribed book:

- Decline the risk
- Take part of the risk
- Take all and reinsure

2.2.5 Other Players

Study the following sections on other players in Chapter 2 of the prescribed book:

- Loss adjusters
- Motor assessors

- The risk manager

2.2.6 Self-insurance

Study the following sections in Chapter 2 of the prescribed book:

- Advantages of self-insurance
- Disadvantages of self-insurance

2.2.7 The regulators

Study this section in Chapter 2 of the prescribed book.

2.3 MARKET ASSOCIATIONS

Study the following sections in Chapter 2 of the prescribed book:

- 2.3.1 South African Insurance Association (SAIA)
- 2.3.2 Financial Intermediaries' Association (FAI)
- 2.3.3 Black Insurance Professionals of Southern Africa (BIPSA)
- 2.3.4 Institute of Risk Management
- 2.3.5 Institute of Loss Adjusters (ILA)
- 2.3.6 South African Underwriting Managers Association (SAUMA)

2.4 EDUCATIONAL ASSOCIATES

Study the following sections in Chapter 2 of the prescribed book:

- 2.4.1 The Insurance Institute of South Africa (IISA)
- 2.4.2 The Insurance Sector Education and Training Authority (INSETA)

2.5 ADDRESSING THE LOW INCOME MARKET

Study this paragraph in the prescribed book.

ASSESSMENT

- (1) Answer the questions at the end of Chapter 2 in the prescribed book.
- (2) Briefly describe the two main methods available to a client who decides to transfer the financial consequences of risk by way of insurance.

FEEDBACK

- (1) Consult the suggested solutions at the end of the prescribed book.
- (2) The two methods available to a client are:
 - try to obtain cover for the entire risk
 - obtain cover for selected risks or catastrophes only.

SUMMARY

This study unit dealt with the insurance concept and the major players in the short-term market. We now proceed to short-term insurance underwriting.

TOPIC 2

Short Term Insurance

AIM

The aim of this topic is to help you develop an understanding of short term insurance.



Learning outcomes

After you have worked through Topic 1, you should be able to

- demonstrate your understanding of short term underwriting principles and practices by describing the legal principles applicable to short-term insurance
 - describing the short-term renewal processes and procedures
 - explaining how reinsurance operates in the short-term market
 - demonstrate an understanding of the regulatory framework within which the short-term insurance market operates by describing the various regulations that apply
 - demonstrate an understanding of the various short-term insurance products available in the market by discussing each of the products
 - discuss SASRIA, COID and other miscellaneous short-term covers available.
-

TOPIC CONTENT

Study unit 3:	The practice of underwriting
Study unit 4:	Renewals
Study unit 5:	Short-term reinsurance practice
Study unit 6:	Claims procedures
Study unit 7:	Regulation of the short-term industry
Study unit 8:	The personal insurance policy
Study unit 9:	Commercial insurance
Study unit 10:	Motor insurance
Study unit 11:	SASRIA, COID and miscellaneous short-term covers

STUDY UNIT 3

THE PRACTICE OF UNDERWRITING

CONTENTS

Learning outcomes

Key concepts

Getting an overview

- 3.1 Essential elements of a contract
- 3.2 Special legal characteristics of insurance contracts
- 3.3 The parts of the policy
- 3.4 Insurable interest
- 3.5 Insurable and uninsurable risks
- 3.6 The proposal form
- 3.7 The procedure
- 3.8 Premium collection

Assessment

Summary



Learning outcomes

After you have worked through this study unit, you should be able to

- explain the purpose of an insurance proposal
- define indemnity, contribution and subrogation
- explain “average” and when it applies
- demonstrate how the principle of contribution operates
- explain how the principle of indemnity is supported by subrogation and contribution
- explain why the principle of utmost good faith applies to insurance contracts
- describe the process of arranging cover, from application to payment of a premium
- describe the factors that are taken into account when underwriting domestic insurance
- explain when a premium is payable for short-term insurance

- list the parts of a short-term policy
- describe the content of each part of the policy
- distinguish between essential and nonessential terms

Key concepts

Indemnity	Contribution	Exceptions	Warranties
Utmost good faith	Misrepresentation	Average	Extensions
Terms	Conditions	Subrogation	

GETTING AN OVERVIEW

The term “underwriting” originated from the Lloyd’s brokers who presented the details of cases to be insured on a “slip” to the representative of the syndicate of insurers in the room. This individual assessed the proposed risk of loss, and indicated the premium and the conditions required by the syndicate. If these were acceptable to the broker, the slip was stamped and signed at the foot to indicate the percentage of the insurance the syndicate accepted.

The process of assessing the terms and conditions to be imposed on an insurance contract is known as “underwriting”. This Study Unit outlines this process by discussing some of the legal principles of insurance, and explaining how one applies for insurance. The various sections of the short-term insurance policy are also covered. It is important to note that the insurer merely invites the public to do business, while it is the insured who offers to be insured. The offer can be made on an application form known as the proposal form.

3.1 ESSENTIAL ELEMENTS OF A CONTRACT

Study the following sections in Chapter 3 of the prescribed book.

- Offer and acceptance – the proposal form
- The parties must be competent
- The agreement must be lawful (legal object)
 - Insurance and wagering agreements
 - Statutory prohibitions
 - Common law
- Legal form
- Consideration

3.2 SPECIAL LEGAL CHARACTERISTICS OF INSURANCE CONTRACTS

In addition to the legal principles that apply to all the contracts discussed in the previous section, some legal principles are unique to insurance contracts. These principles will give you a foundation for understanding the different processes and specific applications of insurance.

Study the following sections in Chapter 3 of the prescribed book.

3.2.1 Indemnity

The principle of indemnity is the most fundamental principle in insurance law. "Indemnity" means that the insured is financially restored to the same position he or she was in before the loss.

- Nonindemnity insurance
- The general principle of indemnity
- The measure of indemnity
- Reinstatement policies
- New for old
- Valued policies

3.2.2 Utmost good faith

- Why is good faith necessary?
- The duty of disclosure and the test for materiality
- Criticism of disclosure
- Facts that need not be disclosed
- Duration of the duty to disclose

3.2.3 The cause of loss (proximate cause)

3.2.4 Subrogation

3.2.5 Contribution

3.2.6 Average

- Average in marine insurance
- Average conditions in policies
- Average and life policies

3.2.7 Fraud, nondisclosure and misrepresentation

- Nondisclosure and the law of contract
- Fraud
- Misrepresentation
- Premiums

3.3 THE PARTS OF THE POLICY

As the insurance contract is subject to the general law of contract, it is necessary to establish what constitutes an insurance contract.

Most insurance law is determined by common law. The contract document nevertheless usually contains specific contractual terms to deal with the same issues as common law does. These include issues such as subrogation, contribution, misrepresentation and disclosure. All contractual terms therefore have to be interpreted with common law in mind.

Most people and institutions require more than one insurance policy to meet their various needs. In the short-term market, a person may for example have a motorcar and therefore requires motor insurance. Homeowners' insurance is required for dwellings, and householders' insurance is required for the contents of the dwelling. All-risks insurance is

required for specified assets which are likely to be removed from the house and subject to risk from a wide range of perils. Public liability insurance is required to protect against ruinous liability claims.

Similarly, companies and other corporate bodies require a number of policies in addition to those mentioned above for the individual, including marine, aviation and contractors' all-risks policies.

It is possible to issue separate policies for each risk, but this is not modern practice. In the short-term industry, it is customary to package these policies in one document. Examples of this approach are Santam's Multiplex policies, Price Forbes's(PF) Multidek range and the Multimark II range. These policies are renewed annually and it makes sense to use one multi-policy document.

These multi-policy documents contain an initial section setting out the general conditions and provisions (including general exceptions) of the policy. These general terms cover all sections in the multi-policy document. Then there are separate sections that cover each risk (eg motor, householders, public liability and employers' liability). Each of these individual sections contains an operative clause that defines the risk covered and specific exceptions and specific extensions. The operative clause, together with the exceptions and extensions, are largely used to define the risk covered by the policy. Individual sections may also contain specific conditions.

Since long-term policies may apply for a period of 20 to 30years, the same considerations do not apply to long-term policies. Life policies continue to be sold individually, but they contain the same structure of conditions, operative clauses, extensions and exceptions.

Components of an insurance policy

When a large number of insurance policies covering different risks in different circumstances are dealt with, it is convenient to work in accordance with some basic structure. A policy may be considered in terms of the following structural components:

- terms, conditions and warranties
- the insuring or operative clause
- exceptions
- extensions

Terms, conditions and warranties

- *Terms*

As stated above, insurance is essentially a contract between the insured and the insurer. The relationship is therefore governed by the law of contract.

In a society that adheres to the principle of freedom of contract, a large measure of freedom exists as to the terms contained in a contract. Once a number of terms have been included, it becomes possible that one or more of these terms will be violated. The consequences of such violation must be determined. Some terms in a contract may be violated with little consequence, whereas the violation of others may have serious consequences.

These same principles apply to the insurance contract.

- *Conditions*

Most insurance policies contain a section that deals with the general conditions of contract. These conditions are usually part of the insurance common or case law, and the contractual terms should therefore be interpreted in the light of general insurance law.

Despite efforts by the insurance industry to standardize and simplify the wording of insurance contracts, it differs and in practice the actual wording must be consulted. Wording drawn up by insurers is generally felt to be more restrictive than that drawn up by intermediaries such as insurance brokers.

The general conditions cover cancellation of the policy, misrepresentation and nondisclosure, and claims and claims handling.

- *Warranties*

One way of removing doubt as to the importance of a contractual term is to elevate that term to an essential term, for example by declaring the term a “warranty” or a “condition precedent”. In common law, there are serious consequences, usually for the insured, if the term is breached, even if the term appears nonessential. If a warranty is breached, the insurer may be able to repudiate liability under the policy, even if the warranty reduces the risk to the insurer.

Warranties are usually divided into two classes, namely affirmative and promissory warranties. Affirmative warranties are those in which the insured affirms an actual fact. In a life policy, the insured may for example warrant that he or she is of a specific age. In a promissory warranty the insured undertakes to maintain a particular performance during the existence of the contract. The insured may for example warrant not to leave insured goods in an unlocked vehicle.

Not every term to an agreement need necessarily be found in the written expression of the contract. Some terms may be implied. There are instances when a court was prepared to read an implied term into a contract, but very good reasons and circumstances are required for this to happen. As a general rule, the court is reluctant to add anything to a contract that is not evident from the wording.

- *The insuring or operative clause*

This operative clause in an insurance policy is probably its single most important clause because it defines what is covered by the policy. In the case of a fire policy, for example, a person trying to recover damages from the insurer would have to prove that the event which took place fell within the promise contained in the operative clause.

A typical operative clause in a fire policy would for example read as follows:

In consideration of the payment of or agreement to pay the premium, the company agrees to indemnify the insured against damage to the whole or part of the property described in the schedule, owned by the insured or for which they are responsible, caused by fire, lightning or thunderbolt, and explosion.

- *Exceptions*

Policies contain exceptions, indicating the risks that are not covered. Two types of exceptions are important: general exceptions (which cover all the individual sections in the multi-policy document) and specific exceptions (which limit the specific risk in each section).

- General exceptions

The general exceptions to a short-term policy include those risks which an insurer—and indeed the short-term market—will not, as a general rule, accept. These exceptions include politically motivated damage (including war damage) and nuclear risks.

- Specific exceptions

Each section of a multi-policy document may contain its own exceptions specific to that particular risk. For example: A public liability policy may have an exception excluding claims arising from employees. A fire policy may be issued to a company that uses arc furnaces in its production process. These furnaces are lined with ceramic material which is damaged by fire during manufacturing. This fire policy may contain a specific exception clause stating clearly that the insurer is not liable for the damage by fire to the ceramic linings.

- *Extensions*

The operative clause is usually framed as widely as possible, but the wording is generally not wide enough to cover every conceivable event. However, the insurer may offer covers that are wider than those mentioned in the operative clause. This is done by way of an extension.

Study the following sections in Chapter 3 of the prescribed book

- 3.3.1 The Heading**
- 3.3.2 The Preamble**
- 3.3.3 The Operative Clause**
- 3.3.4 The Exceptions**
- 3.3.5 The General Conditions**
- 3.3.6 The Policy Schedule**
- 3.3.7 The Disclosure Notice**
- 3.4 INSURABLE INTEREST**

Insurable interest is the legally recognized relationship between the insured and the financial loss he or she suffers.

The following are legally recognised relationships:

- owners and joint owners of property
- mortgagees and mortgagors
- those who legally hold other people's property (bailees)
- agents

- executors and trustees who can insure the property for which they are legally liable
- husbands and wives have unlimited insurable interest in each other's life

Insurable interest is required for all insurance contracts and is the feature that distinguishes this type of contract from wager agreements. The absence of insurable interest could render the insurance contract illegal, void or simply unenforceable.

Study the following section in Chapter 3 of the prescribed book

- When must insurable interest apply

3.5 INSURABLE AND UNINSURABLE RISKS

Study the following sections in Chapter 3 of the prescribed book

3.5.1 Fundamental risk

3.5.2 Pure and speculative risk

3.5.3 Particular risk

3.5.4 Insurable risk

3.6 THE PROPOSAL FORM

Study the following sections in Chapter 3 of the prescribed book

3.6.1 To have or not to have

3.6.2 Good faith and disclosure

- The Reasonable Man Test

3.6.3 The function of the Proposal

- Recap
- Page one of the Proposal
- Page two of the Proposal
- Page three
- Motor section
- SASRIA

3.7 THE PROCEDURE

Study the following sections in Chapter 3 of the prescribed book

3.7.1 Houseowners

3.7.2 Householders

- Sum insured
- Inventory
- Inflation

3.7.3 All Risks**3.7.4 Motor**

- Issuing the policy
- The business policy
- Conclusion

3.8 PREMIUM COLLECTION

Study the following sections in Chapter 3 of the prescribed book

3.8.1 The Short Term Insurance Act**3.8.2 Rules for paying over premium****3.8.3 When premium is due****3.8.4 Methods of payment****3.8.5 Monthly premium payments****3.8.6 Non-payment of premiums****3.8.7 When cover ceases – debit order policies****3.8.8 Conclusion****ASSESSMENT**

- (1) Identify the essential elements of a contract.
- (2) A 10-year-old boy purchases motor insurance over the internet. At the end of the year he demands the return of his insurance premium. On what basis does he make this request? Will he be successful?
- (3) Janice signed an application for life insurance on 10 January. She did not pay the premium at the time. The underwriter at the insurer accepted the application on 17 January and mailed the contract to the agent for delivery to Janice. When the agent called at Janice's home to deliver the policy, he discovered that Janice had died. Is the insurer liable if Janice died on
 - a. 12 January?
 - b. 18 January?
- (4) How would you have answered if Janice had paid the premium with the application?
- (5) Complete the questions at the end of Chapter 3 in the prescribed book.

