

Tutorial Letter 201/1/2018

Risk Financing and Short Term Insurance

RSK3701

Semester 1

Department of Finance, Risk Management and Banking

This tutorial letter contains suggested answers to the questions in Assignment 01, as well as examination guidelines.

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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 completing the first assignment, as well as some information on the examination paper. This guide also contains additional study guidelines.

2 GUIDELINES FOR COMPLETING ASSIGNMENT 01

Question 1: Correct option - 1

Refer to chapter 2 in the prescribed book.

Brokers **are considered to be professional insurance practitioners**. Their main income is the **commission** paid by the insurance companies they represent. **Loss adjusters** are also sometimes called assessors. Although they might assist clients with claims as an additional service, they **are not legally obliged** to handle claims.

Question 2: Correct option - 4

Refer to chapter 2 in the prescribed book.

Adverse selection refers to the tendency that people with a **higher** probability of loss than the average have seeking insurance. **Adverse selection may result in higher losses than expected.** Adverse selection may be **decreased** by introducing clauses (such as a suicide clause) and compulsory medical examinations when a client applies for a policy/policies.

Question 3: Correct option - 4

Refer to chapter 3 in the prescribed book.

A motorcar accident is a typical example of a **particular** risk which is a risk that affects individuals or small groups and arises from individual causes which can be identified. These risks are generally insurable. A motorcar accident is a pure risk as it results in either a loss or no loss. A speculative risk either results in a loss, profit or no change to a situation.

Question 4: Correct option - 3

Refer to chapter 2 in the prescribed book.

Lloyds is not an insurance company, but an association of underwriters and it operates worldwide. Lloyds has underwritten the voice of Bruce Springsteen. The term “underwriter” originated at Lloyds.

Question 5: Correct option - 1

Refer to chapter 3 in the prescribed book.

A proposal form is an offer by the **insured** to be insured. The insurer invites the public to do business, and the insured offers to be insured. The proposal form can be used to advertise other products available from the insurer, elicits a quotation and establishes a warranty.

Question 6: Correct option - 1

Refer to chapter 3 in the prescribed book

“Consideration” is what each party to a contract promises to do. In terms of an insurance policy the consideration is defined as the **payment of the insurance premium.**

Question 7: Correct option - 2

Refer to chapter 3 in the prescribed book.

In an insurance policy, the cancellation clause is reflected under the general conditions.

Question 8: Correct option - 2

Refer to chapter 5 in the prescribed book.

In terms of a quota share treaty, the reinsurer is bound to accept a fixed proportion of every risk. The risk is shared on a **proportional** basis between the cedant and reinsurer. The share of the different parties involved in the agreement is expressed as a **percentage**. The type of reinsurance where only the amount of excess of the cedant's normal capacity for a particular risk is ceded to the reinsurers, is referred to as a **surplus treaty**.

Question 9: Correct option - 3

Refer to chapter 5 in the prescribed book.

An insurer enters into a quota share arrangement, with the ceding insurer retaining 60% of any loss. If the loss amounts to R80 000 under a R100 000 policy, the reinsurer will pay R32 000 (40% x R80 000) while the insurer will be liable for R48 000 (60% x R80 000).

Question 10: Correct option - 3

Refer to chapter 3 in the prescribed book and study unit 3 in the Unisa MO001 guide.

In terms of an insurance policy, **an insurer may repudiate a claim if a warranty contained in the policy has been breached**. The operative clause in the insurance policy contains the agreement in terms of which the insurer agrees to pay when a loss, which is covered in terms of the policy wording, occurs. Specific risks in each section are limited by the exceptions and exclusions to the policy. The recital clause or preamble contains the names of the parties to the contract. The heading of the policy contains the name of the insurer and its head office address.

Question 11: Correct option - 3

Refer to chapter 1 in the prescribed book.

An organisational chart may assist the risk manager in identifying **key staff members**. **Flow charts** may assist in the identification of possible bottlenecks in the production process, process type and supplier risks.

Question 12: Correct option - 4

Refer to chapter 2 in the prescribed book.

