

Project Risk Management

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PMG 510
Project Risk Management

Lecture 7



Lecture

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Lecture Outlines

1. Importance of insurance
2. Types of insurance cover
3. Evaluation of insurance needs
4. Purchase of insurance
5. Captive insurance companies
6. Business continuity management

Insurance and Risk Transfer

Importance of insurance

- Insurance contracts can require the insurance company to **pay for losses** suffered **directly by the insured**.
- This is first-party insurance and includes **property damage insurance**.
- Other types of insurance contract the insurance company to **pay compensation** to other parties if they have been injured or suffer loss because of the activities of the insured.
- This is **third-party insurance** and includes **motor third-party and public/general liability**.

Insurance and Risk Transfer

Importance of insurance

- Insurance contracts are contracts of **utmost good faith**.
- This means that **the insured party is required to disclose** all information relevant to the insurance contract.
- If this information has not been disclosed, the insurance company or **underwriter has the right to refuse to continue** to provide insurance cover and may refuse to pay any claims that have arisen.

Insurance and Risk Transfer

Importance of insurance

- There are advantages and disadvantages associated with the use of insurance as a risk transfer mechanism.
- The advantages are:
 - it provides indemnity against an expected loss.
 - Insurance can reduce uncertainty regarding hazard events that may occur.
 - It can provide economic benefits to the insured, because the loss may be greater than the insurance premium.
 - Finally, insurance can provide access to specialist services as part of the insurance premium. These services may include advice on loss control.

Insurance and Risk Transfer

Importance of insurance

- The disadvantages:
 - Include the delays often experienced in obtaining settlement of an insurance claim and the difficulties that can arise in quantifying the financial costs associated with the loss.
 - There may be disputes regarding the extent of the cover that has been purchased and the exact terms and conditions of the insurance contract.
 - Finally, the insured may have difficulty in deciding the limit of indemnity that is appropriate for liability exposures. This may result in under-insurance and the subsequent failure to have claims paid in full.

Insurance and Risk Transfer

Importance of insurance

- There are alternatives to insurance when an organization wishes to transfer the financial impact of a hazard event.
- Alternatives to insurance are sometimes referred to as alternative risk transfer or alternative risk financing techniques.

Insurance and Risk Transfer

Importance of insurance

- The risk financing options available to an organization include:
 - conventional insurance;
 - contractual transfer of risk;
 - captive insurance companies;
 - pooling of risks in mutual insurance companies;
 - derivatives and other financial instruments;
 - alternative risk finance **mechanisms**; and
 - single premium insurance bonds.

Insurance and Risk Transfer

Importance of insurance

- **Risk retention** may be achieved by accepting a **large excess or deductible** on an insurance policy, deciding not to insure a **certain risk exposure** (self-insurance) or setting up **a captive insurance company**.
- A number of organizations with similar **risk exposures** may decide to **set up a joint captive insurance company**.
- This is often referred to **as risk pooling** or the establishment of a mutual insurance company.

Insurance and Risk Transfer

Importance of insurance

- **Insurance** is a risk **transfer** or risk **sharing** response. It represents an **after-the-event cost containment response** to a risk.
- **Insurance** is most important for **low-probability/ high-impact risks**, such as **destruction of assets or the payment of liability costs**.
- As well as **repairing assets**, insurance is available **for the cost of implementing disaster recovery plans** and the **business continuity plans**.
- Insurance can also be purchased to **cover the increased cost of operation**.

Insurance and Risk Transfer

Importance of insurance

Chicago Fire of 1871

- At about 9 o'clock on the night of 8 October 1871, a fire started in a cowshed behind a Chicago home. It had been an unusually dry summer and the flames jumped quickly from house to house, then from street to street. The blaze raced along from the south-west to the north-east, enveloping the business district. Then the lumber capital of the world, Chicago was a city built primarily of wood.
- Chicago's business district was indeed impressive. With the development of the railroad and the economic boom that followed the American Civil War (1861–65), the city thrived.

Insurance and Risk Transfer

Importance of insurance

- But the fire raged through four square miles of the metropolis; it demolished factories, stores, railroad depots, hotels, theatres and banks.
- Flames burned ships in the Chicago River and consumed nearly all the city's publishing and printing. In the end, property damage totaled \$192 million. Nearly 300 people died in the blaze and 100,000 were made homeless.
- The rebuilding of Chicago was a tremendous endeavor. Insurance companies in the United States and Europe rose to the occasion, producing the sums they were obliged to pay for the damages.

