Meaning of Risk Management

- ***Risk Management*** is a "process that identifies loss exposures faced by an organization and selects the most appropriate techniques for treating such exposures."
- A loss exposure is any situation or circumstance in which a loss is possible, regardless of whether a loss occurs.
  - E.g., a plant that may be damaged by an earthquake, or an automobile that may be damaged in a collision
- New forms of risk management consider both pure and speculative loss exposures.

Objectives of Risk Management

- Risk management has objectives before and after a loss occurs
- **Pre-loss objectives**:
  - Prepare for potential losses in the most economical way.
  - Reduce anxiety.
  - Meet any legal obligations.

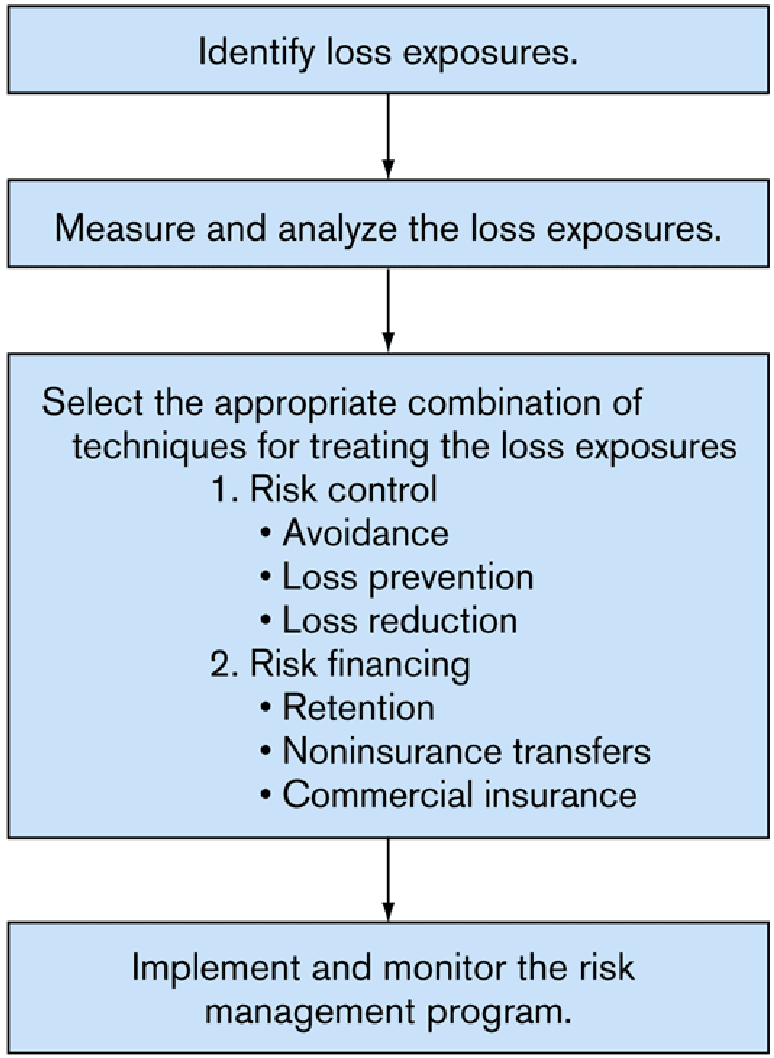
Objectives of Risk Management

- **Post-loss objectives**:
  - Ensure survival of the firm.
  - Continue operations.
  - Stabilize earnings.
  - Maintain growth.
  - Minimize the effects that a loss will have on other persons and on society.

Risk Management Process

1. **Identify potential losses.**
2. **Measure and analyze the loss exposures.**
3. **Select the appropriate combination of techniques for treating the loss exposures.**
4. **Implement and monitor the risk management program.**

Exhibit 3.1 : Steps in the Risk Management Process



1) Identifying Loss Exposures

- Property loss exposures
- Liability loss exposures
- Business income loss exposures
- Human resources loss exposures
- Crime loss exposures
- Employee benefit loss exposures
- Foreign loss exposures
- Intangible property loss exposures
- Failure to comply with government rules and regulations

1) Identifying Loss Exposures

- Risk Managers have several sources of information to identify loss exposures:
  - Questionnaires
  - Physical inspection
  - Flowcharts
  - Financial statements
  - Historical loss data
- Industry trends and market changes can create new loss exposures.
  - e.g., exposure to acts of terrorism

2) Measure and Analyze Loss Exposures

- Estimate the frequency and severity of loss for each type of loss exposure:
  - **Loss frequency** refers to the probable number of losses that may occur during some given time period
  - **Loss severity** refers to the probable size of the losses that may occur
- Once loss exposures are analyzed, they can be ranked according to their relative importance.
- ***Loss severity is more important than loss frequency***:
  - The maximum possible loss is the worst loss that could happen to the firm during its lifetime
  - The probable maximum loss is the worst loss that is *likely* to happen

