Tutorial Letter 201/2/2018
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

Define tomorrow.

UNISA university of south africa

Open Rubric

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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 tutorial letter will further supply you with some additional study guidelines.

2 GUIDELINES FOR ANSWERING ASSIGNMENT 01

Question 1: Correct option 3

Refer to Chapter 2 in the IISA prescribed book.

In the short term insurance market an insurance agent is someone who sells insurance, but it might not be his/her main occupation. **An insurance agent is allowed to sell other products such as property on a commission basis.** Insurance agents are subject to the FAIS Act and need to register with the Registrar of Financial Service Providers.

Question 2: Correct option 2

Refer to Chapter 6 in the IISA prescribed book and Study unit 6 of the Unisa study guide.

Under the special condition of average, a 75% condition of average is applied. In terms of this 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, the pro-rata condition of average will be applied and the insured will pay his/her 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 R150 000 at the time of the loss. A loss of R50 000 was sustained. The sum insured amounts to only 66,67% of the value of the crop at the time of the loss. The insured is therefore considered under-insured and the pro-rata condition of average will be applied. The insurer will only be liable for 66,67% of the loss while the insured will be considered his/her own insurer for the remainder of the loss

Calculations:

Value insured: 100 000/150 000 x 100 = 66.67%

The insurer will be liable for:

R100 000/R150 000 x R50 000 = R33 333,33 of the loss.

Question 3: Correct options 1 and 3

Refer to Chapter 1 in the IISA prescribed book.

Production flow charts may be useful in identifying supplier risk. Pooling of risk change the nature of the risk and **improves** prediction. Although insurance generally involves pooling it **is not** a prerequisite for insurance. **Insurance contracts indemnify the insured in terms of money, services or both.** Driver training is an example of a **pre-loss** minimisation technique. The effect of the possible loss due to bad driving skills is anticipated and the necessary steps are taken to prevent or minimise any damage through proper driver training.

Question 4: Correct option 3

Refer to Chapter 2 in the IISA prescribed book.

Self-insurance may result in lower premiums and more focused risk control programmes. Insurance costs are decreased and investment income is earned on loss reserves resulting in the more effective use of funds for business development purposes. On the other hand, it requires capital to be tied up to make provision for possible losses which means that these funds are not available for other business developments. Claims statistics, which is used to determine premiums into the reserve fund, comes from a very narrow base.

<u>Question 5: Correct option 4</u>

Refer to Chapter 2 in the IISA prescribed book.

In terms of collective insurance only one policy document is issued and the collective share of each insurer is reflected in the policy document. A company which has a share on a collective policy are not allowed to quote against the lead insurer. All claims are handled by the lead insurer.

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

Refer to Chapter 3 in the IISA prescribed book.

In common law, wagering contracts are not illegal, but are **unenforceable**. Insolvent people have a **limited** capacity to enter into contracts. As a rule, no special form is required to conclude a contract and insurance follows the rule. The insurance contract, like other contracts, comes into existence as soon as the parties to the contract have agreed to its essential terms. In terms of common law **neither the issuance of the policy document nor the payment of a premium** is therefore essential for the concluding of a contract. In some cases, policy wording of a particular policy contract may state that payment must be made before the contract will come into force. This modifies the law, but only for that particular contract.

<u>Question 7: Correct option 3</u>

Refer to Chapter 3 in the IISA prescribed book.

Insurance contracts are a contacts of *uberrima fides* (i.e. utmost good faith). The principle of indemnity generally applies to **most** short term insurance policies. This implies that the insured is placed back in the financial position he or she was before the loss. The insured cannot make a profit from a loss. Policies such as life, personal accident and health insurance are considered **non-indemnity** contracts. The amount due to the insured under these policies need not bear any relation to the actual loss the insured suffered. The argument being that a financial value cannot be placed on a human life. **Insurable interest is essential for the issuing of all insurance cover**, including life insurance policies. It is the legally recognised financial relationship between the insured and the financial loss he or she suffers following a loss. Insurable interest, as such, **does not enforce the principle of indemnity**. The principle of indemnity is enforced by conditions such as, average, subrogation and contribution.

<u>Question 8: Correct option 2</u>

Refer to Chapter 3 in the IISA prescribed book.

