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# Understanding the **TOTAL COST OF RISK**

Building a total cost of risk mindset helps risk managers demonstrate value and ensure decisions are taken with short and long-term impacts in mind.

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**A**t a time when pressure on public finances is tighter than ever, understanding and evaluating the long-term impacts of short-term decisions is critical. To support this, organisations should support a risk management culture that considers the total cost of risk of decisions to mitigate negative short and long-term impacts. These can be short-term and long-term, in the context of the organisation or project objectives.

Understanding and accurately assessing the total cost of risk (TCOR) is not a nice to have, it's a must have. It ensures organisations tasked with spending public money responsibly are not hit with long-term costs stemming from unforeseen or unmanaged risks. A TCOR strategy and framework also protects the wider community, especially its most vulnerable members, from the impacts of such risks.

When it comes to balancing quality and price, risk management and insurance are no different to any other product or service: you get what you pay for. By identifying and analysing the TCOR, risk



managers can approach tenders on a more sophisticated level, critiquing how an insurer proposes to support the organisation in managing the whole range of insurable and uninsurable, tangible and intangible risks. Organisations that understand and manage the TCOR sustainably reap the financial, goodwill, and reputational benefits that come from reducing long-term costs and community suffering.

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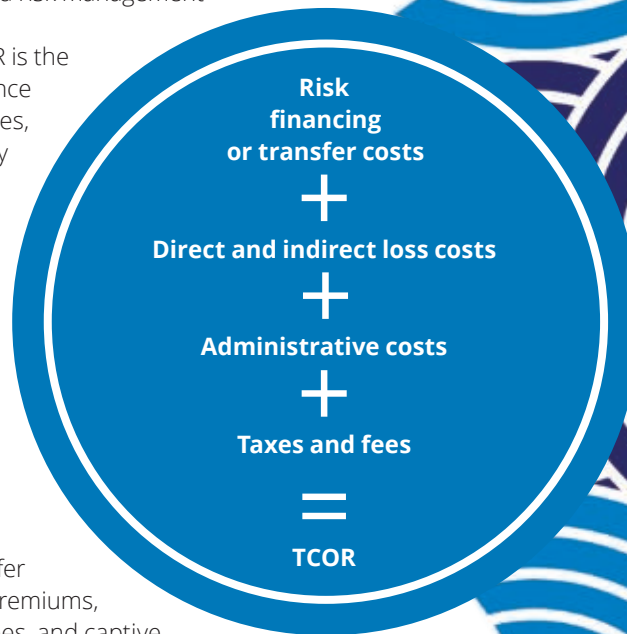
### Defining the total cost of risk (TCOR)

As with all things risk, understanding of the term 'total cost of risk' has evolved with risk management philosophy and leadership. It is an important concept and mindset for those involved in insurance and risk management decisions.

In simple terms, TCOR is the total cost of your insurance premiums, retained losses, risk management activity and administration expenses. There is no definitive model, however most TCOR calculations today include these four elements:

### When calculating the TCOR all four elements must be considered:

- 1** Risk financing or transfer costs are all insurance premiums, broker commission or fees, and captive contributions.
- 2** Direct and indirect loss costs include direct loss costs such as deductibles and claims that are anticipated and funded inside the risk management plan, the cost of administering claims by third-party administrators, uninsured or self-insured losses, plus indirect costs such as additional unfunded business expenses, reputational damage, supply chain failure, political and/or regulatory changes, and social costs that arise from a risk event.
- 3** Administrative costs are additional fees or expenses paid for claims management, risk control and other project costs such as data analytics.
- 4** Taxes and fees include insurance premium tax (IPT) and VAT. ➤





### TCOR and the risk management process

When considering the TCOR, the first element is often the primary focus: risk transfer or insurance cost. But these costs are often far outweighed by elements two and three, loss costs and administrative costs (including risk control). As risk managers our role is to encourage a mindset where we consider risk costs broadly and see insurance in the wider context of risk management.

