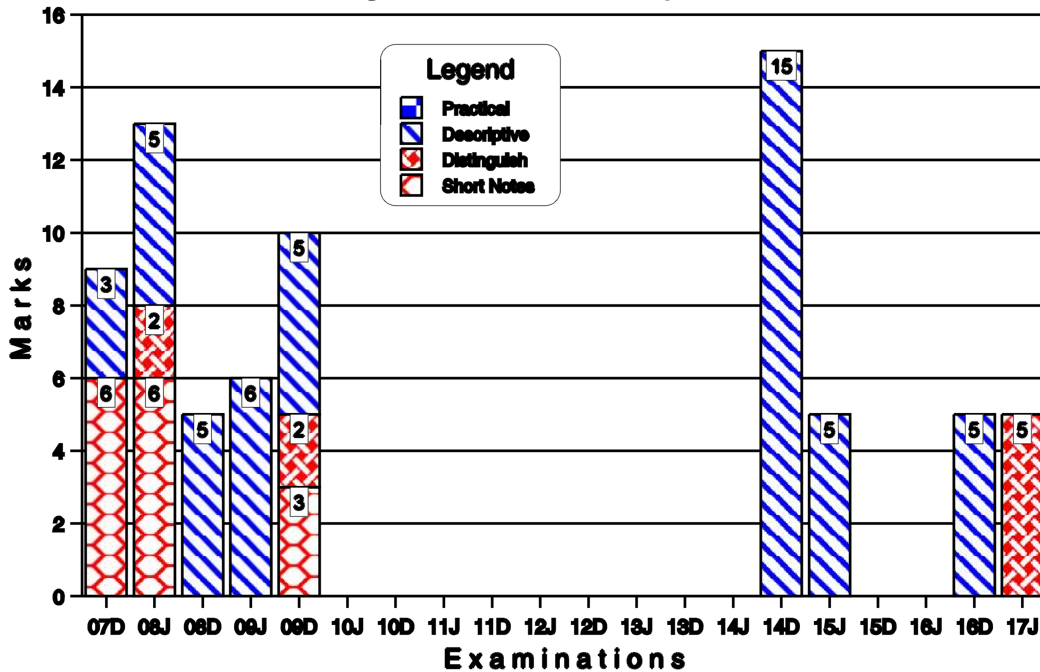
1 UNDERSTANDING AND MANAGING RISK

THIS CHAPTER INCLUDES

- Risk Management
- Role of Insurance in Risk Management
- Perils - Nature
- Risk Analysis
- Risk Planning
- Risk Control
- Mechanism for Transfer of Risk
- Insurance and Reinsurance

Marks of Short Notes, Distinguish Between, Descriptive & Practical Questions



SHORT NOTES

2007 - Dec [8] Write short notes on the following:
(i) Types of pure risk
(ii) Emergency risk management **(3 marks each)**

Answer:

(i) Some types of pure risk pose a substantial threat to the Financial Security of both individuals and business firms. The major types of pure risk that are associated with great Financial and Economic insecurity include-personal risks (risk of old age, risk of premature death; risk of unemployment; risk of poor health); property risks (Direct loss, indirect or consequential loss, natural disasters) and liability risks.

Answer:

(ii) Emergency risk management is a systematic process that produces a range of measures, which contributes to the well being of communities and the environment. Disaster plans are in place in all emergency management areas throughout developed countries and were prepared using the hazard analysis process. The hazard analysis process concentrated on the causes, characteristics and affects of the hazard rather than the level of risk to a community. The process sometimes overlooked three very important issues.
(a) Process Documentation,
(b) Planning,
(c) Stakeholder Consultation.

The ERM process provides a logical and systematic approach that will integrate combat and other agency specific public safety programs (prevention, preparedness, response and recovery) at local district and state level.

The aim of the Emergency Risk Management process is:

To identify, analyze and evaluate risks with potential to require a significant and coordinated multi agency response.

2008 - June [8] Write short notes on the following:
(iii) Personal risks
(v) Emergency risk management **(3 marks each)**

Answer:

(iii) Personal Risks

Personal Risks are those risks that directly affect an individual; they involve the possibility of the complete loss or reduction of earned income, extra expenses and the depletion of financial assets. There are four major personal risks:
(a) Risk of old age.
(b) Risk of premature death.
(c) Risk of unemployment.
(d) Risk of poor health.

