

## CHAPTER 2

### 2.0

#### THE MANAGEMENT OF INSURANCE RISKS

Having discussed insurance and risk earlier in this book, this chapter is aimed at the management of the risk and hence the emergence in Nigeria in 1988 a new association known as "Faculty of Risk Management" {FARIM}. Its goal is aimed at creating risk management awareness with a view to preventing losses and preserving valuable assets. FARIM's membership comprises individuals and corporate bodies from all sectors of the Nigerian economy. The job of the risk manager is to identify the pure risks to which the enterprise is exposed. He thereafter quantifies and analyses them. He now proceeds to classify the risks, bearing in mind the potential maximum loss of each and also the predictability of loss. Having done this, he (the risk manager) may now choose the tools he deems best to deal with each risk.

The risk manager may either recommend the stoppage of some hazardous processes or embark on a loss prevention measure, by not storing all of one's eggs in one basket. All the possibilities, having been exhausted, the entrepreneur may decide, as a last resort, to either bear the risk himself or transfer the risk to someone else. Insurance has proven to be, in almost all the cases, the most effective tool used for transferring of pure risks. The insured saves himself, the anxiety of probable loss when he pays a premium to

an insurance company that promises to indemnify him, if the insured event occurs.

The risk manager must take cognizance of the resources of the firm, for a heavily capitalized company may see a loss to a lowly capitalized company as inconsequential.

### 2:1

#### STEPS IN RISK HANDLING

##### 2:1:1

##### *Risk Identification*

Risk management takes the view that an organization or firm is exposed to risk in a variety of ways and that one such way may lead to a huge financial loss. Think of a large complex factory, shopping center, airport or any large risk, and where would you begin the task of risk identification?

##### 2:1:2

##### *Risk Identification Techniques*

Using a manufacturing plant as the risk, the following techniques will be used after a physical inspection may have been carried out. They are as follows:-

##### (a) **Organizational Charts**

Risks will be easily identified from the organizational structures of the plant and even the entire company.

**(b) The Flow Charts**

In a manufacturing production plant which uses raw materials from two or more sources, risks associated with the production, such as failure to meet orders, failure or break-down of plant, effects of wastes or even by-products, could be identified by the risk manager.

**(c) Check List**

The risk manager may, via a check list (i.e. asking or inquiring about the risks to which each plant is exposed), find out if the plant or even an organization is exposed to the following classes of risks namely: -

- (i) **Direct Risks:** These comprise, fire, corrosion, fraud, structural defects, e.t.c.
- (ii) **Consequential Risks:** These are made up of loss of profits, following or resulting from fire, burglary, inter-group dependency, strikes, etc
- (iii) **Social Risks:** These may be in the form of moral liability or consumer pressure.
- (iv) **Legal Risks:** Civil liabilities, statutory liabilities and contractual liabilities could be detected.
- (v) **Political Risks:** Government intervention, sanctions or acts of foreign governments are also capable of being identified, via the check list

- (vi) **Financial Risks:** Inadequate inflation forecasts and incorrect marketing decisions could also be identified.

**2.1.3**

**Risk Evaluation**

This has to do with evaluating the impact of the risk on the firm or organization. Often times this evaluation is made in a qualitative way (i.e. without the use of quantitative analysis) in which case the risk manager falls back on his experience. Keeping of records facilitates risk evaluation. Computer technology has now simplified record keeping, with provisions for updatements and recalls of information about past losses and projected losses. The risk manager, in the process of evaluation, takes cognizance of the severity and frequency of the losses to embark on control measures.

**2:1:4**

**RISK CONTROL**

The risk manager takes a look at both the physical and financial control measures.

**Physical Control of Risks**

The picture here is on environment harboring one risk or the other. The physical control of risks is carried out by prevention methods (often called Loss Reduction). Elimination or Minimization carries out this loss reduction

### Elimination of risks

A risk may be eliminated by outright disposal of the risk. The inherent risk in owning a car is that of an accident. This risk of accident could be eliminated when you decide and indeed proceed to sell the car.

