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INSURANCE SECTOR EDUCATION
AND TRAINING AUTHORITY

LEARNER GUIDE

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Demonstrate knowledge of Insurable Risk

Introduction

The history of insurance can be traced back thousands of years. In fact, the first basic form of insurance was used in Babylonian times, around 2100 B.C. The policy was paid by the traders in the form of a loan or guarantee for the safe arrival of their goods by caravan and thereafter came the Greeks and Phoenicians wanting the same coverage for their sea borne commerce.

In 1688 insurance transactions in London were informally concluded in Edward Lloyd's coffee shop which later became the one of the 1st modern insurance companies, now called Lloyd's of London.

The first major catastrophes were fire related and due to the damage caused, the need for reinsurance was experienced, which gave rise to the first reinsurance companies.

In its simplest definition, insurance relates to the paying of a premium to protect against some form of loss.

In this learner guide we will explore the concept of pooling, which refers to receiving premiums from many persons and thereby spreading the risk. We will explore the concept of insurance risk, meaning that the person obtaining the insurance should have some or other financial interest in the item being insured.

We will look at risk, which refers to the severity and frequency of loss, and how hazards, both moral and physical, could influence the risk.

We also explore risks that are insurable, and those that aren't. We will investigate as to which insurance class is more suited to the ones that are insurable, and explore ways in which risk can be reduced on risks which are not insurable. We will look at the difference between compensation and indemnity, and the difference between someone that is uninsured, and self-insured, and the consequences thereof.

Module 1

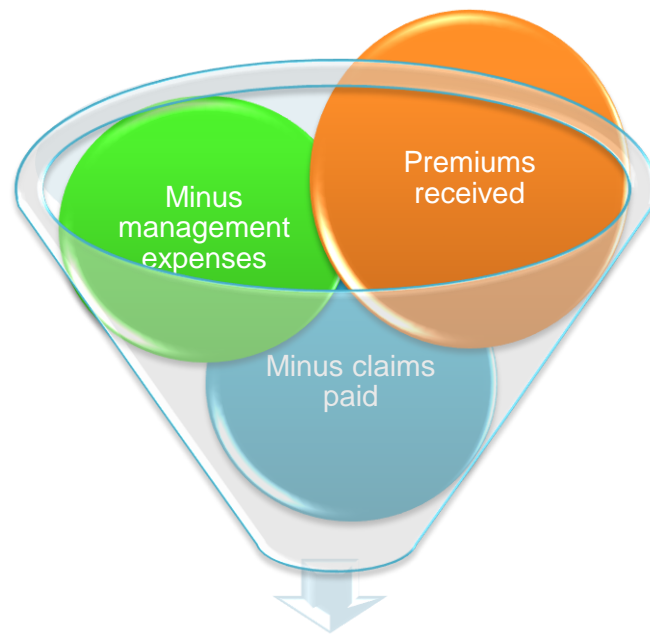
The Concept of Insurable Risk

This Module deals with:

- The concept of pooling of risk with reference to reinsurance, short term insurance and long term insurance
- The concept of insurable interest and an indication of how this impacts on the law of contract
- The concept of particular risk in terms of the effect on the individual
- The concept of pure risk in terms of loss
- The difference between a hazard and a peril
- Ways in which moral and physical hazards impact on insurance policies

1.1 The concept of pooling of risk with reference to reinsurance, short term insurance and long term insurance

In order for the insurer to cover the insured in the event of damage or loss, the insurer needs to pay a premium. All the premiums are collected by the insurer, and are used to pay claims. The primary function of insurance is to cover the losses of few from the premiums contributed by many. There are of course other expenses like salaries, rent, stationary etc. These are usually referred to as management expenses, or overheads. When you deduct the claims payouts and other expenses from the premium income, it would refer to the profit which the insurance company is making. Insurers will manage their claims to ensure that their claims ratio does not exceed a certain percentage (usually in the region of 65 – 68% of premium income) and should manage their expenses, including commissions, to ensure that they are left with a profit. It is important to note that insurers must be liquid and solvent in order to maintain a license. If they are not, they might not be able to pay claims which will prejudice the clients. This situation is not allowed, and closely monitored by the Registrars of Insurance and the FSB.



Profit of insurer

The concept of pooling as it refers to short term-, long term- and re-insurance is more or less the same.

