Paper- 13 : MANAGEMENT ACCOUNTING – STRATEGIC MANAGEMENT

Time Allowed : 3 Hours **Full Marks : 100**

The figures in the margin on the right side indicate full marks.

Section -I (60 Marks)
(Strategic Management)
Answer Question No.1 and any other two more from the rest in this section.
(Please answer all part of the question at one place.)

Question 1.

(a) In each of the cases/ statements given below, one of four alternatives is most appropriate. Indicate the correct answer: **[1×10=10]**

(i) The difference between strategic alliances and joint ventures can best be explained by:
(A) all strategic alliances are joint ventures;
(B) all joint ventures are strategic alliances;
(C) all strategic alliances are temporary phenomena ;
(D) all joint ventures involve equity participation .

(ii) Which of the following could be a core competence?
(A) A brand;
(B) Fixed asset;
(C) Ability to manage the integrity of the asset;
(D) Enlightened leadership.

(iii) The acquisition of Corus by TISCO is an example of:
(A) Horizontal integration;
(B) Vertical integration;
(C) Concentric diversion;
(D) Forward integration.

(iv) Target price is:
(A) Market driven;
(B) Product driven;
(C) Cost driven;
(D) Investment driven.

(v) Sony's distinctive capacity is
(A) Distribution;
(B) Innovation;
(C) Service;
(D) Sales and marketing.

(vi) Which model among the following is not example of mathematical programming models (optimization models)?

(A) Linear programming model;
(B) EOQ model;
(C) CPA or PERT model;
(D) Game theory model.

(vii) McCarthy's marketing mix refers to:
(A) Price, push, pull and product;
(B) Price, promotion, place and product;
(C) Price, profit, promotion and product;
(D) Price, promotion, profits and product.

(viii) The competitive advantage through market share approach is derived from:
(A) Economies of scale;
(B) Experience;
(C) Market power;
(D) All of the above.

(ix) The introduction of 'Nano' by Tata Motors could be viewed as a good example of:
(A) Price leadership;
(B) Cost leadership;
(C) Product leadership;
(D) Technology leadership.

(x) The Product Market Matrix comprising of Strategies of Penetration, Market development, Product development and Diversification was first formulated by:
(A) Ansoff;
(B) Drucker;
(C) Porter;
(D) Andrews.

Answer:

(i) (B) all joint ventures are strategic alliances
(ii) (C) Ability to manage the integrity of the asset
(iii) (A) Horizontal integration
(iv) (A) Market driven
(v) (B) Innovation
(vi) (D) Game theory model
(vii) (B) Price, promotion, place and product
(viii) (D) All of the above
(ix) (B) Cost leadership
(x) (A) Ansoff

(b) State whether the following statements are 'True' or 'False' with justification for your answer:
[1x5=5]

(i) 'Management buy-in' refers to the purchase of all or part of a business firm from its owners by the managers.
(ii) At "EOQ", the carrying cost per unit is equal to the ordering cost per unit.
(iii) "Maturity" stage of PLC is characterized by decreasing rate of increase in sales volume.

(iv) 'PIMS' analysis attempts to establish the profitability (i.e. return on capital) of various marketing strategies.

(v) ABC costing is the process of identifying and learning from the best practices anywhere in the world.

Answer:

(i) False — 'Management buy-in' occurs when a manager or a management team from outside the company raises the necessary fund, buys it, and becomes the company's new management.

(ii) True — At "EOQ", the carrying cost per unit is equal to the ordering cost per unit.

(iii) True — "Maturity" stage of PLC is characterized by decreasing rate of increase in sales volume.

(iv) True: PIMS analysis attempts to establish the profitability (i.e., return on capital) of various marketing strategies. PIMS analysis is more relevant to industrial goods markets.

(v) False – 'benchmarking' is the process of identifying and learning from the best practices anywhere in the world.

(c) Define the following terms (in not more than two sentences): [1x5=5]

(i) Brand

(ii) Kanban card

(iii) Loss-Leader

(iv) Barriers to entry

(v) Turnaround management

Answer:

(i) Brand: A brand is a name, term, sign, symbol or design or combination of them, intends to identify the goods or services of one seller from its competitors.

