NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: HCM 341

COURSE TITLE: INSURANCE AND RISK MANAGEMENT

COURSE GUIDE

HCM 341
INSURANCE AND RISK MANAGEMENT

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INTRODUCTION

Insurance and Risk Management is a course for students studying for a degree in Hotel and Catering Management. It is a two-credit course consisting of l5 units.

Each unit is supposed to be covered in three hours. It is a core course for those specialising in Hotel and Catering Management in the School of Management Sciences.

This course guide therefore, tells you briefly what the course is all about, what course materials you will be using and how you can work your way through the course material. It also highlights the issues of timing for going through these units, and explains the activities and Tutor-Marked Assignment. There are tutorials attached to this course and taking advantage of this will bring you into contact with your tutorial facilitator which will enhance your understanding the course.

WHAT YOU WILL LEARN IN THIS COURSE

The overall aim of this course on Hotel and Catering Management is to expose the role of insurance and risk management in bringing about efficiency and effectiveness in the hospitality industry.

This is done to broaden your knowledge about the benefits that insurance offers the hospitality industry and individual - large or small.

During this course you will learn about the types and structure of insurance policies and risk management programmes.

COURSE AIMS

The aim of this course as pointed out earlier is to expose the students of Business and Human Resources Management with specialisation in Hotel and Catering Management to the concept of risks, risk management and insurance. It is to make you appreciate the risk in the hospitality business environment and the potential of this risk to disrupt the normal flow of business and impair the profit maximisation objective of the firm. In order to achieve this, we shall among other things:

- introduce you to types and nature of risk in the Nigerian hospitality industry
- give an insight into the nature of risk management and insurance

- appraise the hotel and catering management business in Nigeria with a view to analysing the more common risks
- introduce you to the risk management alternatives in the hospitality industry**.**

COURSE OBJECTIVES

To achieve the aims set out above, the course sets overall objectives. In addition each unit has specific objectives. The unit objectives are always included at the beginning of a unit. You are advised to refer to them as you study each unit both at the beginning and at the end to ensure that you check your progress and that you have done what is required of you by the unit.

Below are the other objectives of the course as a whole. By meeting these objectives you should achieve the aims of the course as a whole.

On successful completion of the course you should be able to:

- discuss the nature of insurance
- apply risk management to the hospitality industry
- mention the common risks in hotel and catering management
- explain the concept of risk control and risk financing
- identify the sources of financial risks in hotel and catering management
- list the regulatory bodies in the Nigerian insurance industry
- discuss life and health insurance
- explain the idea of financial planning
- discuss employee benefits in the hotel and catering business
- discuss property insurance
- discuss liability insurance

WORKING THROUGH THIS COURSE

To complete this course you are required to read the study units and recommended text books and explore more current materials on the Internet.

In this course, each unit consists of exercises or activities to test your understanding from time to time. At a point in your course, you are required to submit assignment for assessment purposes. At the end of the course is a final examination.

Below you will find listed all the components of the course, what you have to do and how you should allocate time to each unit in order to complete the course successfully on time.

COURSE MATERIALS

Major components of the course are:

1. Course guide
2. Study units
3. Further readings
4. Tutor-Marked Assignment

STUDY UNITS

There are three modules in this course, they are as follows:

Module 1

Unit 1 Risk Management and Insurance
Unit 2 The Application of Risk Control and Risk Financing
Unit 3 Financial Risk Management
Unit 4 The Private Insurance Industry
Unit 5 Regulation of the Insurance Industry

Module 2

Unit 1 The Nature of Life and Health Insurance
Unit 2 Financial Planning: Personal Risk Management
Unit 3 Life and Health Insurance: Business Financial Planning
Unit 4 Life and Health Insurance: Estate Planning
Unit 5 Employee Benefits

Module 3

Unit 1 Property and Liability Insurance (Homeowner Insurance)
Unit 2 Other Personal Property Insurance
Unit 3 Negligence and Legal Liability
Unit 4 Commercial Liability Insurance
Unit 5 Enterprise and Financial Risk Management

TEXTBOOKS AND REFERENCES

There is no compulsory textbook for this course. However, as you go through the course, you will observe that some textbooks are recommended. These textbooks have been found to discuss these topics sufficiently. Please try and consult some of them. Moreover each unit has its own assigned texts and documents. You should also lay your hands on these for further understanding.

ASSIGNMENT FILE

The major assignment requires of you is a Tutor-Marked Assignment (TMA) which you are expected to complete at the end of each unit and mail to your tutor for marking. The marks you obtain for this assignment will count towards the final mark you will obtain for this course. Any further information will be found in the assignment file.

COURSE ASSESSMENT

Your assessment for this course is made up of two components.

1. Tutor-Marked Assignment
2. Final examination

TUTOR-MARKED ASSIGNMENT (TMA)

Each unit in this course has a TMA attached to it. You can only do this assignment after covering the materials and exercise in each unit. Normally the TMA are kept in a separate file.

Your tutor will mark and comment on it. Pay attention to such feedback from your tutor and use it to improve your other assignments.

The total score you obtain in the TMAs will account for 30% of your overall course mark.

There are many TMAs in the course; you should submit any eight to your tutor for assessment. The highest four of the eight assignments will be counted and credited to your overall course mark.

FINAL EXAMINATION AND GRADING

At the end of the course, you will need to sit for a final written examination of two hours. This examination will count for 70% of your overall course mark. The examination will consist of questions which reflect the types of self-testing, practice exercises and TMAs you have previously encountered. You are advised to prepare adequately for the examination, because the general broad area of the course will be assessed.

COURSE MARKING SCHEME

The following table lays out how the actual course marking is broken down.

ASSESSMENT	MARKS
Eight assignments submitted	Best three assignments with 10 marks each count for 30% of overall course marks
Final examination	70% of overall course marks
Total	100% of overall course marks

HOW TO GET THE MOST FROM THIS COURSE

The distance learning system of education is quite different from the traditional university system. Here the study units replace the university lecturer, thus conferring a unique advantage to you.

For instance, you can read and work through specially designed study materials at your own pace; and at a time and place that suit you best. Hence, instead of listening to a lecturer, all you need to do is read.

You should understand right from the onset that the contents of the course are to be worked at and understood step by step, and not to be read like a novel. The best way is to read a unit quickly in order to see the general aim of the content and then re-read it carefully, making sure you understand the content.

You should be prepared at this stage to spend a very long time on some units that may seem difficult. A paper and pencil is a necessary piece of equipment in your reading as you may need to jot down some important points.

FACILITATORS/TUTORS AND TUTORIALS

Detailed information about the number of tutorial contact hours provided in support of this course will be communicated to you. You will also be notified of the dates, times and location of these tutorials, together with the name and phone number of your tutor, as soon as you are allocated to a tutorial group.

Your tutor will make comments on your assignments, keep a close watch on your progress and on any difficulties you might encounter, and provide assistance to you during the course.

Please do not hesitate to contact your tutor by telephone or e-mail if you need help. The following might be circumstances in which you would find help necessary:

- you do not understand any part of the study units
- you have difficulty with the self-tests or exercises
- you have a question or problem with an assignment or with the grading of an assignment.

You should endeavour to attend tutorial classes, since this is the only opportunity at your disposal to experience a physical and personal contact with your tutor, and to ask questions, which will be promptly answered.

Before attending tutorial classes you are advised to thoroughly go through the study units and then prepare a question list. This will afford you the opportunity of participating very actively in the discussions.

SUMMARY

Dorfman (2009) defines risk management as the logical development and implementation of a plan to deal with potential losses. The purpose of a risk management programme in the hotel and catering management industry is to manage their exposure to loss and to protect their assets.

In the current legal and economic environment, with the nature of the hotel and catering management business where several people from different walks of life are frequently interacted with, there is an increased chance of liability and crime losses. Risk management tools such as loss prevention, risk avoidance, and loss reduction therefore play important roles both in personal risk and business risk management and is much needed in the hospitality industry.

Every organisation and in fact all individual should develop a risk management plan. They should identify and measure all loss exposures. Written decisions, legal documents (such as wills), and other valuable papers should be maintained in a secure place. Adequate amounts of insurance should be purchased. Risk avoidance, loss prevention, and loss reduction alternatives also should be considered. Finally, the programme should be reviewed. The scientific approach to the loss exposure problem is essential to individuals and families in today’s complex and changing financial environment.

MAIN COURSE

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MODULE 1

UNIT 1 RISK MANAGEMENT AND INSURANCE

CONTENTS

1.0 INTRODUCTION

Globalisation, e-business, system privacy and security concerns (especially in light of increased Internet bookings) and the increasing speed of business activity are rapidly changing and expanding the risks faced by the hospitality industry. One significant result is the need for players in this industry to embrace insurance and risk management techniques.

In this unit we will define risk and insurance, discuss the concept of risk management and the functions of insurance and also explain the processes involved in risk management review.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define and explain the concept of insurance
- apply risk management to the hospitality business
- explain the functions of insurance
- describe the process of risk management in the hospitality industry.

3.0 MAIN CONTENT

Understanding the concept of risk, risk management and insurance is essential to ascertain their relevance in hotel and catering management. Despite all precautions, we cannot completely avoid risks. Therefore, there is need for a player in the hospitality industry to familiarise himself with the possible risks in the industry and how to effectively manage these risks when they occur.

3.1 The Concept and Definition of Risk

Risk is part of every human endeavour. From the moment we get up in the morning, drive or take public transport to get to school or to work until we get back into our beds (and perhaps even afterwards), we are exposed to risks of different degrees.

There are many definitions of risk. Risk is the probability of uncertainty of future events. It can also be defined as the quantifiable likelihood of loss. It is the potential that a chosen action or activity (including the choice of inaction) will lead to a loss (an undesirable outcome). Potential losses themselves may also be called "risks". In reality, all human endeavours carry some degree of risk, but some are much more risky than others.

3.2 The Application of Risk Management

Risk management is a discipline for identifying risks, assessing how serious or severe the risks are, and determining ways to address that uncertain future with a goal of avoiding or minimising harm and financial losses (Rejda, 2008). Risk management focuses on those events or occurrences that may cause injury or harm to an organisation, its clients, its assets (including employees) and its reputation.

Once the risks are identified, the risk manager will create a plan to minimise or eliminate the impact of negative events. A variety of strategies is available, depending on the type of risk as several risks may arise in the hospitality business. Common risks include risks like accidents in the workplace, fire, theft, liability, flood and other natural disasters. The type, frequency or the severity of risk usually depends on the activities of an organisation but a serious risk that faces every company in the hospitality business is the risk that its reputation or good will in the community could be eroded by a number of circumstances, from a surly receptionist to financial improprieties. Since the industry is labour intensive, it is inevitable that the organisation is faced with employment-related claims. Each company however needs to conduct an assessment of its activities to determine what it’s most common risks are.

The process for identifying and managing the risk is fairly standard and consists of five basic steps. First, threats or risks are identified. Second, the vulnerability of key assets like information to the identified threats is assessed. Next, the risk manager must determine the expected consequences of specific threats to assets. The last two steps in the process are to figure out ways to reduce risks and then prioritise the risk management procedures based on their importance.

3.3 The Process of a Risk Management Review

The job of managing risk in the catering and hotel management business could be daunting. It is advisable to designate a “risk manager” or a committee charged with the responsibility for identifying risks and suggesting ways to reduce the loss exposures. An effective committee is one that is comprised of a diverse group of people who interact with the business in different ways and therefore may be able to identify a wider spectrum of risks. However, risk management is most effective when everyone, is alert to risks and is encouraged to make suggestions and find creative solutions to prevent injuries, harm to property and reputation, and financial loss. This leads to the development of a risk management plan. A risk management plan is a way to identify risk management goals, strategies to achieve them, measurable outcomes, as well as who will be accountable. A risk management plan may include policies that the organisation already has, or articulate goals to adopt in the future. Generally the risk management plan is developed by the risk manager or the committee and adopted by the management as part of their overall commitment to good governance. To ensure the effectiveness of this plan, the process must be periodically reviewed.

Effective risk management requires a reporting and review structure to ensure that risks are effectively identified and assessed and that appropriate controls and responses are in place.

Changes in the organisation and the environment in which it operates must be identified and appropriate changes made to systems. Monitoring and review process should also be put in place to determine whether:

- the measures adopted resulted in what was intended
- the procedures adopted and information gathered for undertaking the assessment were appropriate
- improved knowledge would have helped to reach better decisions and identify what lessons could be learned for future assessments and management of risks.

The purpose of risk management reviews is to assist in the development of a focused approach to loss prevention. The review is used to develop a programme effectiveness grid that is used first to establish a baseline, then set goals and objectives and evaluate progress.

