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Newsletter from India's Leading Insurance Broking House
March 07

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The risk managers

Message from the Editor

Dear Readers,

For 3 issues in a row, we focused on De-tariffing and its related topics. The sensitization of the various stakeholders to the event of de-tariffing was important. But now that is done – partial freedom is already on, with complete freedom just round the corner.

While we have all celebrated this latest round of liberalisation, the industry also realizes that with freedom comes responsibility. Responsibility to grow the market with healthy practices. For Insurers, this means, among other things, developing the capability and the discipline to distinguish between good and bad risks and price (or accept/ reject) them accordingly. Brokers need to strengthen their knowledge base in preparation for the next D-day. And Corporates will do well to recognize that with free pricing and freedom in coverages, the best managed risks will walk away with the most cost-effective Insurance packages from eager insurers (already some 'loss-leading' insureds have seen thinner queues outside their office on renewal dates).

This is why we focus this month on a topic which is oft-discussed but rarely practiced in Indian corporates – Enterprise Risk Management. It is a powerful concept, perhaps a bit ahead of its time (but so was De-materialisation just 12 years ago), but nevertheless an essential tool. It is a culture and not just a 1-time agenda – and hence will take time to be established.

All the more reason for us to talk about it now.

We hope you will find the article useful.

We wish all our readers a prosperous financial year-end! And a good beginning for the next financial year.

V Ramakrishna
Editor – ***i-notes*** & Managing Director, India Insure

An Introduction to Enterprise Risk Management

Introduction

One of the primary goals of the CEO of any company would be to increase shareholder value and to be able to do this, sound decisions require to be taken about risk financing and risk mitigation. Across industries and organizations, many are realizing that risks are no longer merely hazards to be avoided, but, in many cases opportunities to be embraced. Risk in itself is not bad, but what is bad is risk that it is mismanaged, misunderstood or wrongly priced. Identifying and prioritizing risks, either with foresight or following a disaster management plan has been a long standing management activity. Treating risks by transfer to insurance or other financial products has also been a long standing practice, as has been contingency planning and crisis management. What has been changing though is the attitude of changing the outlook towards risk with a holistic approach rather than a compartmentalized approach and elevating risk management to a senior management function.

What is Enterprise Risk Management and what is its objective

In the simplest language, ERM is generally defined as *assessing and addressing risks, from all sources, that represent either material threats to business objectives or opportunities to exploit for competitive advantage*. It is also defined as the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the effects of risk on an organization's capital and earnings. Enterprise Risk Management expands the process to include not just physical risks but also financial, strategic, operational, and other risks.

Enterprise Risk Management helps the Corporate have a much larger perspective of the risk that they are exposed to. It begins with the top management responding to questions like,

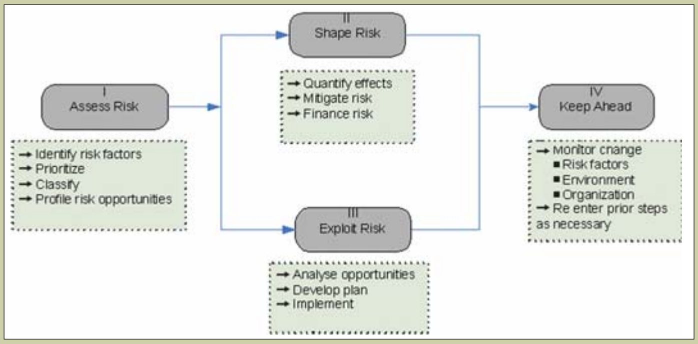
"What unforeseen event may disrupt our strategy?" or

"What risk might materially alter our company's financial status?" or, *"How well does the senior management of my company understand the risks that we are exposed to?"* or

"How well can my team handle risks that the company is exposed to?"

ERM is actually a straightforward process. And, in most cases, the requisite intellectual capital and business practices needed to carry out ERM already exist within the company. But an accurate, useful ERM process is based on sound analytics. Without valid measurements, managing risk is effective and efficient only by chance.

The conceptual approach to ERM



Classification of Risks

Risks in any industry or organization could be broadly classified under one of the following heads:

Hazard risk: These include risks arising from the generally insurable risks like fire, flood, liability, accident, business interruption etc.

Operational risk: Operational risks include risks arising out of a product service failure, or a risk to the supply chain, errors in business reporting, strikes in the company etc.

Financial Risk: Risks in this category include the risk of currency fluctuation, credit defaults, liquidity, inflation etc.

Strategic Risk: These include risks arising from competitors, customer demands, technological improvements, how much risk is the organization willing to absorb etc.

