

## Insurance as the Backbone of Risk Management

Syed Ahmed Salman

Institute of Islamic Banking and Finance, International Islamic University Malaysia, Malaysia

**Abstract:** Human being is the biggest social animal on the earth becoming more and more powerful and reaching to the moon, space and playing a key role in the universe, still he is helpless in the hands of uncertainty or risks. Risks may affect any life, property or even a business organization, often risk creates lot of hurdles and wounds the lives of many in society. This question makes us to think how to assist these unfortunate people. The only way to tackle such situation is through insurance. Insurance has been used, as a risk mitigating tool by us. This study aims to reemphasize the usefulness of insurance and how it helps us in managing the risks faced in almost all aspects of our daily life. By referring to the descriptions of risk by several researchers and its historical development, it can be summed that insurance is the backbone to mitigate majority of risk encountered by us.

**Key words:** Insurance, risk management, historical development, backbone, organizations

---

### INTRODUCTION

Risk is emerged with the birth of human being. Once we are coming out from the mother womb, we are exposed to the worldly environment which is unfamiliar to the newly born babies. Due to the exposure of the environment, the baby can be exposed to risk whether the baby is healthy or not and the baby can be breastfeed by the mother or not. From the stage of newly born baby until he dies, risk is always together like a shadow for the person. Since, the risk is part and parcel of the daily lives. It is faced by us at the individual level, as well as business activities. As a result, we have to rely on the insurance to seek the protection from the misfortune. Thus, this study presents a various definitions of risk and their classification. In addition, how we should manage the risks for individual and business by insurance. The tremendous growth of insurance is also historically evidenced.

### DEFINITIONS AND CLASSIFICATION OF RISK

Risk is defined in many ways. Prior researchers define the risk in many different ways. Some of the definitions are as follows:

- Risk is a measure of the probability and severity of adverse effects (Lowrance, 1976)
- Risk is the probability of an adverse outcome (Graham and Weiner, 1995)
- Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for (Vaughan, 1996)

- Risk is a situation or event where something of human value (including humans themselves) is at stake and where the outcome is uncertain (Rosa, 2003)
- Risk can be defined as the combination of the probability of an event and its consequences (ISO, 2002)
- Risk is the probability of an undesirable event (Campbell, 2005)
- Risk is an uncertain consequence of an event or an activity with respect to something that human value (Renn, 2005, 2008)
- The risk has 2 characteristics, i.e., it is related to uncertainty and it has consequences (Hillson and Webster, 2007)
- Risk can be divided into pure and speculative risks. Pure risk refers to a condition when there is no prospect of gain, if a risk becomes a reality or preservation of the status quo, if the risk does not happen. Speculative risk refers to a position where there is a possibility of either gain or loss such as gambling or a business undertaking (Crockford, 1987)

In the researcher's opinion, the risk can be defined as a positive or negative event whose probability of occurrence and both financial and non-financial impact can be measured reasonably. Generally, risk can be classified into 2 types, i.e., the speculative risk (similar to gambling and it has two possible outcomes which are gain or loss) and the pure risk which can result in loss or no loss (Kassar, 2008; Diacon and Carter, 1992).

In the case of risks in business, there are 5 general types and they are strategic, financial, operational,

compliance (regulatory) and other risks. Strategy risk is defined, as a possible source of loss that might arise from the pursuit of an unsuccessful business plan. For example, strategic risk might arise from making poor business decisions from the substandard execution of decisions from inadequate resource allocation or from a failure to respond well to changes in the business environment. Financial risk defined, as the possibility of loss inherent in financing methods which may impair the ability to provide adequate return. Operational risk is defined, as possibility of loss occurring from the internal inadequacies of a firm or a break down in its controls, operations or procedures. Compliance (regulatory) risk is defined, as exposure to financial loss arising from the probability that regulatory agencies will make changes in the current rules or will impose new rules that will have the negative impact. Other risks will include risks arising from natural disasters, war, changes in the market situations and etc. (<http://www.businessdictionary.com/definition/>).

After presenting the definitions and general classification of risks, the following study will discuss the common and specific types of risks faced by the personal level, as well as business entities.