Step one in the process is to identify and assess risks, then the next step is to manage the risks. Within this step are all the options you have to control your risks, including the four T's: Treat, Tolerate, Terminate and Transfer.

Insurance is one method of risk transfer, covered in element one of the TCOR calculation. In the overall picture, risk control costs included in element three. of the calculation include all the other responses you have to those risks, including inspection regimes, training and security systems. One element that may be overlooked are risk management departmental costs, including the risk manager, the health and safety manager, the costs of the risk committee that meets regularly, and so on. If a risk event happens, a loss occurs, impacts are felt, and a response is triggered. These loss costs are covered in element two of the calculation.

Much of the direct loss costs are covered within the insurance arrangement but deductibles or self-insured elements need to be considered where if there is a loss inside the deductible, the organisation will have to fund it. The anticipated costs of this element need to be included in the calculation and accounted for in an organisation's overall risk budget.

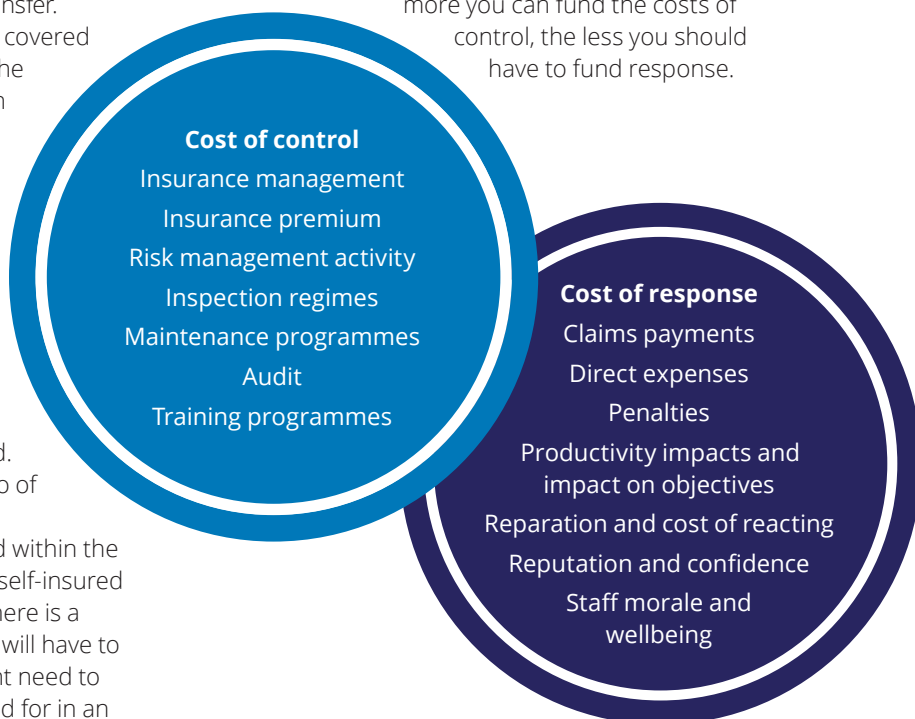
Indirect and uninsurable factors are those which fall outside of the insurance arrangements or plan. These can be tough to identify and quantify but from a project perspective particularly, it's vital to understand the overall cost exposure and the required contingency needed to cover identified risks should they occur.

Employers' liability is a classic example that highlights the importance of accounting for both the direct and indirect costs of loss events. Employers' liability insurance will help you pay compensation if an employee is injured or becomes ill because of the work they do for an organisation. It covers the direct costs of medical treatment and lost wages,

for example. The employer is also responsible for the indirect costs which may include overtime required by others, training of a replacement worker, reduced productivity due to the reduction in capacity and any fines and penalties.

Managing the TCOR is managing the balancing act between cost of control and cost of response. Short-term decisions to reduce funding on control measures will lead to more risk events and more loss costs, as often public service organisations have to fund response activity to protect their communities. The

more you can fund the costs of control, the less you should have to fund response.