The risk management review process can be applied to a number of critical areas of the hospitality business, these include:

i. **Commercial vehicle -** review assesses your existing automobile loss prevention programmes, your current preventive maintenance programmes, driver-hiring practices, driver training and identify areas of improvement.

ii. **Crime susceptibility -** review looks at and makes recommendations regarding your theft security measures in the areas of asset vulnerability, record-keeping, accountability, emergency procedures, incident investigation, burglar alarm systems and transit exposures.

iii. **Network security -** review looks at your network security measures in the areas of management and administration, risk assessment, and protection for internal and external schemes.

iv. **Property-** review helps to identify strengths and weaknesses in management practices and assists with managing property protection programmes.

v. **Business continuation planning -** helps management focus effort on areas most critical to the business and the allocation of necessary resources which ensures the continued survival of the business.

vi. **Machinery breakdown -** review is aimed at evaluating a company's overall susceptibility to kitchen equipment breakdown. It is also used to assist management with the development of a preventative maintenance programme for machinery and equipment.

vii. **Environmental stewardship -** review assesses management practices in this area and helps to identify strengths and weaknesses as well as helping you manage pollution/environmental impairment liability control programmes.

3.4 Definition of Insurance

According to Isimoya (2007) insurance is a social scheme which provides financial compensation for the effects of a misfortune. This financial compensation is provided from the pool of accumulated contributions of all members participating in the scheme. Insurance is the most practical method for handling a major risk. Insurance pools fortuitous losses by transferring such risks to insurer(s) who agree to indemnify the insured for such losses, to provide other pecuniary benefits on their occurrence, or to render services connected with the risk.

In an effort to define insurance, some terms evolve. These terms and some other common insurance terminologies are explained below.

Risk - In insurance, risk is defined as the uncertainty of financial loss.

Insurer - This is the party who is in custody of the funds. He bears the risk of the insured and assesses and pays claims.

Insured - This term is used to refer to the party or person who seeks protection against risk. If the risk is loss of life, then such a party or person is called the assured.

Premium - Premium is the consideration or money paid by the insured to the insurer. In return for which the insurer assumes the risk. Premium may be paid at once, monthly, quarterly depending on the agreement between the insured and the insurer.

Policy - A policy can be defined as the evidence of the insurance contract between the insured and the insurer.

Indemnity - Indemnity is the restoration of the insured to the same financial position he occupied immediately before the happening of the event he insured against.

Contract - A contract can be defined as an agreement which is legally binding on the parties to it and which, if broken may be enforced by action against the defaulting party in a court of law. Insurance contract, therefore, is a contract whereby one party (the insurer) agrees in consideration of money paid to him (the premium) by another party (the insured) to indemnify that other, against loss resulting to him on the happening of certain events or to pay a specified sum or sums on the happening of those events.

3.5 Functions of Insurance

According to Isimoya (2007) insurance performs certain functions as an aid both to trade and to life. Although insurance will not prevent the loss from happening but it provides financial security by way of compensation and lessens the burden of loss, if loss occurs. The functions of insurance are explained below:

Risk transfer- The primary function of insurance is to provide risk transfer mechanism, by which one party called the insurer assumes the risk of another party known as the insured in return for a small amount of money called premium and agrees to compensate him in the event that the risk insured against occurs.

Creation of common pool- Insurance operates by creating a common pool where the losses of the few are borne by the contributions of many. According to Rejda (2008), pooling means the spread of losses incurred by a few over a group, so that in the process, average loss is substituted for actual loss. It involves the grouping of a large number of exposure units so that the law of large numbers can operate to provide a substantially accurate prediction of future losses.

Insurance performs this function by taking contributions in form of premium. The contribution is put in the same pool for all perils in the same class of insurance and any unfortunate member of the group who suffer a loss is compensated from the pool.

Equitable premium- the contributions (premium) paid into an insurance pool must be fair equitable and impartial to all the members of that pool. Although the risks brought into a pool are similar in type, they usually do not contribute the same degree of risk to the pool. For example, the risk of fire contributed by a hotel built of timber is higher than the risk contributed by the one built of bricks to the fire insurance pool. With this knowledge, the insurer calculates the premium payable by each member with respect to the degree of risk he brings to the pool so that two parties with different degree of risk do not pay the same amount otherwise, one insured will be substituting the premium for another insured.

SELF-ASSESSMENT EXERCISE

i. Define risk.
ii. List three things any monitoring and review process should establish.
iii. What are the functions of insurance?

4.0 CONCLUSION

Risk management is a structured approach to managing uncertainty which involves the identification, analysis and economic control of those risks which threaten the assets or earning capacity of an enterprise.

In order to mitigate the impact of risk in the hospitality industry, the management employs different strategies such as insurance to transfer this risk from their good selves to another party (the insurance company, in this case).

In this unit, we explained the concept of insurance. We also discussed the application of risk management to the hospitality business and reviewed the process of risk management in the hospitality industry.

5.0 SUMMARY

This unit is a foundation unit in our study. It provides a basis and the background for our discussions on risk management in the hotel management and catering industry. The terminologies of insurance are defined and steps for effective risk management process are explained.

6.0 TUTOR-MARKED ASSIGNMENT

What are the most common risks facing catering and hotel management business?

7.0 REFERENCES/FURTHER READING

Aduloju, K. (2008). *Principles of Motor Insurance*. Lagos: Pumark Nig. Ltd.

Isimoya, O. A. (2007). *Risks Management and Insurance Application*. (3rd ed.). Lagos: Malthouse Press.

Rejda, G. E. (2008). *Principles of Risk Management and Insurance*. (10th ed.). Boston: Pearson Education Inc.

UNIT 2 THE APPLICATION OF RISK CONTROL AND RISK FINANCING

CONTENTS

1.0 INTRODUCTION

In unit 1, we defined risk and insurance, and discussed the relevance of these concepts to the hospitality industry. In this unit, we will discuss how risk can be controlled and the alternatives available to finance risks when it cannot be controlled.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list the objectives of risk control
- identify the risk control technique suitable to different situations
- enumerate risk financing alternatives.

3.0 MAIN CONTENT

Every individual faces risk. Illness, accidents, the acts of others, and even death, are all potential hazards each of us faces in life. Your business will face possible calamities also. Floods, fire, and the acts of guests, employees, and others can all put your business at risk. To guard against the financial loss these risks can bring, both individuals and businesses need to insure themselves. In its simplest form, insurance involves the spreading of risk from one person or business to a larger group. According to Dorfman (2009), hospitality businesses seek insurance for protection from risk for two basic reasons. First, because doing so makes good financial sense. Second, some types of insurance coverage are required either by law (e.g. workers' compensation) or by lenders to protect their collateral. Examples of popular risk to be insured in the hospitality industry are:

- material damage of business assets, including cover for money, theft and glass
- business interruption insurance which ensures your business income following a claim
- hotel public and products liability for the operation of your business
- machinery and electronic breakdown
- fidelity insurance for theft by staff.

3.1 Risk Control

Organisations in the catering and hotel management business incur costs because they are exposed to unexpected losses. Risk control is an important method for handling these losses. It consists of certain activities that reduce both the frequency and severity of losses (Rejda, 2008). Risk control has three major objectives: loss avoidance, loss prevention and loss reduction.

3.1.1 Loss Avoidance

Sometimes the best method of dealing with an exposure to loss is to avoid all possibilities of the loss occurring. Risk avoidance means the chance of loss has been eliminated. It means a certain loss exposure is never acquired, or is abandoned. In practice, it may mean not hiring labour thus not been exposed to labour related losses, not attending to customers thereby not been exposed to liability losses from customers. The major advantage of avoidance is that the chance of loss is reduced to zero if the loss exposure is never acquired. In addition, if an existing loss exposure is abandoned, the chance of loss is reduced or eliminated because the activity or product that could produce a loss has been abandoned.

However, not all risks are avoidable i.e. a firm may not be able to avoid all losses because that will literarily mean being out of business. The exposure to loss can often be reduced but not eliminated.

3.1.2 Loss Prevention

The goal of loss prevention is to prevent the loss from occurring. Successful loss prevention activities lower the frequency of losses. So long as the benefits exceed the costs, firms should use loss prevention to treat all exposures, whether assumed or transferred to commercial insurers.

Loss control engineers are sometimes employed to identify sources of loss or injury and to institute corrective actions. Some losses can be attributed to workplace hazards such as poor layout of machines, inadequate lighting or ventilation, poor maintenance practices, or insufficient computer security. Other losses are more directly related to human shortcomings and errors, such as bad judgment, inadequate training or supervision, or lack of attention to safety requirements.

Good risk control programmes can be developed and implemented to deal with identified sources of risk e.g. accounting fraud can be prevented if the business accounts are regularly audited, fires can be prevented by ensuring that workers keep safety rules etc.

3.1.3 Loss Reduction

Despite using the best loss-prevention efforts, some losses will inevitably occur. Loss reduction activities aim to minimise the impact of losses. A popular example of a loss reduction device is the automatic fire sprinkler system installed so that a fire will be promptly extinguished. This system is not designed to prevent fires but, rather, to prevent the spread of fires (that is, reduce the severity of the loss from fire); a building can be constructed with fire resistant materials to minimise fire damage; fire doors and fire walls can be used to prevent a fire from spreading etc. loss reduction activities are appropriate when the potential loss is great, and when the loss cannot be avoided. But loss reduction efforts can be justified only if the savings they produce exceed the cost of the efforts.

3.2 Risk Retention

Retention means that an individual or a business retains all or part of a given risk. Risk retention can be active or passive.

3.2.1 Active Retention

Active risk retention means that an individual is conscious of the risk and deliberately plans to retain all or part of it. For example, a hotel may deliberately retain the risk of petty thefts by employees. In these cases, a conscious decision is made to retain part or all of a given risk. Active risk retention is used because commercial insurance is either unavailable or unaffordable.

3.2.2 Passive Retention

Passive retention can be defined as the failure to identify a loss exposure, failure to act or forgetting to act (Rejda, 2008). Sometimes risk is retained because the potential loss is not identified before it occurred. Others find that they have retained risks because of gaps in their insurance programme or because somebody neglected to purchase needed coverage. Certain risks may be unknowingly retained because of ignorance, indifference, or laziness. Passive retention could be very dangerous.

3.3 Risk Transfer

Risk transfer means the original party exposed to a loss can obtain a substitute party to bear the risk (Aduloju, 2008). Risk transfer is a feature of all insurance transactions because the uncertainty of who will pay for the loss is transferred from the individual to the insurance pool. Some methods of risk transfer, however, do not involve insurance. They are known as non-insurance risk transfer. Non-insurance transfers are methods other than insurance by which a pure risk and its potential financial consequences are transferred to another party.

Examples of non- insurance transfers include contracts, leases, and hold-harmless agreements. For example, the hotel's contract with a transport company for the transportation of their employees can specify that the transport company is responsible for any accident to their staff while in their vehicle. If they lease some cars, the lease can specify that maintenance, repairs, and any physical damage loss to the vehicle are the responsibility of the transport company. The risk of a defective television or stereo set can be transferred to the retailer by purchasing a service contract, which makes the retailer responsible for all repairs after the warranty expires. The risk of a price increase in construction costs can be transferred to the builder by having a guaranteed price in the contract. The risk of a rent increase can be transferred to the landlord by a long-term lease. Leasing allows the transfer of the risk of obsolescence to another party (the owner of the property). A firm may insert a hold-harmless clause in a contract, by which one party assumes legal liability on behalf of another party. Thus, a tread mill manufacturer may, by inserting a hold-harmless clause, be held harmless by the hotel management if the thread mill malfunctions, causing injury or even death to a user.

3.4 Self-Insurance

Self-insurance is a special form of planned retention by which part or all of a given loss exposure is retained by the firm (Rejda, 2008). Self-insurance involves self-funding i.e. losses are funded and paid for by the firm. Although self-insurance requires risk retention, it also requires a business to combine a sufficient number of its own similar exposures to predict the losses accurately. Furthermore, a self-insurance plan requires a firm to make adequate financial arrangements in advance to provide funds to pay for losses when they occur. Unless the self-insuring firm calculates and makes adequate payments to its self-insurance fund, a true self-insurance system does not exist.

3.5 Captive Insurance

A captive insurance company is a company owned by a parent firm for the purpose of insuring the parent firm's loss exposures (Isimoya, 2007). In the hospitality industry, the captive's parent may be one hotel/restaurant, several hotels/restaurants, or the entire industry. A single parent captive (also called a pure captive) is an insurance company owned by only one parent while an association or group captive is an insurance company owned by several parents. The motive in forming a captive is to save the overhead and profits earned by commercial insurers.

SELF-ASSESSMENT EXERCISE

i. Give examples of popular risks in the hospitality industry.
ii. Discuss the objectives of risk control.
iii. Distinguish between passive retention and active retention, citing appropriate examples where possible.

4.0 CONCLUSION

Human beings are naturally exposed to risk by the day to day activities we engage in. We have a choice either to assume these risks or to transfer it to another party at a predetermined cost. It is advised that you try to prevent the occurrence of a loss or minimise the effect, when they occur. This is known as risk control. When the risk bearer decides to set aside a fund for settling any eventuality occasioned by a loss or when he decides to transfer the loss to another party for a fee, then he is said to be involved in risk financing.

In this unit we have discussed the treatment available for loss exposures such as risk control, risk retention and risk transfer.

5.0 SUMMARY

This unit treated the risk control and risk financing alternatives. The objectives of risk control are listed. Risk control techniques and the situations in which they are useful are identified and risk financing alternatives discussed.

6.0 TUTOR-MARKED ASSIGNMENT

Explain three non-insurance risk financing methods with examples.

