

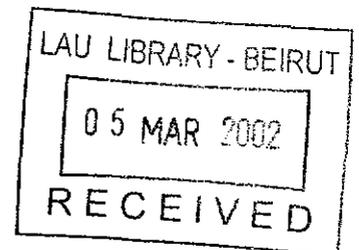
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R I S K S A N D I N S U R A N C E

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CHAPTER I

INTRODUCTION

Commercial Companies transact their business with the aim of achieving certain objectives already set by the shareholders and executed by the Company's management. These Companies are faced with certain risks that avoid them from achieving the already set goals. Top management will have to deal with these risks by a proper risk management process. Some risks are found to be insurable or in other words can be diversified away by the use of insurance devices. The research after going through the various types of risk, will guide management of Companies on the different ways of getting rid of risks thus enabling them to achieve their goals.

I - STATEMENT OF THE PROBLEM

Giant corporations, as well as, small firms are faced on daily basis with various risks that might at any time force them to close down and quit the business. One frequently hears on television or radio of some major fire or explosion or earthquake in some foreign country, a robbery of a certain bank, or a workman falling to his death at a nearby building site. Hardly a day passes without stories like these being reported. Factories may be destroyed by fire, valuable stock could be stolen, computer records damaged or injury caused to innocent people.

All of us, either as private individuals or grouped together as part of commercial and industrial enterprises, are faced with the uncertainties of life. Those businesses which are not owned or run by government (that is, those in the private sector) are created with the aim of covering their operating costs and make at the same time some profit. In order to achieve their profit target, these businesses must expose themselves to various risks. Profit is one of the Company's objectives that is threatened by different risks, other objectives such as survival, shareholders wealth, and even social objectives also might not be achieved if the business firm didnot know how to deal with the risks facing it.

II- STATEMENT OF THE PURPOSE

If risk of any of the events mentioned in the statement of the problem becomes a reality (i.e. a fire broke out in a firm, an explosion, or an earthquake). Then behind these events lies a great deal of anxiety and grief, as can be imagined, for those closely involved. What many people donot realise is that a vast, sophisticated mechanism also lies behind each risk which if properly used can greatly alleviate the financial hardship which may have been caused. This mechanism is insurance and risk is the basic problem with which insurance deals.

In this paper the researcher will try, after giving enough discussion of risk, to highlight the various methods that enable the management of a certain business to deal with the various risks it is exposed to. By proper risk management techniques, the Company can diversify or at least minimize such risks. In firms, the researcher will distinguish between those risks that are insurable and others that cannot be insured and has to be dealt with using other means or techniques. This distinction will not really help solve all the problem of risk, but rather it will help in identifying a major part of those risks that are insurable and then the management's attention will be drawn in this paper to the ways and techniques that should be followed in insuring those risks and thus getting rid of them.

III - PERFORMANCE OBJECTIVES:

The main objective of the research is to be of assistance to management of Companies in their efforts undertaken to diversify away the various risks facing these companies. In order to reach this ultimate objective the reader will go through the following points which are of importance to businessmen and will have to go through while transacting their daily work.

The researcher in course of his study will :

- . Define and classify the insurable risks.
- . Describe different methods of handling risk.
- . Explain method of risk handling through risk management.

- . Identify insurable and uninsurable risks.
- . Will give an idea on insurance buying and insurance prices.

IV - ORGANIZATION OF THE STUDY:

Before trying to solve the problem of risk, enough knowledge of what risk is all about will be of great help, the concept, definition, and classification of risk will be described briefly as a first step. After that the different methods of handling risks are discussed in some detail.

As a second step, the nature and process of risk management is discussed, what are the procedures to be followed by management in identifying the dangers facing the Company and coming out with the best method of dealing with these dangers. The proper method of handling any particular risk will be achieved by following a proper risk management process.

At a later stage, and after having specified, through classification of risk and risk management process, the risks that should be diversified away, those risks that can be insured will be discussed. A list of elements of insurable risks will enable the researcher to discuss how the insurance device works, and how this device can be a means of diversifying away insurable risks.

As a final step, the paper will be of help to management of business enterprises, in pointing out the common errors they should avoid when buying insurance, or planing for insurance. A note on insurance prices will be discussed giving an idea on what basis are rates set.

PRESENTATION AND ANALYSIS OF RESULTS

A) THE CONCEPTUAL FRAME WORK OF RISKS.

Every field of knowledge has its own specialized terminology, and terms which have very simple meanings in everyday usage. Often they take on different and complicated connotations when applied in a specialized field. In this first part of the chapter the researcher will examine a number of basic concepts used in the study of insurance. In particular, the concept of risk, for risk is the basic element with which insurance deals.

THE CONCEPT OF RISK:

It would seem on the surface that the term "risk" is a simple notion. When some one states that there is risk in a given situation, it means there is uncertainty about the outcome, and that the possibility exists that the outcome will be unfavorable. This loose intuitive notion of risk, which implies a lack of knowledge about the future and the possibility of some adverse consequence is satisfactory for conversational usage, but for the paper's purpose a somewhat more rigid definition is desirable.

A definition of risk that is suitable for the economist or statistician may very well be worthless as an analytic tool for the insurance theorist. The fact that each group treats a different body of subject matter requires the use of different concepts, and although the statistician, the decision theorist, and the insurance theorist all use the

term risk, they may each mean something entirely different.

I - CURRENT DEFINITIONS OF RISK:

If we were to survey the best known insurance textbooks used in colleges and universities today, we would find a general lack of agreement concerning the definition of risk. In general we would find the term defined in one of the following ways :

- 1 - Risk is the chance of loss (webster dictionary).
- 2 - Risk is the possibility of loss (Emmett Vaughen Curtis Elliot Fundamentals of Risk & Insurance).
- 3 - Risk is uncertainty (Alan Willet - Economic theory of risk & Insurance).
- 4 - Risk is the probability of any outcome different from the one expected, (Emmett vaughen curtis Elliot Fundamental of Risk and Insurance).

Now, if each definition means approximately the same thing, then there is no real problem. If, on the other hand, each has a different connotation, we must decide which is preferable, and which if any, is suitable for our purposes.

SELECTING A DEFINITION:

There is no sign at this point that insurance theorists will be able to agree on any of the above definitions in the near future. Each has found numerous adherents, and each has certain qualities that make it preferable for some purpose. Even though we cannot agree on a universal

definition, examination of those given above indicates that there are certain elements essential in whatever definition is used : ¹

- a) - The outcome must be in question. The idea of fortuitousness is inherent in each definition. When risk is said to exist, there must always be at least two possible outcomes. If we know in advance what the outcome will be, there is no risk.
- b) - At least one possible outcome is undesirable. This may be a loss in the generally accepted sense in which something the individual possesses is lost, or it may be a gain smaller than the gain that was possible.

For the research purposes, two definitions discussed earlier will be used, but in a slightly modified form providing a precise acceptable notion of risk. Risk is defined as the possibility of an adverse deviation

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Emmett vaughan and curtis Elliot, Fundamentals of risk and insurance, Canada, A-Wiley/Hamilton 1978 Page (7)

Gordon Dickson and Hohn Steele, Introduction to Insurance, England, Burlington Press,,1981,, Page 1

from a desired outcome that is expected or hoped for. Since an adverse deviation from a desired outcome may be viewed as a loss, risk may also be defined as a possibility of loss. In its broadest context, this definition includes any situation where there is a possibility of an unfavorable outcome. Few would deny that there are risks that do not involve money. However since the purpose here is to relate risk to insurance, a special type of risk will be focused upon, that which entails the possibility of financial loss. Financial loss is defined as a decline in or disappearance of value due to a contingency.

II - DEGREE OF RISK:

In conversation people may refer to an event as risky or not too risky and here they are faced with the problem, after defining what is a risk, of determining the degree of risk.