FEEDBACK

- (1) The essential elements of a contract:
 - consensus between the parties
 - parties must be competent to contract
 - performance must be possible and legal
 - prescribed formalities must be complied with e. both parties must exchange consideration.
- (2) He will most probably be successful because he was not legally competent to enter into a contract.
- (3) In submitting the proposal form, Janice offered to be insured. The contract is valid as soon as the insurance company accepts the contract. This happened on 17 January. If Janice had died before this date, there would have been no contract. If she had died after this date, the insurance company would have been liable.
- (4) In South Africa, unlike the UK, consideration is not required for the contract to be valid.

The contract would therefore be valid or invalid regardless of whether Janice had paid the premium EXCEPT if one of the terms of the policy stated explicitly that the premium had to be paid for the contract to be valid. In that case the contract would be invalid regardless of when Janice died.
- (5) Consult the suggested solutions to the questions of Chapter 3 at the end of the prescribed book.

SUMMARY

This study unit dealt with the process of obtaining insurance cover. The essential elements of an insurance contract were highlighted, as was the role of the proposal form. The next unit deals with renewal of short-term cover.

STUDY UNIT 4

RENEWALS

CONTENTS

Learning outcomes

Key concepts

Getting an overview

4.1 The renewal listing

4.2 The claims experience

4.3 Options

4.4 The survey

4.5 South African Special Risks Insurance Association (SASRIA)

4.6 Renewal

Assessment

Summary



Learning outcomes

When you have worked through this study unit, you should be able to

- Describe the renewal process, from receipt of the advance list until dispatch of the renewal documents
- list the steps taken by the underwriter, the broker and the client in the renewal process
- describe the steps required for SASRIA cover when the policy is renewed

Key concepts

Renewal listing

Renewal cycle

Collective insurance

Renewal notice

GETTING AN OVERVIEW

As stated in the introduction to Chapter 4 of your prescribed book, one major difference between short-term insurance and long-term insurance is that short-term insurance has to be renewed annually. This means that the short-term insurance contract is valid for one year

only. The policy expires after a year and the insured and the insurer have the option to renegotiate the contract and renew the policy.

This study unit covers the procedures to be followed by the relevant parties, and the responsibilities of each party during the renewal process.

4.1 THE RENEWAL LISTING

Study the following sections in Chapter 4 of your prescribed book:

- 4.1.1 The renewal listing
- 4.1.2 Explanation for the advanced listing

4.2 THE CLAIMS EXPERIENCE

Study the following sections in Chapter 4 of your prescribed book:

- 4.2.1 Determining trends
- 4.2.2 Conclusions reached

4.3 OPTIONS

Study the following sections in Chapter 4 of your prescribed book:

- 4.3.1 Rates being charged
- 4.3.2 The terms and conditions

4.4 THE SURVEY

Study the following sections in Chapter 4 of your prescribed book:

- 4.4.1 The survey option
- 4.4.2 Conclusion

4.5 SOUTH AFRICAN SPECIAL RISKS INSURANCE ASSOCIATION (SASRIA)

Study the following sections on SASRIA in Chapter 4 of your prescribed book:

- 4.5.1 SASRIA cover

4.6 RENEWAL

Study the following sections on renewal in Chapter 4 of your prescribed book:

- 4.6.1 The renewal cycle
- 4.6.2 The insurer's perspective
- 4.6.3 The broker's perspective
 - Procedures
 - Additional roles for the broker

4.6.2 The insured's perspective

- The role of the insured
- Payment of the renewal premium
- Revised schedules
- Conclusion

ASSESSMENT

- (1) Answer the questions at the end of Chapter 4 in the prescribed book.
- (2) Explain why underwriters prefer to review at least three years' claims experience (and not only one year's) when they consider a renewal.
- (3) Briefly indicate the four occasions when a survey will be carried out.

FEEDBACK

- (1) Consult the suggested answers to the questions on Chapter 4 at the end of the prescribed book.
- (2) Underwriters prefer to review at least three years' claims experience for the following reasons:
 - Shorter periods provide an unbalanced perspective.
 - Underwriters are able to obtain a better idea of trends.
 - It helps the underwriter to identify where things are going wrong. d. Three years' claims experience enables the underwriter to see
 - whether the insured claims regularly
 - whether the insured regularly submits small claims
 - whether it is necessary to consider risk improvements
- (3) A survey will be carried out
 - at renewal
 - at the inception of new risk
 - following a loss
 - for a large risk

SUMMARY

This study unit dealt with the role and the functions of the different parties involved in the renewal process. The next study unit discusses the nature and role of reinsurance.

STUDY UNIT 5

SHORT-TERM REINSURANCE PRACTISE

CONTENTS

Learning outcomes

Key concepts

Getting an overview

5.1 The reasons for and the importance of reinsurance

5.2 Classes of reinsurance

5.3 Proportional reinsurance

5.4 Quota share treaty

5.5 Surplus treaty

5.6 Nonproportional reinsurance

5.7 Stop-loss reinsurance

5.8 Excess-of-loss reinsurance

5.9 Catastrophe excess-of-loss reinsurance

Assessment

Summary



Learning outcomes

After you have worked through this study unit, you should be able to

- provide reasons for reinsurance
- describe what “reinsurance” means
- explain who the cedant is
- explain the difference between treaty reinsurance and facultative reinsurance
- describe two types of proportional reinsurance
- list the advantages and disadvantages of quota share reinsurance
- list the reasons for quota share reinsurance
- explain the operation of a surplus treaty

- calculate a surplus treaty placement
- distinguish between proportional and nonproportional reinsurance
- explain the operation of stop-loss reinsurance
- explain excess-of-loss and catastrophe excess-of-loss reinsurance
- explain what is meant by “layering” in excess-of-loss reinsurance
- list the advantages of layered reinsurance

Key concepts

Reinsurance	Ceding offer	Facultative reinsurance
Cession	Treaty reinsurance	
Retention	Retrocession	

GETTING AN OVERVIEW

It is evident from the previous study units that insurance is a mechanism in terms of which individuals or companies can, for an agreed premium, transfer the risk of losses of unknown magnitude to an insurance company. By offering this service, the insurance company hopes to make a profit as return on the capital it invested. Insurance companies may also find it necessary to affect reinsurance, which is described in this study unit.

5.1 THE REASONS FOR AND THE IMPORTANCE OF REINSURANCE

As the term indicates, “reinsurance” represents insurance of the insurer. It is defined as the shifting of risk or part of the risk by a primary insurer, called the “ceding company”, to another company, called the “reinsurer”. The part of the risk retained by the ceding company is called the “line or retention”, and the portion reinsured is the “cession”.

There are four main reasons why an insurer would want to transfer its business to a reinsurer:

1. Reinsurance enlarges the ceding company’s financial capacity to accept risk.
2. Reinsurance stabilises profits and evens out losses.
3. Reinsurance reduces the ceding company’s reserve requirements.
4. Reinsurance offers a way for an insurer to retire from underwriting a given segment of its insurance business.

5.2 CLASSES OF REINSURANCE

There are two classes of reinsurance, namely proportional (participating) and non-proportional (non-participating) reinsurance. In proportional reinsurance, the reinsurer pays a fixed percentage of total claims. In the case of non-proportional reinsurance, the reinsurer pays only losses above an agreed amount. This amount varies, depending on the claim size.

5.3 PROPORTIONAL REINSURANCE

Study the following sections in Chapter 5 of your prescribed book:

- 5.3.1 Sharing
- 5.3.2 Treaty or facultative
- 5.3.3 Treaty negotiations
- 5.3.4 Recording
- 5.3.5 Types of proportional treaty

Note that there are two types of treaty agreements:

- (1) The quota share treaty
- (2) The surplus treaty

5.4 QUOTA SHARE TREATY

Study the following sections in Chapter 5 of your prescribed book:

- Net retention and ceded percentage
- Monetary limit
- Cedant restriction
- Reasons for quota share
- Advantages
- Disadvantages

Pay attention to the example of a quota share treaty in the prescribed book.

5.5 SURPLUS TREATY

Study the following sections in Chapter 5 of your prescribed book:

- Hazard
- Maximum retention

5.5.1 Reinsurer's share

- Insured's reduced retention
- Increased capacity
- Excluded risk

5.5.2 Other risks

5.5.3 Conclusion

Pay attention to the example of a surplus treaty in the prescribed book.

5.6 NON-PROPORTIONAL REINSURANCE

Note that there are three types of non-proportional reinsurance:

- stop loss

- excess of loss
- catastrophe excess of loss

These three types can be facultative or treaty reinsurance.

Study the following sections in Chapter 5 of your prescribed book:

- Increased use
- Types of non-proportional reinsurance

5.6.1 Stop loss reinsurance

Study the following sections in Chapter 5 of the prescribed book:

- Stop loss – pay attention to the example in the prescribed book
- Premium based
- “Perfect reinsurance”

5.6.2 Excess of loss reinsurance

Study the following sections in Chapter 5 of the prescribed book:

- Maximum amount – pay attention to the example in the prescribed book
- Premium

5.6.3 Catastrophe excess of loss reinsurance

Study the following sections in Chapter 5 of the prescribed book:

- “Layers”
- Starting level
- Maximum losses likely
- The layer involvement
- Advantages of layering
- Conclusion

ASSESSMENT

- (1) The reinsurance arrangement in which the reinsurer does not pay unless the loss reaches a certain size is
 - a. a quota share treaty
 - b. a surplus treaty
 - c. an excess-of-loss treaty
 - d. a facultative agreement

- (2) An insurer wishes to enter into one of the following reinsurance arrangements:
- a. a quota share arrangement with the ceding insurer retaining 60% of losses
 - b. a surplus share arrangement with the ceding insurer retaining policy amounts up to R100 000
 - c. an excess-of-loss arrangement with the ceding insurer retaining all losses under R100 000

How much will the reinsurer pay in terms of each of these arrangements if the loss is

- i. R40 000 under an R80 000 policy?
- ii. R40 000 under a R200 000 policy?
- iii. R200 000 under a R200 000 policy?

(3) Complete Questions 1 to 4 at the end of Chapter 5 in the prescribed book.

FEEDBACK

(1) (c)

(2) For (i) the reinsurer will pay a. R16 000 (b) R0 (c) R0

For (ii) the reinsurer will pay a. R16 000 (b) R20 000 (c) R0

For (iii) the reinsurer will pay a. R80 000 (b) R100 000 (c) R100 000

Catastrophe insurance is an agreement to share losses that occur in a single event (eg a flood). Agreements (1)(a) and (b) above are agreements to share insurance, with the sharing of loss occurring as a result of sharing insurance. Agreement (1)(c) is an agreement to share all losses that exceed a certain amount. Agreements (1)(a), (b) and (c) are not event-specific whereas catastrophe reinsurance is.

(3) Consult the suggested answers to the questions on Chapter 5 at the end of the prescribed book.

SUMMARY

This study unit addressed the nature and types of reinsurance. The next unit addresses the procedures related to handling and processing claims.

STUDY UNIT 6

CLAIMS PROCEDURES

CONTENTS

Learning outcomes

Key concepts

Getting an overview

6.1 Notification of a claim

6.2 The claims department

6.3 Requirements for a claim to be valid

6.4 Indemnity

6.5 Methods of settling claims

6.6 Claims disputes

6.7 Prescription period

6.8 Post-loss action

Assessment

Summary



Learning outcomes

After you have worked through this study unit, you should be able to

- list the three basic requirements for a claim to be valid
- define the concept of “proximate cause”
- explain the operation of “proximate cause”
- explain with whom the burden of proof rests under different circumstances
- define what “prescription” means
- describe the different prescription periods
- describe the four basic methods of settling a claim
- explain the different methods of dispute resolution in respect of claims

- define an ex gratia payment and why subrogation and contribution do not apply
- define “average”, explain why it applies, and demonstrate the use of the average calculation
- describe the steps that are taken or may be taken by an insurer after a loss has been settled

Key concepts

Proximate cause	Dominant cause
Underinsurance	Reinstatement
Prescription period	No-claim bonus
Ex gratia payment	

GETTING AN OVERVIEW

The purpose of an insurance contract is to provide indemnity or compensation if an insured event takes place. Insurers have compiled proposal forms and an underwriting system to ensure a convenient and competent method of initiating contracts. They have also set up a claims department to negotiate and process claims. This study unit considers the entire process of how a claim is handled – from reporting a claim until the claim is paid.

6.1 NOTIFICATION OF A CLAIM

Almost all policies require the insurer to be notified immediately of an event that could give rise to a claim. The insured frequently have to provide full particulars within a stipulated period, say seven, fifteen or thirty days. Notifying the insurer as soon as possible is essential so that a full investigation of the circumstances can be initiated. If this notification is tardy, evidence may become unavailable, or witnesses’ recall of the incident may become muddled. It is usually in the insured’s interest to obtain assistance from the insurer’s claims officials or of independent loss adjusters to help prevent additional loss and to speed up the start of repairs. Although notification should be in writing, this requirement may be waived and the insurer will act on a verbal communication.