Insurance and Risk Transfer

Importance of insurance

- Cities in the United States and abroad sent \$5 million in relief funds, and thousands of donated books replenished Chicago's libraries.
- Before long Chicago began to attract entrepreneurs, businessmen and well-known architects, who found ways to profit from the reconstruction efforts.

Insurance and Risk Transfer

Types of insurance cover

- Generally speaking, there are three reasons **why an organization will wish to purchase insurance cover.**
- In summary, **the reasons for buying insurance** are as follows:
 - Mandatory legal and contractual obligations;
 - Balance sheet/profit and loss protection;
 - Employee benefit/protection of employee assets.

Insurance and Risk Transfer

Types of insurance cover

- In most cases, the purchase of insurance is not compulsory. However, most countries make the purchase of insurance compulsory in certain circumstances.
- Typically, these are the liability classes, including insurance cover to compensate injured employees and for the parties involved in road accidents.
- Apart from the compulsory classes, organizations can decide whether to purchase insurance. This decision will be based on the assessment of the risk and whether the nature and level of risk is within the hazard tolerance of the organization.

Insurance and Risk Transfer

Types of insurance cover

- The cost of insurance (premium) and the extent of insurance coverage are also important considerations when deciding whether to buy insurance.
- Typically, insurance is purchased for low-likelihood/high-magnitude risks, such as flooding, hurricane damage and major fires.

Insurance and Risk Transfer

Types of insurance cover

Different types of insurance

- Mandatory, legal and contractual obligations
- Employers' liability – compensation to employees injured at work
- Public liability – compensation to public or customers
- Motor third party – compensation following motor accident
- Product liability – compensation for damage or injury
- Professional indemnity – compensation to client for negligent advice
- Balance sheet/profit and loss protection
- Business premises – damage to premises by adverse events
- Business interruption – loss of profit and increased cost of working

Insurance and Risk Transfer

Types of insurance cover

- Asset protection – losses, such as loss of cash, goods in transit, credit risk and fidelity guarantee (staff dishonesty)
- Motor accidental damage – repair of own vehicles
- Terrorism – compensation for damage caused by terrorism
- Loss of a key person – compensation on loss of key staff member
- Employee benefit/protection of employee assets
- Life and health – benefits to employees that can include: life cover, critical illness cover, income protection, private medical costs, permanent health cover, personal accident and travel injury/losses
- Directors' and officers' liability – legal and compensation costs

Insurance and Risk Transfer

Types of insurance cover

- Consider the example of the insurance needs of a publisher. In relation to legal obligations, the company realizes that it has to buy employers' liability insurance and motor third-party insurance.
- Also, it is a requirement placed on magazine distributors by the wholesalers that the company purchases libel and slander insurance.
- In order to protect the balance sheet and profit and loss account, the company needs to purchase property damage and business interruption insurance, together with credit risk insurance and goods in transit insurance.

Insurance and Risk Transfer

Evaluation of insurance needs

- There is a wide range of different types of insurance available and the specific activities and features of the organization will assist in deciding the scope of insurance that needs to be purchased.
- Sometimes, there is a shortage of insurance capacity and although the organization has decided that it wishes to purchase that type of insurance, it may not be available at an affordable cost.

Insurance and Risk Transfer

Evaluation of insurance needs

- There has been a **tendency** in recent times for organizations to look at the **whole portfolio of risks they face**.
- This enterprise risk management approach to risk has **resulted in a careful review of how much insurance an organization wishes to purchase**.
- **For example**, if there are significant risks within a project, but insurance is only available **for limited risk exposures**, purchase of insurance for only those limited risks may not be appropriate. The enterprise approach to risk management has reduced the use of insurance as **a risk control mechanism** for some organizations.

Insurance and Risk Transfer

Purchase of insurance

- When looking at the purchase of insurance cover, the organization will need to **consider the 6Cs of insurance buying**, as follows:
 - Cost;
 - Coverage;
 - Capacity;
 - Capabilities;
 - Claims;
 - Compliance.

