

INTRODUCTION TO RISK FINANCING (56-1)

EO 1. **THE IMPORTANCE OF RISK FINANCING:** **Risk financing** provides funds to pay for, or to offset, a business's losses.

There are **two types of risk financing:**

1. **Transfer**--occurs when a business (**the transferor**) uses another organization's (**the transferee's**) resources to pay for, or to offset, its losses.

There are **two types of transfer:**

- a. **Insurance**--transfers the potential financial consequences of specified loss exposures to an insurer.
- b. **Noninsurance risk transfer**--transfers the potential financial consequences of specified loss exposures to a party *other than* an insurer.

A **hold-harmless agreement** applies to losses arising out of a specified relationship or activity.

Hedging uses one asset to offset the risk associated with another asset.

A **futures contract** is an agreement to buy or sell a commodity or security at a fixed future date at a fixed price.

2. **Retention**--occurs when a business uses its own funds to pay for its losses.

There are **six types of retention:**

- a1. **Planned retention**--is deliberate assumption of an identified and analyzed loss exposure.
- a2. **Unplanned retention**--is inadvertent assumption of an unidentified and unanalyzed loss exposure.
- b1. **Complete retention**--assumes the full cost of a retained loss.
- b2. **Partial retention**--assumes a portion of the cost of a retained loss.
- c1. **Funded retention**--arranges funding for losses before they occur.
- c2. **Unfunded retention**--arranges funding for losses after they occur.

There are **three ways to fund losses:**

- a. **Pre-loss funding**--sets aside money in advance of losses.
Advantage: The firm can save money over several budget periods.
Disadvantage: Funds earmarked for future losses are unavailable for other purposes.
- b. **Current-loss funding**--provides money to pay for losses at the time of loss or immediately afterward.
Advantage: Funds are not tied up before they are needed.
Disadvantage: There might not be enough money in the current budget for all cash flow needs.
- c. **Post-loss funding**--arranges to raise money to pay for losses after they have occurred, usually through some form of borrowing.
Advantages: The firm raises only as much cash as it needs, and it can pay for losses over several years.
Disadvantages: The firm must pay interest on the funds it borrows and must pay the fees on any pre-loss credit guarantees. Also, borrowing reduces the firm's credit-worthiness.

EO 2. **FIVE RISK FINANCING GOALS:**

1. **Pay for losses**--Have funds available as needed to pay for retained losses.
2. **Maintain liquidity**--Have funds ready to use when they are needed.
However the business funds its losses, it must maintain enough liquidity to pay for losses when payments are due.
High retentions require more liquidity than low retentions.
3. **Manage uncertainty**--Keep the uncertainty of loss outcomes within a tolerable level.
The maximum level of uncertainty a business can tolerate depends on its size, financial strength, management's degree of risk tolerance, *and* stockholders' degree of risk tolerance.

4. **Manage the total cost of risk**--Control the expenses associated with risk management.
 - Business (speculative) risk** is the risk of loss or gain due to economic variables (such as product demand and inflation).
 - Hazard risk** is the risk of loss due to property, liability, net income, *and/or* human resource loss exposures.
 - There are four categories of expenses that comprise the cost of risk:**
 - a. **Administrative expenses**--include internal administration costs and external services such as claims administration and risk management consulting. Incur only those administrative expenses necessary to run the risk financing program properly.
 - b. **Risk control expenses**--include expenses incurred to reduce loss frequency and/or severity. Run a cost-benefit analysis of risk control measures and use only those measures that, when combined, provide marginal benefits at least equal to their marginal costs. In other words, don't continue to add risk control techniques if they don't continue to reduce the combined cost of retained losses and insurance premiums. Moral and ethical issues influence the choice of risk control measures. Some loss control measures are used simply because they might save a single life or because they provide excessive protection against a dread disease.
 - c. **Retained losses**--Use risk control to reduce losses and then retain losses that would cost more to transfer than to retain. The retention of long-tail losses provides cash-flow benefits
 - d. **Transfer costs**--include insurance premiums and other transfer costs. Use risk control techniques and negotiation to reduce the compensation costs of transferring risks of loss.
5. **Comply with legal requirements**--Do *not* break the law. *Do* honor your contracts.

EO 3. **LOSS CHARACTERISTICS AND SELECTION OF RISK FINANCING TECHNIQUES:**

Frequency is the number of losses over a specified period. **Severity** describes loss size.

Frequency and severity are usually inversely related.

Low-frequency/low-severity losses are of little concern to most businesses. Retain those losses.

High-frequency/low-severity losses are the most predictable losses. Retain those losses.

Low-frequency/high-severity losses are the least predictable losses. Transfer those losses.

High-frequency/high-severity losses are of great concern to businesses because they are hard to transfer *and* they may easily lead to bankruptcy.

Use hybrid plans to control losses of medium frequency and severity.

EO 4. **ENTERPRISE RISK MANAGEMENT (ERM)** is the comprehensive approach to managing all of a business's risks and to maximizing shareholder value.

ERM recognizes four categories of risk:

1. **Strategic risk**--is the risk that a firm will not achieve its long-term goals.
2. **Operational risk**--is the risk of loss due to faulty technology or support system breakdowns.
3. **Financial risk**--is the risk that a business will not be able to meet its financial obligations.
4. **Hazard risk**--is the risk of loss due to property, liability, net income, *and/or* human resource loss exposures.

Strategic, operational, and financial risks are all types of business risk.

There are four ways ERM differs from traditional risk management:

1. ERM treats both business risk and hazard risk. Traditional RM treats only hazard risk.
2. ERM seeks to maximize a firm's economic potential. Traditional RM seeks to restore a firm to its pre-loss position.
3. ERM focuses on the value of the firm. Traditional RM focuses on the value of the loss.
4. ERM focuses on the whole firm and all four categories of risk. Traditional RM focuses on pure loss and the fourth category of risk, hazard risk.