Rizvi College of Arts, Science and Commerce

SUBJECT: Principles and practices of banking and insurance

TOPIC: Understanding Risk

CLASS: FYBBI

SEMESTER: II

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Module – III

Understanding Risk

Chapter 5

INDEX

Introduction:

The term ‘risk’ is used by people in the business of insurance to mean either a peril insured against a person or property protected by insurance.

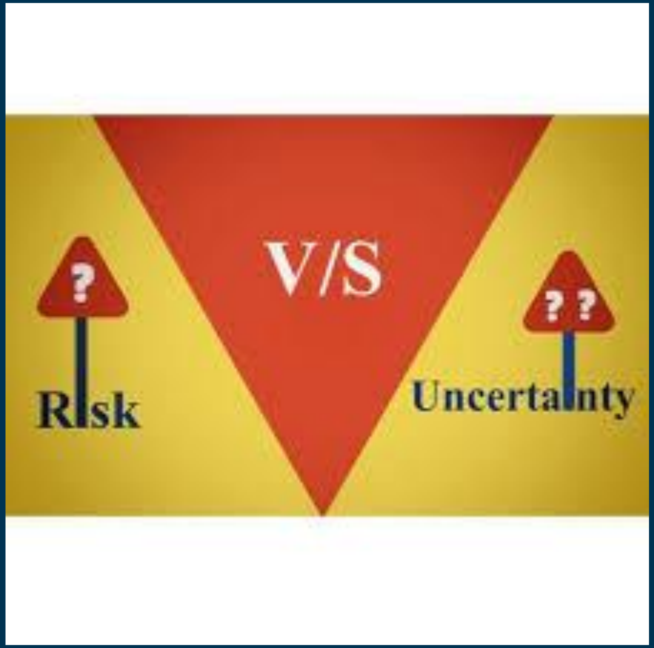
Meaning and Definition of Risk:

The term risk is generally used to refer to a situation where the outcome is uncertain and there is a possibility of loss. The loss is random in nature. It occurs by chance, and may happen to anybody and any property.

According to the Dictionary, risk refers to its possibility that something unpleasant or damage might happen.

Risk Vs Uncertainty:

Risk refers to decision-making situations under which all potential outcomes and their likelihood of occurrences are known to the decision-maker, and uncertainty refers to situations under which either the outcomes and/or their probabilities of occurrences are unknown to the decision-maker.



Degree of Risk:

Degree of risk is related to the likelihood of occurrence. It is measured by the probability of the adverse deviation. In case of an individual, we measure the risk in terms of the probability of an adverse deviation from what is hoped for. Insurance companies make predictions about losses that are expected to occur and charge a premium based on this prediction.

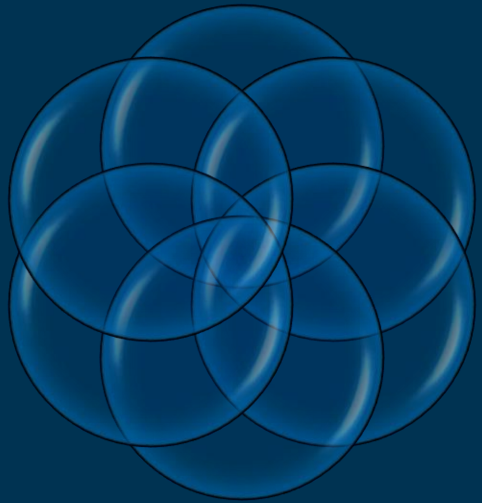
Business Risk:

Business risk management is concerned with possible reduction in business value from any source.

Price risk

Other risk

Credit risk



Operational risk

Pure risk

Market risk

Risk for individuals:

The risks faced by individual and families can be classified in a variety of ways.

