Management of Liability Risk in Insurance

* RK Gaba
**Dr Angrish Kumar Agarwal

*Research Scholar in management, Invertis University, Bareilly (UP)
**Associate Professor, Invertis University, Bareilly (UP)

Abstract

This article will greatly help to understand the liability risk and its management in insurance business. It specifically categories over all insurance business into three different segments and have been elaborated in a very easy manner .The efforts have been made to discuss how liability risk is the main considerable factor in insurance business . It is big challenge for insurance companies to manage this liability risk factor because sometimes these liabilities risks are more than the calculated risk and become too high to manage by insurance companies. This "liability risk" inspires people to buy out insurance and for that reason they visit to different insurance companies to find out the solutions for their risk. It is also a big challenge for insurance companies to manage this liability risk in an efficient manner to compensate the liability risk of their consumers who showed their faith in the company for their rainy days by buying out insurance policies.

Key words: - compensate, consumers, insurance, liability risk,

Introduction and meaning of terminology

Before going ahead it becomes important to know about the insurance and liability risk for that we have to understand the meaning of both the terminology as well.

What is insurance: - Insurance is a method of distributing risk of one individual among a group of individuals. The Chinese were the first ones to employ methods of risk distribution. In this world people seek security because a sense of security may be the next basic goal after meal, clothing and shelter. An individual with insurance security is called economically secured, means the person has managed his basic needs for the family if he is no more. This security comes in the shape of insurance which is provided by insurance companies by doing a contractual agreement with their consumers.

"Insurance is an agreement where, for a certain payment, called premium is paid out by one party and other party the insurance company assures to pay a certain amount upon the occurrence of a specific loss. In other words "protection against loss or damage caused by agreed event/events which are called insurance cover".

Liability Risk: - Companies which are selling something to the consumers or providing services are bound to calculate liability risk because any lapse in services or deficiency in any product may create liability risk for the companies. This liability risk is expected for insurance companies due to the nature of the business but not possible to calculate exactly, that is why it may be limited or unlimited in nature.

- **Limited Liability Risk**: - When the amount is predefined and limited in nature, is called limited liability risk. In other words the limited liability risk is that risk for which the insurance company takes the premium from policy holders and assures to fulfill the liability for what the premium is being paid. Life insurance policies are the best example of limited liability risk because here liability is almost limited and pre decided.

- **Unlimited Risk**: - These are risk where some times companies face the unlimited risk or more risk compares to expected risk or calculated risk due to its product mix. The threat of liability risk grows as the company grows. Growing company naturally becomes more exposed to various kinds of risks i.e. liability claims resulting from employment, such as charges of discrimination or wrong action against employee, catastrophe risk etc may sometimes unlimited in nature.

Companies which are dealing in automobile industry segment sometimes face unlimited risk due to any fault in its products designing or any other reason where there are lots of complaints are being filed by the consumers regarding problem in particular part of the vehicle, in such a situation company has no choice except to call off all the sold products belong to that particular segment or relates to that particular batch for which complaints are being filed. In such a case or cases there may be high amount of liability which may be more than expectation. We can better understand by reading the under given examples:-

- In September 2011 Honda Siel recalled approximate 172155 Units of the City Sedan to fix faulty power window switches.
- Maruti Suzuki recalled approximate one hundred thousand A Star cars to fix a defect in the fuel tank.
- One of the biggest recalls so far, Ford India, the Indian unit of US car maker, recalled approximate 166000 (one hundred sixty six thousand) units of its small car Figo and Sedan classic. The problem was related to the rear twist beam & power assisted steering hose.

These recalls are made by the companies either due to the legal bindings or due to the goodwill/credibility of the companies but in all the cases it creates either unlimited or more than expected calculated liability risk for the companies. Generally manufacturing companies are supposed to expose of these liability risks. Keeping in mind these types of liability risks the insurance companies take insurance cover from other insurance companies to manage their liability risk which is called re-insurance.

Meaning of subject matter

Insurance and Liability Risk: - Insurance and liability risk becomes one word instead of being separate when we discussed about the risk regarding payment of insurance claim by an insurance company against insurance cover. In insurance business the liability risk is defined in a limited form due to its contractual nature. The insurance companies provide insurance covers to individuals as well as to companies/institutions/groups etc. by making contract and assure to provide financial assistance at the time of happening of predefined incidence. This assurance is a liability risk for the insurance companies and for that reason insurance companies make provisions to fulfill their commitment.