Insurance and Risk Transfer

Purchase of insurance

- The cost of insurance is defined by the insurance premium that is required from the organization.
- A second component of the cost is the level of self-insurance (including excess or deductible) that is imposed by the policy.
- This means that if a claim occurs, the organization will have to pay the first part of the claim before receiving any money from the insurance company.
- Insurance policies usually have limitations, warranties and exclusions. These will state that claims will be refused in certain circumstances.

Insurance and Risk Transfer

Purchase of insurance

- These coverage issues need to be explored in detail by the organization purchasing the insurance to ensure that adequate coverage is available.
- The only reason for buying insurance is that claims **will be paid when one of the identified events occurs.**
- The **history of the particular insurance company** in relation to the payment of claims and the reputation of that insurance company **will be important factors when deciding** which insurance company to appoint.

Insurance and Risk Transfer

Purchase of insurance

- For very large organizations with considerable assets, one insurance company on its own may not be willing to offer coverage up to the full value of those assets.
- When buying insurance, the organization will need to think about the capacity that the insurance company is willing to offer in relation to the value of the assets/exposure that need to be insured.

Insurance and Risk Transfer

Captive insurance companies

- A captive insurance company is an insurance company owned by an organization that is **not otherwise involved in insurance.**
- The purpose of a captive insurance company is to provide insurance capacity for the organization by using **its internal financial resources** to fund certain types of **anticipated losses or insurance claims.**
- The organization that owns a captive insurance company is often referred to as **the parent of the captive,** or **simply the parent organization.**

Insurance and Risk Transfer

Captive insurance companies

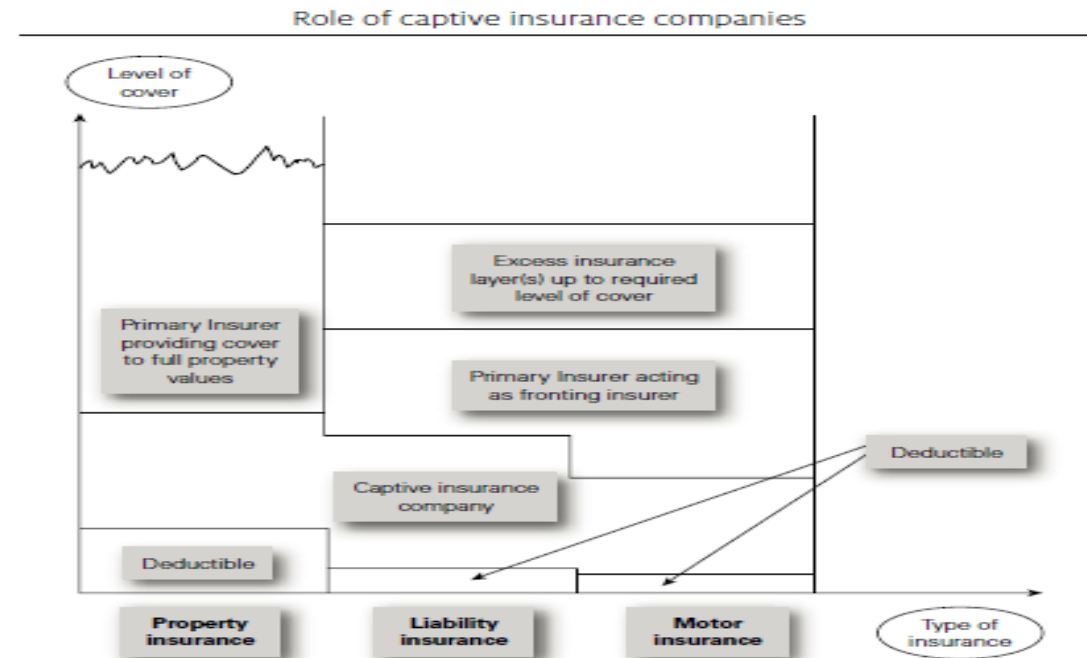
- In general, captive insurance companies are domiciled in a location that has a favorable regulatory and accounting regime that encourages the establishment of captive insurance companies.
- Domiciles for captive insurance companies include Guernsey, the Isle of Man, Gibraltar, Malta, Luxembourg, Bermuda and Ireland.
- In theory, such a company may write insurance business directly into other countries, although compliance issues surrounding non-admitted policies may need to be carefully considered.