(ii) Kanban card: It is notification card that a downstream machine sent to each upstream machine that feeds with parts, authorizing the production of just in a components to fulfill the production requirements. This is also known as "pull" system.

(iii) Loss-Leader: 'Loss leader' means a product or services sold at market at lower-than-normal margins (i.e., probably at a loss) in order to attract customers who might then buy other items of the same company at normal prices.

(iv) Barriers to entry: It indicates the factors like economies of scale, product differentiation and capital requirements, which make it difficult for a new entrant to enter and gain a foothold in an industry.

(v) Turnaround management: The term refers to the management measures, which reverse the trends in the performance indicators of an organization thereby turning a sick enterprise back to a healthy one.

Question 2.

(a) Unrelated Diversification can sometimes work well. When is unrelated diversification a good strategy? Illustrate. [6]

Answer:

Unrelated diversification is also known as conglomerate diversification. Under this type of diversification, there will be addition of dissimilar products or services to the existing line of

business. It involves diversification into business fields, which are not significantly related or similar to the primary business mission. Further under unrelated diversification, a firm may acquire another firm, which has surplus cash even though there may be nothing common with existing business. Unrelated diversification is a good strategy where,

(i) Basic industry is experiencing declining annual sales and profits.
(ii) An organization has capital and managerial talent required to compete in a new industry.
(iii) There is some synergy between existing and proposed new areas of business (ITC in apparel/Agri- business)
(iv) Acquire an related business which offers attractive investment opportunity (Kingfisher Airlines)
(v) Existing business is continuous threat of saturated demand.(Generic chemicals, Cigarette, Land phone etc. business)
(vi) When an organization is subjected to environmental safety or pollution control or antitrust law.

(b) What are the types of simulation models? What are the advantages and disadvantages of simulation models? [3+(2+2)=7]

Answer:

There are several types of simulation as given below:

- Probabilistic Simulation, where one or more independent variables is conceptualized as a probability distribution of values.
- Discrete simulation, where it becomes important to know when an event exactly occurs.
- Visual Simulation is a graphical representation of computerized results. Software for this method is one of the recent developments in computer-human interaction and problem solving.

Advantages of Simulation Models: Decision support systems have been increasingly using Simulation Models for the following reasons:

- Simulation theory is relatively easy to comprehend.
- Simulation can offer solution to ―what-if‖ type question.
- Decision support system analysis work closely with managers who seek solution.
- Simulation Models allow inclusion of real life complexities and no simplifications are necessary.

Disadvantages of Simulation Models:

- An optimal or the best solution is not always guaranteed.
- Building simulation model is a slow and costly process.
- Solutions and inferences from a specific Simulation Model cannot be transferred for other problems.

(c) Write the role of Product development as a part of an overall marketing strategy. [4]

Answer:

Product development involves an organisation seeking to create new products to replace existing ones. The new products may be completely new or revised versions of existing ones. Within a marketing strategy, a company‘s competitive posture is determined by its overall product-market mix and product development strategy is a part of this. Many firms attempt to have a combination of current and new products for survival and growth. The strategies of

market penetration, market development and diversification are also coordinated with the strategy of product development. For an overall marketing strategy, a company will attempt a mixture of these strategies. As a part of an overall marketing strategy, product development performs the following roles:

- Replacement of products, which are in the maturity of PLC.
- Risk reduction through production of a range of products.
- Brand extension
- New markets'entry, etc.

(d) State the basic goals of the Environmental analysis. [3]

Answer:

Environmental analysis has three basic goals:

(i) The analysis should provide an understanding of current and potential changes taking place in the environment. It is important that one must be aware of the existing environment and at the same time have a long-term perspective too.

(ii) Environmental analysis should provide inputs for strategic decision-making. Mere collection of data is not enough. The information collected must be used in strategic decision-making.

(iii) Environmental analysis should facilitate and foster strategic thinking in organization, typically, a rich source of ideas and understanding of the context within which a firm operates. It should challenge the current wisdom bringing fresh viewpoints into the organization.

Question 3.

