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Insurance job: Clearing debris from a shop after the recent Gisborne earthquake.

FAIRFAX/KENT BLECHYNDEN

Insurance softens the blow

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There is a saying that the financial consequences of perhaps 10% of risks can be managed by insurance. Often the biggest risks are not insurable. And some risks can be insured but the premiums are very high.

So where does insurance fit in to risk management?

If risk management is about managing events or circumstances that could impact on objectives, insurance is about softening the financial impacts of loss-causing events.

Insurance is a means of transferring part of the financial consequences of risk to someone else, reducing the monetary loss if something untoward occurs. It doesn't prevent the initial loss, nor does it help directly with non-financial losses (eg, loss of reputation, emotional trauma, death etc).

In the case of the recent Gisborne earthquake, insurers and the Earthquake Commission provided recompense for damage to buildings and stock, loss of income, but probably not for items such as old photographs or works of art.

Insurance has a role to play in managing some of the financial consequences of risk, but there are some outcomes that insurance can't cover (or may be too expensive to cover).

So how can you use insurance as a risk management tool? You need to be clear that all insurance can do is help to put you back in the same position as before the loss.

You should try to behave as if you had no insurance. Such attitudes help make organisations conscious of the need to protect assets and activities and avoid liabilities. With these attitudes in mind, insurance becomes a more valuable risk management tool.

Seen from this perspective, your risk management programme will regard the insurer as the organisation with which you have a contract (the insurance policy) to cover some losses if specified types of events happen.

For example, if you know there is a risk that a fire might damage your factory or warehouse, you might have a range of risk controls that help prevent a fire from starting. These might include regular checks on the electrical system, safe storage and disposal of rubbish and strict controls over the use of flammable liquids. You might also have a sprinkler system to help detect and extinguish a fire.

But there is still a chance a fire could start and destroy or badly damage your building and stop or disrupt your activities. This is what you buy insurance for. It is the "financial ambulance at the bottom of the cliff". It is there just in case your fences at the top of the cliff don't work.