7.0 REFERENCES/FURTHER READING

Aduloju, K. (2008). *Principles of Motor Insurance*. Lagos: Pumark Nig. Ltd.

Dorfman, M. S.(2009). *Introduction to Risk Management and Insurance*. (9th ed.). New Jersey: Pearson Education Inc.

Isimoya, A. O. (2007). *Fundamentals of Insurance*. (3rd ed.). Lagos: Concept Publications.

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UNIT 3 FINANCIAL RISK MANAGEMENT

CONTENTS

1.0 INTRODUCTION

Financial risk has increased significantly in recent years as a result of globalisation. This is because risk may originate with events thousands of miles away that have nothing to do with the domestic market. Information is available instantaneously, which means that change in economic climate and subsequent market reactions occur very quickly. As a result, it is important to ensure financial risks are identified and managed appropriately.

In unit 2, we discussed risk control and risk financing. In this unit, we will discuss the financial risk management process in the hospitality industry.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define financial risk management
- describe the financial risk management process
- explain the factors that encourage financial risk in the hospitality industry
- describe financial risk control in the hospitality industry.

3.0 MAIN CONTENT

3.1 Definition of Financial Risk

Financial risk management is a process to deal with the uncertainties resulting from financial markets. It involves assessing the financial risks facing an organisation and developing management strategies consistent with internal priorities and policies (Christopher, 2001). Financial risk is the inability of the hospitality project to generate enough cash to support their services.

The financial risk management process involves identifying and prioritising the financial risks facing an organisation and understanding their relevance. It may be necessary to examine the organisation and its products, management, customers, suppliers, competitors, pricing, industry trends, balance sheet structure, and position in the industry. It is also necessary to consider stakeholders and their objectives and tolerance for risk. Once a clear understanding of the risks emerges, appropriate strategies can be implemented in conjunction with risk management policy. For example, it might be possible to change where and how business is done, thereby reducing the organisation's exposure and risk. Alternatively, existing exposures may be managed with derivatives. Another strategy for managing risk is to accept all risks and the possibility of losses. There are three broad alternatives for managing risk:

- do nothing and actively or passively by default, accept all risks
- hedge a portion of exposures, while assuming others
- hedge all exposures possible.

Some examples of financial risks that can be incurred by organisations in the hospitality industry include:

- market risk
- credit risk
- liquidity risk
- operational risk
- reputation risk.

3.2 Sources of Financial Risk in the Hospitality Industry

Financial risk is the risk that the hospitality industry will be unable to meet its financial obligations. This risk is primarily a function of the relative amount of debt that the hotel uses to finance its assets (Jude, William and Hazel; 1995). Several items could result in financial risks including employee behaviour, financial structure, financial transaction and fixed cost increasing.

Staff behaviour is a very popular cause of financial risk. Theft and pilfering are common occurrences as the assets used in a hotel business are ones which are also commonly used in the home. For example, some hotels have had to take such precautions as screwing their televisions into the furniture/wall. Moreover, some of the internal risks in hotels result from minor frauds carried out by staff. There is often an unwritten understanding between management and staff that this goes on and is difficult to stop. Sometimes a certain level of 'wastage' will be built into budgeted results in the knowledge that this is the case and cannot be prevented (Jude, William and Hazel, 1995).

Financial structures also cause financial risks. This means that the way which management decides to finance the assets will directly influence the financial risk. The mix of debt and equity finance is known as gearing, and it affects the financial risk of an enterprise. Financial risk often results from fixed cost increasing. Financial risk is the risk which arising from hospitality industry use of fixed cost sources of financing. Fixed cost sources of financing include two kinds of stocks, debt and preferred stock. Debt and preferred stock create risk because of fixed financial costs such as interest expense and preferred dividend payment (Robert and Michael, 2005). If the hotel cannot afford to pay these fixed financial costs, the use of debt and preferred stock will increases, at the same time, the fixed costs will increase and then a firm must pay regardless of its level of sales and profitability. Consequently, the financial risk also continues to increase.

3.3 Financial Fisk Control in the Hospitality Industry

The management and control of risks is a key function of all hotel management. Risk management is often essential for the control of financial risk. Once all the risks have been identified it is then necessary to identify the appropriate financial risk control technique and then ensure that these controls are operating effectively. There are two levels of controlling which are detailed controls and high level controls.

1) Detailed controls are operated by the staff of the hotel, ensuring that the information systems accurately record the individual transactions of the business and summarises them into the financial management information.
2) High level controls are those which look at the business as a whole and are operated by the more senior managers of the business.

According to Berry and Jarvis (1997) all hotel financial information systems have the same key objectives of control which are:

- to provide an accurate billing system—this will ensure that the revenues reports by each department of the hotel are accurate
- to monitor performance of the hotel
- to safeguard assets.

SELF-ASSESSMENT EXERCISE

i. List three alternatives for managing risk.
ii. What is the difference between detailed controls and high level control of risk?

4.0 CONCLUSION

Business organisations in the hospitality industry face a number of risks which have significant impact on the business. Financial risk relates to the inability of a company to support her financial obligations. However, it is associated with the whole organisational structures, processes, management procedures, and human resources decision-making process. It is vital to be able to identify all significant risks faced by the organisation but without a rigorous risk analysis it is impossible to assess the controls which are necessary. Failure to identify a significant risk and effectively control it may have serious consequences for the business.

5.0 SUMMARY

Financial risks are risks which impact on business success in hospitality industry. Financial risk relates to the inability of the firm to meet its debt obligations. It is related to the capital structure of a business, i.e. the way in which it finances its assets. By adjusting the type of finance or the mix of equity finance to debt finance the financial risk can be altered. Choosing various sources of finance, a business must bear in mind the use of the finance, the limitations of the source of finance, the cost, the repayment terms and timing, and the availability of alternatives. As a result, hotels should select the financial strategies according to their actual situation.

6.0 TUTOR-MARKED ASSIGNMENT

i. What are the sources of financial risk in the hospitality industry?
ii. What are the key objectives of control of all hotel financial information systems?

7.0 REFERENCES/FUTHER READING

Berry, A. & Jarvis, R. (1997). *Accounting in a Business Context*. (3rd ed.). Thomson Learning.

Christopher, L. C. *(*2001). *The Risk Management Process*. John Wiley & Sons.

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UNIT 4 THE PRIVATE INSURANCE INDUSTRY

CONTENTS

1.0 INTRODUCTION

A private insurance company is run by private entities, either individually or by joint ventures. The government solely provides social insurance for the citizen but the private insurance industry could provide cover for all other classes of insurance.

In the hotel management and catering business, there is the need to take insurance policy in order to protect the life and properties of the business, the owners and the staff. The usual practice is to take this insurance from the private insurance companies.

In the last unit, we discussed financial risks in the hospitality industry. In this unit, we shall discus the two major classes of insurance offered by the private insurance companies and the types of covers available under them.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the major classifications of insurance in Nigeria
- list all the types of insurance cover available.

3.0 MAIN CONTENT

Insurance can be broadly classified into two main classes-general and life insurance (Isimoya, 2003). These can further be divided based on the cover they provide.

3.1 General Insurance

This can also be categorised under various grouping such as:

1. **Accident and liability insurance-** This comprises:
   i. Personal accident insurance
   ii. Job injury insurance
   iii. Employer's liability insurance
   iv. Third party liability insurance
   v. General liability insurance
   vi. Product liability insurance
   vii. Medical liability insurance
   viii. Professional liability insurance
   ix. Theft and burglary insurance
   x. Fidelity insurance
   xi. Safe burglary insurance inside the premises and in transit
   xii. Any other liability insurance

2. **Motor vehicle insurance-** Provides coverage against losses and liability related to motor vehicles. There are basically three types of cover in motor insurance. The comprehensive, third party, fire and theft and the third party insurance. The third party insurance is a compulsory insurance in Nigeria.

3. **Property insurance-** Provides coverage against fire, theft, explosions, natural phenomena, civil disturbances, and any other insurance included under this class of insurance to the property of the insured person.

4. **Marine insurance-** Provides coverage for goods in transit by sea and the liability related to ship hull, and any other insurance included under this class of insurance.

5. **Aviation insurance-** Provides coverage for aircraft hulls and liability for passengers and third parties, freight transport by air, and any other insurance included under this class of insurance.

6. **Energy insurance-** Provides coverage for oil, petrochemical, other energy installations, and any other insurance included under this class of insurance.

7. **Engineering insurance-** Provides coverage against builder's risks, construction, electrical, and electronic risks, and machinery breakdown, as well as any other insurance included under this class of insurance.

8. **Other classes of general insurance-** these include other 'special' general insurance (not mentioned above). They are usually, mostly designed to provide cover to meet the customer's unique needs.

3.2 Life and Health Insurance

According to Holyoake and Weipers (2005) Life and Health Insurance provides coverage for medical costs and individual or group coverage for death as well as permanent or temporary, total or partial disability with a savings plan for an additional premium paid by the insured.

1. **Life insurance -** also called life assurance – it pays out either a lump sum or a regular income on the death of the person insured. Cover can often be obtained at a modest cost yet it provides a valuable benefit. Types of life assurance cover available are:
   - term assurance
   - whole life assurance
   - endowment assurance

2. **Critical illness cover -** is available alone or combined with life insurance. It provides cover against being diagnosed with a serious disease, such as cancer, even though the insured person might be able to work. Cover is more expensive than straight forward life insurance.

3. **Income protection policies -** also known as Permanent Health Insurance **-** pay a regular income to someone suffering a loss of income through being unable to work due to illness or injury. In certain cases or more manual occupations, it can occasionally be difficult to get cover.

4. **Private medical insurance -** covers the cost of private medical treatment for acute conditions. It allows the insured person to receive treatment more quickly, or at a time of their choice. Hence, it can minimise the disruption to a business. There are different sorts of policies, from low cost with limited cover to those offering wide-ranging cover and benefits. These can be tailored to the needs of the business.

All of these types of insurance can be bought for individuals, or groups of individuals, and can be used in a variety of ways to provide useful and often essential cover to meet many needs.

SELF-ASSESSMENT EXERCISE

i. List the types of insurance policies available under the accident and liability insurance.
ii. List the different types of life assurance cover you know.

4.0 CONCLUSION

In this unit we have discussed the two major classes of insurance available and the types of covers available under those two broad categories. As the business is regarded as an entity, the insurance covers can be taken to protect the business, the manager, the entrepreneur, the employees, clients and third parties.

5.0 SUMMARY

The basics of insurance are simple: one company offers a guarantee future payment for a contracted event. The company offering the guarantee charges a premium for insuring against the event's occurrence. In doing so, the insurance company is protecting the client against certain circumstances. The insurance company assumes all financial responsibility associated with the client’s losses.

This unit treated the private insurance industry. It divides the available covers into two broad classes and discussed the types of covers available under these two broad categories.

6.0 TUTOR-MARKED ASSIGNMENT

i. Discuss the life and health insurance covers that can be obtained from the private insurance company.
ii. Explain the cover provided by:
    a. Motor vehicle insurance
    b. Property insurance
    c. Marine insurance
    d. Aviation insurance
    e. Energy insurance
    f. Engineering insurance

7.0 REFERENCES/FURTHER READING

Holyoake, J. & Weipers, B. (2005). *Insurance. (* 4th ed.). India, Delhi: A.I.T.B.S. publishers.

Isimoya, O. A. (2003). *Risks Management and Insurance Application.* (3rd ed.). Lagos: Malthouse Press.

UNIT 5 REGULATION OF THE INSURANCE INDUSTRY

CONTENTS

1.0 INTRODUCTION

In unit 3, we talked about the two major classes of insurance and the types of covers available under these two broad categories. Both classes of insurance operate under some rules and regulations that govern the business of insurance. These rules and regulations are typically aimed at assuring the solvency of insurance companies. Thus, this type of regulation governs capitalisation, reserve policies, rates and various other "back office" processes.

In this unit, we shall discuss the reasons, methods and problems of insurance regulation in Nigeria.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the reasons for regulating insurance
- mention the methods of regulating insurance
- list all the regulatory bodies of insurance in Nigeria
- enumerate the problems and issues in insurance regulation.

3.0 MAIN CONTENT

3.1 Reasons for Insurance Regulation

According to Isimoya (2007), insurers are regulated by the states for several reasons, including the following:

1) Maintain insurer solvency: Insurance regulation is necessary to maintain the solvency of insurers. Solvency is important for several reasons. The most important however, is that, premiums are paid in advance, but the period of protection extends into the future. If an insurer goes bankrupt and a future claim is not paid, the insurance protection paid for in advance is worthless. Therefore, to ensure that claims will be paid, the financial strength of insurers must be carefully monitored. Also, individuals can be exposed to great financial insecurity if insurers fail and claims are not paid.

2) Compensate for inadequate consumer knowledge: Regulation is necessary because of inadequate consumer knowledge. Insurance contracts are technical, legal documents that contain complex clauses and provisions. Without regulation, an unscrupulous insurer could draft a contract that is too restrictive and legalistic. Also, most consumers do not have sufficient information for comparing and determining the monetary value of different insurance contracts. Without good information, consumers cannot select the best insurance product. Thus, regulation is needed to protect the insuring public from unethical business practices.