A claim form is usually sent to the claimant for completion to elicit pertinent information regarding the insured, the place of loss, the nature of the loss, the time of the loss, a description of the property and its value at the time, and particulars of other insurance policies (except life policies) that cover the insured event.

6.2 THE CLAIMS DEPARTMENT

Study the following sections on the claims department in Chapter 6 of your prescribed book:

- 6.2.1 Client’s responsibility
- 6.2.2 Claims notification

6.3 VALID CLAIM

Study the following sections on valid claims in Chapter 6 of your prescribed book:

6.3.1 Determining the validity of a claim

- Policy in force
- Proximate cause

Hint: Refer to the definition of an discussion on proximate cause in Study Unit 3 when you are studying this section in the prescribed book.

- Legal definition
- Dominant cause
- Original peril still operating
- Points to remember
- Burden of proof
- Rules for the application of proximate cause
- Conclusion
- Terms and conditions
- The loss adjuster
- Conclusion

6.4 INDEMNITY

Study the following sections in Chapter 6 of your prescribed book:

6.4.1 Financial loss

6.4.2 Indemnity

6.4.3 Indemnity versus compensation

6.4.4 Underinsurance

- Average

6.4.5 Betterment

The discussion below supplements the discussion on average in the prescribed book. The word “average” is of French origin and it has a special meaning in marine insurance which is entirely different from the meaning of the word in other classes of insurance.

Marine insurance

Here the word “average” means “partial loss” and it is qualified by the word “particular” or the word “general”.

- a. “Particular average” refers to a partial loss affecting one particular interest, for example the hull or a particular consignment of cargo. The policy may exclude or “be free of” particular average, meaning that partial losses that affect the individual rather than all involved in the maritime venture, are excluded. Sometimes partial losses under a certain percentage, say 3% or 5% of value, are excluded. Since 1982 the new wording for cargo insurance does not contain this clause.
- b. “General average” refers to a loss which is partial when looked at from the total at-risk value in the venture (although it could be total for one individual). If this loss was

incurred voluntarily in order to save the whole venture, and this sacrifice was successful, then all parties to that venture share the loss.

Non marine property insurance

In this case the word “average” means to share the loss, and is used by insurers to combat underinsurance. If the policy contains an average clause, the insured will or may become an insurer for the

Underinsured proportion, and will have to share in the contribution. The most common forms of average clauses appear below.

- *Pro rata condition of average* (This clause applies almost universally to fire and theft policies.)

If an insured sum is low compared to the at-risk value, the insured contributed too little to the common pool. (In other words, sum insured x rate percent instead of value x rate percent.) In order to correct this imbalance, policies subject to the pro rata condition will only pay the proportion of the loss the insured sum bears to the at-risk value (refer to the illustration below).

$$\frac{\text{Sum insured}}{\text{Value}} \times \frac{\text{Loss}}{1}$$

When a first-loss insurance policy is arranged, the insured sum cannot be used because it was agreed that this sum would be substantially lower than the declared at-risk value. However, the underwriter sometimes takes this into account when fixing the rate, and average is sometimes incorporated into these insurance policies on the basis of

$$\frac{\text{Declared total value}}{\text{Actual total value}} \times \frac{\text{Loss}}{1}$$

subject to the limit of the first-loss sum that is insured.

- *Special condition of average*

In this case a 75% condition of average is applied (eg to agricultural produce on farms). The insured will share in the loss only if the insured sum is less than the stated percentage (ie 75%) of the value insured (ie indemnity) at the time of the loss. If average does apply, it is the pro rata condition (as dealt with above) that applies. A similar form of average applies in reinstatement insurance, when the percentage is 85%.

- *The two conditions of average*

This clause is used for fire insurance on stock in certain warehouses. It would be applied to an insurance policy covering stock in several situations or of several types, when there is a possibility that other policies may be in force, but covering more limited situations or more limited types of stock.

The second condition states that the wider ranging policy does not insure what is more specifically insured by the narrower ranging policies. For the application of a pro rata average (as stated in condition one), the value at risk is construed accordingly. The more specific policies have to deal with the loss first.

The formula is:

$$\frac{\text{Sum insured}}{\text{Value at risk (less values covered by more specific policies)}} \times \frac{\text{Balance of loss not paid by specific policies}}{1}$$

6.5 METHODS OF SETTLING CLAIMS

Study the following sections on the methods of settling claims in Chapter 6 of your prescribed book:

6.5.1 Four methods

- Cash settlement
- Replacement
- Repair
- Reinstatement
- Conclusion

6.6 CLAIMS DISPUTES

It is inevitable that disputes may arise from time to time. These disputes may be about

- the question of whether the insurer is liable at all
- and if liable, to what extent

Study the following sections on claims disputes in chapter 6 of your prescribed book:

6.6.1 Resolution of disputes

- Negotiation
- Litigation
- Arbitration

6.6.2 Ex gratia payments

6.7 PRESCRIPTION PERIOD

Study the different prescription periods in Chapter 6 of your prescribed book.

- Notification
- Final submission of claim
- Legal proceedings
- Recovery from third parties
- Government claims

6.8 POST LOSS ACTION

Study the following sections in Chapter 6 of your prescribed book:

6.8.1 After the loss

- A post-loss survey
- Reduction of no claim bonuses
- Reinstate the sum insured
- Deletion of an item
- Conclusion

ASSESSMENT

- (1) A fire leaves a wall standing but in a weakened condition. Several days later, a gale causes the collapse of the wall onto other property. In applying the concept of “proximate cause”, will a fire policy respond to this claim?
- (2) A property is insured for R50 000. The total value of the property is R100 000. A loss of R25000 is sustained on the property. Which amount will the insurer pay out if the policy is subject to the pro rata condition of average?
- (3) A crop is insured for R75000. The full value of the crop is R100000. Crop damage amounting to R20 000 occurs. Which amount will the insurer pay out if the special condition of average applies?
- (4) List and briefly describe the documentation an insurer will require in order to settle a motor accident claim.
- (5) Outline the claims process when a vehicle is to be repaired after an accident.
- (6) Answer the questions at the end of Chapter 6 in the prescribed book.

FEEDBACK

- (1) This is an actual English court case (Gaskarth v Law Union 1872) in which the court decided that the fire was not the proximate cause. It may be stated that the gale was the proximate cause but the crucial factor was the delay of several days during which no steps were taken to repair the weakened wall.
- (2) R12 500
- (3) R20 000 as the crop is insured for 75% of its full value. Under the special condition of average this is considered to be fully insured.
- (4) Motor claim form, copy of the ID book and the driver’s license, quotations for repairs, and other documents the insurer may require (eg cancellation of registration).
- (5) The claims process includes the following:
 - insured obtains quotation for repair
 - assessor sent to inspect vehicle
 - assessor negotiates final deal
 - vehicle is repaired
 - insured pays excess to panel beater
 - insured signs release
 - insured takes delivery
 - panel beater’s net account received by insurance company
 - insurer settles account

- (6) Consult the suggested answers to the assessment questions on Chapter 6 at the end of the prescribed book.

SUMMARY

This study unit addressed the nature of the claims procedure. In the next study unit we will consider the regulation of the short-term industry

STUDY UNIT 7

REGULATION OF THE SHORT-TERM INDUSTRY

CONTENTS

Learning outcomes

Key concepts

Getting an overview

7.1 Short-term insurance business

7.2 The Short-term Insurance Act, 53 of 1998

7.3 Parts of and schedules to the Short-term Insurance Act of 1998

7.4 Intermediaries/Brokers

7.5 Other statutes

7.6 Compulsory insurance

Assessment

Summary



Learning outcomes

After you have worked through this study unit, you should be able to

- provide reasons why the short-term insurance market should be regulated
- list the aims of the Short-term Insurance Act 53 of 1998
- list the various duties of the short-term insurer in terms of The Short-term Insurance Act of 1998
- describe the various statements and accounts that have to be submitted
- describe what the statement of liabilities has to contain
- explain why a correct claims estimate is important
- explain the importance of premium collection with respect to company assets
- explain the importance of the solvency margin and how it is calculated

- detail the solvency requirements in terms of the Act
- explain how value-added tax applies to premiums and claims, including recovery and third party
- list short-term policies that are exempted from VAT
- list examples of statutes governing compulsory forms of insurance
- list the reasons for compulsory insurance
- explain some of the differences between state insurance and commercial insurance

Key concepts

Solvency margin	Registrar
Audit committee	Ombudsman
Value-added tax	Salvage recoveries
Compulsory insurance	

GETTING AN OVERVIEW

As indicated in a previous study unit, short-term insurance contracts have to be renewed regularly, whereas long-term insurance cannot be cancelled by the insurer once a contract has been entered into. It was also indicated that short-term insurance is primarily concerned with risk assessment, whereas long-term insurance and pension and provident funds are concerned with investment results and risk assessment.

These differences, and the fact that there was definitional uncertainty in the previous Insurance Act concerning the business areas of long and short-term insurers (so that they encroached on each other's traditional markets), emphasised the need for a better demarcation between the two industries and for separate legislation. This study unit discusses the stipulations of the Short-term Insurance Act, 53 of 1998, other statutes affecting the short-term insurance industry, the impact of value-added tax on the industry, and compulsory short-term insurance.

7.1 SHORT TERM INSURANCE BUSINESS

Short-term insurance is described by the Act as the business of providing or undertaking to provide policy benefits under any of the following short-term policies:

- An engineering policy
- A guarantee policy
- A liability policy
- A miscellaneous policy
- A motor policy
- An accident and health policy
- A property policy
- A transport policy

Refer to this section in the prescribed book.

7.2 THE SHORT TERM INSURANCE ACT, 53 OF 1998

Study the following sections of the Short-term Insurance Act of 1998, in Chapter 7 of your prescribed book.

7.2.1 The Act

- Authorisation

7.2.2 Registrar of insurance

- Statements and accounts
- Statement of liabilities
- Claims estimates
- Statement of assets
- The Melamet Commission

7.2.3 Solvency margins

- Conflict of interests
- Solvency requirements
- Curatorship

7.2.4 Parts of and schedules to the Short Term Insurance Act of 1998

The Act is divided into parts and schedules. The most important parts of and schedules to the Act are discussed in the prescribed book. Please refer to the various parts of the Act as discussed in paragraph 7.2.4 in the prescribed book.

7.2.5 Intermediaries/Brokers

Study the following sections in Chapter 7 of your prescribed book:

- Policyholder protection rules

7.3 OTHER STATUTES

Study the following sections on other statutes in Chapter 7 of your prescribed book:

7.3.1 Financial Institutions (Investment of Funds) Act 1964

7.3.2 Financial Advisory and Intermediary Service Act (FAIS), 37 Of 2002

7.3.3 Value-added Tax Act 89 of 1991

- Vendors
- Returns and tax payments
- Definition of “insurance”
- VAT invoices
- Commissions
- Local reinsurance
- Lloyd’s
- Zero-rated

- Claims
- Administration
- Third-party claims
- Salvage recoveries
- Recoveries from third parties
- Conclusion

7.3.4 The National Credit Act 34 of 2005

7.3.5 The Consumer Protection Act 68 of 2008

7.3.6 The Second-hand Goods Act 6 of 2009

7.3.7 Protection of Personal Information Bill [B9-2009]

7.4 COMPULSORY INSURANCE

Study the following sections on compulsory insurance in Chapter 7 of your prescribed book:

- Provision of funds
- Easing the state's burden
- Public attitude
- Protection of the insured

7.4.1 Examples of compulsory insurance

- Nuclear Energy Act 34 of 2008
- Oil pollution
- The Unemployment Insurance Act 63 of 2001
- Export credit insurance
- Conclusion

ASSESSMENT

- (1) Explain why the short-term market requires a regulatory framework that differs from the long-term market.
- (2) Complete the questions at the end of Chapter 7 in your prescribed book.

FEEDBACK

- (1) The long-term market usually involves contracts that are valid for long periods. In contrast, short-term policies are valid for one year only, enabling the insured to consider entering into another annual agreement with the insurer.
- (2) Consult the suggested answers to the questions on Chapter 7 at the end of the prescribed book.

SUMMARY

This study unit described the nature of the supervision of the short-term insurance industry. We now proceed to a discussion of specific short-term policies.

STUDY UNIT 8

THE PERSONAL INSURANCE POLICY

CONTENTS

Learning outcomes

Key concepts

Getting an overview

8.1 Homeowners

8.2 Householders

8.3 All-risks insurance

8.4 Personal accident insurance

8.5 Personal liability

8.6 Small-craft insurance

Assessment

Summary



Learning outcomes

After you have worked through this study unit, you should be able to

- describe the cover available in terms of the various sections of a personal lines policy
- explain what is meant by homeowners, householders, all risks, personal accident, and personal liability insurance
- explain why a client requires the different types of cover
- explain the difference between a policy of inclusions and a policy of exclusions
- explain which policies in personal lines are policies of inclusions and which are policies of exclusions

Key concepts

Personal lines policy Standard construction
 Defined peril Unbundle
 Personal liability

GETTING AN OVERVIEW

Individuals purchase short-term insurance to protect some of their most important assets such as their home, its contents, and their motorcars and to protect themselves against liability claims and accidents.

The following types of cover are offered in domestic insurance packages:

- homeowners' insurance
- householders' insurance
- motor vehicle insurance
- all-risks insurance
- personal liability insurance
- personal accident insurance

A prospective policyholder may decide which types of cover are effective in a domestic package, but some insurers impose a limitation on the insured's choice. The cover is usually provided under one policy – this study unit addresses these covers.