Another good way of eliminating a risk is that of disposing of or selling your pet (may be a dog that often bites people). However, there is an exception and that is the non-closure of a community factory that provides jobs and other necessities for the benefit of the entire community. The fear of fire and the associated losses are not enough reasons for its closure, as a means of eliminating risk.

### Minimization of Risks/Losses

This falls into two stages namely:-

#### (a) *Pre- Loss Minimization*

This is achieved by the use of specialists like fire surveyors and plant engineers, who professionally offer preventive advice and recommendations. The wearing of seat belts in private cars is another good example of pre-loss minimization. The wearing of crash helmets by motorcyclists is yet another example. Other examples include the use of guards while working on dangerous machinery and the installation of extractor fans in paint spraying booths.

#### (b) *Post-Loss Minimization.*

Properties salvaged from burning houses (i.e. houses) could be sold to reduce losses. The employment of industrial nurses minimizes loss-related injuries for which the employers are liable. The installation of automatic sprinklers surely minimizes the losses resulting from fire outbreaks

### 2:1:5

### FINANCIAL CONTROL OF RISKS

By the use of financial mechanism, risks could be controlled by

#### Retention or Transfer.

##### (a) *Retention of Risks*

The firm may retain the first portion of loss (i.e. by excess or deductibles) and insure the unpredictable risks, having identified and evaluated the risks with their projected losses. The firm that retains the sum of ₦100, 000 with an excess/deductible of ₦ 25,000 per loss earns some discount (i.e. on the payable premium) from the insurer. One development from the retention of risk has been the formation of the captive companies. The captive company accepts business from the parent company in most cases, but at times from other companies.

##### (b) *Transfer of Risks*

This transfer is otherwise called "insurance". A landlord may transfer the risk of fire to his tenants

by the inclusion of a relevant clause (which by contract compels the tenants to pay a percentage of the fire insurance premium) in the tenancy agreement, which provides for the fire insurance of the house. If the landlord effected the insurance himself, he would have charged the tenants, higher rents. Insurance will always be the most important method of financing the cost of risk, but before long the "Insure all" will give way to the retention of the high frequency but low severity risks. The retention of the lower levels of the more serious losses in the form of deductibles (i.e. excess) or captive insurance arrangements is slowly gaining grounds.

## 2.2

### THE ADMINISTRATION OF THE RISK MANAGEMENT PROCESS

The introduction of risk management as a distinct and specialist area of management has led to the emergence of risk managers in the management charts of the ever increasing number of companies and other business organizations. Although the management style of the risk manager varies from person to person, nevertheless, the risk manager's job is both advisory and executive. The risk manager's performance is usually assessed by the resultant economic results. Traditionally, as a departmental head, the risk manager is also responsible for solving the staff management problems as well as motivation and training.

### 2.2.1

#### THE RISK MANAGER'S DUTIES

##### (A) *The Development of the Risk Management Philosophy*

This is a guiding policy that clearly states where the company stands on the issue of risk and its management. This company helps the company to define its positive attitudes to risk instead of just being responsive only when a risk occurs. It also serves as a yardstick to measure the effectiveness of the risk manager in particular and his department in general. Results of the policies adopted must be monitored and recorded with a view to reviewing them periodically.

##### (B) *Write Risk Management Manuals*

This risk management manual is aimed at explaining why and how things are done and the pattern should be tailored to individual needs. A manual comprises:-

- (i) The corporate risk philosophy and a statement of its aims and policy as regards the handling of the risk.
- (ii) The response from the risk handling, distinguishing physical and financial risk controls.
- (iii) Contingency plans should be put in place to take care of the major loss producing incidents.
- (iv) The provision of insurance policies for the company showing procedures to cover:-

- (a) Attitudes to the purchase of insurance protection.
- (b) Risks that need not be insured.
- (c) Specimen policies to be provided for study.
- (d) Claims notification and handling procedures are clearly stated. It should be noted that (risk management, being a continuous process) policies are reviewed periodically in line with the changing world with its attendant dynamic economic environment.