3) Ensure reasonable rates: Regulation is also necessary to ensure reasonable rates. Rates should not be so high that consumers are being charged excessive prices. Nor should they be so low that the solvency of insurers is threatened. In most insurance markets, competition among insurers results in rates cutting which results in premiums that are too low that it becomes unrealistic. Regulation also protects consumers against some insurers who may attempt to increase rates to exorbitant levels after a natural disaster occurs so as to recoup their underwriting losses.

4) Make insurance available: Another regulatory goal is to make insurance available to all persons who need it. Insurers are often unwilling to insure all applicants for a given type of insurance because of underwriting losses, inadequate rates, adverse selection, and a host of additional factors. However, the public interest may require regulators to take actions that expand private insurance markets so as to make insurance more readily available. If private insurers are unable or unwilling to supply the needed coverage, then government insurance programmes may be necessary.

3.2 Methods for Regulating Insurers

According to Rejda (2008), three principal methods are used to regulate insurers, they are: self-regulatory bodies, legislation and the courts.

1) **Self-regulatory bodies:** are various associations in the Nigerian insurance industry that voluntarily regulate insurance practice. Examples are:

   (a) The Chartered Insurance Institute of Nigeria (CIIN)
   (b) The Nigerian Insurers Association (NIA)
   (c) The National Insurance Commission (NAICOM)
   (d) Risk and Insurance Management Society of Nigeria (RIMSON)
   (e) West African Insurance Companies Association (WAICA)
   (f) African Insurance Organisation (AIO)
   (g) The Nigerian Corporation of Insurance Brokers (NCIB)
   (h) Association of African Insurance Brokers and Brokers' Associations
   (i) The Institute of Loss Adjusters of Nigeria (ILAN)
   (j) Professional Reinsurers Association of Nigeria
   (k) Africa Reinsurance Corporation(ARC)

2) **Legislation:** Insurance laws regulate the operations of insurers. These laws regulate (1) formation of insurance companies, (2) licensing of agents and brokers, (3) financial requirements for maintaining solvency, (4) insurance rates, (5) sales and claim practices, (6) taxation, and (7) rehabilitation or liquidation of insurers. Also, laws have been passed to protect the rights of consumers, such as laws restricting the right of insurers to terminate insurance contracts and laws making insurance more widely available.

3) **Courts**: Courts periodically hand down decisions concerning the constitutionality of insurance laws, the interpretation of policy clauses and provisions, and the legality of administrative actions. As such, the various court decisions can affect the market conduct and operations of insurers in a significant way.

3.3 Regulated Areas in the Insurance Industry

Insurers are subject to numerous laws and regulations (Isimoya, 2007). The principal areas regulated include the following:

1) Formation and licensing of insurers: All states have requirements for the formation and licensing of insurers. A new insurer is typically formed by incorporation and after being formed, insurers must be licensed to do business.

2) Solvency regulation: insurers are required to meet some financial regulations such as the admitted assets, reserves, surplus,

investments etc. this is so that they can constantly maintain solvency.

3) Rate regulation: premium rates are regulated so that rates are adequate, not excessive, and not unfairly discriminatory.

4) Policy forms: usually new policy forms have to be approved by the commissioner for insurance before it can be put to use by the company. The purpose of this is to protect the public from misleading, deceptive and unfair provisions.

5) Sales practices and consumer protection: sales practices are regulated by laws concerning the licensing of agents and brokers and by laws prohibiting unfair practices.

3.4 Current Problems and Issues in Insurance Regulation

Insurance regulators face numerous problems and issues. Some issues include the following:

- unethical practices by brokerage firms
- questionable accounting practices
- unauthorised entities selling insurance
- modernising insurance regulation
- insolvency of insurers
- credit-based insurance scores.

SELF-ASSESSMENT EXERCISE

i. What are the reasons for insurance regulation in Nigeria?
ii. List 10 associations in the Nigerian insurance industry that voluntarily regulate insurance practice in Nigeria.
iii. What areas of insurance are regulated? Discuss any four.

4.0 CONCLUSION

In this unit we have discussed the reasons for insurance regulation, the methods for regulating insurers, regulated areas in the insurance industry and the current problems and issues in insurance regulation.

5.0 SUMMARY

This unit treated the regulation of the insurance industry in Nigeria. The reasons for regulating insurance, the methods of regulation, the areas of the insurance business that is being regulated and the current problems and issues encountered in insurance regulation are also discussed. The knowledge gained from this unit will make an insured know how the insurance company is regulated.

6.0 TUTOR-MARKED ASSIGNMENT

i. List the common problems of insurance regulation in Nigeria.
ii. Discuss the methods for regulating insurers in Nigeria.

7.0 REFERENCES/FURTHER READING

Isimoya, A. O. (2007). *Fundamentals of Insurance*. (3rd ed.). Lagos: Concept Publications.

Redja, G. E. (2008). *Principles of Risk Management and Insurance*. (10th ed.). Boston: Pearson Education Inc.

MODULE 2

UNIT 1 NATURE OF LIFE AND HEALTH INSURANCE

CONTENTS

1.0 INTRODUCTION

Life assurance and health insurance are two distinct products that are usually offered together as a package in the insurance industry. These intangible products share some common insurance terminology, but also have unique terms related to the category of protection they provide. Each product functions as an exchange of the insured person's premium payments in exchange for guaranteed benefit payments on covered events as stated in the insurance policy.

In this unit, we will define and discuss the nature of life and health insurance. We shall also look at the benefits offered by each of these products.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define life and health insurance
- list the benefits of life and health insurance.

3.0 MAIN CONTENT

The type of risks faced by players in the catering and hotel management industry such as that of death, illness, injury and accident, are no different from those faced by others. Therefore, the importance of sufficient and efficient risk management strategies to cover losses caused by health or untimely death cannot be overemphasised. One of the available means of managing risk to the health or/and life is the life and health insurance.

3.1 Health Insurance

Health insurance is insurance against the risk of incurring medical expenses among individuals. It is evidenced by a policy. According to Black and Skipper (2004), a health insurance policy is a contract between an insurance provider (e.g. an insurance company or a government) and an individual or his sponsor (e.g. an employer or a community organisation). The contract can be renewable (e.g. annually, monthly) or lifelong in the case of private insurance, or be mandatory for all citizens in the case of national plans. The type and amount of health care costs that will be covered by the health insurance provider are specified in writing, in a member contract or "Evidence of Coverage" booklet for private insurance, or in a national health policy for public insurance. Health insurance is also known as a “living benefit". That's because, unlike life insurance, the policy is designed that you collect the money while you are alive.

By estimating the overall risk of health expenses among a group of hotel employees, an insurer (with the help of the hotelier/hotel manager) can develop a routine finance structure, such as a monthly premium or payroll tax, to ensure that money is available to pay for the health care benefits specified in the insurance agreement. The benefit is promptly paid, on the occurrence of the events insured against. Health insurance may be the most important type of insurance you can own. Without proper health insurance, an illness or accident can wipe you out financially and put you and your family in debt for years.

Health insurance premiums can be expensive, especially if you have to purchase them on your own. However, in the end, having health insurance is most often less expensive than remaining uninsured. If you do not have health insurance, you will have to pay for all of your health care costs out of pocket. When you have insurance, though your premiums may seem expensive, they don't compare to the full cost of major medical procedures.

Medical bills can leave you in debt and may lead to difficulty paying your other bills. Medical coverage for one accident, emergency, or surgery - especially if it involves specialist or follow-up visits may be quite enormous but the money you save in medical bills is often well worth the up-front costs of the insurance policy.

3.1.1 The Benefits of Health Insurance

The benefits of health insurance far outweigh the cost of it. The advantages to owning a health insurance policy are numerous. Accessing an affordable policy with a sufficient amount of coverage will not only provide you with peace of mind but also with a financial cushion if you require immediate medical attention at some point in the future. Health insurance provides relief for many people from the financial demands placed on them by soaring medical costs and astronomical hospitalisation bills. Without insurance, it is easy to become consumed with the weight of your medical bills.

Insurance offers an alternative to having to pay for all medical expenses outright. Even a trip to the doctor for a yearly checkup can be a financial burden without reasonable medical health insurance. To effectively assess the benefits of health insurance, it is best to look at the financial stability it provides to the policy holder. Generally, people who choose to purchase health insurance receive the following benefits:

i. Higher quality medical care.
ii. The ability to seek medical attention when necessary from a qualified physician (studies show that people without insurance are much less likely to seek regular screenings and address health concerns).
iii. Management of pre-existing health conditions to prevent future complications.
iv. Financial stability when medical emergencies arise.
v. The option to cover every member of the family so that no one is left without insurance. This improves longevity of the lineage.

3.2 Life Assurance

Human life is subject to risks of death and disability due to natural and accidental causes. When human life is lost or a person is disabled permanently or temporarily, there is a loss of income to the household. The family is put to hardship. Sometimes, survival itself is at stake for the dependants. Risks are unpredictable. Death/disability may occur when one least expects it. An individual can protect himself or herself against such contingencies through life assurance. Life assurance is insurance on human beings. Though human life cannot be valued, a monetary sum could be determined which is based on loss of income in future years. Hence in life assurance, the Sum Assured (or the amount guaranteed to be paid in the event of a loss) is by way of a ‘‘benefit’’ in the case of life assurance.

Life assurance products provide a definite amount of money to the dependants of the insured in case the life insured dies during his active income earning period or becomes disabled on account of an accident causing reduction/complete loss in his income earnings (Rejda, 2008). Life assurance is a form of insurance that pays monetary proceeds upon the death of the insured covered in the policy. Essentially, a life assurance policy is a contract between the named insured and the insurance company wherein the insurance company agrees to pay an agreed sum of money to the insured's named beneficiary upon the death of the insured person, so long as the insured's premiums are paid. Depending on the contract, other events such as terminal illness or critical illness may also trigger payment. The policy holder typically pays a premium, either regularly or as a lump sum. Other expenses (such as funeral expenses) are also sometimes included in the premium; however, the earliest form of life assurance simply specifies a lump sum to be paid on the policy holder's death. The major advantage of life assurance is "peace of mind" of the policy holder, in knowing that his death will not result in financial hardship for his loved ones.

3.2.1 Types of Life Assurance

Generally life assurance can be grouped into two major types:

i. Term assurance
ii. Permanent life assurance

3.2.1.1 Term Assurance

Term assurance is pure insurance protection that pays a predetermined sum if the insured dies during a specified period of time. On the death of the insured, term insurance pays the face value of the policy to the named beneficiary. All premiums paid are used to cover the cost of insurance protection.

The term may be 1, 5, 10, 20 years or longer. But, unless renewed, the insurance coverage ends when the term of the policy expires. Since this is temporary insurance coverage, it is the least expensive to acquire. The main characteristics of term assurance are:

i. Temporary insurance protection
ii. Low cost

iii. No cash value
iv. Usually renewable
v. Sometimes convertible to permanent life assurance

3.2.1.2 Permanent Life Assurance

Permanent life assurance provides lifetime insurance protection (does not expire), but the premiums must be paid on time. Most permanent policies offer a savings or investment component combined with the insurance coverage. This component, in turn, causes premiums to be higher than those of term insurance. The investment may offer a fixed interest rate or may be in the form of money market securities, bonds or mutual funds. This savings portion of the policy allows the policy owner to build cash value within the policy which can be borrowed or distributed at some time in the future. The main characteristics of permanent life assurance are:

i. Permanent insurance protection
ii. More expensive to own
iii. Builds cash value
iv. Loans are permitted against the policy
v. Level premiums

There are three basic types of permanent insurance:

1. Whole life: Whole life assurance provides lifetime protection, for which you pay a predetermined premium. Cash values usually have a minimum guaranteed rate of interest and the death benefit is a fixed amount. Whole life assurance is the most expensive life assurance product available.

2. Universal life: Universal life assurance separates the investment and the death benefit portions. The investment choices available usually include some type of equity investments, which may make your cash value accumulate quicker.

3. Variable life.

SELF-ASSESSMENT EXERCISE

i. What is a health insurance policy?
ii. What are the benefits of health insurance?
iii. List the characteristics of term life assurance.
iv. List the characteristics of permanent life assurance.

4.0 CONCLUSION

In this unit, we have discussed the quest of human beings to protect themselves against risks of sickness, accidents and death. We discussed the alternatives available to mitigate the loss occasioned by this risk to achieve security and reduce uncertainty.

5.0 SUMMARY

This unit treated the nature of life and health insurance. This provides a background for our study of other areas of life and health insurance and provides a much needed introduction to the topic.

6.0 TUTOR-MARKED ASSIGNMENT

i. What is life assurance?
ii. Distinguish between the two major types of life assurance policies.

7.0 REFERENCES/FURTHER READING

Black, K. & Skipper, H. (2004). *Life and Health Insurance*. (13th ed.). India: Pearson Education.

Rejda, G. E. (2008). *Principles of Risk Management and Insurance*. (10th ed.). Boston: Pearson Education Inc.

