Introduction to Business II

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Business Risk Management and Insurance

- Meaning and types of Insurance
- Types of Business Risks
- Dealing with Business Risks
- Risk Management
- Insurance
- Types of Insurance policies
- Effecting Insurance policy

Meaning of Risk

- **Risk** is defined as uncertainty concerning the occurrence of a loss.
- It is the potential for an action or event to have an adverse impact
- The chance or uncertainty of some event occurring or not occurring
- Succinctly, it is the possibility of a loss or adverse event that has the potential to interfere with an firm's ability to fulfil its mandate and for which an insurance claim may be submitted

Types of Risk

- **Speculative (dynamic) risk** is a situation in which the outcome is either profit or loss. Examples of speculative risks are betting on a horse race, investing in stocks/bonds and real estate.
- **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), with no benefit. The person has no control over this.
- Examples of pure risks include premature death, occupational disability, catastrophic medical expenses, and damage to property due to fire, lightning, or flood.
- *Both terms may refer to bad things that may befall a person*

Forms of Risk

- **Uninsurable risks** are risks that are considered to be too high or illegal/ prohibited by public policy and that the insurance firm would not want to cover.
- E.g. are bad debt, changes in fashion, time lapses between ordering and delivery, war, loss of job, new machinery or technology and different prices at different places.
- **Insurable risks** are covered by insurance companies.
- E.g. are Theft, Fire, Personal accident , Death, Flood, Air disaster, Shipwrecks, Motor disasters

Methods of Handling Risk

- **Risk Avoidance**: with this, a business or an individual may decline to enter into a risky activity. E.g. buying of T-bills
- **Risk Control**: it is a step taken by a firm to reduce the frequency of risk. It is adopted if avoidance is not feasible. E.g. training of employees on safety measures
- **Risk Retention**: it is where the firm assumes or retain the financial consequences of the loss. It is resorted to when it is not possible to avoid or control risk
- **Risk Transfer**: it is where the consequences of the risk are so devastating that the firm cannot bear the loss alone. It transfers the risk to insurance company by paying premium

Guidelines to evaluate whether a risk is insurable or not

- Policy holder must have an insurable interest
- Loss should be measurable
- Chances of loss should be measurable
- Loss should be accidental
- Risk should be dispersed geographically
- The insurance company can set standards for accepting risk

RISK MANAGEMENT

- It is the process of identifying, analysing and taking precautionary steps to mitigate/curb uncertainty.
- Risk management ensures that an organisation identifies and understands the risks to which it is exposed.
- It guarantees that the organisation creates and implement an effective plan to prevent losses or reduce the impact if loss occurs
- Risk management plan includes strategies and techniques for recognising and confronting these threats

RISK MANAGEMENT

- Purchasing insurance is not risk management
- A thorough and thoughtful risk management plan is the commitment to prevent harm.
- Risk management addresses many risks that are not insurable such as brand integrity, potential loss of tax-exempt, status for volunteer groups

Benefits of Managing Risk

1. Reducing liabilities
2. Assisting in clearly defining insurance needs
3. Enhancing the ability to prepare for various circumstances
4. Protecting people from harm
5. Protecting the reputation and image of the firm
6. Saving resources
7. Protecting the environment

Question: Can a firm effectively eliminate risk?

Role of Insurance in Risk Management

- Insurance is a valuable risk-financing tool.
- Few organisations' have the resources to cater for the risk themselves and pay for all the losses
- Insurance is a promise of compensation for specific potential future losses in exchange for a periodic payment.
- It is designed to protect the financial health of an individual, and entities in the case of unexpected loss

Definition of insurance

- It is an agreement by which the insurance company protects the insured against losses associated with specified risks in return for a fee or premium payment
- It is the pooling of money by a company from a group of people or organizations, to pay for the fortuitous losses that any of them may suffer
- A financial service allowing individuals to pool their exposure to risks of economic loss resulting from the occurrence of uncontrollable events such as fire, death, earthquakes, etc.

The Concept of Insurance

- Insurance companies **accept premiums** from individuals and companies and this becomes a large pool of fund which can be invested for further growth. It is from this large pool that the insurance company is able to pay out damages for unforeseen eventualities as they happen.
- In this way the burden of the minority are relatively financed by the premium of the majority who have taken out insurance

The Concept of Insurance

- **Insurer:** it is the company that undertakes to sell insurance
- **Insured**: it is the entity or the person buying the insurance. They are the policyholder
- **Insurance rate:** it is a factor used to determine the amount to be charged for a certain amount of insurance coverage called the premium
- **Reinsurance companies** are insurance companies that sell policies to other insurance companies allowing them to reduce their risks and protect themselves from very large losses

Classification of Insurance Companies

The two main classification are:

1. **Life Insurance companies** : it sells life insurance, annuities and pension products
2. **General, Non-life or Property/Casualty Insurance companies**: it sells other types of insurance

Reasons for Insurance

1. It helps people to quickly recover from damages and losses
2. It helps in sharing the risk of people in an affordable manner.

