

OUTLINES

- Definition of Risk,
- Classifying risks,
- The process of Risk Management
- Insurance of the Small Business

- Before we define risk for our purpose it would be advisable to consider the various definitions given by different scholars and practitioners to comprehend the basic concept of risk
- The term risk used in different ways. The following **definitions** given by different scholars and practitioners in the field:
 - *Risk is the channel of loss*
 - *Risk is the possibility of loss*
 - *Risk is uncertainty*
 - *Risk is the dispersion of actual from expected result*
 - *Risk is the probability of any outcome different from the one expected*

- **In enterprise risk management**, a risk is defined as a possible event or circumstance that can have negative influences on the enterprise in question.
- Its impact can be on the very existence, the resources (human and capital), the products and services, or the customers of the enterprise, as well as external impacts on society, markets, or the environment.
- **In a financial institution**, enterprise risk management is normally thought of as the combination of credit risk, interest rate risk or asset liability management, liquidity risk,

CLASSIFYING RISK

Generally, Business risks can be classified into two broad categories:

1. Market risk is the uncertainty associated with an **investment decision**. An entrepreneur who invests in a new business hopes for a gain but realizes that the eventual outcome may be a loss.

2. Pure risk is used to describe a **situation where only loss or no loss** can occur-**there is no potential gain**.

- A pure risk exists when there is a chance of loss but no chance of gain/profit.
- Example: Owner of an automobile faces the risk of a collision loss. If collision occurs, he will suffer a financial loss. If there is no collision, the owner will not

CLASSIFYING RISK BY TYPE OF ASSET

Risk may be grouped according to the **type of asset-Physical or human-needing protection.**

1. Property risks

- **Property-oriented risks** involve tangible and highly visible assets. Many property-oriented risks are insurable; they include:
 - *Fire , Natural disasters, Burglary, Business swindles (or **fraudulent transactions**) and, Shoplifting.*

2. Personnel risks

- **Personnel-oriented losses** occur through the **actions of employees**. The three primary types of Personnel-oriented risks are:
 - *Employee dishonesty, Competition from former employees, Loss of key executives*

3.Customer risks

- Customers are the source of profit for small business, but they are also the source of an ever-increasing amount of business risk. Much of these risks are: ***On-premises injuries and Product liability***
- ***On-premises injuries:***
 - Customers may initiate legal claims as a result of on-premises injuries.
e.g. When a customer breaks an arm by slipping on icy steps while entering or leaving a store;
 - Inadequate security, which may result in robbery, assault, or other violent crimes; Customers who are victims often look to the business to recover their losses.

What is risk management?

Many

definitions...

- Risk management is a **systematic way of protecting business resources and income against losses** so that the organization's aims are reached **without interruption, creating stability and contributing to profit.**

OR

- Risk management is the identification, measurement and treatment of liability, property and personal **pure risks** that the business organization is facing in order to reduce and prevent the unfavorable effects of risk at **minimum cost.**

Risk management and Insurance management

- What is the difference in b/n?
- Risk management is broader than insurance management in that it deals with both **insurable and uninsurable risks**. Insurance management ***for most part*** it is restricted to the area of those risks that are considered to be insurable.
- Naturally only pure risks are insurable . Speculative or market risks are not. Even all pure risks are not insurable
- The emphasis in the risk management concept is on **reducing the cost of safeguarding against risk** by whatever means.

The process of Business risk management

In general, the basic functions of the risk management in carrying out of the responsibilities assigned are:

1. **To recognize exposure to loss**

- ✓ Is also called as *risk identification*
- ✓ Is the 1st step of risk managers' function.
- ✓ Is the most vital task
 - What types of possible losses are there?
 - Failure to identify exposure to loss ==> the risk manager will not have any chance of handling the loss that identify the risk.

9 Some techniques for identifying risk are:

□ Brainstorming

- Interviews and self-assessment □ Facilitated workshops
- SWOT analysis □ Risk questionnaires and risk surveys
- Scenario analysis □ Using technology
- Other techniques

2.To estimate the frequency and size of loss, i.e., to estimate the probability of loss from various sources. It is also called as *risk measurement*.

Risk measurement means

- Determination of the chance of an occurrence or relative frequency.
- Determination of the impact of losses upon financial affairs.

3.To decide the best and most economical method of handling the risk if loss. (*risk response development*)

i.e. Selection of the proper tool for handling risk

- Identifies and evaluates possible responses to risk.*
- Evaluates options in relation to entity's risk appetite, cost vs. benefit of potential risk responses, and degree to which a response will reduce impact and/or likelihood.*
- Selects and executes response based on evaluation of the portfolio of risks and responses*

5.Revaluating the decision

Initial risk management plans will never be perfect. Practice, experience, and actual loss results will necessitate changes in the plan and contribute information to allow possible different decisions to be made in dealing with the risks being faced.

Once the risk manager has **identified and measured** the risks facing the firm, the next task is to **seek for appropriate tools and decide how best** to handle them. Risk can be handled through the following tools:

Tools of Risk

- **Management** Once the risk manager has identified and measured the risks facing the firm, the next task is to seek for appropriate tools and decide how best to handle them. Risk can be handled through the following tools.
 - 1. Avoidance
 - 2. Retention/acceptance
 - 3. Loss prevention and reduction
 - 4. Separation / Diversification
 - 5. Transfer

Tools of Risk Management

1. Avoidance

One way to handle a particular pure risk is to avoid the property, person or activity with which the risk is associated.

