The Cost of Risk and the Concept of Risk Partnership*

by John W. Reid**

Abstract

A recent survey in UK has highlighted the large discrepancy between the insured and uninsured costs of losses, demonstrating that the true cost of risk is much higher than previous estimates. Risk is never totally transferred by insurance, and if insureds recognise that they retain a partial ownership of the risk there is a greater likelihood that there will be better loss control. The paper promotes the concept of "risk partnership" as a more correct representation of the contract between insurer and insured than the more generally used term of "risk transfer".

1. Risk in the commercial environment

All businesses operate in an environment of risk and uncertainty, and therefore exposure to loss is an unavoidable element of every commercial enterprise. Indeed, the concept of enterprise is closely associated with activities of adventure and risk-taking.

The scale of operations of modern commercial and industrial organisations is such that they are exposed to losses of catastrophic proportions. This has been evidenced in a dramatic way in recent years by the headline-making disasters we have witnessed around the world. In our newspapers and on our television sets we have seen the massive media coverage of events such as Bhopal (1984), Chernobyl (1986), Piper Alpha (1988) and Exxon Valdez (1989).

Likewise, industrial and technological developments have resulted in business being faced with many new and emerging risks – such as in the petrochemical industry, space exploration, and telecommunications. And the cost of error or failure has increased as a result of society becoming more litigious, as witnessed by the record-breaking compensation payments being awarded in the industrialised world, and especially in the USA.

But as well as these more spectacular manifestations of risk, we need to be aware of the insidious toll of risk which day-to-day gnaws away at life, health and wealth.

* Paper presented at the MORE 9 - Seminar in Basle, Switzerland, November 1993.

** Head of Department of Risk and Financial Services, Glasgow Caledonian University, Scotland, UK.

The headline-making disasters we hear so much about are no more than the tip of the iceberg. Beneath the surface of the media spotlight lurk the ordinary, everyday risks with which business managers spend their working days. There is the human suffering to individuals and families caused by deaths and injuries. There are losses to business operations and public services (and therefore to the economic wealth of the nation) caused by a vast array of risks. In the UK in 1992 fire claims amounted to £850 million – equivalent to £2.33 million per day (1); and theft claims amounted to £1,025 million – equivalent to £2.8 million per day (2).

2. Impact on corporate objectives

So far, losses have been considered at the macro-level of business activity. But the impact of losses at the level of individual organisations must also be examined, and one way of doing this is to look at how losses can frustrate corporate objectives. Most business organisations will have an expressed corporate aim or mission statement, which in turn is likely to be supported by a number of specific corporate objectives.

Typically, in a business enterprise, a dominant objective will be that of generating profit. Profit (or indeed, loss) is a function of revenue in relation to costs, and accordingly a reduction in accidental losses will automatically result in increased profitability. Traditionally, managers in business take a great interest in factors over which they believe they have some influence or control – for example, reducing labour costs, or increasing sales. But they have been slow to recognise that they can also reduce the cost of accidental losses (such as fire damage), and thus increase profits.

The results of a major survey in the UK published earlier this year (3) vividly demonstrate this capacity. The research was carried out by the Accident Prevention Advisory Unit (APAU) of the Health and Safety Executive (HSE). The survey investigated five very different companies who all had a good safety record. The results showed that one company, with a well-established management system, was losing as much as 37 per cent of its yearly profits through accidents, and in another company accidental losses accounted for 5 per cent of its total running costs (Figure 1).

Figure 1: Summary of losses identified

<i>Industry</i>	<i>Costs representing</i>
1. Construction	8.5% of tender price
2. Creamery	1.4% of operating costs
3. Transport company	37 % of profits
4. Oil platform	14.2% of potential output
5. Hospital	5 % of annual running costs

(Source: HSE)

Another anticipated corporate objective of any business organisation is survival. Often this is an implicit rather than an explicit objective, but presumably all businesses aim to remain in business (apart, maybe, from those set up solely to achieve a short term objective

for example, to organise a major sporting event). It is therefore important to consider the potential impact of a major loss on an organisation's ongoing viability. There are a number of salutary examples of major corporations going into liquidation following a catastrophic event – possibly the most notorious being the mighty Pan Am airline which was put out of business largely as a result of the financial impact of the Lockerbie terrorist bombing incident.

