

INSURANCE & RISK MANAGEMENT

INSURANCE

Putting premium value on risk factor

ROGER ESTALL

RISK management is all about successful outcomes. Contemporary risk management thinking goes like this: Organisations have objectives, for companies it is usually to produce a financial return for the shareholders and perhaps to be a good citizen in the process; statutory organisations exist for their statutory purpose; not-for-profit organisations typically pursue social purposes.

Risks are all the possibilities that could affect an organisation achieving its objectives. The only reason to actively manage risk is to increase the likelihood of organisational success.

To manage risks successfully, they must first be understood. That means identifying them, analysing their scale and evaluating them against the organisation's risk appetite. If, despite existing controls, the risks exceed the appetite, something must be done to make success more likely. In risk management parlance, taking those measures to adjust the risk is called "treating" the risks.

Insuring a risk is a type of risk treatment suited to those risks for which, if something happened, the availability of money to replace the value that was lost would keep the objectives on track. Of course, there are many risks for which money is not the solution (for example, loss of reputation or personal injury). Fur-

thermore, conventional insurance is not the only means of ensuring money will be available if needed.

Even though the concept of insurance is to "spread the cost of the losses of the few over the many who pay premiums," it is still an expensive risk treatment and one that comes with its own uncertainties. For example, will the insurer be solvent when called on to pay claims? Will the wording of the policy cover the circumstances of the loss? Will the amount of cover taken be sufficient for the scale of the event? Far from these points being obvious, they are

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vital issues that warrant attention and expert advice if the insurance cover is to be more than illusory.

To make sensible insuring decisions, it is necessary to have a detailed understanding of the risk and to match that up against the insurance arrangements.

But this same risk understanding will help influence insurance costs. It works like this: The insurer has to

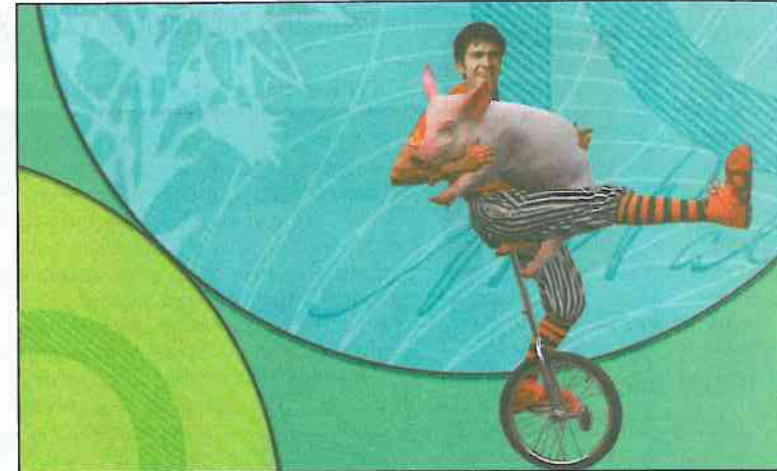
make a judgment about how much to charge. Four things will count:

- The number of claims (if there are many small claims, the insurer will expect to recoup the cost in the next year's premium);
- The insurer's perception of the risk (how effective are the risk controls that influence how likely it will be that an insured event occurs and if an event does occur, how serious will be the consequences);
- How much cover is bought;
- The current general state of the reinsurance market (how much will the insurer have to pay for their own protection against a large loss).

While an individual insured can't do much about the global fluctuations that influence the last of these points, it can do a lot about the first three.

It can elect to take a sufficiently large "deductible" (policy excess) so the insurer is not paying for small losses which they will recover, plus their overhead, the next year. Of course, the more confident an organisation is about its risk controls, the more confident it will be about increasing this deductible or setting up a self-funding arrangement for even medium-sized losses.

The insured organisation can enhance the insurer's perception by taking sensible risk control measures (which also contribute to organisational success) and making sure the insurer correctly understands these. (There is a saying insurers fill the



Managing risk can be a real balancing act.

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gaps in their knowledge of the risk with additional premium.)

Professionally presented risk information helps fill those gaps and is a good investment, but the information must be accurate as insurers are generally entitled by law to rely on what they are told.

This same understanding of the risk will help decisions about how much cover to buy - for example, for the type of insurance that protects organisations from either the loss of revenue or increased costs that can follow on from some kind of disruption. If the organisation has a well structured and tested contingency plan, the period of interruption is

likely to be shorter and so too can the policy's interruption period.

Organisations that don't make their insuring decisions in the context of their overall approach to managing risk are doing themselves a disservice. The Australian and New Zealand Standard on risk management (AS/NZS 4360:2004) contains excellent advice that will help even small organisations take a more thoughtful approach to risk management and thus to their insurance buying.

Visit www.risksociety.org.nz for more information.

■ Roger Estall is the past chairman of the New Zealand Society for Risk Management Inc.