(a) Explain the way a cost leadership strategy can help a firm in handling the five competitive forces. [5]

Answer:

Cost leadership strategy in handling five competitive forces: Being the low-cost provider in an industry, a firm can provide some attractive defenses against the five competitive forces:

- In meeting the challenges of rival competitors, the low cost firm is in the best position to compete offensively on the basis of price, to defend against price war conditions, to use the appeal of lower price to grab sales (and market share) from rivals, and to earn above-average profits (based on bigger profit margins or greater sales volume). Low cost is a powerful defence in markets where price competition thrives.

- In defending against the power of buyers, low costs provide a company with partial profit margin proaction since powerful customers is rarely able to bargain price down past the survival level of the next most cost-efficient seller.

- In countering the bargaining leverage of suppliers, the low-cost producer is more insulated than competitors from powerful suppliers if the primary source of its cost advantage in greater internal efficiency.

- As regards potential entrants, the low-cost leader can use price-cutting to make it harder for a new rival to win customers; the pricing power of the low-cost provider acts as a barrier for new entrants.

- In competing against substitutes, a low-cost leader is better positioned to use low prices as a defence against companies trying to gain market inroads with a substitute product or service.

(b) Identify the most important pitfalls that ought to be avoided in starting and doing strategic planning. [5]

Answer:

The issues in a corporate strategic planning involve judgments, values, passions and perceived consequences. So, irrationality cannot be avoided. Major pitfalls that should be avoided in starting and doing the strategic planning may be listed as follows:

(i) Failure to develop throughout the company an understanding of what strategic planning really is, how it is to be done, and the degree of commitment of top management in doing it well.

(ii) Failure to accept and balance interrelationships among intuition, judgment, managerial values and the formality of the planning system.

(iii) Failure to tailor and design the strategic planning system to the unique characteristics of the company and its management.

(iv) Failure to encourage managers to do effective strategic planning by basing performance appraisal and rewards solely on short-range performance measures.

(v) Failure to modify the planning system as conditions within the company change.

(vi) Failure to understand the analytical tools used in different parts of the planning process.

(vii) Failure to balance and link appropriately the major elements of the strategic planning and implementation process.

(viii) Failure to secure in the company a climate for strategic planning that is necessary for its success.

(ix) Failure to understand the importance of strategy implementation and how to make that process efficient and effective.

(x) Failure to mesh properly the process of management and strategic planning.

(c) "A Dog (in respect of BCG matrix) need not be divested always. Someone can acquire a Dog." State. [2]

Answer:

Considerable criticism has been made for some time of the BCG's belief that ―Dogs are essentially worthless‖ and they should be liquidated or divested, if possible. In some industries

however, Dogs provide a platform for development of future stars, act as loss leaders or otherwise help to complete a product range. Dogs can also be acquired for strategic reasons-could be for tax planning, could be to kill competition etc.

(d) Distinguish between 'Strategy' and 'Policy'. [5]

Answer:

Strategy: Strategy refers to the determination of the purpose or mission and the basic long-term objectives of an enterprise, and the adoption of courses of action and allocation of resources necessary to achieve these aims. Therefore, objectives are a part of strategy formulation.

Policy: Policies are general statements or understandings that guide managers thinking in decision making. They ensure that decisions fall within certain boundaries. They usually do not require action but are intended to guide managers in their commitment to the decision they ultimately make. The essence of policy is discretion. Strategy, on the other hand, concerns the direction in which human and material resources will be applied in order to increase the chance of achieving selected objectives.

Certain major policies and strategies may be essentially the same. A policy of developing only through retailers may be an essential element of a company's strategy for new product development or marketing. One company may have a policy of growth through the acquisition of other companies, while another may have a policy of growing only by expanding present markets and products. While these are policies, they are also essential elements of major strategies. Perhaps one way to draw a meaningful distinction is to say that policies will guide a manager's thinking in decision - making if a decision is to be made while a strategy implies the commitment of resources in a give direction.

(e) Differentiate —Demand-pull and Cost-push inflation. [3]

Answer:

Demand-pull and Cost-push inflation: Inflation is the phenomenon of rising prices of goods and services in general. It can come about due to a scarcity of supplies in relation to demand; this is known as demand-pull inflation. It may also result from an increase in the cost of some critical input, such as steel or petroleum, which then triggers off a gradual rise in prices in general; this is known as Cost-push inflation.

Question 4.

