INSURANCE AS A RISK TRANSFER MECHANISM IN SMALL AND MEDIUM ENTERPRISES (SMEs)

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Abstract

This paper aims to provide an insight into the application of insurance as a risk transfer mechanism surrounding the small and mediumenterprises (SMEs). SMEs owners must develop a sound risk management program and utilize appropriate risk transfer mechanism in order to protect their business and enhance their opportunity for business sustainability. Insurance is a useful tool for managing risks. Even though it is not the ultimate solution in a risk management strategy, it is indeed an important aspect in any business operations in order to protect assets and to reduce losses. However, the practice is slightly distorted. SMEs businesses in various countries are facing issues such as lack of good risk management strategy, inadequate insurance protection, non-insurance, non-compliance and lack of awareness on this matter. This paper could be beneficial to the SMEs by increasing their awareness about the significance of insurance as a risk transfer mechanism, types of insurance schemes available in the market and the impact of good risk management practices.

Keywords: Insurance, risk transfer, SMEs.

INTRODUCTION

Risk management had been practised for thousands of years (Bernstein, 1996). However, the formal risk management concept existed only in the twentieth century (Merna& Al-Thani, 2005). The concept that began as a field in the early 1950s was limited in scope to pure loss exposures where risks were managed through controlling and financing techniques. Insurance has been the most popular financing approach in managing corporate risk. It has been used to manage property, liability, and related insurable risks.

Most of the risk management definitions stressed on two key points: firstly, risk management is concerned with pure risk and secondly, the risk management process (Vaughan & Vaughan, 2003). Generally, the role of risk management is to reduce property, human, and financial losses

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(Eick, 2003). Panigrahi (2012) defined risk management as an ongoing process that can help enhance operations, prioritize resources, ensure regulatory compliance, achieve performance targets, improve financial performance and ultimately, prevent loss/damage to the entity. Specifically, the purpose of risk management within an organisation is "to reduce the possibility of future events harming an organisation and control the probability that results will deviate from the expected" (Zech, 2001, p.2), to reduce the cost of pure risks and set out safety and disaster management by providing adequate coverage through an insurance technique (Baranoff, 2004) and, "*to enable an organisation to progress towards its goals and objectives"* (Williams, Smith & Young, 1995, p.27). The basic techniques of risk management are risk avoidance, risk reduction, risk retention and risk transfer. Nevertheless, insurance is used as the most common risk transfer mechanism.

Insurance is a contract in which one party agrees to indemnify (compensate) another party in the event of loss or damages caused by risks specified in the contract, in exchange for the payment of a certain amount known as the "insurance premium" to the first party. The premium could be arranged to be paid as a lump sum amount or it could be paid as periodic amount. Insurance is a useful tool for managing risks. It is an important aspect of any operations including SMEs in order to protect assets and to reduce losses. Instead of protecting properties and lives physically, insurance serves to protect the business against adverse financial consequences of losing properties and lives. Thus, a business suffering from losses would be able to recuperate and rebuild their business by utilizing the compensation paid by insurance companies.

SMEs business owners should be aware of the benefits of incorporating insurance in to their operations. The immediate effect of utilizing insurance in a business is two-fold; it gives protection against losses and it influences the success of loan applications with banks and financial institutions. Hence, it is imperative to ensure the adequacy of insurance coverage undertaken. Adequate insurance coverage signifies that a company's risks are well-covered under a good risk management strategy.

Failure to improve the risk management process can cause severe financial loss and damage to reputation. This will be reflected in stakeholders' confidence and trust. Having a good risk management system in place will impress the lender and may make the difference in obtaining the funds. It can be an information system about how business is doing as well as a system to control risk. However, risk is one of the most overlooked areas in small businesses in spite of the fact that it is clear to most small business owners that operating any business involves risk. SMEs still respond reactively to risk by utilizing risk avoidance and risk transfer techniques (Smit, 2012). SMEs experience difficulty in securing finance because of the high level of risk and insufficient level of return associated with the Industry.

Despite its size, SMEs is actually the foundation of any economically stable nation and it plays an important role in the economic growth and sustainable development of any economy (Ariyo, 2005 and Panigrahi, 2012).However, being a small and almost inconsequential business entity, SMEs are threatened with financial and strategic risk (Terungwa, 2012). For financial risks, their main concern is about cash flow, sources of money and availability of funds to pay wages, operate and expand their businesses. On the other hand, strategic risk associated with market competition and economic conditions that could directly affect their performances. These two risks alone have made SMEs unattractive to potential investors (Aruwa, 2004).