8.1 HOMEOWNERS**Property covered**

The homeowner's policy insures the following property:

- the buildings of the residence
- outbuildings, fixtures and fittings for which the policyholder is responsible as owner (not as tenant) in or on the above structures

Some insurers extend the property cover to include the following items:

- fixed glass against accidental breakage
- fixed sanitary ware and bathroom fittings against accidental breakage but not chipping and scratching
- swimming pool machinery against accidental damage, excluding wear and tear and deterioration
- fixed television antennae against breakage
- connections between the property and public services against accidental damage for which the homeowner is responsible

Study the following sections on homeowners in Chapter 8 of your prescribed book:

- 8.2.1 Definition
- 8.2.2 The premium
- 8.2.3 Defining standard construction
- 8.2.4 The perils covered
- 8.2.5 Extensions to cover

8.3 HOUSEHOLDERS

Property covered

The householders' policy covers the contents of the policyholder's private residence and outbuildings. It does not cover items that belong to a business. It covers everything that is normal to a private house that belongs to the insured or a member of his or her family. The items insured must be in the building or in the outbuildings.

Study the following sections on householders in Chapter 8 of your prescribed book:

- 8.3.1 Definition
- 8.3.2 Defining the building
- 8.3.3. Rating factors
- 8.3.4 The perils covered
- 8.3.5 Extensions to cover
 - Extensions
 - Loss of money
 - Conclusion

8.4 ALL RISKS INSURANCE

From the discussion so far it should be clear that insurance companies will as a rule insure a defined property from defined perils. For example: A house may be covered against fire or lightning, in which case both the asset and the peril are clearly defined.

A more recent development is the introduction of a much more extensive policy known as the all- risks policy or the assets all-risks policy. This cover is considerably broader than the conventional perils policy since it is intended to cover a wider spectrum of assets against as many perils. It is also not confined to specific premises as in some of the other policies discussed in previous study units, but is offered on a world wide basis. In order to meet these requirements, it has been constructed as a policy of exclusions. This means that if an asset is not excluded, it is covered.

This form of cover is extensively used in policies for individual persons, families and businesses. Many of the major corporations arrange their cover in terms of an assets all-risks package. When the insurance market hardens, there is a tendency to limit this form of cover (or to "unbundle" the cover) and to start insuring specified assets against specified perils once again.

The operative clause

The operative clause of a all-risks policy will typically be worded as follows:

“loss of or damage to the whole or part of the property described in the schedule while anywhere in the world by any accident or misfortune not otherwise excluded”

It is clear from this operative clause that the cover is exceptionally broad, extending to anywhere in the world, by any accident or misfortune not otherwise excluded.

When an all-risks policy is arranged for an individual, the classes of assets are fairly well defined. These assets normally include personal effects (eg clothing, jewelry, pocket-sized calculators, electric razors, portable radios and tape recorders). Other property that may be included in the all- risks policy is property not insured in terms of personal effects. If the value of the property exceeds a specified amount, usually R2000, a documented description of the asset, including a certificate of value, is required. Car radios, contact lenses, automatic swimming pool cleaners and pedal cycles are normally included in this cover.

Study the following sections on all-risks insurance in Chapter 8 of your prescribed book:

- 8.4.1 Away from home
- 8.4.2 All-risks insurance
- 8.4.3 Exclusions
- 8.4.4 Rating factors
 - Miscellaneous items
 - Items separately specified
- 8.4.5 Excesses

8.5 PERSONAL ACCIDENT INSURANCE

Personal accident insurance compensates the insured for injury or death caused by violent external and visible means as a direct result of an accident. Illness is not covered.

Most insurers include a personal accident section in their domestic packages. The benefits offered for a personal accident are confined to capital payments for death or permanent total or partial disablement resulting from physical injury caused by violent, accidental, external and visible means. Illness is not covered. Personal accident insurance is a policy of compensation and not indemnity since it is impossible to put a price on someone’s life. The insurance can only pay compensation for the injuries sustained or death.

Study the following sections on the personal accident section in Chapter 8 of your pre- scribed book:

- 8.5.1 What is covered?
- 8.5.2 External visible and violent
- 8.5.3 Age restrictions
- 8.5.4 Rating

8.5.5. Conclusion

8.6 PERSONAL LIABILITY

The personal liability policy is designed to indemnify the insured or a member of his or her family for legal liability they incur. In previous study units we discussed the presence of liability cover in householders' and homeowners' policies. The cover in these policies is specifically for liability incurred at the insured's premises. The cover under personal liability insurance is specifically for liability which the insured incurs away from home. Personal liability is therefore distinct from the ownership or occupancy of a residence and is a liability under common law to other members of the public.

Example

Personal liability may arise from a person's carelessly stepping into the road and causing a motor accident, or it may arise from the consequences of a bad slice at golf or from the negligent handling of a firearm.

Methods of insuring liabilities

Domestic policies usually cover some of the liabilities identified above. However, domestic packages do not necessarily cover all these liabilities. Most packages include owner's liability cover as an extension of the homeowner's policy and occupant's, tenant's and employer's liability as extensions to the householders' policy. A separate section provides cover against personal liability.

Exceptions

The following exceptions apply to liability cover in a domestic package:

- liability for the death or injury of the policyholder
- liability for loss of or damage to property belonging to the policyholder
- liability arising from
 - the conduct of business for reward
 - ownership of land or buildings other than the private residence of the owner
 - ownership of vehicles and animals other than domestic animals
 - liabilities that the policyholder has agreed to accept and for which he or she would not have been responsible without the agreement
 - the consequences of all wilful or malicious acts

Study the following sections on personal liability in Chapter 8 of your prescribed book:

8.61 Additional liability cover needed

8.6.2 Premium

8.7 SMALL CRAFT INSURANCE

Study the following sections on small-craft insurance in Chapter 8 of your prescribed book:

8.7.1 Cover provided

8.7.2 Premium

ASSESSMENT

- (1) Should a homeowner have both homeowner and householder cover? Explain.
- (2) Explain why the all-risks policy is referred to as a policy of exclusions.
- (3) Explain why personal accident cover is a policy of compensation and not one of indemnity.
- (4) Complete the questions based on Chapter 8 in your prescribed book.

FEEDBACK

- (1) Yes, the homeowner's policy covers the buildings and the outbuildings, and the householder's policy covers the contents of private dwellings.
- (2) It has been constructed as a policy of exclusions. This means that if it is not excluded, it is covered.
- (3) A personal accident policy provides cover for death and permanent or temporary disablement. One cannot be indemnified for loss of life, and therefore it is a policy of compensation and not of indemnity.
- (4) Consult the suggested solutions to the questions on Chapter 8 at the back of the prescribed book.

SUMMARY

This study unit described the nature and covers provided by a personal lines policy. In the next unit the nature of commercial insurance is discussed.

STUDY UNIT 9

COMMERCIAL INSURANCE

CONTENTS

Learning outcomes

Key concepts

Getting an overview

9.1 Multi-peril policies

9.2 Fire section

9.3 Accident classes

9.4 Liability

9.5 Other types of cover

Assessment

Summary



Learning outcomes

After you have worked through this study unit, you should be able to

- list the advantages of multi-peril policies
- list the standard exceptions to the multi-peril policy
- list the general conditions of the multi-peril policy
- define the different covers available under the multi-peril policy
- list the perils covered under the different sections of the multi-peril policy
- list the exclusions from cover under the different sections of the multi-peril policy
- define theft from a legal point of view as well as from an insurance point of view
- explain the difference between the legal definition and the cover available in terms of a theft policy
- explain what “first-loss basis” means with respect to theft insurance
- give examples of what may be covered in terms of a business all-risks policy

- explain the cover provided under
 - goods in transit insurance
 - money insurance
 - fidelity guarantee insurance
 - glass insurance
 - group personal accident insurance
 - liability insurance
 - accidental damage insurance
 - asset all risks and electronic equipment insurance
 - solvency guarantees and court bonds

Key concepts

Multi-peril policies Consequential losses
 Business interruption Solvency guarantees
 Court bonds

GETTING AN OVERVIEW

The short-term insurance available to individuals was discussed in the previous study unit. This study unit deals with the commercial short-term cover available to companies. The purpose of this study unit and of Chapter 9 in the prescribed book, is to consider the cover provided for businesses, and the nature of some short-term insurance policies for businesses. This study unit is supplementary to the prescribed book.

9.1 MULTI-PERIL POLICIES

In the past the insured had a separate policy for fire, accident, liability and some other covers. Companies therefore had numerous policies, each with its own renewal date and specific premium. This was neither a cost-effective nor an efficient way of handling insurance. Nowadays a multi-peril policy is issued to amalgamate a number of policies into one document. When combined, these various classes of business are referred to as “departments”.

Study the following sections on multi-peril policies in Chapter 9 of your prescribed book:

- Standard exceptions
- General conditions

Activity 9.1

List the possible advantages of a combined policy.

Feedback

The following are advantages of combining various forms of insurance into one policy:

- It is less costly from an administrative point of view.

- There is only one premium and one renewal date to care about.
- There is less chance of overlooking one form of cover.
- Such a combination is easier to market.

9.2 FIRE SECTION

The fire section contains all the fire type policies. Probably the single largest peril threatening assets is the peril of fire. One may argue that earthquakes constitute a greater risk, but the frequency of earthquakes in South Africa is very low whereas the frequency of fire is high. Protection against fire and specified perils is defined in terms of a fire policy. A study of the fire policy reveals the difference between the assets all-risks and the fire policies. Generally, the fire policy insures against specified perils, whereas an assets all-risks policy does not specify the perils concerned.

The following policies form part of the fire section:

- buildings combined policy
- office premises policy
- business interruption insurance
- accounts receivable

The general structure of a fire policy is discussed before going into the details of each policy.

The general fire policy

The operative clause

Typically the operative clause of a fire policy refers to damage to property by

- fire, whether due to an explosion or otherwise
- lightning or thunder bolt
- explosion of gas used for domestic purposes or for heating or lighting a building

The insured property is defined in a schedule. It is property which the insured owns but could also be property for which the insured is responsible.

- *The meaning of fire*

Fire is where there is ignition either of the insured property or of the premises where it is situated. Damage caused by heat or fermentation unaccompanied by ignition is not covered. The cause of the fire is generally irrelevant. The fact that the insured's negligence caused the fire would not exempt the insurer from liability. When an insurance company which insured a house against fire avers that the insured deliberately set the house on fire, the onus is on the insurer to prove that the insured committed arson.

Damage by water used to extinguish the fire or to prevent it from spreading is covered as is damage by explosion caused by a fire.

Consequential losses such as loss of profits due to the destruction of assets are not covered by the fire policy, because it is essentially an assets policy. These consequential losses may be covered in terms of the consequential loss or business interruption policy.

- *Specific exceptions*

The perils described in the operative clause are very narrow. The cover is restrictive and the exceptions limit it even further. Earthquakes and volcanic eruptions are excluded, as is damage by explosion or damage to property undergoing a heating or drying process.

- *Specific extensions*

The fire policy was originally offered as stand-alone cover. However, it is possible to extend the fire policy to cover what is known as “additional perils” by means of extensions. If extensions are used, the policy takes on the form of a general assets policy.

The following perils may be insured against or may be included in the insurance cover by way of extensions:

1. **Damage caused by an explosion.** It is clear from the operative clause that if a fire results from an explosion, damage caused by the fire is covered but not the damage caused by the explosion itself. However, it is possible to extend the policy to cover explosion damage.
2. **Earthquake and earth tremor extension.** Earthquake damage clearly does not fall within the operative clause. Policies normally contain an earthquake and earth tremor extension.
3. **Special perils extension.** The special perils extension includes perils such as storms, wind, water, hail or snow. Damage caused by aircraft, other aerial devices or articles dropped from an aircraft may also be covered, but damage caused by sonic shock waves is excluded.
4. **Impact damage.** The impact extension covers the damage caused by animals or vehicles, but excludes damage to such vehicles or property in or on such vehicles. If owners therefore accidentally crash their car into the wall of their house, damage to the wall is covered but not damage to the car. Damage to the car would be covered by the motor policy.
5. **Sprinkler extension.** Closely allied to damage by fire is damage caused by water as a consequence of a leaking sprinkler system. Sprinkler systems are installed to prevent damage caused by fire, but they tend to go off quite often, resulting in water damage without cause. It is possible to insure against such water damage by means of a sprinkler extension.
6. **Subsidence and landslip extension.** Damage caused by subsidence and landslip can be covered by an extension.

- *Miscellaneous clauses*

Fire policies normally contain a number of miscellaneous clauses (eg the rent clause and the architect’s and other professional fees clause). The architect’s clause covers additional costs which may be incurred in the form of professional fees for the reinstatement or replacement of the insured property following the damage.

If a building is burnt down, it may not be desirable to reinstate it exactly as it was before it was damaged, but the building may instead be improved. A capital addition clause, normally limited to 15% of the insured sum, is often included in insurance policies.

Study the following sections on the fire section in Chapter 9 of your prescribed book:

9.2.1 Insured perils for fire sections

9.2.2 Sum insured

9.2.3 Buildings combined

- Perils covered under buildings combined

9.2.4 Office premises policy

- Perils covered under office premises
- Sum insured

9.2.5 Business interruption insurance

- Perils covered
- Indemnity period
- Gross profit

Note that in practice the indemnity period may be up to five years. When the gross profit is calculated for a period of more than one year, the insured must multiply the annual figure with the indemnity period.

- Uninsured costs/standing charges
- Accounts receivable
- Application of accounts receivable

9.3 ACCIDENT CLASSES

Study the details of the following covers provided under the accident section in Chapter 9 of your prescribed book:

9.3.1 General exceptions

9.3.2 Theft insurance

- “Theft” defined
- The importance of forcible and violent entry or exit
- Extensions
- Underwriting considerations
- First loss sum insured
- Malicious damage
- Conclusion

In terms of the new Multimark III wording, the malicious damage cover under theft and fire has changed. Previously, if moveable property was stolen, the malicious damage to other contents was excluded in terms of the fire section. In terms of the new Multimark III wording, the cover is much greater. The insurer should be careful when a survey is conducted, as the fire sum insured now also comes into play. Thieves may steal few goods, but destroy plant and machinery that are worth a great deal of money.

9.3.3 Business All Risks (BAR)

- Important applications

9.3.4 Goods in transit (GIT)

- What is covered?
- What should not be covered?