When risk is discussed consideration should be given to both the frequency with which an event may take place and the severity of each incident with which it might occur. By estimating these two elements a clearer view can emerge enabling us to determine the degree of risk.

III - RISK DISTINGUISHED FROM PERIL & HAZARD:²

It is not uncommon for the terms "Peril" and "Hazard" to be used interchangeably with each other and with "risk". However to be precise, it is important to distinguish these terms. A peril is a cause of a loss, we speak of the peril of fire or windstorm, or hail or theft. Each of these is the cause of a certain loss that might occur. A hazard on the other hand, is a condition that may create or increase the chance of a loss arising from a given peril. It is possible for something to be both a peril and a hazard. For example, sickness is a peril causing economic loss, but it is also a hazard that increases the chance of loss from the peril of premature death. Hazards are normally classified into three categories : (1)

- a) - A physical hazard : consist of those physical properties that increase the chance of loss from the various perils (i.e. type of construction might increase the chance of fire)
- b) - Moral hazard ; refers to the increase in the probability of loss which results from evil tendencies in the character of the insured person in the hope of collecting from the insurance Company.

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Emmett Vaughan and Curtis Elliot, Fundamentals of Risk and Insurance, Canada, A-Wiley/Hamilton 1978, Page 9

c) - **Morale Hazard** : results from a careless attitude on the part of the insured persons toward the occurrence of losses. The purchase of insurance may create a morale hazard, since the realization that the insurance Company will pay the loss may lead the insured to exercise less care than if forced to bear the loss alone.

IV - CLASSIFICATION OF RISK:³

Risks may be classified in many ways; however, there are certain distinctions that are particularly important for the purposes of the research.

a) - Financial and Nonfinancial risks:

In its broadest context, the term risk includes all situations in which there is an exposure to adversity. In some cases this adversity involves financial loss, while in others it does not. There is some element of risk in every aspect of human endeavor, and many of these risks have no financial consequences. Even a blind date carries an element of risk. In this text the researcher is concerned with those risks which involve a financial loss.

b) - Static and Dynamic risks:

A second important distinction is between static and dynamic risks. Dynamic risks are those resulting from changes in the economy (i.e. changes in the price level, consumer tastes, income and out put, technology). These dynamic risks normally benefit society over the long run since they are the result of adjustments to misallocation of resources.

Static risks involve those losses which would occur even if there were no changes in the economy. Some individuals holding the elements of the economy constant will still suffer a financial loss arising from perils of nature and the dishonesty of other individuals. Static risks, unlike dynamic risks, are not a source of gain to society. Static losses involve either the destruction of the asset or a change in its possession as a result of dishonesty or human failure. Moreover, static risks appear with a more degree of regularity than dynamic risks and as a consequence are generally more predictable.

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- Emmett Vaughan and Curtis Elliot, Fundamentals of Risk and Insurance, Canada, A-Wiley/hamilton 1978, Page 10

Gordon Dickson and John Steele, Introduction to Insurance, England, Burlington Press, 1981, Page 3

c) - Fundamental and Particular Risks;

The distinction between fundamental and particular risks is based on the differences in origin and consequences of the losses. Fundamental risks involve losses that are impersonal in origin and consequence. They are group risks, caused for the most part by economic, social, and political phenomena, although they may also result from physical occurrences. Fundamental risks affect large segments or even all of the population. Particular risks, on the other hand, involve losses that arise out of individual events and that are felt by individuals rather than by entire group, unemployment, war, inflation earthquakes, and floods are all fundamental risks, while the burning of a house and the robbery of a bank are particular risks.

Since fundamental risks are caused by reasons more or less beyond the control of the individuals who suffer the losses, it is held that society rather than the individual has the responsibility to deal with them. Although some fundamental risks are dealt with through private insurance, it is an inappropriate tool for dealing with most fundamental risks, and some form of social insurance or other transfer program may be necessary.

Unemployment and occupational disabilities are fundamental risks treated through social insurance. Flood damage or earthquakes make a district a disaster area eligible for government funds.

Particular risks are considered to be the individual's own responsibility. They are dealt with by the individual through the use of insurance, loss prevention or some other technique.

d)- Pure and speculative risks:

One of the most useful distinctions is that between pure risk and speculative risk, the term pure risk is used to designate those situations which involve only the chance of loss or no loss. Speculative risk in contrast described a situation where there is a possibility of loss and also a possibility of gain. One of the best examples of pure risk is the possibility of loss surrounding the ownership of property. On the other hand gambling is a good example of speculative risk.

The distinction between pure and speculative risks is very important, because normally only pure risks are insurable. Insurance is not concerned with the protection of individuals against those losses arising out of speculative risks.

Moreover pure risks can be classified under the following categories :

- a) - Personal Risks: i.e. loss of personal earning caused by premature death, unemployment, sickness or disability.
- b) - Property Risks: i.e. loss of property owned by the individual caused by fire, theft...
- c) - Liability Risks: i.e. causing through negligence or carelessness unintentional injury to other persons.
- d) - Risks arising from failure of others: i.e. when a person fails to meet his obligation in performing a service for you, you are faced with a financial loss, and here risk arises.

V - METHODS OF HANDLING RISK: ⁴

Whether risk is defined as the possibility of loss, uncertainty concerning loss, or the probability that the actual result will differ from what is expected, the greatest burden in connection with risk is that some losses will actually occur. When a house is destroyed by fire, there is a financial loss. When someone is negligent and that negligence results in injury to a person or damage to other's property, there is a financial loss. These losses are the primary burden of risk and the primary

⁴ - Emmett Vaughan and Curtis Elliot, Fundamental of Risk & Insurance, Canada, A-Wiley/Hamilton 1978, Page 13 .

reason that individuals attempt to avoid risk or alleviate its impact. There is no escape from the presence of risk and humanity must accordingly seek ways of dealing with it. The existence of risk is a source of discomfort to most people, and the uncertainty accompanying it causes anxiety and worry. Since risk is unpleasant, people's rational nature leads them to attempt to do something about it. Basically people deal with risk in either one of the five following ways or a combination of some of them, they avoid, retain, transfer, share or reduce it.

a) - Risk may be avoided:

Risk is avoided when the individual refuses to accept the risk even for an instant. This is accomplished by merely not engaging in the action that gives rise to risk. If you donot desire to face losing your savings in a hazardous venture, then pick one where there is less or no risk. The risk aversion is one method of dealing with risk, but it is a negative rather than a positive technique, for this reason it is an unsatisfactory approach to dealing with risk. If risk avoidance were utilized extensively, the individual and society would suffer.

b) - Risk may be retained:

Risk retention is perhaps the most common method of dealing with risk. The individual faces an almost unlimited array of risks;

in most cases nothing is done about them. When the individual does not take positive action to avoid, reduce, or transfer the risk, the possibility of loss involved in that risk is retained. This retention may be voluntary or involuntary. Voluntary risk retention is characterized by the recognition that the risk exists, and a tacit agreement to assure the losses involved. The decision to retain a risk voluntarily is made because there are no alternatives more attractive. Involuntary risk retention on the other hand takes place when the individual exposed to the risk does not recognize its existence. In these cases the person so exposed retains the financial consequences of the possible loss without realizing that he or she does so.

Risk retention is a legitimate method of dealing with risk; in many cases it is the best way. Each person must decide which risks to retain and which to avoid or transfer on the basis of his or her margin for contingencies or personal ability to bear the loss. A loss that might easily be borne by another. As a general rule, risks that should be retained are those that lead to relatively small certain losses.

c) - Risk may be Transferred:

Risk may be transferred from one individual or company to another individual company who is more willing to bear the risk. An excellent example is the process of hedging, a method of risk transfer accomplished by buying and selling for future delivery, whereby dealers and processors protect themselves against a decline or increase in market price between the time they buy a product and the time they

sell it. It consists of simultaneous purchase or sale for immediate delivery and purchase or sale for future delivery, such as the sale of futures in the wheat market at the same time that a purchase is made in the spot market.

