Chapter Six

Risk and Insurance of Business Enterprises

Risk and Insurance of Business Enterprise

6.1 What is Risk?

- Risk is the possibility of suffering some form of loss or damage as a result of decision making.
- It is the chance of an unfavorable outcome associated with an action.
- Uncertainty is not knowing what will happen in the future.
- The greater the uncertainty, the greater the risk.

Con…

- ✓ If there was no risk, there would be no return to the ability to successfully manage it.
- ✓ For each decision there is a risk-return trade-off.
- ✓ Anytime there is a possibility of loss (risk), there should also be an opportunity for profit.
- ✓ Successful Entrepreneurs take calculated risks; they set their own objectives at a level where there is a moderate risk of failure.

Con…

- ✓ Entrepreneurs must decide between different alternatives with various levels of risk.
- ✓ They have internal locus of control, for they take responsibility for their actions.
- ✓ They did not blame fate or some other external force.
- ✓ However, even with carefully planned road map there is risk here comes the need for risk management and Insurance.

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- Risk management is the control of an individual's or company's chances of failure through insurance measures.
- A sudden unexpected event can derail even the most detailed plan unless you have anticipated and planned for catastrophic events

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- Hence, insurance products are useful in managing these risks.
- The entrepreneur should evaluate his life, disability, liability/umbrella, and long-term care insurance

Con…

- This difference leads to the classification of risks as either speculative or pure risks.
- **A speculative risk** is a risk that accompanies the possibility of earning a profit. Most business decisions, such as the decision to market a new product, involve speculative risks. If the new product succeeds in the marketplace, there are profits; if it fails, there are losses.

Con…

- **A pure risk** is a risk that involves only the possibility of loss, with no potential for gain. The possibility of damage due to hurricane, fire, or automobile accident is a pure risk because there is no gain if such damage does not occur. Another pure risk is the risk of large medical bills resulting from a serious illness. Again, if there is no illness, there is no monetary gain.

Con…

Risk can be classified in a number of ways. Here it is classified according to the CIMA Official Terminology

- **Business or operational:** relating to activities carried out within an entity, arising from structure, systems, people, products or processes.

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- **Country:** associated with undertaking transactions with, or holding assets in, a particular country. Risk might be political, economic or stem from regulatory instability. The latter might be caused by overseas taxation, repatriation of profits, nationalization or currency instability

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- **Financial:** relating to the financial operations of an entity and includes:
  - Credit risk
  - Currency risk
  - Interest rate risk
  - Liquidity(funding) risk

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- **Reputational:** this is damage to an entity's reputation as a result of failure to manage other risks.
- **Strategic risk:** these are risks stemming from the entity's strategy and pose the greatest threat to the achievement of the strategy.

6.2 The Process of Risk Management

- The Enterprise Risk management (ERM)process encompasses:
  - Articulating risk strategies and promoting a positive risk culture
  - Designing a risk governance structure
  - Comprehensive and robust risk identification, assessment, and measurement

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- Formulating a spectrum of risk response options
- Implementing risk control policies and procedures
- Monitoring and reporting.

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- **Risk Management** is the name given to a logical and systematic method of identifying, analyzing, treating and monitoring the risks involved in any activity or process.
- Risk Management is now an integral part of business planning.

I) **Identify the risks**

Defining types of risk, for instance, ‘Strategic’ risks to the goals and objectives of the organization.

- Identifying the stakeholders, (i.e.,who is involved or affected).
- Past events, future developments.

II) Analyze the risks

How likely is the risk event to happen? (Probability and frequency?)

What would be the impact, cost or consequences of that event occurring? (Economic, political, social?)

III) Evaluate the risks

- Rank the risks according to management priorities, by risk category and rated by likelihood and possible cost or consequence. What is the likelihood of the risk event occurring? , determine inherent levels of risk.

- Almost certain
- Likely
- Moderate
- Unlikely
- Rare?

What is the consequence if the risk event occurs?

- Extreme
- Very high
- Moderate
- Low
- Negligible?

IV) Treat the risks

Develop and implement a plan with specific counter-measures to address the identified risks.