Meaning of liability risk:-"Liability risk is an assurance that is given by the insurance provider to their consumers to compensate the loss in future on the happening of predefined subject matter. It is a legal binding for insurance companies to pay insurance claim to their consumers on the happening of predefined subject matter because for that insurance cover insurance companies are charging premium from their consumers.

Type of insurance: - Insurance is divided into three different segments and to know the clear meaning of insurance we will have to understand all these three segments separately.

1. Life Insurance: - Insurance cover based on human life (Cover for Life)

2. Health Insurance: - Health based insurance cover.

3. General Insurance: - It includes all other insurances i.e. Accidental insurance, marine insurance, product liability risk insurance coverage, trade credit insurance cover, export credit insurance cover etc.

Short description of different insurance segments

Life Insurance: - We often listen to take life insurance to compensate the loss of future income in case of any untimely demise of the person specifically the earning hand of the family. Life is the most precious and no one can calculate its true value in money terms. The basic motive of life insurance is to provide cash either in lump sum or in installments to the insured person's family or legal heir on the death of insured to allow loved ones to remain financially secure. Life insurance is the foundation stone among all investments because it creates immediate estate up to the sum assured for which an individual signs the contract with insurance companies. This quality of immediate estate creation is not available in any other form of investment or savings instrument.

Calculation the Need of Insurance: - The most important part of buying life insurance is to determining how much insurance an individual needs? Since everyone's financial circumstances and goals are different so it becomes very difficult to calculate the amount of right insurance cover. There is not any thumb rule to tell how much insurance cover is required to an individual? Every financial advisor has its own criteria of calculation because of the different circumstances /needs /priorities of every individual. If we adopt mathematical way of calculation it seems easy but when we try to calculate the insurance cover amount on the basis of input provided by individual it becomes difficult to calculate. There are many ways of calculating insurance need for an individual:-

1. Calculation of insurance need by calculating **human life valuation**.

2. Calculation of Insurance need on the basis of immediate expenses, ongoing expenses and future expenses.

3. Calculation of insurance need by using the formula:- (Current & future obligations) **-** (Savings+ investment + spouse Income + Present insurance cover) = insurance need .Using the above mention formula and adding the approximate inflation cost, financial experts calculate the approximate real value of insurance need.

4. Somewhere financial experts calculate insurance need approximate 10 to 20 times the annual income of the family.

Riders in Insurance: - Rider to an insurance policy essentially offers an additional insurance cover which rides along with the base policy. It is an endorsement to a life insurance policy that either adds additional coverage or limits the life insurance company's liability for payment of benefits under certain conditions. '**Riders can provide more coverage to you on the basis of your original policy.'** Life Insurance riders add additional functionality to the basic insurance policy.

Definition: - "Riders are the supplementary benefits added to the primary life insurance policy purchased by an insured/consumer."

Normally the following types of riders are available along with life insurance policy:-

- **Accidental Benefit Rider**: - It is a typical example of rider which mean that if death happens because of an accident an additional sum of money will be paid to the nominee or legal heir of the insured equal to sum assured or as per terms and conditions of the policy.

- **Disability benefit rider**:-If any insured becomes disabled due to an accident then a certain sum of money is payable to insured in lump sum or in installment as per the terms and conditions of the insurance policy.

- **Critical illness rider**:- All the major illnesses are the part of critical illness rider . Some of the examples of critical illness mentioned are organ failure, organ transplantation, bypass surgery, cancer surgery etc. . Happening of any of critical illness a guaranteed sum of money is paid to the insured in lump sum or in installment as per terms and conditions of the insurance policy.

- **Premium waiver benefit rider**:- Normally this benefit rider is given along with the children policies where proposer is father or mother and in the event of death of proposer the future premiums are stopped and policies become fully paid. In some insurance policies insurance companies provide premium waiver rider for critical illness reasons or disability reasons but it all depends upon the terms and conditions of the insurance policies.

- **Increasing sum assured rider**:-Under this rider the death benefits sum assured increased with a certain % limit every year or increase after the gap of certain years up to the maximum % allowed by the Insurance companies. It help consumers to cover up future increasing liabilities or inflationary impact without taking any new insurance policy.