UNIT 2 FINANCIAL PLANNING: PERSONAL RISK MANAGEMENT

CONTENTS

1.0 INTRODUCTION

Personal risk management has long been recognised as necessary and essential in Individuals' and families' financial programmes. They can benefit from developing a risk management programme which covers their personal exposure to loss.

Having discussed how the individual can insure his life in the last unit, in this unit we shall discuss how an individual's financial objectives can be accomplished, using the personal risk management as a tool. In this unit, we shall list the stages involved in the financial planning process and apply the knowledge of financial planning to personal risk management.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list the financial planning process
- apply financial planning to personal risk management.

3.0 MAIN CONTENT

3.1 The Financial Planning Process

The personal financial planning process offers a road map for accomplishing an individual's financial objectives. It provides an orderly, systematic approach to planning. According to Arthur and

Hems (1985), the process itself involves six interrelated steps, which are:

a) Gather information
b) Establish objectives
c) Analyse information
d) Develop the plan
e) Implement the plan
f) Monitor and revise the plan

3.2 Personal Risk Management

The most basic element of each individual's financial plan is the establishment and maintenance of a sound programme of personal risk management. The practice of risk management can be defined as the identification, measurement, and treatment of exposures to potential losses. Risk management is concerned with losses that arise from damage to or destruction of property, from liability, and from loss of income or additional expenses occasioned by death, incapacity, unemployment, retirement, and loss of health. Risk management involves the identification, measurement, and treatment of property, liability, and personal loss exposures (Black and Skipper, 2004).

3.3 Application of the Financial Planning to Personal Risk Management Process

Risk management involves the identification, measurement, and treatment of property, liability, and personal loss exposures. We shall apply the six-step of Black and Skipper (2004) personal financial planning process to the risk management process tracks.

a) Gather information: One must first gather information to permit loss exposure identification. Individuals, families, and businesses face three classes of losses: property, liability, and personal. Direct property loss exposures are those that exist because of the possibility of damage to, destruction of, or disappearance of personal or real property. Indirect property loss exposures exist when an individual, family, or business can suffer a reduction in income (revenues less expenses) from the loss of use of property or when the value of property that is not damaged is lessened because of direct damage to other property.

b) Establish risk management objectives: The second step in the risk management process is to establish objectives. These objectives should be consistent with and complement the overall personal financial plans of the individual. Sometimes, the overall goal may be stated simply as the family avoiding financial catastrophe.

c) Analyse information: The third step in the risk management process is to analyse information gathered to permit estimation of the potential financial consequences of losses. This step technically involves an estimation of the chance that a loss will occur and the impact that such a loss would have upon the finances of the individual, family, or business.

d) Develop the risk management plan: Once exposures have been measured, the various tools of risk management should be considered and a decision made with respect to the best combination of tools to be used. The tools primarily include:

- risk avoidance—avoiding the risk altogether
- risk reduction—reducing the chance or/and magnitude of a loss
- risk transfer—transferring the financial consequences of loss to another party
- risk retention—retaining or bearing the risk personally.

e) Implement the risk management plan: The fifth step in the risk management processing is to implement the risk management plan. Usually, risk management entails simply purchasing an insurance policy. But it may also require a major personal commitment from the individual.

f) Monitor and revise the risk management plan: The sixth and final step in the risk management process involves monitoring the entire risk management plan and revising it as circumstances dictate. This means that the family should be aware that exposures to loss can be eliminated, created or altered.

SELF-ASSESSMENT EXERCISE

i. List the financial planning process.
ii. Discuss the fourth stage of the risk management plan.

4.0 CONCLUSION

Individuals will always be faced with risk, in order to be able to effectively overcome these risks, the risks have to be well managed and a plan develop to mitigate it after the occurrence. In this unit, we have discussed the financial planning process; the personal risk management and the application of financial planning to personal risk management.

5.0 SUMMARY

Individuals and families can benefit from developing a risk management programme which covers their personal exposure to loss. In this unit we have highlighted the six stages involved in the financial planning process and applied this knowledge to personal risk management.

6.0 TUTOR-MARKED ASSIGNMENT

Explain the personal risk management process.

7.0 REFERENCES/FURTHER READING

Arthur, W. J. & Hems, R. M. (1985). *Risk Management and Insurance*. (5th ed.). New York: McGraw-Hill Book Company.

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UNIT 3 LIFE AND HEALTH INSURANCE: BUSINESS FINANCIAL PLANNING

CONTENTS

1.0 INTRODUCTION

In the last unit, we applied financial planning to personal risk management. In this unit, we will continue to explain the relevance of financial planning to life and health insurance particularly of the employees in the hotel and catering management business.

Life and health insurance is most often purchased for family or other personal reasons. However, life and health insurance can serve important business purposes for the life of a business entity as well.

In this unit, we explore a special business application of life and health insurance in the hospitality industry. As we discuss key employee death and disability insurance.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- describe how the death or disability of a key individual can impact the financial position of a firm
- explain key employee disability insurance
- list the uses of the key employee insurance.

3.0 MAIN CONTENT

3.1 Background to Key Employee Indemnification

Many business firms have been built around a single individual whose capital, energy, technical knowledge, experience, or power to plan and execute make him or her a particularly valuable asset of the organisation and a necessity to its successful operation. A hotel, a restaurant, a catering outfit may be greatly dependent on one of its employees or owners whose financial worth as an endorser, or ability as an executive, may be the basis of the firm's good credit rating. The death or disability of this key man could have profound adverse financial effects on the organisation.

3.2 Definition of Key Employee Insurance

The key employee insurance also called the key man/person insurance is purchased to indemnify a business for a decrease in earnings brought about by the death or disability of a key employee.

Economic losses and business instability due to death or disability is guarded against by taking insurance to indemnify the business for the loss of the services of the deceased or disabled employee and the proceeds received will aid in bridging the period necessary to secure the services of a worthy successor or substitute or to provide general business stability.

3.3 Uses of the Key Employee Insurance

i. It improves the financial rating of the organisation: Anything that stabilises the financial position of a firm enhances its value thereby, improves its general credit rating.

ii. It provides a financial cushion if one or more key personnel die or becomes disabled.

iii. The firm's liquidity is enhanced through accumulations of cash values that are available at all times.

iv. It enables the organisation to obtain a larger line of credit and on good terms.

v. It may be pledged as collateral.

3.4 Key Employee Disability Income Insurance

Key employee disability insurance provides for payment of a monthly indemnity to a business entity during the total disability of an essential employee who is the named insured under the policy (Black and Skipper, 2004). Benefits begin after a specified period of disability the elimination period—and they continue while the insured is disabled for up to 12 or 24 months.

The amount of indemnity normally corresponds to the value of the employee to the business, and generally it is and should be issued independently of any limits that the insurance company may have set for personal insurance. Although the payment of benefits depends on the disabled status of the insured, the policy itself is owned by the business entity and all benefits are paid directly to the business.

3.5 Overhead Expense Insurance

Overhead expense insurance covers the monthly business expenses of business owners and professionals in private practice when they are disabled. A reimbursement-type benefit is paid during total disability that is uniformly defined in occupational terms. The policies usually begin benefits at the end of 30 or 60 days of disability and pay up to a specified amount of benefit each month while disability continues, until an aggregate benefit amount has been paid. The aggregate amount generally is a multiple of 12, 18, or 24 times the monthly benefit, rather than a specifically limited duration of months. The basic policy waives any premium due during disability.

Covered expenses usually include rent or mortgage payments for the business premises, employee salaries, instalment payments for equipment, utility and laundry costs, business insurance premiums that are not waived during disability, and any other recurring expenses that the insured normally incurs in the conduct of his or her business or professional practice.

SELF-ASSESSMENT EXERCISE

i. What is key employee insurance?
ii. Explain the ‘‘key employee disability insurance’’.
iii. List five expenses covered by the overhead expense insurance.

4.0 CONCLUSION

In this unit we have seen that losses such as loss of profit, loss of customers, inability to fulfill contractual obligations occasioned by the death or disability of a key employee of a business can be transferred to the insurance company for a relatively lower sum under the key employee insurance, key employee disability insurance or the overhead insurance.

5.0 SUMMARY

We have generally discussed the concept of key employee indemnification which is important to the well being and survival of organisations. The knowledge gained in this unit will assist an entrepreneur/manager in the hospitality industry to protect his business against these risks.

6.0 TUTOR-MARKED ASSIGNMENT

i. What is overhead expense insurance?
ii. List five uses of the key employee insurance.

7.0 REFERENCES/FURTHER READING

Arthur, W. J. & Hems, R. M. (1985). *Risk Management and Insurance*. (5th ed.). New York: McGraw-Hill Book Company.

Black, K. & Skipper, H. (2004). *Life and Health Insurance*. (13th ed.). India: Pearson Education.

UNIT 4 LIFE ASSURANCE AS IT RELATES TO ESTATE PLANNING

CONTENTS

1.0 INTRODUCTION

In the last unit we discussed about business financial planning using life and health insurance. The purpose of estate planning is to develop a plan that will enhance and maintain the financial security of individuals and their families. Estate planning is concerned with the distribution of property at death, but it is unavoidably intertwined with lifetime financial planning.

In this unit, we will explain how an insured's property passes to his dependants after his death. We shall also describe the tools of estate planning and list the uses of life assurance with respect to estate planning.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain how property passes at death
- describe the estate planning tools
- list the uses of life assurance.

30 MAIN CONTENT

3.1 How Property Passes at Death

When a person dies, all real and personal properties owned or controlled by him and all properties to which he, she, or the family is entitled pass to someone. Such properties pass, however, in different modes, depending on the nature of the property. The commonest modes are:

i. First, for most individuals, the most important mode of property distribution at death is probate, which is the judicial process by which the will of a deceased presented to a court, and the court appoints someone to administer the estate, including distribution of the property in accordance with the terms of his will (if there is one) or the government intestacy laws (if there is no will).

ii. Second, property passes at death via the nature of property ownership e.g. a joint tenancy with the right of survivorship means that, at the death of one of the owners, title (ownership) vests automatically in the survivor. Such properties cannot be passed by will so is not subject to probate.

iii. Third, property can pass by right of contract. This means that contracts can be established before death and call for payments at or after death.

iv. Finally, property can pass by right of law.

3.2 The Estate Planning Team

Professionals from a variety of fields are usually enlisted in order to achieve best result in estate planning. Though a person may have knowledge in more than one field, the list of a typical estate planning team consists of:

- an attorney
- an insurance specialist
- a bank trust officer
- an accountant
- an investment counsellor.

3.3 Estate Planning Tools

Several tools are available for estate planning. They include wills, gifts, living wills, trusts, joint ownership. The most popular two in Nigeria are:

a) Will: A will is a legal declaration of an individual's wishes as to the distribution of his property at death (Black and Skipper, 2004). It is the principal means by which most estate plans are implemented. A person who dies without a valid will or without a complete disposition of his property is said to have died intestate. The state prescribes to whom and how the deceased's property is to be shared using the intestate succession statutes. In situations where there is no surviving blood relative, then the property passes to the state. This is known as escheat.

b) Gifts: A gift is the transfer of property ownership for less than an adequate price (Black and Skipper, 2004). The difference between the property's fair market value and its sales price is the value of the gift and defines the gift. For a gift to be complete, the donor (giver) and the recipient must both be competent, and the donor must have a clear intent to make a gift. Furthermore, the donor must give up ownership and control and the gift must be delivered to and accepted by the recipient. A gift is not considered complete if it is delivered and then borrowed back for an indefinite period. A life assurance policy often is an example of gift - the value of the property being the replacement cost.

3.4 Tax Implications of Life Assurance and your Estate

Proceeds from life assurance that are received by the beneficiaries upon the death of the insured are generally income tax-free. However, according to Black and Skipper (2004), there are three circumstances that cause life assurance to be included in the deceased's estate:

1. The proceeds are paid to the executor of the deceased's estate.

2. The deceased at death possessed and observed an incident in the policy. An incident of ownership includes the right to assign, to terminate, to name beneficiaries, to change beneficiaries and to borrow against the cash reserves.

3. There is a transfer of ownership within three years of death. This is in order to prevent tax evasion as death tax will not be paid on properties which have been transferred.

3.5 Objectives of Life Assurance

Life assurance has many uses in an estate plan, including estate liquidity, debt repayment, income replacement and wealth accumulation.

It can also help to reduce the amount paid as death tax especially for large estates.

3.6 Examples of Life Assurance Policies

There are many different types of policies to consider, at different price levels, depending on the needs of the potential insured.

3.6.1 Joint Whole Life Assurance

Also known as first-to-die life assurance policy, this is a group insurance policy where benefits are paid out to the surviving insured upon the death of one of the insured group members. The insurance policy can be designed as either a whole life or universal life policy. A first-to-die policy can reduce taxes upon the death of the first spouse if the unlimited marital deduction is not fully used.

3.6.2 Survivorship Life Assurance Policy

Also known as second-to-die insurance policy is similar to joint life in that the policy insures two or more people. However, survivorship life pays out upon the last death instead of the first one. Because the benefit is not paid until the last insured dies, the life expectancy is greater and therefore the premium is lower. Survivorship policies are typically either whole or universal life policies and are usually written to insure husband and wife or a parent and child.