(a) Benchmarking exercise is based on "best exercise" and not on "best performances". Discuss. Also state briefly the important benchmarking processes used in strategy implementation. [3+6=9]

Answer:

The term "Benchmarking" is defined as the continuous process of measuring the products, services and business practices of a company against the toughest competitors or those companies search for industry's best practices that lead to superior performance. In other words, it is a tool for improving performance by continuously identifying, understanding, adopting and adapting best practices and processes followed by an entity- both internally as well as externally. From this definition, it is evident that a benchmarking exercise has to be based

on "best practices" and not on "best performances". Practices signify continuity in use while performances may be flash in the pan and not continuous. Best practice is a continuous process of learning, feedback, reflection and analysis of what works or does not work and the reasons therefore.

Important benchmarking processes used in strategy implementation. The following are some of the important benchmarking processes used in strategy implementation:

- **Strategic Benchmarking:** This aims at enhancing company's holistic performance by analysing the long-term approaches and strategies adopted by the "best practice companies" for their success in any sector across the globe.

- **Functional Benchmarking:** Optimization of functional processes or activities through Benchmarking can be done by comparing with different business sectors but engaged in similar functions or processes.

- **Process Benchmarking:** The initiating firm focuses its observation and investigation of business processes with a goal of identifying and observing the best practices from one or more benchmark firms. Activity analysis will be required where the objective is to benchmark cost and efficiency. This type of benchmarking processes is applied to back-office processes, where outsourcing may be a consideration.

- **Product Benchmarking (or Competitive Benchmarking):** This is confined to the area relating to the performance characteristics of the company's key products and services of the companies in the same sector.

- **Internal Benchmarking:** This involves Benchmarking against the companies own divisions or branches or strategic business units situated at different locations. The purpose is to develop a database which gives access to information and a cross fertilisation of the managerial acumen within the company.

- **Financial Benchmarking:** This involves performing a financial analysis and comparing the results in an effort to assess the company's overall competitiveness.

(b) What are the "key success factors" for a business enterprise? How would you determine them? Compare and contrast the different types of standards which can be used for evaluation and control of strategy? [3+3+3=9]

Answer:

Key variables, key success factors or critical success factors are most important for a successful strategy for a business enterprise. A typical list of such factors for a business organisation is given below:

(i) Marketing: sales order book position, market share, gross margin or repeat order.
(ii) Production: capacity utilisation, cost of production, timely deliveries.
(iii) Assets management: inventory turnover, sundry debtors, ROI.
(iv) Personnel: employee turnover, absenteeism, man-days lost in strikes, etc.

It is to be noted that the key variables for designing the system of evaluation and control differ from business (and thus organisation) to business. Also in a large multi-business organisation, they may vary from one organisation unit level to another. Knowledge of key characteristics of

industry in which the business falls is imperative and useful for identifying key success factors. Some of the key variable on the other hand will emerge from the company's functional strategies. For instance, if a company has proposed aggressive strategies, the number of new products introduced in a period will be a key success factor.

The guidelines for identifying key variables may be as under:

- Is it important in explaining the success or failure of the organisation?
- Is it volatile and can change quickly, often for reasons not controllable by the managers?
- Is it significant enough to require prompt action when a change occurs?
- Is it not easy to predict changes in key variables?
- Can the variables be measured, either directly or via a surrogate?

The next important issue is to set the standards against which actual performance is to be measured. That standard of performance could be any of the following three types;

(i) Historical standards: In this type of standards, comparison of present performance is made with the past performance.

(ii) Industry standards: In this type of standards, the comparison of a firm's performance is made against similar other firms in the industry. The difficulty here-is that all the firms may not be exactly the same for purposes of comparison.

(iii) Present standards: The goals/targets are decided by the firm's management to be achieved in a particular period. The present standards convey the aspiration levels and take into account environmental conditions, if properly derived. These are more realistic and also consider the organisation's capacity to achieve the same. These, however, require tremendous analysis. Absence of such analysis may lead to reverse results. However, for a company developing a conscious strategy, present standards provide the best alternative.

(c) What is Crown Jewel tactics in the field of hostile takeover? [2]

Answer:

Crown Jewel tactics: Whereby the target company arranges to sell its crown jewel namely highly profitable part of the business or ones which market values better in order to dissuade the predator. However, such strategic initiative requires clear understanding of predators target businesses and valuation guidelines to be effective.