Riders are an important and integral part of insurance policies. A policy rider in an insurance policy represents a provision or modification to an existing insurance policy that provides additional coverage to the policy holder. Riders on insurance policy provide additional protections against risk. In short

"**Riders are like icing on cakes but these are real culprits for enhancing liability risk for insurance companies".**

Health Insurance: - It is one of the most focused areas of Indian insurance industry. In this sector there is phenomenal growth has been seen during the last one decade. It is not only rapidly growing segment in non life insurance industry but also an emerging business for life insurance companies. This sector has become so significant that IRDAI has to issue modified guidelines for this sector and the same have been implemented from 01.10.2013. Seeing the importance and the need of the vast population the health insurance is becoming in the priority list of government agenda.

Definition of Health Insurance: - The term health insurance is used to describe the insurance that covers the medical expenses of the insured. This cover may be either through reimbursement of expenses or on cashless basis. In India most of the health insurance covers are being provided by Central Government to their employees through Central Government Health Scheme (CGHS) and by state government through its Employees State Insurance Scheme (ESIS). Under these two schemes almost all the government employees are getting benefits of health insurance. Other than these two governments run insurance schemes the other insurance companies either government run insurance companies or private run insurance companies are providing various health insurance schemes to general public.

General Insurance:- General insurance covers all the other insurances excluding pure life insurance cover .These insurance covers are taken by consumers after careful planning either to reduce their risks up to a bearable level or to eliminate them completely. In modern society there are many examples of risk. A house owner faces a large potential for possibility of economic loss caused by fire. A driver faces a potential economic loss if his vehicle is damaged by an accident. There is also an expected risk of third party damage which will have to be paid by driver or owner of the vehicle. General insurance companies reduce economic risk by providing insurance cover for these incidences.

Types of Insurance cover under General Insurance: - There are different types of insurance covers are being provided by general insurance companies for different reasons. The following are some common types of insurance covers available through general insurance companies:-

1. **Fire Insurance**:- An insurance policy that protects our assets from any loss occurred due to fire. This insurance may covers house hold articles, business goods, machineries etc. but depends upon the terms and conditions of the insurance policy.

2. **Export Credit Insurance**: - This insurance policy covers foreign receivables against Commercial and political risks which could result in nonpayment of invoice. The risk is covered when credit is extended to qualified international buyers.

3. **Marine Insurance**: - It covers the loss or damage of ships, cargo, merchandise,

Terminals, docks and any other property by which cargo is transferred, acquired. The cover is provided between the points of origin and final destination.

4. **Trade Credit**:-This insurance provides protection against loss due to credit risks such as payment default, debts, insolvency or bankruptcy.

5. **Motor Vehicle Insurance: -** There are many insurance cover options are available under Motor vehicle insurance such as:-

- **Compulsory third party insurance**: - It provides insurance cover against liability for the death of or bodily injury to any person caused by use of a motor vehicle.

- **Third party property damage cover**: - Third party property damage covers damage to another person or to the property of the others. It does not include repairs of owner's vehicle damaged due to an accident.

- **Comprehensive cover**: - Comprehensive insurance provides protection from damage caused to your vehicle other than a collision such as theft ,collision with animals , loss due to stormy winds, vandalism , etc

6. Partnership protection insurance:- It provides protection for partners to purchase another partner's share of the business in the event of death or disability.

7. Personal accident covers: - It provides cover against accidental death and also provides disability cover up to a certain % of your salary or business income while you are not in position of working due to the result of an accident disability. These policies offer a variety of cover, but it is up to the consumers to choose the protection what they need.

8. Cover against loss of money: - It provides protection against theft of cash and other negotiable instruments i.e. cheque, postal orders, drafts from business premises or while in transit to and from the bank.

9. Travel Insurance:-Travel insurance covers the costs and reduces the risk associated with unexpected happening of unfavourable event/events during domestic or international travel. Travel insurance usually covers costs associated with medical expenses and trip cancellations. Some travel insurance policies also cover to rented equipment, such as rented cars, or rented equipments. Some other events that might be covered are lost or stolen of luggage, fraud etc.

Management of Liability risk

Management of liability risk is based on the accuracy of probability. Larger the accuracy better the management of liability risk. The economic basis of insurance is that the occurrence of loss affects a fraction of a large population. The larger the population of insured assets or persons, the accuracy of probability of loss keeps improving. It is the probability theory that enables the insurer to cope up with variations in the pattern of actual losses. Underwriters and actuaries also consider the various measures of dispersion, that is the actual difference between the actual losses and expected losses while setting premiums or assessing liabilities.

