Solutions to incertitude: risk management in insurances

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SOLUTIONS TO INCERTITUDE: RISK MANAGEMENT IN INSURANCES

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Introduction

Business and risk have always been considered complementary concepts. Many companies are successful because of their ability to correctly recognize and to direct successfully all the risks resulting from the activities developed. Thus, we may say without being wrong, that risk represents an essential part in business.

In general, the greater the benefits, the higher the risks. Due to the economic and technological development, the improvement of the living standards and the freedom of moving forward, the number and the variety of risks are on the increase. The success of a company over its competitors depends on the way of administrating the risk.

Historically, risks management in business relied on a particular component from the risks portfolio of different companies, called *hazard* – risk or risks together with injured persons and damaged properties, etc.

Remarkable results regarding hazards were obtained due to this traditional approach to risks management, thus contributing to the creation of various products and insurance solutions.

At present, hazards management, although important, is no longer adequate to provide success. The company's leadership must focus much more on the ensemble of activities than on certain particular activities, because:

- The majority, if not all the risks in business, can adopt the examples of risks as shown above in the four quadrants (operational, financial, hazard and strategical). These examples represent generic risks of a company.

OPERATIONAL RISKS	FINANCIAL RISKS
- Cost of utilities; - Cost of materials; - Cost of manpower; - Staff fluctuation etc.	- Cost of capital accumulation; - Structure of obligations; - Budget restraint; - Bank's support etc.
HAZARDS	**STRATEGICAL RISKS**
- Injured/stick staff; - Responsibility for third parties; - Natural perils etc.	- Development strategy; - Company's image; - competition; - research/ development activity etc.

- Compared to the vision based on the control of hazards, the one based on the management of all the four types of risk will offer much more control upon the benefit of a company.

Thus, the necessity of considering risks in a systematic way in order to prevent their appearance, to reduce the costs for the possible damages caused and to find the most adequate ways of covering these risks. From this point of view, risk's management may represent a very good solution.

1. The Development of the Risk Management Process in Insurances

Risk Management is a well defined process of identification, analysis and economic control of risks which might affect the activity of a company. For a successful intervention, an examination of the following main steps in the risk management process is very necessary:

- ✓ Identification;
- ✓ Assessment;
- ✓ Analysis;
- ✓ Supervision.

I. Risks Identification

A first step is to identify the potential risks which might affect the company. This step requires the involvement of the staff charged with the supervision of all departments of the company and the knowledge of all activities developed here in order to identify the risks.

II. Risks Assessment

At the beginning, a great number of risks will be identified, but we can note that some risks are more important than the others. It is essential to assess the risks with a high potential in preventing the company to achieve its goals.

There are various methods of assessment, among the most significant we can mention[1]:

- Risk inspection;
- Interview;
- Form;
- Financial Documents Analysis;
- Graph of Transformations Analysis;
- Damages Portfolio Assessment.

The analysis performed concluded that some of the risks are already well controlled, helping us to determine their impact on the company. Practice confirmed the fact that a high potential risk, well managed, may have a less significant impact than a risk with a lower loss but not managed. Consulting specialists' assistance is required in the risk management process for correct analysis and assessments of the risks level, which are very important in establishing the quality of results of the risks management process.

III. Risks Analysis

The final purpose of the analysis is an adequate strategy of dealing with risks, using the following options:

- Risks retention (risks are conserved at an acceptable level, on one's own account);
- Risks transfer, risk is transferred to an insurance company or by contract with another party, a contractor;
- Use of methods concerning the risks control or reduction;
- Change or avoidance of the strategy employed when dealing with serious risks which can not be managed.

The management of several risks may produce a combination between the methods above-mentioned. Each risk will be treated in a different way; the professional support offered by the consulting specialists has a great importance in this sense

IV. Risks Supervision

Each company has its dynamics and deals with continuous changes. Risks follows the same dynamics, actions have changing effects and the current risk does not match the profile any longer. A constant process of identification must be adopted for new risks (e.g. IT risks or risks produced by new regulations or laws).