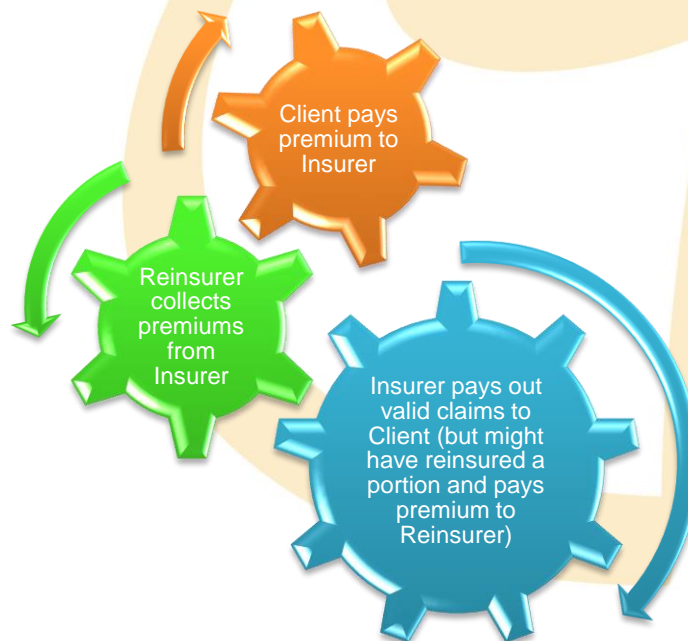
- Short term insurance: The losses of (hopefully) few are paid from the “pool” where all the premiums have gone into. However, the loss is not guaranteed.

In the case of short term insurance the loss is not certain. Insurance companies make use of actuaries which, based on scientific research, statistics available in the market, for instance police statistics and those from other insurers as well as their own experience, attempt to determine scientifically what the probability is that a person will claim, and if so, how soon will they claim, how often will they claim and the amount of the claim. That is why, during the process of underwriting which we will cover shortly, insurers ask questions about the subject matter of insurance, hazards, the risk and previous losses. Based on the proposer’s personal circumstances and previous losses, and the scientific information that the insurers have, they predict their risk, and the premium that they charge will be based on this.

- Long term insurance: Again, premiums are “pooled” and used to pay losses.

The big difference here is that the loss (death or retirement) is certain to happen; it is just a matter of time. The insurer is not sure WHEN the payment will occur, but the insurer is sure that the payment will occur. (Unless of course the policyholder committed fraud, the contract is not valid due to misrepresentation or non-disclosure or other relevant grounds for rejection)

- **Re-insurance:** In essence it works on the same basis as an insurance company. The biggest difference of course is that re-insurers only insure insurance companies and not the client's risk directly. As mentioned previously, it is done to spread the risk of large losses or losses that exceed the insurers' retention limit, in other words, the limit they place on a single item which they are not prepared to cover in excess thereof. For instance, if an insurer places a retention limit of R1 million rand on cars, it means that they would not want to pay more than R1 million in the event of a loss. If a car is placed on cover that exceeds R1 million, they would retain the cover on the R1 million, but source re-insurance for the amount that exceeds that. So if an Audi R8 Spyder that currently retails at R1, 719 000 is accepted on cover, the insurer would seek re-insurance on the R719 000. This is done in different ways, by means of facultative or treaty re-insurance etc. but that detail is not required at this stage.



1.2 The concept of insurable interest and an indication of how this impacts on the law of contract

There must be a (financial) **relationship** between the subject matter (item/risk insured) and the insured.

This is not only when you own something... if you stand to lose, or be prejudiced by loss of or damage to an article and benefit by the article not being lost or damaged, you have insurable interest in the item.

You will learn in the Law of Contract unit standard that insurable interest forms an essential part of an insurance contract. If there is no relationship between the insured and the insured item, there is no contract – therefore insurable interest affects the law of contract. Most insurers will not accept the subject matter of insurance if there is not insurable interest, but again, there are exceptions, this is generally speaking.

Let's look at some examples:

- Mr Client bought a car (on finance through WesBank) from a Renault dealer.
 - Mr Client has insurable interest in the item as he will suffer a financial loss when loss or damage occurs to the car.
 - WesBank has insurable interest in the item as well, as they are “technically” still the owners of the car and will remain to be just that until Mr Client repays the full outstanding amount on the vehicle.
- Ms Client will inherit a “Klaerhout” painting worth R1 million from her mother. Even though she does not own it yet, she will, and if something occurs to that painting she will be prejudiced financially. She therefore has insurable interest in this painting.
- Mr Client borrows his friend's cell phone for a holiday. Even though he has not bought this item, it is in his best interest to look after this item because if something happens to this cell phone he would have to reimburse his friend for the loss, therefore he will suffer a financial loss. This client and the friend has a financial interest in this item (insurable interest)

For most insurers the client must have insurable interest in the item when cover is obtained, during the lifespan of the cover and at claim stage. Some insurers will not allow a father to place his daughter's car on cover if she is the registered owner of the vehicle as he does not have insurable interest in this item. It is important to note that there are insurers that will place this car on the client's policy even though there is no insurable interest.