The proceeds of the policy can be used to cover estate taxes, to provide for heirs or to make a charitable contribution. The premium on a second-to-die policy is generally lower than for separate policies because the premium is based on a joint age and the insurance company's administrative expenses are lower with one policy.

SELF-ASSESSMENT EXERCISE

i. List those that you will expect to be members of a typical estate planning team.
ii. Discuss the two most popular estate planning tools in Nigeria.
iii. What are the objectives of life assurance in an estate plan?

4.0 CONCLUSION

In this unit we discussed life assurance as an estate planning tool. Life assurance has come a long way since the days when it was known as burial insurance and used mainly to pay for funeral expenses. Today, life assurance is a crucial part of many estate plans. You can use it to leave much-needed income to your survivors, provide for your children's education, pay off your mortgage, and simplify the transfer of assets. Life assurance can also be used to replace wealth lost due to the expenses and taxes that may follow your death, and to make gifts to charity at relatively little cost to you.

5.0 SUMMARY

In this unit we have been educated on how property passes at death from the owner to others, the objectives of life assurance and the tax implications of life assurance policies. The tools and the knowledge needed for effective estate planning are also discussed.

6.0 TUTOR-MARKED ASSIGNMENT

i. Mention the ways by which you can pass on your properties to other people after death.
ii. Write short notes on (a) joint whole life assurance; (b) survivorship life assurance policy.

7.0 REFERENCES/FURTHER READING

Black, K. & Skipper, H. (2004). *Life and Health Insurance*. (13th ed.). India: Pearson Education.

Redja, G. E. (2008). *Principles of Risk Management and Insurance*. (10th ed.). Boston: Pearson Education Inc.

UNIT 5 EMPLOYEE BENEFITS

CONTENTS

1.0 INTRODUCTION

Government, employers, and individuals all play a role in the economic security of families and individuals. Employee benefit plans have an important place in this process. Employee benefit plans are employer-sponsored plans that provide benefits to employees as part of their total compensation. These benefits are an important part of the system of total compensation provided by employers. Along with other elements of a company's compensation system, these employee benefits should be effectively planned, coordinated, and balanced to help meet the objectives of both the employees and the employer.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- define employee benefits
- list the rationale for employee benefit plans
- explain the differences between individual and group life insurance.

3.0 MAIN CONTENT

3.1 Definition of Employee Benefits

Employee benefits include all benefits and services, other than wages for time worked, that are provided to employees in whole or in part by their employers. According to Henderson (1997) employee benefits are benefit plans for employees that arise from the following five categories of employer payments or costs:

a) Legally required social insurance payments. These include employer contributions to the following programs:
   - social security
   - medicare
   - unemployment compensation insurance
   - workers' compensation insurance
   - temporary disability insurance.

b) Payments for private insurance and retirement plans. These include the cost of establishing such plans, as well as contributions in the form of insurance premiums or payments through alternative funding arrangements. Benefits are provided under these plans for personal loss exposures such as the following:
   - old age
   - dental expenses
   - death
   - legal expenses
   - disability income
   - property damage
   - medical expenses
   - liability judgments.

c) Payments for time not worked. These include the following:
   - vacations and holidays
   - maternity leave
   - sick leave
   - sabbatical leaves
   - jury duty.

d) Extra cash payments to employees. These are cash payments other than wages and bonuses based on performance. Benefits in this category include the following:
   - educational expense allowances
   - savings plans
   - moving expenses
   - christmas bonuses
   - current profit-sharing payments
   - suggestion awards.

e) Cost of services to employees. These include items such as the following:
   - subsidised cafeterias
   - adoption assistance
   - recreation programmes
   - wellness programmes
   - clothing allowances

- day care centers
- financial counseling
- transportation benefits.

3.2 Rationale for Employee Benefit Plans

There is both business and economic rationale for employee benefits. Some reasons include:

i. To achieve a smoother income/consumption stream over an employee life cycle so that even after retirement, the employee is still able (to a large extent) maintain the lifestyle which he is used to, despite the loss of income. Thereby enjoying minimum discomfort throughout their lives.

ii. To meet competition for employees. The direct compensation and the company’s benefit must be competitive with those offered by other companies in the hospitality industry and in similar location to your own. Otherwise, the good employees will seek employment in competing firms with better welfare packages.

iii. It reduces the amount paid in tax.

iv. The presence of employer provided medical benefits may reduce employee turnover thereby contributing to increased productivity.

v. Retirement income programmes in which employer contributions are tied directly to profitability frequently leads to increased productivity.

3.3 Group Life Assurance

Group life assurance is a life assurance policy in which a single contract covers an entire group of people, e.g. the employees of a hotel or the staff of a catering outfit. Typically the life assurance policy owner is an employer or a labour organisation and the life assurance policy covers the employees or members of the group. Depending on the group life assurance policy, the insured person may receive life assurance coverage as an employee benefit, make a contribution to pay part of the cost, or may pay for the group life assurance policy on their own.

Group life assurance is often provided as part of a complete employee benefits package. In most cases, the cost of group coverage is far less than you would pay for a similar amount of individual protection.

3.4 Differences between Individual and Group Life Assurance

Group life assurance historically was based on the risk characteristics of the group as a whole without the intensive underwriting of each member, recognising that some members of the group would be less of a risk than others (Harold, 1998). Many groups purchasing group life assurance generally were strongly cohesive with many common characteristics linking all members of the group. For example, all employees of an established company such as a hotel or a catering outfit are all generally considered to be healthy to perform the tasks at hand and the level of risk involved in their employment is known. This produces savings for members, as it lowers the costs of underwriting and issuing policies.

Unlike an individual life assurance policy, group life assurance coverage is not based on the risk associated with an individual person. Group life assurance policies are established based on the risk factor of the group as a whole (Henderson, 1997), so higher risk members of the group are protected from being adversely singled out and either excluded or forced to pay more. A member of a group life assurance policy is typically protected from their employer or organisation cancelling their specific insurance as long as the person remains a member of the group. When an individual buys into a group life assurance policy, they cannot be exempted from the group life assurance coverage as long as they remain in the group, and may have the option to continue to buy into the group plan for a certain period of time, even after they leave that employment.

SELF-ASSESSMENT EXERCISE

i. Define employee benefits.
ii. What is group life assurance?
iii. What are the rationales of having an employee benefit plan for your employers?

4.0 CONCLUSION

In this unit, we discussed employee benefit plan, the reasons for providing your employees with any benefit plans. We also explained the working of group life assurance and distinguished between individual and group life assurance.

5.0 SUMMARY

This unit treated the concept of employee benefit plan and the concept of group life assurance. Explaining the difference between individual and group life assurance and what the employer stand to gain by a competitive employee benefit plan. The knowledge gained in this unit will assist you in making informed decisions about the employee benefit plan of your organisation.

6.0 TUTOR-MARKED ASSIGNMENT

Explain the difference between group life assurance and individual policies in an hotel or/and catering management outfit.

7.0 REFERENCES/FURTHER READING

Black, K. & Skipper, H. (2004). *Life and Health Insurance*. (13^{th} ed.). India: Pearson Education.

Henderson, R. (1997). *Compensation Management in a Knowledge-Based World*. Upper Saddle River, NJ: Prentice Hall.

Redja, G. E. (2008). *Principles of Risk Management and Insurance*. (10^{th} ed.). Boston: Pearson Education Inc.

Skipper, H. D. (1998). *Risk and Insurance*. Boston, MA: Irwin/McGraw-Hill.

MODULE 3

UNIT 1 PROPERTY AND LIABILITY INSURANCE (HOMEOWNER INSURANCE)

CONTENTS

1.0 INTRODUCTION

Home ownership comes with many responsibilities; the most important of which is protecting the financial investment you have made in your home. In this unit, we will discuss the variety of covers available under the homeowner insurance policy. We shall discuss the nature of homeowner insurance policy and the reasons why they are taken up.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of homeowner insurance policy
- describe the basic coverage provided by homeowner insurance policy
- list the optional coverage provided by homeowner insurance policy
- enumerate the uses of homeowner policy.

3.0 MAIN CONTENT

3.1 The Covers Provided by the Homeowner Policy

A homeowner policy is a protection package that provides coverage for your property, medical payments for others, and protection against claims someone else makes against you. This type of policy is available for primary residence homes occupied by the owners. Most homeowner insurance policies provide a package of coverage. The main types of coverage are described below.

3.1.1 Dwelling Coverage

This coverage pays for damage to your house and to structures attached to your house. This includes damage to fixtures, such as plumbing, electrical wiring and permanently installed air-conditioning systems.

This coverage pays the actual cost to replace your home up to the limit of your policy. The amount of coverage is generally a percentage of the amount it would cost the insurance company to completely rebuild your home. Some policies offer guaranteed replacement cost. Under this policy, the company will pay the full cost to replace your home, even if it is above the policy limit.

3.1.2 Coverage for other Structures

This coverage provides for the repair or replacement of other permanent, separate, unattached structures on your property. The limit is typically 10% of the dwelling coverage. This coverage protects against a loss to a detached garage, personal workshop or attached fence. It usually will not provide coverage for other buildings on your property that tenants occupy, or buildings you use for business. If you have an unusually large detached garage or several outbuildings on your property, you may need to buy additional coverage.

3.1.3 Personal Property Coverage

This coverage provides for repair or replacement of your furnishings and personal items, such as your television, stereo, clothing, dishes, etc. The cost is usually 70% of the dwelling coverage for replacement costs, depending on your insurance company. Your replacement coverage is based on the used value until you actually replace the item. This means your insurance company will initially pay you for the used value of your item. After you buy the replacement item, your insurance company will pay you the difference between the used value and the actual replacement cost.

This coverage extends worldwide, reimburses you for the value of your possessions, including: furniture, electronics, appliances and clothing, damaged or lost even when they are not on your property, such as those kept in a different location or with your child at college. But usually provides only up to 10% of the personal property coverage limit for property you take with you when you travel. You may be able to buy increased limits on personal property for an additional cost.

Insurance companies usually offer personal property coverage on a named peril basis. This means that the policy will specify and list the perils that trigger coverage. Commonly covered perils include fire, lightning, windstorm, hail, explosion, riot or civil commotion, aircraft, vehicles, smoke, vandalism and malicious mischief, theft, and damage caused by falling objects.

3.1.4 Coverage for Loss of Use or Additional Living Expenses

This coverage pays for your living expenses if your house is deemed inhabitable or for some of your additional living expenses while your home is being repaired. However, your normal cost-of-living expenses, such as your house payment or utility bills, are not covered. Your policy usually will include the loss of use or additional living expense coverage at 20% of your dwelling coverage limit without additional premium.

3.1.5 Medical Payments Coverage

This coverage pays the medical expenses of others when they are accidentally injured on your property. Generally, this coverage is limited to any non-resident on your property with your permission. The insurance company does not need to determine negligence to pay the injured person or their provider. This coverage also is called “good neighbour” coverage.

3.1.6 Personal Liability Coverage

This coverage pays expenses for bodily injury and property damage sustained by others when you are legally liable. Personal liability coverage extends beyond your property limits. If an incident involving family members occurs, those who live with you (as defined in your policy) at other locations will be covered by the liability of your family members.

3.1.7 Additional Coverage

This type of coverage generally provides for debris removal, damage to trees, plants and shrubs. Additional coverage also may include credit card coverage. This protects you if someone steals your credit card and makes unauthorised charges. Your policy may cap the amount of coverage in this category, and it may limit the coverage to specific perils.

3.2 Optional Coverage

The following optional coverage can be added to your homeowner policy provided an additional premium is paid.

i. Flood
ii. Home daycare
iii. Home business
iv. Sewer backup endorsement
v. Umbrella liability policies
vi. Secondary residence premises endorsement
vii. Earthquake
viii. Theft coverage endorsement
ix. Credit card forgery

3.3 Uses of Homeowner Insurance

Homeowner insurance is an important purchase for many people. According to Dorfman (2009), there are two major reasons to buy homeowners insurance:

a. To protect your assets

Homeowner insurance covers the structure of your home and your personal property, as well as your personal legal responsibility (or liability) for injuries to others or their property while they are on your property.

b. To satisfy your mortgage lender

Most mortgage lenders require you to have insurance as long as you have a mortgage and to list them as the mortgagee on the policy. If you let your insurance lapse, your mortgage lender will likely have your home insured. Compared to a policy you would buy on your own, the premium might be much higher and the coverage will be limited to damage to the structure of your home. The lender can require you to pay this higher premium until you get your own homeowner insurance again.

SELF-ASSESSMENT EXERCISE

i. List the optional coverage that can be added to your homeowner policy.
ii. What are the uses of homeowner insurance policy?

4.0 CONCLUSION

We purchase homeowner insurance to protect some of our most important assets: the home and its contents, assets they almost certainly could not afford to lose. In several cases, when people borrow money to purchase their home, lenders require insurance to protect their financial interest in the property. In this unit, both the basic, the optional and the additional coverage provided by the homeowner insurance policy are described. The nature of homeowner insurance policy its uses are also discussed.

