

# 2018



**Prescribed Material for**

**Risk Financing and  
Short Term Insurance  
RSK3701**



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**Content and Material**

**Authored and Updated by  
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### **OVERVIEW**

The field of insurance is extremely dynamic and challenging; while a sound knowledge of the different sectors of the industry is essential for all working therein. The learning content in this guide will provide you with opportunities to learn more of the approach and application of short term insurance and to explore the specifics of this part of the insurance market.

The purpose and learning outcomes of this guide are to equip students who are not normally involved in the short term insurance field, with the necessary competencies (knowledge, values and skills) to be able to apply the fundamental concepts, principles and processes in providing the main classes of short term insurance products and services.

The short term insurance sector in South Africa has for many years been a leader on the international insurance stage and represents a very dynamic and important component in the insurance and financial services industry and the active student should keep up-to-date with the actual changes to processes and practices, even if the examination is usually restricted to the regulations, procedures and practices actually in force some six or more months before the examination.

The learning material is updated annually, but UNISA will generate and distribute a special tutorial letter (501) if practice or statutory regulations and/or requirements change to the extent that the material needs to be updated and/or replaced ahead of the scheduled date and made applicable to the next forthcoming examination.

When you have worked through this guide you will be able to:

- assess the importance of the different short term insurance market players in terms of their roles, functions and interrelationships and how their activities interact with that of other role players in the South African short term insurance market;
- apply the necessary steps and procedures in underwriting, renewing and reinsuring of short term policies involved in arranging cover from the stage of application till the payment of premium is received, the renewal process from the time of the receipt of the advance till the dispatch of the renewal documents and determining and finalising the most appropriate reinsurance arrangement;
- apply the steps and formalities in the finalisation of short term insurance claims involving the steps and formalities applied in the finalisation of short term claims in the validation of submitted claims, the application of the principle of indemnity, the determination of the claim settling method, resolving of any claims disputes, the application of prescription periods of policies and the steps to be followed after the settlement of a claim;
- analyse the implications of short term insurance related legislation and compulsory insurance with due consideration to the duties and obligations of short term insurers, the required solvency margins of short term insurers, the management of short term insurance offices and the handling of compulsory insurance by short term insurers;
- compile a report on available short term insurance policies in terms of types of perils covered, extensions to cover, exclusions, conditions, premium calculations and claims handling.

Each chapter has its own set of learning outcomes and you should check that you have reached each of these before you move on to the next chapter.

Each chapter also has a number of questions at the end. These are divided into revision questions and written questions. The revision questions are there to test your own grasp of the material that you have studied in the chapter. The answers to these questions are provided in the Unisa guide.

Suggested answers to the written questions can be found at the end of the book. However, these are guidelines rather than model answers and thus perhaps contain more detail than you would need to provide in the examinations. You should attempt these written questions under examination room conditions, ie without reference to the learning material or your own notes.

Unless the context indicates a contrasting intention,

- the singular shall include the plural and vice versa;
- the masculine includes the feminine and vice versa.

(Masculine form of words have been used. This is done purely for convenience and carries no implications or connection with regard to gender whatsoever.)

### **Acknowledgements**

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# Table of Contents

<b>CHAPTER 1 - RISK MANAGEMENT .....</b>	<b>1</b>
1.1 RISK MANAGEMENT AS A CONCEPT .....	2
1.2 RISK IDENTIFICATION .....	4
1.3 RISK EVALUATION .....	9
1.4 RISK CONTROL.....	10
1.5 PERSONAL RISK MANAGEMENT .....	14
Revision questions.....	16
Written questions .....	17
<b>CHAPTER 2 - SHORT TERM INSURANCE MARKET .....</b>	<b>18</b>
2.1 INSURANCE DEVICE.....	19
2.2 SHORT TERM INSURANCE MARKET .....	27
2.3 MARKET ASSOCIATIONS.....	45
2.4 EDUCATIONAL ASSOCIATIONS .....	48
2.5 ADDRESSING THE LOW INCOME MARKET .....	49
Revision questions.....	51
Written questions .....	52
<b>CHAPTER 3 - PRACTICE OF UNDERWRITING .....</b>	<b>53</b>
3.1 ESSENTIAL ELEMENTS OF A CONTRACT .....	54
3.2 SPECIAL LEGAL CHARACTERISTICS OF INSURANCE CONTRACTS.....	58
3.3 PARTS OF THE POLICY .....	69
3.4 INSURABLE INTEREST.....	72
3.5 INSURABLE AND UNINSURABLE RISKS .....	73
3.6 PROPOSAL FORM.....	76
3.7 PROCEDURE.....	85
3.8 PREMIUM COLLECTION .....	89
Revision questions.....	93
Written questions .....	94

---

<b>CHAPTER 4 - RENEWALS.....</b>	<b>95</b>
4.1 RENEWAL LISTING.....	96
4.2 CLAIMS EXPERIENCE.....	97
4.3 OPTIONS.....	98
4.4 SURVEY.....	99
4.5 SOUTH AFRICAN SPECIAL RISKS INSURANCE ASSOCIATION (SASRIA).....	100
4.6 RENEWAL.....	100
Revision questions.....	105
Written questions.....	106
<b>CHAPTER 5 - SHORT TERM REINSURANCE PRACTICE .....</b>	<b>107</b>
5.1 REASONS FOR AND THE IMPORTANCE OF REINSURANCE.....	108
5.2 CLASSES OF REINSURANCE.....	108
5.3 PROPORTIONAL REINSURANCE.....	109
5.4 QUOTA SHARE TREATY.....	110
5.5 SURPLUS TREATY.....	112
5.6 NON-PROPORTIONAL REINSURANCE.....	116
Revision questions.....	123
Written questions.....	124
<b>CHAPTER 6 - CLAIMS PROCEDURES.....</b>	<b>125</b>
6.1 NOTIFICATION OF A CLAIM.....	126
6.2 CLAIMS DEPARTMENT.....	126
6.3 VALID CLAIM.....	127
6.4 INDEMNITY.....	131
6.5 METHODS OF SETTLING CLAIMS.....	133
6.6 CLAIMS DISPUTES.....	134
6.7 PRESCRIPTION PERIOD.....	136
6.8 POST LOSS ACTION.....	138
Revision questions.....	141
Written questions.....	142

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**CHAPTER 7 - REGULATION OF THE SHORT TERM MARKET .....143**

7.1	SHORT TERM INSURANCE BUSINESS .....	144
7.2	SHORT TERM INSURANCE ACT .....	145
7.3	POLICYHOLDER PROTECTION RULES.....	153
7.4	DEMARCATION REGULATIONS .....	161
7.5	OTHER STATUTES .....	163
7.6	COMPULSORY INSURANCE .....	175
	Revision questions.....	180
	Written questions .....	181

**CHAPTER 8 - PERSONAL INSURANCE POLICY .....182**

8.1	PERSONAL LINES .....	183
8.2	HOUSEOWNERS .....	183
8.3	HOUSEHOLDERS .....	185
8.4	ALL RISKS INSURANCE .....	188
8.5	PERSONAL ACCIDENT INSURANCE.....	190
8.6	PERSONAL LIABILITY INSURANCE .....	191
8.7	SMALL CRAFT INSURANCE .....	193
8.8	CONCLUSION .....	193
	Revision questions.....	194
	Written questions .....	195

**CHAPTER 9 - COMMERCIAL INSURANCE.....196**

9.1	MULTI-PERIL POLICY.....	197
9.2	FIRE SECTIONS.....	198
9.3	ACCIDENT CLASSES .....	204
9.4	LIABILITY .....	213
9.5	OTHER TYPES OF COVER .....	215
	Revision questions.....	218
	Written questions .....	219

<b>CHAPTER 10 - MOTOR INSURANCE .....</b>	<b>220</b>
10.1 COMPULSORY MOTOR VEHICLE INSURANCE.....	221
10.2 TYPES OF COVER IN MOTOR INSURANCE .....	224
10.3 FIRST AMOUNT PAYABLE .....	227
10.4 MOTORCYCLES .....	229
10.5 COMMERCIAL VEHICLES.....	230
10.6 MOTOR TRADE RISKS.....	232
10.7 METHODS OF RATING .....	234
10.8 CLAIMS HANDLING.....	237
Revision questions.....	241
Written questions .....	242
<b>CHAPTER 11 - SASRIA, COID AND MISCELLANEOUS COVERS .....</b>	<b>243</b>
11.1 SOUTH AFRICAN SPECIAL RISKS INSURANCE ASSOCIATION.....	244
11.2 COMPENSATION FOR OCCUPATIONAL INJURIES AND DISEASES (COID) ACT .....	249
11.3 SPECIALIST INSURANCE COVERS.....	250
11.4 BANCASSURANCE AND GROUP SCHEMES.....	254
Revision questions.....	258
Written questions .....	259
<b>CHAPTER 12 - CONCEPTS OF ALTERNATIVE RISK TRANSFER.....</b>	<b>260</b>
12.1 ALTERNATIVE RISK TRANSFER (ART) .....	261
12.2 RISK RETENTION FACILITIES.....	267
12.3 CAPTIVES.....	274
12.4 FINITE RISK INSURANCE AND CAPITAL MARKET INSTRUMENTS .....	282
Revision questions.....	292
Written questions .....	293
<b>SUGGESTED ANSWERS.....</b>	<b>294</b>

# CHAPTER 1

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## RISK MANAGEMENT

### Learning Outcomes

When you have completed this chapter you should be able to:

- define risk management as a concept;
- explain how insurance fits into risk management;
- list the three steps in the process of risk management;
- describe three methods used in risk identification;
- explain risk evaluation; and
- explain quantitative and qualitative methods of evaluation.

---

In this chapter we are going to examine risk management as a concept and how insurance, particularly short term fits into this concept.

## **1.1 RISK MANAGEMENT AS A CONCEPT**

### **1.1.1 RISK DEFINED**

In other studies you will probably have come across this, but we reiterate it here for ease of reference.

- Risk is the uncertainty of loss.
- Risk management is therefore a means of removing some or all of this uncertainty.

### **1.1.2 CONCEPT OF RISK MANAGEMENT**

We need to locate insurance in the overall concept of risk management. There is much more to this than buying insurance for those risks that are insurable.

Risk management looks at all the areas that can cause a loss, and not just at insurable risks.

Over the past thirty years or so the market has seen risk management develop and grow. Today risk management is so important that there is a degree devoted to it through Unisa. It is a complex subject, and in this course we can only touch on the concept.

We shall try to locate our current knowledge of insurance within the overall picture of risk management, and then look at the key components and a definition of risk management.

