PRISM
PRACTICAL RISK MANAGEMENT

DISTINGUISHING BETWEEN RISK TYPES

Insurers manage risk on behalf of their stakeholders. The policyholders of long- and short-term insurers, funeral insurers, microinsurers and reinsurers all expect these entities to pay the utmost attention to the risks that they take on. Their shareholders expect no less of them either. Not all risks are equal, however. Some should be avoided and others tolerated but managed. Some risks, however, must be actively sought in the pursuit of the business strategy of the insurer.

We are all different in our attitudes to risk. Some will spend a few rand on lottery tickets in the hope of a return, others a great deal more at the races or casinos. Cyclists take different approaches to hair-raising downhills and children to the thrills at the amusement park. Some invest in cyber-currency; others avoid it.

Our circumstances play a part in these differences. Keen to jump from an aircraft with a chute on my back when young, I had a rather different attitude when the children arrived. As a student, I weaved through traffic to cross the road. I will probably wait my turn at the marked crossing when I am older.

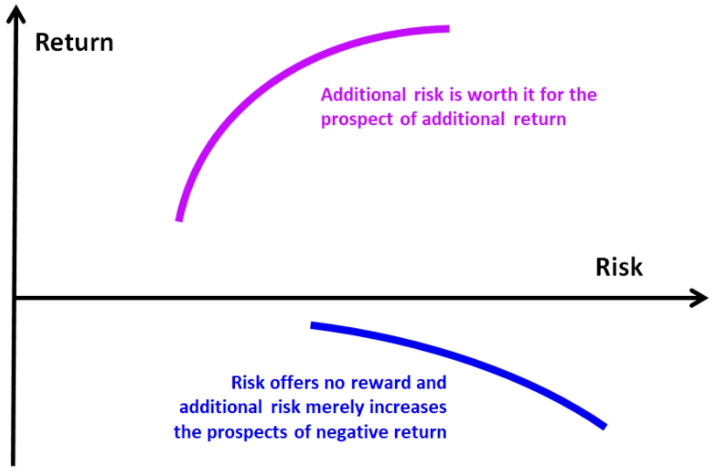
It is not just the situation that matters, though. The risks themselves may be intrinsically different. For example, the assets backing our savings typically need to provide a good real return in the long run. So short-term investment volatility is sought because it provides a better prospect of long-term gain. We tolerate physical discomfort when exercising for the potential of improved fitness. These risks are worth taking for the reward offered.

Other risks do not offer such prospects. Most of us avoid trouble with the law no matter the potential gains. We are particularly wary of actions that might lead to reputational damage.

Risk characteristics

Our management of the risks in insurance benefit from a similarly careful approach. First, understand the nature of these risks, classifying them into broad types in the process. Then determine the most appropriate way to respond to each of them.

Some risks may be depicted like the pink line on the chart alongside. Taking more of the risk is expected to deliver a return, even if only in the long-term. In other words, achieving the objectives of the fund is facilitated by taking more risk. Underwriting risk is a fine example of this: insurers must take on such risk in order to succeed.



Others are more like the blue line. Any exposure to the risk is bad. There is no reason to add further to the risk. Reputation risk, for instance, is always to be avoided. There is also no merit in adding to regulatory risk.

Others fall somewhere in the middle. Operational risk is almost impossible to avoid completely. The costs of doing so most likely exceed the corresponding benefits. So, it is better to acknowledge the existence of the risk. Then we should devote appropriate resources to identifying the sources of such risk and to managing the potential for the damage that it could cause.

Risk management strategy

We need to take a deliberate approach. Strategy is not just appropriate for the pursuit of our goals but for our defence of those goals as well. We have a better chance of achieving what we seek from our risk management practices if we identify their objectives.

And how do we do this? We establish first the priorities of our business. We then identify the traps most likely to imperil these goals. This puts us in a strong position to itemise the types of risks that we are exposed to and describe an appropriate approach in response to each of them.

Success in risk management takes hard work. To determine the key risks to success, we must start by defining this success. And then we need to scrutinise those risks with care. Does further exposure to these risks promise the prospect of success as we have defined it, or does it detract from it? This provides the foundation for a deliberate approach to each of these risks, ultimately **in pursuit of the objectives of the insurer**.

18.08.2021

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