#### **COMMON TYPES OF RISKS FACED BY INDIVIDUALS AND BUSINESS ENTITIES AND THEIR RISK MANAGEMENT**

**Faced by individuals and their risk management:** By nature, human being is weak and there is a tendency that they will try to find a mean to protect and secure them in the misfortune. Common types of risks faced at the individual levels are related to risks to the property owned, for instance car and house, health, permanent disablement and personal accidents. Risks related to the property involve fire and flood. In the case of health, the cost of medical expenses is a burden for the individuals. Moreover, when someone is suffering from permanent disablement, the continuation and survival of the life is not easy since it needs strong financial support. Similarly, the personal accidents might be difficult to avoid in the daily lives, since most of us have experience ranging from the minor to the major accidents. Common current practice to claim the expenses incurred in the case of misfortune is buying the insurance. In most of the cases, parents want the kids to be secured, especially in the case of education and they will start engaging in the insurance product, i.e., child education plan. Salary earners are, also interested to have sufficient amount of money when they retired and hence, they prefer to buy the insurance products, for instance investment linked products and retirement products.

In addition, the government policy makes the people unavoidable from insurance. For instance, it is compulsory for the motor insurance and it is widely practiced in many developed countries, such as Canada, United States of America, United Kingdom and in many developing countries such as Malaysia and India. In some countries like the United States of America if the people do not have health insurance, they cannot be admitted to the hospital. Therefore, insurance cannot be avoided due to the living style of the daily life now-a-days.

#### **Faced by business entities and their risk management:**

The main purpose of existence of the business entities is to earn profit and it cannot be attained without taking risk. According to the capital asset pricing model, risk and return are highly and positively correlated. This means that the higher the risk is the more return will be and the lower the risk is the lesser the return will be mention the top 10 risks faced by the business entities worldwide and they are related to economic slow down and slow recovery, regulatory or legislative changes, increasing competition, damage to reputation and brand, failure to attract or retain top talent, failure to innovate to meet customer needs, business interruption, commodity price risk, cash flow or liquidity risk and political risk and uncertainties.

Business entities manage the risks by taking 5 steps. These steps are the suggested steps according to AON (2013). They are as follows:

**Step 1; establishing the context:** The purpose of this step is to make a suitable boundary in which the business entities should manage the risks. In establishing the boundary, the external and internal environments, risk profile, risk appetite of the business entities are the main factors to examine.

#### **Step 2; risk identification and assessing the major risks:**

In this stage, business entities identify the cause and source of the risk. It includes 2 types of identifications, i.e., initial risk identification and continuous risk identification. Initial risk identification is practised especially for the new projects, products or activities. Continuous risk identification is done to identify the new risks which have not be deducted before to double check whether the existing risks are still relevant and to examine whether there is any changes in risks.

**Step 3; risk analysis and evaluation:** Risk analysis and evaluation is to assess the possibility of occurring and its impacts on the companies in order to locate the risks based on the seriousness for treatment.

**Step 4; risk treatment/response strategy:** A few options are available for risk treatment. They are:

- Risk transfer
- Risk termination
- Taking the opportunity
- Accepting the risks
- Avoiding the risks
- Risk mitigating

**Risk transfer:** In the case of risk transfer, the companies will engage with the insurance operators whereby the risks of the companies are transferred to the insurance operators. The former ones will pay the premium and the later ones will take responsibility and pay the compensation.

**Risk termination:** In the case of risk termination when the companies assess the risks and they become at the acceptable levels, the companies will terminate their monitoring on these risks.

**Taking the opportunities:** Sometimes, the companies are willingly to take risk to take the business opportunities in order to receive the return.

**Accepting the risks:** The companies will accept the risks if the probability of risk occurrence is low, the consequence is not much affected on the performance of the companies, the cost of treating the risks is higher than the benefits and the risks is within the risk appetite of the companies.

**Avoiding the risks:** If the companies are choosing the risk avoiding strategy, they will remove the causes of risks or involve in the project or investment in which undesirable risk might be faced.