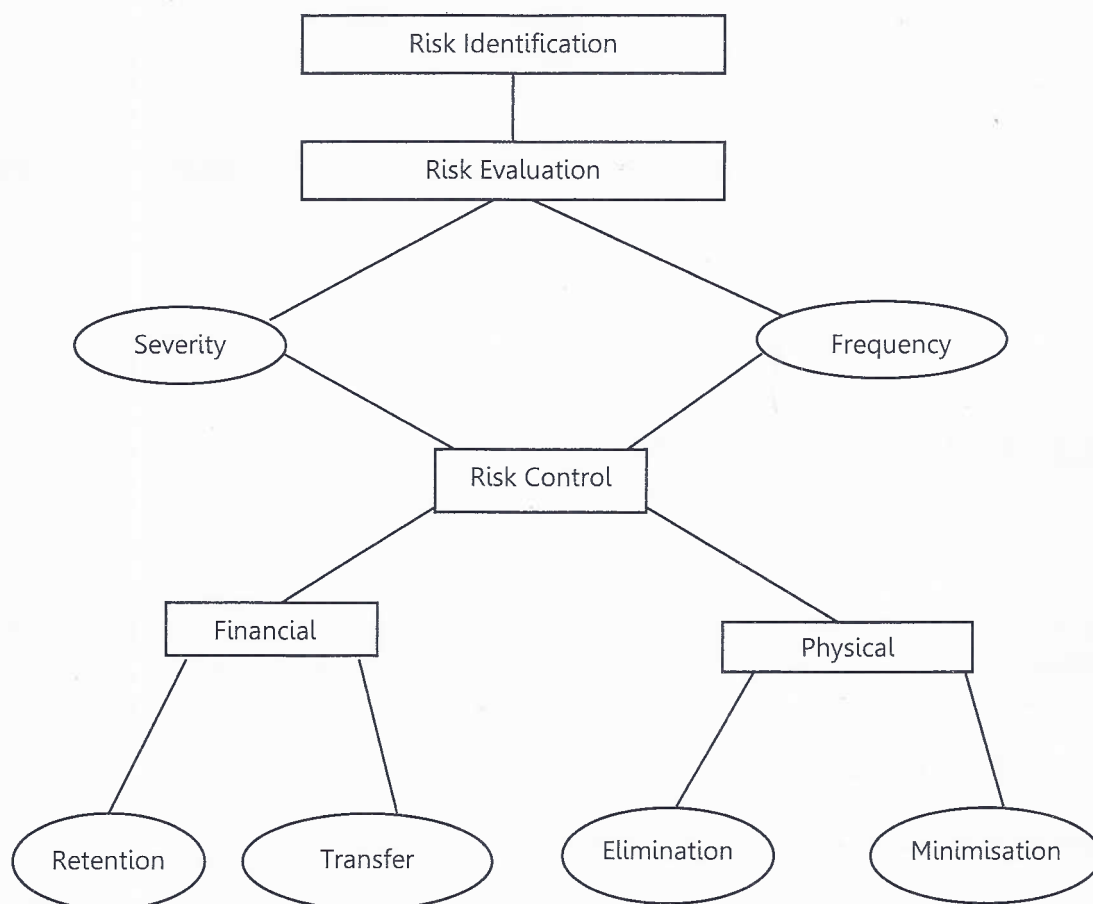
### **1.1.3 RISK MANAGEMENT PROCESS**

Risk management takes a far broader view of the problems posed by risk, than insurance does. This is the first important point to grasp as we try to discover the nature of risk management. Rather than being limited to the risks which are insurable, risk management examines all risks which the business may be exposed to. There are three steps involved in risk management. They are:

- identification of risk;
- evaluation of risk; and
- control of risk.

Figure 1.1 on the next page shows us the process in a diagrammatic format.

**Figure 1.1**  
**Risk management process**



#### **1.1.4 INSURANCE INVOLVEMENT**

The diagram shows us that risk control can involve the financial transfer of risk and this is the area where insurance becomes involved. Remember that not all risks are insurable.

##### **INSURANCE IS A SUBSET**

The diagram clearly demonstrates that insurance is a subset of risk management and not the other way around. This does not demean the role insurance plays but clearly puts the role of insurance in perspective.

When viewed from this perspective it is easy to see why risk management was not welcomed enthusiastically by insurance practitioners. It was viewed as an attack on the historical role of insurers and to a certain extent, still is by many insurance practitioners today.

Some brokers and companies realised the benefits and today many offer risk management as a service to clients, for a fee. This is perhaps one area that could be used by insurers and brokers as a means of marketing themselves.

### **1.1.5 THREE STEPS**

We will now look at the three risk management steps of identification, evaluation and control and we will expand on each in turn.

Identify, evaluate and then manage areas where there is a risk of loss or damage.

## **1.2 RISK IDENTIFICATION**

Companies are exposed to risk in a variety of ways and any one of these could cause financial loss. Remember that the main focus is financial loss.

Risk is viewed in the widest sense and not limited to insurable risks. Steps are taken, using established identification aids, to highlight all areas where a loss, or liability can be incurred.

### **1.2.1 RISK MANAGER**

The risk manager is a specialist and is not limited to one function.

An engineer may be able to identify engineering risks and a lawyer may be able to identify legal risks, but the risk manager must have a broad overall knowledge. He must be able to oversee all the activities of the company.

The task of identifying risk is a daunting one. Imagine a large factory complex, or international airport. Where do you begin to identify risk?

There must be some structure to your approach and we now look at a number of risk identification techniques.

### **1.2.2 PHYSICAL INSPECTION**

Before starting it is important to first carry out some kind of physical inspection. This may simply involve walking around the plant to add to knowledge you may have gained from company publications, or maybe from information managers have given when you have spoken to them.

This helps you to get a feel for the place and may help direct your formal identification techniques.



### 1.2.3 AIDS TO IDENTIFICATION

Having completed the initial inspection the following aids may help in identifying areas of risk:

- organisational charts;
- flow charts; and
- check lists.

There are other methods such as fault trees, hazard analysis, hazard and operability studies, but for the purpose of this course we will only look at the three mentioned above.

#### ORGANISATIONAL CHARTS

These charts show the basic organisational structure of the company. They show the relationship between the personnel - on a business basis. They can highlight weaknesses in the structure, which could cause problems for the risk manager.

#### EXAMPLE

- The works manager must report all accidents or near accidents to each of 3 senior managers.
- To do this he has to fill out 6 pages of documentation, in triplicate.
- This is a long involved process and is a positive disincentive to effective reporting of accidents.
- How happy or enthusiastic is he going to be about this time consuming task?

The risk manager could then streamline the system and cut down on the workload so that he gets information much more quickly. Perhaps as simple as having the form reduced in size.

#### FLOW CHARTS

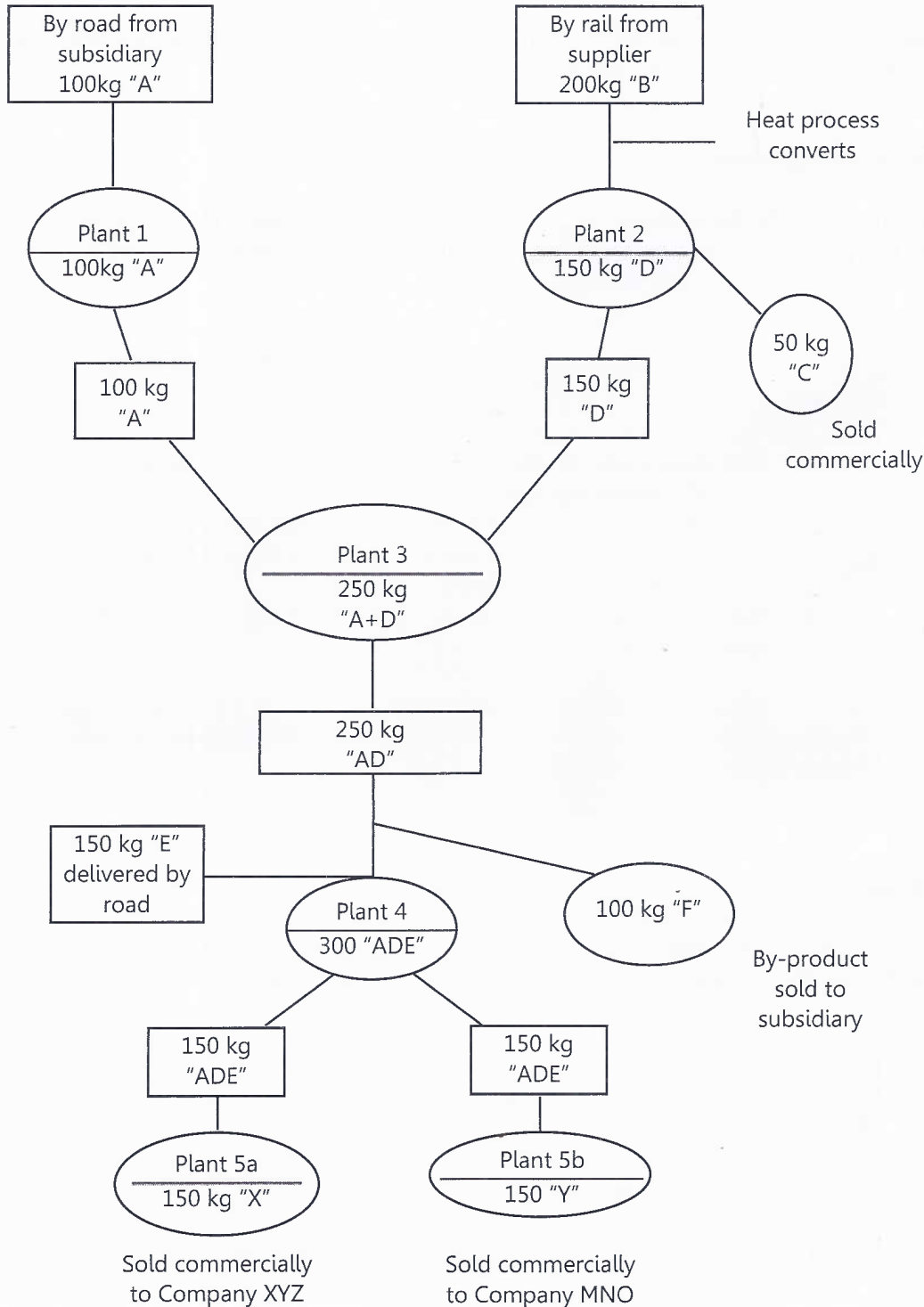
A flow chart is particularly helpful in companies where the system of manufacture or production involves materials flowing through a process. Figure 1.2 illustrates a system where a product "X" is manufactured.

We can see from the flow chart that:

- 2 items of raw material arrive in quantities of 100kg and 200kg;
- item "A" arrives by road;
- item "B" arrives by rail;
- the two items are processed in plants 1 and 2 respectively;

- as a result of the process in plant 2, a by-product "C" is produced and this "C" is sold commercially;
- the two resultant ingredients are combined in plant 3;
- a by-product is produced, which is sold to a subsidiary;
- ingredients are added in plant 4 to the remaining product;
- two final products are produced and are sold commercially.

Figure 1.2  
Risk identification flow chart



---

### Flow Chart Interpretation

A flow chart like this enables the risk manager to see at a glance where problems could arise. He would take into consideration such things as:

- what effect would a fire at a suppliers premises have on the business?
- how easy would it be to find another supplier?
- what effect would there be if plant 2 was destroyed by a fire or other type of peril?
- how long would it take for us to start some kind of interim operation?
- what effect would there be on the company's profits?
- will there be a breach of contract, if we cannot supply by-product "C" to our client?
- could one of the other plants be utilised to replace one which was unable to work?

The flow chart is very helpful for a process type risk.

- Remember that an insurance company is an example of a process risk also. However, here it is correspondence and the like which come in, but this goes through a process just the same.

### CHECK LISTS

In this instance, the risk manager asks a number of questions about each item of say, plant.

#### FOR EXAMPLE

- He first lists the main areas of activity within a factory complex.
- He then asks the same set of questions about each area.
- These questions normally revolve around the risks to which the plant can be exposed.

Figure 1.3 is an example of the check list.

