Tutorial Letter 202/1/2018

Risk Financing and Short-Term Insurance

RSK3701

Semester 1

Department of Finance, Risk Management and Banking

This tutorial letter contains the suggested answers to the questions in Assignments 02 and 03.

CONTENTS

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 Assignments 02 and 03.

2 GUIDELINES FOR COMPLETING ASSIGNMENT 02

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

Refer to Study unit 12 in the Unisa RSK3701 study guide.

Working capital reflects the liquidity of the business. A range of between 1% and 25% of working capital is considered as a guideline to be used when deciding on the amount to be reserved for loss assumption. Where the current assets of a business cannot be easily liquidated, or where the liquidity levels fluctuate throughout the financial period, the lower end of the scale should be considered for loss assumption. The higher end of the scale applies to stable and higher liquidity ratios.

The working capital ratios reflected in the scenario set out in this question are indicative of a liquid working capital position and the business is in a good position to handle current liabilities. The working capital ratios of the business are favourable for a risk retention programme, and a **higher level of loss assumption based on working capital guidelines is possible.**

<u>Question 2: Correct option - 1</u>

Refer to Chapter 7 in the prescribed book.

The solvency margin of a company is the **difference** between the total value of its assets and its outstanding liabilities. Policyholders usually prefer **higher** solvency ratios while shareholders of a company usually prefer lower solvency margins. Higher solvency margins indicate a **lower** utilisation of resources.

<u>Question 3: Correct option - 1</u>

Refer to page 225 in the IISA prescribed book.

Under motorcycle insurance, **cover for theft of accessories and spare parts of the motorcycle is provided if the motorcycle is stolen.** No cover is provided for damages to the motorcycle if a passenger is being carried on the motorcycle. Full cover for the motorcycle can however be provided by adding a pillion passenger extension to the policy. Passenger liability is, however, still excluded under this extension and the policy needs to be further extended to cover passenger liability. The driver of a motorcycle is covered only when driving his own motorcycle.

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

Refer to page 65 in the Unisa RSK3701 study guide.

Hull insurance covers not only completed vessels but also those **under construction or navigation.** Both the hull and 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.

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

Refer to page 32 of the IISA prescribed book.

Business Asset All Risk policies are **policies of exclusions.** If the cause of the loss is not excluded, then the loss is covered. Cover is therefore very wide. Although standard wordings can be used, these policies are normally tailored to fit the client’s needs.

<u>Question 6: Correct option - 3</u>

Refer to page 187 of the IISA prescribed book.

A Householders policy covers the contents of a private dwelling but can also be extended to include cover for **fire brigade charges, accidental damage to television sets and video cassette recorders and the personal effects of guests**. Accidental damage to fixed sanitaryware can be covered under houseowners insurance but chipping and scratching are excluded.

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

Refer to page 203 of the IISA prescribed book.

In terms of Business Interruption Insurance, the additions basis to determine the annual gross profit of the insured is calculated as **net profit plus standing charges.**

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

Refer to pages 197 to 204 of the IISA prescribed book.

Exclusions to policies can be deleted and the peril covered for an extra premium. **Exceptions** to a policy cannot be deleted and will always apply. Collusion or theft by employees is a general exception under most accident policies. Loss or damage arising from war is a standard **exception** to commercial multi-peril policies. Cover for property, also covered in terms of a marine policy, is also a standard exception to commercial multi-peril policies.

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

Refer to page 131 of the IISA prescribed book

Limit of liability is used when the amount of the loss will be known only after the event, for example, legal liability insurance, while **sum insured is used to indicate the amount of the financial loss covered by insurance where the amount of loss that could occur is known at the time the policy is issued.** In terms of marine insurance, the word average means “partial loss” and it is qualified by the word “particular” or the word “general”. In non-marine property insurance, the word “average” means to share a loss and is used by insurers to combat underinsurance **(Refer to pages 32 and 33 in the RSK3701 study guide.)** A special condition of average clause is used where the insured will share in the loss only if the insured sum is less than the stated percentage (75%) of the value insured at the time of the loss.

<u>Question 10: Correct option - 3</u>

Refer to page 199 of the IISA prescribed book.

In terms of Business Interruption Insurance, standing charges represent costs that **will not** vary with the loss and **include costs such as car leases and rent.** Standing charges must be added to net profit when calculating the insured gross profit on an addition basis. Package and postage costs are considered uninsured costs. These costs will vary in accordance to the loss, for example, if production decreases, packaging and postage costs will also decrease.

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

Refer to page 138 of the IISA prescribed book.
Once the underwriting department has been notified that a claim has been settled, it could reduce or delete the no claim bonus, delete the lost item, reinstate the sum insured and/or conduct a post-loss survey.

<u>Question 12: Correct option - 1</u>

Refer to page 85 in the RSK3701 study guide.

