WHY EVERY BUSINESS NEEDS TO COVER ITS RISKS

By David Choo

A Disaster Waiting to Happen

Businesses often need to take chances in order to grow and flourish, but that does not mean they should be taking unnecessary risks. The right insurance, and for the right amount, is crucial.

Someone once said all men's motivation comes from either a desire for gain or a fear of loss. And while it might be more exciting to put your money and effort into that desire for gain, there are always downsides, setbacks or even full-scale disasters to contend with.

One should not just focus on what can go right, but also on what can go wrong. But preventing what can go wrong has proved much harder than simply predicting that things can go wrong.

Take the risk exposures that businesses face, for example. The presence of a billion-dollar property and casualty insurance business is strong evidence that companies are facing up to business risk exposures squarely. Insurance is just one aspect of handling risk, however, yet it might not always be available and it might not always be the most effective solution. The process of risk management comprises risk control and risk financing.

Risk control is concerned with how to prevent or reduce risks from happening and controlling the losses when they do occur. Such measures include risk avoidance, the segregation and diversification of items prone to risk, loss prevention, loss reduction, and the non-insurance transfer of risk.

Taken together, these measures can reduce business risk considerably. A simple common-sense approach may appear sufficient for small and uncomplicated businesses, but the important thing is to be systematic and thorough as you go through each measure. The danger to avoid is to be penny-wise and pound-foolish: why save on small costs like fire extinguishers and yet at the same time risk big losses like seeing your factory razed to the ground?

MANAGING RISK

Frequency	SEVERITY: High	Low
High	Avoidance Some segregation/diversification Loss prevention/reduction Non-insurance transfer	Retention Loss prevention (if benefits exceed cost)
Low	Insurance Some segregation/diversification	Retention or Loss prevention

While the first four measures are, by and large, self-explanatory, the fifth – the non-insurance transfer of risk – includes using contracts to transfer risks to another party, as well as outsourcing risky processes.

NOT ALL RISKS CAN BE AVOIDED

A thorough risk survey or audit will not only reveal what can be done to control risk occurrence and its impact, it can also expose risks that cannot be totally prevented. The best way to handle these would be either to retain them if the financial impact is bearable, or insure them if the financial impact is great.

Risk retention may also be combined with insurance to achieve lower premiums through such means as the deductible (what the insured must bear himself) and co-insurance (the percentage of losses, after accounting for the deductible, borne by the insured).

The key thing in considering insurance is to focus on the financial impact and not the probability of occurrence. In other words, improbable risk should still be insured if the occurrence has a severe financial impact. After all, insurance premiums already factor in probability, and improbable risks usually mean lower premiums. Consider, for example, the low premiums for fire insurance compared with the relatively higher premium for workmen compensation policies.

The table (see **Managing Risk**) shows the usual treatment of risks according to frequency of occurrence and financial severity.

Over the years, the application of risk control and financing measures has resulted in businesses resorting to insurance for mostly low-frequency but high-severity risks. These might include property insurance in the event of a fire or other extraneous perils, plus theft, material damage and consequential loss.

Insurance could also cover employee liabilities like workmen compensation and common law cover, while public liability insurance would cover the risk of injury or death to a third party, or damage to the property of a third party. A third party is simply someone who is not part of your family and is not an employee. Other types of insurance deal with professional indemnity, product liability, and the liability of directors and officers.

MOST INSURANCE IS NOT SUBSTANTIAL ENOUGH. BUSINESSES SHOULD KEEP TRACK OF THE UPWARD TREND IN CLAIMS AMOUNTS AND THE LIABILITY AWARDS BY THE COURTS.

OVERSIGHTS

There are, however, four common mistakes that people make when insuring a business, or, in some cases, not insuring it. First on the list is a business insuring its physical property but not the consequential loss or the loss of profits, even though the underlying risks insured against are the same. The loss of profits is often much larger than the destruction of physical assets.

Second, some businesses neglect to insure themselves against the wrongful acts of their directors and officers, which is a form of specialised liability. A third problem, also related to key company personnel, is a lack of 'key man' insurance to insure business continuity, or insurance to fund a buy-and-sell agreement between partners and shareholders.

And, finally, most insurance is not substantial enough. Businesses should keep track of the upward trend in claims amounts and the liability awards by the courts.

Why do businesses often overlook these important matters? For starters, liability insurance policies and policies dealing with consequential loss are comparatively complicated when compared to those that cover fire and theft.

It can also be difficult to secure such cover, since not many insurance companies provide professional indemnity, product liability, or directors and officers liability insurance. Insurance of this kind is also perceived to come with high premiums, while few agents and brokers are familiar with these classes of cover and so concentrate on more run-of-the-mill insurance.

So what is the right way forward? Businesses should exercise a combination of prudence and caution. A fledgling business is, after all, said to be just a disaster away from extinction, and plenty of more established businesses need to have their risk bases covered to ensure they don't pour hard-earned money down the drain.

Adages like "better safe than sorry" and "prepare for the worst, hope for the best" should be practised by businesses just as eagerly as they are by individuals. **si**

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