9.3.5 Money insurance

- The major limit
- The minor limit
- Crossed cheques limit
- Theft by employees

9.3.6 Fidelity Guarantee insurance

- Premium calculation

9.3.7 Glass insurance

- Sum insured and rating
- Rented premises

9.3.8 Group Personal Accident insurance

- Types of cover
- Basis of cover
- Insured person
- Stated benefits
- Other differences

9.4 LIABILITY

Study the following sections on liability in Chapter 9 of your prescribed book:

9.4.1 Public liability cover

- Liability assumed by contract
- What the policy covers

9.4.2 Professional liability

Note that professional liability is designed to cover the following types of risk:

- | |
|---|
| <ul style="list-style-type: none"> • Pharmacist: dispensing medicine or giving wrong advice • Doctor: when treating a patient • Architect: when giving professional advice |
|---|

In fact, anyone who, because of their profession, mistreats or gives bad advice.

- How indemnity is achieved
- Amounts over the limit of indemnity

9.5 OTHER TYPES OF COVER

Study the following sections on other types of cover in Chapter 9 of your prescribed book:

9.5.1 Accidental Damage insurance

9.5.2 Assets All-Risks insurance and Electronic Equipment insurance

9.5.3 Solvency Guarantees and Court Bonds

ASSESSMENT

- (1) A small manufacturing company manages its fire risk very well. However, this company is located near a river which overflowed once or twice and caused damaged to stock kept at ground level.
 - a. Will flood damage be covered by the fire or the extended fire policy?
 - b. What measures can the owner take to ensure that normal insurance rates apply?
- (2) What is the difference between a fire policy and an assets all-risks policy? Explain.
- (3) A company has goods on consignment. Will these goods be covered against fire perils in terms of the fire policy?
- (4) Complete the questions based on Chapter 9 in the prescribed book.

FEEDBACK

- (1)
 - a. Flood damage may be included by way of an extension to the fire policy.
 - b. The sum insured must be on a replacement basis.
- (2) Assets all risks policies are designed on an “exclusion basis”. Everything that is not excluded is therefore covered. These policies give wider cover than the fire policy.
- (3) Insured property is defined in a schedule to the policy. The policy normally includes property owned by the insured, but also property for which the insured is responsible (eg goods on consignments).
- (4) Consult the suggested solutions to the questions on Chapter 9 at the end of the prescribed book.

SUMMARY

This study unit described the nature of and the covers provided by the commercial insurance policy. The nature of motor vehicle insurance is discussed in the next study unit.

STUDY UNIT 10

MOTOR INSURANCE

CONTENTS

Learning outcomes

Key concepts

Getting an overview

10.1 Compulsory motor insurance

10.2 Types of cover in motor insurance

10.3 First amount payable

10.4 Motor trade risks

10.5 Rating methods

10.6 Claims handling

Assessment

Summary



Learning outcomes

When you have worked through this study unit, you should be able to

- explain cover in terms of the Road Accident Fund Act 56 of 1996
- define the limit of liability under the Act
- explain when the limit of liability does not apply
- define the three basic forms of cover under a motor policy
- list the categories of “first amount payable” under a motor policy
- explain what “cumulative first amount payable” means
- list the cover in terms of the Motor Traders’ Internal and Motor Traders’ External policies
- define the rating methods pertaining the different classes of motor insurance
- explain what is meant by an “aggregate excess” Key concepts

Key Concepts

Aggregate excess	Road Accident Fund Act 56 of 1996
Third-party cover	Third party, fire and theft
First amount payable	Motor trader's internal
Motor trader's external	Claim-free bonus
No-claim bonus	

GETTING AN OVERVIEW

The risk of driving a motorcar can have a number of financial consequences, some of which are covered by a motor policy. Firstly, the vehicle itself may be damaged, which is often referred to as "own damage". Secondly, there may be legal liability claims because of damage to someone else's vehicle or property or injury to some other party (referred to as the "third party"). The first and second parties are the parties to the insurance contract, namely the insured and the insurer. The third party is anyone who is not party to the insurance contract.) Thirdly, medical costs may arise from injuries to the people in the car, and particularly the driver. These three areas of financial consequences are normally covered by the motor policy. The insured has the option to insure only specific exposures, or to buy comprehensive cover for all these exposures.

The following types of cover are available:

Third party only cover. This is the most basic form of cover. It provides no cover for the insured's vehicle. It only covers damages the insured is legally liable for as a result of the negligent use of the insured vehicle.

Third party, Fire and Theft. The cover is similar to third party cover but is extended to cover the insured vehicle for loss or damage arising from fire, self-ignition, lightning, explosion and theft or any attempt to steal the vehicle.

Where a vehicle is recovered after being stolen, damage caused to the vehicle is covered.

Comprehensive cover. Comprehensive cover includes the benefits from the other two policies, along with accidental damage to the insured vehicle and some limited medical cover.

The cover provided under the different policies above are now discussed in more detail, starting with compulsory motor insurance in terms of the Road Accident Fund Act, 56 of 1996.

10.1 COMPULSORY MOTOR INSURANCE

The motor vehicle, which has become an essential part of modern life, is a risk not only to its owner, but also to third parties such as passengers and pedestrians.

Most countries in the world have specific legislation dealing with compensation in the case of motor vehicle accidents. In South Africa, third parties are compensated for personal injury claims in which fault or negligence is involved in terms of the Road Accident Fund 56 of 1996 (previously the Multi-lateral Motor Vehicle Accidents Fund Act 93 of 1989 [MMF]). The premium is collected by a levy on motor fuel. All claims are handled by the Road Accident Fund (RAF).

Important features of the Act

Note the following important features of the RAF Act in addition to the discussion in your prescribed book:

1. Liability on the Fund's part to pay compensation is based on fault or negligence. The fact that a person has been injured in a motor accident is not sufficient to justify compensation. Negligence must be proved before the Fund becomes liable.
2. The RAF only covers claims for personal injury, including loss of earnings and support.
3. Section 21 of the RAF Act, 1996, states that a person injured in a motor accident where negligence is involved, must submit his or her claim against the RAF and not against the person who caused the injury. Only the following are protected by this section:
 - the owner
 - a person who drove with the permission of the owner
 - the employer, when the driver of the vehicle drove as an employee in performing his or her duty
 - People who drive the vehicle without permission, for example a thief, are not protected by this section.

Activity 10.1

- (1) A father of three children is killed in an accident. His wife cannot prove negligence. Is she entitled to compensation from the RAF?
- (2) An injured party thought a moving bus would follow its normal route and turn. He therefore did not stop at the intersection, controlled by a yield sign, but passed through. The bus did not turn but went straight on, and a collision took place. Does the injured party have a claim?

Feedback

- (1) No. The Fund will only compensate a third party for loss or damage due to injury or death caused by the negligence or by another unlawful act of the person who drove the car or by the owner of the car.
- (2) In the actual case the bus driver was held to be negligent because he drove straight on without giving warning of his intention of to go straight through the intersection.

Study the following sections on compulsory motor insurance in Chapter 10 of your prescribed book:

10.1.1 What is covered

10.1.2 Limit of liability

- Exception
- When cover does not apply
- Administration

10.2 TYPES OF COVER IN MOTOR INSURANCE

The motor insurance policy is an indemnification policy. All the principles of indemnity apply. The indemnity is against loss or damage, and therefore includes events such as theft when the entire vehicle is lost or disappears. The policy also covers repair costs incurred due to an accident.

When a loss occurs, insurers will normally pay the market value of the vehicle. This value is calculated by using The Auto Dealer's Digest, which is a guide supplied to motor dealers. Most insurers calculate the amount to be paid by determining the average between the trade value and the retail value of the vehicle. If a motor vehicle is less than one year old, or has done less than 30000km, it is market practice to pay the cost of a new car.

Study the following sections on the types of cover in motor insurance in Chapter 10 of your prescribed book:

10.2.1 Third-party-only cover

- Exclusions
- Extensions to cover
- Limit of liability
- Road Accident Fund cover

10.2.2 Third party, fire and theft

10.2.3 Comprehensive cover

- Exceptions
- Indemnity
- Windscreen cover

10.3 FIRST AMOUNT PAYABLE

Study the following sections on the first amount payable in Chapter 10 of your prescribed book:

10.3.1 Motor car first amount payable

- Cumulative first amounts payable
- Application

10.4 MOTORCYCLES

Study the following sections on motorcycles in Chapter 10 of your prescribed book:

- Additional exclusions
- Application

10.5 COMMERCIAL VEHICLES

Study the sections on commercial vehicles in Chapter 10 of your prescribed book:

10.6 MOTOR TRADE RISKS

Study the following sections on motor trade risks in Chapter 10 of your prescribed book:

10.6.1 Types of cover

10.6.2 Types of policies

10.6.3 Rating a motor trader policy

10.7 METHODS OF RATING

Study the following sections on rating methods in Chapter 10 of your prescribed book:

10.7.1 Motor cars

10.7.2 Claim rewards

- Difference between a back bonus, no-claim bonus, and cash

10.7.3 Behavioural costing for motor policies

10.7.4 Rating commercial vehicles

10.7.5 Rating motorcycles

10.7.6 Motor fleet insurance

10.8 CLAIMS HANDLING

Study the following sections on claims handling in Chapter 10 of your prescribed book:

10.8.1 Documentation required

10.8.2 Repaired vehicle

10.8.3 Total loss

10.8.4 Aggregate excess

ASSESSMENT

- (1) Will the cost of hiring a replacement vehicle after an accident be covered by a motor policy?
- (2) John insured his vehicle for private use but uses it to deliver goods for his business. The vehicle is damaged while John is delivering his products to a customer. Will the insurance pay for the damage to the car?
- (3) Calculate the first amount payable in the case of a commercial vehicle that was involved in an accident and to which the following apply:
 - The driver of the vehicle was under 21
 - The vehicle does not qualify for a no-claim bonus

- The carrying capacity is 10 tons
 - The value of the vehicle is R300 000
- (4) One of your clients has advised you that she plans to purchase a business that buys and sells both new and second-hand private motor vehicles and light delivery vehicles. She asked you what insurance cover you would recommend for these vehicles. You are required to write a report to your client, outlining:
- a. the types of cover available
 - b. what each policy covers
 - c. what information she has to send to enable you to obtain quotations
 - d. your recommendation regarding the cover available for her premises, outlining reasons for the recommendation
- (5) Complete the questions based on Chapter 10 in the prescribed book.

FEEDBACK

- (1) No. The motor policy normally contains a number of specific exceptions (eg consequential loss, depreciation, wear and tear, mechanical or electrical break downs, failures or breakages).The cost of hiring a vehicle after an accident is a consequential loss. The cost is therefore not covered by the policy.
- (2) No. The motor vehicle policy specifically excludes cover if the vehicle is used for other purposes than those for which it is insured.
- (3) The first amount payable will be equal to:

Basic (5% of R300 000)	R15 000
No no-claim bonus	R150
Driver under 21	R150
Carrying capacity excess	R15 000 (5% of R300 000)
Total	R30 300

- (4) (a) The following types of cover are available:
- comprehensive, third party, fire and theft or third party only
 - motor traders external
 - motor traders internal
- (b) Motor traders external
- covers the vehicle while on the road or temporarily garaged during a journey
 - covers the insured's own vehicles as well as vehicles that are in custody or under
 - control
 - provides no cover while the vehicle is at own premises
- Motor traders internal
- covers vehicles damaged on the premises

- covers only insured's own vehicles
- covers customers' vehicles, limited to loss or damage due to the insured's negligence,
- and loss or damage due to defective premises, plant and machinery

(c) Motor traders internal may be rated on

- named driver basis
- trade plate basis
- wages basis

Motor traders external may be rated on

- size of insured's premises
- wages for the company

(d) Any six of

- fire
- theft
- money
- fidelity
- glass
- personal accident
- liability

(5) Consult the suggested answers to the questions on chapter 10 at the end of the prescribed book.

SUMMARY

This study unit described the nature of compulsory and voluntary motor insurance. The nature of other miscellaneous covers in the short-term market is discussed in the next study unit.

STUDY UNIT 11

SASRIA, COID AND MISCELLANEOUS SHORT-TERM COVERS

CONTENTS

Learning outcomes

Key concepts

Getting an overview

- 11.1 South African Special Risks Insurance Association (SASRIA)
- 11.2 The Compensation for Occupational Injuries and Diseases Act (COID), 130 of 1993
- 11.3 Specialist insurance covers
- 11.4 Travel insurance
- 11.5 Bank assurance and group schemes

Assessment

Summary



Learning outcomes

After you have worked through this study unit, you should be able to

- list the type of SASRIA coupons available
- explain which SASRIA covers require an underlying policy
- explain which SASRIA covers do not require an underlying policy
- describe when SASRIA cover may be issued
- define who are not covered in terms of the COID Act of 1993
- list the types of cover available in the engineering department
- explain the concept and scope of construction insurance
- list the types of policies issued for marine insurance
- list the cover that may be arranged in aviation insurance
- explain “bank assurance”
- explain group scheme business

- list the cover available under travel policies

Key concepts

SASRIA business	COID Act, 130 of 1993
Engineering insurance	Marine insurance
Aviation insurance	Travel insurance
Bank assurance	Construction insurance

GETTING AN OVERVIEW

The following specialized covers are available in the short-term market, and are discussed in this study unit:

- The cover provided by the South African Special Risks Insurance Association (SASRIA)
- The cover provided by the Compensation for Occupational Injuries and Diseases Act, 130 of 1993
- Engineering insurance
- Construction insurance
- Marine insurance
- Aviation insurance
- Travel insurance
- Bank assurance and group schemes

11.1 SOUTH AFRICAN SPECIAL RISKS INSURANCE ASSOCIATION (SASRIA)

Study the following sections on the South African Special Risks Insurance Association (SASRIA) in Chapter 11 of your prescribed book:

11.1.1 Types of cover

11.1.2 Structure of the company

11.1.3 Functioning of SASRIA business

- Issuing coupons
- Types of coupons
- Underlying policy

11.1.4 Premium accounting

- Accounting returns to SASRIA
- Value-added Tax (VAT)
- Monthly premiums
- Pro rata premiums
- Cancellation of SASRIA

11.1.5 Claims

- Claims procedures
- Claim documentation
- Loss adjusters
- Prescription period
- VAT claims

11.2 THE COMPENSATION FOR OCCUPATIONAL INJURIES AND DISEASES ACT (COID), 130 OF 1993

The COID Act of 1993 replaced the Workmen's Compensation Act of 1941. The Workmen's Compensation Act gave workers the right to compensation from the state for injuries caused by an accident at work. The Act only covered people who earned less than a specific amount. People earning more than this amount had to sue their employer and prove negligence in court. This meant that employers needed insurance protection for the liability they could incur.