Additionally, risk may be transferred or shifted through contracts. A Hold-harmless agreement, in which one individual assumes another's possibility of loss is an example of such a transfer. For example, a tenant may agree under the terms of a lease to pay any judgements against the land-lord which arise out of the use of the premises. Insurance as will be elaborated later in this paper is also a means of shifting or transferring risk. In consideration of a specific payment (the premium) by one party, the second party contracts to indemnify the first party up to a certain limit for the specified loss which may or may not occur.

d) - Risk may be Shared:

The distribution of risk is accomplished in a number of ways in our society. One understanding example of a device through which risk is shared is the corporation. Under this form of business, the investment of a large number of persons is pooled.

A large number of investors may pool their capital, each bearing only a portion of the risk that the enterprise may fail. As we shall see, insurance is another device designed to deal with risk through sharing.

e) - Risk May be Reduced:

Risk may be reduced in two ways, the first through loss prevention and control. There is almost no source of loss where some efforts are not made to avert the loss. Safety programs and loss prevention measures such as medical care, fire departments, night security guards, sprinkler systems, and burglary alarms are all examples of attempts to deal with risk by preventing the loss or reducing the chance that it will occur. Some techniques are designed to prevent the occurrence of the loss, while others, such as sprinkler systems, are designed to control the severity of the loss if it does happen; From one point of view, loss prevention is the possibility of loss could be completely eliminated, risk would also be eliminated. From a second point of view, loss prevention is seen to be an inadequate approach to dealing with risk. No matter how hard we may try, it is impossible to prevent all losses, from happening. In addition in some cases the loss prevention may cost more than the losses themselves.

The other way of reducing risk is through the use of the law of large numbers. Through the combination of a large number of exposure units, a reasonable estimate of the cost of the losses can be made. On the basis of this estimate, it is possible for an organization such as an insurance company to assure the possibility of loss of each exposure, and yet not face the same possibility of loss itself.

We have discussed so far different definitions of risk focusing on them from the insurance point of view. We have then classified risk into different categories in an attempt to specify those risks that may be diversified away by insurance means. At the end we have stated the various ways available to the individual to handle the risk facing him and causing him frustration and worry.

B) - RISK MANAGEMENT

1 - THE NATURE OF RISK MANAGEMENT:

Risk management is a scientific approach to the problem of dealing with the pure risks faced by individuals and businesses. Many business firms have highly trained individuals who specialize in dealing with pure risk. In some cases this is a full-time job for one person, or even for an entire department within the company. Those who are responsible for the entire program of pure risk management (of which insurance buying is only a part) are risk managers. Risk management as a profession is older than the title "Risk Manager", for the technique was utilized by businesses and individuals long before the term became fashionable.

The risk manager evolved from the insurance manager, and because the title is growing in popularity, many insurance managers are called risk managers. The terms are often used interchangeably, without a great deal of attention to the actual role of the individual. To distinguish between the risk manager and the insurance manager, a functional approach should be used.

Risk management is broader than insurance management in that it deals with insurable and uninsurable risks, and the choice of the appropriate techniques for dealing with them. Insurance Management included the use of techniques other than insurance (for example, non insurance, or retention of risks as an alternative to

insurance) but for the most part it is restricted to the area of those risks that are considered to be insurable.

The managers of a business are responsible for conserving the firms assets and its income. It is the risk manager's responsibility to shield both assets and income from losses associated with pure risks. Thus, while the objective of management in general is the conservation of assets and maximizing of profit, the objective of risk management is to make sure that losses from pure risks do not prevent management from seeking its goals. Risk management then, is something more than insurance management in that it deals with both insurable and uninsurable risks, but it is something less than overall management, since it does not concern itself -except incidentally) with business risk.

Risk management also differs from insurance management in philosophy. Insurance management involves techniques other than insurance, but in general these other techniques are considered primarily as alternatives to insurance. Instead of the traditional focus of the corporate insurance buyer on simply getting the most insurance for the dollar spent, the emphasis in the risk management concept is on reducing the cost of safeguarding against risk by whatever means are most appropriate. Under this scheme, insurance is viewed as simply one of several approaches for minimizing the pure risks the firm faces.

THE RISK-MANAGEMENT PROCESS: 5

The process by which the risk manager achieves the risk management goal consists of six steps.

- I - Determination of objectives
- II - Identification of the risks
- III - Evaluation of the risks
- IV - Consideration of alternatives and selection of the risk treatment device.
- V - Implementation of the decision
- VI - Evaluation and review.

I - Determination of objectives:

The first step in the risk management process is the determination of objectives, that is deciding precisely what it is that the organization wants from its risk-management-program.

The practice of risk management techniques assists in the achievement of corporate objectives by :

- 1 - Preventing or reducing losses which could otherwise delay the achievement of some corporate goal.
- 2 - The design of risk financing techniques which ensure sufficient cash flow after a loss has occurred and frequently at lower cost than could be the case otherwise.

- 3 - Ensuring that the costs of pure risks are included in capital budget decisions.
- 4 - Improving the marketing and quality of products by ensuring that potential liabilities have been examined and consciously accept with defined limits.
- 5 - Allowing managers and others to concentrate on the entrepreneurial aspects of business with the peace of mind that the pure risks have been handled adequately.
- 6 - Allowing more confidence in the financial forecasting by reducing fluctuations in profits and cash flow.

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- Emmett Vaughan and Curtis Elliot, Fundamentals of Risk and Insurance, Canada, A-Wiley/Hamilton 1978, Page 31 .

II - Identifying the Risk Exposures:

Obviously, before anything can be done about the risks an organization faces, someone must be aware of them. In one way or another, the risk manager must dig into the operations of the Company and discover the risks to which the firm is exposed. It is difficult to generalize about the risks that a given organization is likely to face, because differences in operations and conditions give rise to differing risks. Some risks are relatively obvious, while there are many which can be and often are, overlooked. To reduce the possibility of overlooking important risks facing the firm, most risk managers use some systematic approach to the problem of risk identification. A few of their more important tools include insurance policy checklists, risk analysis questionnaires, flow process charts, analysis of financial statements, and inspections of the firm's operations:

- a) - Insurance policy checklists: Insurance policy checklists are available from insurance Companies and from publishers specializing in insurance related publications. Typically, such lists include a catalogue of the various policies or types of insurance that a given business might need. The risk manager simply consults such a list picking out those policies applicable to the firm. A principle defect of this approach is that it concentrates on insurable risks only, ignoring the uninsurable pure risks.

- b) - Risk Analysis Questionnaires: Risk analysis questionnaires, sometimes called "fact finders" are designed to lead the risk manager to the discovery of risks through a series of detailed and penetrating questions. In some instances, these questionnaires are designed to identify both insurable and uninsurable risks. Unfortunately, because such questionnaires are usually intended for a wide range of businesses, they cannot include unusual exposures or identify loss areas that may be unique to a given firm.
- c) - Flow Process Charts: In certain instances, analysis of a flow chart of the firm's operations may alert the risk manager to singular aspects of the firm's operations that give rise to special risks. Probably the most positive benefit of using flow charts is that they force the risk manager to become familiar with the technical aspects of the firm's operations, thereby increasing the likelihood of recognizing special exposures.
- d) - Analysis of Financial Statements: Analysis of the firm's financial statement can also aid in the process of risk identification. The asset listing in the balance sheet

may alert the risk manager to the existence of assets that might otherwise be overlooked. The income and expense classification in the income statement may likewise indicate areas of operation of which the risk manager was unaware.

- e) - Inspections : Just as one picture is worth a thousand words, one inspection tour may be worth a thousand checklists. An examination of the firm's various operation sites and discussions with managers and workers will often uncover risks that might otherwise have gone undetected.