SECTION-II (40 Marks)
(Risk Management)

Answer Question No. 5 and any other two from the rest in this section.
(Please answer all parts of the question at one place.)

Question 5.

(a) In each of the cases/statements given below, one of four alternatives is correct. Indicate the correct answer: [1x5=5]

(i) The most commonly used techniques for measurement of liquidity risk is:
(A) The gap analysis of maturing assets to the maturing liabilities;
(B) The financial analysis;
(C) The audit of maturing assets;
(D) The gap analysis of current assets to the maturing liabilities.

(ii) Variability in return on investment in the market is referred to as:
(A) Market Risk;
(B) Physical Risk;
(C) Pooling Risk;
(D) Business Risk.

(iii) The concept of the process of identification of separate risks and put them all together in a single basket, so that the monitoring, combining, integrating or diversifying risk can be implemented, is called:
(A) Physical risk;
(B) Pooling risk;
(C) Business risk;
(D) Sharing risk.

(iv) Performance related risk measures do not include:
(A) Operating earnings;
(B) Weighted Average Cost of Capital (WACC);
(C) Economic Value Added (EVA);
(D) Shortfall risk.

(v) Commercial Insurance do not include:
(A) Jewelers block policy;
(B) Bankers Indemnity policy;
(C) Endowment policy;
(D) Marine cargo policy.

Answer:

(i) (A) The gap analysis of maturing assets to the maturing liabilities
(ii) (A) Market Risk
(iii) (B) Pooling risk
(iv) (D) Shortfall risk
(v) (C) Endowment policy

(b) State whether the following statements are 'True' or 'False' with justifications for your answer. **[1x5=5]**

(i) Purchasing power risk is the uncertainty of the purchasing power of the monies to be received, in the future.
(ii) Hedging involves the transfer of pure risk.
(iii) In future trading the exchange rate at which the currencies are agreed to be exchanged under the contract is called "call and put option".
(iv) Risk management is the process used to systematically manage exposures to both pure risks and speculative risks.
(v) Risk cannot be avoided through insurance but may be considered as a means to transfer the risk.

Answer:

(i) True: Purchasing power risk is the uncertainty of the purchasing power of the monies to be received, in the future.
(ii) False: Hedging involves the transfer of speculative risk.
(iii) False: In future trading the exchange rate at which the currencies are agreed to be exchanged under the contract is called strike price.
(iv) False: Risk management is the process used to systematically manage exposures to pure risks.
(v) True: Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment. So, risk cannot be avoided through insurance but may be considered as a means to transfer the risk.

Question 6.

(a) Explain the concept of "Risk Pooling" and "Diversification of Risk ". [3+3=6]

Answer:

Risk Pooling: The concept of pooling risk is the process of identification of separate risks and put them all together in a single basket, so that the monitoring, combining, integrating or diversifying risk can be implemented. Monitoring becomes easier when the specific agency put in charge knows that all the risks have been identified and they are being monitored according to the system drawn up to quantify the total risk through pooling and with a control figure i.e., plan the way to monitor, actually monitor and then check whether there are variations from the monitoring exercise and then act to correct the deviation. This correction act can be combining risks or integrating risks or diversifying risks. For example, whenever a project is put up, Transit Insurance is taken for transporting the various plant and machinery from the manufacturers to the project site. The materials are then received at the site and stored until erection. Storage Insurance will cover the risk during the storage. During erection of different plant & machinery, risks due to mechanical, electrical etc., are covered through Erection Insurance. The erected plant & machinery is then tested and trial runs are taken for guarantee purposes on continuous run, as per the contract. The risk covered during this period is covered as risks for commercial run. All these risks put together is called pooling. This single pooled policy has a risk value and premium payable and the conditions attached thereto by both the insurer and the insured to carry out those obligations are clearly spelled out in the policy documents.

Diversification of risk: This involves identifying both the systematic and the unsystematic risks. Systematic risk is inherent and is peculiar to the type of the business/firm and can be reduced or diversified through functional level strategy. The unsystematic risk is external to the organization and is termed as "market risk". The identification of characteristics of market risk through statistical correlation "Beta", which is a measure of market risk, lends itself for manipulation through portfolio management.