**Figure 1.3**  
**Classification of risks**

Type of Risk	Details
<b>Direct:</b>	
<ul style="list-style-type: none"> <li>• fire</li> </ul>	
<ul style="list-style-type: none"> <li>• corrosion</li> </ul>	
<ul style="list-style-type: none"> <li>• explosion</li> </ul>	
<ul style="list-style-type: none"> <li>• fraud</li> </ul>	
<ul style="list-style-type: none"> <li>• structural defect</li> </ul>	
<ul style="list-style-type: none"> <li>• war</li> </ul>	
<b>Consequential:</b>	
<ul style="list-style-type: none"> <li>• loss of profits following fire</li> </ul>	
<ul style="list-style-type: none"> <li>• following theft</li> </ul>	
<ul style="list-style-type: none"> <li>• inter-group dependency</li> </ul>	
<ul style="list-style-type: none"> <li>• strike</li> </ul>	
<b>Social:</b>	
<ul style="list-style-type: none"> <li>• moral liability</li> </ul>	
<ul style="list-style-type: none"> <li>• consumer pressure</li> </ul>	
<b>Legal:</b>	
<ul style="list-style-type: none"> <li>• civil liabilities</li> </ul>	
<ul style="list-style-type: none"> <li>• statutory liabilities</li> </ul>	
<b>Political:</b>	
<ul style="list-style-type: none"> <li>• governmental intervention</li> </ul>	
<ul style="list-style-type: none"> <li>• acts of foreign governments</li> </ul>	
<b>Financial:</b>	
<ul style="list-style-type: none"> <li>• inadequate inflation forecasts</li> </ul>	
<ul style="list-style-type: none"> <li>• incorrect marketing decisions</li> </ul>	



- cost in man hours;
- cost of damage; and
- effects on other areas.

### 1.3.4 CONCLUSION

It is important to remember that no matter how much data the risk manager has at his fingertips, it is his judgement that he must rely on to make the final decision.

## 1.4 RISK CONTROL

The third and final step in the risk management process is the control of risk. From diagram 1.1 we can see that this falls into two categories - financial and physical. These are now explained.

At the end of the day it is the economic control of risk which is the objective of the risk manager. He has identified and evaluated risk only so that he can decide how best to respond to it. This is the final, crucial step at which point he must use all the information at his disposal, to make the best decisions on behalf of the company.

### 1.4.1 PHYSICAL RISK CONTROL

#### ELIMINATION

This is what many people associate with risk management. This is understandable as the one sure way of not having a loss is to eliminate the possibility totally.

In some instances this is possible.

#### FOR EXAMPLE

- If you get rid of your dog it will not be able to bite the neighbours' children;
- to make sure you don't have a chip pan fire, you could get rid of the chip pan and buy ready-made chips;
- if you sell your car, you cannot have a motor accident with it.

However, how are you going to get around? In the bus? It can have an accident. Total elimination is really not possible, except in a very few cases.



---

## MINIMISATION

This is the area that loss prevention, or risk management is most concerned with. The minimisation of the uncertainty of loss.

The effort of minimising losses falls into two areas:

- pre-loss; and
- post-loss.

### Pre-loss Minimisation

This is where the effects of the loss are anticipated and the necessary steps taken to prevent or minimise. Here are some examples:

- the wearing of a seat belt;
- the use of protective guards on dangerous machinery;
- the use of protective clothing when handling dangerous substances; and
- installation of extractor fans in paint spray booths.

### Post-loss Minimisation

This is where measures are taken that reduce the amount of the loss. Examples of this are:

- the roof tiles are blown from the house in a storm and the owner puts tarpaulins over the affected area to stop water leaking in;
- an industrial nurse is employed to give immediate treatment of injuries at a factory; and
- fire extinguishers are installed, so that fires can be extinguished before they rage out of control.

From this you can see that some post loss actions have to be anticipated prior to the loss, so that some fall partly into the category of pre-loss minimisation.

There is a condition written into short term contracts, with which the insured must comply. The insured must take reasonable steps to safeguard the property, and to minimise any loss that occurs. The fact that he is insured therefore does not relieve the insured of the duty of risk management.

## 1.4.2 FINANCIAL RISK CONTROL

Just as we divided physical control into minimisation and elimination, we divide financial control into retention and transfer.

---

## RETENTION

Once he has evaluated the amount of the risk, the risk manager has to decide whether or not the company can keep the risk for themselves, or if they will have to purchase insurance.

There are a number of ways in which the risk manager can transfer or retain the risk:

- he can retain the whole risk for himself;
- he can try to obtain insurance for the whole risk; or
- he can retain part of the risk and try to obtain insurance for catastrophe cover.

If the client decides to retain the risk for himself he has two options. These are:

- self insurance or captive insurance; or
- non-insurance.

### Self Insurance versus Non-Insurance

We discussed this concept early on. There is no need to recap on it here, but if you are in doubt go back and revise the concept.

What we need to examine is the difference between non-insurance and self insurance. The table below gives a brief outline of the difference.

Difference Between ...	... non-insurance...	... and self insurance
<b>Fund</b>	There is no fund allocated for any losses which may occur.	The insured has set up a fund to cover the losses which may occur.
<b>Risk improvements</b>	There may or may not have been risk improvements to prevent losses.	The insured will probably have identified problem areas and will have taken some measures to improve the risk.
<b>Handling of losses</b>	When a loss occurs it will be very much a case of the "finger in the hole in the dam wall" to try and fix things, or prevent further loss.	The insured will have plans and claims procedures organised, with dedicated staff to handle them.

## RISK TRANSFER

If the insured self-insures it is a form of risk transfer, but the main type of risk transfer is that of buying insurance. We said that the client has two options open to him in this instance.

They are:

- try to obtain insurance for the whole of the risk; and
- obtain insurance purely for catastrophe cover, or selected areas only.

It should be noted however that we say "try to obtain". This is because there is no obligation on the part of an insurance company to accept the risk. They can accept or decline.

We will explain the difference between the two in the final part of this chapter.

### Insure the whole risk

Here it is obvious that the insured decided not to retain any risk for themselves, and purchase cover from an insurer.

The only amount the insured retains will be the amount of any excess or franchise payable.

An excess is the amount that the insured is responsible for each and every time there is a loss. A franchise is an amount that applies to each and every claim, but if the claim exceeds the amount of the franchise, the insured will have his claim paid in full.

### EXAMPLES

Type of deductible	Amount of claim	Deductible	Claim payment
Excess	R500	R500	R0
Franchise	R500	R500	R0
Excess	R1 000	R500	R500
Franchise	R1 000	R500	R1 000

### Catastrophe Cover

This is when the insured elects to retain part of the risk for himself. He decides that he can carry losses up to a certain amount, but if the loss is greater than this amount it will be disastrous.

**FOR EXAMPLE**

- The insured has assets worth R20 000 000;
- he has six premises;
- it is unlikely they will all be destroyed at one time;
- in any one year he can meet losses up to R2 000 000;
- the insured can then insure the assets, but have an aggregate excess of R2 000 000.

This means that in any one year he will pay all claims until these total R2 000 000.

When the losses exceed this amount the insurance company will then start to meet the claims.

For this aggregate excess the insured will obtain a discounted premium from insurers. It also gives him an incentive to ensure that the risk is managed professionally and effectively.

## 1.5 PERSONAL RISK MANAGEMENT

In this chapter the techniques we have looked at have focused on the large business type risk. This does not mean to say that they cannot be applied to the personal or domestic insurance environment.

The same type of reasoning can be employed and the smaller type client can always obtain advice on risk management techniques.

All risks insurance for valuables can be expensive, and the client might decide to self-insure items he can afford to lose. Although unpopular with the insured, excesses are another way of sharing the risk with the insurers, and reducing the premium that would otherwise be required. Additional physical protections might not bring about immediate premium reductions, but there is a benefit if they help reduce the cost and frequency of claims.

When a risk is quoted on by short term insurers, they will often send out a surveyor to check the risk and to ensure that the protections and other factors are adequate. Too often, the broker and the insured see this as interference by the insurer.

Occasionally this may be true, however the surveyor and insurer have wide experience that can benefit the client. It is important that the confrontational position is removed and advice actively sought by all involved.

**CONCLUSION**

There is no doubt that the concept of risk management has grown and will continue to do so as inflation increases the values at risk and the insurance premiums required for these.

---

## QUESTIONS ON CHAPTER 1

### Revision questions

*Work through these revision questions as a test of your understanding of this chapter. We suggest that you attempt these before tackling the written questions. Please note that suggested answers are not provided as the chapter's text contains the answers.*

1. Would the wearing of a seat belt be considered a pre-loss or post-loss step?
2. What is the difference between an excess and a franchise?
3. Can risk management techniques be applied by an individual for his own purposes?

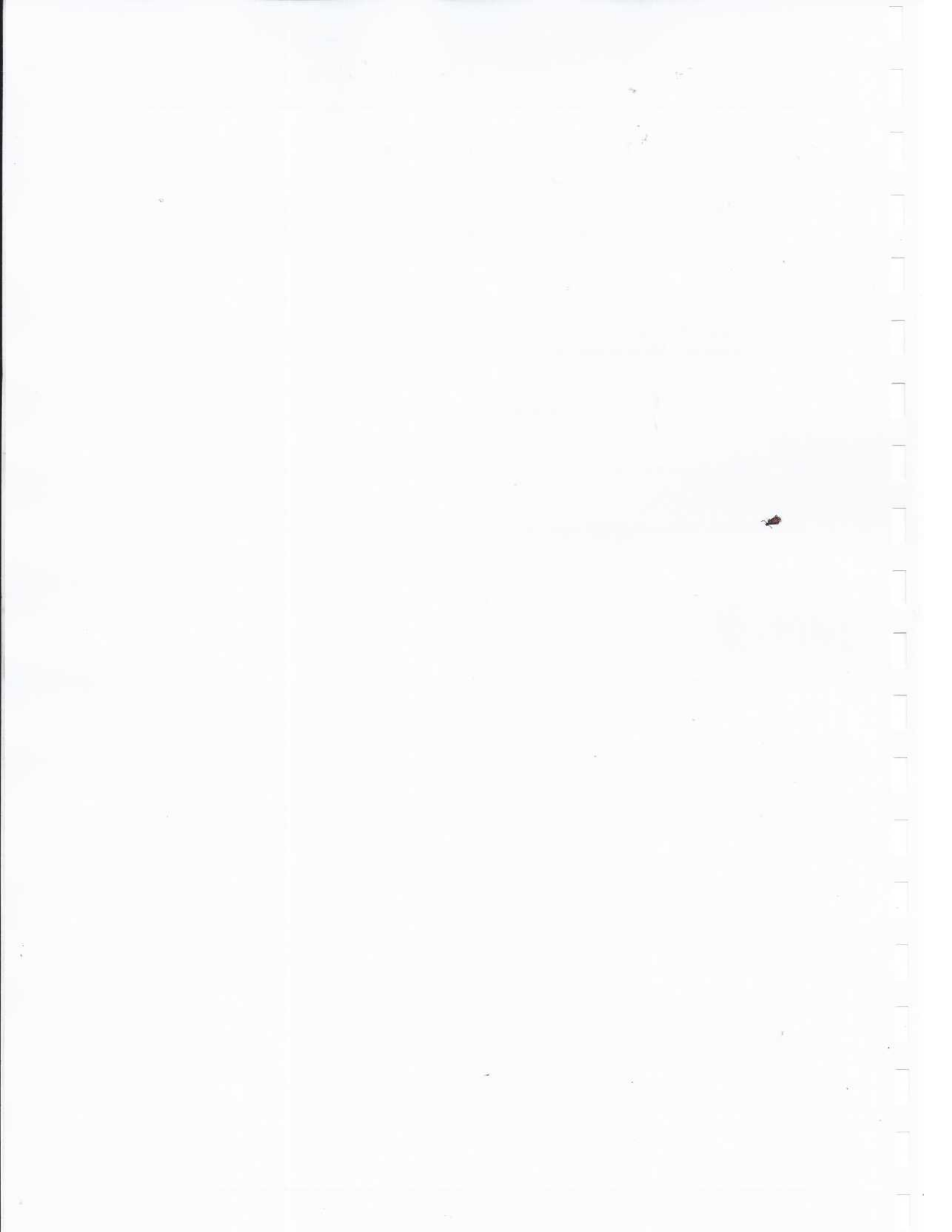


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### Written questions

*Attempt these questions after you have completed this chapter and its revision questions. Suggested answers to these questions are at the end of this book.*

1. You are a short term broker and your client has just asked you to explain the concept of risk management. Write to your client explaining what risk management is.
2. Explain what a flow chart is and draw one up for the processes in your department or office.
3. Draw a diagram showing the various steps in the risk management process.
4. Describe the two methods open to the client who decides to transfer risk.