It is imperative to note that risks are not limited to purely catastrophic events, but could also refers to potential events that impact on the effectiveness and efficiency of operations influencing the ongoing performance of an organisation. In the context of SMEs operations, they are exposed to risk at all time. These risks could directly impede day-to-day operations, decrease revenue, increase expense or cause business to fail (Panigrahi, 2012). A rationale business manager would have known that they have to atleast resort to insurance to cover risks to life and property. Nonetheless, there are many other risks faced by all businesses; some are uninsured, the others might have been overlooked or ignored.

A sound risk management program should assists in reducing the chance of risk or to lessen the impact of loss. Risk management starts by identifying possible threats and then implements techniques to mitigate or eliminate them. Alternatively, SMEs may also want to consider purchasing insurance as a way to mitigate damage caused by these unforeseen threats. However, many small businesses are often underinsured. First, they may not have the capital to acquire all the insurance they need to cover their bases. Second, they are unaware of what need to be insured (Patterson, 2013). Thus, this paper attempt to provide a general insight on the application of insurance as one of the risk transfer mechanism that could be utilized to manage risks in the SMEs.

The next section summarizes the types of insurance available to cater to the need of SMEs businesses. This followed by a brief discussion on the application of insurance as one of the risk transfer mechanism by looking at various countries experiences. The discussions look at how SMEs owners perceived the need to use insurance as a means of protection, the reasons of not purchasing insurance and the rules governing the need of insurance for business entities. The last section discusses the issue in light of the SMEs businesses in Malaysia.

TYPES OF INSURANCE SUITABLE FOR SMEs BUSINESSES

There are various insurance products available in the market. These products are classified under two major categories, which are the life insurance products and general (non-life) insurance products. It caters to the needs of both personal and commercial buyers. However, as a general guideline, SME business owners can choose from the following range of insurance products or more, depending on the nature of their businesses and their loss exposures. The table below lists down types of suitable insurance products and the extent of its coverage that could be beneficial to the SMEs businesses.

Table 1: Types of Insurance

Type of insurance product	What is the extent of coverage?
All Risks Insurance	It covers loss or damage to the property insured caused by any accident (wide cover) or on specified perils basis (restricted cover)
Burglary Insurance	It covers loss or damage to the property as a result of theft.

Business Interruption Insurance	It covers loss of profit arising from physical loss or damage to the property insured, thus hindering a company from carrying out its planned level of business.
Electronic Shield Insurance	It provides indemnification for any unforeseen or sudden physical loss or damage to electronic equipment such as computers, thus requiring replacement or repair.
Employer's Liability Insurance	It indemnifies the employer against liability lawsuit for employee claims resulting from bodily injury or disease sustained during the course of employment.
Equipment Insurance	It covers loss or damage to equipment, its accessories and spare parts caused by accidental collision or overturning, fire, external explosion, etc.
Fidelity Guarantee Insurance	It covers all direct pecuniary loss sustained by the insured as a result of acts of dishonesty and fraud committed by an employee and which is discovered within the insurance period.
Fire Insurance	It covers loss or damage to property caused by fire or lightning and other extraneous perils such as explosions, storms, riots, etc.
Money Insurance	It provides coverage for loss of money occurring from money in transit namely when collecting and/or delivering money from/to bank or money stolen while in the personal custody of an employee.
Professional Indemnity Insurance	It gives protection to professional who supply skills or services against their legal liability to compensate parties other than the insured for losses sustained as a result of their professional negligence.
Product Liability Insurance	It provides compensation to the insured for bodily injury, loss or damage to third parties' property caused by defective designs, packaging, etc. of goods sold, supplied, tested, repaired and serviced by the insured.
Marine Cargo Insurance	It is an insurance cover for merchandise that is transported by rail, road, air and sea. As SMEs are venturing more into the export businesses, the practice of insuring goods in transit becomes increasingly important to their business operations.

Indeed, there are various insurance products available in the market. The purpose of offering these products is similar, which is to provide protection to policyholder and to indemnify policyholder against losses. SMEs business operators must take the opportunity to insure the business appropriately. Even though insurance is not the ultimate solution, it helps to provide protection and professional advices that could be beneficial to small businesses.

INSURANCE AS RISK TRANSFER MECHANISM

Exposures to risk are part of all businesses including SMEs and insurance has been one of the important risk transfer mechanism to deal with these issues. However, to what extent that it has been practiced in a real business context? Many studies have been done to identify risk management issues related to small businesses and the extent that these owners utilized insurance as one of the risk transfer mechanism in managing their business risks. Evidences from various countries are highlighted in the discussion. However, it must be noted that different countries have different approaches to deal with this issue, such as India, Australia, United Kingdom, Scotland, Nigeria and Ghana.