(b) Describe the role of Management Accountants in insurance risk management. [6]

Answer:

In the wake of economic uncertainties through which the business passes, a Management Accountant has to stay close to risk management process in an organisation and bring about a structured thinking within the business about risks. Irrespective of his role, as a Management

Accountant in an insurance company or an insured company, a Management Accountant has to appreciate the computation of the premium rates for different insurance product, as also fully define the character of the losses to be covered. Value imputation of risks to be covered by the insurer's company has two aspects:

(i) Quantifying the total risk to be covered for calculating a premium as a definite fraction of the risk value covered by the policy.

(ii) If the quantification of risk is so high and the corresponding premium is also likely to be high enough for an insured to back out, then develop a framework where the insurer's company can reinsure itself for the policy risk with another insurance company. This will help in reducing the premium for the insured.

A Management Accountant in an insured company has his task cut out in two directions. At the time of covering the risk, he has to work closely with the cross functional team to identify the direct values of the risks involved and indirect consequent values of the risks involved. For example, in the first instance, the replacement cost of a plant being insured is a direct cost and has to be quantified by proper methodology. The next step is to estimate the consequential loss of profits due to stoppage of plant due to breakdown of the plant being replaced. During the period of economic uncertainties, the management accountant can fortify the management thinking process -through providing a robust, highly reliable, fast and responsive, transparent and reliable Information Management, which will continuously highlight the risks inherent in every management activity.

(c) How do you shape institutions for project risk management and what are the strategies to be adopted? [3]

Answer:

Institutions can be shaped by anchoring projects, ensuring repayment of investments, providing social utility. This risk could be avoided by stabilisation of long term future to enable investments, enhance the legitimacy of the project by developing practices like inviting the representatives of both the institutions and the public. Develop a strong framework for structuring decision making.

Question 7.

(a) State the Impact of Macro Economic Factors on Risk. [4]

Answer:

Relationship between risk and return can never be over emphasized, higher the risk the return needs to be higher and the computation of the risk premium has always been a million dollar question. However, risk perceptions of investors tend to be different with the onset of business cycles. In recession, investors tend to be conservative as their appetite for risk is reduced and they go after growth sectors which have lower risk. In a security market, low risk growth sector have always been the biggest gainers in terms of returns. This explains that onset of recession upset the risk return balance.

Macro Economic factors like change in interest rates, inflation, money supply and index of industrial production have a big impact on the investors risk perception. Analysis has shown that in a regime of high interest rates and high inflation low risk sectors perform better than high risk stocks. As the interest rates and inflation decline the high risk sectors tend to do better.

(b) State the types of risks a firm may face while developing a new product / market. [7]

Answer:

Developing a new product/market exposes a firm to a combination of four kinds of risks. These risks are particularly acute where diversification is concerned because of the simultaneous novelty of both product and market.

i) Market risk: The firm has entered in a new market where established firms already operate. The risks involved are:
- Not correctly understanding the culture of the market or the needs of the consumer;
- High distribution costs due to lack of economies of scale;
- Failure to be seen as credible by the buyers in the market due to the lack of track record or brand;
- Exposure to retaliation by established firms with more entrenched position.

ii) Product risk: the firm is involving itself in a new production process, which is already being conducted by the rival firms. The risks this poses are:
- Higher production costs due to lack of experience;
- Initial quality problems or below quality products causing irreparable harm to the reputation in the market;
- Lack of established production infrastructure and supply-chain relations, which will make costs higher and may limit product innovation and quality.

iii) Operational and Managerial Risk: this boils down to the danger that management will not be able to run the new business properly. This carries with it with the second danger that management will also be distracted from running the original business effectively too.

iv) Financial risk: this relates to the share price of the business. Shareholders are generally suspicious of 'radical' (and particular diversification) for the following reasons:
- The product and market risks lead to volatile returns;
- The firm may need to write off substantial new net assets if the venture fails;
- The investment needed will reduce dividend and/or necessitate new borrowing;
- A diverse and unique portfolio makes it harder to compare the firm with others in the same industry when trying to evaluate its risks and returns. The effect will be for the share price to decline to reflect the uncertainties created by the strategy.