Stamp duties are no longer payable on short-term insurance policies. Consideration in terms of insurance policies is defined as the payment of the premium. The replacement of stolen assets with new assets is not necessarily 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. Insurable interest is required for all insurance policies.

<u>Question 9: Correct option 1</u>

Refer to Chapter 3 in the IISA prescribed book.

The policy schedule includes details of the **period of the insurance**, **special terms and conditions and first amount payable**. Exceptions are highlighted in a separate section of the policy document.

<u>Question 10: Correct option 1</u>

Refer to chapters 3 and 6 in the prescribed book.

Mr A insured his car, valued at R400 000, with Company X for R150 000 and Company Y for R250 000. Mr A is involved in an accident and damage to his car amounts to R25 000. His claim, however, is repudiated due to some technical reasons. Company Y, however, decided to make an ex gratia payment of R15 625 to Mr A.

Where a claim is not covered for technical reasons, or where there has been a genuine misunderstanding an insurer may decide to pay the claim or a part thereof. This is normally a decision made on management level and is often for business reasons. Ex gratia payments are **not** indemnity payments and therefore the principle of contribution does not apply. Company X will for this reason **not be** liable to a share of the payment to Mr A. Ex gratia payments are made without prejudice by insurers and therefore **does not** affect future claims payments.

<u>Question 11: Correct option 1</u>

Refer to Chapter 5 in the IISA prescribed book.

In **proportional reinsurance** the whole of a risk is split in some ratio between a cedant and the reinsurer. The reinsured is bound to cede and the reinsurer bound to accept a **pre-determined share of each and every risk** that falls within the scope of the treaty. Two of the most widely used proportional treaties are the quota share treaty and the surplus treaty. A **surplus treaty** is a proportional reinsurance arrangement whereby only the amount of excess of the cedant's normal capacity for a particular risk is ceded to the reinsurers and not a fixed proportion of every risk. The reinsurers base the amount they wish to hold on the net retention of the insurer. In the surplus treaty, the reinsurer's retention is expressed as a number of lines.

In terms of a **quota share treaty** the reinsurer is bound to accept a fixed proportion of every risk. The share of the different parties involved in the agreement is expressed as a

percentage. The commission rate on a quota share treaty is normally higher than for a surplus treaty.

<u>Question 12: Correct option 2</u>

Refer to Chapter 3 in the IISA prescribed book.

Unemployment is an example of a **fundamental** risk. Fundamental risks affect a large part of society or even the world and are regarded as commercially uninsurable. These risks are outside the control of a person or a group of people.

<u>Question 13: Correct option 3</u>

Refer to chapter 5 in the prescribed book. Pay attention to the suggested answers to Question 3 of Chapter 5 in the yellow page section of the prescribed book.

An underwriter is requested to underwrite a tyre manufacturing plant. The sums insured are:

Fire	R 50 000 000
Loss of profits	R 30 000 000

The underwriter has a net line of R2 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.

Suggested solution:

Net line	R 2 000 000
Plus 50% for loss of profits	R 1 000 000
Total net line	**R 3 000 000**
Nine lines surplus treaty	R 27 000 000
Gross retention	**R 30 000 000**

Total sum insured:	
Fire	R 20 000 000
plus Loss of profits	R 20 000 000
	R 40 000 000
Less gross retention	R 30 000 000
Facultative required	**R 10 000 000**

<u>Question 14: Correct option 4</u>

Refer to Chapter 3 in the IISA prescribed book.

Insurable interest must exist at the time a life insurance policy is issued but is not required **at the claims stage**. Insurable interest must exist **at the time of a marine loss**. Insurable interest **is not** a requirement for wagering agreements. Insurable interest must exist at the **time of issuing** of a motor policy, at the **time of the loss,** and at the **renewal** of the policy.

<u>Question 15: Correct option 4</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 10 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.

Please note that Mrs de Swardt will retire from Unisa on 31 August 2018. Please refer any academic enquiries for the remainder of the academic year to Mrs Yousuf and Ms Legotlo. Ms Legotlo can be contacted by email, legottg@unisa.ac.za, or alternatively by telephone at 012 429 4927.

Best wishes

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