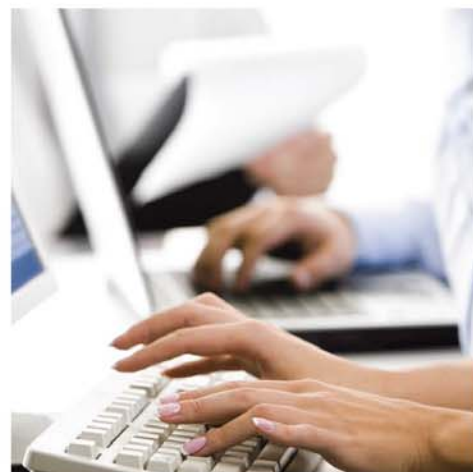


The changing landscape of small business risks

A report commissioned by Premierline Direct



Nottingham University
Business School



premierline direct
BUSINESS INSURANCE

A company of Allianz 

Report by Christopher O'Brien, MA FIA ASA
Director of the Centre for Risk and Insurance Studies, Nottingham University Business School

Introduction

With the impact of the recession lingering over SMEs, this report looks at the potential threats they face and how business insurance may evolve to meet future risks.

Through this report, we consider risks such as reduced demand for products and services, financial issues such as lack of cashflow and accessible credit, and increased legislation and regulations and look at what SMEs perceive as threats to their business. The report then explores how SMEs manage the risks they face, putting these into the context of a risk assessment and how they view insurance to cope with the potential consequences of a risk. The report concludes by drawing together all this information to consider the business insurance landscape to meet future risks.

Identifying the risks

Reduced demand

Research shows that SMEs believe the greatest threat to their business is the risk of reduced demand for their products and services, as quoted by 52%. The reason for this is many firms concentrate on the way they supply their goods and services. For example, companies ensure their premises are protected and insured against fire risk, their workers are safe from injury, and their suppliers are managed and contracted to deliver supplies of the necessary quality to the right place at the right time. Firms are therefore looking to manage the variability within these 'supply' factors that they have some control over especially as research shows small businesses depend heavily on their suppliers - 12% said the failure of a supplier to deliver on the time agreed was a threat to their business.

What is more difficult to manage is the 'demand' side of this risk – customers cannot be controlled so easily. So, the potential of reduced demand is one that naturally features highly in the list of risks to which firms feel exposed. It is therefore not surprising to find that, in a recession, SMEs put the potential for reduced demand at the top of their list of threats with it being particularly an issue for small businesses in Wales (66%) and the Midlands (61%). It was also noticeable that males (55%) were more concerned than females (46%) about the threat of reduced demand.

However, there are steps that companies can take to reduce this 'demand' risk. There are marketing techniques to ensure that firms supply products and services that meet customers' needs, and that they consider how these needs change. In addition, a business may consider expanding into new markets

to ensure its survival and grow. However research shows 12% of female business owners are concerned about the inability to expand into new markets, compared to only 8% of males.

There were other aspects of 'demand' that concerned SMEs. Nearly a third (32%) classified increasing competition as a threat. Young business owners felt this was particularly important, with 39% of those aged under 35 referring to this. The Midlands was the region where increasing competition was most seen as a threat (39% of respondents) and the changing nature of consumer demand was seen as a threat by a greater proportion of females (32%) compared to males (26%).

Furthermore, businesses should not underestimate the importance of having adequate protection through their insurance, which can help the company to continue operating as normal even if there are unexpected adverse events so they can fulfil customer demand and protect the risk to their reputation. Research shows that 21% of females were concerned about reputation risks compared to 15% of males. However, less than one in six SMEs has business interruption cover, which would prove invaluable in helping a business survive an incident that caused loss of income and help protect its reputation by getting the business up and running quickly.

Financial risks

Financial risks were also regarded as particularly serious with 41% of SMEs saying that late payments were a threat to their business - consistent with the problems of the recession. This figure was highest in Wales and Scotland (each 53%) and lowest in the Midlands (35%).

With financial concerns front of mind for SMEs, lack of cash flow to develop the business was regarded as a threat by 29% of respondents. Regionally, the proportion was highest in the Midlands (35%) and lowest in the North (26%). For one-employee businesses the figure was 23%. Although stock markets have been unstable, this was seen as a threat by relatively few small businesses (3%). More significant was the fluctuating value of the pound, seen as a threat by 13%.

With financial institutions having restricted their lines of credit, lack of accessible credit was considered a risk by 15% of respondents. This figure was highest in London (18%) and lowest in the Midlands (11%). Larger SMEs saw this as more of a problem than the smaller ones.

Following the banking crisis, it is hoped that SMEs have been alerted to the possible implications for their own business with banks having to manage credit differently post-crisis. The question is whether there are others who, while not finding credit to be a problem now, may face such a difficulty in the future.

Regulation and legislation

SMEs were also concerned by increased regulations and/or legislation, with 39% saying that this was a threat. Males (41%) regarded it as more of a problem than females (34%). The South was the region where this was most important (45%), although London scored lowest (31%). Where the small business was just one employee, this concern was lower (29%).

