Personal risk and how to manage it!

Published on Fri, Jan 23, 2009 at 14:09 , Updated at Fri, Jan 23, 2009 at 14:30
Source : Moneycontrol.com

By Gaurav Mashruwala

Risk is nothing but an unfavorable outcome of an event. Event may or may not take place. However if that unfavorable event had to take place; then it can throttle any good plan. Imagine a situation where a person aged 47 has made an excellent retirement plan. He has made investments in assets that will mature exactly at the time of his retirement, at age of 60. There are sufficient tax benefits available for investing in those retirement plans. He has nominated his wife as the beneficiary. The arrangement is inflation proof. All in all, an excellent plan.

Unfortunately, he dies at the age of 49, leaving his wife and children either with no assets or assets that will mature after 11 years i.e at the age he would have retired, had he been alive. For the next several years his family will have to live in financial distress. This is an example of excellent retirement planning, but poor risk management.

Let us look at another case where a person has an excellent life insurance. In the event of his untimely death, his family would get a large sum of money. This corpus could be utilised to take care of the family for several years. Unfortunately, this person suffers from a heart attack. There is no health insurance. While there is plan in place to meet expenses after his death, there is no plan to meet unforeseen expenses while he is alive. Family will now have to bear entire cost of treatment. Only option left for them is to borrow funds for his treatment.

Financial planning without proper risk management is incomplete. A risk management widget replenishes the financial loss suffered owing to the unfavourable outcome of an event.

Risks

There are two kinds of risks: speculative/investment risk and pure risk.

Speculative/investment risk is one where there are three likely outcomes: gain, status quo and loss. When we invest in the stock market we can either gain or loose or there could be a no gain/no loss situation. This is called speculative/investment risk. For this type of risk there is no formal insurance product.

Pure risk has two likely outcomes: status quo and loss. While driving on the road there are only two possible outcomes, there can either be an accident or there cannot be an accident. This means there is either loss or status quo. For loss suffered from pure risk there are different kinds of insurance policies.

Types of pure risk

Personal risk: This is the risk that affects the income earning capacity of an individual. For example: death, disability, illness, accident, unemployment and so on.

Property risk: This risk results in a loss and/or damage to property. For example: fire, theft, terrorism, war, flood and so on.

Liability risk: This risk exposes an individual to the third party. For example: an accident while driving a car, negligence by a professional and so on.

Rules of risk management

While evaluating risk, the following rules must be kept in mind:

<u>Don’t risk more than what you can afford to lose:</u> Consider the impact of a risk. If the impact is going to be fatal or unbearable, it is prudent to insure the risk. For instance, the death of an earning member of the family can prove fatal to the financial health of the rest of the family members. This is a loss that the family cannot afford to risk. Therefore, it is important to insure the life of an earning member.

<u>Consider the odds of a risk occurring:</u> If the probability of the risk occurring is high, insurance may not be the solution. For instance, if a jeweller has a shop in an area prone to high crime, it is recommended to move the shop to another, more safe area. In this case, insurance may not be the solution.

<u>Don’t risk a lot for too little:</u> If the cost of acquiring insurance is very low compared to the potential loss, then it is recommended to undertake insurance.

Risk management techniques

There are basically two risk management techniques: risk control and risk financing.

<u>Risk control:</u> There are two ways in which the risk can be controlled.

The first is risk avoidance -- if a father is worried about his son’s motorcycle riding habits, he could ask his son to stop riding the motorcycle. This will ensure that the risk of an accident is avoided.

The second is risk reduction – if the motorcycle riding cannot be stopped completely, the father can ensure that his son wears a helmet and also has speed restrictions. This will reduce the risk of an accident.

<u>Risk financing:</u> If risk cannot be controlled, it is prudent to ensure that in the event of a risk occurring there is a mechanism in place to make good the financial loss. There are two methods of risk financing.

The first is risk retention – if the severity of financial loss is not high and where frequency of occurrence is high, it is better to retain risk. For instance, a company which provides medical benefits to its employees may decide not to opt for insurance for smaller sicknesses like coughs and colds. The company will itself bear the cost treatment for its employees.

The second method is risk transfer – the same company will undertake insurance for those illnesses that cost a lot for treatment. In the event of an employee being infected by a major illness, the insurance company will reimburse the treatment amount. In this scenario, the company is transferring the financial risk to an insurance company.

The author is a Certified Financial Planner.