Reputation risk: The risks arising here include the risk to the brand and reputation in the manner in which the organization executes its strategies.

Regulatory risk: The risks arising in this category primarily include those related to compliance with regulations or contractual agreements – not just those that are financially based.

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Information risk: Risk in this category arises due to the failure of data / information knowledge being relevant and timely **or** the risk of the information not being reliable

How would it benefit the Corporate?

Good corporate governance should include a holistic approach to risk management and this can take place only by having a structured enterprise risk management programme. In order to develop a holistic approach to risk management, it is vital that there is commitment towards it from the Board and the Senior management. For this to happen, it is important for the senior officials of the company to understand the benefits of the program The value of Enterprise Risk Management is not just in the identification of risk, but also in understanding its impact on the fundamental financial and operational underpinnings of a firm. The notion is that if a corporation can identify and understand its risks better than its competition can, it will generate a measurable competitive advantage

Enterprise Risk Management provides enhanced capability to

- **Align risk appetite and strategy** – Risk appetite is the degree of risk, on a broad based level, that a company or entity is willing to accept in pursuit of its goals. Management considers the entity's risk appetite first in evaluating strategic alternatives, then in setting objectives aligned with the selected strategy and in developing mechanisms to manage the related risks
- **Link growth, risk and returns** – Companies accept risk as part of value creation and preservation, and they expect returns commensurate with the risk. ERM provides an enhanced ability to identify and assess risks, and establish acceptable levels of risks relative to growth and return objectives.
- **Enhance risk response decisions** – ERM provides the platform to identify and select among alternative risk responses – risk avoidance, reduction, sharing and acceptance. It provides methodologies and techniques for making these decisions
- **Minimize operational surprises and losses** – Companies have enhanced capability to identify potential events, assess risk and establish responses, thereby reducing the occurrence of surprises and related costs or losses. **It provides transparency through enhanced internal and external reporting**
- **Identify and manage cross enterprise risks** – Every company faces a large number of risks affecting different parts of the organization. ERM would help the management understand inter related impacts and be able to come out with solutions to multiple risks. It assists ability to aggregate business unit risks across an enterprise enabling better understanding of risk across functions and business units
- **Decision making** - It would support informed decision-making
- **Seize opportunities** – Management considers potential events – rather than just risks and by considering a full range of events, the management is able to understand how certain events could be translated into opportunities. It helps in identifying and exploiting areas of 'risk-based advantage'
- **Rationalize capital** – Healthy information flow on the company's total risk would enable the management assess more effectively the overall capital needs and thereby improve capital allocations
- **Protecting shareholder confidence** - Uncovering areas of high-potential adverse impact on drivers of share value thereby protecting and building shareholder value. It would assist to generate the best returns on investment thereby building Investor confidence
- **Robust Risk Culture -** Results in establishing a healthy "risk culture"

Case Studies

Given below are a couple of cases indicating how opting for an ERM has benefited various companies

- A large software developer considered insuring its building against fire damage. In analyzing risks related to the loss of the building, it concluded that the most serious impact of a fire was not the financial loss of the building, but displacement of its employees and interruption of operations. The company determined that it had the capital capacity to reconstruct the building and concluded it did not need fire insurance for the building. It resulted in choosing to reallocate its resources to address how it would deploy and equip staff following a loss.
- A University identified and assessed the risk associated with managing its student dorms and concluded that it did not have the requisite in- house capabilities to effectively manage large residential properties. The university outsourced the dorm management to a property managed company better able to manage and reduce the likelihood of property related risks.
- A manufacturer and importer of footwear established a vision of becoming a market leader in high quality footwear. To achieve this, it set out to manufacture shoes that combine durability and comfort, using the most advanced technology, together with highly selective import sourcing. The company reviewed its external operating environment and identified social and related events like an ageing consumer market and changing trends in work attire. Economic factors identified foreign currency fluctuations. Internal technology factors pointed out to outdated distribution management systems, and personnel factors to inadequate marketing training.

The Indian Market

It is heartening to note that in India the concept of Enterprise Risk Management is beginning to catch on. While a few Corporates have begun to realize the importance of this and created the post of a Corporate Risk Manager to look into the several angles from which the company could face a threat of risk, a vast majority of Corporates look to risk handling only from the insurance angle, choosing to believe that by taking an adequate amount of insurance, they are adequately protected. The position of a CRO has come about partly because of the pressure regulators and shareholders have put on companies to properly divulge the business risk. CROs in a financial institution will have to integrate credit risk, market risk, operational risk, economic capital and risk transfer.