- **Two approaches of risk avoidance:**

- i. Refusing to assume an activity*

e.g. For instance, a firm can avoid a flood loss by not building a plant in a place where flood is frequently affecting. In case of refusing, we are discontinuing the activity

- ii. Abandonment of previously assumed activities:*

e.g. A firm that produces a highly toxic product may stop manufacturing that product.

2. Retention/Acceptance

- It is the most common method of handling risk by the individual or the firm itself.
- Bearing all the risk by that person/organization.

Types of retention

i. Planned/conscious/ active risk retention

- It is characterized by the recognition that the risk exists, and tacit agreement to assume the losses involved.
- The decision to retain a risk actively is made because there are no alternatives more attractive.

Prerequisites of Active Retention

- Active/planned retention should be considered only when at least one of the following conditions exists:
 - It is impossible to transfer the risk to someone else or to prevent the loss from occurring
 - When the maximum possible loss is so small
 - When the chance of loss is so extremely low
 - Self-insurance is a special case of active retention. Self-insurance is not insurance, because there is no transfer of the risk to an outsider.

ii. Unplanned/Unconscious/ Passive Retention

- Passive risk retention takes place when the individual exposed to the risk does not recognize its existence.
- In this case, the person so exposed retains the financial consequence of the possible loss without realizing that he does so.

3. Loss Prevention and Reduction Measures

- Prevention is defined as a measure taken **before** the misfortune occurs.
- Generally speaking, loss prevention programs intend to **reduce the chance of occurrence.**

Example:

- Constricting a building with a fire resistance material / fireproofing.
- Constructing a building in a place where there is little danger.
- Regularly inspecting the machine / area
- The existence of automatic loss detection

- **Loss reduction** measures try to **minimize the severity** of the loss once the peril happened/ ***after*** the event occurs.

For Example:

- Automatic sprinkler
- An immediate first aid
- Medical care and rehabilitation service
- Guards
- Cover

4. Separation /Diversification

- Separation of the firm's exposures to loss instead of concentrating them at one location where they might all be involved in the same loss.
 - Separation==>Dispersion/Scattering the exposure in different places.
 - ***“Don't put all your eggs in one basket”***
- Example: Instead of placing its entire inventory in one warehouse, the firm may elect to separate this exposure by

5. Transfer

- It is also called as *shifting method*.
- When a business organization cannot afford to cover the loss by itself, it may look for/transfer institutions.
- **Insurance** is a means of shifting or transferring risk.
- The following matrix can determine which risk management be used.

Loss Frequency	Loss Severity	Appropriate risk Management technique
Low	Low	Retention
High	Low	Retention & Reduction
Low	High	Insurance
High	High	Avoidance

INSURANCE FOR BUSINESS

- Insurance' may be defined as a contract in writing under which one party agrees to indemnify the other party against a loss or damage suffered by it on account of an uncertain future, in return for a consideration called 'premium'.
- The person/business who gets its life/property insured is called 'Insured/Assured'.
- The agency which helps in entering into an insurance arrangement is called 'Insurer' or 'Insurance Company'.
- The agreement or contract which is put in writing is called a 'policy'.

INSURANCE FOR BUSINESS...

1. Basic principles for a sound insurance program

Basic principles in evaluating an insurance program include:

- *Identifying insurable business risks*
- *Limiting coverage to major potential losses and*
- *Relating premium costs to probability of loss*

2. Requierments for obtaining insurance

1. ***There must be a sufficiently large number of homogenous exposure units to make the losses reasonably predictable.***

- Insurance is based on the operation of the law of large numbers.

2. The loss produced by the risk must be definite and measurable.

- The loss must have financial measurement or financial implication.
- The risk must be calculated
- **Example:** For instance a person may purchase disability insurance. How do we know that the person is unable to do? Thus, the risk must be definite and measurable.

3. The loss must be fortuitous or accidental.

- the loss must be the result of a contingency, i.e., it must be something that may or may not happen. It must not be something that is certain to happen.
- Wear and tear or depreciation, which is a

4. The loss must not be catastrophic

- All or most of the objects in the group should not suffer loss at the same time because the insurance principle is based on a notion of sharing losses.
- **Example:** Damage which results from war, flood, windstorm and so on would be catastrophic in nature and hence do not have insurance.

5. The loss must be large loss.

- The risk to be insured against must be capable of producing a large loss, which the insured could not pay without economic distress.

- In case the loss occurs, it must be severe that must be transferred to the insurer. The occurrence and nature

6. Reasonable cost of transfer

- i.e: the probability of loss must not be too high because the cost of transfer tends to be excessive.
- To be insurable, the chance of loss must be small. The more probable the loss, the more certain it is to occur.
- The more certain it is, the greater the premium will be. But to make insurance attractive, the premium has to be for less than the face of the policy.

Policy

- The normal types of insurance policy in Construction Industry include the following:

1. **Professional Indemnity Insurance (PI):** It is taken out by the designer/Consultants as cover against their liability for acting negligently
2. **Contractor's All Risks Policy:** This policy covers loss or damage from what so ever cause to the contract works or materials whilst on the contract site(s) and in use in connection with the contract during the performance of the contract and the period of maintenance.
3. **Contractors Third Party Liability Policy** This policy covers loss or damage to third party persons or property arising out of the construction or maintenance of the works.
4. **Contractors Employers Liability Policy** : This

**END OF THE COURSE
WISH U A BRIGHT
FUTURE!!!**