A survey by disaster management consultants in America a few years ago indicated that 43 per cent of insured businesses which suffer a major fire never re-open for business, and 28 per cent of those who do re-open are closed again within three years. In other words, six out of every ten organisations suffering a major fire, fail to survive.

Another objective might relate to an organisation's reputation. Many would regard a company's reputation as its most valuable asset, and in recent times we have seen much commercial activity being invested in efforts to preserve that asset. In contingency planning, attention is given to the need for responding appropriately to media attention, and in our present environmentally conscious age, many organisations have put considerable effort into their "green image".

One significant element that concerns company's reputation is its public attitude towards health and safety – in terms of its own workforce and the public generally. Manufacturers are concerned to demonstrate that their products are safe – a good example of this being the motor car industry which has recently attached considerable emphasis in its advertising to the features of new models – for example, a full-size driver's airbag fitted as standard.

We have looked at the impact of loss in terms of separate corporate objectives, but it is important to think in terms of the total cost of any single loss incident. For example, if a fire occurs in a factory and an employee is injured in the incident, the total cost could involve property damage (building, plant, machinery, equipment, materials, goods), liability damages (employers liability claim by injured worker), and net income losses (in terms of lost working time, managerial and legal expenses, damaged product, loss of profit, etc.). It is the holistic cost of any single event that needs to be taken into account when considering the impact on corporate objectives.

3. Insured and uninsured costs of losses

It is clear from the foregoing that risk can have a major impact in preventing a business organisation from achieving its objectives. Accordingly, it follows that effective risk management will enhance commercial success and prosperity. But it is also clear from the record of losses referred to earlier – in terms of both major catastrophes and everyday losses – that business organisations, broadly speaking, are not successful in managing their risks.

One possible reason for this poor record of risk management, it is contended, is an inappropriate corporate attitude to risk. Business managers, in line with the public generally, very commonly are of the view that because they have insurance their losses will be compensated. But the reality is that many elements making up the total cost of loss are not covered by insurance or are uninsurable – for example, fines, costs of preparing the claim, excluded perils.

Stark evidence of the differences that can arise between the insured and uninsured losses is provided by the recent survey in the UK referred to earlier (3). Comparisons were made in four organisations that were studied in detail, and it was shown that only a small proportion of the actual costs of their losses was covered by insurance. In fact, the uninsured costs ranged from between 8 and 36 times the insured costs (Figure 2).

Figure 2: The hidden costs of accidents

(Source: HSE)

4. Risk partnership

Insurance is frequently referred to as a risk transfer mechanism. However, in the light of the evidence that insurance covers only a fraction of the total cost of risk, it is clear that business organisations cannot “contract out” of the impact of risk by the purchase of insurance, and the “risk transfer” label that is often attached to insurance therefore seems misleading.

Even although it provides only partial indemnification, insurance is seen by virtually every business organisation to be a sensible – indeed an essential – purchase. If, therefore, businesses see the sense in covering some of the total cost of their risks, does it not make sense for them to likewise endeavour to control the other (usually the greater) element – ie, the uninsured costs? What is being suggested is that businesses have much to gain by

recognising that even with insurance they retain the major ownership of risk arising from their activities. Accordingly they (more so even than their insurers) will benefit from the effective management of their risks.

The argument is that effective risk management will greatly benefit the insured – by reducing the uninsured cost of losses. It will also benefit the insurer – because claims will be reduced. As both parties – insured and insurer – are adversely affected by risk, it is suggested that they should operate in a form of “risk partnership” for the purpose of managing risk.

In practice, this means that business organisations must accept responsibility for their own risks, and should consequently adopt a responsible attitude to the risks they face. In return, their partners in risk management – their insurers – should recognise and reward genuine and sound attempts by their insured to manage risk.

5. Conclusion

The attitude expressed by “I’m not worried – it’s insured” is very much in keeping with the principle of insurance being regarded as a risk transfer mechanism – ie, the risk is totally transferred to the insurance company. But risk is never totally transferred by insurance, and if insureds can be assisted to recognise that they retain a partial ownership of the risk, it is likely that there will be better loss control.

“Risk partnership” is therefore a more correct representation of the contract between insurer and insured than the more generally used term of “risk transfer”. Its adoption has potential mutual benefits for both parties to the insurance contract.

REFERENCES

1. Association of British Insurers: press release, 19 March 1993.
2. Association of British Insurers: press release, 29 March 1993.
3. Health and Safety Executive, 1993: *The Costs of Accidents at Work*; HMSO, London.