**Risk mitigating:** In mitigating the risks, the companies will try to minimize the possibility of the risks and consequences. If the companies are planning to mitigate the risks, they need to compare cost and benefit of mitigating the risks.

**Step 5; risk monitoring:** Effective monitoring is necessary to ensure that the risks have been managed effectively. The main aim of this monitoring process is to check the existence, level of seriousness and changes in risk priorities based on risk appetites. Frequency of the monitoring depends on the level of severity of risks.

**Step 6; risk communication:** Risk communication is necessary to make sure that all the branches are aware of

risk management and learn the risks faced by other branches. The risk report should be reviewed by the board of directors for modifying the existing strategies and for developing the new strategies if necessary.

Discussion in this study shows that insurance can be used, as a tool in managing the risks faced by the business entities.

## **HISTORICAL DEVELOPMENT OF INSURANCE AND ITS FUTURE OUTLOOK**

Previous studies, highlight the important role of insurance in the personal lives, as well as business activities. Both individuals and business entities try to seek protection by buying the insurance and so far, it is widely practiced all over the world. This study is going to highlight the usefulness of insurance by referring the historical development of insurance. This study is written by referring to Prudential Insurance Company of America (1915), Diacon and Carter (2005), Alhabshi *et al.* (2012), Mehr (1986) and Mishra and Mishra (2012). What is takaful a guide to Islamic insurance, 2008.

Around 3,000 B.C., insurance for the property becomes popular in China. Agreement at that time is the insuring partner reimburses the owners of the ship and goods in the case of loss. The history of insurance can be traced back to during the time of Babylonians around 1,750 B.C. During this time, Mediterranean sailing merchants in Babylon are trying to get the protection from the money lenders by paying the extra amount in addition to the borrowed principal amount in the event of loss from the sink of ship and loss of goods from robbery and bad weather. The Code of Hammurabi was introduced and it was the 1st basic insurance policy. Around 1,600-1,000 B.C. Phoenicians adopted the bottomry contract. The Greeks, also adopted the bottomry contract for sea trade around 4 B.C. and they were followed by Romans. The Rhodian Sea Law and the principle of contribution can be traced back to B.C. 1000. During this time, the purpose of the contribution is to help if the ship is caught in the storm and damage of cargo. The Rhodian Sea Law is the most ancient principle governing commerce by sea.

In the case of insuring the people, it is started in Iran. Achaemenian monarchs of Ancient Persia started to insure their people and the insuring process is registered with the governmental notary offices. The insured person will get the compensation when he is in trouble. If the registered amount exceeds 10,000 Derrik, he will receive an amount of twice of the registered amount.

During A.D. 133, the idea of life insurance seems to be started from Romans who created the 1st burial

insurance for the members who join burial clubs called *Fratres*. The funeral expenses are paid to surviving family members. In addition, during A.D. 220, the Mutual Benefit Life Insurance Company came out with Roman life table. During A.D. 600, the Greeks and Romans introduced the origins of health and life insurance while organizing guild called benevolent societies. The purpose of this society is to care for the families and pay funeral expenses of members upon death.

During A.D. 622, the concept of *al-aqilah* started the emergence of insurance in Madinah. Their practice is to give the money to the immediate family members of the dead person who is killed. From A.D. 634-644, during the second caliph of Islam, Umar B. Al-Khattab, a *diwan* (committee) of *Mujahideen* (collectors) is created. The persons whose names are under the committee need to provide the mutual assistance and to contribute blood money for manslaughter committed by someone from their own tribe.

The practice of insurance is widely spread in Spain A.D. 912-961. Laws of Oleron and Wisbuy in France provide the compulsory sickness provision for mariners during A.D. 1266-1798. In England, *Gild* (Gilds were among the most ancient social institutions in England) ordinance is provided during A.D. 1283-1385, as a rule for the decent burial of the members and adequate support in sickness or poverty.

The earliest known contract of marine insurance started in Italy in A.D. 1347. In the case of England, marine and fire insurance policies are practiced during A.D. 1547-1686. In the case of United States, 1st insurance institution has been established in A.D. 1735 and the congress established the United States marine hospital service in 1798 and it is compulsory deductions from seamen's wages.