Doctrines of Insurance

1. There should be a certain definite (pure) loss taken place at a time, in a known place and from a known cause
2. The incident that represent the cause of the claim should be accidental or beyond one's control
3. The size of the loss must be significant from the perspective of the insured
4. The amount of the premium should be affordable
5. The possibility of loss and the cost of compensation should be calculable or estimable

Principles of Insurance

Utmost Good faith

- *Uberrimae fidei* refers to absolute honesty and must characterise the dealings of both the insurer and the insured.
- The doctrine of utmost good faith requires that the client discloses all material fact/relevant personal information.
- For example, if you are applying for life insurance, you are required to disclose any previous health problems you may have had.
- Likewise, the insurance agent selling you the coverage must disclose the critical information you need to know about your contract and its terms.
- The principle of utmost good faith is supported by three important legal doctrines e.g. representations, concealment and warranty.

Principles of Insurance

Insurable Interest

- A person has an insurable interest in something when loss or damage to it would cause that person to suffer a financial loss or certain other kinds of losses.
- For example, if the estate you own is damaged by fire, the value of your estate has been reduced, and whether you pay to have the estate rebuilt or sell it at a reduced price, you have suffered a financial loss resulting from the fire.

Principles of Insurance

Insurable Interest

- By contrast, if your neighbour's estate, which you do not own, is damaged by fire, you may feel sympathy for your neighbour, but you have not suffered a financial loss from the fire. You have an insurable interest in your own estate, but in this example, you do not have an insurable interest in your neighbour's property.
- In non-marine insurances, the insured must have insurable interest when the policy is taken out and also at the date of loss giving rise to a claim under the policy

Principles of Insurance

Indemnity

- This principle states that a person must not make profit out of an accident or loss
- It places one back to the exact monetary position before a loss
- The principle of indemnity has two fundamental purposes.
  - First is to prevent the insured from profiting from a loss. If the insured could profit from a loss, then they may causes the loss to make a profit ,or be complacent in preventing a loss
  - Secondly, is to reduce moral hazard. If the loss payment does not exceed the actual amount of the loss, the temptation to be dishonest is reduced..

Principles of Insurance

Indemnity

- The concept of indemnity does not mean that all covered losses are always paid in full.
- Deductibles, cash amount limits, and other provisions can result in the amount paid being less than the actual loss.

Principles of Insurance

Subrogation

- Subrogation means substitution of the insurer in place of the insured for the purpose of claiming indemnity from a third person for a loss covered by insurance.
- It prevents the insured from collecting twice for the same loss.
- It also uses to hold the negligent party responsible for the loss.
- Thirdly, subrogation helps to hold down insurance rates.

Principles of Insurance

Contribution

- Where a person takes two or more insurance policy covering the same property, in the event of the unexpected happening, the insurance companies will contribute proportionally just to indemnify the insured to his/her original position.
- Remember, insurance is not to make profit but to be placed at the level before the unexpected happened

Principles of Insurance

Proximate Cause

The insurer will only be liable to pay a claim under an insurance contract if the loss that gives rise to the claim was proximately caused by an insured peril

The loss must be directly attributed to an insured peril without any break in the chain of causation.

Procedure for Effecting Insurance Policy

- Enquiry
- Prospectus
- Proposal form
- Premium
- The policy
- Cover note
- The claim form

Procedure for Effecting Insurance Policy

- **Enquiry** – A person wanting insurance cover may contact an insurance company, an agent of a company or an insurance broker, or may, in fact, be approached first by an insurance salesperson.
- **Prospectus**- this is a document prepared by an insurance company, which explains each type of policy that can be taken out with them.

Procedure for Effecting Insurance Policy

- **The Proposal Form**- this is a form that a person seeking insurance completes and returns to the insurance broker or company.
- **The Premium**- The premium is the weekly, monthly, or annual amount that is paid to a customer in return for insurance cover

Procedure for Effecting Insurance Policy

- **The Policy**- On the acceptance of the proposal and subsequent payment of the premium, the insurer will issue a policy to the insured.
- **Cover Note**- pending the preparation of the policy, the insurer issues a cover note to serve as an "ad-hoc policy".
- **The Claim Form**- This is a form supplied by the Insurance Company, which must be accurately completed by the insured person when they wish to claim compensation for accident or loss.