1.3 The concept of particular risk in terms of the effect on the individual

Risk refers to the probability of an incident happening. Insurers will assess the severity (size) of the risk, as well as the frequency (how often). The higher the severity and/or frequency, the higher the risk. The higher the risk, the higher the premium.

A particular risk is a loss that has its origin (where it begins) in discrete events, which essentially has a personal cause. Particular risks are thus risks that are insurable.

These risks originate in discrete events which are essentially personal in cause. These risks can usually be prevented by individual behaviour. These are for example, fire damage to a home or motor vehicle accident. On the other hand, fundamental risks tend to affect a large section of society for instance wars or economic recessions and many more. These are events that individuals cannot prevent.

1.4 The concept of pure risk in terms of loss

Pure risks represent the downside, or no change outcomes of possible future events. They only include the possibility of loss or no loss situations.

For example, if a fire occurs in a home, a loss is incurred. Had there been no fire, there would not have been a loss.

Pure risks are typical insurable losses and as such the financial consequences can be transferred to an insurer.

In order to understand pure risks better, let us also explain the concept of speculative risk. Gambling at a casino, betting on horses or sports or playing the

Lotto would be examples of speculative risk. Lets say you gamble R1 000 at the casino. There is a chance that you might win, but there is also a (bigger) chance that you will lose your money. Then you would have lost R1 000. If you compare this with the definition of a pure risk, you can see that in the event of pure risks, there is no chance of winning anything, you cannot be better off if you don't have an accident. But if you are in an accident, you would have lost out on the use of the car, and you would have to use money to fix the car, unless you have transferred the risk to the insurer, whom would pay the damages to your car if the claim is valid. You could still lose money, as you would in most cases need to pay the excess and you could be liable for other costs as well, depending on the circumstances of the claim.

1.5 The difference between a hazard and a peril and how hazards impact on insurance contracts

A peril is a sudden, unforeseen (external) event. It gives rise to pure risks. It is the cause or source of loss. (The actual "happening")

For example, fire, flood, accident etc.

A hazard relates to the environment surrounding the cause of a loss. They contribute to the cause or source of loss. For example, lightning strikes and causes fire at a gas station. The gas is a hazard. Due to the gas, the fire will cause more damage than what it would have, had there been no gas around.

In terms of insurance we differentiate between two different hazards, namely moral and physical hazards.

Moral hazard

Is the name given to the risk that one party to a contract can change their behaviour to the detriment of the other party once the contract has been concluded. Fire insurance, for instance, gives people an incentive to commit arson, especially if they have a business in financial trouble and they decide that they'd rather have the cash from the insurance proceeds on the buildings than the buildings themselves.

- This is one of the reasons why insurance companies prefer NOT to pay cash in the event of a claim, but in this case rather repair or replace the buildings.

It is also well known that there are people that believe that they must claim from insurance companies as they are “losing out” on their premium. Therefore they claim for an incident that never happened or claim for items that they never possessed as they feel that they have “earned” it. This constitutes fraud and if caught the insurer will reject the claim, cancel the policy and might even prosecute the client.

Physical hazard

Refers to properties that increase the chance of loss from the various perils, for instance a thatch roof increases the chance of loss when a fire occurs. Explained in another way, it refers to the environment surrounding the loss. Living next to a highway increases the chance of burglary. As mentioned previously, living next to a gas station increases the probability and severity of fire, than if you lived next to a river. Living next to a river on the other hand increases the probability (frequency and severity) of floods, than if you lived high up on a mountain. Living high up on a mountain again increases the probability of lightning than if you lived below next to the river. These are physical hazards.