Conclusion

In just the last few years, industry and government regulatory bodies, as well as institutional investors, have turned to scrutinizing companies' risk management policies and procedures. In more and more countries and industries, boards of directors are now required to review and report on the adequacy of the risk management processes in the organizations they govern. ERM clearly links risk management with the creation of organizational value and expresses risk in terms of impact on organizational values. ERM would require to be a part of the enterprise culture of tearing down silos in handling risks to make it effective and bear the desired results. It certainly comes as a ray of hope when insurers who normally interact with the finance or HR department are now getting introduced to the Chief Risk Officers who are championing the cause of ERM. Only once there is sufficient data to prove the benefits of championing the ERM cause would ERM become an accepted norm by all the organizations.

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Delay in Start up Insurance

Introduction

While undertaking any project, the cash flows form a vital part of the strategy. The projections are made for the revenue flow from the date of project completion / commissioning. Invariably there may arise situations where in the entire project gets delayed due to a mishap in the project site or due to accident to the vessel carrying machinery vital to the commissioning of the plant.

Both principals and contractors are being confronted with increasing financial risk exposure following the shift from governmental funding programs to private financing

Further, the approach towards private financing for large capital investments has also undergone considerable change. Principals now often collateralize loans with project assets and repay them directly through project earnings. In effect, they are securitizing future project revenues in advance while completing financial closures for the project.

As a result of private finance, protecting the revenue stream with appropriate insurance is increasingly regarded as of equal, if not greater importance, than protecting the assets themselves and accordingly, stringent conditions regarding delays in scheduled project completion have been added to contracts between financiers and principals, and, in turn, to those between principals and contractors. In turn, these conditions compel the parties involved to acquire the broadest possible insurance cover available in the market.

Commonly referred to as Delay in Start-up insurance (DSU) or Advance Loss of Profits insurance (ALOP), the insurance of revenue for projects under construction has gained significant importance over the last decade or so.

What does DSU cover?

DSU is the terminology used by the Marine insurance market for the consequential loss risk arising from loss or damage to materials whilst in transit en - route to the contract site from the place of origin.

ALOP similarly is the cover provided during the construction stage for consequential losses incurred in being unable to complete or commissioning the project due an insured peril.

Who can take a DSU / ALOP policy?

Only those parties who are exposed to a “loss-of-profits” risk in the event of a delay in start-up can be insured. They primarily constitute the owner, the principal, the future operator or parties financing the project, but not contractors, manufacturers or suppliers of the facilities.

Sum Insured : The sum insured should represent the Anticipated Gross Profit (i.e., Net Profit + Standing Charges) for the Indemnity Period selected. Net Profit means “Business profit before taxation”.

Standing Charges means fixed charges incurred even in the absence of business activity eg. interest charges, salary & wages, Director’s fees, O&M costs, liquidated damages.

Indemnity Period should be selected keeping in mind the maximum period required for re-importing, re-erecting and/or re-testing any part of the project.

Pricing : This section of insurance falls beyond the purview of tariff and is purely non tariff and for large projects it is governed by the reinsurance market.

Some features of a DSU policy : The policy pays for the actual loss of gross profit incurred during the period of delay, commencing from the scheduled date of commencement of commercial operation upto the actual date of commencement of commercial operation subject to a time excess and indemnity period selected. However, for a claim to be tenable under the DSU / ALOP policy, the **delay should have occurred due to a peril covered** (and payable) under the marine -cum- erection policy, storage-cum -erection policy or contractor’s all risk policy.

The policy does not cover delay due to:

- Inventory losses
- Delay in shipment of supplies
- Normal project schedule slippages
- Non -availability of funds for repairs/replacement to damaged items
- Cancellation of license or Govt. restrictions etc

Claims Case study

Fire during the construction of an office block : A construction project for a high-rise office block in Great Britain not only involved high-tech building installations for telecommunications, air conditioning, surveillance etc. but also a very complex facade design. A red marble from Brazil was used. This was cut and ground in Carrara, Italy, before being inserted into the corresponding aluminum mounts at a specialist facade company in Germany ready for fitting on site.