Types of Insurance

Life Assurance

- **Life insurance** provides a cash benefit to a deceased's family or other designated beneficiary, and may specifically provide for burial and other final expenses.
- There are certain **restrictions** in place with this type of cover – for instance **suicide** is not covered.
- It is important to read the terms and conditions relating to life insurance cover

Types of Insurance

Life Assurance

- The most common form of life insurance cover is known as **term life cover**, and this covers you for a fixed term, which is usually fifteen years.
- If you die within this term then the specified sum is paid out to the named beneficiary. However, if you do not make a claim within the term the policy will then expire at the end of the fixed term

Some Life Assurance Policies

- Whole life assurance: it provides coverage for the entire life of the person insured regardless of how long or how much has been collected in premium payment.
- On the death of the policy holder compensation is paid to the dependants.
- Part of the policy goes toward the insurance portion of the policy, part of the premium payment goes toward administrative expenses and the remainder goes toward the investment or cash portion of the policy
- Interest drawn on the investment portion is usually tax-free until it is withdrawn

Some Life Assurance Policies

- Universal Life Insurance: with this, the life portion of the policy is separate from the investment or cash portion of the policy
- The investment portion is invested in money market funds as opposed to stocks and bonds under whole life insurance.
- The cash value portion of the policy is an accumulation fund that investment interest
- Child Education Policy: the holder saves towards the child's future education

Some Life Assurance Policies

Mortgage Protection Policy: it is an insurance taken up against a loan to buy a house. The insurance company takes up the debt on the death of the policyholder and pay on their behalf.

Endowment fund: it is a policy taken out for a fixed number of years and it embodies a saving element. It can be the retirement date, death or a fixed future date.

Group Life Assurance policy: it is taken to cover an employee or a member of the society so that if one person should die, compensation is paid to the society

Motor Vehicle Insurance

- This policy protects vehicle owners against a liability or bodily injury and property damage inflicted by the vehicle. The forms are:
- Act of cover : covers death and injuries suffered by passengers and pedestrians; so compensation is paid to them.
- Third party: it provides cover and damages to third party property. It is the minimum insurance required by law
- Comprehensive: it covers everybody and the car as well

Accident Insurance

- Personal accident policy: insuring yourself against accident
- The workmen compensation policy: it covers the workmen in the industries so that if an injury occurs such employee will be indemnified
- Burglary policy: it covers burglary of property by theft or any other means
- Fidelity guarantee policy: it is a policy against financial loss through the act of dishonesty of the employees
- Good-in-transit policy: it covers goods in transit so that if there is any loss/ accident, there will be compensation

Accident Insurance

- Cash-in-transit policy: it covers loss of money transported from one place to another. It also covers cash is locked safe
- General liability Policy: it covers the people external to the company, thus injuries to third parties who come to the factory.
- Product liability Policy: it is a legal liability to compensate a member of the public who suffers injury or falls ill by the use of the firm's product.

Marine Insurance

- This covers the liability or damage to ships and cargo. Although specific variations are possible, policies normally cover capsizing, sinking, fire and water damage and vandalism
- Types of Marine losses are
  - Constructive total loss
  - General average loss
  - Particular average loss

Kinds of Marine Policies

- Cargo insurance policy: it covers loss or damage of the cargo while in transit
- Marine hull policy: it provides cover for loss or damage to a vessel and its fixtures
- Voyage policy: it covers the risk between two points usually from one port to another
- Time policy: it is a policy the covers a subject matter for a specified period of time
- Floating or Open policy: it is a policy taken to insure a large amount and the premium is paid on the sum. When a voyage is about to be undertaken, the insurer is notified of the goods shipped, their value and the name of the ship. The amount is then written off the policy when the voyage is completed

Kinds of Marine Policies

- Valued policy and Unvalued policy: valued policy is one which always contains an agreed value, which needs not necessarily be the real value of the thing insured and vice versa.
- Policy Proof of Interest(PPI): it is taken out by insurers who have genuine interest, which however, it will be difficult to proof in the event of loss. Such policies are void but generally honoured

Perils on the Sea

- Barratry: it is a wrongful act committed by either the master or the crew, to the prejudice of either the owner or the chatterer of the ship
- Jettison: it is a means of throwing overboard of part of a cargo to lighten a ship in the interest of the remainder to the cargo
- Salvage: it is the throwing of all cargo overboard in order to save the ship

Insurance Terminologies

People who work in Insurance

- **Actuary**: work out the sum of money to be paid as the insurance premium based on the level of risk associated
- **The Adjuster**: one who works out the extent of damage after an accident
- **Underwriter**: he agrees to bear the financial burden of an accident. He gathers information and decides whether an application should be accepted or not
- **The Agent**: they sell or market insurance to people
- **Brokers:** they are the link between the public and the insurance company

Insurance Terminologies

Policy: is a written contract effecting insurance and often evidenced by a certificate

Underwriting: is the process of selecting risks for insurance and classifying them according to their degrees of insurability so that the appropriate rates may be assigned

Sum assured: it is the minimum amount payable to the assured or his dependents on the death of the life assured

Insurance Terminologies

Surrender value: it is the amount an insurance company pays to an insured if they wishes to discontinue the endowment policy after 2 or 3 years

Surrender charge: it is the fee charged to a policyholder when a life insurance policy or annuity is surrendered for its cash value. The fee reflect expenses incurred by placing the policy on its books

Surrender Period: it is the set amount of time during which the insured has to keep majority of the money in an annuity contract

Insurance Terminologies

Under Insurance: it occurs when the amount for which the property is insured is less than the value of such property

Proximity of Damage: the factors that triggered the accidents/ loss must be close and not remote in order to secure a claim.