

Tutorial Letter 202/2/2018

Risk Financing and Short Term Insurance

RSK3701

Semester 2

Department of Finance, Risk Management and Banking

This tutorial letter contains the suggested solutions to Assignments 02 and 03.

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 Assignments 02 and 03.

2 GUIDELINES FOR ANSWERING ASSIGNMENT 02

Question 1: Correct option 4

Refer to Chapter 6 in the prescribed book.

Proximate cause refers to the dominant cause of a loss. It is **not** necessarily the first or last cause of the loss where more than one cause/event contribute to the loss. The insurer is only liable for losses proximately caused by an **insured** peril.

Question 2: Correct option 4

Refer to Chapter 9 in the prescribed book.

Fidelity guarantee insurance is specifically designed to deal with fraud and theft by employees and covers theft of **money** and of **stock** and **goods**. The level of hazard under fidelity guarantee insurance is judged by the **levels of control** (how easy it would be for

staff to steal) and the **salaries and wages** paid in a business. Fidelity guarantee insurance can be issued on **named persons'** basis, a **position** basis and a **blanket** basis. The premium of fidelity guarantee insurance is based on the **sum insured**, the **number of employees** and the **level of controls** to prevent theft and how hazardous the risk is.

Question 3: Correct option 3

Refer to Chapter 9 in the prescribed book.

Money transported to and from the bank is covered under **money insurance**. Theft of money by employees is covered under money insurance only if discovered within **14** days of it happening. The breakage of mirrors in a fitting room of a retailer is covered under **glass** insurance. Shoplifting **is not** covered under theft insurance as there is no forcible or violent entry or exit to or from the premises involved.

Question 4: Correct option 4

Refer to Chapter 8 in the prescribed book.

Personal accident policies are policies of compensation. Personal accident policies provide **no cover** for illnesses. Temporary disablement due to an accident is normally payable for **52 to 104** weeks. Cover is normally restricted to persons between the ages of **15 and 70**.

Question 5: Correct option 3

Refer to Chapter 8 in the prescribed book and study unit 8 in the Unisa study guide.

A House Owners policy covers the buildings and outbuildings of a residence but can also be extended to include fixed television antennae against breakage, swimming pool machinery against accidental damage, excluding wear and tear and fixed sanitary ware against accidental breakage but not chipping and scratching. Damage to television sets and video cassette recorders will be covered under a Householders policy.

Question 6: Correct option 2

Refer to Chapter 11 in the prescribed book.

The government is the sole shareholder of SASRIA. The government has a **limited** liability of R1b towards SASRIA. SASRIA **only covers risks in South Africa**. A similar arrangement applies in Namibia (NASRIA). SASRIA is **not underwritten** by the government, but it is a separate insurance association controlled by a board of directors.

Question 7: Correct option 2

Refer to Chapter 7 in the prescribed book.

An excessive claim reserve will result in a **decrease** in the share price of the insurance company and a **decrease** in investments from external sources. An excessive claim reserve will result in a **higher** solvency margin. The loss ratio of the insurer appears **higher** than it actually is because of the higher solvency margin.

Question 8: Correct option 1

Refer to Chapter 8 in the prescribed book.

A man murdered by thugs on his way home from work is likely to be covered in terms of a Personal Accident policy. A worker sustaining lung cancer as a result of working in an asbestos plant and a woman dying after being diagnosed with malaria, will not be covered as **illness is not covered** under this policy. A man injured when picking up a heavy box will not be covered under this policy as there was **no violence involved**.

Question 9: Correct option 3

Refer to study unit 8 in the Unisa study guide.

Exceptions in terms of liability covers in a domestic package include among others, liability arising from **conduct of business for reward**, liability for the **death of the policyholder**, and liability arising from the **ownership of animals, other than domestic animals**. Liability arising from the negligent use of a firearm or from the consequences of a bad slice at golf will be covered.

Question 10: Correct option 3

Refer to Chapter 6 in the prescribed book.

Arbitration is used to resolve problems of quantum. An *ex gratia* payment is made without prejudice and therefore **does not** affect future claim payments. Contribution and subrogation **do not apply** to *ex gratia* payments as these are not indemnity payments but are **compensation payments**.

Question 11: Correct option 4

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

A ship has an insurable value of R5 000 000 but is insured for only R4 000 000. The ship is damaged during a storm at sea. Damage amounts to R500 000. The insurer will be liable for **R450 000** of the loss. The amount is calculated as follows:

$$\frac{R4\,000\,000}{R5\,000\,000} \times \frac{R500\,000}{1}$$

$$= R400\,000$$

Question 12: Correct option 2

Refer to Chapter 8 in the prescribed book.