Answer:

(v) ***Please refer 2007 - Dec [8] (ii) on page no. 10***

2009 - Dec [8] Write short notes on the following:
(iv) Risk management insurance. **(3 marks)**

Answer:

Risk management insurance:

Risk management can be defined as various alternatives concerning the management of pure risks. It is a discipline that provides for the systematic identification and analysis of loss exposures faced by the firm or organization, and for the best methods of handling these loss exposures in relation to the firm's profitability. As a general rule, the risk manager is concerned only with the management of pure risks, not speculative risks. All pure risks are treated, including those that are uninsurable.

A successful risk management programme requires the cooperation of a large number of individuals and departments throughout the firm, and risk management decisions have a greater impact on the firm than insurance management decisions.

A firm or organization has several risk management objectives prior to the occurrence of a loss. The most important of these includes the following:

- Economy;
- Reduction of anxiety; and
- Meeting externally imposed obligations.

DISTINGUISH BETWEEN

2008 - June [5] (c) Distinguish between the following:
(iii) 'Risk management' and 'insurance management'. **(2 marks)**

Answer:

Please refer 2007 - Dec [5] (d) (ii) on page no. 12

2009 - Dec [5] (c) Distinguish between the following:
(ii) 'Morale hazard' and 'moral hazard', **(2 marks)**

Answer:

'Morale hazard' and 'moral hazard'

Morale hazard refers to insured who are simply careless about protecting their property because the property is insured against loss. Moral hazard is more serious since it involves unethical or immoral behaviour by the insured who seek their own financial gain at the expense of the insurers and other policy holders.

2017 - June [6] Differentiate between risk, peril and hazard. **(5 marks)**

DESCRIPTIVE QUESTIONS

2007 - Dec [5] (d)
(ii) 'Risk management' and 'Insurance management', **(3 marks)**

Answer :

Risk management can be defined as various alternatives concerning the management of pure risks. It is a discipline that provides for the systematic identification and analysis of loss exposures faced by the firm or organisation, and for the best methods of handling these loss exposures in relation to the firm's profitability.

Difference Between Risk Management and Insurance Management:

Risk management should not be confused with insurance management. Risk management is a much broader concept and differs from insurance management in several respects. First, risk management places greater emphasis on the identification and analysis of pure loss exposures. Second, insurance is only one of several methods that can be used to meet a particular loss exposure; as you will see, the techniques for meeting losses, not just insurance. Finally, a successful risk management programme requires the cooperation of a large number of individuals and departments throughout the firm, and risk management decisions have a greater impact on the firm than insurance management decisions. Insurance management affects a smaller number of persons.

Risk Management Process in an Organisation

In order to attain the preceding goals and objectives, the risk manager must perform certain functions. There are four basic functions of a risk manager.

- Identifying potential losses;
- Evaluating potential losses;
- Selecting the appropriate technique or combination of techniques for handling losses; and
- Administering the programme

Identifying Potential Losses:

The first function of a risk manager is to identify all pure loss exposures. This involves a painstaking identification of all potential losses to the firm. The risk manager normally tries to identify six types of potential losses.

1. Property losses;
2. Business income losses;
3. Liability losses;
4. Death or disability of key persons;
5. Losses resulting from job-related injuries or disease; and
6. Losses from fraud, criminal acts, and employee dishonesty.

Evaluating Potential Losses:

After the potential losses are identified, the next step is to evaluate and measure the impact of losses on the firm. This involves an estimation of the

potential frequency and severity of loss. The risk manager must estimate the frequency and severity of loss for each type of loss exposure. The various loss exposures can then be ranked according to their relative importance.

Selecting the Appropriate Technique For Handling Loss:

After the frequency and severity of losses are estimated, the risk manager must then select the most appropriate technique, or combination of techniques, for handling each loss exposure. They are as follows

- Avoidance;
- Retention;
- Non-insurance transfers;
- Loss control; and
- Insurance.

Administering the Risk Management Program:

The fourth and final function of the risk manager is the administration of risk management program. Common activities of the risk managers included loss exposure identification and measurement, arrangement of insurance handling claims, design and installation of employee benefit plans, participation in loss control measures, safety, group insurance, and self-insurance administration. A risk management policy statement is necessary in order to have effective administration of the risk management program. This statement outlines the risk management objectives of the firm as well as company policy with respect to treatment of loss exposures. It also educates top-level executives in regard to the risk management process, gives the risk manager greater authority in the firm, and provides standards for judging the risk manager's performance. The risk management process involves the entire firm. Other functional departments within the firms are extremely important in identifying pure loss exposures and methods for treating these empower. Indeed, without the active cooperation of the other departments, the risk management programme will be a failure.