In terms of the COID Act 130 of 1993, all employees, except those listed, are covered. This means that employees have lost their common law right to sue the employer. The need for employees' liability cover fell away. The main purpose of the Act is to provide compensation for disablement caused by accidents, and industrial diseases contracted by workers in the course of their employment, or for death which may result from such accidents or diseases.

The Act is divided into 11 chapters and contains four schedules.

Study the following sections on the COID Act of 1993 in Chapter 11 of your prescribed book:

11.2.1 Employers' liability cover

11.2.2 The COID Act

- Persons not covered by the Act
- Limited benefits

11.2.3 Employers liability cover

11.3 SPECIALIST INSURANCE COVERS

Study the following sections on specialist insurance covers in Chapter 11 of your prescribed book:

11.3.1 Engineering insurance

- Types of engineering insurance

11.3.2 Construction insurance

11.3.3 Marine insurance

11.3.4 Aviation insurance

Study the following sections on marine and aviation insurance in addition to the material in the prescribed book.

- **Marine insurance**

The earliest type of insurance was marine insurance, and the origin of modern commercial insurance can be traced to this type of insurance. A number of insurance-like practices existed before modern commercial practices developed. These practices can be traced back to the Greeks, Romans and Phoenicians.

One of the first insurance-like practices was the bottomry bond, which was a loan made to finance a venture. The vessel was pledged as security for the loan. If the vessel did not survive the venture, the money was retained and could be used to replace the vessel. If the vessel survived, the money was returned and a premium paid. The respondentia bond is similar to the bottomry bond, except that the cargo and not the vessel was pledged.

Another early practice of risk sharing, traceable to the Greek island of Rhodes, is general average. In terms of general average, the loss suffered by one party in a venture was shared equally by all parties to the venture. If the captain of a ship for example deemed it necessary to jettison some cargo to save the balance of the ship, the owners of the cargo that was saved would contribute to the loss of the owners whose cargo had been jettisoned. General average is dealt with in terms of Section 66 of the Marine Insurance Act of 1906, the relevant portion of which reads as follows:

- (1) "A general average loss is a loss caused by or directly consequential on a general average act. It includes a general average expenditure as well as a general average sacrifice.
- (2) There is a general average act where any extraordinary sacrifice or expenditure is voluntarily and reasonably made or incurred in time of peril for the purpose of preserving the property imperiled in the common adventure. It is emphasized that general average is a consequence of marine law and quite distinct from marine insurance. In terms of the General Average Act the party to the marine adventure could find itself incurring a substantial liability, which is insurable."

Marine insurance was first introduced to the United Kingdom by the Lombards some 600 years ago to cover international trade. In those early days, marine insurance was not undertaken by specialist insurers but as part of everyday trading by merchants along the lines of a mutual aid insurance system. Merchants met at convenient places to discuss the sharing of risks and one of the earliest meeting places was the coffee house of one Edward T Lloyd in Tower Street, London. This subsequently became Lloyd's of London— perhaps the most famous name in insurance throughout the world.

Details of the proposed marine adventure would be entered in a document that would later be referred to as a policy. The participating merchants would write their names underneath, indicating the proportion of risk they were prepared to cover and the premium to be charged. In time, such signatories became known as underwriters, and they were the people who were at risk. In 1575 a Chamber of Assurances was established in the Royal Exchange in London to register marine insurance policies and to settle disputes between policyholders and underwriters. The Chamber of Assurances lacked legal powers and dissatisfaction grew because its decisions were unenforceable in law. In 1601 a Court of Arbitration was established to deal with these disputes. The Chamber was disbanded in the middle of the 18th century.

More than a century later, most marine insurance was still provided by individuals although they were often full-time professionals.

Modern insurance practice

Transport by sea exposes a venture to risks of loss or damage to assets, consequential losses, and liabilities due to a number of perils. The modern insurance policy deals with four main areas:

- hull
- cargo
- freight
- marine liability

(1) Hull insurance

Hull losses comprise damage to or loss of the vessel and associated machinery. Anything that can float and move, even if only occasionally, can be classified as a hull. Marine hull policies are available to cover not only completed vessels but also those under construction or navigation, and specialized cover can be obtained against damage to off shore oil and gas installations. The term "hull" is used for historical reasons. Initially the insurance did not cover all the fittings, but only the hull. Today the term "hull and machinery" (H+ M) is used to make it clear that both the hull and the propulsion equipment are covered. In the marine hull market, the term "hull" is commonly deemed to cover two further areas, namely disbursements and collision liability. Disbursements include the ship's stores and bunker fuel up to a maximum of 25% of the total value insured for H+M. Collision liability or running down collision (RDC) liability provides cover for liabilities arising from running down other ships. This loss is also limited to the value insured for the H + M.

Cover is arranged in various ways, for example time policies or voyage policies.

(2) Cargo

The purpose of marine transport is to convey various items of cargo. The loss of or damage to such cargo can be insured against. Cargo is of course an asset, and therefore cargo insurance is a form of asset cover. Cargo insurance covers goods that have been sold and are being shipped to a buyer. The cargo can also be insured in various ways, for example fob (free on board) or cif (cost insurance and freight).

(3) Freight

Freight is the cost of transporting cargo, including the hiring of a ship when necessary. Freight may be lost if the cargo cannot be delivered for some reason. If freight is payable in advance, the cargo owner must bear this loss, and for this reason it is normally added to the agreed value of the cargo. Otherwise the ship owner or carrier annually insures against the loss of freight.

(4) Marine liability

Damage or injury to third parties have many causes. Marine insurance covers three-quarters of the liability arising from collisions with other vessels and pollution caused by oil seepage. Other marine liabilities are covered by associations of ship owners known as protection and indemnity associations, or P&I clubs, which are organised to provide mutual aid and are financed by members' contributions.

The perils insured against

The standard form of Lloyd's policy enumerates several perils to be insured against (eg the seas, men of war, fire, enemies, pirates, rovers, thieves, jettisons, letters of mart and counter

mart, reprisals, taking at sea risks, restraints, determinants and detentions of all kings, princes and people of whatever nation, condition or quality, barratry of the master and mariners, and all other perils, losses and misfortunes that cause hurt, detriment, or damage to the goods and merchandise and ships.

Essentially, assets are covered against specified perils. When these perils are analysed, it is usual to talk about perils on the sea, perils of the sea, and extraneous risks. It is emphasised that the loss-producing event must be fortuitous (ie damage due to rust would not be covered by a marine policy).

(1) Perils of the sea

These perils include stranding, sinking, collision and extraordinarily heavy weather.

(2) Perils on the sea

These perils include fire, theft, jettison, and barratry. The modern wording of the institute clauses is essentially all-perils (or all-risks) insurance.

(3) Policy wording

Until 1982 the wording of most marine and cargo insurance forms were traditional and could be traced back to 1601. For example: The so-called Lloyd's "S & G form for marine insurance" was adopted in 1779 and survived with only minor changes for over 200 years. The wording was brought up to date in 1982 by the introduction of revised standard and printed clauses termed "institute clauses" that were updated again in 2009.

- **Aviation insurance**

Various forms of aviation insurance cover the hull, cargo, freight and liability. Aviation insurance is available to aircraft owners, operators and manufacturers and also to airport authorities. Special problems arise with aviation liability insurance because of the extensive values at risk and the international nature of many flights. The extent of legal liability is often laid down by internationally agreed conventions. Aviation liability insurance can be obtained to cover specified liabilities.

Liability to injured passengers

In an aviation accident, passengers might be injured. Liability to passengers is governed in terms of conventions such as the Warsaw Convention of 1929. According to this Convention, operators are liable for injury to passengers and damage to their property without claimants having to prove negligence on the part of the operator. The Warsaw Convention also specifies a maximum limit of liability to passengers.

The limit of liability was altered by the Haig Protocol of 1955 and the Montreal Agreement of 1966. These conventions mainly deal with international air travel.

Liability for non-passenger third parties

It should be evident from disasters such as the Lockerbie crash in Scotland that persons on the ground are also exposed to injury from flying aircraft. The liability for injury to non-passenger third parties is influenced by the Aviation Act, 74 of 1962.

Liability of aircraft manufacturers

It should be evident that if an aircraft crashes and it is shown that the accident was due to a manufacturing defect, the manufacturer of the aircraft can be held liable. Liability cover is therefore available to aircraft manufacturers.

Owners and operators of airports are also exposed to liability claims. In South Africa there have been several cases in which aircraft and airport operators were involved in litigation.

The aviation policy / operator's policy

The aviation policy takes many forms. For the purposes of this study unit, an operator's policy is discussed. This policy normally has three sections. Section one deals with loss of or damage to the aircraft, section two with legal liability to third parties other than passengers, and section three with legal liability to passengers. Each of these sections has an operative clause, own conditions, and special exceptions.

Loss of or damage to aircraft

This section deals with loss of or damage to the aircraft, and is an asset risk. The operative clause typically reads as follows:

Coverage

- (a) The company will at its option pay for, replace or repair accidental loss or damage to the aircraft described in the schedule arising from the risks covered, including disappearance, if the aircraft is unreported for sixty days after commencement of the flight, but not exceeding the amount insured and subject to the amounts deducted below.
- (b) If the aircraft is insured for the risks of flight, the company will in addition pay reasonable emergency expenses necessarily incurred by the insured for the immediate safety of the aircraft consequent upon damage or forced landing up to 10% of the insured value specified in the schedule.

The operative clause shows that it is only aircraft specified in the schedule that are insured and that provision is also made to pay for aircraft that have disappeared. In other words, it is recognized that the aircraft or its wreck cannot always be located. If the aircraft has been missing for more than 60 days, it will be presumed to have disappeared and payment will be made. The section contains specific exceptions or exclusions (eg normal exclusions dealing with avoidance of liability for wear and tear and engineering breakdown).

Legal liability to third parties other than passengers

The operative clause of section two typically reads as follows:

The company will indemnify the insured for all sums the insured becomes legally liable to pay and will pay compensatory damages (including costs awarded against the insured) in respect of accidental bodily injury (whether fatal or otherwise) and accidental damage to property caused by the insured aircraft or by persons or objects falling from the aircraft.

The liability of the insurance company is for amounts the insured is legally liable to pay. This operative clause, as with other liability operative clauses, does not define the actual basis of the liability of the insured. For example: If an accident occurs and an operative clause simply requires the insured to be held liable in terms of a statute such as the Aviation Act of 1962, this basis of liability is not excluded by the operative clause.

Section two has its own specific exclusions. Generally, the insurance company is not liable for claims arising from injury to employees, directors or partners, etc. The intention is clearly that

these forms of liability should be dealt with in terms of the employer's liability policy. This section also excludes claims arising from the flight or the cabin crew. This distinction caters for cases in which the crew are not members or employees of the company. Another exception is that liability does not apply to passengers or goods in care, custody and control of the company.

An unusual source of liability that is peculiar to the operation of aircraft is claims arising from noise and pollution (eg breaking the sound barrier which causes sonic booms). This form of liability is generally excluded under section two. The company will, however, be liable for damage caused by an explosion if the plane crashes and the explosive boom damages property. In this case the proximate cause is the accident and not the noise.

Liability to passengers

This part of the policy typically reads as follows:

The company will indemnify the insured in respect of all sums the insured becomes legally liable to pay, and will pay compensatory damage (including costs awarded against the insured) in respect of

- Bodily injury (fatal or otherwise) to passengers while entering, on board or alighting from the aircraft
- Loss of or damage to baggage and personal articles of passengers arising from the accident to the aircraft

Again it is worth noting that this clause indemnifies the insured against amounts the insured becomes legally liable to pay. However, the clause does not define the grounds of liability. If the liability is, for example, limited by the Warsaw Convention in conjunction with subsequent protocols, the insurance company will pay those amounts. As the grounds of liability are not specified, negligence is not specifically required for the policy to apply.

Section three has its own exceptions. Generally, the company will not be liable for injury or loss sustained by its employees and the crew. The operational crew and the employees have to be covered by another policy.

It is customary in liability policies of this nature to limit the liability exposure of the insurer. The limit is generally in the region of R200 million.

Miscellaneous provisions

Aviation policies are specialized policies dealt with by specialized sectors of the insurance market, and these sectors have their own peculiarities. Cover is normally only for the aircraft specified in the schedule, and on a named pilot basis. It is therefore customary that the pilots who fly the aircraft be nominated. It has been held that to violate this list of names is a material fact which is grounds to avoid the policy (*Nel v Santam Insurance Company* 1981 (2) SOUTH AFRICA 230 (T)).

Another general requirement is that the insured should comply with all air navigation and airworthiness orders and regulations issued by a competent authority affecting the safe operation of the aircraft. It is not always possible to comply with all the air navigation regulations, but failure to do so can invalidate the policy.

Although the pilots are named in the policy, it does happen that when an aircraft is for example sent in for maintenance, it may be flown by pilots who are not named in the

schedule. It is not practicable to name all the pilots who park the aircraft, and so the policy makes provision for not named pilots to park the plane.

Liability policies normally exclude liability assumed by contract. This exception for contractually assumed liability also applies to aviation policies other than the liability policy accepted for baggage. An aircraft is normally registered for a particular number of passengers, and if this number is exceeded, the insurer may avoid liability.

