

RISK MANAGEMENT AND INSURANCE

By B. H. SAUNDERS

Price Forbes Sedgwick (Natal) Limited

Abstract

Risk management covers identification, measurement and control of risk situations, the prevention of accidents, and the protection of a company's assets. Self-insurance and external insurance are discussed and the insurance broker's role in fire protection guidance, engineering surveys and insurance market rates is explained.

Introduction

Risk management represents the co-ordinated efforts of top management, the various operating and staff departments of an organisation and its insurance advisers to conduct a safe, economical operation. The term goes far beyond the purchase of orthodox external insurance; it embraces also risk identification, risk measurement, the control of risk, loss and accident prevention and self-insurance, together with their administration. All these must be welded together within the most economical administrative framework to minimise their overall cost.

Many causes contribute to this more professional approach to risk control. The expanding scale of industry has been accompanied by greater concentrations of capital resources and a marked increase in production hazards in many industrial processes. Such factors as the increased capacity of plant, more sophisticated machinery and materials, the adoption of flow line methods and of large undivided buildings help to explain the alarming increase in South Africa's fire wastage over the last decade.

A further aspect of risk management is "disaster planning" prior to the occurrence of any major loss — this involves the drawing up of an emergency plan which can be implemented when disaster strikes thus minimising, as far as possible, the adverse consequences of an interruption to normal business. Apart from the financial considerations of self-insured losses there are other factors which need to be reviewed such as the availability of alternative premises; the availability of alternative sources of supply for vital raw materials; and the degree to which other plants in the company, if applicable, could assist in picking up the turnover lost at the premises involved in the disaster. The main essential is to be prepared for a disaster so that the action to be taken is carefully planned beforehand and decisions are not made in haste after the disaster has occurred when management thinking is involved with a whole host of problems.

Changes in social attitudes have meant that industrial and commercial companies have had to shoulder heavier liabilities and their relations with suppliers, consumers, employees and the government have become more complex. These changes have been accompanied by an increase in claims consciousness on the part of employees and the general public. The upsurge in crime and higher traffic densities are other factors contributing to the rapid increase in risk exposure.

Risk identification

Risk is not always self-evident. It may exist in many different forms; in the physical features of buildings or plant, in

financial dependency on output; accounting methods; contract conditions and in human behaviour. Major areas of risk are:—

- (i) Destruction of property or key plant e.g. by fire, explosion or other perils.
- (ii) Consequential loss following such destruction.
- (iii) Loss by criminal act, e.g. theft or embezzlement.
- (iv) Loss arising from claims brought either at common law, under statute, or by reason of contractual obligations, e.g. products liability claims.
- (v) Insolvency or default of customers, e.g. credit risks.
- (vi) Loss of service of key employees, e.g. from death or disability.

Risk Measurement

In theory, it is possible to measure risk where there is a sufficient number of similar risk units for the law of averages to operate; but few, if any, organisations have operations so extensive that their overall losses are predictable, even when averaged over a period of — say ten years. The catastrophic type loss occurs so sporadically that loss patterns cannot be clearly determined. Nevertheless, risk can often be measured with some accuracy, especially in those areas producing small and/or constantly recurring losses. Minimum and "catastrophe" exposures, which are too easily underestimated, can also be analysed. However, few risk situations are static; changes in physical and moral hazards are continuous and constant revision is needed.

It is essential to appreciate that the capacity of a large loss to upset trading results is not diminished in any way by the relatively small chance of its happening; risk exposures and risk probabilities must be separately identified and analysed.

Loss and accident prevention (risk improvement)

In the long run the cost of insurance is geared to the cost of claims; thus, if the incidence and severity of losses can be reduced premiums will be favourably affected. When quantifying the "cost of claims" insurers and insureds tend to think in terms of the tangible loss only but from the latter's point of view the intangible losses associated with claims are a very real factor. No insurance policy can adequately provide reimbursement in respect of such intangible aspects as inconvenience; the cost of training a replacement operative; re-establishing lost or prejudiced markets, etc.

Risk improvement can be achieved in many areas; the most obvious is the physical reduction of fire hazard by fire-resisting construction; physical separation of hazardous processes; adequate extinguishing appliances; and an efficient fire defence organisation; sprinklers or detection systems; and the spread of risk by duplication of essential resources. Turning to factory accidents, improved guarding of machinery and better house-keeping can show substantial rewards; elsewhere liabilities may be limited through the application of contractual provisions, e.g. standard conditions of sale. In motor insurance and in other fields tight management control will invariably improve the loss record. Thus responsibility for implementing risk

improvement measures spreads over many departments — secretarial, accountancy, commercial production, motor transport, etc., and there is need for a central analysis and co-ordination of this effort to ensure that the total expenditure on both insurance and risk control produces the optimum cost/benefit.

Self-insurance

There are few risk situations in which an organisation has the resources to absorb the maximum possible loss with no financial discomfort and it is common and wise to link self-insurance plans with external insurance that provides protection when losses exceed a certain level. More generally the question is not whether risk retention should be practised in place of insurance, but rather where the dividing line should be drawn between losses to be assumed and those to be shifted to insurers.

Over a period an insurer's break-even loss ratio (losses incurred to premiums earned) varies from 50% to about 70% according to class of insurance and on small losses this ratio is lower than on large ones. Therefore it is generally in the interest of a company to bear uninsured losses that would not significantly affect its cash resources.