Insurance companies are associated to various type of liability risks and to manage these risks is the most important factor for these insurance companies. The insurance companies try their level best to manage their liability risk with the help of managing risk techniques. The following are the few techniques used by insurance companies to manage their liability risk:-

(1) **Risk transfer techniques**: - This technique helps to minimize the total cost of capital needed to deal with a risk by reinsuring. In this technique the insurance company retain the risk cover up to their risk taking capacity and more than that the risk is transfer to the other company by taking another insurance policy and excess risk is transferred to another insurance company . It helps insurance companies to coup up their risk in a comfortable manner.

(2**) Risk retention financing**: - This technique is related to capital market. After liberalization and resultant innovations the power of capital market is well known. In capital market there are number of different products available for managing liability risk. Companies are using debt, hybrid and equity tools for managing their liability risk.

(3) **Assets management technique :-** This management technique plays an important role in risk transfer and risk retention financing . This technique refers to the professional management approach of investment such as stocks, bonds and real estate etc.

(4) **Contingent capital management technique**:- Contingent capital represent one way of financing a loss after the event has occurred. This system helps when a major loss creates a crisis of liquidity and companies are feeling impossible to raise fresh funds. This technique of management of liability risk helps to comply with solvency margin and also helps to recoup from facing a loss from any events.

(5) **Reinsurance system of Risk Management**:- Basically the reinsurance programme helps to manage the liability risk in insurance business . It also allows an insurer to accept risks beyond its normal retention and so ensure that it is not placed at a serious disadvantage compared to its competitors. The primary object of reinsurance is that it should reduce the insurer's probability of bankruptcy because the insurer retains the insurance as per their risk taking capacity. Reinsurance provides a protection for the gross business of insurance company .The basic role of the reinsurance is to safeguard the solvency of an insurer against random fluctuations in the overall claims experience and an accumulation of losses arising out of one event.

(6) **Special purpose vehicle**:- It is a new concept in the field of risk management in insurance field. Its main function is to facilitate the transfer of insurance risks to capital market. The capital raised is used to set up the special purpose vehicle, which then issues a conventional reinsurance policy to the policy holders. This is done to ensure that the transaction is formally recognized as a type of reinsurance.

These liability risk management techniques have been compared to the shock absorbers on a vehicle which do not make the road smoother but make a bumpy ride into a smoother one. Similarly, these techniques do not reduce losses but merely smoothers out the effect on the insurers. Continuing the analogy with the vehicle, to ensure that the shock absorbers do not become worn out and the vehicle cease to function, the road must be repaired. So it is with reinsurance that the underlying problem of inadequate rates of direct business must be addressed in order to secure successful operation of the insurer with effective reinsurance support. These techniques provide financial stability to insurance companies by increasing their solvency. These methods of management give to the insurer a far greater flexibility in the size and types of risks the insurer can accept.

Conclusion

Management and right estimation of the liability risk is very important from the company's point of view due to its serious implications in business because it directly impacts the financial health of the company. Liability risk is to be measured well in advance otherwise it may be death knell for an insurance company. Insurance companies are made just for taking risk on behalf of their consumer and if these risks are not calculated up to the best possible limit it may put a question mark on the financial health of the companies. That is why the calculation of liability risk as well as its management becomes very important for the future growth of the companies.

References

1. A.S. Chaubal &C.B.Murati, (revised edition 2013). *Risk Management* . Mumbai: Insurance Institute Of India.

2. A.S. Chaubal, K. Ramachandaran (revised edition 2013). *Reinsurance Management.* Mumbai: Insurance Institute Of India.

3. Dr Somial Nagpal, Rachin agarwal,Abhishek agarwal, Richa N.Gautam etc. (Revised edition 2013). *Health Insurance.* Mumbai: Insurance Institute Of India.

4. K. subramanyam & Gopal Kumar (Revised edition 2013). *Acturial Aspects Of Product Development* . Mumbai: Insurance Institute Of India.

5. from dnaindia.com (2013, sep 14). Retrieved 2015, from anaindia.com/money/report ford-india-recalls-1-66-lakh-cars-18888684.

6. *BIZguides (Types of Insurance)* (2011, june). Retrieved 2016, from www. smallbusines .wa.gov.au.