Tutorial Letter 201/2/2017
Risk Financing and Short Term Insurance

RSK3701

Semester 2

Department of Finance, Risk Management and Banking

This tutorial letter contains the suggested solution to assignment 01 and examination guidelines.

Bar code

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Please note / important notes:

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1 INTRODUCTION

Dear Student

The purpose of this tutorial letter is to provide you with guidelines on answering the first assignment, as well as some information on the examination paper. This guide will supply you with some additional study guidelines.

2 GUIDELINES FOR ANSWERING ASSIGNMENT 01

Question 1: Correct option 1

Refer to Chapter 1 in the IISA prescribed book.

Brokers are allowed to collect premiums from the insured but have no legal obligation to handle claims on behalf of their clients. They can be held legally liable for advice given to clients. Brokers may operate in the reinsurance market.

Question 2: Correct option 1

Refer to Chapter 1 in the IISA prescribed book.

Production flow charts may assist the risk manager in identifying supplier risks and process type risks. Weaknesses in the organisational structure of an organisation and lines of authority can be identified by studying the organisational charts of an organisation.

<u>Question 3: Correct option 2</u>

Refer to Chapter 2 in the IISA prescribed book.

Pooling results in smaller deviations from expectations in terms of possible losses. An insurer is not necessarily better able to prevent losses as uncertainty remains. With reference to one risk confronting one individual, the positions of the insurer and insured are virtually identical (page 20, prescribed book). Shoplifting is an insurable risk in terms of the characteristics of an insurable risk. Shoplifting cannot however be insured under a theft insurance policy as it does not meet the requirement in terms of the definition of theft as defined in insurance. This aspect will be dealt with later in the prescribed material. Reinsurance cannot assure the buyer of insurance that all insurers will charge the same premium for the same risk. This is not the purpose of reinsurance.

<u>Question 4: Correct option 2</u>

Refer to Chapter 3 in the IISA prescribed book.

It is possible to insure an asset with more than one insurer. In terms of the insurance principle of indemnity the insured will however not be allowed to profit from insurance. The principle of indemnity is enforced by the condition of contribution where more than one policy is in force for a specific asset. In this case each insurer is liable for a rateable portion of the loss. In this particular case, the house is insured for R2 000 000 with ABC Insurer and R1 500 000 with DEF Insurer. The actual value of the house is R2 000 000. A loss of R500 000 is sustained. Although the total amount of insurance amounts to R3 500 000 between the two insurers, each insurer will only be liable for a portion of the loss of R500 000. (In case of a total loss, each insurer will still contribute proportionally to indemnify the insured for the value of the house, being R2 000 000. The insured will not be able to claim the total value insured from each of the insurers as this will breach the principle of indemnity which specifies that the insured will be put back in the financial position he/she was before the loss.)

Portion payable by ABC Insurer:
R2 000 000/R3 500 000 x R500 000 = R285 714,29

Portion payable by ABC Insurer:
R1 500 000/R3 500 000 x R500 000 = R214 285,71

<u>Question 5: Correct option 3</u>

Refer to Chapter 3 in the IISA prescribed book.

When taking out a fire policy, material facts to be disclosed will include the location of the premises, the type of business carried out at the premises and any previous claims experience. Although the number of staff working at the premises would be useful information, it will not necessarily be material to assess the risk in terms of a fire.

<u>Question 6: Correct option 4</u>

Refer to Chapter 3 in the IISA prescribed book.

The breaching of a warranty in an insurance contract by the insured may result in the repudiation of a claim by the insurer, even if the warranty reduces the risk to the insurer (refer to the discussion on page 30 of the Unisa study guide). The first amount payable is reflected in the schedule of a policy document. The reasonable man test is generally applied to test the validity of insurance contacts. Insurance contracts are however based on the premise of *uberrimae fidei* or utmost faith.

<u>Question 7: Correct option 4</u>

Refer to Chapter 5 in the IISA prescribed book.

An insurer enters into a quota share arrangement with the ceding insurer retaining 60% of any loss. This represents a 60/40% quota share treaty. The cession to treaty is thus 40%. In this case the reinsurer will be liable to pay 40% of the loss of R40 000 calculated as follows:

R40 000 x 40% = R16 000

<u>Question 8: Correct option 4</u>

Refer to Chapter 5 in the IISA prescribed book.

In terms of a surplus treaty only the amount of excess of the cedant's normal capacity for a particular risk is ceded to the reinsurers. In terms of a **quota share treaty** the reinsurer is bound to accept a fixed proportion of every risk. A surplus treaty is a proportional reinsurance agreement between the cedant and reinsurer. In the surplus treaty, the reinsurer's retention is expressed as a number of lines.

<u>Question 9: Correct option 4</u>

Refer to Chapter 5 in the IISA prescribed book.

An underwriter is requested to underwrite a tyre manufacturing plant. The sums insured are for fire and loss of profits of R35 000 000 and R10 000 000 respectively. The underwriter has a net line of R3 000 000 and can take an additional 50% if the risk involves Fire and Loss of profit. The underwriter has a nine line surplus treaty. Under this scenario no facultative reinsurance is required. The gross retention is R45 000 000 and the total net line is R4 500 000.

These amounts are calculated as follows:

Net line	R 3 000 000
Plus 50% for loss of profits	R 1 500 000
Total net line	**R 4 500 000**
Nine lines surplus treaty	R 40 500 000
Gross retention	**R 45 000 000**
Total sum insured:	
Fire	R 35 000 000
plus Loss of profits	R 10 000 000
	R 45 000 000
Less gross retention	R 45 000 000
Facultative required	**R 0**

Question 10: Correct option 3

Refer to Chapter 3 in the IISA prescribed book.