When a short-term insurer is offered a risk to underwrite, there will be times when the size of the risk is beyond its capacity. One of the options available to the insurer is to take a share of the risk and to approach a broker who places the remaining portion of the risk with other insurers. The policy becomes a collective policy, also referred to as coinsurance. In terms of collective insurance only one policy document is issued, claims are handled by the lead insurer and a company which has a share in a collective policy may not quote against

the lead insurer. The broker is responsible for placing cover elsewhere in cases where one of the insurers who shares in the policy is liquidated.

Question 13: Correct option - 4

Refer to study unit 6 in the Unisa study guide.

Under the special condition of average, a 75% condition of average is applied. In terms of this special condition, the insured will only share in the loss if the insured sum is less than the stated percentage (i.e. 75%) of the value of the asset at the time of the loss. If the sum insured is 75% or more, the insured will be considered fully insured and the whole amount of the loss will be paid by the insurer. If the sum insured is less than 75% of the value of the asset at the time of the loss, a pro-rata average will be applied and the insured will pay a pro-rata percentage of the loss.

In the case stated in the question, the farmer insured his crop for R100 000. The value of the crop was R120 000 at the time of the loss. A loss of R50 000 was sustained. The sum insured amounts to 83,33% of the value of the crop at the time of the loss. The insurer is thus liable for the full value of the loss.

Calculations:

$$100\,000/120\,000 \times 100 = 83.33\%$$

The insurer will be liable for the full R50 000.

Question 14: Correct option - 2

Refer to chapter 1 in the prescribed book.

Post-loss minimisation involves measures taken to reduce the amount of losses should they occur. Examples of post-loss minimisation include hiring security guards to protect premises after a fire and the activation of sprinkler systems with the outbreak of a fire. Training in the use of dangerous substances and fire drills are pre-loss minimisation measures. These involve measures taken to prevent or reduce anticipated losses and their effects.

Question 15: Correct option - 1

Refer to chapter 3 in the prescribed book and study unit 3 in the Unisa guide.

Indemnity, the most fundamental principle in insurance law, means that the insured is financially restored to the same position s/he was in prior to the loss. The insured is not to be placed in a better position after the loss than before the loss. Indemnity in terms of insurance is enforced through the principles of subrogation, average and contribution.

Note to students: Please make sure you know each of these concepts and the manner in which each enforces the principle of indemnity.

Insurable interest, which is required for all insurance contracts, 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. Insurable interest does not, however enforce the principle of indemnity as such.

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.

The examination paper will comprise TWO sections.

SECTION A comprises ten (10) multiple choice questions counting one mark each and ten (10) true/false questions counting two (2) marks each. The answers to these questions must be indicated on the exam paper as instructed. No mark-reading sheet will be supplied.

SECTION B 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); and for correct statements, emphasise why the answer is considered correct.
- Indicate the answers to the **multiple choice questions** in 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 correctly. Remember: if you are a borderline case, we might try to find a mark or two.

Some of the major problems students experienced in this paper in previous examinations are the following:

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

When a question requires you to “name and discuss for ten (10) marks” you are normally expected to list at least five (5) facts and give a brief explanation of (or elaboration on) each fact. When a question asks you to “name and briefly explain three (3) factors for ten (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 ensure that you include sufficient facts in the answer. Make use of headings and subheadings in your answer.

- **Misinterpretation of questions**

This is normally a major problem. When you read a question, make sure that you underline the key words. 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 use more than the allocated space per question as you will run out of time and will not be able to complete the paper. Should you however need more space than what is allocated, use the rough work page. Mark it clearly as an extension of an answer and refer to the rough work page in your answer on the paper. **Please do not ask for an additional script to complete an answer.** 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” will not earn you 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 have found this module both interesting and rewarding up to this stage. We wish you all the best with Assignment 02. Please do not hesitate to contact us if you experience any difficulties with the study material for this module.

Best wishes

MRS CECILE DE SWARDT (AJH 5-115)

MISS ZAKHIYYA YOUSUF (AJH 5-118)

MS TSHOLOFELO LEGOTLO (AJH5-092)

DEPARTMENT OF FINANCE, RISK MANAGEMENT AND BANKING