Activity 11.1

- (1) Identify items in your possession that have at some point been covered by inland marine insurance.
- (2) Identify some items that have not been covered by inland marine insurance.

Feedback

All items that at some time constituted cargo would probably have been covered under a marine policy. Note that ocean marine policies cover ships and cargo on inland waterways and that inland marine policies cover goods transported by truck, railroad, railway express, parcel post, and registered mail.

11.3.5 Travel insurance

Study the following sections on travel insurance in Chapter 11 of your prescribed book:

- Travel agents
- Credit cards
- Cover available
- Conclusion

11.4 BANK ASSURANCE AND GROUP SCHEMES

Study the following sections on bank assurance and group schemes in Chapter 11 of your prescribed book:

- 11.4.1 Benefits of a group scheme**
- 11.4.2 Disadvantages of a group scheme**
- 11.4.3 Targeted markets**
- 11.4.4 Other brokers**
- 11.4.5 Conclusion**

ASSESSMENT

- (1) What is covered by an aviation policy for operators?
- (2) Describe the loss exposures insured by hull, cargo and freight policies.
- (3) Describe the cover provided by the COID Act of 1993.

- (4) Define who is not covered by the COID Act of 1993.
- (5) Is the COID Act an improvement on the Workmen's Compensation Act? Justify your answer.
- (6) Explain briefly why SASRIA was formed.
- (7) List the types of SASRIA cover available.
- (8) Explain why SASRIA cover requires an underlying policy.
- (9) Complete the questions on Chapter 11 in the prescribed book.

FEEDBACK

- (1) The following are covered:
 - a. loss of or damage to aircraft
 - b. legal liability to third parties
 - c. liability to passengers
- (2) "Hull" covers losses to the vessel and associated machinery. "Cargo" covers loss of or damage to cargo and "Freight" covers the cost of transporting cargo
- (3) All employees (with a few exceptions) are covered against occupational injuries and diseases. The injured employee has a statutory right to compensation under Section 22(1) of the COID Act, 1993. In order to claim from the fund it must be shown that an employee had an accident that caused disablement or death.
- (4) A number of persons are excluded in Section 3(2) of the COID Act, 1993. The most important are
 - persons in military service and members of the South African Police Service
 - domestic employees employed as such in a private household
- (5) Yes. The Workmen's Compensation Act gave workers the right to claim compensation from the state for injuries sustained from an accident at work. However, the Workmen's Compensation Act only covered persons earning less than a specified amount. Persons who earned more than this amount had to sue their employer and prove negligence in court. This meant that employers needed insurance protection for the liability they could incur.
- (6) The objectives of SASRIA were originally set out as the provision of insurance cover to protect assets against certain defined events, primarily politically motivated acts and acts of terrorism and political riot. Today nonpolitical riots and strikes are also covered.
- (7) There are four types of coupons or cover available:
 - Material damage: this coupon is used to cover risks such as fire, glass, goods in transit and money.
 - Contract works and/ or construction plant: this coupon covers engineering type risks.

- Consequential loss: this covers business interruption type losses.
 - Motor policy: this covers all types of motor vehicles.
- (8) The underlying policy through the insurer provides the insured with the appropriate coupon to prove that cover exists. A coupon is a SASRIA certificate and a policy for the specific cover.
- (9) Consult the suggested answers to the questions of Chapter 11 at the end of the prescribed book.

SUMMARY

This study unit described the nature of specialised short-term insurance cover. We now proceed to a discussion on self-funding and alternative risk financing techniques in the short-term market.

TOPIC 3

Self-funding and Alternative Risk Financing Techniques (ART)

AIM

The aim of this topic is to help you develop an understanding of the concept self-funding as alternative risk financing technique.



Learning outcomes

After you have worked through Topic 1, you should be able to

- demonstrate your understanding of self-funding as risk financing technique by classifying risks into funding categories based on severity and frequency
 - critically analyzing a company's capacity to fund losses
 - demonstrate an understanding of the various sources of alternative risk financing available to the short term insurance market by describing how they work
-

TOPIC CONTENT

Study unit 12: Self-funding and Alternative Risk Financing Techniques (ART)

STUDY UNIT 12

SELF-FUNDING AND ALTERNATIVE RISK FINANCING (ART)

CONTENTS

Learning outcomes

Key concepts

Getting an overview

12. Self-funding

12.2 Risk Retention

12.3 Captives and Rent-a-Captives

12.4 Finite risk insurance and Capital market instruments

Assessment

Summary



When you have worked through this study unit, you should be able to

- determine which risks can be self-funded and list the advantages and disadvantages of self-funding
- determine how much self-funding a company can afford
- describe the different types of deductibles
- determine the most cost effective deductible level
- describe contingency risk policies
- explain what a captive is and how it works
- distinguish between a wholly-owned captive and a rent-a-captive
- list the relative advantages and disadvantages of captives
- conduct a feasibility study for setting up a captive
- explain finite insurance
- outline the basic types of finite products
- describe the capital market instruments that are used in the funding of catastrophic type risks

Key Concepts

Self-funding	Loss severity
Loss frequency	Risk retention
Risk aversion	Deductibles
Straight deductibles	Aggregate deductibles
Disappearing deductibles	Franchise deductibles
Captives	Fronting
Rent-a-captive	Finite insurance
Loss Portfolio Transfers	Spread Loss Treaties
Retrospectively rated programmes	CATEX
Cat Bonds	Cat puts

GETTING AN OVERVIEW

Risk financing is the arranging of a source of finance to provide for the fortuitous losses of a business. Self-funding is a subset of the available funding alternatives to cater for the financial consequences of losses. It usually refers to a set of financing alternatives other than insurance, although (as you will see in this study unit) some of the alternative risk-financing techniques combine self-funding with insurance as a funding alternative.

12.1 SELF-FUNDING AND ITS ADVANTAGES

You may ask why companies would prefer to fund losses themselves if they run the risk of depleting their reserves when insurance is available and has been the principal risk-financing technique for some time. To understand this, you have to consider the nature of losses.

Study the following sections on the nature of losses in Chapter 12 of your prescribed book:

12.1.1 The nature of losses

- Type 1 losses
- Type II losses
- Type III Losses

12.1.2 The objectives (advantages) and disadvantages of Self-funding

- To reduce insurance costs
- To improve cash flow
- To provide the opportunity to earn investment income
- To increase the scope of risks funded

12.1.3 How much self-funding can a company afford?

Study the section below in addition to the material on self-funding in the prescribed book:

Before a decision is taken to self-fund losses, the extent of the company's risk retention has to be determined, and then the extent of the available resources to pay for potential losses. The company's ability to absorb losses is determined by considering the following financial factors:

- working capital
- total assets
- earnings
- earnings per share
- sales

- *Working Capital*

The first and perhaps most critical factor to be considered is working capital, because this factor reflects the liquidity of a company and its ability to handle current obligations. As a guideline, 1% to 25% of the company's working capital offers a measure of loss assumption. When a company cannot easily liquidate current assets, 1% of its working capital could be set aside to finance losses. Conservatism is also indicated if the relative liquidity of the working capital fluctuates considerably throughout the year, in other words if the working capital is heavily strained at the end of the sales cycle because of concentrated receivables, or strained at the beginning of the sales cycle because of a concentration in inventory. In this case, the proportion of working capital allowed for loss assumption should be adjusted to the lower end of the scale. Conversely, 10% to 25% should be used when a company has a very liquid working capital position—that is cash or cash equivalents or accounts receivable that turn over regularly and predictably.

- *Total assets*

The ability to absorb losses may also be determined by deciding on the proportion of total assets available to finance losses. A range of 1% to 5% of total assets is considered practical. The low end of the scale would apply to an entity whose assets are already highly leveraged and illiquid. The high end of the scale applies when a company has a high concentration of liquid or unmortgaged assets.

- *The earnings method*

To obtain an indication of a company's ability to fund losses through earnings, the risk manager should consider current earnings and the entity's previous five years' earnings record. The suggested range of values is 1% to 3% of currently retained earnings plus 1% to 3% of average pre-tax earnings over the preceding five years.

In contrast to the working capital and total assets approaches, both of which are measures of the short-term ability to raise funds, the earnings method is long range in nature. It relies on the underlying earning power demonstrated by the company's history as the ultimate source of funds to provide for losses.

- *Earnings per share*

The effect of self-funding losses on the company's earnings per share is normally the most tightly constrained measure of its loss assumption ability.

The earnings-per-share guideline is used as a conservative measure to ensure that self-insurance does not over-extend a public company or public entity to a point where earnings per share or current budget would be impaired by a large loss in a single financial reporting period.

The normal level of loss assumption is 10% of earnings per share for a public company, and 10% to 15% of the expected excess of revenue over expenditure in a public entity. The proportion is totally subject to the company's management's discretion, based on the perception of what is required by investors in a particular industry.

- *The sales budget*

The final earnings indicator is based on the sales budget, with a range of 0,5% to 2% of the company's annual sales or revenue. This indicator measures a company's ability to generate revenue and must be tempered by other indicators to develop a valid measure of its loss assumption ability. The 0,5% applies to a company engaged in a high volume, heavily leveraged operation. The 2% in all probability applies to a manufacturing or service operation, because its profit margins are traditionally higher.

These indicators of financial ability to assume loss are applied in terms of the constraints of the entity's general attitude to risk. Computation may produce widely different figures. For example: The working capital approach could yield R1 million in loss assumption ability, total assets of R2 million, the sales budget R3million, and earnings per share R0,5million. The company's management may then be willing to pay the insurance premium to transfer risk in excess of R0,5 million because of its commitment to shareholders pertaining to the stability of earnings. An additional cost of R0,5 million variation in profit caused by an uninsured loss or a series of uninsured losses, would be unacceptable to investors. Another company's board may take a more liberal view and elect to assume a higher possible variation in earnings. Such seemingly different views on or interpretations of the same set of data stem from "risk aversion". This is a function of a company's attitude to risk, its management style, and even its culture. Risk aversion cannot be measured, and no single rule of thumb exists to cover all possible attitudes. Any analysis or recommendation has to include all the options from which management and the board of directors can make a decision.

The company's ability to assume risk is evaluated in accordance with the above guidelines. When a programme is implemented, the risk manager should be aware of insurance companies' risk-rating plans and whether these plans allow an insured to assume varying degrees of risk and to receive premium reductions or refunds based on actual loss during the insurance period. When this approach is followed, it becomes possible to stabilize loss exposure over time and to maximize the effectiveness of the insurance-buying function of risk management.

If an insured company increases the amount of expected aggregate losses it wants to self-insure, it is reasonable to expect its insurance premium payments to drop. This trade-off should continue as long as the company receives at least proportional reductions in its premiums. It is the introduction of the company's particular financial constraints that produces an immediate improvement in some of the existing standards for setting retention levels.

Activity12.1

- (1) Calculate the risk retention level for your own company by using the above financial indicators.
- (2) You have been appointed as the risk manager of a company with the following financial results:

Turnover R8,4 m

Net assets R3,6 m

Net current assets R1,2 m

Determine the upper and lower levels of this company's retention capacity.

Feedback

(1) When you determine your company's risk retention capacity, you would have to determine the sum of the following:

- 1% to 25% of its working capital
- 1% to 5% of its total assets
- 1% to 3% of current plus 1%–3% of preceding 5 years pretax earnings
- 10% to 15% of its earnings per share
- 0,5% to 2% of the sales budget

The lower margins would represent the lower risk retention ability and the higher margins a higher ability.

(2)

		Lower level	Higher level
Turnover	R8,4m	$8\,400\,000 \times 0,5\% = R42\,000$	$8\,400\,000 \times 2\%, = R168\,000$
Net Assets	R3,6m	$R3\,600\,000 \times 1\% = R36\,000$	$R3\,600\,000 \times 5\% = R180\,000$
Net current assets	R1,2m	$R1\,200\,000 \times 1\% = R12\,000$	$R1\,200\,000 \times 25\% = 300\,000$
		R90 000	R648 000

With the limited information provided, the lower limit would be R90 000 and the upper limit R648 000. Refer to the assessment question at the end of this study unit for a more detailed example.

12.2 RISK RETENTION

Risk retention means that a company intentionally or unintentionally decides to retain the financial consequences of losses for its own account. In the case of "funded retention", a special fund is created to fund these losses. "Unfunded retention" is when losses are funded from cash flow.

A logical first choice for a company wanting to retain some of its risks, is the deductible approach.

Study the following sections on deductibles in your prescribed book:

12.2.1 What are deductibles**12.2.2 Types of deductibles**

- Straight deductibles
- Aggregate deductibles
- Disappearing deductibles
- Franchise deductibles

12.2.3 Determining deductible levels

- The least cost rule

12.2.4 Deductible funding policies (Contingency risk policies)**12.3 CAPTIVES AND RENT-A-CAPTIVES**

Study the sections below in addition to the material on Rent-a-captives in your prescribed book

12.3.1 Captives

- *What is a “captive”?*

Captives are colloquially known as “DIY insurance”, “formalised self-insurance”, and “formalisation of the risk retention process”.

A captive may be formally defined as:

An insurance (or reinsurance) company which is owned or controlled by a noninsurance company and which is established to insure (or reinsure) the risks of its parent company or affiliated companies.

- *How do captives work?*

Captives function like commercial insurers. In other words, they insure and reinsure and invest funds. The primary difference between captives and commercial/professional insurers is that captives concentrate on the parent company’s risks. (The parent company would almost always have good risk-control programmes and procedures in place before it considers self-insurance to a degree that requires using a captive.)

Two common arrangements exist for captives to provide cover for a parent company (and subsidiaries and affiliates), namely the direct method and the indirect method.

Direct method. Premiums are remitted directly to the captive who retains a portion according to the liability it decides to carry, and cedes or reinsures the remainder.