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Insurance and Risk Transfer

Captive insurance companies



Insurance and Risk Transfer

Captive insurance companies

Benefits of captive insurance companies

- For many years, large corporations have enjoyed many benefits from operating their own captive insurance companies. Most were established to provide coverage where insurance was unavailable or unreasonably priced.
- These insurance subsidiaries were often domiciled offshore, especially in Bermuda or the Cayman Islands.
- The risk management benefits of these captives were primary, but their tax advantages were also important.

Insurance and Risk Transfer

Captive insurance companies

Benefits of captive insurance companies

- A properly structured and managed captive insurance company can provide the following benefits:
 - tax deduction for parent company for premium paid to captive;
 - opportunity to accumulate funds in a tax-favoured domicile;
 - distributions to captive owners at favourable income tax rates;
 - asset protection from the claims of business and personal creditors;
 - reduction in insurance premiums paid by the operating company;
 - access to the lower-cost reinsurance market; and
 - insuring risks that would otherwise be uninsurable.

Business continuity

Business continuity management

- There has been considerable interest in the subjects of **business continuity planning (BCP) and disaster recovery planning (DRP)** in recent times.
- **Several standards** have been published around the world. This illustrates the importance of BCP as an integral part of risk management.
- This increased **concern has been reinforced** by the potential for major disruption posed by **extreme weather events, terrorist attacks, civil emergencies and the fear of a flu pandemic.**

Business continuity

Business continuity management

- In simple terms, BCP is how an organization prepares for future incidents that could jeopardize its existence.
- The range of incidents that should be covered will include everything from local events like fires through to regional disruption such as earthquakes or national security incidents and extend to international events like terrorism and pandemics.

Business continuity

Business continuity management

- **British Standard BS 31100:2011 defines BCP as:**

“[An] holistic management process that identifies potential threats to an organization and the impacts to business operations that those threats, if realized, might cause, and which provides a framework for building organizational resilience with the capability for an effective response to safeguard the interests of its key stakeholders, reputation, brand and value-creating activities.”

Business continuity

Business continuity management

- In case of a serious incident such as loss of access to premises or the failure of a major part of an organization, it is important to have in place a well-defined, documented and tested **disaster recovery plan**.
- Such plans inevitably focus on recovery of **access to IT systems and data**, but also commonly cover the provision of **alternative premises (if needed)** and other facilities, as well as setting out plans for communications with employees and with other **stakeholders such as suppliers, customers and the media at a time of crisis**.

Business continuity

Business continuity management

- Business continuity plans build upon this by setting out longer-term plans for restoration of 'business as usual' in the immediate aftermath of a disaster.
- A business continuity plan is an important part of reducing the impact of a hazard incident.
- The plan should include arrangements for reducing the damage caused during the incident and containing the cost of recovery from it.

Business continuity

Business continuity management

- Disaster recovery plans are a particular component of BCP.
- **EX.** If a computer system fails to operate correctly or data has become corrupted, the organization will need emergency procedures to ensure that the data can be recovered and/or ensure that the organization continues in existence.
- There may also be a wider need for a specific plan to manage any crisis that may result from an operational disaster.

Business continuity

Business continuity management

- The main difference between the disaster recovery and crisis management plans is :
 - the disaster recovery plan will be mainly concerned **with actions to restore the infrastructure of the organization** and a crisis plan will also be concerned with **external stakeholders and actions** to manage the associated stakeholder reaction and expectations.

Business continuity

Business continuity management

- Many organizations are now taking the view that **BCP** should be viewed as having three components.

1- The **first** response to any major event **is to activate the crisis management plan to ensure appropriate response** to the crisis and, in particular ensure that stakeholders are aware of the situation.

- This will require **effective communication with all stakeholders**, so that the **damage to reputation** resulting from **the incident is kept to a minimum**.

Business continuity

Business continuity management

2- **secondly**, the organization will then seek to **recover from the event by implementation of a disaster recovery plan.**

3- However, as the disaster recovery plan is being implemented, the organization will still need to consider the **ongoing management of the crisis.**

The organization should ensure that implementation of the disaster recovery plan is viewed as the second, but sometimes overlapping, stage of responding to the incident. In fact, in certain circumstances, it will only be possible to implement the disaster recovery plan once the immediate crisis has been contained.