- Earnings risk
- Medical expenses risk
- Physical asset risk
- Financial asset risk

Classification of Risk:

- **Classification Risk**
  - Financial risks
  - Non-Financial risk
  - Static risks
  - Dynamic risks
  - Fundamental risks
  - Particular risks
  - Pure risks
    - Personal risks
    - Property risks
    - Liability risks
    - Risk arising out of failure
  - Speculative risks

Distinction between Static Risks & Dynamic Risks:

Static Risks	Dynamic Risks
(1) It involves the losses that occur even if there were no changes in the economic environment.	It involves the losses resulting from changes in the economic environment.
(2) Occurrence of static loss can be easily predicted. E.g. quality problem.	Occurrence of dynamic loss is not be easily predict able e.g. computer defects.
(3) This risks are more suited to treatment by insurance than dynamic risks e.g. security safety etc.	Unlike static risks, dynamic risks are not suited to treatment by insurance. E.g. Earthquake, flood etc.
(4) This risks are not a source of gain to the society. E.g. Environmental pollution.	This risks normally benefits the society. E.g. Development of technology.

The Burden of Risks:

The presence of risk results in certain undesirable social and economic effects. Risk entails three major burdens on society: The size of an emergency fund must be increased. Society is deprived of certain goods and services.

Elements of Insurance Risks:

A risk that conforms to the norms and specifications of the insurance policy in such a way that the criterion for insurance is fulfilled is called insurable risk.

The most common examples are key property damage risks, such as floods, fires, earthquakes, and hurricanes. Litigation is the most common example of pure risk in liability. These risks are generally insurable. The traditional insurance market does not consider speculative risks to be insurable.

Risk Identification:

Risk identification is the process of determining risks that could potentially prevent the program, enterprise, or investment from achieving its objectives. It includes documenting and communicating the concern.

The various methods of risk identification are:

(1) Check list method
(2) Financial statement method
(3) Flow chart method
(4) Onsite inspections
(5) Interactions with others
(6) Contract analysis
(7) Statistical records of losses

Methods of Handling Risk:

1. Prevention of risks (or) Avoiding of risks
2. Reduction of risks
3. Shifting of risks (or) Transferring of risks
4. Acceptance of risks and
5. Spreading of risks

Risk Management:

Risk management is the identification, evaluation, and prioritization of risks followed by coordinated and economical application of resources to minimize, monitor, and control the probability or impact of unfortunate events or to maximize the realization of opportunities.

Risk management is the process of identifying, assessing and controlling threats to an organization's capital and earnings. These threats, or risks, could stem from a wide variety of sources, including financial uncertainty, legal liabilities, strategic management errors, accidents and natural disasters.

Features of Risk Management:

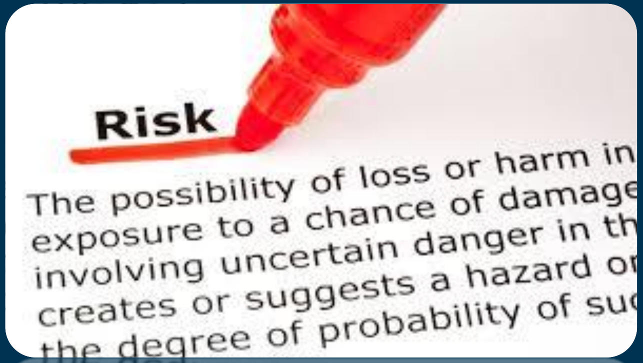
1. Risk management is a scientific approach to the problem of dealing with only pure risks.
2. Risk management gives importance to insurable and uninsurable risk.
3. It mainly emphasises reducing the cost of handling risk by using appropriate methods.
4. It helps to evaluate the risks faced by a business enterprise.
5. It helps to create the right business policies and strategy.
6. It helps to manage and control men and machines.
7. Create risk awareness and understanding among the people.
8. Avoid expenditure, interruption and misery relating to risks.
9. Decide which risks are worth taking/pursuing, and which are not.
10. Select the suitable technique or method to handle the risks.

Importance of Risk Management:

The purpose of risk management is not to eliminate all risks. It is to minimize the potential negative consequence of risks. By working with risk managers, employees can make smart risk decisions to improve the chance of reward.