### (C) Monitor

These changes, in line with the changing economic environment or product changes should be monitored seriously.

### (D) Communication

The changes, so monitored, should be adequately communicated to the policy makers of the organization.

### (E) Review

On the receipt of the changes that were monitored, the risk management process will be subjected to a review to reflect the current changes.

### (F) Publish

The reviews should be published and communicated to the managers whose responsibilities

they are to implement. These could be done by the use of newsletters, sign posts, notice boards, pamphlets, gazettes, etc.

### (G) Identify Risk

This has to do with the study of the environment and its working, with a view to detecting all the attendant risks.

### (H) Analyze Risk Data

The analysis of risk data comprises two issues namely: (a) Collation and (b) Evaluation.

#### (a) Collation

This is all about the gathering of all the collected information, for the purposes of comparison and examination, to ensure completeness and sequence. Collation is usually effected by the use of the "Check List" system. The study of the existing information in comparison with the new ones is very essential and this involves serious record keeping. The risk management department must have at its disposal, records relating to:-

- (i) Buildings, plants, machinery and other fixed assets, being properties of the organization, or for which it is responsible.
- (ii) Staff list and the organizational chart.

- (iii) Insurance documentation, i.e. policy register, premium payments, claims data, inspection reports, coverage report, etc.
- (iv) Losses, dates and amount of interim payments and final settlement, nature of loss, cause of loss and preventive steps taken to avoid re-occurrence.

(b) **Risk Evaluation.**

Risk evaluation involves two elements:

- (a) the probabilities of loss-producing events occurring; and
- (b) The potential losses.

A major problem for the risk manager is that even if he knows the probabilities of any of the risks to which his organization is exposed, such knowledge is of severely limited value when it comes to planning how to handle the risks. In effect, probabilities are mean values conveying useful information when the decision-maker controls a large number of exposure units, but the smaller the number of the units, the larger will be the variation in outcomes from that expected from the basis of probability.

Therefore, a part of a risk evaluation exercise must be to itemize and value assets exposed to loss and the size of the potential income and liability losses, allowing for potential impact of inflation on future income and replacement costs of assets.

(I) **Risk Control**

The reason for risk control is to minimize the total cost of risk to an organization while simultaneously ensuring the long term economic survival of the organization.

**2.2.2**

**RISK CONTROL MEASURES**

The measures could be in any of the following forms:-

- (a) Elimination of Risks.
- (b) Loss prevention i.e. a case of risks occurring without any resultant loss.
- (c) Reduction of the extent of the loss. All the measures of risk control comprise prevention and controlling actions before and after the occurrence of the loss. Strictly speaking, all risk control measures may be seen as planning tools and since the likelihood of a loss is foreseen, the measures that are implemented are expected to prevent and control the loss.

Risk control measures cannot be implemented. Immediately or soon after the occurrence of the loss, the applicable loss control measure is known as the "Post Loss Control" measure. This is aimed at maximizing the recovery from the loss by sale of salvages.

The major objective of loss control is to reduce the total cost of loss to the lowest possible level, via the following measures:-

- (i) Preventing losses from occurring by avoidance.
- (ii) Protecting people and or their properties from loss.
- (iii) Detecting and limiting the extent of any loss that may occur, and
- (iv) Maximizing the recovery from any loss that has already occurred.

#### (J) & (K) **Retention & Transfer**

Retention and transfer of risks are at the discretion of the risk manager and the organization. While retention refers to the financing of any organization's losses from its internal resources, the transfer of risks refers to the financing of the organization's losses from external resources, which is principally by insurance coverage. These have earlier been treated in details.

### 2.2.3

#### **THE CHECK LIST OF RISKS (DATA BASE SYSTEM)**

The check list system is approached in this order: -

- (A) Risk Identification (Treated earlier)
- (B) Physical Structure

#### (a) **Buildings, Fixtures and Equipment**

The risk manager checks the physical hazards inherent in the structure:- the fire resistant materials used in the construction of the structures (i.e. buildings), how secure the fixtures and equipments are, against damages or loss due to fire or burglary.