History of the insurance product development is reviewed, the earliest type of insurance is marine insurance and it has been formally executed in the form of insurance agreement in Italy on 13th October, 1347. This marine insurance was available in France, Spain, Italy, Flanders and England by 1500 and early forms of marine policies are found in the records of the high court of the admiralty of England from 1547. The 1st corporate marine insurers in Europe were the Royal exchange assurance and the London assurance, both established in London in 1720.

Fire insurance is originated in Germany in 1623 with the establishment of the great Werder fire fund in Prussia but the 1st fire insurance companies were established in England. Around 1681, the fire office was established in

London by Dr. Nicholas Barbon, followed by the friendly society in 1683 and the hand-in-hand fire and life insurance society (also known as the contributors for insuring houses, chambers or rooms from loss by fire by amicable contribution) in 1720.

In the case of life insurance, it is available from the late 16th century. The earliest recorded example in the UK dates from 1588. Regarding pensions and annuities, it started in 1706 by the Amicable Society in London. The earliest references advising people to take out an annuity to guard against old age and infirmity date from the 1830's but investigations into the sex and average age of annuitants of the Norwich Union Society for insurances on lives and survivorships in 1822 suggest that by this date, about one third of annuities were being used to provide what we would now think of as pensions. Occupational pension schemes existed by the 1880's when the Norwich Union Fire Insurance Society 1st instituted a superannuation scheme for its own staff. However, these schemes only really became popular in the 1920's and 1930's.

Accident insurance refers to all types of commercial insurance other than marine, aviation, fire and life. Among the earliest accident insurers were those established to insure against damage caused by hailstorms, a form of insurance pioneered by the Mecklenburg Hail insurance association, established in Germany in 1797. This form of insurance began in France in 1822 and came into the UK in the 1840's with the establishment of the Farmers and Gardeners Hailstorm Insurance Company in 1842.

Livestock insurance is designed to protect the farmers from loss due to disease in their animals, originated in Northern Germany in the 1720's. It existed in Denmark by 1774 but was only successfully introduced in Britain in the mid-19th century with the establishment of firms, such as the Farmers and Graziers Cattle Insurance Company in 1844 and the Norfolk Farmers Cattle Insurance Society in 1849.

Plate glass insurance is to protect shopkeepers from the high expense of repairing large shop windows, originated in France in 1829 with the establishment of *La Parisienne*. Its development in the UK is inhibited by the window tax levied until 1851. The first UK plate glass insurer, the Plate Glass Universal Insurance Company is not established until 1852. It is instituted in 1840 by the guarantee society in UK which was established to protect employers from fraud or embezzlement by staff.

Personal accident insurance is the insurance against death or injury caused by accidents. It is originated in UK with the establishment of the Universal Railway Casualty

Compensation Company in 1848. It was followed a year later by the 1st Accidental Death Insurance Company which insured against death and injury caused by accidents of all kinds not limiting itself to those caused by railway travel. Later on, US have started it in 1863 for the railway passengers. About 3 years later, personal accident insurance was introduced into Australia and France.

Employers liability insurance, also appears to have originated in the UK. In 1880 in response to the employers liability act, the employers liability assurance corporation was established to insure employers against losses caused by claims from employees injured at work. The company introduced this form of insurance to America 6 years later. Burglary insurance originated at Lloyds in London in 1887. The first company to issue policies was the Mercantile Accident and Guarantee Company of Glasgow in 1889. In the case of motor insurance, it was introduced into the UK around 1896.

In sum, although the original concept of insurance has not been started in UK, it seems that most of the currently available insurance products are started in UK. The earlier paragraphs have discussed the historical development of the insurance. Now-a-days, variety of insurance products is offered all over the world and the regulators are aware of the importance of insurance for the individuals and business and it has been recognized, as one of the important financial sectors which support for the development of the country economy (Tucker, 2013). In spite of economic slow down and lower interest rate, there are still opportunities to be gapped by the insurance operators in the developing and mature markets. India is one of the leading countries in the rapid development of their financial markets. Asia-Pacific region is leading the world GNP growth rate, although there is a slowdown in the overall global economic growth. Although, the economy is slowing down, there are still opportunities for insurance market players especially in health, pension and catastrophe insurance. It is suggested that the regulators should build up the confidence of the public in the insurance sector and hence, adequate rules and governing standards should be available, especially for the product transparency and policy wordings. In addition, the insurance operators should make the investment in information technology to catch the wider aspect of potential customers and to advertise online and to communicate with the existing customers all the relevant information. Moreover, the insurers should focus on bancassurance and also innovate new services for the mobile technology, since there is a rapid increase in the use of mobile technology currently (Capgemini and Efma, 2013).

