Benefits of insurance

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Addressing the Issue of Poor Risk Management in Companies

Shareholders entrust management teams with their capital. Unfortunately quite often it turns out that risk is managed poorly and as a result shareholder's interests are inadequately protected.

Shareholders like to have a clear understanding of the risks they take and the measures in place to mitigate it. High risk acts as a deterrent in several projects. Indian companies in particular have a low threshold for risk. In a survey of risk-appetite conducted across Asia-Pacific region in 2011 by Swiss Re, a reinsurance major, India ranked 7th behind the developed markets of Japan, Hong Kong, Australia, Singapore, South Korea and Taiwan.

CFOs of many mid-sized firms can comprehensively narrate a long list of uncertainties, including customers defaulting on payments, risk to lives of key employees, corruption by employees, regulatory changes, competitor litigations and so on. However, if one probes deeper on the steps taken to address these risks the answers are often inadequate. This dichotomous behavior is reflected in a survey conducted by leading financial advisory firm KPMG in 2011. In this survey, more than 77% of Indian respondents said they faced increased risks in the past 2-3 years. However, survey results further reveal that risk management policies and responsibilities are informal in India when compared to more developed markets.

There are several ways to manage the risks described above. One of the generally accepted routes is Insurance. Traditionally, Corporate India has looked at Insurance as an 'avoidable cost', hence limited its coverage to basic property insurance against common perils e.g., Fire, Burglary. This approach has

resulted in very low penetration levels. According to the latest data published by Swiss Re, India in 2010 had a penetration of 0.7 per cent of GDP whereas the World average is 2.9 (more than four times) and developed countries like US, Switzerland have ratios of around 4.5 (more than six times).

If companies were more aware about the insurances available they would think of it as a cost-efficient risk management tool. Let me provide some examples on how risks that can be addressed by Insurance.

"Stuff happens to big boys"

Firstly , let's begin the most pervasive product of non-life insurance i.e., Fire Insurance. Even Fire Insurance is largely limited to large enterprises only. It was only during last *Diwali*, a posh restaurant next to our office was burnt to ashes because of an oil spill from *deepawali diya*. As you would expect, the restaurant was uninsured and had to bear a loss of crores of rupees. Such a massive financial loss could have been averted just by paying some thousands every year as annual insurance premium. But the syndrome that only large companies are exposed to such risks prevents them from taking such rational decisions.

Customer defaults on payments

This is a pervasive problem that few companies can avoid. To provide for such defaults, companies traditionally keep aside 1-5% of their revenues as 'provision for doubtful debts'. However, this provision does not help in major defaults. Insurance provides for a concept called Credit Insurance, where on payment of small premiums a company gets covered for customer defaults. This saves costs and protects against volatility in defaults.

Regulatory and litigation risks

Over the last decade, exporters have witnessed magnificent growth. Many exporters deal with clients in multiple countries and are under the purview of regulations in those countries. A civil law suit, initiated by a client, in a foreign country can entail significant burden on limited resources of the company. In some of the recent cases individual Directors and key executives of the Company have been held personally liable. In such cases, Insurance covers such as professionally indemnity, Directors liability, Errors and Omissions cover can help cover the company for financial damages, at a fraction of the cost of the paid-up capital of the company.

Product liability insurance

For a manufacturer, if product manufacturing, marketing and distribution were not enough of a hassle, there is another risk of third party damage caused by its products. This could be any bodily injury caused due to its product malfunction. The risk is real enough for Walmart to mandate all its suppliers (both domestic and international) to have Product Liability Insurance coverage. However, where not specifically required a large majority of Indian manufacturers remain vulnerable to such risks.

Though few and far in-between (and thankfully so!), such risks have the ability to singlehandedly drain all financial resources of the company. In many such cases the company has been rendered bankrupt.

Eventually, executives are accountable to their shareholders to preserve their capital. In an environment, where risk management tools are easily available, top executives unwittingly do not act in the best interest of company shareholders. In the race to protect the earnings number for the next quarter, executives expose companies to several vulnerabilities, thus threaten the very existence of the business in the long term.

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