

## Long-term protection: An ideal example of effective personal risk management

Protecting against the event of our death represents excellent risk management. First, we know it will happen but cannot say when. Second, its consequences can be devastating for those who survive us. Fortunately, we live in a time in which it is not difficult for us to exchange this uncertainty with a reliable counterparty in return for a bearable monthly premium. The key question to ask of course is how much and what types of protection do we need.

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In last week's article, we considered the rationale for insurance as a transfer of risk. An entity that cannot manage this risk passes it on to another in return for a consideration, typically called a premium. This week, we look at excellent examples of personal risk management, life insurance and its many siblings and cousins.

### Rationale for the market

Why do we start by asking questions about the underlying reason for the existence of a market? Two reasons are worth considering in this instance.

The first is general. A market that is founded on a clearly defined exchange of value in which both parties gain more than they give up is much more likely to thrive than one that does not. In addition, all healthy markets are dynamic, growing from their starting position. Establishing a sound understanding of the basis for the exchange helps us to determine its boundaries, those points at which this logic might break down.

The second is specific to the market considered here. Under law, insurers in South Africa and elsewhere may only offer products that meet identified purposes. They must establish, in fact, that this rationale exists.

Long-term insurance, offering payment against events such as death, disability or serious illness, meets the needs of a customer because these are generally events whose consequences you and I cannot absorb ourselves. It is a rare family that, on the death of a breadwinner, has the resources to go on with life as if nothing had happened. For most of us, this would have a catastrophic impact on financial wellbeing, setting aside all its other effects. The same argument applies in the event of permanent disability or a life-threatening illness.

In short, the customer would rather suffer a known monthly financial loss (premium) than the possibility of an unknown very large loss (consequences of the event).

But why does this product work for the insurer? The same three reasons may be put forward as for short-term

(also called non-life) insurance. A soundly managed insurer, with appropriate skills and information, has the financial capacity, specialised pooling and portfolio diversification to offer these products profitably.

Financial capacity is provided by capital sufficient to absorb claims, even if such claims are above expectation. Specialised pooling facilitates predictability: insurers cannot predict the death of a customer, but they can forecast the number of deaths per year for a large group of such customers. And portfolio diversification helps to spread this risk, not just over many customers, but also across a range of product types.

So, the market works because both parties gain more than they lose. The customer puts more value on the risk transferred than on the premium payable in respect of that risk. The shareholders of the insurer expect to make a profit on their investment.

### Unhappy customers

If the logic behind long-term insurance is sound and both parties benefit from the transaction, why do we not hear more people singing the praises of their life cover? Let us consider the perspectives of the two parties to this transaction and a third that may have an interest in it.

Customers are partly at fault. Risk transfer is not exactly tangible. The ice cream that delivers a smile on the phase of my child is rewarding. A holiday gives real benefit. So does my comfy chair or mobile phone. A life insurance policy, in contrast, is not something I frame and hope my guests will see. Being the right thing to do does not automatically translate into desirable action.

Running an insurance company is expensive, complex and risky. Among the risks that insurers are exposed to is the possibility that they do not sell sufficient policies to cover their costs. Insurers are not exactly incentivised to spend more time and money ensuring that their new product is just perfect for its intended customers. *Close enough*, in other words, may be *good enough*.

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However, a third party has a special role to play in closing this gap. The third party is an intermediary, typically known as a financial adviser. You may be adept at determining just how much life- and disability cover is sufficient to put you back to where you were before the horror event, prioritising such events to fit your budget. If you are, you are probably a satisfied customer already. But if not, have your adviser show you how to exercise this judgment. Only, make sure that their financial interest in your decision-making is just as transparent.

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