The cover provided by all risk insurance is also referred to as *away from premises risks*. **A cricket bat broken during a match will not be covered under the All Risk section of a Personal Lines policy.** A radio system stolen from a locked motor vehicle **will be covered** under the All Risk section of a personal lines policy. Money, cheques and coins **are not covered** under the All Risk section of a personal lines policy.

Question 13: Correct option 2

Refer to Chapter 10 in the prescribed book.

Motor traders' internal policies only cover the insured's **own vehicles** against accidental damage. It is rated on the **size** of the insured's premises and the **wage figure** for the company. Vehicles temporarily garaged in the course of a journey are covered **under motor traders' external policies**.

Question 14: Correct option 1

Refer to Chapter 12 in the prescribed book.

A straight deductible applies to each and every loss and is subtracted before a loss payment is made. The insurer will be liable for **R7 000** of the loss while the insured will be liable for the deductible value of R5 000. The calculation is as follows:

Amount of loss – deductible

$$R12\,000 - R5\,000 = R7\,000$$

Question 15: Correct option 1

Refer to Chapter 12 in the prescribed book.

Consider a policy with a R5000 deductible and a recapture factor of 5%. For a loss of R4 500, the **insurer** would not be liable for any amount of the loss. The amount of the loss is less than the value of the deductible. The insured will cover the whole loss.

Note: please read the questions carefully in the exam. Make sure that you distinguish between the amount payable by the insurer versus the deductible payable by the insured.

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 insures 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 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 according to 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.

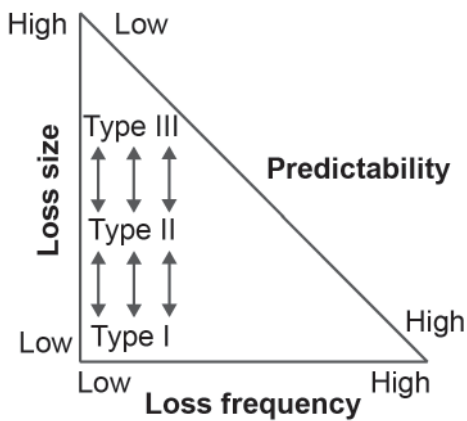
Under liability insurance, a distinction is made between the insured's liability and the insurer's liability under the policy. The insured is personally liable to a third party, irrespective of the policy limitations√. In this case, the insurer's liability under the policy amounts to R3 million. The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

Question 2

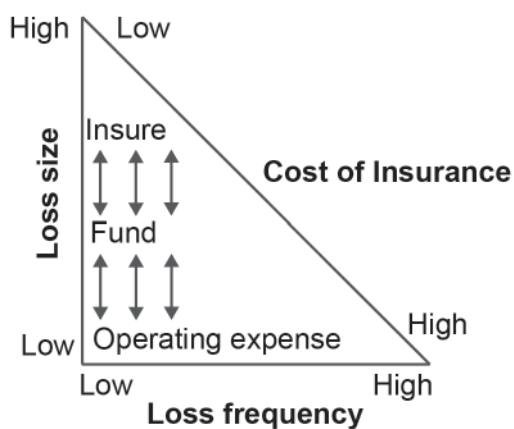
Suggested solution:

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:

$$R2\,000\,000/R3\,500\,000 \times R500\,000^{\sqrt{}} = R285\,714,29^{\sqrt{}}$$

DEF Insurer will be liable for:

$$R1\,500\,000/R3\,500\,000 \times R500\,000^{\sqrt{}} = R214\,285,71^{\sqrt{}}$$

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√.

Question 5 (5 marks)

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

Refer to Chapter 7 of the IISA prescribed book.

Suggested solution:

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.

Please note that Ms De Swardt will retire from Unisa on 31 August 2018. Please refer any academic enquiries for the remainder of the academic year to Ms Yousuf and Ms Maré. Ms Maré can be contacted by e-mail, mares@unisa.ac.za.

Best wishes

MS CECILE DE SWARDT (AJH 5-115)

MS ZAKHIYYA YOUSUF (AJH 5-118)

MS TSHOLOFELO LEGOTLO (AJH5-109)

DEPARTMENT OF FINANCE, RISK MANAGEMENT AND BANKING

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