2008 - June [6] (b) Why the insurance is considered the most practical method for handling risk? **(5 marks)**

Answer:

For most individuals, the insurance is the most practical method for handling a major risk. Here, risk transfer is used since a pure risk is transferred to the

insurer. Then the pooling technique is used to spread the losses of the few over the entire group so that average loss is substituted for actual loss finally, the risk may be reduced by application of the law of large numbers, whereby an insurer can predict future loss experience with some accuracy.

2008 - Dec [6] (b) How is the need for insurance assessed by the risk manager? **(5 marks)**

Answer:

The risk manager must assess the insurance coverage's that are needed. Since there may not be enough money in the insurance budget to insure all possible losses, the need for insurance can be divided into several categories depending upon the importance.

One useful approach is to classify the need for insurance into three categories:

- **Essential insurance :**
  It includes that coverage required by law or by contract, such as workers compensation insurance. Essential insurance also includes that coverage which will protect the firm against a catastrophic loss or a loss that threatens the firms survival.
- **Desirable insurance :**
  It is protection against that may cause the firm financial hardships, but not bankruptcy.
- **Available insurance :**
  It is coverage for small losses that do not disrupt the activities of the firm on a large scale.

2009 - June [5] (c) Comment on the following:

(i) Only pure risks are insurable. **(1 mark)**

Answer:

(i) Only pure risks are insurable : The statement is correct. Pure risk is defined as a situation where there are only the possibilities of loss or no loss. Only pure risks are insurable as insurers don't insure speculative risks.

2009 - June [7] Attempt the following:

(iii) What are the major advantages of retention technique in a risk management programme? **(5 marks)**

Answer:

Advantages of retention technique in a risk management programme

The retention technique in a risk management programme has the following advantages:

(a) **Saves money:** The firm can save money in the long run if its actual loss is less than the insurance premium.

(b) **Lower expenses:** There may be sizable expenses saving, The firm may at a lower cost provide the services by the insurer. Some expenses may be reduced, including loss adjustment expenses, general administration expenses, etc.

(c) **Encourage loss prevention:** Since the expenses are retained, there may be a greater incentive for loss prevention within the firm.

(d) **Increases cash flow:** Cash flow may be increased by retention, since the firm can use the funds that normally would be held by the insurer.

2009 - Dec [6] Attempt the following:

(ii) "The first function of a risk manager is to identify all pure loss exposures". Explain. **(5 marks)**

Answer:

The first function of a risk manager is to identify all pure loss exposures. This involves a painstaking identification of all potential losses to the firm. Main task involved is the identification of sources of hazard to which the firm is exposed. This may be done by past record, through checklist of various perils or through physical inspection of the construction of the building, occupation of the building, process of manufacture therein and exposure points in the process. The risk manager normally tries to identify six types of potential losses, viz. Property losses, Business income losses, liability losses, death or disability of key persons, losses relating to job-related injuries or diseases, losses from fraud, criminal acts and employee dishonesty.

The risk manager has several sources of information that can be used to identify the major and minor loss exposures.

2014 - Dec [2] (b) It is generally believed that an insurance contract wholly and fully handles and eliminates all risks. Do you agree with the statement? Discuss. **(10 marks)**

Answer:

One of the important components of management is planning and control and once a risk is identified and analysed, it is important to plan and adopt a suitable strategy for effective controlling. Risk planning and controlling is the stage that comes after the risk analysis process is over. There are five types of handling and controlling risk and these are-

(a) Risk avoidance
(b) Risk retention
(c) Risk transfer
(d) Loss control and
(e) Insurance

Of all the type stated above, Insurance is a type of risk financial or loss financing, which is used to guard against the risk of losses. Losses are guarded against by transferring the risk to another party through the payment of an insurance premium, as an incentive for bearing the risk. Insurance is a more commonly known concept that describes the act of guarding against risk. An insured is the party who seeks to obtain an insurance policy while the insurer is the party that shares the risk for a paid price called an insurance premium. Yet , it is to be noted that an insurance cover does not wholly or fully handles or eliminates all risks. Insurance does not eliminate risk. It only compensated or indemnifies for the losses as per the policy conditions and provisions. Therefore, an the Insurance policy pays compensation only if a loss has occurred due to insured perils or insured risks and for insured properties.