The preferred approach to risk identification is a combination approach, in which all of the tools listed above are brought to bear on the problem. In a sense, each of these tools can provide a part to the puzzle, and together they can be of considerable assistance to the risk manager. But no individual method or combination of methods can replace the diligence and imagination of the risk manager in discovering the risks to which the firm is exposed. Because risks may lurk in many sources, the risk manager needs a wide-reaching information system, designed to provide a continual flow of information about changes in operations, the acquisition of new assets, new construction and changing relationships with outside entities.

III- Evaluation of Risks:

Once the risks have been identified, the risk manager must evaluate them. This means measuring the potential size of the loss and the probability that it is likely to occur. The evaluation requires some ranking of priorities. Certain Risks, because of the severity of the possible loss they would entail, will demand attention prior to others, and in most instances there will be a number of exposures that are equally demanding. Any exposure with the potential for a loss that would represent a financial catastrophe ranks in the same category as any other exposure equally dangerous, and there is no distinction among risks in this class. It makes little difference if bankruptcy results from a liability loss, a flood or an uninsured fire loss. The net effect is the same. Therefore, rather than ranking exposures in some order of importance such as 1,2,3 it is more appropriate to group them into general classifications such as critical, important, unimportant. One set of criteria that may be used in establishing such a priority ranking focuses on the financial impact that the loss would have on the firm, for example :

- . Critical risks include all exposures in which the possible losses are of a magnitude that would result in bankruptcy.
- . Important risks include those exposures in which the possible losses would not lead to bankruptcy, but would require the firm to borrow in order to continue operations.

. Unimportant risks include those exposures in which the possible losses could be met out of the existing assets or current income of the firm without imposing undue financial strain.

To assign individual exposures to one of these three categories, one must determine the amount of financial loss that might result from a given exposure, and also the ability of the firm to absorb such losses. Determining the ability to withstand the losses calls for measuring the level of uninsured loss that could be borne without resorting to credit, and deciding on the firm's maximum credit capacity.

IV) - Consideration of Alternatives and Selection of the Risk Treatment Device:

Once the risks have been identified and evaluated, the next step is the consideration of the techniques that should be used to deal with each one. These were discussed earlier in this paper they include risk avoidance, retention, sharing transfer, and reduction. In practical application, the risk manager focuses on four of these : Avoidance, Reduction, Retention, and Transfer.

The form that each of these devices may arise can vary considerably. Retention, for example, may be accompanied by specific allocations in the budget to meet uninsured losses and may also be

supported by the accumulation of a fund. On the other hand, it may include neither of these. Transfer may be accomplished through contractual arrangements such as surety bonds, by subcontracting, or through insurance. Risk reduction efforts may be classified in many ways. One common method is to distinguish between those efforts aimed at preventing losses and those aimed at minimizing the severity of loss if it should occur; these are called, respectively, "loss prevention" and "loss control".

This phase of the risk management process is primarily a problem in decision making; more precisely, it is deciding which of the techniques available should be used in dealing with each risk. The extent to which the risk-management personnel must make these decisions on their own varies from organization to organization. Sometimes the organization's risk-management policy establishes the criteria to be applied in the choice of techniques, outlining the rules within which the risk manager may operate. If the risk-management policy is rigid and detailed, there is less latitude in the decision making done by the risk manager. He or she becomes an administration of the program rather than a policy maker. In other instances, where there is no formal policy or where the policy has been loosely drawn to permit the risk manager a wide range

of discretion, the position carries much greater responsibility.

In deciding which of the techniques available should be used to deal with a given risk, the risk manager considers the size of the potential loss; its probability, and the resources that would be available to meet the loss if it should occur. The benefits and costs in each approach are evaluated and then, on the basis of the best information available and under the guidance of the corporate risk-management policy, the decision is made.

V) - Implementing the Decision:

The decision is made to retain a risk, this may be accomplished with or without a reserve and with or without a fund. If the plan is to include the accumulation of a fund, proper administrative procedure must be set up to deal with a particular risk, the proper loss prevention program must be designed and implemented the decision to transfer the risk through insurance must be followed by the selection of an insurer (insurance company) negotiation, and placement of the insurance.

VI) - Evaluation and Review:

Evaluation and review are essential to a program for two reasons. First, the risk management process does not take place in a vacuum. Things change; new risks arise and old ones disappear. The techniques that were appropriate last year may not be the most advisable this year.

Second, mistakes sometimes occur. Evaluation and review of the

risk-management program permits the manager to review decisions and discover mistakes, it is hoped, before they become costly.

Although the evaluation and review of the risk-management operation should be continuing functions of the risk manager, some firms also hire independent consultants periodically to review their program. The risk-management consultant is an independent adviser who offers this service for a fee. Such experts may be hired to evaluate the entire risk-management program, or particular segments of it. They are employed by business firms that are unable or unwilling to create the position of risk manager within their organization, but they are also retained by many companies, who have a risk manager, but consider an outside review to be desirable.

Rules of Risk Management:⁶

One of the earliest contributions to this field was the development of a set of "rules of risk management". These guidelines for risk management decision making are quite simply common sense principles applies to the pure risk situation, three basis rules of risk management are proposed:

- a) - Don't risk more than you can afford to lose.
- b) - Consider the odds.
- c) - Don't risk a lot for a little.

⁶ - Emmett Vaughan and Curtis Elliot, Fundamentals of Risk and Insurance, Canada, A-Wiley/Hamilton 1978, Page 35 .

These three rules, simple as they are, provide a basic frame-work within which risk-management decisions can be made.

- a) - Don't risk more than you can afford to lose : the first and the most important of the three rules, although it doesn't tell us what ought to be done about a given risk, it does tell us which risks something must be done about. If we begin with the recognition that when nothing is done about a risk, the individual or firm retains the possibility of losses arising out of that exposure, determining which risks something must be done about boils down to determining which ones cannot be retained. The answer to this question is explicitly stated in this first rule, don't risk more than you can afford to lose.

The most important factor in determining which risks about which something needs to be done is the maximum potential loss that might result from the risk. Some losses can be financially devastating,

literally wiping out the assets of an individual or firm, while others involve only minor financial consequences. If the maximum potential loss from a given exposure is so large that it could result in bankruptcy, retention is not realistic, and either the possible severity must be reduced to a manageable level or the risk must be transferred .

The question of the size of a risk that can safely be retained is a complicated and technical one. The level of retention for specific areas of exposure is directly related to an enterprise's total loss-bearing capacity, and this in turn depends on the organization's net worth cash flow, liquid reserves, and the availability of outside funds in the event of emergency.

b) - Consider the Odds:

If the risk manager can determine the probability that a loss may take place, he or she is in a better position to deal with the risk than would be the case without such information, but it is possible to attach undue significance to such probabilities. The probability of a loss occurring is less important to the risk manager than the financial consequence if it does happen. Even if the risk manager knows that the probability of loss from a given

exposure is remote, the decision must still be based on its possible severity. If the risk carries a possible catastrophic loss, the fact that the probability is small is of little significance.

This is not to say that the probability of a given exposure is not a consideration in determining what should be done about it. To the contrary, just as the potential severity of loss indicates which risks something should be done about, knowing whether the probability that a loss may occur is slight, moderate, or almost certain can assist the risk manager in deciding what should be done about a given risk. A high or low probability of loss provides a useful indication of which tool is most appropriate for dealing with a given risk, although not in the way that most people think.

A high probability should be taken as a sign that insurance is probably not an economical way of dealing with the risk. If we keep in mind the fact that insurance operates on the principle of averages, we can see why this is so. On the basis of past experience, the insurance company estimates the amount that it must collect to cover the losses that will occur. In addition to covering the losses, it must recover the costs of operating the company. Therefore, paradoxical though it may seem, the best buys in insurance cover those losses that are least

likely to happen. The higher the probability of loss, the less appropriate is insurance as a device for dealing with risk.