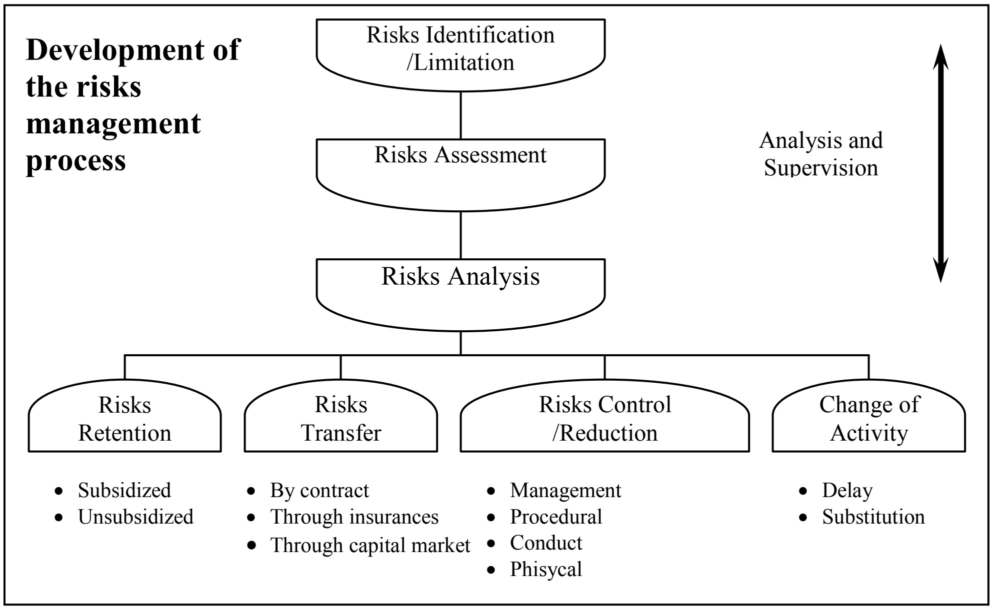
The final purpose of the steps above-mentioned is to introduce the risk management process in the activity of a company, making its participants aware of the existence of risks and helping them realize that an active involvement is essential in their administration.

These actions may seem difficult but their results worth the trouble because an adequate risks management brings important benefits in business such as:

- Utmost good faith of the

[1] Constantinescu D.A., “Risk Management in Insurances” Technical Publishing, Bucharest, 1999, pg. 265

shareholders;
- Efficiency;
- Reduction of costs;
- Improvement of the productivity and the company image, raise of employees' spirits;
- Additional funds, etc.



2. Alternative Strategies of Financing the risks

Insurance firms and companies often strikes against the limits of the classical proceedings in the risks management process. Both insurance and re-insurance companies are not able to take over all the risks of a company. Many times risks that produce grater fears, can not be covered, some of operational risks represent a good example of such situations (systems out of function, security breaches, certain meteorological risks, some risks of accidental pollution, some civil responsibilities etc.).

In addition to this, insurances do not present an immediate character: the indemnity is paid after a certain period of time starting from the occurrence of the insured event this delay is necessary for the insurer in order to inspect and solve the damages produced, thus firms may have a discontinuous activity meanwhile or their activity may be postponed.

Certain alternatives to the classical insurance products must be considered in the development of the risk management process. We can speak about two strategies of financing the risks[2] as alternatives to the insurances existing already in the market. These strategies are useful when risk can not be covered through common insurance policies.

First strategy is called "*Finite structure*" and is an agreement through which the person insured will pay in annual installments a premium of 80% of the agreed value of the indemnity (the rest of 20% constitutes a normal insurance).

Each payment of the annual installment bears an interest which will facilitate the financial effort of the person insured.

If the "risky" event doesn't occur during a certain period of time (5 years maximum) or the value of the damage is lower than the lump sum accumulated,

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[2] *Risk consult* – www.marsh.ro

the insured will be remunerated with 50-80% of the premium, interests included.

"*Finite structure*" is the strategy that creates a balance between self-financing and risk transfer, the damage value spreads out on a period of 5 years; this agreement is an insurance because it offers its fiscal advantages; a substantial remuneration is paid if damages are reduced.

A second strategy called "*Contingent Capital Facility*" represents an agreement through which the insurer has the obligation to remunerate the damages as an advance and the insured has the obligation of paying back this sum.

The insured person pays an annual premium of a reduced value till the occurrence of the damage. Once the event took place, the insurer pays the entire value of the loss and the insured agrees to pay annual premiums which cover the value of the damage and the interest. This product is a "hybrid", it is considered an insurance and offers flexibility, diversification of capital sources, a way of financing unplanned expenses associated with aleatory risks.

The purpose of these strategies is to diminish the financial efforts of companies when serious damages occur as a materialization of risks that can not be insured by ordinary policies, the cost of the damage being spread out on a period of 5 years, on pre-established terms.

For both strategies, insurers must provide high financial standards and insured persons must have a solid financial situation. The negotiation of such agreements lasts between 4 and 6 months and the insured sum has a minimum value between 30 and 50 million of USD.

For example, for a *"Finite structure"* agreement on 5 years with a limit of responsibility of 80% financed by the insurer, the insured person pays a sum of 24 million USD – meaning over 4 million USD, including the interests, as annual installment. Only companies with strong financial situation have access to these strategies, due to the terms imposed by the insurers and the sums required.

In conclusion, a good management of risks doesn't mean only to prevent disasters; it can be also a source of advantages. Firms with a good management of risks are important candidates for investments and acquisitions and companies with a clear understanding for risks covering are more likely to become reliable.

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