Purchasing insurance, however, is not risk management. A thorough and thoughtful risk management plan is the commitment to prevent harm. Risk management also addresses many risks that are not insurable, including brand integrity, potential loss of tax exempt status for volunteer groups, public goodwill and continuing donor support.

Further Insurance is primarily concerned with risks that have a financially measurable outcome. But not all risks are capable of measurement in financial terms.

One example of a risk that is difficult to measure financially is the effect of bad publicity on a company-consequently this risk is very difficult to insure. However, this is a good point to stress how innovative some insurers are in that they are always looking for ways to provide new covers, which the customers want. The difficult part is to be innovative and still make a profit. It is hence that the concept of insurance is only one of the methods of risk management and is practiced in useful situations. It must be noted here that the Insurance contract covers only all pure risks and not speculative risks. Further, all risks Insurance policy covers all the risk, it is a myth. The fact is all policies are subject to certain exclusions.

2014 - Dec [5] How does 'insurance' differ from 'hedging'? **(5 marks)**

Answer:

Though both Insurance and Hedging techniques are similar in that risk is transferred by a contract and no new risk is created, there are major difference between them which are as under:

Insurance	Hedging
1. Insurance transactions involve transfer of insurable risk which can generally be met.	1. Hedging on the other hand is a technique of handling risks that are typically uninsurable, for example protection against decline in the price of agriculture products and raw materials. Which are speculative risks and not pure and insurable risks.
2. Insurance can reduce the risk of an insured by the law of large numbers.	2. Hedging risk typically involves only risk transfer, not risk reduction.
3. In an insurance contract, both the parties win if the loss does not occur.	3. Hedging contract, the risk of adverse price fluctuation is transferred to speculators who believe that they can make a profit because of superior knowledge of

	market conditions. Thus mere transfer of risk takes place, but no reduction.

2015 - June [4] Loss control is an important method in handling risk. What are its major objectives? Describe them briefly. **(5 marks)**

Answer:

Loss control is an important method for handling risk. It has two major objects:

(a) Loss prevention:

Loss prevention aims at reducing the probability of loss so that frequency of losses are reduced, e.g. if you follow good health habits, watch your weight and give up smoking, the chances of heart attacks are minimized. Loss prevention is important for business of the enterprises as loss frequency can be reduced by enforcement of strong safety measures.

(b) Loss reduction:

Loss reduction involves reduction in severity of loss. This can be achieved by installing sprinkler system in a warehouse which would help in speedy extinguishment of fire, installing perfect partition wall between two highly inflammable commodities, practicing segregation and construction of fire resistant materials to minimize losses.

2016 - Dec [5] Why do insurers insure 'pure risks' only? Define 'risk' and distinguish between 'pure risk' and 'speculative risk'. **(5 marks)**

Answer:

1. Pure (static) risk is a situation in which there are only the possibilities of loss or no loss. The only outcome of pure risks are adverse (in a loss) or neutral (with no loss) never beneficial. Examples of pure risks include premature death, occupational disability catastrophic medical expenses, and damage to property due to fire, lightning, or flood.
2. Insurance companies generally insure only pure risks through their commercial, personal and liability insurance policies, since the law of large numbers can be applied more easily to pure risks than to speculative risks. The law of large numbers is important in insurance because it enables insurers to predict loss figures in advance.

3. Risk is the potential of loss (an undesirable outcome, however not necessarily so) resulting from a given action, activity and/or inaction. The notion implies that a choice having an influence on the outcome sometimes exists (or existed). Potential losses themselves may also be called "risks". Any human endeavor carries some risk, but some are much riskier than others.
4. Pure (static) risk is a situation in which there are only the possibilities of loss or no loss, as oppose to loss or profit with speculative risk.
5. Speculative (dynamic) risk is a situation in which either profit or loss is possible. Examples of speculative risks are betting on a horse race, investing in stocks, bonds and real estate. In Business, the decision to venture into a new market, purchase new equipment's, diversify on the existing product line, expand or contract areas of operations, commit more to advertising, borrow additional capital, etc., carry risks which are inherent to the business. Speculative risk is uninsurable.
6. Society as a whole may benefit from a speculative risk even though a loss occurs, but it is harmed if a pure risk is present and a loss occurs. Therefore, the insurances insure only pure risks.