# CHAPTER 2

## SHORT TERM INSURANCE MARKET

### Learning Outcomes

When you have completed this chapter you should be able to:

- describe the short term insurance market;
- list the players in the short term insurance market;
- demonstrate the interrelation between the various market players;
- draw a diagram to illustrate in pictorial form, this interrelationship;
- describe the functions of the South African Insurance Association and the Financial Intermediaries Association;
- explain the difference between non-insurance and self-insurance;
- list the advantages and disadvantages of self-insurance;
- explain what a captive insurance company is;
- explain the operation of Lloyd's with particular reference to South Africa;
- explain what a mutual indemnity association and a P&I club is;
- describe the function of the loss adjuster and the motor assessor;
- explain the types or classes of cover which are available to the different type of customer; and
- explain reinsurance and collective insurance.

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## 2.1 INSURANCE DEVICE

The insurance mechanism is introduced, and the manner in which it operates is discussed. Insurance is defined, and the notion is emphasised that the essence of insurance is the transfer of the financial consequences of risk and sharing the loss that occurs equitably.

In the previous study unit we defined risk and distinguished between the different types of risks. We also indicated that insurance can be used to transfer the financial consequences of loss to a third party, namely the insurer. The insurance mechanism is therefore one of the techniques used in risk management.

One of the interesting things about risk is the way people react to it. If the risk is speculative and the amount at stake is not too high, taking a chance can be enjoyable. It can be fun to bet on the horses or to invest in a speculative share, especially if we think that we have a good chance of winning. We also do not mind making what seems to be a good business decision, even though there is the possibility of suffering a loss. However, in the case of pure losses (operational-and personal risks), where there is nothing to be gained and perhaps much to lose, our usual reaction is one of uncertainty and insecurity. Individuals and businesses dislike event/pure risk and look for ways to minimise its impact or to avoid it completely.

### 2.1.1 WHAT IS INSURANCE?

Insurance is defined as a system of handling risk by combining many risk exposures with the cost of losses being shared by all the participants.

From a financial point of view, an insurance system accomplishes the redistribution of the cost of losses by collecting a premium from every participant in the system. In exchange for payment of the premium, the insurance system promises to pay the insured compensation in the event of a loss. In most insurance systems, only a small percentage of those insured suffer losses.

Insurance companies receive premiums from many people. These are paid into a fund or pool to pay for losses. Each premium is split between the different perils that are covered, and there is a separate pool for each peril.

#### EXAMPLES

- A fire pool exists from which all insured fire losses are met.
- The motor pool pays for all motor losses.
- Each class of business has a separate pool.

The insurance system redistributes the cost of losses from the unfortunate few who experience losses to all the members of the insurance pool.

In a legal sense, insurance is a contractual arrangement in which one party agrees to compensate another party for losses. The party agreeing to pay for losses is the "insurer". The party who receives compensation for a loss is the "insured". The payment the insurer receives is called a "premium". The insurance contract is called a "policy".

Imagine a group of 100 people who each own a television set. Assume that each set costs R1 000. The owners of television sets realise that their sets might be stolen or destroyed by fire. To protect their investment, each of them buys an insurance policy. An insurance policy is a legal contract in terms of which the insurance company agrees to pay for stated losses. The price of the policy is called the premium and the price in this case is R25. This is the amount the insurance company collects from each of the participants (commonly referred to as the policyholders or the insured). The insurance company has been insuring TVs for many years and has found that an average of two out of every 100 units are either stolen or destroyed. By charging the 100 owners each R25 the company will accumulate a fund of R2 500. If the loss experience remains the same as in the past; there will be two losses and the insurance company will have to pay out R2 000 (R1 000 to each of two policyholders). The remaining R500 is used to pay the insurance company's operating costs and the remainder is the insurance company's profit.

What does this system achieve? It relieves the TV owners of the financial consequences of risk. It does this by a process of combining risk into a pool where the losses of a few are shared by all the participants. This is feasible because the insurer is able to estimate the total amount of the loss. Because the insurance company can predict the amount accurately, it is able to calculate the premium each owner must pay to cover his share of the possible loss.

Insurance therefore has two fundamental characteristics;

- the transfer of financial consequences from an individual to a group; and
- the sharing of losses on some equitable basis by all members of the group

The primary function of insurance is that it eliminates the uncertainty associated with financial loss in exchange for a small premium. A secondary function is that insurance reduces the risk to society as a whole by pooling risks and being able to predict losses within narrow limits.

### **2.1.2 HOW DOES INSURANCE WORK?**

A definition and indication of the purpose of insurance as well as the way in which it differs from some other activities or chance events, provides an indication of what insurance is. Real understanding, however, requires an analysis of how it works. This section is therefore devoted to a discussion of the basic principles of risk assumption, probability, the law of large numbers, and the problem of adverse selection. Some familiarity with these principles is essential to an understanding of insurance.

#### **RISK ASSUMPTION**

Financial aspect. Insurance is created by an insurer who, as a professional risk-bearer, assumes the financial aspect of risks transferred to the insurer by the insured. Most insurance contracts are expressed in terms of money although some indemnify the insured by providing service. A life insurance contract, for example, obligates the insurer to pay a specified sum of money upon the death of the person whose life has been insured.

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A liability insurance policy not only requires the insurer to pay money on behalf of the insured, but also to provide legal and investigative services when the event occurs that had been insured against. The terms of a health insurance policy may be fulfilled by providing medical and hospital services for the insured when he is ill or injured.

Whether the insurer fulfils its obligations with money or services, the burden it assumes is financial. The insurer does not guarantee that the event insured against will not happen. Moreover, it cannot replace sentimental values or bear the psychological cost of a loss. A home may be worth only R100 000 for insurance purposes, but have many times that value to the owner in terms of sentiment. The death of a loved one can cause almost unbearable mental suffering which is in no way relieved by receiving a sum of money from the insurer. Neither of these loss aspects can be measured in terms of money, and therefore such risks cannot be transferred to an insurer. As these non-economic risks create uncertainty, insurance can clearly not completely eliminate it.

Prediction. As a device for handling the financial aspect of risk, Insurance is feasible because insurers are able to combine the risks of individuals into a group and pay losses with funds collected from the group members. The function of insurers is to assume risk, and the purpose of insurance is to reduce uncertainty. A common question, then, is why is the insurer better able to assume a risk than the insured? In other words, how does the situation of the insurer and of the insured differ? Clearly, if they are not different, the insured is no better off transferring his risk than retaining it.

It is sometimes said that the difference lies in the fact that the insurer has more extensive financial resources than the insured. This is usually true, but not always. Occasionally, the insured is bigger than the insurer. In any event, the insurer is obligated to a large number of insured. So the extent of its financial resources compared to those of one of its insured, is not a measure of its ability to bear a risk. Moreover, if the only difference between the insurer and the insured is the financial capacity to bear loss, the transfer agreement is mere speculation.

Another suggestion is that the insurer may differ from the insured in terms of its ability to prevent loss. Perhaps this is true in general, but in most cases the complete elimination of a possible loss is impossible. Uncertainty therefore remains. With reference to one risk confronting one individual, the positions of the insurer and the insured are virtually identical.

The fundamental difference between the insurer and the insured lies in predicting future events. As far as you are concerned, the insurer has no greater ability to predict than you. However, the insurer does not have to make the same prediction as you did. You have to predict what might happen to you as an individual. The insurer, on the other hand, makes predictions for all the insured as a group. When a large number of risks or exposures is combined into a group, the risk the insurer faces is not the same as the risk to which you are exposed, nor is it merely the sum of the risks of all the group members. The difference between the insurer who assumes a risk and the insured who transfers the risk, is that the insurer is able to make more accurate and reliable predictions. The reason for this difference lies in the concept of "pooling".

Pooling. If we accept the definition that risk is an unfavourable deviation from the expected, your risk is a function of your expectations and the state of the world which can cause events to deviate from those you expected. The insurer's risk is defined in the same way, but is not identical to yours because the insurer's expectations are different.

The difference between you and the insurer is not that the insurer's predictions for an insured individual are more reliable, but the insurer can make predictions for the group which are more reliable than your predictions for yourself. Pooling therefore changes the nature of the risk and improves a prediction. This, in turn, results in smaller deviations from expectations.



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## LAW OF LARGE NUMBERS

An insurance system can only operate successfully when potential losses can be predicted accurately. Accurate prediction reduces risk. Insurance pools reduce risk because a mathematical principle, called the "law of large numbers", is applied. Simply put, the law of large numbers states that the greater the number of predictions of an event based on chance, the greater is the chance that the actual result will approximate the expected result.

For example: If a die were to be rolled six times, we would expect each face to appear once, because each of the six sides has an equal chance of appearing on a given throw. The law of large numbers leads to the conclusion that the more often the die is rolled, the more likely that the one-sixth probability will realise.

Suppose an insurance pool expected 1% of its members to experience a loss, based not on the reasoning of the die example but on historical records of losses. The law of large numbers states that the greater the number of exposures, the more likely it is that the 1% loss figure will be realised.

By applying the law of large numbers, the insurance company can accurately predict the number of losses it will experience during a particular period. The relative accuracy of the company's predictions increases as the number of exposures as in the insurance pool increases. If loss can be predicted accurately, then the cost can be budgeted and shared in advance and an appropriate premium is charged. The substitution of a small premium in place of an uncertain loss motivates many consumers and businesses to purchase insurance.

It must be emphasised that the law of large numbers only allows accurate predictions of group results. It does not allow us to predict accurately what will happen to a particular exposure unit in the group.

The unique contribution of pooling to the insurer as risk bearer should now be apparent. It is a function of the law of large numbers. Insurer operations are affected by this law in two ways. Firstly, if the probability of a loss is to be estimated accurately, a large number of cases must be considered. Secondly, the law of large numbers affects insurer operations because after the probability has been estimated, the estimate can only be used as the basis for predicting future losses when the insurer is dealing with sufficiently large numbers. For example: if an insurance company provides one person with R10 000 in life insurance for one year in exchange for a R100 premium, it will either make R100 or lose R9 900 on the transaction, since we can be sure that the person whose life is insured will either die during the year or he will not.