It is not surprising many SMEs were concerned about regulatory change, as new rules and regulations hit businesses regularly. When new obligations arise, it is often necessary for the insurance industry to respond, either creating new areas of cover within a policy or amending the rules to adhering to the policy. With a general election looming, and the possibility of a change in government, the uncertainty is greater than normal. Businesses need to be alert to changes that go beyond a minor impact but which effect the way a market works, leading to a strategic threat to their company.

Technology risks

It is change that leads to many risks, and in recent years there has been a major shift in the way businesses work as a result of the internet or, more widely, the revolution in Information and Communication Technologies (ICT). While it's not possible to predict what the changes over the next few years will be, change will happen. Only 7% of SMEs thought that IT capabilities were a major threat. Perhaps small firms are very adaptable, but they need to think beyond whether ICT changes affect the way they work: the more damaging threat is if there are changes in ICT that undermine the SME's business model. Dealing with that kind of threat can be very difficult.

Energy costs

Increasing energy costs were seen as a threat by 15% of businesses and there were some noticeable regional variations, with Midlands scoring highest (25%) and the East lowest (9%). With energy costs due to continue to rise, this risk will no doubt become a greater concern for more SMEs.

It was surprising that some (5% of) SMEs perceived there are no threats to their business. This may reflect a lack of perception rather than reality. Academic research shows that people tend to be over-

confident when they make assessments of potential future outcomes, hence the assumption that those that did perceive threats may not have thought widely enough about potential threats. Of course it is the 'unknown unknowns' that are the most difficult.

Firms' objectives

The significance of the recession was seen when SMEs were asked what their main (up to four) objectives, apart from increasing profits, over the next three to five years are. Scoring highly, with 54%, was 'surviving the recession.' The figure was highest in the Midlands (63%) and London (62%).

However, the forward-looking nature of small businesses was also apparent, as 61% replied that one of their main objectives is to increase sales. This was especially important for young business owners, applying to 79% of those under 35 years old.

Introducing new products and/or services is a main objective for 28% of SMEs. Again, this is most prominent for younger respondents, applying to 37% of the under-35s. The regions where this is most prominent are London, the South and Scotland (32%). In addition, some businesses are keen to diversify into new markets. While 23% overall said this is a main objective, it is especially important for London businesses (31%). However, with the lack of accessible credit, which was also indentified as a risk by SMEs, the question is whether these objectives will become a reality and how businesses will make it happen?

Financial targets are also at the forefront of their minds. 39% said one of their main objectives is to improve cash flow, this being especially the case for the larger businesses. 17% said they want to reduce the level of company debt although that applied to only 11% for one-employee firms, perhaps because they have lower overhead costs and therefore less debt. 18% said they wanted to lower operational costs: this was highlighted by the larger businesses and those based in London, perhaps as a consequence of the recession.

Increasing the size of the workforce is a main objective of just 9% of respondents although, for other firms, increasing numbers of employees may be as a result of other expansion objectives rather than being an aim in itself.

One in ten (10%) of SMEs said an objective is to sell the company. As we would expect, this was more significant for more established businesses, and less important for the one-employee firms.

Risk management by SMEs

With businesses being aware of the potential threats to their company, do they formally manage risk? Only 20% of SMEs have had a risk assessment for their business conducted in the past 18 months to assess potential threats and issues that may affect them. Most of those who have not had a risk assessment said the business was too small (73%). Some (37%) could not see the value in having one done, 13% said they did not have the internal skills to do it, 30% did not have the time, and 20% said they could not afford to employ a specialist for this.

However, in practice, SMEs may be assessing and managing risks on an informal basis, with the issues being weighed up in the mind of the business owner. However, this may not be robust: the person at the heart of the business may not, on his/her own, be able to appreciate what the hazards are.

Where a risk assessment was done, operational and financial risks tended to be highlighted. Over half (54%) said that the risk assessments covered health and safety issues, 38% covered fire/floods and 36% covered IT risks. Possible financial threats were covered in 49% of risk assessments. Business sustainability, which may include a wide range of risks, was covered by 43% of risk assessments.

However, it must be a concern that these assessments frequently failed to miss important risks. In addition, given the importance of financial risks to small businesses, why did only 49% of risk assessments cover these? The most popular response by SMEs when asked to name the main risk facing them was the threat of a fall in the demand in their products or services, however, only 37% of risk assessments covered this and 34% considered potential new competition. So, there is clearly a gap between what these assessments are covering (or, at least, how they are remembered) and the threats that small businesses fear.

The role of insurance

Insurance is a valuable tool to help protect businesses against potentially crippling costs and some areas of cover are compulsory such as employer's liability. While many small businesses view

insurance as a 'necessary evil', most also agreed or tended to agree that insurance was essential for protecting their livelihood.

However, SMEs have difficulty understanding business insurance and what risks their policy covers them against. There was a disturbing degree of ignorance regarding employers' liabilities and their insurance coverage. For example, 30% did not know that temporary workers need to be covered under the employer's liability cover and 44% did not know whether employees could claim compensation if they were assaulted when escorting money to the bank.