(c) List the different statutes governing Employer-Employee liability in India. [4]

Answer:

The following are some of the important statutes governing the Employer-Employee liability:

- Minimum wages Act;
- Payment of wages Act;
- Workmen's compensation Act;
- Provident Fund Act;
- Gratuity Act;
- Shops and Establishments Act;

- Industrial Disputes Act;
- Trade Union Act;
- Factories Act.

Question 8.

Write short notes on any three: **[5×3=15]**
(a) "Causa proxima"principle of insurance
(b) Solvency related measures in the context of risk management
(c) Risk adjusted performance measurement
(d) 'Knock-for-Knock' Agreement

Answer:

(a)"Causa Proxima" principle of insurance:

Causa Proxima is defined as "the active efficient case that sets in motion a chain of events which brings about a result, without the intervention if any force started and working actively from a new and independent source". Proximate cause means the most closely and directly connected of the perils insured against with loss. Thus the insurer is liable for loss, if the risk must be insured against is the proximate or the last cause of loss occurred. If there is one cause of loss identified, it is not required to go further into the cause of causes. If there is a series of causes of damage or loss is identified in such the nearest peril is the one insured against the principle of because proxima is applied. And also the insurer is bound to be responsible only if the closest cause comes within the meaning of the risk insured. Thus the closest peril is the one insured against risk, the loss of the subject matter would be compensated.

(b) Solvency related measures in the context of risk management:

These measures concentrate on the adverse 'trail' of the probability distribution and are relevant for economic capital requirements.

- Probability of ruin: the percentile of the probability distribution corresponding to the point, at which the capital is exhausted.
- Shortfall risk: the probability that a random variable falls below some specific threshold level (Probability of ruin is a special case of shortfall risk, in which the threshold level is the point at which capital is exhausted)
- Value at Risk (VAR): the maximum loss an organisation can suffer, under normal market conditions, over a given period of time at a given probability level. VAR is a common measure of risk in the banking sector, where it is typically calculated daily and used to monitor trading activity.
- Expected Policy holder Deficit (EPD) or Economic Cost of Ruin (ECOR) – It is an enhancement to the probability of ruin concept (and thus shortfall risk at VAR) in which the severity of the ruin is also affected. Technically, it is the expected value of shortfall.
- Tail Value at Risk (Tail VAR) or Tail Conditional Expectation (TCE) - an ECOR-like measure in the sense that both the probability and the cost of 'tail events' are considered.
- Tail events - unlikely but extreme events, usually from a skewed distribution. Rare outcomes, usually representing large monetary losses.

(c) Risk adjusted performance measurement:

The best practice recommendation on risk management was enunciated in the G30 report on derivatives. The recommendations have been considered very sound and are very much in use currently. These include:

(i) Establish independent risk managers for market and credit risk

(ii) Market to Market on a daily basis with consistent valuation measures

(iii) Measure and limit market and credit risk rating using value at risk (VaR) techniques to estimate probable loss over a period of time

(iv) Strengthen operational controls, systems and training

(v) Make investment and funding forecasts

(vi) Identify revenue sources and next conduct stress testing

The above recommendations ensure that adequate information could be available for the management to manage risk and avoid nasty surprises. RAPM framework brings together and measures the tradeoff between risks and rewards.

(d) 'Knock-for-Knock' Agreement:

The 'knock-for-knock agreement' is an agreement entered into among the insurance writing motor insurance. The agreement provides that in the event of damage caused by collision or attempt to avoid between two vehicles, the insurer of each vehicle will bear his own loss within the limits of his policy; irrespective of legal liability and will not enforce his subrogation rights, if any, against the other insurer. This agreement covers all vehicles which are not playing for hire or reward.

While an insurer will be able to pursue a recovery from the party responsible for an accident or from its policy-holder, there will be a costly administrative procedure. The knock-for-knock agreement simplifies recovery claims among insurers and, over time, attributes costs fairly among insurers.

However, these agreements between insurers have been criticised as unfair on the party not responsible for an accident. If, for the sake of administrative ease, an insurer pays out to repair damage done to its policy-holder's own car instead of pursuing the party responsible for the accident for all relevant costs, an effective claim is recorded against that policy-holder's insurance record. In this way, knock-for-knock agreements can result in policy-holders finding unexpectedly, when they come to renew their insurance, that there are higher premiums regardless of responsibility for an accident they were involved in.