Hazards

Physical:

Properties (the environment) which increases the probability, severity or frequency of loss (gas station)

Moral:

Personal behaviour or character (commits fraud or criminal acts)

Module 2

Insurable and Non-Insurable Risks

This Module deals with:

- The concept of insurable risk applied to financial loss
- Looking at different situations to determine whether there is insurable risk, types of risks that are unlikely to be insured and suggestions for other ways to reduce such risks
- Undesirable risks and an indication of the conditions under which each could be insurable and when each would be regarded as non-insurable
- Fundamental risks that are non-insurable under standard insurance policies and an explanation as to why such risks do not qualify for insurance

2.1 The concept of insurable risk applied to financial loss

This aspect refers to incidents (perils) or items (subject matter of insurance) where you can transfer the risk (insure it) or where you have to carry the risk (not possible to insure it).

We need to remember that not everything and anything is insurable. There are things that you cannot take insurance for.

First we will be looking at the necessary criteria for insurable “risks” (subject matter of insurance), and then at that which does not qualify for insurance and what can be done to reduce the risk of that which is not insurable.

An insurable risk is a risk that meets the ideal criteria for insurance. The concept of insurable risk underlies nearly all insurance decisions.

For a risk to be insurable, the following aspects need to be true:

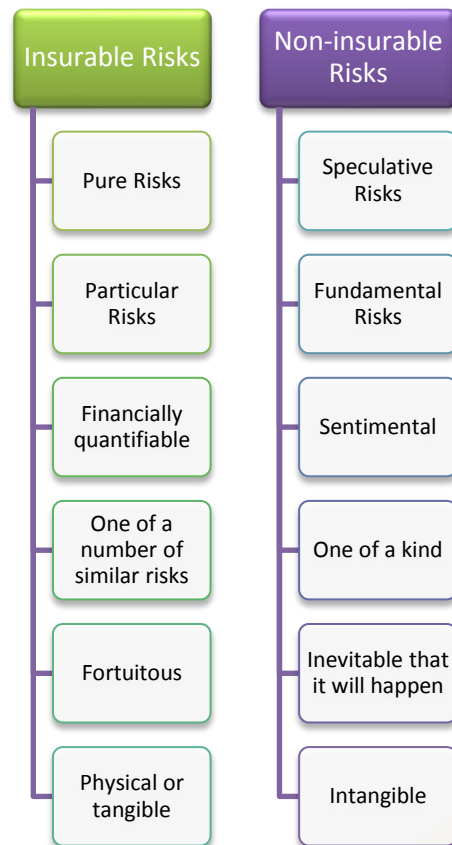
- The insurer must be able to charge a premium high enough to cover not only claims expenses, but also to cover the insurer's expenses. In other words, the risk cannot be catastrophic, or so large that no insurer could hope to pay for the loss.

- The nature of the loss must be definite and financially measurable. That is, there should not be room for argument as to whether or not the claim should be paid or what the amount due would be.
- The loss should be random in nature, or else the insured may engage in adverse selection (anti-selection).

2.2 Different situations to determine whether there is insurable risk, types of risks that are unlikely to be insured and suggestions for other ways to reduce such risks

Insurance is not effective for risks that are not insurable risks. For example, risks that are too large cannot be insured, or the premiums would be so high as to make purchasing the insurance infeasible. Also, risks that are not measurable, if insured, will be difficult if not impossible for the insurer to quantify, and thus they cannot charge the correct premium. They will need to charge a high premium in order to mitigate the risk of paying too large a claim. The premium will thus be higher than ideal, and inefficient.

It can be seen from the above that not all risks can be insured. The ones that can typically be insured are the *pure risks*. Non-insurable risks are typically the end-economic (occurrences, events, activities and decisions affecting a business operating profit) and incidental risks (risks which arise naturally from a business's activity).



There are ways that risk can be reduced on risks that are *non-insurable*.

It is possible to:

- Eliminate the risk (sell your car, then it cannot be stolen or be damaged in an accident)
- Reduce the risk (install a tracking device, park the car in a locked garage behind locked gates, drive very slow, attend an advance driving course)
- Retain the risk (save money to replace the car when stolen or fix the car when it is in an accident – this is referred to as Self Insurance)
- Transfer the risk – this can only be done when the risk is insurable by taking out insurance on the item, therefore not a mechanism that is possible on non-insurable risks

Examples of alternative methods of risk reduction on uninsurable risks could include the following