Nearly half (48%) did not know whether they automatically received cover for a temporary increase in stock values; 45% did not know whether they would be able to claim for loss of income should the business have to be closed temporarily or permanently due to an outbreak of a disease; and 47% did not know whether they could claim compensation if someone was injured by a product supplied by the company.

This lack of knowledge about insurance is disturbing and business owners appear to be under-valuing insurance. So, there is mileage in the insurance industry educating SMEs and helping them better understand the coverage that insurers provide.

The potential future insurance landscape

Business insurance policies cannot cover everything that can go wrong for a small business, however, SMEs were asked what their 'wish list' would be for additional cover in their policy at no extra cost. 43% wished to cover the legal costs of suing customers with bad debts, and 16% wish to cover the legal costs of suing suppliers who failed to give a refund for unsupplied goods. Here, the recession may have led to small businesses viewing risks differently, being particularly concerned about financial risks. There may be circumstances beyond the business owner's control that they are not insured against, but could cripple the business. So this is an area where insurers may have to expand the level of legal cover they provide to help businesses protect their cashflow and reduce damage caused by loss of revenue. Also on the 'wish list' was more comprehensive protection of intellectual property rights, referred to by 21% of SMEs.

The survey also identified that many SMEs do not recognise that some risks can already be covered under business insurance policies. More than a quarter (28%) want to cover the cost of stolen goods,

22% of SMEs wished to cover loss of income as result of electricity, gas or water supply failing, 15% want cover for environmental damage and 10% were looking for compensation if a supply chain collapses. These are risks that many policies already cover suggesting SMEs do not fully recognise the value of existing insurance.

There is scope to expand the level of cover provided by insurance in the future. In particular, where new government regulations impose additional obligations on employers, insurers can look to provide insurance for the new liabilities. For example, extending the level of cover provided by commercial legal protection to include legal disputes when defending actions to meet environmental directives and obligations.

Further, what will new technology bring in the form of new risks? New hardware or software that is prone to breakdown or becoming infected with viruses? Or where either personal or business data is lost or mis-used? These risks are present already but they may become more serious as the power of ICT increases. Insurers need to understand these risks and help small businesses manage them, by ensuring their cover matches what is required. It may be that insurers set minimum standards for compliance on business owners, in a similar way to security measures, requiring the business installs adequate anti-virus systems and having back up systems in place to ensure vital data isn't lost.

Insurers can also see if they are able to expand the scope of what is insurable. In particular, many large firms have taken on board the concept of enterprise risk management, where they think holistically about the whole range of risks that face them, assess what they can satisfactorily keep and where they can ask if someone else can take them on. Some of those risks are ones that insurers have traditionally specialised in, such as employer's liability, public liability and building and contents cover. But consider the credit risks and financial risks that SMEs have. These are important; indeed, the survey indicates that many SMEs see them as important threats.

Insurers may be able to help SMEs with some of these issues. Credit insurance can insure against bad debts and defaulted payments. It is provided by specialised insurers but perhaps traditional insurers could offer this in addition to their usual cover? They may wish to buy reinsurance with a specialised insurer to enable them to do this. Other firms may be subject to interest rate risk, for example. Could an insurer help hedge this threat on the financial markets? This is not traditional insurance. However, by looking at the range of risks facing SMEs, an insurer could help provide a package of more complete protection. An insurance company would find it difficult to cover the possibility that the demand for the

products or services declines, but the insurer would still be going some way towards providing an enterprise risk management solution.

Conclusion

Research shows that SMEs are considerably aware of the risks their business faces and that the turmoil in the economic climate has heightened awareness of just how great threats such as a drop in demand for goods or service, late payment and lack of cashflow are to their survival.

The changing business landscape and the environment within which SMEs now compete, means that business insurance could play an even greater role in protecting businesses. While it is not feasible for an insurer to cover every single threat to a company, there are areas where cover can be extended for extra legal costs. In addition, with SMEs focused on receiving best value from their cover, insurers may need to consider how they position their proposition.

With SMEs accepting the need to manage risk and most seeing insurance as essential for protecting their livelihood, we could see insurers placing additional terms and conditions on the business owners to ensure that as the areas of cover expand, the business does all it can to reduce their level of risk.

Comment from Chris Little, managing director of Premierline Direct:

“As the UK’s first direct business insurance provider, we’re keen to embrace change and ensure that we continue to meet our customers’ needs. This report provides a valuable insight into what our customers want and the risks they believe threaten the future stability of their business. It is our responsibility to assess these risks and consider ways in which we may extend the level of cover we provide in the future. In addition, we can use this information to offer valuable support to help businesses manage these risks, regardless of whether they are covered by the insurance policy or not.”

Note

The figures are from You Gov Plc. The total sample size was 582 SMEs. Field work was undertaken before 8th and 10th June 2009. The survey was carried out online. The figures have been weighted and are representative of all GP adults (aged 18+)