A change in consumer preferences is an example of a particular risk to a retailer as it might affect the turnover of the specifically retailer negatively.

Question 11: Correct option 1

Refer to Chapter 3 in the IISA prescribed book.

In insurance practice, premiums are due on the inception date of a new policy. Premiums paid to an accredited intermediary are deemed to have been received by the insurer. In short term insurance the client has no grace period as he or she has in the long term market. If the policyholder is however a natural person, the insured must be allowed at least 15 day's grace for the payment of renewal premiums. For monthly policies this applies from the second month of the policy. Annual policies are most common to the commercial insurance market.

Question 12: Correct option 2

Refer to Chapter 3 in the IISA prescribed book.

Stamp duties are not payable on short-term insurance policies. In terms of common law, neither the issuance of a policy nor the payment of a premium is essential for concluding a contract. The insurance contract, like any other contract, comes into force as soon as the parties have agreed to its essential terms. Consideration in terms of insurance policies is defined as the payment of the premium. The replacement of stolen assets with new assets is not considered a violation of the principle of indemnity, since no general principle demands that the loss has to be determined in terms of the market value of the asset.

Question 13: Correct option 1

Refer to Chapter 3 in the IISA prescribed book.

Insurable interest is the legally recognised relationship between the insured and the financial loss that he or she might suffer after a loss incident. Joint owners of property therefore have an insurable interest in each other's life. Neighbours however do not have an insurable interest in each other's life. Trustees are allowed to insure the property for which they are liable for. There is a legally recognised relationship between mortgagees and mortgagors.

Question 14: Correct option 2

Refer to Chapter 7 in the IISA prescribed book.

The solvency margin of a company is represented by the capital from shareholders and free reserves of the company. Policyholders usually prefer higher solvency margins because it gives them greater security with the insurer of choice. Higher solvency margins however indicate a **lower** utilisation of resources and shareholders therefore usually prefer **lower** solvency ratios.

Shareholders wish to see the insurance company write the maximum amount of business and create the maximum utilisation of resources.

<u>Question 15: Correct option 2</u>

Refer to Chapter 3 in the IISA prescribed book.

Annual policies are quoted annually but paid in monthly instalments. Monthly policies are reviewed on a monthly basis, immediately affected by changes in the underwriting philosophy of insurer and most common to the personal lines markets.

3 GUIDELINES FOR THE EXAMINATION

A two-hour, 70 marks, partial fill-in paper will be set for both the May/June and October/November examinations. The mark you obtain out of 70 will be converted to a percentage mark.

The examination paper will comprise TWO sections.

<u>SECTION A</u> comprises 20 multiple choice questions of 1 mark each and 10 True/False questions of 2 marks each. The answers to these questions must be indicated on the exam paper as instructed. No mark reading sheet is supplied.

<u>SECTION B</u> comprises essay, paragraph and calculation type questions.

Additional study guidelines:

The following general guidelines apply to both the May/June and October/November examination papers:

- When answering true/false questions you must indicate whether the statement is true or false. This must be followed by a proper motivation which supports your initial answer. **In the exam, no marks will be awarded for a true or false answer without a proper motivation.** A motivation can be approached in two ways. For a false statement, first motivate why the answer is false and then indicate what would be the correct statement or fact(s). For correct statements, emphasise why the answer is considered correct.
- Indicate the answers to the **multiple choice questions** on the **answer book** as indicated. No mark reading sheet will be provided.
- Answer the written questions in **point format**. Underline or highlight the main facts. Make use of headings and subheadings in your answers.
- **Never leave open spaces**. Guess the answer if you have to – you may guess right. Remember if you are a border case we might try to find a mark or two. If there is open spaces this is impossible.

Some of the major problems experienced by students in this paper in previous examinations have been as follows:

- **Not including sufficient facts in an answer**

When a question requires you to “name and discuss for 10 marks” it normally expects you to list at least five facts and give a brief explanation of or elaboration on each fact. When a question asks you to “name and briefly explain **three** factors for 10 marks” it requires you to list the three factors and give a more detailed explanation of each. A discussion question should be answered in point form and facts should be highlighted - in this way you can insure that you include sufficient facts in the answer. Make use of headings and subheadings in your answer.

- **Misinterpretation of questions**

This is normally one of the major problems. When you read a question, make sure that you underline the key words in the question. In the answer itself, ensure that you at least refer to those key words and base your answer on them.

- **Including too much detail in the answers and repeating facts**

Do not exceed the allocated space for a question. You will run out of time and will not be able to complete the paper. Be careful not to repeat facts - you can prevent this by answering the questions in point form and highlighting key words and concepts.

- **Incomplete facts**

Students tend to include only a certain part of a fact. For example: A characteristic of finite insurance is high premiums. These, however, can be offset by a commutation option which offers a substantial return of premiums to the insured **if the loss experienced under the contract is lower than the expected losses.** Without the part in bold, the fact is incomplete. If you are required to list the disadvantages of self-funding, merely listing “loss prevention services” does not earn any marks. The answer should read: “Loss of insurer services such as loss prevention services”. Although you are only required to list facts, your answer should still make sense and be self-explanatory.

4 CONCLUDING REMARKS

We trust that you are finding this module both interesting and rewarding up to this stage. We wish you all of the best with Assignment 02. Please do not hesitate to contact us if you have any difficulties with the study material for this module.

Best wishes

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