Risks never insured	Alternative risk reduction methods
Interest rate risks (exposure of interest rate earnings and charges to changes in market interest rates)	<ul style="list-style-type: none"> • Forecasting of interest rates and ensuring that provision is made for additional expenses
Liquidity risk (specifically related to banks – unable to pay deposits back to clients)	<ul style="list-style-type: none"> • Holding greater cash reserves and ensure that required ratio is kept to honour the deposits
Investment risk (market changes having a negative effect on the value of financial instruments)	<ul style="list-style-type: none"> • Managing portfolios – invest money in a less aggressive fund, or a fund where the return is guaranteed
Credit risk (a lender failing to meet financial commitments)	<ul style="list-style-type: none"> • Thorough credit appraisal • Action late/non-payers immediately
Resource risks (labour, technology, capital etc.)	<ul style="list-style-type: none"> • Plan and employ resources that will be able to research and develop as market changes
Sales variability (fluctuations due to consumer demands)	<ul style="list-style-type: none"> • Plan • Design and develop as the market's demands change

(Please note that niche insurance does exist for credit risk dependant on the available cover, and new insurance products are constantly being developed for risks that are traditionally seen as uninsurable)

When looking at personal lines insurance there are incidents (some can be seen as perils) that cannot be insured (unless stated otherwise). These typically include:

- Rust
- Wear and tear
- Consequential loss
- Computer viruses
- Damage as a result of cleaning, repairing, dying, restoring etc.

- Mildew, rising damp etc. (gradual operating cause)
- Defective workmanship

There are also items (subject matter of insurance) that are non-insurable under personal lines insurance, such as:

- Plants in the garden. Some insurers will cover up to a maximum amount of R5000 for damage resulting from an incident for which you can claim.
- Dams or dam walls
- Retaining walls
- Sporting items damaged during the process of sport and hobby items
- Buildings and the contents in buildings not approved by the local authorities

Again, some insurers might cover items or perils that are traditionally seen as uninsurable, or additional cover at an additional premium. A good example will be that insurers do not cover rust, but some insurers covers burst geysers or pipes as a result of rust, sometimes at an additional premium and usually there will be limits on the cover that it provides.

2.3 Self Insurance

When a person makes a conscious decision to carry his/her own risk, he/she is referred to as “SELF-INSURED”. He/she might have the money to replace an item, or he/she might put money into a bank account in order to build up a fund out of which to pay claims.

The insured might decide to self-insure a car radio for instance (not standard to the vehicle) or a tow bar – therefore not specifying it and not paying an additional premium for it, and in the event of an incident, cover the cost of the item self.

The consequence of this, however, is that the insured will be “out of pocket”. Even if he/she made provision for this expense, it still means that money is spent on something that could have been used for something else.

Some clients accept a higher (voluntary) excess. An excess is the first amount payable by the insured in the event of a claim. If for example the excess on the vehicle is R2000 (as determined by the insurer) and the client decides to increase

that to R5000, the insured has chosen a voluntary excess. In essence this means that the client insures the first R5000 of any claim – therefore he “self-insures” R5000 of the car. If he is in an accident and the damages to his car amount to R4990 he cannot claim from the insurer, he needs to pay this himself. The insurer will pay for damages or liability claims over and above R5000. (Most insurers, however, charge no excess on liability claims.)

Remember, where insurance cannot be obtained on an item, and it cannot be self-insured, the risk can be minimised or eliminated.

2.4 Undesirable risks and an indication of the conditions under which each could be insurable and when each would be regarded as non-insurable

There are risks that are insurable, even though they are undesirable. For instance, a BMW M3 is a high performance vehicle, and even though it is insurable, the risk associated with it is high (high probability of an incident happening) and therefore the premium should be considerably high. That is if it is used for private use. If this M3 is used as a racing car, it would not be possible to cover this vehicle under a personal lines policy.

You would need to think of other examples where an undesirable risk would be insurable, and not be insurable, depending on the circumstances. There will be a question on this aspect in the assessments.

2.5 Fundamental risks that are non-insurable under standard insurance policies and an explanation as to why such risks do not qualify for insurance

The consequences of natural disasters (catastrophes) such as earthquakes or floods are severe (e.g. the tsunami that affected so many coastal countries December 2004). Thousands of lives were affected, businesses, the economy. The cost of clean-up, medical assistance, relief projects such as food and water, temporary accommodation for those affected, the cost to rebuild the buildings, to name but a few resulted in astronomical financial losses. It is however important to note that natural disasters are insurable in South Africa. At least for the moment, as due to the increase of severity and frequency of weather related incidents (for instance

hail), some insurers are indicating that they would either implement higher excesses, or exclude cover completely.