As far as an individual is concerned, knowing the probability of death during the coming year is no help in predicting the future. As far as the one individual's life is concerned, the insurance company is in no better position to make predictions than the individual is. Given a large number of similar lives, however, the insurer can make accurate predictions about what will happen to the group. Although there is no way of predicting which of the people whose lives are insured will die, it is possible to make fairly accurate predictions for the group based on the underlying probability. The insurer does not need to know what will happen to anyone person. All it needs is an accurate prediction for the group. The basis for this is probability and the law of large numbers.

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## ADVERSE SELECTION

Adverse selection is the tendency among people with a greater probability of loss than the average to seek insurance. The result might be greater losses than expected on the basis of past experience. Insurers try to prevent this situation by learning enough about the applicants for insurance to identify such people whom they can either reject or place in a group whose members have a similar loss probability. This is the purpose of medical examinations for older life insurance applicants or anyone who applies for a large insurance amount.

Some insurance policy provisions are designed to reduce adverse selection. For example: The suicide clause in life insurance contracts avoids liability to an applicant who purchases life insurance because he is contemplating taking his own life. The pre-existing conditions provisions are difficult to insure, partly because of catastrophe exposure and partly because of limited experience on which to base predictions.

### 2.1.3 ELEMENTS OF AN INSURABLE RISK

You should now understand the role of insurance in handling risk. Now you need to know why only some risks can be insured. It is important to understand that although everything carries some form of risk, not all risks can be insured. Insurable risks have the following characteristics:

- **similar risks** - experience of similar risks is necessary to establish a fair premium. Insurers can of course insure unusual risks (eg spacecraft or a model's legs) but generally a sufficient number of similar exposures is required for the insurance mechanism to work efficiently;
  - **measurable and definite loss** - we must be able to tell when a loss occurred to attach a particular value to it. It is impossible to compensate somebody for the mental suffering caused by the loss of a loved one, but the financial suffering brought about by death can be insured against;
  - **fortuitous or accidental loss** - this means that the loss is due to accident or chance. The insured cannot deliberately burn down his business and expect the insurers to indemnify him;
  - **inevitable loss** - according to our definition of risk, an inevitable loss would present no risk and is therefore uninsurable. Although death is inevitable, the time of death is uncertain and is therefore insurable;
  - **non-catastrophic loss** - a risk which affects a very large part of the population violates the fundamental principle that the loss of a few is carried by a large number of people. Catastrophes such as drought and famine are therefore not insurable;
  - **insurable interest** - insurable interest is the legally recognised relationship between the insured and the potential financial loss. This concept is discussed in more detail in a later study unit. Remember: You can only insure things with which you have a legally recognised financial relationship. For example: You can insure your house against fire because if it burns down, you will suffer a financial loss; and
  - **public policy** - the law recognises that contracts may not be against public policy (ie against the interests of the public at large). Since insurance is a legal contract, it would for example be unacceptable to insure against a fine for exceeding the speed limit.
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### 2.1.4 SELF-INSURANCE

Although it is by definition impossible, the term "self-insurance" has been widely accepted. The term refers to establishing a scheme in terms of which risk is consciously retained, provision is made for its financial consequences, but no insurance company is involved. The term "self-insurance" is a misnomer, however, in that one cannot transfer to or pool with oneself.

#### EXAMPLE OF SELF-INSURANCE

Suppose a company has one salesperson and owns one vehicle worth R100 000. The company is exposed to a large number of risks in connection with its vehicle, but let us consider damage to the vehicle by hail. The company may insure against this loss by transferring the risk to an insurance company, or it may decide to retain the risk and pay for losses as they occur. If it shifts the risk to an insurer, the annual cost of hail damage becomes certain: the cost equals the insurance premium. If the risk is retained, however, annual losses due to hail are entirely uncertain. The probability of such losses, which could run from zero to R100 000, cannot be determined on the basis of past experience because the number of units exposed to loss in the past is too small. Even if the probability of loss could be determined, it would be useless for predicting future experience. The company is in the same position as an individual vehicle owner in this respect.

However, suppose a second company has a fleet of 5 000 vehicles, each worth R100 000, and each used by a different employee in a different part of the country.

As this group is fairly large, its past experience could provide a reliable indication of the future cost of hail damage. The owners of the fleet cannot predict what will happen to one particular vehicle, but their prediction for the group as a whole could be reasonably accurate.

The company could for example establish a fund from which it could pay for hail damage to its vehicles instead of paying premiums to an insurance company to perform, the same operation. Through pooling, the magnitude of deviations from expectations is reduced to manageable proportions. This places the self-insuring company in a position similar to that of an insurer who assumes the hail risk of a large number of vehicle owners. The risk each owner bears is the possibility that damage to the vehicle in the pool could exceed the prediction. With 5 000 vehicles in its fleet, and a fund from which to pay the cost of damage caused by hail, the company is in fact operating its own insurance scheme. It is a "self-insurer".

**ACTIVITY**

List four advantages of self-funding (or self-insurance), based on your prior knowledge of self-funding.

**Answer**

The following are four possible advantages you could have listed.

1. Self-insurance avoids expenses associated with the traditional commercial insurance market. These expenses include the insurer's overheads and profit, the insurance agent's commission, and the premium taxes insurers have to pay.
2. Self-insurance saves on high insurance premiums. The company may believe that its loss experience is significantly better than the average experience in terms of which rates are determined, or that the rating system does not accurately reflect the hazards associated with exposure to risk.
3. Self-insurance gives better control over the claims process. Some companies may want the ability to control the claims process. They could argue that insurers sometimes pay claims that should have been contested.
4. Self-insurance enables the capturing of investment returns. Some insurance buyers may believe that the investment income from loss reserves is not adequately reflected in rates, and that they could capture the investment income which insurers earn on their reserves.

**ACTIVITY**

List four disadvantages of self-funding (or self-insurance), based on your prior knowledge of self-funding.

**Answer**

The following are four possible disadvantages you could have listed.

1. Self-insurance could leave the company exposed to catastrophic loss. This disadvantage could be eliminated by purchasing reinsurance just as insurers do.
2. Losses could vary considerably from one year to the next, resulting in the loss of the tax deduction in losses when there are no profits from which to deduct losses.
3. Possible adverse employee and public relations could arise from adjusting losses.



4. The company could lose available insurer services, such as loss prevention services and claim handling. This loss could be overcome by purchasing these services from insurers (i.e. "unbundled") and by retaining a third-party administrator to handle claims.

## 2.1.5 REINSURANCE

### NATURE OF REINSURANCE

Reinsurance is an arrangement in terms of which an insurance company transfers all or a portion of its risk from an insurance contract (or contracts) to another company. In effect, the insurance company that issued insurance policies, purchases insurance from another company. This could protect it against all or part of the losses against which it is insuring its policyholders. For example: A company which insures a building for R100 000 against loss by fire, could enter into an agreement with a reinsurer who requires the reinsurer to pay half of all losses under the policy. In the event of a R10 000 loss, the insurer would pay the insured R10 000 and then collect R5 000 from the reinsurer.

In this process, the company transferring the risk is called the ceding company, and the company assuming the risk is called the reinsurer. When a claim is lodged on a policy, the reinsurer is liable to the ceding company, not to the insured. The insured has a contract with the insurer, not the reinsurer. The amount the ceding company is willing to bear, is called its retention. The size of the retention is influenced by factors such as the extent of the company's surplus and its experience with the particular type of risk as well as the temperament of its management. As a general rule, new and small companies would establish retention limits that are smaller than those of older and larger companies.

### PURPOSE OF REINSURANCE

The main reason for reinsurance is because the ceding company wants to protect itself against losses beyond a specified sum, but competition and the demands of its agency may require issuance of policies for greater amounts. A company that issued policies no larger than its retention, would severely limit its opportunities in the market. Many of the insured do not want to place their insurance with several companies but prefer to have one policy with one company for each risk. Agents who represent companies offering insurance find it inconvenient to place insurance in small amounts/when they are insuring a large risk. In addition, a company must protect itself from catastrophic losses in a particular line (for example, storm damage) or a particular area.

A company who offers a particular line of insurance for the first time, may want to protect itself from excessive losses and also take advantage of the reinsurer's knowledge of proper rates to be charged and underwriting practices to be followed. In other cases, a company that is expanding rapidly may have to shift some of its liabilities to a reinsurer in order to avoid impairing its capital.

### SIGNIFICANCE OF REINSURANCE FOR THE INSURED

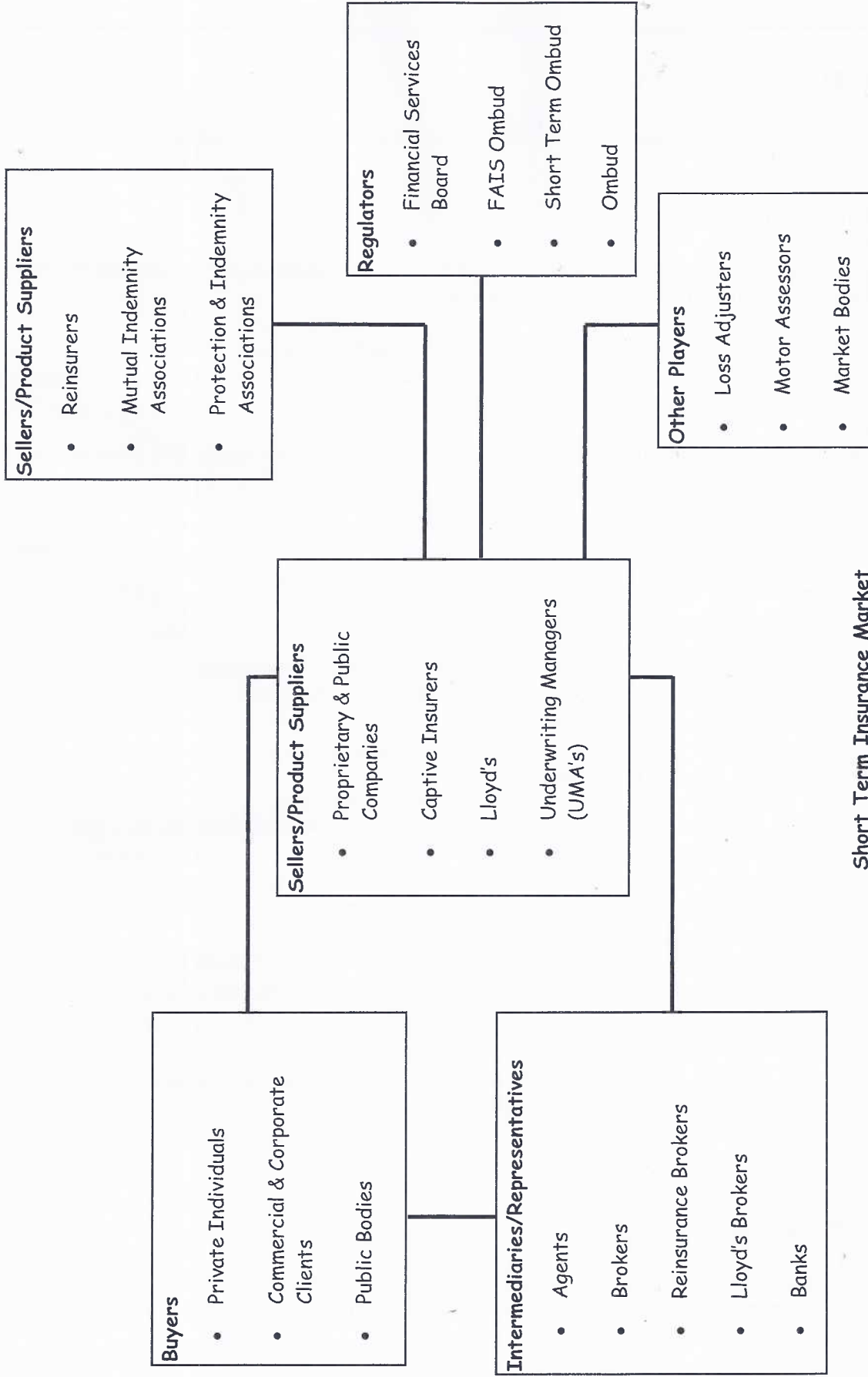
Reinsurance is significant to the insurance buyer for a number of reasons:

- reinsurance spreads the risk and increases the financial stability of insurers;

- reinsurance facilitates placing large or unusual risks with one company; and
- reinsurance helps small insurance companies to stay in business.