5.0 SUMMARY

In this unit, we discussed homeowner insurance policy, the coverage available to the policy holder and also the additional coverage available subject to additional premium. The optional coverage and the uses of the homeowner insurance were also discussed. The knowledge gained in this unit will assist you in making informed decisions about purchasing a homeowner insurance policy.

6.0 TUTOR-MARKED ASSIGNMENT

What are the main types of coverage available under the homeowner insurance policy?

7.0 REFERENCES/FURTHER READING

Dorfman, M. S. (2009). *Introduction to Risk Management and Insurance*. (9th ed.). New Delhi: PHI Learning.

Rejda, G. E. 2008). *Principles of Risk Management and Insurance*. (10th ed.). Boston: Pearson Education Inc.

UNIT 2 BUSINESS INTERRUPTION INSURANCE

CONTENTS

1.0 INTRODUCTION

The hospitality business is very vulnerable to economic fluctuations especially when compared to other industries, as there are various risks involved in running a hospitality business. However, as with any other industry, the risk of losses from unforeseen events such as fire, flood, theft, etc., clearly remains. But in the aftermath of a disaster, restaurants, hotels, and other entities may face significant losses in revenue which are not directly related to the loss, but rather, arise out of the interruption of business operations. If and when this occurs, business interruption insurance may provide compensation for these losses.

In the last unit we discussed the homeowner insurance policies. In this unit, we will discuss the concept of business interruption insurance and the cover it provides to the hospitality business.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the meaning of business interruption insurance
- describe the cover provided by business interruption insurance.

3.0 MAIN CONTENT

3.1 Definition of Business Interruption Insurance

Business interruption insurance is a form of insurance coverage that replaces business income lost as a result of an event that interrupts the operations of the business, such as fire or a natural disaster (Rejda, 2008). Also known as business income insurance, business interruption insurance covers the loss of income that a business suffers after a disaster while its facility is being rebuilt. Business interruption insurance is not sold as a separate policy, but is either added to a property/casualty policy or included in a comprehensive package policy. A property insurance policy only covers the physical damage to the business, while the additional coverage allotted by the business interruption policy covers the profits that would have been earned.

The purpose and nature of business interruption insurance - often provided as a separate provision, section or endorsement to a commercial property insurance policy- is to "indemnify the insured against losses arising from the inability to continue the normal operation and functions of the business, industry, or other commercial establishment insured" (Black and Skipper, 2004). Business interruption insurance is "designed to protect the earnings which the insured entity would have enjoyed had the event or occurrence insured against not intervened, but not to place the insured in a better position than if no interruption of the business had occurred." Thus, business interruption insurance does not reimburse the policyholder for the cost of damage to property; rather, business interruption insurance provides coverage for loss resulting from necessary interruption of business conducted by the insured and caused by loss, damage or destruction by any of the perils covered herein during the term of this policy to real and personal property.

3.2 Coverage

The following are typically covered under a business interruption insurance policy:

i. Profits- Profits that would have been earned (based on prior months' financial statements).

ii. Fixed costs- Operating expenses and other costs still being incurred by the property (based on historical costs).

iii. Temporary location- Some policies cover the extra expenses for moving to, and operating from a temporary location.

iv. Extra expenses- Reimbursement for reasonable expenses (beyond the fixed costs) that allow the business to continue operation while the property is being repaired.

3.3 Coverage Requirements

Under a business interruption policy, the following are required to trigger coverage:

i. There must be physical damage. Because business interruption coverage is derived from property insurance, the business property must sustain damage.

ii. The physical damage must occur at the property described in the business interruption policy. If a business has not sustained damage, but access is restricted because of damage at a neighboring property, the policy may not provide coverage.

iii. The physical damage must have been caused by an incident covered by the policy. “Named perils” policies list the specific types of incidents that will be insured. In contrast, an “all perils” policy insures all disruptive incidents and the uninsured incidents will be listed on the policy.

iv. The damage must directly result in a necessary interruption of operations.

By obtaining broad business interruption coverage available, the hospitality industry can focus on fixing what is broken without worrying about going out of business before the repairs are completed. Many businesses without the business income coverage shut down their business operations after their business is completely shattered due to some unforeseen event. It covers the loss of income and helps a business return to the financial position as it was in prior to the disaster.

3.4 Critical Aspects of Business Interruption Insurance

Business owners from hospitality industry should be aware of some of the critical aspects of business interruption insurance. Here, we will take a look at some critical aspects of hotel business interruption coverage and understand why it is very useful for businesses in hospitality sector.

3.4.1 Business Interruption Period

The business interruption period is the length of period for which the benefits are payable under an insurance policy. This period is the most critical part of quantifying the business interruption loss. It covers a business from loss of income for a specified period till the damaged business property is repaired or reopened. Some hotels being aware of the losses that may persist even after repairs are done; opt for “extended period of indemnity”. As it may take some time for the hotel to regain bookings and rebuild market share.

3.4.2 Loss of Rooms Revenues

The business in the hospitality or the lodging industry may suffer financial performance as two of its main functions, occupancy percentage and average daily rate (ADR) may get affected. In simpler terms, a hotel damaged by a hurricane or fire or stuck in a deep local recession will not be able to generate any revenues because of closed rooms, especially in hotels and lodges. Business interruption insurance compensates you for lost income due to loss of rooms. It covers the profits you would have earned, based on your financial records.

3.5 Other Lost Revenues

Revenues from food and beverage, conferences, spa, etc., can constitute a significant portion of a hotel’s income. When a business is interrupted, not only revenues through rooms are affected, some or all of these sources of income are typically interrupted. The business interruption insurance covers all the profits that would have been earned.

3.5.1 Ordinary Payroll

Even if the business activities are temporarily stalled, operating expenses, and other costs such as rent, electricity bill, taxes, interest payable on bank loans, payroll costs etc., cannot be ignored. The business still needs to retain some employees such as accountants, front office executives etc. The business owner needs to pay salaries to them. In this kind of situations business interruption insurance is very helpful as ordinary payroll coverage is a common endorsement in many policies.

3.5.2 Extra Expenses

Business interruption policies generally allow an insured hotel to claim extra expenses incurred during the period of indemnity. It reimburses for reasonable expenses that allow the business to continue operation while the property is being rebuilt. Some policies also cover the extra costs required for moving the business to a different (temporary) location.

Business interruption insurance is one of the most important insurance policies that help in minimising the adverse consequences of some unwanted events for the businesses in the hospitality industry. A well-thought out risk strategy by hotel owners or operators can make a significant difference at the most crucial times.

SELF-ASSESSMENT EXERCISE

i. What is business interruption insurance?
ii. What is covered under a business interruption insurance policy?
iii. Under a business interruption policy, what is required to trigger coverage?

4.0 CONCLUSION

In this unit we have discussed business interruption insurance which is an extension to the property insurance. We defined business interruption insurance, discussed the covers provided and the extended revenues it covers.

5.0 SUMMARY

This unit treats business interruption insurance. It is an option open to hotels, restaurants, caterers and managers in the hospitality industry to insure against losses arising from an inability to continue the normal operation and functions of their business. The knowledge gained in this unit will help to protect your business against such losses.

6.0 TUTOR-MARKED ASSIGNMENT

i. Write briefly on two critical aspects of hotel business interruption insurance coverage and show why it is very useful for businesses in hospitality sector.
ii. Apart from these two major aspects of losses, explain any other two revenues losses in the hospitality business that is covered by business interruption insurance.

7.0 REFERENCES/FURTHER READING

Black, K. & Skipper, H. (2004). *Life and Health Insurance*. (13th ed.). India: Pearson Education.

Redja, G. E. (2008). *Principles of Risk Management and Insurance*. (10th ed.). Boston: Pearson Education Inc.

UNIT 3 NEGLIGENCE AND LEGAL LIABILITY

CONTENTS

1.0 INTRODUCTION

As discussed in the last unit, a business entity could suffer considerable loss when the business is interrupted but special concerns affect the "hospitality industry" because they hold their property open to the public at large. Though all individuals and organisations (both commercial and non-commercial) face liability exposures for their activities, commercial organisations are exposed more to liability losses than others.

In this unit, we will discuss liability and negligence. We will also discuss the common sources of liability and the instruments by which these risks can be transferred to the insurance company.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list the source of liability in the hospitality industry
- describe liability insurance
- explain the types of liability insurance used in the hospitality industry.

3.0 MAIN CONTENT

Liability can be defined as a company's legal debts or obligations that arise during the course of business operations. While negligence is an unintentional tort, involving the failure of a person, to exercise the degree of care that a reasonable person would have exercised under similar circumstances to avoid doing harm to others. Negligence is the most common base for legal liability insurable under liability policy.

3.1 Source of Liability in the Hospitality Industry

The hospitality industry continues to grow, regardless of the rocky economy. However, this is an industry with very specific risks and the owner of a hospitality business needs to be aware of what they are. Some of them include:

1. Food poisoning. It is frighteningly easy to end up with a food contamination issue. It only takes one small piece of bad chicken or a single oyster to give a whole group of people a dose of food poisoning.

2. Catering for people’s functions means you are providing a service that contributes to their special day. A mistake on your part could ruin their function.

3. More people than ever appear to be experiencing food allergies. You must provide accurate descriptions of your dishes so people don’t inadvertently eat something that could harm them.

4. Kitchens can be potentially dangerous environments. You are responsible for maintaining a safe working environment, in order to prevent accident/harm to your staff.

5. A refrigerator breakdown or a major electrical outage could result in you losing perishable ingredients.

6. Third-party crimes which results from the fault (negligence) of the hotel in reasonably protecting guests from foreseeable harm.

7. The personal injury of guests caused by the criminal act of another patron or guest, if it can be established that the hotel was negligent or at fault.

8. Hotels are generally liable for damages if they cannot honour a confirmed reservation because of "overbooking."

9. Hotels are generally liable for losses resulting from bed bug infestations.

10. Hotels are generally liable forcible ejection and liquor liability.

3.2 What is Liability Insurance?

Liability insurance is a part of the general insurance system of risk financing to protect the purchaser (the "insured") from the risks of liabilities imposed by lawsuits and similar claims. It protects the insured in the event he or she is sued for claims that come within the coverage of the insurance policy (Rejda, 2008).

The purpose of liability insurance is to shift the financial liability for covered claims from you, the insured business owner, to the insurance company. Any damages or injuries that occur to a third party while on your property, or as a result of using your product or service, are paid for by your provider instead of by you or your business.

3.3 Harm or Damage Caused by Third Persons

Hotels have an affirmative duty to exercise reasonable care for the safety and security of their patrons. Therefore, they must protect their guests and employees from foreseeable criminal acts of third parties. In most states, a greater burden of protection is placed upon hotels than upon landlords and other business owners. However, the law in this area varies greatly from state to state. Most states hold that hotels are not liable for third-party crimes unless at fault (negligent) in reasonably protecting guests from foreseeable harm.

3.4 The Types of Liability Insurance

The three types of liability insurance which is needed in the hospitality industry include:

3.4.1 General Liability Insurance

The most comprehensive of liability insurance policies available to small business owners, general liability insurance, or GLI, as it is also called, covers your business against claims of bodily injury, physical injury, and property damage that affect your customers, employees, vendors, and visitors on your business premises, or anywhere else where you conduct business (provided it is covered by the policy). It also covers immediate medical relief at the time of the accident and the legal cost of your defense if you are sued as the insurance company will pay for your defense even if the suit is groundless or the person who is suing you is lying about what happened.

Although it is the most-expensive type of coverage available, it generally includes most of the other types of policies, and therefore makes the purchase of additional protection unnecessary.

3.3.2 Employers' Liability Insurance

This policy covers employers against liability claims from their employees for accidents or ill health that they may suffer whilst working and that are due to the negligence of their employers.

This is a compulsory insurance that all employers are required to have under Employers' Liability (Compulsory Insurance) Act 1969. Employers' liability (EL) provides cover in respect of injury or disease caused during the period of the policy. Hence, the policy that is in force at the time the injury to the employee was caused will deal with the claim, irrespective of when the claim is actually made against the employer. EL will therefore cover you for claims for ill health made in the future due to exposures that may occur today but do not manifest themselves during the current policy period e.g. asbestos related diseases. Your insurance should cover all employees, including contract staff, casual and temporary workers.

3.3.3 Public Liability Insurance

Public liability (PL) covers your business for damages payments and legal costs of bodily injury to third parties and damage to third party property caused negligently during your business activities either as a caterer or hotel. It covers claims from members of the public, visitors, passers-by, trespassers and bona fide sub-contractors both on your own premises and at third party premises where you or your employees may work.

This means that you are protected in the event you are sued by someone who slips and falls on your floor, has their car or other property damaged at your place of business, or who is otherwise injured by some form of accident on your premises. It only covers public claims (e.g. third parties, including customers) however. Your employees, vendors, and shareholders are not included in the coverage.