## CONCLUSION

This study has explained the definitions of risk and its classification. In addition, the important role of insurance in the personal life and business dealings is highlighted. When the historical development of insurance is revisited, it seems the root of insurance originated from marine in 3000 B.C. and now-a-days, there are various types of insurance products available to cater the different needs of the customers. The literature has highlighted that future insurance industry is leading towards providing the innovative health, pension and catastrophe insurance products and investing in information technology and concentrate on mobile marketing to reach wider market.

## REFERENCES

- AON, 2013. Global risk management survey 2013. Aon Risk Solutions. <http://www.aon.com/2013GlobalRisk/>.
- Alhabshi, S.O., K. Sharif, H.A. Razak and E. Ismail, 2012. *Takaful Realities and Challenges*. Pearson, Malaysia.
- Campbell, S., 2005. Determining overall risk. *J. Risk Res.*, 8: 569-581.
- Capgemini and Efma, 2013. World insurance report, 2013. [http://www.capgemini.com/resource-file-access/resource/pdf/wir\\_2013\\_0.pdf](http://www.capgemini.com/resource-file-access/resource/pdf/wir_2013_0.pdf).
- Crockford, N., 1987. *The Administration of Insurance*. ICSA Publishing Limited, England.
- Diacon, S. and R.L. Carter, 1992. *Success in Insurance (Success Studybooks) Paperback*. 3rd Edn., Hodder Murray, UK.
- Diacon, S.R. and R.L. Carter, 2005. *Success in Insurance*. 3rd Edn., John Murrary, UK.
- Graham, J.D. and J.B. Weiner, 1995. *Risk Versus Risk: Tradeoffs in Protecting Health and the Environment*. Harvard University Press, Cambridge.
- Hillson, D. and R.M. Webster, 2007. *Understanding and Managing Risk Attitude*. Gower Publishing Ltd., England.
- ISO., 2002. *Risk management vocabulary. Guidelines for use in standards*. ISO/IEC Guide 73.
- Kassar, K., 2008. *What's Takaful: A Guide to Islamic Insurance*. Bisc Group, Beirut, Lebanon.
- Lowrance, W.W., 1976. *Of Acceptable Risk-Science and the Determination of Safety*. William Kaufmann Inc., Los Altos, California.
- Mehr, R.I., 1986. *Fundamentals of Insurance (Irwin Publications in Economics)*. 2nd Edn., Irwin Professional Publishing, Illions.

- Mishra, M.N. and S.B. Mishra, 2012. Insurance: Principles and Practice. Chand and Company Ltd., New Delhi.
- Prudential Insurance Company of America, 1915. The Documentary History of Insurance, 1000 B.C.-1875 A.D. Prudential Press, New Jersey.
- Renn, O., 2005. Risk governance: Towards an integrative approach. White Paper No. 1, International Risk Governance Council, Geneva, September 2005.
- Renn, O., 2008. Risk Governance. Coping with Uncertainty in a Complex World. Earthscan, London.
- Rosa, E.A., 2003. The Logical Structure of the Social Amplification of Risk Framework (SARF): Metatheoretical Foundations and Policy Implications. In: The Social Amplification of Risk, Pidgeon, N., R.E. Kasperson and P. Slovic (Eds.). Cambridge University Press, New York, pp: 47-79.
- Tucker, M., 2013. Insurance vital to Asian economies: AIA's Tucker. Jun 20, 2013, pp: 82.
- Vaughan, E.J., 1996. Risk Management. 1st Edn., John Wiley and Sons, New York.