Under a policy with a R10 000 deductible and a recapture factor of 5%, the insured would pay a deductible of **R8 250** for a loss of R45 000.

Calculation:

[(R45 000 – R10 000) x (1 + 0,05)] = R36 750.

The amount of the deductible the insured must pay decreases from R10 000 to R8 250, which is determined as R45 000 – R36 750 = R8 250.

<u>Question 13: Correct option - 2</u>

Refer to page 101 in the RSK3701 study guide.

Finite risk insurance **has an aggregate limit of cover,** limiting the exposure of the insurer. These insurance policies are multiyear contracts and do not require annual renewals.

<u>Question 14: Correct option - 2</u>

Refer to page 101 in the RSK3701 study guide.

Through Loss Portfolio Transfers (LPT's), loss portfolios can be ceded, costly and lengthy run-off activities pertaining to losses can be avoided and the balance sheet figures of the cedent can be improved. LPT's are often indispensable in mergers and acquisitions because they eliminate old risks and reassure investors that these old liabilities will not get out of control.

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

Refer to page 104 in the RSK3701 study guide.

Capital market instruments include, amongst others, insurance derivatives and Catastrophe Bonds (CAT BONDS). Finite quota shares and Retrospectively Rated Programmes are examples of Finite Insurance cover.

3 GUIDELINES FOR COMPLETING ASSIGNMENT 03

Question 1 (10 marks)

NOTE:

When answering true/false questions, you must indicate whether a statement is true or false. This must be followed by a proper motivation which supports your 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, indicate why the answer is considered correct.

1.1 An insured insured his vehicle with two different insurance companies for its full value. In the case of a loss, he would therefore be sufficiently insured as well as be able to profit from the insurance.

False

Refer to Chapter 3 in the prescribed book.

Short-term insurance policies are policies of indemnity, meaning that the insured is put back in the financial position s/he was in prior to the loss. The insured cannot make a profit from insurance√. A contribution condition is written into most short-term policies to enforce the principle of indemnity. Contribution is applied where the insured is insured with more than one insurer. According to this principle, each insurer will pay a rateable portion of the loss√.

1.2 A company delivering goods overseas, will need marine insurance to cover possible losses of goods in transit.

True

Refer to Chapter 9 in the prescribed book.

Goods in Transit insurance (GIT) is designed to cover goods while they are being delivered by the insured or to the insured. This cover applies to local delivery service to South Africa and neighbouring countries√. Overseas deliveries must be covered by marine insurance√.

1.3 In terms of a motorcycle insurance, the basic excess payable by the insured varies with the market value of the motorcycle.

False

Refer to Chapter 10 in the prescribed book.

In terms of motorcycle insurance, the basic excess varies with the engine capacity of the vehicle. The reason for this is that the larger the engine capacity, the more powerful the machine is, which increases the chance of a loss caused by, for example, an accident.

1.4 Mr A insured his vehicle with ABC insurance company. Mr A is involved in a motor car accident caused by the negligence of a third party. The third party is not insured. In this case Mr A will be able to claim the amount of damages from his own insurer and the third party.

False

Refer to Chapter 3 in the prescribed book.

The principle of indemnity will prevent the insured from claiming twice for the same loss and thereby making a profit from insurance√. Indemnity is enforced by the condition of subrogation, included in short-term insurance policies. In terms of the condition of subrogation, the insurer, after paying out a claim, obtains a subrogation right, which allows the insurer to recover the amount of the loss from the third party who caused the loss√.

1.5 Under the personal liability section of his short-term policy, Mr A is insured against possible legal liability claims up to the value of R3 million. Mr A is found negligent after causing a motor car accident. The driver of the other car, who sustained serious injuries, sues Mr A and is awarded an amount of R3,2 million for damages and injuries sustained. In this case Mr A, in his personal capacity, will not be liable for any portion of the damages awarded to the third party.

False

Refer to Chapter 8 in the prescribed book.

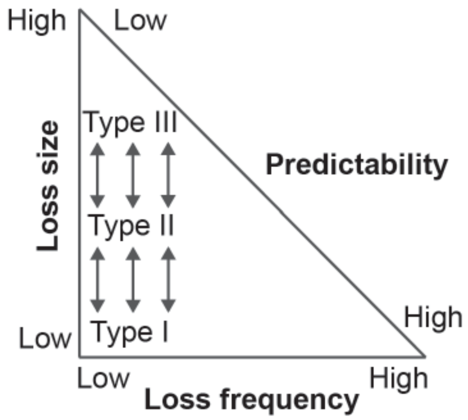
Under liability insurance, a distinction is made between the insured’s liability and the insurer’s liability under the policy. The insured is personally liable to a third party, irrespective of the policy limitations√. In this case, the insurer’s liability under the policy amounts to R3 million. The remainder of the claim, in this case R200 000, will be the responsibility of the insured, Mr A√.