If a business takes a risk and fails, its people learn from that failure, Slaggert teaches. Risk management is important in an organization because without it, a firm cannot define its objectives for the future. The ability to manage risk will help companies act more confidently on future business decisions.

Role of Risk Management:



Risk management is the process of identifying, measuring and treating property, liability, income, and personnel exposures to loss. The ultimate goal of risk management is the preservation of the physical and human assets of the organization for the successful continuation of its operations.

The risk manager always believes that “prevention is better than cure”.

Risk Management Tools:

Two broad techniques that are used in risk management for dealing with risks are:

- Risks Control and
- Risks Financing

Risk Management Process/Steps:

Determination of Objectives

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Risk identification

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Risk analysis

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Considering alternatives

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Implementation of the decision

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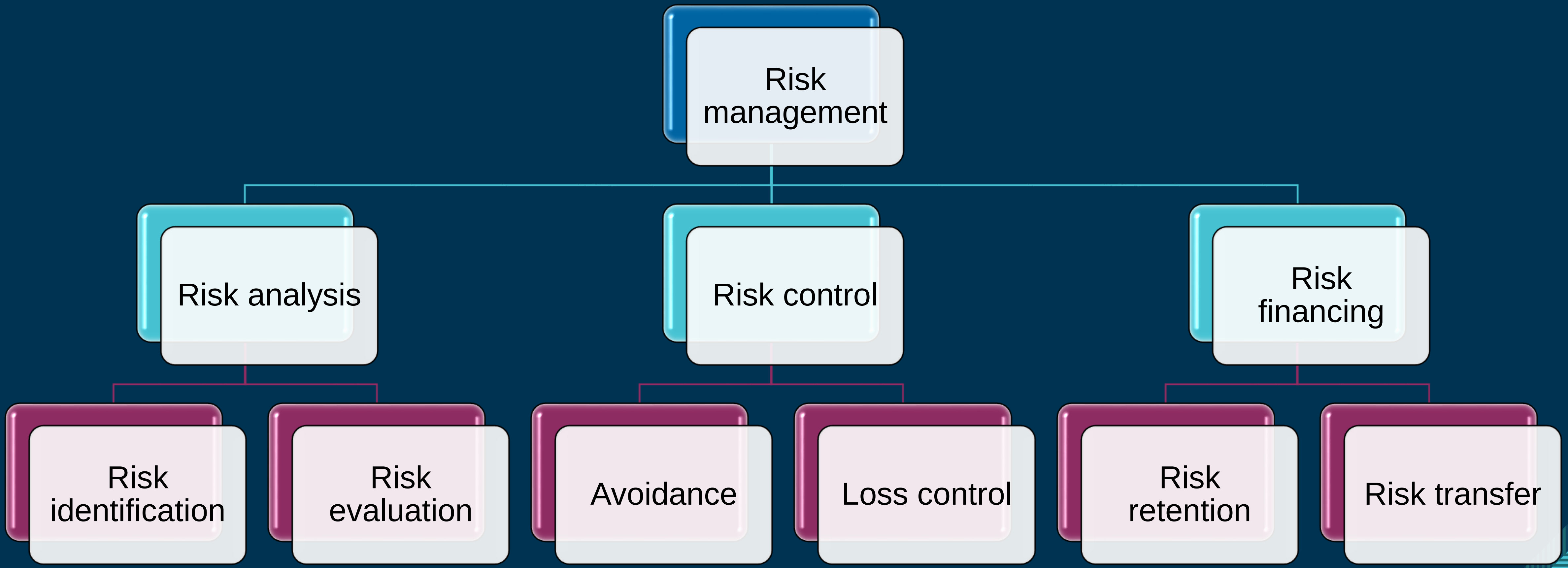
Evaluation and review

Risk Management in Life Insurance:



Risk Management Information System (RMIS):

A risk management information system is an information system that assists in consolidating property values, claims, policy, and exposure information and providing the tracking and management reporting capabilities to enable the user to monitor and control the overall cost of risk management.

Thank You...!