Business continuity

Business continuity management

- When implementation of the crisis management arrangements is well advanced, and the disaster recovery plan has been activated, the organization will then be able to turn its attention to **the third and broader operational issue of business continuity.**

An example of this three-stage approach is when a serious road traffic accident occurs that obstructs a major road or highway. The initial response of the emergency services will be to deal with the crisis that may involve injuries to people and, in certain circumstances, a vehicle fire and/or other traffic travelling too fast towards the incident

Business continuity

Business continuity management

- When the immediate crisis has been contained, the disaster recovery phase can be implemented and this will include clearing the damaged vehicles and/ or repairing the road surface and crash barriers.
- It is only when these two stages have been completed that bringing the road back into use, or the business continuity aspect, can be addressed.

Business continuity

Business continuity management

- If the road traffic accident involved commercial vehicles or there was an allegation that a driver from the identified company caused the incident, the need for crisis management responses will extend to the road haulage or transportation company involved in the incident.
- The company should activate their crisis management plan to demonstrate social responsibility and to ensure minimum damage to their reputation.
- The road haulage company may also wish to take action during the crisis to support other stakeholders, including the families of drivers who may have been injured in the incident.

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Business continuity**Business continuity management**

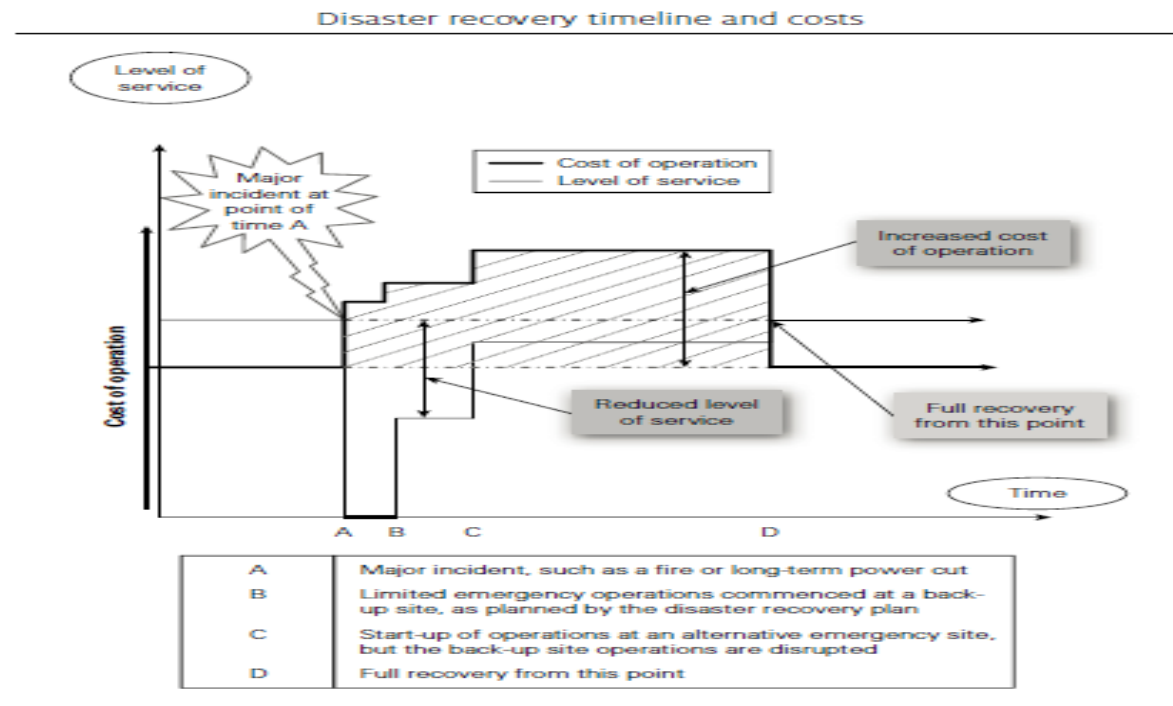
- Next Figure provides an illustration of a disaster recovery timeline and costs.
- The need to ensure adequate crisis management and effective communication with stakeholders covers the whole period of disruption (from point A to point D) and possibly beyond.

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Business continuity

Business continuity management



Conclusion

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Thank You