To illustrate this point, let us take the extreme case of a man condemned to die in the electric chair. If an insurance company were to agree to sell him a L.L. 100,000.- life insurance policy, it would have to charge something more than the L.L. 100,000.-. In addition to the amount of the claim (which is relatively certain), the Company must add the cost of administration, making the cost of the policy more than the amount to be paid out in the claim. The purchase of insurance under these terms would be absurd. Yet for the insurance buying public as a whole, the cost of insurance is always greater than the amount paid out in claims. The higher the probability of loss, the closer the insurance comes to the point where the loss is a certainty, and the more expensive the insurance becomes relative to the expected value of the loss. In those instances where the probability of loss is very high, insurance buyers simply trade pounds with the insurance companies, paying premiums to collect those losses that are certain to happen. The best buys in insurance are those in which the probability of loss is low and the potential severity is high. The worst buys are those where the size of the potential loss is low and its probability high, yet this seems to be precisely the type of insurance coverage that most people seek.

c) - Don't Risk a Lot for a Little:

The first rule provides guidance regarding risks that would always be transferred (those bringing catastrophic losses whose potential severity can't be reduced). The second governs those that should not be transferred (those in which the probability of loss is very high). But they leave a residual class in which some other form of direction is needed. There are many instances where the potential loss might not result in bankruptcy, but for which transfer might still be desirable. The rule "don't risk a lot for a little" provides guidance for these residual classes.

In essence, the third rule dictates that there should be a reasonable relationship between the cost of transferring a risk and the value that accrues to the transfer or. It provides guidance in two directions. First, risks should not be retained when their possible loss is large (a lot) relative to the premiums saved through retention (a little). On the other hand, there are many instances in which the premium is disproportionately high relative to the risk transferred. In this latter case, the premium represents "a lot" while the possible loss is "a little".

While the rule "don't risk more than you can afford to lose" imposes a maximum level on retentions, the rule "Don't risk a lot for a little" recommends that some risks involving losses below this maximum retention level should also be transferred. This means that while the maximum retention level should be the same for all risks, the actual retention level for some exposures might be less than this maximum. As a matter of fact, since there are differences in the rating structures for different types of insurance, it is probably advisable to determine the actual level of retention for each risk individually on the cost-benefit basis implied in the third rule.

RISK CHARACTERISTICS AS DETERMINANTS OF THE TOOL:

From the foregoing discussion, it is clear that there are some risks that should be transferred, and some that should be retained. It is clear that in other cases neither transfer nor retention is satisfactory; In these avoidance or reduction is necessary. Much of what has been written in the field of risk management and insurance buying tends to obscure the fact that there are only four basic approaches to dealing with pure risks:

avoidance, reduction, retention, and transfer—and that it is the characteristic of the risk itself that determines which of these is most appropriate in a given situation. Each of the tools should be used when it is the most appropriate and least expensive means of achieving the financial security that the individual or firm facing the loss desires. Under what circumstances, then, is each of the tools appropriate?

From the foregoing discussion, it is possible at this point to summarize a few general guidelines about the relationship of the various tools and particular risks. The matrix in the figure 2.1 categorizes risks into four classes, based on the combination of frequency (probability) and severity of each risk.

	HIGH SEVERITY	LOW SEVERITY
HIGH SEVERITY		
LOW SEVERITY		

Fig. 2.1.

Although real world risks are not divided so conveniently, the model nevertheless provides a useful technique for analysis, and it is possible to derive some general conclusions by considering the various combinations of severity and frequency illustrated in the chart.

As we have seen, when the severity of loss is high, retention is not realistic and some other technique is necessary. However, we have also seen that when the probability of loss is high, insurance becomes too costly. Through a process of elimination, we conclude that the most appropriate tools for dealing with those risks marked by high severity and high frequency are avoidance and reduction. Reduction may be used when it is possible to lower the potential severity or the probability to a manageable level; otherwise the risk should be avoided.

Those risks characterized by high frequency and low severity are most appropriately dealt with through retention and reduction; retention because the high frequency implies that transfer will be costly, and reduction to minimize the aggregate amount of losses that must be borne.

Those risks with high severity and low probability are most appropriately dealt with through insurance, the high severity implies a catastrophic impact if the loss should occur, and the low probability implies a low expected value and hence a low cost of transfer.

Finally, those risks characterized by low severity and low frequency are best dealt with through retention. They seldom occur, and when they do, their financial impact is inconsequential.

Although not all risks will fit precisely into the categories in the chart, many will. In those instances in which the probability or the severity is not clearly high or low, the principles must be modified to meet the particular situation.

THE NON-PROFESSIONAL RISK MANAGER:

In giant corporations, the risk manager can devote full attention to the problems of pure risk. In smaller firms, this executive probably has other duties as well. In the smallest firm, the risk manager may very well be the person who manages everything. This person's job as risk manager is an extremely heavy burden, for it demands the utmost precision if loss is to be avoided. Decisions must be made as to what kind of insurance is to be purchased, how much and from whom. If the insurance coverage is inadequate and a loss occurs, the firm will suffer a financial loss. If on the other hand the business is overinsured, the loss in wasted premiums is just as real.

Certainly, the non professional risk manager needs all the help he can get. Such an administrator may seek and obtain advice from many sources to assist in making decisions, but in the last analysis

the decision remains that one person's burden. Unfortunately, the risk managers who must depend on the services of others can't always be certain that their advisers are genuinely interested in advising (as distinguished from selling). For this reason, the non professional risk manager should understand and appreciate the principles of risk management. He must know enough about the problem to recognize whether his advisers are of any good. He must know enough about risk management and insurance to know when help is needed and must then be able to determine if he is getting the right kind.

C) - THE INSURANCE DEVICE AS MEANS OF COVERAGE

As have been discussed earlier, there are a number of ways of dealing with risk. This paper is concerned primarily with the most formal of these various approaches being insurance. An examination of the insurance device, focusing on its nature and the manner in which it deals with risk will be discussed now.

Insurance is a means whereby groups of people, facing similar risks, can club together for protection against certain financial losses. Each individual transfers his risk to the club or fund, in return for a fee or premium. The unfortunate few who suffer losses claim compensation from the fund. Insurance is a complicated and intricate mechanism, and it is consequently difficult to define. However in its simplest aspect, it has two fundamental characteristics :⁷

- a)- Transferring or shifting risk from one individual to a group.
- b)- Sharing losses, on some equitable basis, by all members of the group.

a)- RISK TRANSFER:

Insurance is a risk transfer mechanism, whereby the individual or the business enterprise can shift some of the uncertainty of life on to the shoulders of others. In return for a known premium, usually a very small amount compared with the potential loss, the cost of that

⁷ - Emmett Vaughan and Cutis Elliot, Fundamentals of Risk and Insurance, Canada, A-Wiley/Hamilton 1978, Page 13

loss can be transferred to an insurer. Without insurance, there would be a great deal of uncertainty experienced by an individual or an enterprise, not only as to whether a loss would occur, but also as to what size it would be if it did occur:

For example, a houseowner will realize that each year several hundred houses are damaged by fire. His uncertainty is whether in the coming year his house will be one of those damaged, and he is also uncertain, whether, given that he will be one of the unlucky ones, his loss will amount to a hundred pounds or so for the redecoration of his kitchen or whether the house will be gutted and cost him many thousands of pounds to repair. Even though, the probability of their house becoming one of the loss statistics is extremely low, most houseowners nevertheless elect to spend, say L.L. 500.- 600.- on house insurance, rather than face the extremely remote possibility of losing a house worth L.L. 200.000.-

b)- LOSSES SHARING (THE COMMON POOL):

in the early days of marine insurance (being the first kind of insurance to be applied), the merchants agreed to make contributions to the suffering loss after the loss had taken place. This practice did not fully transfer the cost of uncertainty, it merely reduced it. A merchant undertaking a voyage would have the risk of a total loss removed from him, but the exact amount of his share of a loss could not be determined until after the event had taken place.