Fundamental risks arise from losses that are impersonal in origin and in consequence and originate in the economic, political or social interdependency of society, although they may also arise from purely physical occurrences. They are seldom preventable, especially by an individual. These losses can be catastrophic in nature. Due to this, it is unlikely that economic insurance would be made available to mitigate the consequences.



Module 3

The Principle of Average

This Module deals with:

- The application of average in insurance
- The difference between indemnity and compensation

3.1 The application of average in insurance

Average, in general insurance, is a policy provision which has the effect of reducing a claim payment where under-insurance is discovered.

Where assets are insured for less than their full value, the insured is required to bear a proportion (portion/pro-rata) of any loss. The proportion is the amount by which the assets are under-insured expressed as a percentage of its indemnity value at time of the loss.

The formula is as follows: $(\text{Insured Value} / \text{Actual Value}) \times \text{loss}$.

For example, the insured insures his household content for R100 000. He has a burglary, resulting in a R30 000 loss. The assessor establishes that the actual value of the content (at time of loss) was in fact R200 000. What effect would this have on the claim and why?

The claim will be settled proportionally, as the client was under-insured.

The claim will be settled as follows: $100\,000 / 200\,000 \times 30\,000 = R15\,000$

Insurance companies and their agents go to great lengths to explain the concept of average to a client. If the client does not have the correct cover the result will most definitely lead to disappointment and an uninsured portion of the loss. This could be prevented by informing the client of the impact of underinsurance on the settlement of a claim. This brings us to the next topic, which relates to what the responsibility of the insurer is in terms of assisting the insured in the recovery from the loss

3.2 The difference between indemnity and compensation

What needs to happen when a valid claim is paid? It depends what the subject matter of insurance is. Either one of two things should happen. Either the client will be indemnified or compensated for the loss. It is important that you understand the difference between indemnity and compensation.

In the event that the subject matter of insurance is an item, i.e. a vehicle, contents, building, all risks (covering items taken out of the house such as spectacles, cell phones, portable computer equipment, cameras, handbag etc.), watercraft etc. the client should be INDEMNIFIED after a loss (if it is a valid claim). In the case that a client becomes disabled or dies after a covered event (an accident) the client cannot be indemnified and the restitution that takes place is called COMPENSATION.

Indemnity is placing the insured in the same financial position as he/she was in immediately prior to the incident.

Compensation is the restitution (which is related to the word restore) for an injury suffered.

Restitution is the name given to a form of legal relief in which the plaintiff recovers something from the defendant that belongs, or should belong to the plaintiff.

Injury is damage or harm caused to the structure or function of the body caused by an outside agent or force, which may be physical or chemical.

Long term insurance focuses on the life events, such as death or retirement of a person (non-indemnity insurance), whereas short term insurance focuses on the replacement value of objects (e.g., a motor vehicle) in the event of a loss (indemnity insurance), with personal accident and sickness also covered.

The concepts of “indemnity” and “non-indemnity” (compensation) are further explained as follows:

- Contracts of life are non-indemnity insurance, in that the sum assured does not necessarily bear any relation to the actual loss (e.g. to a man’s wife, his life may either be worth more than a sum assured of R10 000 or it may be worth nothing at all).

- Under contracts of indemnity insurance the insured is entitled to recover the actual commercial value of what he has lost. Indemnity insurance includes all insurance against damage to property, such as fire, motor, burglary, public liability, etc.

For example, a client is shot in the head during a hijacking. The client is insured for comprehensive vehicle insurance as well as personal accident insurance.

The client survives but loses the sight in his left eye.

The insurance company will INDEMNIFY the client for the vehicle which has been hijacked. The retail value (if this was the insured value) will be determined according to “The TransUnion Auto Dealers’ Guide” together with any insured non-standard accessories. The excess (first amount payable by the client in the event of a claim) will be deducted and the balance will be paid to the client. (If there is any outstanding finance at the bank it will be settled and the balance (if any) will be paid to the client). Some insurance companies (depending on certain conditions) will replace the vehicle within the first year, some replace it within the first 3 years, but terms and conditions apply mostly referring to the condition and mileage of the vehicle. Therefore the client is placed in the same FINANCIAL position that he was in immediately prior to the hijacking – he is therefore indemnified.

The insurance company will COMPENSATE the client for the loss of his sight. It is impossible for the insurance company to give the client his sight back or to place the client in the same financial position in terms of his sight. The insurance company will however pay a stipulated amount (usually according to a sliding scale depending on the loss) to the client limited to the maximum amount of cover, i.e. R25 000 or R100 000.

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