During the very labour-intensive interior finishing stage, involving large numbers of personnel, a fire broke out in the atrium, which rapidly spread through all nine floors of the approximately 55 m-high building. The large number of vertical and horizontal openings in the building during the installation work facilitated the spread of a great deal of smoke and conflagration gases throughout the building. A number of facade elements which had already been fully mounted were thus soiled to such an extent by soot, smoke and conflagration gases that they had to be replaced. Unexpected problems arose in connection with the exchange of these facade elements, which not only increased the property damage but also prolonged the period required for repair work:

- the colour of the marble being excavated from the Brazilian quarry had altered in colour in the course of the further exploitation of the quarry. Only after laborious searching could a sufficient quantity of material in the original colour range be excavated;
- according to the usual construction schedules, facade work is generally carried out towards the end of the construction phase, thus leaving enough time even for very time-consuming facade construction work such as this. However, this situation was completely altered with the procurement of replacement facade elements following the fire. The excessive amount of time required for facade construction began to have a negative effect on the fire damage repair work, due to the search for material, its shipment to Italy and overland transport to the manufacturing plant;
- at the manufacturing plant itself, series production of the marble facade elements had long since come to an end, making it necessary to rearrange production sequences before the replacement elements could be manufactured.

The conclusion to be drawn and noted in this case is the fact that imported components and materials, made-to-order items, prototypes and complex construction sequences have a general tendency to aggravate the risk in the case of ALOP cover. It is therefore essential to recognize such circumstances at an early stage, whether through an in-depth study of the risk documents or through pin-pointed enquiries, in order to ensure that this is adequately taken into account in the underwriting phase.

Conclusion

As the awareness is catching on, the demand for these products have been steadily on the rise. A strong interest comes from lenders who aim at comprehensive insurance protection with new investments. Risk control is essential in ALOP insurance. It begins already in the underwriting phase, especially with a detailed review of the stated sum insured. The claim handling of ALOP losses is complex and each case represents a unique situation that must be correctly assessed in terms of the policy. With the increased dependence on private financiers, this is a highly recommended product to safeguard the interest of the principal.

Emergency Action Plans and Fire Prevention Plans

Introduction

Having an Emergency Plan for an organization of any nature is an effective risk management tool. Businesses with more than ten employees must have *written* Emergency Action Plans (EAPs) and *written* Fire Prevention Plans (FPPs). For businesses with fewer than ten employees, the elements of the plan can be communicated orally)

Emergency Action Plan (EAP)

An EAP details the actions employees are to take in the event of an emergency. An *emergency* may include bomb and violence threats, accidental releases of toxic vapors, chemical spills, fires, or explosions. The plan should address all potential emergencies that can be expected in the workplace.

The primary objective of the EAP is to have all employees know how to:

- exit to safety
- alert fellow employees
- notify the appropriate emergency resource agency

The EAP must include, as *a minimum,* these elements:

- emergency escape procedures
- procedures to be followed by employees who remain to perform critical plant operations
- procedures to account for all employees after an emergency evacuation
- rescue and medical duties for those employees who are to perform them
- preferred means for reporting emergencies
- names or regular job titles of persons or departments to be contacted for further information or explanation of duties under the plan

Fire Prevention Plan (FPP)

The Fire Prevention Plan (FPP) is a *written plan* intended to educate employees about specific hazards of their jobs. In essence, the FPP is an extension of the EAP. It is recommended that employees responsible for the EAP also administer the FPP.

The FPP must include, *as a minimum,* these elements:

- a list of the major workplace fire hazards and their proper handling and storage procedures, potential ignition sources and their control procedures, and the type of fire protection equipment or systems that protect against these hazards
- names or regular job titles of personnel responsible for maintenance of equipment and systems installed to prevent or control ignitions or fires
- names or regular job titles of personnel responsible for control of fuel source hazards
- guidelines for proper housekeeping procedures
- guidelines for training employees in the fire hazards of the materials and processes to which they are exposed
- procedures for preventive maintenance of equipment and systems installed on heat-producing equipment.

Experience has shown that organizations with EAPs and FPPs usually recover successfully from emergencies. Where plans exist, reaction times are reduced, coordination is accelerated, hazards can be contained, and business activities can be resumed more quickly.

Is *your* organization prepared for an employee emergency? The requirements for an EAP and FPP outlined in this article will help you refine your existing plan or begin a new one *today!*

Source: Hartford

Corrigendum:

Our January 2007 issue of inotes carried an article on “Selecting your Insurer” in which we had erroneously mentioned that only two of the four PSU insurers have been rated mentioning that Oriental Insurance and United India have not opted to be rated.

The ratings of the 4 PSUS today stand at

United India Insurance:	iAAA rating by ICRA
Oriental Insurance Co.:	B+ + (Very Good) by AM Best AAA by CRISIL; iAAA by ICRA
National Insurance Co.:	AAA by CRISIL
New India Assurance Co.:	A (Excellent) by AM Best

We deeply regret the error and the inconvenience caused and stand corrected

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