A research is attempted to study the benefits of a sound risk management program in small businesses in India. Panigrahi (2012) stated that risk management is a useful process that can be adopted by SMEs to improve their business sustainability and chances of successful longevity. It is also believed that risk management practice is less developed within the small business sector due to lack of risk expertise and understanding of the subject matter. The attitudes of the business owners and their knowledge towards risks play an essential role in how systematically risks are handled. It its simplest form, risk management practice should involves purchasing insurance to cover life and property risk. Similar to other countries, SMEs in India also face issues related to uninsured businesses, underinsured policies, lack of awareness and restricted access to insurance expertise.

Terungwa (2012) studied the financing options available to the SMEs in Nigeria, focusing on cases in Benue and Nasarawa states. He associated the financing options problems with the need of having good risk management practice. He discovered that the predominant SMEs are lacking in good risk management strategies and insurance cover, thus lead to their substantial financial constraints. His analysis derived that one of the main sources of financing SMEs in Nigeria is provided by commercial banks, merchant banks and development banks. However, banks have been very restrictive and reluctant to grant loans to SMEs which they associated with high-risk sector. He surveyed 84 SMEs and he found that almost 74% of these sample are being deprived of bank loans facility due to poor risk management strategies. He recommended that the government should put an effort to enlighten small business owners on the benefits of good risk management practice and the use of insurance to protect their business.

The Insurance Council of Australia conducted a survey in 2007to investigate how SMEs owner utilized insurance policy to protect businesses. The survey involved 1,000 registered Australian small businesses that employ less than 20 workers. From the sample, about 67% are SMEs with less than five employees. The findings from their survey indicated that about 26% of all SMEs do not have any form of general insurance to protect their businesses. In addition, sole traders have the highest rate of non-insurance with 40% operating their business with no general insurance at all. Of the owners who purchased insurance, 80% of them are underinsured and they complained that the cost of insurance as a barrier to purchasing.

Meanwhile, The Chartered Insurance Institute produced a “Climate Change Research Report” in 2009 to discuss the impacts of climate change on small businesses operating in the United Kingdom (UK). This report is supported by a survey conducted by AXA Insurance in determining insurance procurement by small businesses. The report lined out several major climate change threats to small businesses which are floods, storms, heat wave, drought and secondary effects of climate impediment on employees. All these threats pose both direct and indirect losses to SMEs, ranging from loss of assets and financial resources to loss of usage and increasing absenteeism that will indirectly impede business operations.

Accordingly, AXA surveyed the efforts taken by small businesses in order to face the impacts of climate change. In a focus group of 2,420 businesses exposed to flood risk, almost 90% are underinsured. This issue is associated with lack of professional insurance advice since most small businesses do not utilize or have the capacity to seek for specialist insurance brokers. AXA also studied the risk management practices among 1,200 SMEs and revealed that most of these companies did not even meet the basic risk management standards to meet their insurance cover requirement. Out of these samples, 27% were not documenting risk assessments and 16% were not recording accidents or incidents. This indicates that there is a lack of awareness of risk amongst small businesses and their extent of understanding of, and attitude towards, safeguarding against loss. In the long run, this could increases potential societal risk, in the event of extreme losses due to climate change.

In addition, the Federation of Small Businesses (FSB) in Scotland ascertained that severe and unpredictable weather is the utmost threat to uninsured Scottish small businesses. Thus, FSB have attempted to increase insurance awareness among business owners, emphasizing that it is imperative for all business owners to have adequate insurance protection in order to protect them from losses due to weather risks.

A most recent survey is undertaken by Zurich Insurance in 2014. They produced SMEs' Risk Index to evaluate the major risks surrounding SMEs businesses. From their index, death and critical illnesses is the biggest risk threatening the success of SMEs operations. Thus, this risk should be managed by purchasing life insurance protection for owners and key employees in the SMEs businesses. However, they discovered a contradicting outcome from the survey. Instead of using insurance as risk transfer mechanism and protection, 65% of the small business owners jeopardise their operations by not having insurance protection to cover life of the owner and key employees in the business.

On the other extreme, Ghana perceived this issue in a different manner. According to Ghana's Insurance Law (Act 724), "*insurance as risk management tool in Ghana is mandatory*". Thus, all small businesses in Ghana are expected to comply with this requirement. However, issues of non-compliance still exist and this lead to disasters, fatalities and financial losses among the businesses. A study is accomplished by Aduko (2011)to investigate the insurance procurement by 171 small businesses in the Tamale metropolis. The study revealed that small businesses in Ghana are still exposed to risks of uninsured businesses, inadequate insurance coverage, lack of awareness and ignorance about importance of insurance as risk transfer mechanism. All these issues are related to inefficiency of the insurance services such asdelay in claim settlements due to bureaucratic matters, insufficient compensation, high cost of insurance premium, misunderstanding of clauses and information asymmetry. In this instance, insurance lost its attractiveness and its purpose to protect is diminished.