## **2.2 SHORT TERM INSURANCE MARKET**

The following page is a diagrammatic representation of the short term insurance market. We will look at each sector of the market and how it functions in the remainder of this chapter.



Short Term Insurance Market



## 2.2.1 BUYERS

There are several types of buyers in the short term market which are detailed below.

### PRIVATE INDIVIDUALS

You and I are private individuals. We need insurance for the house we live in, the car we drive, the clothes we wear and the liability we may incur due to our negligence.

At one time personal lines business was very unattractive, as it was costly to administer and the claims experience was poor. Today technology has reduced costs and the increase in business has helped to spread the losses over a larger base.

Companies have developed the Personal Lines Policy to cope with our needs. The personal lines or domestic policy can have the following sections<sup>1</sup>.

<b>Houseowners</b>	<ul style="list-style-type: none"> <li>• This covers the building of the private dwelling.</li> <li>• The perils covered are listed in the policy.</li> </ul>
<b>Householders</b>	<ul style="list-style-type: none"> <li>• This covers the contents of the private dwelling.</li> <li>• The perils covered are listed in the policy.</li> </ul>
<b>All Risks</b>	<ul style="list-style-type: none"> <li>• This gives cover for the property of the insured, whilst they are away from the dwelling.</li> <li>• Cover is normally on a worldwide basis.</li> <li>• Cover is for any loss or damage <b>not excluded</b> under the policy.</li> </ul>
<b>Personal Liability</b>	<ul style="list-style-type: none"> <li>• This covers legal liability the insured may incur.</li> <li>• Cover is for any legal liability which the insured may incur <b>not excluded</b> under the policy.</li> </ul>
<b>Motor</b>	<ul style="list-style-type: none"> <li>• Cover is available on a third party only, third party fire and theft, or fully comprehensive basis.</li> </ul>
<b>Personal Accident</b>	<ul style="list-style-type: none"> <li>• Cover for the insured and immediate family against accidental death or serious injury.</li> </ul>

### COMMERCIAL CLIENT

This is the smaller business type risk. There are many of these, ranging from the local corner shop, to some quite large enterprises. The standard policy, described in this course, is designed for these small to medium risks.

<sup>1</sup> These are the standard sections - some insurers offer variations, such as travel insurance.

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## CORPORATE CLIENT

These are major enterprises and groups often needing tailor-made solutions to their insurance needs. An example is Amalgamated Beverage Industries Ltd (ABI).

The main differences between the corporate and the commercial client are:

- the size of the risk - the sums insured, or limits of indemnity are much greater for the corporate client;
- the premiums - the larger the risk, the greater the exposure and therefore the premium charged is greater. However, the bigger clients can afford to carry much larger excesses;
- the corporate client tends to have an advantage in premium negotiations and claims settlement in view of the size of the account; and
- because of the size of the large corporate accounts, if the broker or the insurer loses the business to a competitor, then the effect on the loss of income can be substantial.

We will look at the type of cover available for these clients, after we have defined public bodies, as they both require the same type of cover.

## PUBLIC BODIES

These are businesses which operate in the public sector.

**EXAMPLES of these are:**

- Local Authorities (Municipalities)
- Trade Unions
- Eskom

Many of the public bodies do not insure all of their assets, but will only insure against catastrophic losses. Because of their size, the insurances for these buyers may be spread over a number of insurers on what is called a collective basis. We will look at collective insurance later.

The insurance cover for commercial clients is written in the commercial department of insurance companies. Many of the bigger companies have a separate corporate insurance department to handle bigger accounts.

## TYPE OF COVER AVAILABLE

There is a wide range of different perils that can be insured against. Policy wordings can vary widely, but the market has tended to offer very similar cover.

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Very large accounts can be written on an Asset All Risks basis and this type of cover is also briefly described.

### **Policy Wording**

We are going to look at policy wordings at this stage, rather than define the type of policy available and the sections which can be included.

### ***Multi Peril Policy***

Historically, a policy would be issued for each of the different types of cover the client needed. There were a number of disadvantages, which included:

- the client could have a different renewal date for each policy;
- he would have to pay each premium separately;
- he could easily forget to renew one of the policies; and
- the company had to issue separate documents, which increased costs.

Multi-peril policies are policies with various sections combined into one document. This means that:

- there is only one renewal date;
- there is one premium;
- it is cheaper to issue; and
- there is only one document.

Usually, the insurers market their personal lines multi-peril policies under a brand name, for example, Allsure, or Multiplex or some other name.

Multimark<sup>2</sup> was a commercial insurance multi-peril policy wording which was drawn up by South African insurance companies and the insurance intermediaries, in joint consultation. Revised versions of the wording were issued from time to time. The last version was Multimark III.

All the short term insurance companies used the Multimark policy, with some companies using the standard wording more than others. However, the different companies have their own version of multi-peril policies which they can now use instead of Multimark.

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<sup>2</sup> The Multimark wording was withdrawn in 2007.

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### **Sections**

We stated that the multi-peril or standard policy is a document with various sections. Below are details of the sections which can normally be included.

The sections that may be included:

- fire;
- buildings combined;
- office contents;
- business interruption;
- accounts receivable;
- theft;
- money;
- glass;
- fidelity;
- goods in transit;
- business all risks;
- accidental damage;
- public liability;
- employers' liability;
- stated benefits;
- group personal accident;
- motor; and
- electronic equipment.

Each section of the policy will have a different sum insured or limit of indemnity and different terms and conditions, as well as different perils which are covered. We examine these in more detail later on.

### **Asset All Risk**

This policy is specifically issued on the value of the total assets belonging to the company. It is normally only issued for the larger type of corporate risk, as each policy is written specifically for the client. Standard wordings can be used but this is very much a policy tailored to fit the client's needs.

It is a policy of exclusions. If the cause of the loss is not excluded, then the loss is covered. Cover is therefore very wide. There will be separate limits for different types of cover.

**FOR EXAMPLE**

Total Assets Sum Insured R50 000 000

Theft limit R50 000

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## 2.2.2 INTERMEDIARIES

The intermediaries in South Africa are responsible for placing most of the short term insurance business. They therefore need to have a good working relationship with the various insurance companies.

There is a growing trend however towards direct selling by insurers, particularly in the personal lines type of business. Despite this, the intermediary is still very important in the market place.

In short term insurance there are different types of intermediary:

- the Broker;
- the Underwriting Manager;
- the Agent; and
- Lloyd's Broker

### **BROKER**

Brokers are the intermediaries who provide advisory and intermediary services. They will normally have an agency agreement with many insurers. Reinsurance brokers also operate in the market.

Brokers are considered to be professional insurance practitioners and are legally liable for the advice they give clients. If they give incorrect advice the client may take legal action and for this reason the broker will require professional indemnity cover. As from 2010 Professional Indemnity cover is a requirement under legislation.

A broker may be responsible for the collection of premiums from the insured. The broker must therefore have a financial guarantee to cover any premiums which he collects from a client, but has not yet paid over to the insurance company. This is further explained in a later chapter under premium collection.

A broker's main income is the commission he is paid by insurers, for introducing new business, or renewing existing business. There is no legal obligation on the part of a broker to handle claims, but as a service to their clients, the broker will may have claims staff who liaise with the insurers on the clients behalf.

The broker may also charge a fee for his services, provided that this is shown separately in the account sent to the client. Banks play a major role in the sale of insurance policies, often through a brokerage that forms part of their operation.

### **UNDERWRITING MANAGER**

The underwriting manager referred to here is not an insurance company official, but a special type of intermediary called an Underwriting Management Agency. Registered insurers are allowed to outsource underwriting and claims setting authority to certain intermediaries, provided that this is in terms of a written mandate, in which the scope of authority is clearly set out.

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Usually, this is because the intermediary has special knowledge or facilities for transacting a particular class of business, and it makes business sense for insurers to outsource the underwriting and administration. The insurer remains ultimately responsible for the cover issued.

They decide on the underwriting terms, in consultation with the insurer from whom they do business and under whose license they operate. Profits are usually shared between them and the insurer.

### **AGENT**

In the short term market an insurance agent is someone who sells insurance, but it might not be their main occupation.

An example of this would be the estate agent who also sells short term insurance. This is particularly true in smaller communities where the agent can supplement the income from his main occupation by assisting his clients with their insurance needs.

It is important to realise that the agent still has a duty towards the client for whom he arranges insurance. He is just not considered, in a legal sense, as professional as the broker, but all FSP's are subject to the FAIS Act (mentioned below).

The FSP in short term insurance, whether he is an agent or a broker, has certain responsibilities and is expected to behave in an ethical manner. The Financial Advisory and Intermediary Services (FAIS) Act lays down a compulsory code of conduct for FSP's. Among other matters, the provisions include amongst others:

- registration and licensing by the Registrar of Financial Services Providers. For this representatives must show their academic standing, their code of ethics and their financial standing to prove their fit and proper status;
- keeping proper accounting records, in which the clients' funds are separate from those of the financial services provider;
- keeping records of any complaints made against the FSP, and the outcome of these; and
- appointing a compliance officer, who must ensure that the regulations are complied with.

Complaints are to be decided upon by a special official to be known as the Ombud.

The role of the FAIS Ombud is to serve as a cost-effective dispute resolution system through which customer complaints against FSP's or representatives will be processed. The Ombud will consider and dispose of complaints in a procedurally fair, formal, economical and expeditious manner with regard to:

- the legal and contractual relationship between the complainant and the other party; and
- the provisions of the FAIS Act.



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The FAIS Ombud is empowered to:

- award fair compensation for any financial prejudice or damage suffered by a complainant; and/or
- issue a directive to an FSP to take steps to resolve the complaint.

### **LLOYD'S BROKER**

Lloyd's brokers mostly operate in specialist fields, placing the risk through an arrangement with the Lloyd's market. While the controls on Lloyd's underwriters operating in South Africa are specially set out in the Short Term Insurance Act, it should also be understood that Lloyd's members have to undergo a careful process of selection before being appointed and that Lloyd's has a robust system of reserving to protect policyholders.

### **OTHER DISTRIBUTION CHANNELS**

With developments in marketing it is not unusual to find insurance being sold by a number of other channels, including finance officers of banks, retail store staff on instalment sale deals and even funeral parlour owners.