Public liability to third parties can arise in the following ways:

i. **Negligence** - Liability can arise from an act of negligence if someone acts or fails to act in a reasonable manner. However, it is up to the courts to decide what a reasonable manner is.

ii. **Nuisance -** This can be defined as a wrong doing by unlawfully disturbing a person in the enjoyment of his property.

iii. **Trespass -** is an unlawful act committed with force or violence on the person or property of another.

iv. **Strict liabilities -** these are liabilities that are imposed by law even where the business or individual person could prove reasonable care.

v. **Statutory liability -** these are liabilities that have been introduced by law, even where the policyholder has exercised care. For instance, a notice of limited/non liability has to be displayed in a hotel otherwise the proprietor could find himself fully responsible for losses such as damage or theft of customers' belongings from a hotel room if he fails to disclose the necessary notice.

vi. **Contractual liability -** these are additional liabilities that are assumed under the terms of a contract negotiated with a third party.

SELF-ASSESSMENT EXERCISE

i. List five sources of liability in the hospitality industry.
ii. How can public liability to third parties arise?

3.4 Insurability of Liability

Liability insurance does not protect against liability resulting from crimes or intentional torts committed by the insured. This is intended to prevent criminals, particularly organised crime, from obtaining liability insurance to cover the costs of defending themselves in criminal actions brought by the state or civil actions brought by their victims. According to Dorfman (2009), a contrary rule would encourage the commission of crime, and allow insurance companies to indirectly profit from it, by allowing criminals to insure themselves from adverse consequences of their own actions.

4.0 CONCLUSION

In this unit, we highlighted the possible sources of liability in the hospitality industry. We learnt about the concept of liability insurance, with particular attention to the types most relevant to the hospitality industry and their provisions.

5.0 SUMMARY

Liability insurance is a policy that protects a business or individual from a risk where they are highly vulnerable to lawsuits for their malpractice, injury or ignorance. This unit treats liability and negligence in the hospitality industry and the ways in which these risks can be transferred to the insurance industry so that a liability claim does not disturb the profit making objective of the organisation.

6.0 TUTOR-MARKED ASSIGNMENT

i. What is liability insurance?
ii. Explain three types of liability insurance which are needed in the hospitality industry.

7.0 REFERENCES/FURTHER READING

Black, K. & Skipper, H. (2004). *Life and Health Insurance*. (13th ed.). India: Pearson Education.

Dorfman, M. S. (2009). *Introduction to Risk Management and Insurance*. (9th ed.). New Delhi: PHI Learning.

Redja, G. E. (2008). *Principles of Risk Management and Insurance*. (10th ed.). Boston: Pearson Education Inc.

UNIT 4 INDIVIDUAL AND COMMERCIAL LIABILITY INSURANCE

CONTENTS

1.0 INTRODUCTION

One of the most important aspects of owning and operating a hotel is minimising the various physical and liability risks associated with this type of business. Risk management is the process of evaluating a hotel's risk exposure and developing strategies for mitigating those. It incorporates a program for reducing exposure supplemented by insurance protection should an incident occur. A hotel owner and operator would be far better off if they could eliminate all the possibilities of an incident occurring on their property. Since this is not always possible, particularly incidents they have no control over, adequate insurance protection provides a way to reduce exposure to a financial loss.

In unit 3, we discussed liability arising as a result of negligence. In this unit we will discuss property risk, premises liability, products liability, automobile liability and workers compensation.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- list the unique risks in the catering and hotel management industry
- explain practical ways to mitigate or prevent risks in the catering and hotel management industry.

3.0 MAIN CONTENT

When reviewing your hotel's risk management strategies, it is essential you understand all the potential areas of exposure and exactly how insurance policies are structured to handle the unfortunate incidents that could occur.

In this unit, we will discuss the primary areas of concern including the property itself, premises liability, automobile liability, worker's compensation, fidelity, boiler etc. and ways of risk as an effective risk management strategy will reduce a hotel's insurance cost. The following are some of the unique risks faced by hotels.

3.1 Property Risk

Property risk exposures in the industry are primarily due to the high combustibility of contents and multiple sources of ignition that exist in a hotel. Managing these as well as updating building electrical wiring, plumbing and heating systems must be a top priority to mitigate the potential for a fire loss. Additionally, smoke alarms and sprinklers should be installed in all areas of the building and kitchen equipment must meet all National Fire Protection Association requirements. For resort areas, storm damage is always a concern and needs to be addressed.

It is always essential to insure a hotel's buildings and furniture, fixtures and equipment to replacement cost. Replacement cost is the cost to repair or re-build to the position before a loss. Another major component of your property insurance is the BI (Business Interruption) exposure. BI exposure can be substantial due to lack of backup facilities and the seasonal natures of certain hotel operations. A hotel must be sure to complete a business income worksheet to ensure proper insurance proceeds for a loss of profits and continuing expenses. An accurate account of annual revenues by type such as room, food, and beverage will be advantageous while searching for the best and least expensive coverage.

3.2 Premises Liability

A hotel's premises liability exposure is high due to the number of guests typically on the property at any given time. High-rise hotels pose unique life-safety issues. Hotels should implement every safety code possible to ensure guest safety and reduce their liability. Stairways, elevators, railings and floor coverings should all be in good condition. Exits should be clearly marked, and lighting should be available in the event of a power outage. Balconies should be regularly inspected and maintained.

Guestrooms could be accessed by magnetic keys or other similar systems that are unique for each new guest. Services and recreational facilities, such as exercise rooms, swimming pools, laundry facilities, gift shops, barber, beauty and other personal services, require separate review. It is important to identify all the potential liabilities and develop a risk management strategy to reduce the chance of an incident.

3.3 Service Liability

Products liability exposures can be high if the hotel has a restaurant or lounge serving alcohol. A major area of liability exposure is in the serving of alcohol to guests and non-guests. Risk of harm can be created by serving alcohol to an already-intoxicated person. The law generally provides that persons injured by intoxicated persons may sue the seller/provider of the alcohol (in this case, the hotel). Hotels can also lose their liquor licenses for serving minors, and, in many states, can be sued for a subsequent drunken driving accident caused by the minor. Employees should also be trained in the proper handling of food to prevent food poisoning or the spread of other transmissible diseases. Liquor liability exposures can be high if employees are not property trained to recognise the effects of excessive alcohol consumption and take actions may result into liability for the company.

3.4 Automobile Liability

Automobile liability exposure is also high for some properties, like airport hotels, when it is necessary to pick up and deliver guests to and from the hotel and for catering business because they have to transport 'men' and materials to the venue of their engagement. Valet services present garage-keepers exposure for damages to guest's vehicles. With automobile exposures, pre-approval of acceptable MVR's (driving history report), and restricting driving duties to those between the ages of 18-65, are effective methods in managing this type of risk.

3.5 Workers Compensation

Workers compensation exposure is also high within the hospitality industry. Cleaning and maintenance operations can cause workers to experience lung, eye or skin irritations and reactions. Slip and falls, as well as lifting, back injury, hernia, sprain and strain, are all common occurrences. Management should ensure that all employees are in good condition of health and within the fixed age limit to reduce or even eliminate this class of risk.

SELF-ASSESSMENT EXERCISE

i. Explain premises liability in the hospitality industry.
ii. How can automobile liability be incurred and how can it be prevented?

4.0 CONCLUSION

In this unit we discussed the unique risks in the catering and hotel management industry and practical ways to mitigate or prevent risks in the catering and hotel management industry. The risks discussed are those frequently occurring in the industry such as the property risk, premises liability, products liability, automobile liability and workers compensation.

5.0 SUMMARY

All entrepreneurs in the catering and hotel management business should have a risk management strategy that works to reduce the exposure and then provides adequate insurance to cover unfortunate incidents that were not prevented. In this unit the different ways in which liability could accrue to an entrepreneur in the catering and hotel management business are discussed in addition to ways in which exposure to these risks can be reduced.

This unit treated such topics as property risk, premises liability, products liability, automobile liability and workers compensation.

6.0 TUTOR-MARKED ASSIGNMENT

Explain service liability in the hotel and catering management business with any appropriate example.

7.0 REFERENCES/FURTHER READING

Black, K. & Skipper, H. (2004). *Life and Health Insurance*. (13^{th} ed.). India: Pearson Education.

Redja, G. E. (2008). *Principles of Risk Management and Insurance*. (10^{th} ed.). Boston: Pearson Education Inc.

UNIT 5 ENTERPRISE AND FINANCIAL RISK MANAGEMENT

CONTENTS

1.0 INTRODUCTION

Modern risk management jointly considers losses that arise from both pure and speculative risks. This approach is based on the logic that a loss from currency fluctuations is as destructive to a firm's value as an equivalent fire loss. Moreover, considering all sources of loss together may produce more efficient results than the traditional separation of risk categories. Modern risk managers also recognise that a corporation's financial structure has a direct bearing on its risk management programmes.

In this unit we will discuss the alternative risk transfer market. We shall explain enterprise and financial risk management terms such as credit risks, currency risks, interest rate risk, liquidity risks and several others.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- explain the concept of enterprise risk management
- define the vocabularies of financial risk management
- distinguish between derivatives and other financial transactions.

3.0 MAIN CONTENT

3.1 Traditional Risk Management versus Financial Risk Management

Traditional risk management has been devoted to solving management problems associated with pure risks—the exposures that can only produce a loss or no change. While financial risk management describes a programme to manage speculative risks. Potential losses arising from such things as interest rate changes, currency fluctuations, credit risks or commodity price changes are covered under the financial risk management programme**.**

3.2 Enterprise Risk Management

Enterprise risk management (ERM) is a comprehensive risk management programme that considers an organisation's pure risks, speculative risks, strategic risks and operational risks (Doherty, 2000). It simultaneously considers all sources of loss. In other words, it combines both traditional and financial risk management programmes.

3.3 Financial Perils in Financial Risk Management

Credit risk: Credit risk refers to loss potential caused by a borrower defaulting on a loan.

Currency risk: this is also known as the currency exchange rate risk. The currency exchange rate is the value for which one nation's currency may be converted to another nation's currency. Hence, the currency exchange rate risk is the risk of loss of value caused by changes in the rate at which one's nation currency may be converted to another nation's currency. In other words, Currency risk refers to loss potential caused by unfavorable fluctuations in the value of domestic currency relative to foreign currencies.

Interest rate: Interest rate risk refers to loss potential caused by increasing interest rates reducing market value of fixed-income securities, such as bonds. It is the risk of loss caused by adverse interest rate movements. The general rule is that when interest rates rise, the value of fixed-income securities falls. Falling interest rates produce gains in fixed-income security prices. The longer the maturity, the more volatile is the market price for fixed income securities.

Liquidity risk: Liquidity risk refers to loss potential caused by having to take a substantial discount to liquidate an investment quickly. Market risk refers to loss potential caused by having to liquidate an investment at an unfavourable price, perhaps during a downturn of the business cycle.

3.4 Derivative Securities and Other Financial Transactions

Derivative security refers to a financial instrument whose value is based on the value of an underlying financial asset or commodity.

Futures contracts are orders placed by traders in advance to buy or sell a commodity or financial asset at a specified price (Rejda, 2008). These contracts are traded in organised commodities or securities markets. Risk managers use futures to provide a hedge when an increase or decrease in a commodity prices can reduce profits.

For example, consider a hotel that is unsure that it will be fully booked in summer due to a large number of worthy competitors and want to hedge their position. As a result of these, they decide to give out their rooms in advance during winter, at a huge discount, say #50,000 per room instead of the going rate of #100,000 in summer to Assume that an intending customer who wants to go on vacation to that area during summer may chose to hedge his position by buying a futures contract that allows him to pay #50,000 during summer but he may have to pay a non- refundable fee of #10,000 now. If a major competitor is forced to shut down and due to demand price of rooms rise to #120,000, the hotel is still bound to collect #50,000 but the right to stay in that hotel for #50,000 is worth #70,000. The customer's #70,000 gain on the futures contract is however reduced by #10,000 paid for the contract in winter. Nevertheless, the customer has hedged the potential high cost of increase in hotel price. And the hotel's loss is reduced by the #10,000 it received from selling the contract in winter.

SELF-ASSESSMENT EXERCISE

i. Distinguish between traditional risk management and financial risk management.
ii. Describe two financial perils in financial risk management.

4.0 CONCLUSION

The line drawn between insurance and other risk transfer techniques is becoming less distinct as insurance companies and other financial services firms begin to offer innovative combination products. Many formerly uninsurable exposures are finding an alternative risk transfer market that combines capital markets, reinsurance agreements, and investment banking arrangements to allow the transfer of risk that the ordinary insurance market cannot accommodate.

We have introduced several innovative financial solutions to evolving risk management problems in this unit by discussing traditional risk management, financial risk management, enterprise risk management, financial perils in financial risk management and derivative securities and other financial transactions.

5.0 SUMMARY

We have previously discussed effective risk management programmes for pure risk. In this unit, we distinguished between traditional risk management and financial risk management; we defined enterprise risk management and explained financial perils in financial risk management. We also discussed derivative securities and other financial transactions with examples.

6.0 TUTOR-MARKED ASSIGNMENT

i. What is enterprise risk management?
ii. Explain the futures contract giving adequate examples.

7.0 REFERENCES/FURTHER READING

Neil, A. D. (2000). *Integrated Risk Management; Techniques and Strategies for Reducing Risk.* New York: McGraw-Hill.

Redja, G. E. (2008). *Principles of Risk Management and Insurance* (10th ed.). Boston: Pearson Education Inc.