This state of affairs is not ideal and modern insurance practice fixes the insured's contribution (premium) at the contract, so that he knows the full extent of his required share of losses for that year. It may, of course vary in the light of the claims costs for future years.

The insured's premium is received by the insurer into a fund or pool for that type of risk, and the claims of those suffering losses are paid out of this pool. An insurance company will pay its motor claims out of the monies it has received from those insuring motor cars and so on.

Because of the large number of clients in any particular fund or pool, the insurance company can predict with reasonable accuracy the amount of claims likely to be incurred in the coming year. There will be some variation in claims costs from year to year and the premiums include a small margin to build up a reserve upon which the company can draw in bad years. Therefore, subject to the limitations of the type of cover bought, the insured will not be required to make further contributions to the common pool after the loss. Moreover these contributions paid into the fund should be fair to all the parties participating i.e. on equitable basis. The underwriter (the person accepting the proposal on behalf of the pool or the insurer) will evaluate the degree of risk each individual is transferring to the pool and upon

this degree of risk a fair premium is charged from this individual.

To summarize, the primary function of insurance is to provide a risk transfer mechanism by means of a common pool into which each policy holder pays a fair and equitable premium, according to the risk of loss he or she brings to the pool.

Insurance Defined From the View Point of the Individual:

On the basis of the functions described above, insurance can be defined from the individual's view point as follows :

"Insurance is an economic device whereby the individual substitutes a small certain cost (the premium) for a large uncertain financial loss (the contingency insured against) which would exist if it were not for the insurance".

The primary function of insurance is the creation of the counterpart of risk, which is security. Insurance does not decrease the uncertainty for the individual as to whether or not the event will occur, nor does it alter the probability of occurrence, but it does reduce the probability of financial loss connected with the event. From the individual's point of view, the purchase of an adequate amount of insurance on a house eliminates the uncertainty regarding a financial loss in the event that the house should burn down,

Many persons consider an insurance contract to be a waste of money unless a loss occurs and indemnity is received. Some even feel that if they have not had a loss during the policy term, their premium should be returned. Both view points constitute the essence of ignorance. Relative to the first it is already known that the insurance contract provides a valuable feature in the freedom from the burden of uncertainty. Even if a loss is not sustained during the policy term, the insured had received something for the premium, the promise of indemnification if a loss had occurred. With respect to the second, one must appreciate the fact that the operation of the insurance principle is based upon the contributions of the many paying the losses of the unfortunate few. If the premiums were returned to the many who did not have losses, there would be no funds available to pay for the losses of the few who did. Basically, then, the insurance device is a method of loss distribution. What would be a devastating loss to an individual is spread in an equitable manner to all members of the group, and it is on this basis that insurance can exist.

Insurance Defined from the View Point of Society:

In addition to eliminating risk for the individual through transfer, the insurance device reduces the aggregate amount of risk in the economy by substituting certain costs for uncertain losses. From a

social point of view, insurance is an economic device for reducing and eliminating risk through the process of combining a sufficient number of homogeneous exposures into a group in order to make the losses predictable for the group as a whole. Insurance does not prevent losses, nor does it reduce the cost of losses to the economy as a whole. As a matter of fact, it may very well have the opposite effect for the economy as a whole. The existence of insurance encourages some losses for the purpose of defrauding the insurer, and, in addition, people are less careful and may exert less effort to prevent losses than they might if it were not for the existence of insurance contracts.

The Economic Contribution of Insurance:

Property that is destroyed by an insured contingency is not replaced through the existence of an insurance contract. True, the funds from the insurance company may be used to replace the property, but when a house or building burns, society has lost a want-satisfying good. Insurance as an economic device finds its justification in the certainty about the financial burden of losses it creates and in its functional burden of losses it creates and in its function of spreading the losses that occur. In providing a mechanism through which losses can be shared and uncertainty reduced, insurance brings peace of mind to society's members and makes costs more certain.

Insurance also provides for a more optimal utilization of capital. Without the possibility of insurance individuals and businesses would be obligated to maintain relatively large reserve funds to meet the risks that they may assume (self insurance). These funds would be in the form of idle cash, or would be invested in safe, liquid, and low-interest-bearing securities. This would be an inefficient use of capital. When the risk is transferred to the professional risk bearer, the deviations from expected results are minimized. As a consequence, insurers are obligated to keep much smaller reserves than would be the case if insurance did not exist. The released funds are then available for investment in more productive pursuits, resulting in a much greater productivity of capital.

Insurance and Gambling:

It is often claimed that insurance is a form of gambling. "you bet that you will die and the insurance company bets you won't" or "I bet the insurance company L.L. 400 against L.L. 100 000.- that my house will burn". The fallacy of these statements should be obvious. In the case of a wager, no chance of loss, and hence no risk, exists previous to the wager. In the case of insurance the chance of loss exists whether or not there is an insurance.

contract in effect. In other words, the basic distinction between insurance and gambling is that gambling creates a risk, while insurance provides for the transfer of existent risk.

Elements of an Insurable Risk:

While it is theoretically possible to insure all possibilities of loss, some are not insurable at a reasonable price. For practical reasons, insurers are not willing to accept all the risks that others may wish to transfer to them. To be considered a proper subject for insurance, there are certain characteristics that should be present. The eight prerequisites listed below represent the ideal elements of an insurable risk. Although it is desirable that the risk have these characteristics, it is possible for certain risks that do not have them to be insured:

1) - Financial Value:

The risk must involve a loss that is capable of financial measurement. We have touched on this before and it is important to remember that insurance is concerned only with situations where monetary compensation is given following a loss. This feature of the insurable risk is easily identified, for example, damage to property where the level of compensation can be equated with the cost of repairs.

Where property is stolen it is similarly easy to measure the loss in financial terms. Where someone is injured by you in a motor car accident, then the court will decide how much the injured person should receive in compensation. This amount is then a financial measure of your risk.

In the vast majority of cases the financial value of the risk will not be known before the event occurs but all we are concerned with is that when it does take place the loss is capable of financial measurement. In life assurance it is rather more difficult to say that the financial loss suffered by a wife when her husband dies is a specific sum of money. What we can say is that the level of compensation to be paid in the event of death has been determined prior to taking out the policy.

2) - Homogeneous Exposures:

There must be a large number of similar, homogeneous, risks before any one of that number is capable of being insured. There are two reasons for this. The first is that the measurement of risk by probabilities and statistics relies on there being a reasonable experience of past events. Statistics have been compiled by most insurance companies on common risks such as fires, explosions, motor accidents, thefts, injuries and deaths.

The second is that if there were only three or four exposures then each one would have to contribute a very high amount if losses were to be met from these contributions. On the other hand if there were thousands of similar exposures then the contributions could be comparatively small as only a few would be unfortunate enough to suffer a loss and hence require it to be met from the contributions. The insurance of household contents against fire is an example of homogeneous exposures, whereas the insuring of a concert pianist's fingers is not

3)- Pure risk only:

Insurance is concerned only with pure risks; speculative risks, where there is the possibility of some gain, cannot be insured. This is generally the case although certain modern developments may lead us to alter this statement in due course. Speculative risks are normally taken in the hope of a gain and the provisions of insurance may act as a distinct disincentive to effort in that even if you do not try as hard as you could to bring about the gain you will earn the profit from your insurance policy. This is obviously not acceptable but in addition the speculative risk can often be unacceptable for other reasons such as lack of statistical experience or high probability of a loss on the part of the insurer. It is important to note that we are not concluding that all pure risks are insurable; what we are saying is that speculative risks, on the whole are not, or in other words all insurable risks are pure risks.