There are basically three methods of assuming risk :

- (i) Allowing losses to lie where they fall as an operating expense.
- (ii) Spreading losses either on an "ad hoc" basis or through a formal internal funding arrangement.
- (iii) For the very large corporation, assuming losses by means of a "captive" insurance company, established specially for the purpose.

Method (i) has the advantage of making the impact of losses felt at the point of origin and this may have a healthy effect on loss prevention attitudes; but where the size of losses is such that it would distort the operating results of a unit or division of the organisation, method (ii) is preferable.

External insurance

Insurance provides the most effective means of converting fortuitous losses into a known amount in an organisation's budget, so that its liquid reserves may be minimised. Moreover the insurance cost, being fixed, can be absorbed into overheads and provided for in the normal selling price of the end product. At the same time, shareholders are assured that the earning power of the business will be conserved.

Having first agreed a programme of loss prevention measures, having next identified those risks which should be self-insured, there remain finally the risks which it is proper to cover by purchasing external insurance. Here particular care must be given to catastrophe exposures, i.e. to securing cover for those losses which can really disrupt or cripple even the soundest organisation. In negotiating such an insurance portfolio, the first essential is that the policies should provide the widest possible cover with adequate indemnity limits, and be placed with insurers of unquestionable security. Premium rates must, of course, be keen, but in the long run these will follow the success or otherwise of the loss prevention measures taken; hence risk identification and measurement, followed by risk improvement, is at the root of all risk management thinking.

Employee group benefits such as group life, accident and sickness covers (where effected for the benefit of the employee) are outside the scope of risk management; these are really a personnel function, although implementation of the benefits, whether by insurance or by "self-funding", may well utilise risk management thinking.

The broker's role in risk management

Insurance brokers should be concerned, not only with placing insurances for clients on the widest cover at advantageous terms, but also in the other aspects of risk management.

In assessing the insurance requirements of a business, it is essential to carry out a full investigation into its activities in order to understand the management philosophy and identify the major risks. Then, in order to establish adequate sums insured and indemnity limits, assistance should be given in estimating the maximum possible losses that could occur in the key areas.

In the field of loss prevention in South Africa insurance brokers provide, as part of normal service, expert advice on fire prevention. Fire surveyors and fire protection consultants are employed as part of normal staff complement.

Services are provided as follows :—

- (i) Periodical inspections of premises to check house-keeping standards and the efficacy of fire protection arrangements with survey recommendations being submitted to the client.
- (ii) A wide range of fire protection services including the conduct of seminars; training of works brigade staff; advice on and planning of sprinkler installations and other fire fighting equipment.
- (iii) Formulation of risk improvement programmes and advice on their most economical implementation. Insurers, if allowed to take the initiative here, are usually not concerned with such key factors as capital cost, premium saving, future planning and the relative importance to future profitability of a client's various production facilities.
- (iv) Guidance, in consultation with architects and local authority, in planning new premises and major extensions, right from the drawingboard stage through to day-to-day operation; such early advice can often substantially reduce both the cost of physical protections and the ensuing premiums.
- (v) Constant review of market rates; surveyors are continually seeking ways to achieve premium savings and in practice are frequently able to demonstrate anomalies in existing ratings particularly when premises of a new client are inspected for the first time or when changes take place in buildings or plant layout. (The inspections differ materially from insurers' fire surveys which set out primarily to provide purely factual data for rating purposes.)

In addition, security consultants advise on security problems affecting risks such as theft, money, fidelity, marine and transit losses.

On self-insurance brokers in their own long term interest give the best possible advice, regardless of the immediate brokerage involved; and are continually investigating with clients the possible effects of discontinuing certain policies (once an insurance has been taken out there is usually a very marked reluctance to discontinue it even though circumstances may have subsequently changed). For example, it was recommended to large motor fleet operators that they consider moving from conventional comprehensive cover to other less conventional forms of insurance.

Finally, brokers offer guidance on streamlining internal insurance administration and communication procedures. Unless this problem is controlled in a positive manner, far too much paperwork can so easily be generated. Likewise, failures of internal communication can produce exceedingly expensive mistakes.

Insurers' attitude to risk management

Nowadays insurers generally are coming to realise that simply raising their premiums does not guarantee a return to profitability. Increasingly therefore they are recognising the values of properly thought out risk improvement programmes, particularly in the field of fire insurance where loss prevention methods may qualify for substantial premium discounts. At the same time substandard risks are being looked at in a harsher light and notwithstanding the underlying principle of insurance namely that "the losses of few are spread over many" the trend to intelligent and effective underwriting is correct and should be supported by insureds, insurers, and brokers in the interests of the country's overall economy.

On self-insurance, too, insurers' attitude is beginning to change, although possibly not quickly enough. "Tariff" Companies, essential for absorption of really large fire risks, are

being encouraged to view problems and projects with greater flexibility, particularly when dealing with the needs of very large organisations.

Conclusion

The increasing degree of automation in industry and heavy plant investment both underline the need to preserve a business from loss. At the same time, competition is forcing business to operate more efficiently, with smaller margins for profit and contingencies. Both the heavy cost of replacing physical assets and the limited availability of funds for doing so argue the need for increasing attention to the control of risk. The risk management approach is to regard insurance as the last line of defence in protecting the company's assets and earning power after all other measures have been effectively explored.