Effectively in each case there would have to be an authorised agent or broker where consumers are given any choice of benefits.

In addition, there is a flourishing direct sales market, using both inbound and outbound call centres, television, the internet and direct mail or coupon systems by both direct insurers and brokers.

### **2.2.3 INSURERS**

As a long term insurance practitioner you will be aware of the different types of company structures within the market place. Perhaps there are some which are new to you, and we discuss them in this section.

In South Africa all short term insurers are subject to the Short Term Insurance Act, 1998.

Short term insurance companies are also subject to the Companies Act, 2008.

The types of insurance companies are:

- Proprietary Companies;
- Public or Mutual Companies;
- Captive Insurance Companies;
- Lloyd's;
- Reinsurers;



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- Mutual Indemnity Associations; and
  - Protection and Indemnity Associations.

### **PROPRIETARY COMPANIES**

A proprietary company, (Pty Ltd), prohibits the offering of its shares to the public and restricts the transferability of its shares. The shares of a private company cannot be offered to the public at large. The restriction of not more than 50 shareholders was lifted in terms of the 2008 Companies Act and there is now no limit to the number of shareholders in a Proprietary Company.

Shareholders are also afforded more protection when it comes to the level of liability that they face for company debts.

### **PUBLIC OR MUTUAL COMPANIES**

These companies have no shareholders but are owned by the policyholder. They have become extremely rare in the South African market.

### **CAPTIVE INSURANCE COMPANIES**

More and more businesses are electing to self-insure. This means that instead of transferring the risk to an insurer, they set up a fund from which they can pay claims.

They can do this in three ways. They can:

- establish a fund and allocate personnel to administer it and handle claims;
- establish a separate company (a captive) to underwrite and handle their insurance, of which some of these are registered offshore to take advantage of tax benefits; or
- set up a separate fund with an existing insurer, and make use of the insurer's administration facilities and insurance licence (cell captive and rent a captive).

Each of the second two types of arrangement must comply with the Insurance Act and Companies Act, where applicable. They have the added advantage that they can place reinsurance with the professional reinsurance companies.

### **Conclusion**

Captive insurance and self-insurance have enjoyed an increase in popularity in recent times. There is one insurer who deals with only Cell Captives, and other insurers have set up arrangements to enable businesses to practice this form of self-insurance, without the expense of setting up their own Captive insurance company.

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## LLOYD'S

Edward Lloyd owned a coffee shop in the City of London. At that time, coffee was still a novelty and coffee shops resembled clubs where people of similar backgrounds and interests met to chat and do business.

Lloyd astutely realised that he could attract the wealthy and influential merchant shippers by offering current information on shipping and cargoes. From this service developed the Insurance Organisation formerly called Lloyd's of London and now known worldwide as Lloyd's.

Lloyd's is not an insurance company, but in fact an association of underwriters. The names who provide the backing for risks underwritten are responsible for all losses. Until recently they had unlimited liability, and backed the risks underwritten with their personal money and assets.

The individual names create syndicates. The syndicate has an underwriter whose responsibility it is to accept business on behalf of the syndicate and to decide on terms and conditions.

The term underwriter actually originated at Lloyd's. When a risk is offered by a broker he will have a slip with all the details of the risk. The underwriter will check the details and if he wishes to take part or all of the risk, he will sign at the bottom of the slip and indicate the amount of his share premium, terms and conditions.

### Lloyd's today

In recent years Lloyd's has faced major concerns in its operation. The names faced catastrophic losses and there was serious worry within the market as to the future of this association.

Quoting from an older Lloyd's web page:

*"In May 1995, Lloyd's set out its reconstruction and renewal plan, the most far-reaching and ambitious programme of change that any insurer has ever undertaken. The plan sought to combine radical changes necessary to take the market forward with pursuing the qualities of innovation, flexibility and competitiveness which have been among its traditional strengths."*

Following the reconstruction and renewal, Lloyd's has recovered. One of the major differences is in who may become a name.

### Names

Backing for the risks underwritten is provided by individuals who must satisfy strict financial and other requirements before they can be accepted as members. Men and women of any nationality can be accepted. In 1994 the rules were changed and limited liability members and corporate members can now also be admitted. Both types of members have to deposit funds with Lloyd's in a certain proportion to the amount of business they wish to underwrite.

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### Central Fund

As well as furnishing a deposit with Lloyd's for the business they back, members also have to contribute to the Central Fund. This fund protects the insured public in case the security and personal assets of the members is insufficient to meet losses which may arise.

### South African Connection

In terms of the Short Term Insurance Act, Lloyd's must appoint a representative and deputy representative, whose duty it is to give the Registrar a list of names and addresses of Lloyd's correspondents in South Africa, and act as defendant or respondent in court proceedings.

- Lloyd's is among the largest property and liability insurers (including reinsurance) in South Africa.
- The operations of Lloyd's are worldwide.
- Lloyd's maintains a Trust Account in South Africa as extra security for its South African policyholders.

### Risks Lloyd's have underwritten

- The Titanic - the vessel that could not sink.
- A prize offered by Cutty Sark whisky for the finder of the Loch Ness Monster.
- South African Actress Kerry Wallace had to shave her hair off for a Startrek movie - Lloyd's insured against the possibility of it not growing back.
- Bruce Springsteen's voice has been insured for £6 million.
- A comedy theatre group insured themselves against the risk of a member of their audience dying laughing.

The above are some examples of the truly innovative or even bizarre underwriting that may be undertaken, but the bulk of business is in respect of conventional risks.

### MUTUAL INDEMNITY ASSOCIATIONS

Mutual Indemnity Associations are different from a mutual company in that the association only accepts business from members of a particular trade.

These associations grew out of trade associations but the area where they have survived is within the marine market. The association was formed to cover risks which were either too expensive in the insurance market, or which insurers would not cover.

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### **PROTECTION AND INDEMNITY ASSOCIATIONS (P&I CLUB)**

This is the best known form of mutual indemnity association. These bodies operate in the marine market and insure:

- liabilities for cargo;
- liabilities for crew and passengers;
- liabilities to third parties; or
- 25% of the shipowner's liability for damage to another ship, by his vessel, normally excluded under the hull policy - the hull policy covers only 75% of liability, the P&I club covers the rest.

### **2.2.4 REINSURERS**

The principle of reinsurance is similar for short term and long term business. In the short term market there are various ways of arranging treaty reinsurance.

One of the major differences is that a treaty is normally negotiated every year.

Later in this book there is a chapter dedicated to explaining the different types of reinsurance in the short term market, with practical examples. It is important to understand how they work and how insurance companies protect themselves.

When a short term insurer is offered a risk to underwrite, there will be times when the size of the risk is beyond his capacity. He has three options open to him which is to:

- decline the risk;
- take part of the risk; or
- take all of the risk and reinsure.

These are expanded briefly below for the benefit of students who have not studied reinsurance previously.

#### **DECLINE THE RISK**

There will be occasions when the underwriter will decline the risk. It may be because of adverse features, but it could be because the risk is too large for the company to hold.

If an underwriter is continually refusing larger types of risk because of capacity problems, brokers will soon start going elsewhere with their business.

The underwriter therefore needs to get extra capacity.

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### TAKE PART OF THE RISK

The second option is that the underwriter can take a share of the risk and the broker can place the rest of the risk with another insurer. The policy is then a Collective Policy, and referred to as coinsurance.

Features of a collective policy are:

- each insurer takes a share of the risk;
- the lead insurer issues a policy;
- the policy document reflects the percentage share of each of the companies;
- the claims are handled by the lead insurer;
- it is normal for the other insurers on the policy to follow the lead's decision;
- a company who has a share on a collective policy cannot quote against the lead company; and
- the lead insurer receives a handling fee from the other insurers who share in the risk.

This is an acceptable method of dealing with large risks, but it is time consuming from the brokers point of view and can be difficult to handle the administration. When the AA Mutual and the IGI collapsed, intermediaries had difficulties to face when they had to place all the business they had through these companies with another insurer, very quickly.

#### IMPORTANT FACT

An important aspect of a collective policy is

- if one of the companies that share in the policy should be liquidated, the broker is responsible for placing the cover elsewhere.

Therefore:

- if there should be a loss and the cover has not been placed, the client will be considered his own insurer for that percentage of the loss;
- this uninsured portion of the loss will not be shared among the other companies;
- if the broker has been negligent and not placed the cover he could face a professional indemnity claim.

#### Broker's Preference

From the above the broker might prefer to have an underwriter take the whole of the account.

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## TAKE ALL AND REINSURE

The final option which the underwriter has is to take the whole of the risk and place reinsurance with professional reinsurers. There are two methods of placing reinsurance and these are:

- facultative; or
- treaty.

The concept is the same as in long term business. The difference with short term business is that different kinds of treaty which can be arranged. These will be discussed later on.

Reinsurance allows the underwriter to accept larger risks.

### ACTIVITY

Identify the major reinsurers in South Africa.

### Answer

Some major reinsurers in the South African short term market:

- Munich Reinsurance
- Hannover Reinsurance
- Swiss Re Southern Africa
- Africa Reinsurance

## 2.2.5 OTHER PLAYERS

In our diagram of the short term market at the beginning of this chapter, we included under other players loss adjusters, motor assessors, risk managers, the regulator(s) and market organisations.

We have tried to avoid areas which would have been covered in long term insurance reading.

### LOSS ADJUSTERS

When a client reports a small claim to an insurer the insurance company will request supporting documentation and will settle the client's loss.

For the larger losses, or where the insurer is dubious of the claim, it is normal for them to appoint a loss adjuster.

The loss adjuster will contact the client and will usually go to the client's premises. Here he will look at:

- damage caused by the peril which caused the loss;



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- point of entry and method of entry where the loss is theft; and
  - supporting documentation, as the insured must prove his loss.

The loss adjuster will also:

- obtain quotes for replacement of articles;
- find contractors to carry out repairs;
- liaise with the police and other involved parties; and
- ensure that post loss protections and minimisation efforts are carried out.

When he has completed his investigation, he will send the insurer a report containing details of his findings and recommendations as to how the insurer should progress.

**NOTE**

It is not the duty of the loss adjuster to settle the claim. He can only make recommendations to the insurer.

The loss adjuster normally deals with all classes of insurance except motor. He may sometimes be called in to investigate a motor theft. Loss adjusters are sometimes referred to as claims assessors.

The client only meets the loss adjuster or assessor when there is a claim. This can be a very traumatic time in the client's life and whilst the assessor or adjuster is working for the insurance company, they also have to be sensitive to the client's needs.

**MOTOR ASSESSORS**

When an insured has a motor accident he will have to obtain quotes for the repairs. The insurance company will send a motor assessor out to inspect the damage and negotiate, if necessary, with the panel-beater.

The motor assessor may or may not authorise the repairs. This will depend on whether or not the claims department has advised him to do so.

The motor assessor is normally someone with a panel-beating or motor mechanic background.



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## RISK MANAGER

Business and industry over the last few decades have become more aware of risk. They have tried to develop ways of preventing losses from happening, or reducing any loss that does happen. They employ people called risk managers to identify problem areas and to manage risk.

Risk management can be defined as:

*"The identification and control of risks which may affect the company."*

The risk management process is covered in more detail in the next chapter.

### 2.2.6 SELF-INSURANCE

Self-insurance refers to the extent to which a client accepts part of the risk for his own account. Self-insurance not only acts to reduce the premium paid to the insurer but is also a form of risk management because the client has a vested interest in protecting against any loss.