4) - Particular and Fundamental :

Particular risks are generally insurable provided they satisfy the other criteria of insurable risks. Fundamental risks however do not present such a straightforward picture. The widespread, indiscriminate nature of the effect of most fundamental risks has resulted in them (fundamental risks) being uninsurable. It is not accurate to say that all fundamental risks cannot be insured but it is true to say that insurers are very careful in selecting those for which they wish to provide cover.

Fundamental risks that arise out of the nature of the society we live in are largely uninsurable and those that arise due to some physical occurrence depend for their insurability on the circumstances. As a result war and changing customs are largely uninsurable. Fundamental risks due to some physical occurrence such as climatic or tidal conditions (natural hazards) may be insurable but this could depend on the geographical location of the object being insured.

5) - Fortuitous :

The loss must be entirely fortuitous as far as the person seeking insurance is concerned. It is not possible to insure against an event that will occur with certainty as in such

case there will be no risk involved, no uncertainty of loss. The frequency and severity of any risk must be completely beyond the control of the person insuring.

In the case of most risks this will always be apparent but in life assurance some could argue that there is no uncertainty about death, it is one of the few certainties we have. Life assurance is however still involved with fortuitous events as it is the timing of death that is beyond the control of the person effecting policy. This is not true in the case of suicide and most policies will cover death from suicide as long as it occurs a reasonable time after the policy was taken out i.e. suicide was not being planned, at least not in the short term, when the policy was effected.

6) - Insurable Interest:

The risk that is to be insured must result in some form of financial loss, and it is easy to anticipate situations where a person could insure another person's house or car so that when the house or car was damaged he, in addition to the owner of the property, would receive compensation from the insurance company. To take this a stage further, there would be no reason why a person could not go round to the local hospital and take out a life assurance policy on the lives of those people who were very ill.

To counteract this possibility one of the basic doctrine of insurance is that the person insuring must be the one who stands to suffer some financial loss if the risk materializes.

7) - Against Public Policy:

It is a common principle not be contrary to what society considers the right and moral thing to do. This applies to insurance contracts in the same way and one form of risk that is not insurable is one that is against public policy. It would not be acceptable to society at large if a person could burn down his own factory or shop in order to recover insurance money and this form of risk has been catered for above when we said that the loss must be fortuitous as far as the person insuring is concerned.

One form of risk that was not mentioned earlier was the risk of being fined by the police. The fine is intended to penalize the person and while insurance may be available to meet the losses following a motor accident, it is not possible to provide insurance to pay the fine of the driver who was found guilty of some offence.

8) - Reasonable Premium:

The final feature of the insurable risk is that the premium must be seen to be reasonable in relation to the likely financial loss. A risk that results in a loss with an extremely high frequency may involve a premium that would be unreasonable from the insuring person's point of view. Similarly a straightforward risk such as that caused by fire or theft may result in an unreasonable premium, depending upon the object exposed. The insurance premium required to cover a ball point pen against fire or theft may be quite unreasonable in relation to the potential financial loss in view of the insurance company's costs.

The existence of the above eight characteristics should be looked for in any risk against which insurance is sought. The criteria outlined above place some limit on the range of risks which can be insured but this should not be over-emphasised. The whole network of insurance which we now go on to examine has grown and developed in the face of these limitations. Those common features protect insurance companies and it may be that adherence to them has played a large part in building a strong insurance market place.

D) - BUYING INSURANCE

Although insurance is only one of the techniques available for dealing with the pure risks that the individual or the firm faces, many of the risk management decisions boil down to a choice between insurance and noninsurance. Although the basic principles of risk management have already been discussed, it may also be useful to examine the application of a few of these principles to the area of insurance buying.

Common Errors in Buying Insurance:

In general, the mistakes that most people make when buying insurance fall into two categories: buying too little and buying too much. The first, which is potentially the more costly, consists of the failure to purchase essential coverages that can leave the individual vulnerable to unbearable financial loss. Unless the insurance program is designed to protect against the catastrophes to which the individual is exposed, an entire life's work can be lost in a single uninsured loss. On the other hand, it is possible to purchase too much insurance, buying protection against losses that could more economically be retained. The difficulty in buying the right amount of insurance is compounded by the fact that it is possible to make both mistakes at the same time. As a matter of fact, although most people spend enough to provide an adequate insurance

program, too often ignore critical risks, leaving gaping holes in the overall pattern of protection, while unimportant risks are insured, using valuable premium that would be more effectively spent elsewhere.

Some insurance buyers turn the entire decision making process over to an outside party such as an insurance agent or broker. In a sense, they delegate the responsibility for both policy decisions and administration to this outside party. While such a course of action may relieve the insurance buyer of the decision burden; it may not result in an optimal program. When the choices involved in the purchase of insurance are delegated to an outside party, there is often a tendency to insure exposures that might better be retained. An insurance agent does not enjoy being in a defensive position when a loss takes place, and when charged with the overall responsibility for the insurance decisions, may decide to protect himself as the client by opting for more rather than less insurance. While a competent agent or broker is a valuable source of advice, the basic rules governing the decisions should be made by the person or persons most directly involved, since these decisions are likely to have large financial impact over the long run, either in premiums paid or losses sustained if hazards are not insured.

The Need for a Plan:

The basic problem facing any insurance buyer is that of using the available premium pounds to the best possible advantage. To obtain maximum benefit from the pounds spent, some sort of plan is needed. Otherwise, there is a tendency to view the purchase of insurance as a series of individual, isolated decisions, rather than a single problem, and there are no guidelines to provide for a logical consistency in dealing with the various risks faced.

A priority ranking for insurance expenditures: Such a plan can be formulated to set priorities for the allocation of premium pounds on the basis of the previously discussed classification of risks into critical, important, and unimportant, with insurance coverages designed to protect against these risks classified as essential, desirable, and optional.

- . ESSENTIAL Insurance coverage include those designed to protect against loss exposures that could result in bankruptcy. Insurance coverage required by law is also essential.
- . IMPORTANT Insurance coverages include those which protect against loss exposures that would force the insured to borrow or resort to credit.
- . OPTIONAL Insurance coverages include those which protect against losses that could be met out of existing assets or current income.

The large loss principle-essential coverages first: the premium emphasis on essential coverages follows the first rule of risk management and the axiom that the probability that a loss may or may not occur is less important than possible size. Since the individual must of necessity assure some risks and transfer others, it seems only rational to begin by transferring those that he could not afford to bear. One frequently hears the complaint, "the trouble" with insurance is that those who need it most can least afford it". There is considerable truth in this statement. The need for insurance is dictated by the inability to withstand the loss in question if the insurance is not purchased, so while it is true that those who need insurance are those who can least afford it, it is also true that they are the ones who can least afford to be without it. In determining whether or not to purchase insurance in a particular situation, the important question is not can I afford? but rather can I afford to be without it?

When the available pounds can't provide all of the essential and important coverages you want to carry, the question becomes where to cut. One approach is to assure a part of the loss in connection with these coverages. You can do this by adding higher deductibles to these coverages, thereby freeing some pounds for others that you desire. In many lines of insurance, full coverage is uneconomical because of the high cost of protecting against small losses. If you exclude coverage for these losses through deductibles, the premium credits granted may permit you to purchase others that are desirable.

Insurance as a last resort - optional coverages: As we have seen, insurance always costs more than the expected value of the loss (in cases of certainty). This is because in addition to the expected value of the loss (the pure premium), the cost of operating the insurance mechanism must also be borne by the policy holders. For this reason, insurance should be considered a last resort, to be used only when absolutely necessary.

It is in connection with this latter aspect of insurance that many people fail to appreciate the appropriate function of the mechanism. The insurance principle should not be utilized to indemnify for small relatively certain losses. These can more desirably be carried as a part of the cost of product on in a business or as one small cost to an individual of maintaining himself and his family. Why should one want to collect from an insurance company for the two or three shingles blown off the roof during a windstorm? Why should the normal family want full coverage for maternity benefits in a hospitalization policy? In many instances, these small, relatively certain losses can be eliminated from the insurance operation by specifically excluding them or by using a deductible. Insurance companies, in providing indemnity for such small losses in their contracts, are as guilty of the misuse of the insurance principle as are the insureds who buy them.