#### (b) **Environment**

The location of a building may pose some dangers. These locations could be: fuel dump, areas of heavy rain storm and flooding, industrial sites near the air ports, notwithstanding that there seem to be good aviation accident records in Nigeria. The society is also part of the environment, and in this case, the socio-political environment. One cannot afford to loose sight of the expectations and pressures from the society such as consumer pressures, government pressures and competition pressures. These, if ignored, may lead to irrational actions that are capable of bringing about losses to the establishments.

#### (c) **Organization and Operations**

The attention here is on the interactions and the processes in an organization on one hand and financial accountability on the other hand.

### (d) Organizational Charts

An organizational chart shows the structure of the hierarchy, relationships, communications and control in the establishment or organization. From the entire nature of the chart, one can easily see the difference between an establishment that is prone to risk factors and that, which is quite is complacent to hazards.

An organization that has a distorted communication system surely is more exposed to risk, as there might be difficulty in reacting promptly to situations that might give rise to dangerous activities, inimical to the organization.

### (e) Flow Charts

These are "schematic" arrangements of the order of the occurrence of events, which bring about the completion of some desired objectives or goals. The make-up of the chart largely depends on the type of the organization and the operational activity that is under study. In an industrial manufacturing organization, its flow chart indicates the order and the timing of the activities, from the raw material to the final output stages. A careful examination of the sequence of the activities will provide information on areas of accidents, wastage of man-hours or delays that bring about losses to the organization.

### (f) Systemic Analysis

In a commercially oriented enterprise, a system analysis may be defined as a collection of objects or functions with interactions and inter-dependencies, designed to achieve some given or stated goals. There are "open loop" and "closed loop" systems. A closed loop system is that which uses a feed back of information to

Correct errors that might pass undetected in an open loop system.

In a non-commercially oriented enterprise such as the public service, the applicable system analysis (as a very convenient tool), used for assessment, may be described as a method of calculating costs in relation to benefits, in activities, where it is not possible to apply market system analysis.

In summary, systems analysis is given by the following requisites:-

- ♣ Explanation of the purpose of the system.
- ♣ Information needed to achieve the purpose.
- ♣ Sources of data that can provide the information.
- ♣ Method of obtaining the data.
- ♣ Determination of when the information should be used.
- ♣ Determination of the way and form the information should be used.

Simply put, this is the production of information in the entire system of operation for management purposes.

### (g) Financial statements

This is an information (in accounting terms) of the activities of a particular organization for a given period. By analyzing these statements, comparing results within given periods, or by making comparisons with those of similar organizations, a manager may discover:

- ♥ If the firm operated profitably.
- ♥ If the firm operated at a loss.



- ♥ The areas that contributed to the loss.
- ♥ The areas the need to be fortified or phased out etc.

### (h) **Personnel, Size and Effectiveness**

Business comprises such factors of production as land, capital and labour. The "Optimum Size of Labour" is that which when combined with a given amount of other resources, produces the best result.

Risk management, therefore, identifies fully, any deviations from a stated or calculable optimum size of labour. However, the size of labour is one thing, the effectiveness in its application, is yet another.

Factors, like timing, job specification and compensation, largely influence effectiveness.

Personnel size may also be viewed from sex distribution/composition or from the professional background of the employees.

### (I) **Moral Hazards**

As in physical hazards, moral hazards are also risk factors. Human beings are prone to negative behaviors that can create costs and losses to an establishment. A risk manager should watch out for a deviation from a good and approved behavior. Another factor to watch out for is the employer and employee relationship, which influences the morale of the workers either positively or negatively.

### (j) **Legal Hazards**

Court judgments and fines for breaches of the laws can give rise to serious losses to an organization (usually legal entities), being part of the society. A risk manager should be able to guard against such activities likely to give rise to such breaches.

### (k) **Accuracy**

Decisions, facts, given proper intellectual and managerial disposition, should be accurately recorded systematically. Some lapses may be accidental due to ignorance and inability to organize records. Some may be willfully done, being the result of moral hazards.