#### ADVANTAGES OF SELF-INSURANCE

As with everything there are advantages and disadvantages to self-insurance. Here we list the advantages:

- premiums should reflect a discount for the self-insured proportion which can be invested to cover future losses. As the fund grows so the percentages of self-insurance can be increased resulting in further premium discounts;
- the premiums are not increased because of other peoples' claims;
- there is a very strong incentive to reduce claims and control losses; and
- if there is a loss there will be no disagreement with insurers over the settlement.

#### IMPORTANT

It is very important to remember that even if the company decides on self-insurance, or sets up a captive insurance company, there must still be some form of policy guidelines, as to what is covered and what is not covered. The company is still practising a form of insurance, by carrying its own risks.

#### Non-insurance

Where the insured has no fund and where there are no guidelines, this is non-insurance.

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### DISADVANTAGES OF SELF-INSURANCE

- A catastrophic loss could occur and deplete the fund.
- Individual losses may not affect the fund too much, but the aggregate effect of several large losses in any one year may also have a catastrophic effect on the fund.
- Capital has to be tied up, which could have been used to develop the business.
- There may be a need to employ insurance specialists to handle the fund and administrative matters.
- The technical advice of professional insurers could be lost.
- The claims statistics, which should be used to decide on premiums into the fund, will come from a narrow base.
- Shareholders may criticise the transfer of large sums of money into the fund.
- There may be a temptation in troubled years to dip into the fund.
- The basic principle of spreading the risk is not adhered to.

### CONCLUSION

Later we deal with the handling of claims in short term insurance and the actual claims process will be discussed then. In the meantime, it is very important that insurance practitioners realise that the other players in the market also owe a duty of professionalism to the clients that they come into contact with.

### 2.2.7 REGULATORS

The FSB acts as the main regulator for most of the financial services sector including short term insurance, along with long term insurance and retirement funds.

The statutory FAIS Ombud's office handles disputes regarding FSP's in general. There is also a voluntary Ombud for Short Term insurance to handle general complaints.

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## 2.3 MARKET ASSOCIATIONS

In South Africa, there are various associations which are involved in the insurance market. We will look at the main ones involved in the short term market. These include:

- The South African Insurance Association (SAIA);
- Financial Intermediaries Association (FIA);
- The Black Insurance Professionals of South Africa (BIPSA);
- The Institute of Risk Management of South Africa (IRMSA);
- The Institute of Loss Adjusters of South Africa (ILASA); and
- The South African Underwriting Managers Association (SAUMA)

### 2.3.1 SOUTH AFRICAN INSURANCE ASSOCIATION (SAIA)

Membership of the South African Insurance Association is open to all Short Term Insurers and Professional Reinsurers. It has a number of functions which include:

- representing the interests of the short term industry to government; and
- promoting co-operation between the public and short term insurers.

#### Areas of SAIA involvement

SAIA also administers or takes part in a number of bodies such as:

- South African Nuclear Energy Insurance Pool (Home and Foreign) which covers nuclear risks;
- the Growing Timber Pool, which is a specialised insurance cover for timber plantations;
- the Intermediaries Guarantee Facility Limited, which is able to provide the guarantees needed by brokers handling premiums on behalf of insurers in terms of the Insurance Act; and
- the Association of Marine Underwriters in South Africa, which looks after marine underwriters interests.

This list is not the total list of SAIA's roles, but gives an indication of the Association's activities.

SAIA also looks to undertake activities aimed at strengthening the market, for example;

- they initiated a fraudline, whereby insurance fraud can be reported by the public;
- they assisted in the creation of a movement called Proudly Insurance aimed at building pride in the industry amongst employees and to improve the image of the industry in general; and

- the concept of SAIA Approved, which sought to endorse suppliers to the industry such as panel beaters and security firms with a view to better controlling quality standards.

Several of the SAIA member companies created a body known as the Insurance Crime Bureau (ICB), which will ultimately oversee all of its crime-fighting activities, especially with regard to organised crime.

The Insurance Data System (STRIDE) was created in conjunction with TransUnion to provide a facility for claims management through maintaining a centralised database of insurance claims and policy information to help insurers manage the risk and many aspects of insurance fraud.

### **2.3.2 FINANCIAL INTERMEDIARIES ASSOCIATION (FIA)**

Over the years various representative bodies of intermediaries were formed in an attempt to control conduct and to pursue issues of importance to the intermediary with insurers, bodies representing the insurers and the regulating authority.

At the end of 2007, the two biggest of these bodies, SAFSIA (formerly known as SAIBA) and The Insurance Brokers Council (IBC) merged to form the Financial Intermediaries Association (FIA).

Later in 2008 the Life Underwriters Association of South Africa (LUASA), also joined forces with them.

The body is only open to intermediaries and various entry criteria are applied.

The FIA's primary purpose is to represent, protect, promote and further the common interests of its members.

### **2.3.3 BLACK INSURANCE PROFESSIONALS OF SOUTHERN AFRICA (BIPSA)**

BIPSA was officially launched in November 2004, and have been formally incorporated as a section 21 Company.

BIPSA's Executive Committee and its extended structures take the responsibility of contributing constructively to the transformation of the insurance industry seriously. Their vision is to create a demographically representative insurance industry both in leadership and ownership. Their mission is to accelerate transformation and development for black insurance professionals and their values are probity, independence, professionalism, service, equity, urgency and entrepreneurship.

BIPSA has the following strategic pillars - development, entrepreneurship, transformation, insurance education and awareness, that form the objectives as a catalyst for transformation in the insurance industry.

BIPSA intends to introduce one of the largest (if not the largest) structured mentorship programmes in South Africa. Managers and leaders from across the industry are invited to act as mentors to learners from their own and/or other insurance companies. BIPSA is hoping to ensure that black insurance professionals acquire the necessary skills and competencies to drive and influence both strategic and operational decision-making within the insurance industry.

There are also two separate intermediary organisations known as the Black Brokers' Forum (BBF) and the Association of Black Insurance brokers (ABIB).

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### 2.3.4 INSTITUTE OF RISK MANAGEMENT

In the next chapter we examine risk management. The South African Risk Management Association (SARIMA) and the Society of Risk Managers (SRM) came together with other bodies to form the Risk Management Federation from which the Institute of Risk Management of South Africa (IRMSA) was subsequently formed.

The Institute has embodied a range of objectives providing:

- professional accreditation of individual members;
- a forum for discussion of and interaction on current risk issues;
- a credible platform enabling practitioners to speak on matters affecting the discipline;
- research and project development;
- education and training; and
- opportunities for networking and professional development through conferences, briefings and topic focused workshops

### 2.3.5 INSTITUTE OF LOSS ADJUSTERS

This is the professional body for loss adjusters. The institute has professionally recognised qualifications and the loss adjuster can qualify as an Affiliate, Associate, or Fellow of ILASA. More recently, they introduced a Continuous Professional Development (CPD) requirement for their members.

The Loss Adjusters Mission is:

- to maintain and enhance the prestige and status of the profession;
- to uphold the integrity and reserve the independence of Loss Adjusters;
- to uphold the standard and to provide for the effective control of the professional conduct of Loss Adjusters;
- to promote the skill, efficiency, service and responsibility of the profession;
- to establish and maintain high standards of education and knowledge;
- to regulate the exercise of the profession;
- to represent generally the view of the profession and to promote the common interest of members of the profession; and
- to co-operate, liaise with or make representations to such other authorities, societies, corporate bodies or persons as it may deem fit.

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### 2.3.6 SOUTH AFRICAN UNDERWRITING MANAGERS ASSOCIATION (SAUMA)

Established in 1999, this body represents the many underwriting managers operating in the market. Their membership total approximately 80 and they have representation at the IISA and the FSB. The minimum criteria to become a member of SAUMA includes the following:

- Professional Indemnity of R5m; and
- Fidelity cover of R1m.

Underwriting Managers are experts in their niche fields and are fully supported by the FSB.

Sauma is the only line of communication between FSB and Underwriting Managers.

## 2.4 EDUCATIONAL ASSOCIATIONS

### 2.4.1 INSURANCE INSTITUTE OF SOUTH AFRICA

In the past, the IISA has involved itself in training and education but it has reverted to being purely a professional body.

The Insurance Institute of South Africa has a code of conduct which applies to all its members.

The Insurance Institute of South Africa aims to promote the highest professional and ethical standards in the insurance business, both in Southern Africa and elsewhere.

### 2.4.2 INSURANCE SECTOR EDUCATION AND TRAINING AUTHORITY (INSETA)

In March 2000 the Minister of Labour established twenty-five Sector Education and Training Authorities or SETA's which cover every sector in the South African economy. SETA's have replaced the thirty-three industry training boards.

The Insurance Sector Education and Training Authority or INSETA was established as one of the twenty-five SETA's (subsequently reduced to twenty three).

INSETA represents the training and skills development interests of ten sub-sectors within the insurance sector. These include short and long term insurance, pension funding, risk management, unit trusts, health care benefits, funeral benefits, reinsurance and financial intermediaries.

The functions and responsibilities of SETA's are defined in the Skills Development Act, 1998 as follows:

- develop a sector skills plan;
  - implement the sector skills plan;
  - develop and administer learnerships;
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- support the implementation of the National Qualifications Framework (NQF);
  - undertake quality assurance; and
  - disburse levies collected from employers in the sector they represent and report to the Minister of Labour and to the South African Qualifications Authority (SAQA).

## 2.5 ADDRESSING THE LOW INCOME MARKET

As part of the Financial Services Charter, providers undertook to introduce measures to accelerate the usage of financial service products amongst the lower income market. Adherence to the Living Standards Measures (LSM) 1-5, typically earning under R3 000 per month was used. These products are required to adhere to what is generally known as the CAT standards which are fair Charges, easy Access and decent Terms.

The first of these offerings was the range of Mzansi bank accounts, followed by the Mzansi short term insurance policies.

Key requirements for these products, as per the Financial Sector Charter access Committee, include:

- simple, easy to understand documentation;
- facilities to cater for irregular premiums;
- preset cover levels (no application of average);
- alternatives to the standard practice of requiring applications and changes to policies to be done in writing;
- alternative premium payment methods to cope with clients who do not have bank accounts;
- alternative distribution channels (not only brokers);
- household and contents cover, with disaster cover being the bare minimum;
- a compulsory excess to reduce the incidence of fraud; and
- theft cover as a percentage of the total cover.

The long term industry has a similar initiative, branded as "Zimele" which means to stand on your own two feet.

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## QUESTIONS ON CHAPTER 2

### Revision questions

*Work through these revision questions as a test of your understanding of this chapter. We suggest that you attempt these before tackling the written questions. Please note that suggested answers are not provided as the chapter's text contains the answers.*

1. What does an asset all risk policy cover?
2. What is the role of the loss adjustor?
3. What is the main association that represents insurance intermediaries in South Africa?
4. What are the different sectors that are covered by INSETA?
5. What is the name used for short term products aimed at the low income market?

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### Written questions

*Attempt these questions after you have completed this chapter and its revision questions. Suggested answers to these questions are at the end of this book.*

1. Describe fully the functions of the South African Insurance Association.
2. Describe the various players in the South African short term market.
3. Explain the difference between self-insurance and non-insurance.
4. Explain the features of a collective policy.
5. Your client owns a corner café and is considering self-insurance. Explain the advantages and disadvantages to him.