

Understanding short-term insurance

The short-term insurance industry is a very competitive and ever-changing industry. We want to explain the things that recently changed in the short-term insurance industry in our country, and how it will eventually influence us.

Short-term insurance is based on quotation systems which means that premiums are determined according to each applicant's individual profile, so an important question is.....

Why do some people pay more for insurance than other people?

In order to answer this question, let's go back in time to ancient China, about 2 000 years B.C. There, different boat owners used to share the loads that they had to transport between the different boats. E.g. if one boat owner had 500 chickens to transport, and another boat owner had 50 bags of rice, they would each transport some of the other one's load. This was done to ensure that, if something should happen to one of the boats, a portion of their own load would still arrive at the destination. Later on, they started dividing the payments for transport according to the share of the load and the value of the cargo.

This principle is still visible today! We pay our proportionate share of exposure to claims into a "premium pool". In this way, if any one of us experienced a loss that we would not be able to pay for ourselves, this "pool" will have enough money to repair our damages or replace our valuables. So this means that if somebody drives a more expensive car than you, he should, in theory, pay more than you for insurance. But it's not that simple. To ensure "fairness", a process called **rating**, using **rate factors**, is applied as follows:

Steven's car might be worth more than Mary's car, but Mary drives her car every day, and Steven only drives once a month. Mary's exposure on the roads is more than Steven's making her a higher risk. Easy! Not quite. What if Mary is 50 years old and has been driving since the age of 20, and Steven is only 18 years old and got his license the same day that he bought the car? Wouldn't Mary actually be a better "risk" than Steven.

Problem solved? No. Mary's car has no immobiliser or gearlock, and it is parked outside in the street every night, whilst Steven's car has an immobiliser, gearlock, a satellite tracking device and parked in a lock-up garage every night so it seems that Steven poses less risk.

To summarize:

Insurance premiums are a way of paying money into a pool so that any losses that an individual might experience can be covered from the pool's resources.

The decision regarding who should pay what is done through a process called rating using rate factors like age, security and driving frequency.

Next time we'll have a closer look at some of the things that make up the typical South African insurance policy through the eyes of a risk manager.