Subsequently, UK established a law governing small businesses where all businesses employing staff must have Employer's Liability Insurance (ELI) or they could be penalized heavily by the Health & Safety Executive (HSE).This has motivated LV Insurance to conduct a survey in 2013 to investigate demands for ELIamong SMEs in the UK. Surprisingly, despite this specific legal requirement, they found that more than 350,000 small businesses in the UK did not have ELI in place. Their survey also concluded that one in every 20 small businesses in the UK did not even have any general insurance policy to protect their businesses. This could be perceived as direct non-compliance to the legal requirements specified for the enterprises.

Looking at these various countries experiences, it could be presumed that SMEs are indeed an important economic contributor to a nation's economy. All surveys highlighted the significance of having good risk management strategy, the risk surrounding the SMEs business operations and the need of insurance. At the same time, these countries also encounter similar issues with SMEs businesses, issue of non-compliance, insufficient insurance cover and non-insurance problems. All of these problems are associated with financing constraint and lack of awareness on the application of insurance as a risk transfer mechanism.

A GENERAL OUTLOOK ON MALAYSIAN SMEs INDUSTRY

Small and medium enterprises in Malaysia are governed by SME Corporation of Malaysia. SME Corp. is responsible in formulating overall policies and strategies for SMEs in Malaysia. They are also responsible in coordinating all government agencies efforts associated to SMEs. SME Corp. has also become the reference point for information and advisory services to all SMEs in Malaysia.

The Malaysian government has established a micro insurance and Takaful coverage for small businesses and micro enterprises called the 1Malaysia Micro Protection Plan (1MMPP) with a minimum premium of RM20 per month for coverage ranging from RM10, 000 to RM20, 000. It is seen to offer adequate coverage and protection for the SMEs. Apart from that the insurance industry has also come up with several SME insurance packages in order to serve the unique needs of SME in Malaysia.

Most local SMEs are quite aware of the importance of fire and theft insurance for the protection against property and physical assets. However, SMEs are still inattentive of the significance of "key man" insurance scheme, savings and/or life protection schemes in companies. This situation is similar to other countries that have been discussed in the earlier part. In addition, many small enterprises do not have adequate coverage in the form of basic fire insurance coverage. They also do not perform annual reviews to upgrade or adjust coverage in accordance with growth in their business. They have been renewing past policies based on past figures and conditions, which brings about the risk of inadequate coverage when a claim is made. Coverage for professional indemnity and product liability insurance are quite scarce as they are only provided by a limited number of insurance companies.

Insurance companies have been quite selective and have even declined to accept coverage for SMEs in some sectors such as furniture. Some vehicle models that are likely to incur high claims are also denied coverage, which is very troublesome for some SMEs due to their financial constraints. Thus, in order to provide a solution to this problem, the government introduced the 1Malaysia Micro Protection Plan (1MMPP). This scheme can serve as a starting point to obtain some basic insurance, especially for new SMEs and micro enterprises, while waiting for more comprehensive and adequate coverage, but one still has to look at its underwriting rules, coverage, returns, benefits and services rendered to determine the scheme's value. This scheme has also attracted more enterprises, especially micro enterprises, to subscribe to this plan for their businesses due to lower monthly payments. However, the plan is only applicable to the common type of claims which will prove challenging to the SMEs in dealing with large unexpected losses. In order to ensure that SMEs are secured against unforeseen losses, they have to be educated on the importance of having adequate coverage. This will determine the sustainability of the business.

In the future, insurance coverage, such as key man and professional indemnity should be made affordable to SMEs and micro enterprises. To further protect and develop their businesses, SMEs should start with a detailed risk management and business continuity plan to identify their risk transfer plans

CONCLUSION

There are a few conclusions that could be derived from this paper. First, a good risk management strategy is imperative to ensure the success of all business operations. By not having a sound risk management strategy, a business entity is jeopardizing its operations and restricting its opportunity to expand their business. Second, instead of providing protection and appropriate compensation against losses or damages, inadequate insurance cover will only create complicated issues that will finally rendered the insured void of any financial guarantees. This will ultimately cause greater financial losses to the business entity as a whole. Third, the insurance industry should strive to offer more affordable insurance products that specifically cater to the needs and financial capacity of small businesses. This will help to make insurance more attractive and serve its purpose to protect the businesses. Finally, all small business operators must be made aware of the importance of having proper insurance coverage, increase their understanding on the subject matter and allow them to have access to the expert services in the insurance industry. Hence, it could be concluded that insurance is indeed one of the important risk transfer mechanism that could be utilized by all SMEs business owners to protect their business and to ensure sustainability of their operations.

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