Take flooding as an example. Zurich's Flood Resilience Alliance research of cost-benefit from dozens of specific flood resilience programmes has identified there is, on average, a 1:5 benefit/cost ratio. This illustrates that not only is resilience building positive from a humanitarian point of view, it is also cost-efficient.

### TCOR analysis examples

#### Example 1

An organisation can make short term savings by looking only at the initial cost of a contract or a risk management response, but failing to consider the wider impacts and the TCOR can lead to paying more in many ways over the life of the contract.



For example, a school has to replace a roof on its music building. Facing increasing demands to save costs, a decision is made to re-cover the roof instead of replacing it, leaving the roof flat. Following heavy rain, the building suffers serious water ingress. Had the roof been replaced this would not have occurred.

The direct impact on the school is obvious: it has to make an insurance claim for damage to the building and its contents. However, the indirect costs and consequences to the students and community are more subtle. Students from low-income families are unlikely to have spare funds to purchase or rent an instrument while the school waits for insurance funds to replace their stock. In addition, community theatre and singing groups may rent the building outside of school hours to hold rehearsals or lessons. Loss of the building may result in the school missing out on much needed revenue while the building is being replaced.

The above example highlights the wide impacts of risk events. A TCOR approach to this decision would have looked beyond the short-term cost saving. The direct and indirect loss costs that could be incurred could have been avoided with a deep dive into the short and long-term consequences.

### Example 2

Highways risk provides an illustration of the roles insurers and risk managers can play in a TCOR approach.

Section 58 of the *Highways Act 1980* provides that road owners have a duty to ensure they are safe for drivers, pedestrians, and other road users, to avoid injury or damage to property. There is a risk that a council or highways agency may

receive personal injury and property damage claims resulting from potholes on a particular road.

The obvious part of the TCOR process is that the risk manager transfers the financial damages part of this risk to an insurer through the payment of an insurance premium. The insurer then pays the financial compensation should the claim be upheld.

However, the authority will be mitigating the likelihood of this risk occurring through a highways maintenance programme, including highways inspection processes. These control measures have a cost attached but are offset by the costs saved through a lower incidence of claims, which have both direct and indirect costs. If changes are made to these controls, a change in inspection methods for example, the incidence of claims may go up, negating the cost saving perceived to have been made.

Initially it may seem that the insurer's role is only to pay out on the claim in this example. However, an insurance company's specialist risk engineers can provide data, expertise and services to assist an organisation in identifying and managing highways risks. If these are included in the insurance premium, they do not add to the TCOR calculation.

## The role of risk managers in managing the TCOR

### Risk managers can better manage risk by:

- Accurately assessing the direct and indirect total costs of identified risks.
- Optimising risk mitigation and transfer strategies.
- Working with insurers to get the best value out of insurance policies and ensure add-on insurance services are valued in the procurement process.
- Review and implement risk management technology-based resources such as risk capture systems and sensors which can dramatically reduce the overall cost of risk. ➤

**Managing the TCOR is managing the balancing act between cost of control and cost of response.**





# Not only is resilience building positive from a humanitarian point of view, it is also cost-efficient.

Ensuring a risk manager has the training, skills, and resources required to undertake tasks effectively allows an organisation to take more risks. Knowing that every department has the data and frameworks required to identify, analyse, and manage risks is the key to being equipped to meeting the direct and indirect challenges brought on by today's systemic challenges, and other trials that may lay in wait for us in the future.

Zurich Municipal is publishing a series of articles looking at a TCOR mindset through our series, *A wider lens: The risks of short-term decision-making*. We aim to return to the fundamentals of risk analysis and management, by examining how an organisation understands its risk profile and the different elements that make up that overall picture, along with the total long-term cost benefit of eliminating or at least mitigating those risks. ●

## References

<sup>1</sup>Councils warned over rise in fake pothole claims, Zurich UK News

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