Question 2

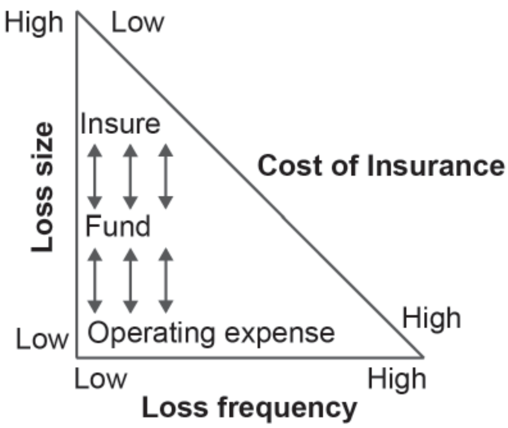
Suggested solution:

Refer to Chapter 12 of the IISA prescribed book.

The relationship between the severity and the frequency of losses and the funding decision is depicted in the two diagrams below.



Loss types and predictability√√



Loss types and Insurance√√

The above two diagrams show that the cost of insuring the highly predictable losses (high frequency and low severity) is high. The main reason is the high cost associated with predictable losses. The insurance company must recover an amount that is at least equal to the size of the loss plus an additional amount for profits and administrative costs. This boils down to what is referred to as "rand swapping" which is quite costly to the insured. By funding these losses from its own resources, the company saves a substantial amount of money. This is especially true if we take into account that these losses can run into millions of Rand to which insurance companies may add as much as 40%√.

In order to receive the marks for the graphs, you should have listed all the necessary details on them. In this particular question, only a graphic presentation was required. A discussion of the various types of losses was not required. In line with this, only 5 marks were awarded to the question. Should a discussion of the types of losses have been required, the mark allocation of the question would have been higher.

Question 3 (5 marks)

You have insured your house for R2 000 000 with ABC Insurer. You transfer your bond to another bank and take out insurance on the house with DEF Insurer for R1 500 000. You do not cancel your insurance with ABC Insurance Company. The actual value of your house is R2 000 000. A fire breaks out in your house causing damages of R500 000.

Determine the **amount payable** by each of the insurers. In your answer refer to the policy **condition(s)** that will apply to this particular claim.

Refer to Chapter 3 of the IISA prescribed book.

Suggested solution:

The condition of contribution will be applied in this case as the asset is insured with two insurers. In terms of the contribution condition each insurer will only pay a rateable portion of the loss√. The amounts payable by the two insurers are calculated as follows:

Total amount of insurance: R2 000 000 + R1 500 000 = R3 500 000.

ABC Insurer will be liable for:

R2 000 000/R3 500 000 x R500 000√ = R285 714,29√

DEF Insurer will be liable for:

R1 500 000/R3 500 000 x R500 000√ = R214 285,71√

Question 4 (5 marks)

Highlight the different **prescription periods** enforced in the handling of insurance claims.

Refer to Chapter 6 of the IISA prescribed book.

Suggested solution:

- **Notification of claims:** Short-term policies require prompt notification of any occurrence likely to give rise to a claim. Some policies specify a set time; other policies mention as soon as reasonable, but with a good reason for any delays in notifications√.

- **Final submission of claim:** There is a limited period for the final submission of a claim. In the standard policy wording, a period of 2 years is specified. Some policies specify shorter periods√.
- **Legal proceedings: If the claim is** repudiated by insurers, the insured has a limited period in which to institute legal proceedings against the particular insurer√.
- **Recovery from third parties: Apart from the policy prescription periods, there are statutory** prescription periods that apply particularly to recoveries from third parties. Normally, a three-year period is specified√.
- **Government claims:** In claims involving the SANDF, SAPS, Government and semi-government organisations, prompt notification is required of the intention to claim against them. Expert legal advice should be obtained as prescription periods may vary√.

<u>Question 5 (5 marks)</u>

Explain the impact of the **National Credit Act No 34 of 2005** on **insurance.**

Refer to Chapter 7 of the IISA prescribed book.

<u>Suggested solution:</u>

The thrust of the National Credit Act is to control the activities of money lending, mainly to private individuals. The Act, however, also impacts on insurance in the following manner:

- Where cover is required as part of a lending agreement, the concept of "free-choice" of cover is extended√. More choice in terms of the particular cover is allowed to the borrower. The cover selected, however, must still be done in consultation with the lender√.
- The control over the amount of cover, for example, credit life cover, may be applied only on the basis of decreasing cover to meet the outstanding amount√. The cover required must be reasonable and not be unreasonably costed√.
- Insurance premiums are normally charged on a monthly or annual basis. On smaller loans, premiums must be charged on a monthly basis√.
- Short-term insurers must submit a quarterly report to the National Credit Regulator.

4 CONCLUDING REMARKS

We trust that you have found the study of this module both interesting and rewarding. Please visit the discussion forums to gain insight in the experiences of fellow students.

We wish you all the best with your preparation for the examination. 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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