Consider:

- Priorities (Strategic and operational)
- Resources (human, financial and technical)
- Risk acceptance, (i.e., low risks)

V) Monitor and review

- In identifying, prioritizing and treating risks, organizations make assumptions and decisions based on situations that are subject to change, (e.g., the business environment, trading patterns, or government policies)
- Risk Management policies and decisions must be regularly reviewed

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Risk Managers must monitor activities and processes to determine the accuracy of planning assumptions and the effectiveness of the measures taken to treat the risk.

Methods can include data evaluation, audit, compliance measurement.

Risk Response

1) Avoid

- you put a plan in place to make sure that it could never happen.
- You can’t do this with all risks, but it’s a handy approach to shutting down trouble before it happens where you can

2) Transfer

- Transferring a risk means shifting the responsibility for it on to someone else.
- The best example of this is an insurance policy. When you buy an insurance policy, you shift some of the impact of the risk on to the insurance firm, and they would be liable if the risk did happen.

3) Mitigate

- In this type of risk response strategy, you try to minimize either the probability of the risks happening or the impact.
- For example, you find that a team member may leave for a certain duration during the peak of your project.
- Therefore, to minimize the impact of his absence, you identify another employee with similar qualifications from your organization and inform his boss that you may need him for your project for a period of time.

4) Accept

- This risk response strategy can be used with both kinds of risks, Here you don’t take any action to manage the risk but you do acknowledge it.
- You can accept the risk either by actively acknowledging it or passively acknowledging it. In active acceptance, you keep a separate contingency reserve to manage the risk if it occurs,

6.3 Introduction to Insurance of Business Enterprises

- Insurance is a contract in which one party agrees to indemnify (compensate) another party in the event of loss or damages caused by risks specified in the contract, in exchange for the payment of a certain amount known as the ―insurance premium‖ to the first party. The premium could be arranged to be paid as a lump sum amount or it could be paid as periodic amount.

Table 6.1: Types of Insurance

Type of insurance product	What is the extent of coverage?
All Risks Insurance	It covers loss or damage to the property insured caused by any accident (wide cover) or on specified perils basis (restricted cover)
Burglary Insurance	It covers loss or damage to the property as a result of theft.
Business Interruption Insurance	It covers loss of profit arising from physical loss or damage to the property insured, thus hindering a company from carrying out its planned level of business.

Electronic Shield Insurance	It provides indemnification for any unforeseen or sudden physical loss or damage to electronic equipment such as computers, thus requiring replacement or repair.
Employer's Liability Insurance	It indemnifies the employer against liability lawsuit for employee claims resulting from bodily injury or disease sustained during the course of employment.
Equipment Insurance	It covers loss or damage to equipment, its accessories and spare parts caused by accidental collision or overturning, fire, external explosion, etc
Fidelity Guarantee Insurance	It covers all direct pecuniary loss sustained by the insured as a result of acts of dishonesty and fraud committed by an employee and which is discovered within the insurance period.

Fire Insurance	It covers loss or damage to property caused by fire or lightning and other extraneous perils such as explosions, storms, riots, etc.
Money Insurance	It provides coverage for loss of money occurring from money in transit namely when collecting and/or delivering money from/to bank or money stolen while in the personal custody of an employee.
Professional Indemnity Insurance	It gives protection to professional who supply skills or services against their legal liability to compensate parties other than the insured for losses sustained as a result of their professional negligence.
Product Liability Insurance	It provides compensation to the insured for bodily injury, loss or damage to third parties' property caused by defective designs, packaging, etc. of goods sold, supplied, tested, repaired and serviced by the insured.

Marine Cargo Insurance	It is an insurance cover for merchandise that is transported by rail, road, air and sea. As SMEs are venturing more into the export businesses, the practice of insuring goods in transit becomes increasingly important to their business operations.

Insurability of the Risk Insurers will accept responsibility for risks that meet at least the following conditions:

- Losses must not be under the control of the insured.
- The insured hazard must be geographically widespread
- The probability of a loss should be predictable.
- Losses must be measurable.
- The policyholder must have an insurable interest.

End of Chapter Six