

Risk Management Exam 2 Study Guide:

Topic 6: Risk Financing Options (Part II of Step 3 in RM Process)

- Sources of Funds:
 1. External Funds (someone else pays) → "Risk Transfer"
 2. Internal Funds (we pay) → "Risk Retention"
 - a. Either have to borrow money or issue debt (bonds, etc.)
 3. Alternative Risk Financing Strategies:
 - a. Lie outside insurance or similar contract (ex. Hedging with Derivatives)

- Risk Transfer of the Financing Type:
 - Firm seeks funds from unrelated 3rd parties to pay for losses
 - Still have that activity/asset exposed to loss, just transferring financial responsibility only.
 - Ex: INSURANCE → transfer the financial responsibility of a loss to the insurer. In exchange, insurer earns premium
 - Ex: Non-Insurance Risk Transfer:
 - Lease: with loss to property while tenant is occupying, both landlord and tenant may be financially responsible. The lease contract transfers risk to tenant
 - Hold Harmless Agreements: portion of a contract that states if a 3rd party sues both contract parties, only one party assumes financial responsibility

- Risk Retention
 - A firm or individual assumes financial responsibility for losses that occur
 - Ex: NOT buying insurance, being underinsured, having insurance with a deductible
 - 2 ways to classify:
 1. Active Risk Retention: knowingly retaining financial responsibility
 2. Passive Risk Retention: unaware about retaining financial responsibility
 - a. Results from failing to identify loss exposures
 - Retention is also classified as:
 1. Funded Retention: firm sets aside funds each time period to pay for losses
 - a. Used for high severity, low frequency situations
 - b. Used for predictable losses
 2. Unfunded Retention: when losses do occur, we pay for it out of current revenue or borrowed funds.
 - a. Used for low severity, low or high frequency

- Risk Retention = Self-Insurance
 - Self-Insurance is Active and Funded Retention
 - For firms with many loss exposures and potential large losses
 - Common self-insurance programs → Health insurance & Worker's Compensation
 - Self-Insured Retention (SIR)

- Characteristics Ideal for Self-Insurance
 1. Fairly predictable losses
 - Larger firms with many loss exposures
 - If large enough, it's better to self-insure than to pay a Risk Charge + Admin. Cost
 2. Long Payout Period
 - Ex: Firm self-insures worker's compensation; it pays out payments for a long time

- Advantages of Self-Insurance
 1. Potential Cost Savings (reduces the Cost of Risk)
 - a. Cost of Self-Insurance = "premium" = p^* + Admin costs
 - b. Cost of Market Insurance = Gross premium = p^* + Risk Charge + Admin costs
 2. Time Value of Money
 - a. Insurers get interest free loan (premium) and earn interest between premium payout (inflow) and claim payment (outflow)
 - b. With Self-Insurance, money could earn higher rate of return than the value of insurance
 3. Firm could retain the full benefits of loss control (reduction & prevention)
 - a. Ex: Worker's Compensation (safety training, rehab) decreases claims by \$100,000 but insurance company only decreases premium by \$50,000
 - b. With Self-Insurance, there's a "dollar for dollar" benefit
 - c. Moral hazard: Self Insurance < Market Insurance
 4. Flexibility in the design of insurance programs
 - a. Ex: Health insurance → Affordable Care Act (small income firms don't have to provide contraceptives)
 - b. Mandated benefits may be required of insurers but NOT for self-insurance

- Disadvantages of Self-Insurance
 1. Possibility of Catastrophic Loss
 - a. Ex: company self-insures health insurance benefits
 - b. Firm may buy "stop-loss" insurance
 - i. Specific/individual stop-loss = retain the first \$X of any ONE claim
 - ii. Aggregate stop-loss = retain the first \$X of all claims together
 2. Firm misses services available from insurer
 - a. Ex: Claims settlement, return to work programs, wellness programs, other stuff
 - b. Administrative Services Only (ASO) contract with insurer
 - c. Third Party Administrator (TPA) contract without insurer
 3. Potential for employee "public relations" problems
 - a. Employee isn't happy with benefits and causes public harm to the company

- Captives and Risk Retention Groups
 - Came about during the hard markets in the 1980s-1990s for liability and medical malpractice insurance
 - Take risk out of the market and retain instead
 - Captives → a wholly owned insurance subsidiary of a non-insurance firm
 - Primary purpose is to insure risk of parent firm
 - Parent provides capital to start the captive
 - Single Parent Captive: one company owns subsidiary and they pay the parent company
 - Association Captive: captive sponsored by association of firms
- Advantages of a Captive
 - Helps firms during hard market conditions
 - Location advantages (where it is domiciled)
 - Tax benefits (premiums paid to captives are tax deductible)
 - Regulatory requirements (capital)
 - Proximity
 - Best places for captives internationally: Luxembourg, Caymans & Bermuda
 - Domestically best places for captives: Delaware and Vermont
 - Able to access the reinsurance market (insurance for insurance companies / wholesale insurance)
 - Ex: buy \$10M policy for \$100K from AIG. AIG keeps the first \$2M and reinsures the next \$8M for \$50K.
 - Firm cannot go directly to Reinsurance Company. Instead, the firm creates a captive who can then go to a Reinsurance Company.
- Risk Retention Groups (RRGs)
 - Captive owned by multiple firms in the same industry
 - Engaged in collective risk sharing
 - ONLY for liability insurance as established by a 1986 law

Topic 7: Selecting from RM Options (Step 4 of RM Process)

- Loss Matrix → decision making tool to help figure out which RM option to use
 - Indicates the possible \$ values of expenditures, associated with combinations of:
 - RM alternatives
 - Future possible states of the world
 - Assume two possible states → Loss or No Loss