There is nothing intrinsically wrong with optional coverages. They are just not a very good way to spend the limited amount of money available for the purchase of insurance. If the individual's psychological makeup is such that he desires protection against even the smallest type of loss, optional coverages are probably all right. The real problem with such coverages is that the individual who insures against small losses often does so at the expense of exposures that involve losses that would be financially catastrophic. While an individual or business firm might desire some optional coverages, they should be purchased only after all important ones have been. Of course, all essential coverages should be bought before premiums are spent on the less important critical coverages. In this way, the money will be spent where they are most effective, protecting first against those losses that could result in bankruptcy, next against those that would require resort to credit; and finally, when all other exposures have been covered, against those losses that could be met out of existing assets or current income.

Selecting the Agent and the Company:

While the selection of an insurance company is an important aspect of the insurance buying process, in most cases the individual is probably well advised to focus primary attention on selecting the agent rather than the company, when an insurance policy is purchased, a part of the premium goes to the insurance company to pay for the protection. A second part is compensation to the agent for the service he provides to the

insured. The most important part of this service consists of the advice the agent gives. Careful selection of the adviser is a fundamental part of insurance buying. From the point of view of the insured, the primary qualifications for a good agent are knowledge of the insurance field and an interest in the needs of the client.

The insured may receive assistance from the agent in selecting an insurer if the agent represents several companies. However, in the case of most life insurance agents and certain property and liability agents who represent only one company, the selection of the agent will automatically include the selection of the company. **In choosing a Company, the major consideration should be its financial stability.** In addition, certain aspects of the company's operation, such as its attitude toward claims and cancellation of policy holders' protection, are important. Finally cost is a consideration.

In view of the importance of the financial stability of the insurer in the selection process, a few comments relative to the determination of financial stability are in order. Actually, analysis of an insurance company's financial strength follows the same principles used in the financial analysis of any corporation. However, industry accounting practices require certain modifications, making the evaluation of an insurer's financial stability a somewhat more complicated procedure. For this reason

it is probably advisable to consult an evaluation service rather than to attempt the analysis alone.

Policies :

A policy of insurance is a printed and typewritten document which is evidence of a contract between the person transferring the risk (the insured) and the organisation accepting that transfer (the insurer). The information which the policy contains relates to the identity of the parties to the contract, the period of operation of the contract, the details of the risks which have been transferred and the cost or premium required for that transfer.

All contracts have conditions applying to them and insurance contracts have terms and conditions relating to changes in risk, claims procedures, disclosure of facts, and claims disputes, among others, which relate to particular types of risk. The policy will also define the level of compensation which either agreed when the contract is arranged, as in life and personal accident policies, or is a direct measure of the insured's loss, subject to the terms and conditions as in property and liability policies.

A Note On Insurance Prices:

There is hardly an insurance policy in the world that some company cannot make a little broader for a higher premium, nor is there a policy that cannot be sold more cheaply by reducing the coverage. This is not to imply that all insurance that is less expensive is poor, or that the most expensive policies are the best.

It is simply a reminder that insurance prices are based on the law of large numbers and that the broadness or narrowness of the coverage will affect the amount of losses and, hence the premium. Any increase in the amount the insurance company must pay for losses will be reflected in higher premiums.

Also, insurance companies vary in their degree of efficiency, and exhibit a considerable spread in prices based on differing expense factors. In some instances the lower expense factor is a result of a smaller commission paid to the agent or the lack of certain services. The cost reduction in such cases must be measured against the lack of service. The most important part of this service consists of the advice the agent provides. In considering the price differences in the insurance market, proper consideration should be given to the need for advice and to whether it is provided.

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CHAPTER 3

CONCLUSION, RECOMMENDATIONS, AND SUMMARY

Conclusion

It would be extremely difficult to learn about diseases without looking at the patient. In the same way, it would be impossible to understand insurance without looking at risk. Risk is at the very center of insurance and before moving to examine the latter in some detail, it has been essential to understand fully the concept of risk. It is not possible to be dogmatic and state a definition of risk that is authoritative in the sense that it will find universal acceptance. It has been possible, however, to provide a definition that will satisfy our requirement. We have looked upon risk as the possibility of loss and in particular of financial loss that can be prevented from taking place by the use of different insurance devices.

Before dealing with the risk, distinction between the different types of risk should be clear, there are static and dynamic risks, fundamental and particular risks, as well as, pure and speculative risks. This classification will enable the business enterprise, exposed to any specific risk, to know the proper and adequate way to handle this risk. Risk may be avoided, retained, transferred, shared or reduced. One of these five possibilities should be in some way adequate to the company and thus can be applied.

Summary

Whatever the appropriate way of handling pure risk may be, it can best be reached through applying proper risk management process. The risk management process and the steps to be followed that have been discussed are normally carried out in large and some medium sized companies by a risk or insurance manager and his small team. The individual in his personal and domestic risk situation, or the small trader with his business interests, can follow similar techniques.

Flow charts, inventories, checklists and so on can be used to identify risks, and professional advice sought on the best physical and financial tools to be used to handle them. It is important that a conscious effort is made to study and control the risks which face business daily. Large scale retention of risk is unlikely to be financially acceptable but much can be done to arrange a more satisfactory insurance program that would be the case without adopting such techniques. The techniques used can be summarized under the following three main headings, even though they have been applied in the research in six steps. :

- a) - Identification
- b) - Assesment or evaluation
- c) - Control - Physical and Financial.

Before deciding which of the techniques available should be used to deal with a given risk, the risk manager should consider the size of the potential loss, its probability of taking place, and the resources that would be available to meet the loss if it should occur. A cost-benefit analysis is used and with the guidance of the corporate risk-management policy, the decision is made.

The reader should remember the three rules of risk management being :

- a) - Don't risk more than you can afford to lose.
- b) - Consider the odds.
- c) - Don't risk a lot for a little.

When we talk about risk, it must be clear in our minds that it incorporated both the frequency with which an event may take place, and the severity of each incident which does occur. The degree of both the frequency and severity of any risk will help the risk manager in determining the best way of dealing with this risk, whether through reduction, retention; avoidance, or transfer by using insurance means.

Insurance deals with risk through its two fundamental characteristics, risk sharing and risk transfer. For a risk to be insurable it should have the following features common in all insurable risks.:

- a) - The risk must involve a financial loss.
- b) - The risk only be one of several similar risk.
- c) - All pure risks only are insurable, whereas some of particular and fundamental risks are insurable.
- d) - The risk must be related to fortuitous loss.
- e) - There should be an insurable interest.
- f) - Risks should not be against public policy.
- g) - There should be a reasonable premium for insuring such risks.

Following the proper risk management steps discussed in the research, the business enterprise will avoid committing the common mistakes that most people fall into when buying insurance, mainly buying too little or buying too much. The insurance agent or broker, even through has some advantages in being relied upon, has a defect in that there is often a tendency to insure exposures that might better be retained. The basis problem facing an insurance buyer is the proper allocation of the amount of money, being the insurance budget, to the best possible advantage companies should rank risks, being

exposed to according to priorities, whether insurance coverage is essential for protection, important, or just optional.

Recommendation

In order to make use of this research, the reader should take the following recommendations into consideration, and make sure that if such recommendations are being applied by managements of companies, such companies will be in a much better off position than those with no proper risk handling approach :

- 1) - Enough understanding of what risk is all about, and how badly can risk hurt companies in avoiding corporate goals from being achieved.
- 2) - Follow the risk management process as explained in the research which will enable the management in reaching the best way to deal with risks.
- 3) - A good understanding and belief that insurance is a device that can really be relied on and should be considered at an early stage and before any loss occur and cause any harm.

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