Indirect method. Risks are directly insured with a conventional commercial insurer who then, by specific agreement, reinsures a specified portion of a particular type or types of cover back to the captive. This is known as “fronting” (for which a fee is generally payable). Fronting is an arrangement in terms of which a captive concludes contracts with an insurer who is licensed to conduct business in a jurisdiction (where the captive is unable to get a license or is excluded for some reason) to provide the required cover and then to reinsure some (or all) of the risk with the captive.

It is not uncommon for a parent company to have more than one captive. Examples are: one for property and one for casualty, one for domestic and one for foreign, and one for deductibles and one for excess reinsurance.

- *Reasons for establishing a captive and cautionary comments*

1. Business expenditure, both of a capital nature and day to day, on risk control to minimise or eliminate risks are not compensated for by insurance premium reductions, although some reductions do materialise. The reason is simply because insurers have no practical way of verifying the effectiveness of the risk control programmes of each and every one of their clients, and their business philosophy is that the premiums of the majority help pay for the losses of the minority. So, if an owner believes that his/her own losses are likely to be less than conventional insurers' calculations of premium rates demonstrate, the owner must self-insure to get a payback for his/her risk control expenditure. The owner would object to sharing the cost of losses of inefficient businesses.
2. The insurer's expectation is that premiums will cover claims for losses, with the addition to the premium of an administration cost and an underwriting profit margin. In addition, the insurer expects investment income on premiums before they are repaid as claims. A well-designed self-insurance programme using a captive should lead to most of these benefits accruing to the owner instead.
3. Insurance markets go through cycles, often giving rise to hard and soft premium rates that are quite unrelated to individual, industrial, national or worldwide claims experience. More often than not, these fluctuations are due to "noninsurance" factors such as investment income and interest rates. This inconsistency disturbs insurance buyers because it makes accurate budgeting and planning difficult. It also increases the administrative burden because inconsistency frequently promotes changes in brokers and insurers. Using a captive, however, should minimise or eliminate frustration caused by noninsurance factors as the captive provides some refuge from volatile and inconsistent commercial insurance rates.

The problem of protected insurance markets crops up in the same context. These generally arise when governments try to develop a local insurance industry and/or want to preserve foreign currency resources. In such a situation claims experience and competitive market prices have little to do with premium rating. In these circumstances a local owner would probably have no option as to where insurance may be purchased, and using captives is either restricted or prohibited. In the case of a multinational with a local subsidiary, the only option would probably be to deal with the local insurer to reinsure the balance over its own retention to the multinational captive so as to ensure some control of and influence over its subsidiary's covers.

4. In conventional insurance markets, the standard covers on offer are sometimes inadequately or incorrectly designed for special situations, and from time to time there may also be unacceptable exclusions. To purchase difference in conditions (DIC) covers for these and for risks that are not normally insurable is often an expensive

exercise. In these situations a captive, especially a joint interest or association captive, is usually the best solution to obtaining economic coverage. Such a captive is the ideal mechanism for “assigned risk pools” (i.e. to meet the special or unique needs of a particular industry), and industry members together contribute to an insurance fund for their own common but special risks, for example those of physicians/ hospitals/clinics where the captive is known as a “bed pan mutual”.

5. The flexibility obtained from direct parent control of decisions in a captive provides advantages that are not easily obtainable from conventional insurers. The following are key advantages:

Cash flow. Premiums are normally paid up front to the insurer, and the payout period for claims can extend over years. With a captive, premium payments can be scheduled to be more cost and loss-related and the parent will benefit directly from investment income.

Interpretation. Depending on the reinsurance arrangements, the interpretations of policy wording and timing of claims settlements become internal decisions.

Cost. The size and cost of administration is directly controlled and limited to the absolutely necessary. Some functions may even be handled by existing corporate staff. Clearly other functions such as sales and marketing fall away.

6. The size of the parent and the nature of the captive’s business often enable direct access to reinsurance markets. This means that
- reinsurance commission, which traditionally accrues to insurers, is eliminated or accrues to the benefit of the captive
 - reinsurance premiums do not have to cover costs such as marketing, debt collection and engineering services, and are therefore proportionately lower than those of a conventional insurer

Other benefits of direct access to reinsurers:

- Premiums can be negotiated to relate more directly to the insured’s own risk and experience.
- There is a more flexible and accommodating attitude when underwriting unusual risks is considered.

7. Noninsurance businesses uphold accounting standards and conventions covering treatment of possible losses from contingencies. Generally, a charge can be made against income if, firstly, events demonstrate asset impairment or that a liability has been incurred, and secondly, the loss can be reasonably estimated. If neither of these conditions is met, “income” may not be charged and only a note on the contingency is permitted. Obviously an appropriation from retained earnings cannot be prohibited, but such appropriation would have to be shown with shareholders’ equity on a balance sheet. This is clearly unsatisfactory if the business is to self-insure meaningful losses successfully.

The above does not apply to an insurer who is obliged to provide for contingencies by way of charging against income. There are methods for quantifying the provisions required from insurers but these fall outside the scope of this module. These obligations also apply to a captive as an insurer and so using a captive ensure proper accounting and financial practice in a self-insurance programme. A noninsurance business may charge insurance premiums against income for accounting and tax purposes, and claims proceeds paid by insurers are then dealt with on a simple capital and revenue basis. However, if no premiums are paid, self-insured losses are in all probability required to pass the deductibility tests of capital and revenue.

8. In most countries, onerous statutory and regulatory controls apply to insurers, ranging from issue (or not) of licence, minimum solvency margin, regular returns covering various or all aspects of the insurer's business activities, control of or limitations on transferability of funds to foreign insurance and reinsurance markets, and control and direction with regard to the investment instruments used. The nature of captives permits an almost unlimited choice of domiciles with less stringent supervisory systems.

Some countries specifically create, by legislation or lack of legislation, an environment which is attractive to captive managers because of fewer controls and restrictions. These naturally include tax-free or nominal tax situations so that captives are able to build up reserves faster.

9. The success of captives established for the above and possibly other reasons are realities that can easily be verified. In addition, expertise derived from the range of experiences, techniques, skills and consultancy services relative to owning and managing captives, is common knowledge and can be acquired fairly economically. These two factors are powerful reasons for the increased use of captives and for the expansion of services in different countries to advise on and manage captives.

Establishing and using a captive should not under any circumstances destroy relationships between insured and insurer. Conventional insurers do provide a range of real and valuable services to their clients (e.g. claims assessing and administration, risk surveys and engineering advice). Moreover, some risks are probably best left to the professionals, for example "long-tail" risks such as product liability, product contamination and public liability where time exposure and values have practically no limit. This also applies to catastrophe-type losses.

It is doubtful whether all captives and their managers are always cleverer than the conventional insurance and reinsurance markets. They are certainly not immune to and cannot ignore market trends.

It appears from the available statistics that there are some 3 000 active captives in the world (excluding "rent-a-captives" and their clients). In fact, this is a minuscule number relative to the world's insurance requirements and this, among other reasons, clearly indicates that captives only belong in the realm of large insurance portfolios.

- *Captive domicile*

The governments of a number of fairly small countries (and some states in the USA) have, for economic reasons, deliberately created a positive and supportive environment for captives to settle in and operate in or from their jurisdictions. The most important features of the supportive environment are easy entry and licensing facilities, minimum controls, restrictions

and statutory returns, and certainty about taxation (usually tax-free or nominal taxes). This environment has also encouraged all the peripheral support mechanisms and services required to manage captives successfully.

12.3.2 Captive management

- *Feasibility studies*

As for any other project or business, a feasibility study is required to test and verify the viability and competitiveness of the captive and, as for the total risk management function; it has to be reviewed regularly.

It is necessary to determine whether using a captive is preferable to existing or alternative insurance and financing options. In other words, would the cost and quality of coverage to be provided by the captive (including operating costs plus reinsurance costs as may be required to limit or stop losses at predetermined levels) be better than those obtainable from commercial insurers? Also, would it produce net underwriting and investment income as payback for risk control expenditure?

It was stated above that insurance markets have historically been subject to business cycles which consequent “hard” and “soft” premiums. It is reasonable to assume that those cycles will continue and also that the fluctuations will not only be caused by pure underwriting factors. Consequently, and notwithstanding the fact that a short-term view is also important, a captive should be viewed and used as a long-term supplier of a special financial service.

- *Key input factors to the feasibility study:*

1. An effective and appropriate risk control programme must be in place in the insured’s business and must have proven statistically to produce a better (lower) than average loss experience.
2. Statistics covering risk financing costs and loss experiences must be available for at least a three-year period.
3. A decision is required about the nature and limit of risks to be insured in order to determine the equity capital and the premium income needs. To arrive at such a decision, a detailed analysis is required of the characteristics of the various risks to which the company is exposed and of unsatisfactory features of existing insurance arrangements (e.g. unprotected exposure).

Under ordinary circumstances, the losses that are self-insured tend to be those which, but for a good risk control programme, occur frequently and predictably, with catastrophes reinsured by professional insurers. Likewise, captive operations do not usually take on “long-tail liability” risks because of the complicated methods required for determining premiums and provisions and their open-ended time element. Nevertheless a number of captives have been established specifically and exclusively to underwrite liability risks when the available commercial cover is inadequate, with too many exclusions and mandates, uneconomic premiums and capacity limits.

4. In the case of joint interest and multiparent captives, some forethought and agreement are necessary on how premiums will be adjusted to reflect individual experiences, the extent of premium adjustments, and whether funding will be on a post-loss or prior-loss basis.

5. Establishing the amount of capital the captive requires is critical and affected by objectives relating to:
 - the intended exposure to large individual losses and/or accumulations of losses from one event and/or accumulations of losses in any insurance period and the availability and cost of excess insurance/reinsurance
 - the net retained risk and the net premium to be received
 - new capital or a borrowing facility
 - the rate of return expected on capital invested
6. Establishing the security of the insurers and reinsurers with whom the captive may conduct business is a complex insurance-cum-financial exercise which is best dealt with by specialist brokers. In this case a ceding company will probably insist on approving the captive's reinsurance arrangements, including security, and may also require clauses in the agreements that allow direct access to the captive's reinsurers. The ceding company may also require guarantees or indemnities from the parent.
7. Finally, the exercise should culminate in a projection of premium income and claims (both gross and net), cash flows, investment income, and net operating profit.
 - *Management – own or external*

The question whether a captive should be managed by employees of its parent or by an external team is relevant to those who do the feasibility study and those who assume ongoing management responsibility.

Introducing a captive into the risk-financing structure does not eliminate or reduce normal insurance documentation and procedures. It remains necessary to decide on the risks to be covered, assemble the sums insured, enter into contracts (policy), pay premiums and prove claims.

Consequently the team would have to come from the financial, legal, insurance, broker, loss adjuster and risk control functions and services. Clearly the degree of company management involvement will depend on which of those functions and services it has in-house. If the parent company's staff is available and competent, they should participate with external consultants.

Apart from a board of directors, which is responsible for the direction and control of the captive, staff will be required for the following activities:

- Insurance and reinsurance. Together with brokers, staff will be required to negotiate terms for business inwards and outwards.
- Administration. Staff will be required for administration, accounting, finance and investments.
- Legal and auditing. Staff will be required to ensure compliance with external regulations, internal controls, preparation of policy documents, and claims settlements.

12.3.3 Rent-a-captive companies

Study the following sections on Rent-a-captive companies in Chapter 12 of your prescribed book:

- Description
- Advantages

12.4 FINITE RISK INSURANCE AND CAPITAL MARKET INSTRUMENTS

Study the following sections in your prescribed book:

12.4.1 Finite risk insurance

- Characteristics of finite risk insurance
- Functions of finite risk insurance
- Major types of finite risk insurance
 - a) Loss portfolio transfers (LPT's)
 - b) Adverse development covers (ADCs)
 - c) Finite quota shares (FQSs)
 - d) Spread loss treaties (SLTs)
 - e) The guaranteed cost approach
 - f) Retrospectively rated programmes (retro-rated programmes)

12.4.2 Capital market instruments

- Catastrophe bonds (CATBONDS)
- Insurance derivatives
- Catastrophe risk exchange (Catex)
- Catastrophic-event –triggered equity put

ASSESSMENT

- (1) ABC Plastics, a medium sized manufacturing plant, is considering the implementation of a self-insurance programme and approaches you for some assistance in this regard. The following information is supplied by the auditor of the concern to assist you with your final recommendations:

Annual sales	R800 000
Net income after tax	R220 000
Average net income after tax for 5 years	R235 000
Net income percentage of turnover	28%
Un-mortgaged assets	R200 000
Current ratio	2,5:1
Asset test ratio	1,5:1

You are required to comment on the aforementioned organisation's ability to absorb losses and to make recommendations with regard to the implementation of a self-insurance programme. All recommendations should be backed by sound theoretical principles.

FEEDBACK

NORM	RATIO OF COMPANY	RECOMMENDATIONS AND COMMENTS
Working capital 1-25%	2.5:1 Current ratio 1,5:1 Asset test ratio√	The working capital ratios imply that a higher ratio of working capital may be reserved for self-insurance. Recommended range – 15% of working capital. The figure cannot be calculated as the amounts of current assets and liabilities are not supplied.√
Total assets 1-5%	Unencumbered assets: R200 000	There is not sufficient information as the total assets and liability figures are not provided. Therefore a lower range of 1% of un-mortgaged assets is recommended. √
Earnings 1-3% of current earnings Plus 1-3% of pretax earnings over the past year	The earnings was relative stable for the preceding five years and use higher scale of 2% can be used: R220 000 x 0,02 = R4 400 R235 000 x 0,02 = R4 700√	Based on earnings, an amount of R9 100 can be recommended to be reserved for self-funding√
Earnings per share	No information supplied.	
Sales Budget 0.5-2% of annual sales or revenues	Sales – R800 000 Profit margin – 28% √	The profit margin is relative low and the lower end of the scale, 1% of annual sales, is therefore recommended. R800 000 x 0,01 = R8 000√

SUMMARY

This study unit dealt with self-funding, its advantages and disadvantages and the various sources of self-funding available in the short-term market.