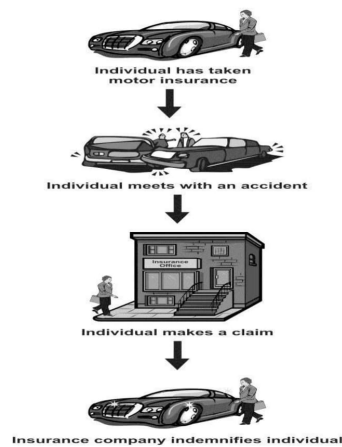


Diagram 4: How insurance indemnifies the insured.



There are other ways to transfer risk. For example when a firm is part of a group, the risk may be transferred to the parent group which would then finance the losses.

Thus, insurance is only one of the methods of risk transfer.

D. Insurance as a tool for managing risk

When we speak about a risk, we are not referring to a loss that has actually been suffered but a loss that is likely to occur. It is thus an expected loss. The cost of this expected loss (which is the same as the cost of the risk) is the product of two factors:

- i. The **probability** that the peril being insured against may happen, leading to the loss
- ii. The **impact** or the amount of loss that may be suffered as a result

The cost of risk would increase in direct proportion with both probability and amount of loss. However, if the amount of loss is very high, and the probability of its occurrence is small, the cost of the risk would be low.