### (l) **Risk Data Collation**

An effective way of collecting information or risk in a systematic manner is the "Check List System". This ensures that all items of interest are entered in the list.

### (m) **Measurement of Risk**

There are types of measurement data:-

- i. **Frequency** of the loss producing events, e.g. frequency of car accidents per place per annum, frequency of fire outbreaks in an industrial zone per year and the frequency of break-ins by robbers/thieves in a given location per year.

**ii. Severity** of the loss producing events (i.e. light or heavy):

This will give information on how frequent the big or small losses occur, thus measuring the severity of the losses, e.g. number of accidents (may be car accidents) giving rise to given cost of repairs.

**iii. Maximum Probable Loss**

A risk manager should know events that could create maximum possible or probable losses. This knowledge prepares him to combat future accidents or losses. An underwriter should be able to know the maximum probable cost of the building and its contents, should it be engulfed totally by fire.

**(n) Sources of Information**

Information on losses and damage are derivable from: -

i. Police Report: - accidents on the road and burglary/theft (may be car snatching).

ii. Fire Service: - fire out breaks with the attendant costs of losses and the number of drowning (that is common now in Nigeria where locally sunk water wells abound as a popular source of water supply).

iii. Other agencies such as: -

Railways for derailments and injuries.

Insurance companies for claim records of the claims department.

**(o) Treatment of Risk**

Risk can be treated in the following ways:

i. **By Avoidance:** One, who is faced with the economic problem of a loss of his car to thieves, may decide not to buy a car. He may also decide to stay indoors, to avoid loss of fares or even accidents from use of public transport. However, he could run further risks at home in case of domestic gas explosion or even lightning, thus revealing that man cannot completely avoid risks.

ii. **By Reduction:** Risk, defined earlier as a chance of loss, can be reduced if it occurs. The reason one maintains his car is to prevent accidents, but where it occurs, the loss could be reduced. Also the provision of fire extinguishers in cars is capable of reducing the risk of fire.

iii. **By Retention:** Retention of risk is recommended where risks are unavoidable. It can take various forms like:

(a) *Unplanned Retention of Risk:*

Unplanned Retention of risk can take place by the existence of the ignorance of a particular risk such as when

one contacts a disease and unknown to him, he subsequently died without any medication.

Lack of the knowledge of the treatment of a risk can also bring about an unplanned retention of the risk. "Goiter", ironically is seen by many as an untreatable ailment.

Laziness and indifferences: Lazy people would not explore further treatment of risk. In like manner, students, who would not make use of the library, run the risk of failure in examinations.

(b) *Planned Retention of Risks:*

**Minor Risks**

A student may not wish to insure his ball pen because it is inexpensive, though very important to him.

**Major Risks**

The retention of major risks usually costs large sum of money to manage such as:- cost of staff and the facilities for running the retention management unit, the liability to read the risks and arrive at a proper estimate, etc. In view of the circumstance one may think of transferring the risk.

iv. **By Transfer:**

(a) **Non-Insurance Transfer:**

Liabilities for loss or damage to property may be transferred to another unit/agency or person. A good example is common in contract awards, where certain risks are transferred to the contractor or the sub-contractor, via indemnity clauses or exclusion clauses.

*Other methods include:*

Depositing his money in the bank's vault.

A landlord may set up a trust to manage his estate, where he has no knowledge of estate management. He may also deposit his will or jewelry in the bank's vault.

One may also enlist his children (with some gutter behavior) into children's home.

(b) **Insurance Transfer:**

The transfer of one's liability for loss of life or damage to property, to an insurance company, is common place.

i. **Human behavior Towards Risks:** Living is all about risk-taking, and having accepted the phenomenon, you have two categories of human beings namely: - **Risk Preferrers and Risk Averters.**

- ▲ **Risk preferrers:** These are people who like taking risk like: - the game of Rugby, mountain climbing, gambling and space exploration.
- ▲ **Risk Averters:** Risk Averters comprise all those who avoid taking risks of any sort. They would insure anything that is insurable and also avoid any job that will expose them to any type of risk.