3) Select the Appropriate Combination of Techniques for Treating the Loss Exposures

- Risk control refers to techniques that reduce the frequency and severity of losses
- Methods of risk control include:
  - Avoidance
  - Loss prevention
  - Loss reduction
- Avoidance means a certain loss exposure is never acquired, or an existing loss exposure is abandoned
  - The chance of loss is reduced to zero
  - It is not always possible, or practical, to avoid all losses

3) Select the Appropriate Combination of Techniques for Treating the Loss Exposures

- Loss prevention refers to measures that reduce the frequency of a particular loss
  - e.g., installing safety features on hazardous products
- Loss reduction refers to measures that reduce the severity of a loss after is occurs
  - e.g., installing an automatic sprinkler system

3) Select the Appropriate Risk Management Technique

- Risk financing refers to techniques that provide for the funding of losses
- Methods of risk financing include:
  - Retention
  - Non-insurance Transfers
  - Commercial Insurance

Risk Financing Methods: *Retention*

- ***Retention*** means that the firm retains part or all of the losses that can result from a given loss
  - Retention is effectively used when:
    - No other method of treatment is available
    - The worst possible loss is not serious
    - Losses are highly predictable
  - The retention level is the dollar amount of losses that the firm will retain
    - A financially strong firm can have a higher retention level than a financially weak firm
    - The maximum retention may be calculated as a percentage of the firm's net working capital

Risk Financing Methods: Retention

- A risk manager has several methods for paying retained losses:
  - Current net income: losses are treated as current expenses
  - Unfunded reserve: losses are deducted from a bookkeeping account
  - Funded reserve: losses are deducted from a liquid fund
  - Credit line: funds are borrowed to pay losses as they occur

Risk Financing Methods: Retention

- A captive insurer is an insurer owned by a parent firm for the purpose of insuring the parent firm's loss exposures
  - A single-parent captive is owned by only one parent
  - An association or group captive is an insurer owned by several parents
  - Many captives are located in the Caribbean because the regulatory environment is favorable

Risk Financing Methods: Retention

- Captives are formed for several reasons, including:
  - The parent firm may have difficulty obtaining insurance
  - To take advantage of a favorable regulatory environment
  - Costs may be lower than purchasing commercial insurance
  - A captive insurer has easier access to a reinsurer
  - A captive insurer can become a source of profit
- Premiums paid to a captive may be tax-deductible under certain conditions

Risk Financing Methods: Retention

- Self-insurance is a special form of planned retention
  - Part or all of a given loss exposure is retained by the firm
  - Another name for self-insurance is self-funding
  - Widely used for workers compensation and group health benefits
- A risk retention group is a group captive that can write any type of liability coverage except employer liability, workers compensation, and personal lines
  - Federal regulation allows employers, trade groups, governmental units, and other parties to form risk retention groups
  - They are exempt from many state insurance laws

Risk Financing Methods: ***Retention***

Advantages

- Save on loss costs
- Save on expenses
- Encourage loss prevention
- Increase cash flow

Disadvantages

-Possible higher losses

-Possible higher

expenses

-Possible higher taxes

Risk Financing Methods: *Non-insurance Transfers*

- A non-insurance transfer is a method other than insurance by which a pure risk and its potential financial consequences are transferred to another party
  - Examples include:
    - Contracts, leases, hold-harmless agreements

Risk Financing Methods: *Non-insurance Transfers*

Advantages

- Can transfer some losses that are not insurable
- Save money
- Can transfer loss to someone who is in a better position to control losses

Disadvantages

- Contract language may be ambiguous, so transfer may fail
- If the other party fails to pay, firm is still responsible for the loss
- Insurers may not give credit for transfers

Risk Financing Methods: *Insurance*

- Insurance is appropriate for loss exposures that have a low probability of loss but for which the severity of loss is high
  - The risk manager selects the coverages needed, and policy provisions:
    - A <u>deductible</u> is a provision by which a specified amount is subtracted from the loss payment otherwise payable to the insured
    - An <u>excess insurance policy</u> is one in which the insurer does not participate in the loss until the actual loss exceeds the amount a firm has decided to retain
  - The risk manager selects the insurer, or insurers, to provide the coverages

Risk Financing Methods: *Insurance*

- The risk manager negotiates the terms of the insurance contract
  - A manuscript policy is a policy specially tailored for the firm
    - Language in the policy must be clear to both parties
  - The parties must agree on the contract provisions, endorsements, forms, and premiums
- The risk manager must periodically review the insurance program

Risk Financing Methods: *Insurance*

Advantages

- Firm is indemnified for losses
- Uncertainty is reduced
- Insurers may provide other risk management services
- Premiums are tax-deductible

Disadvantages

- Premiums may be costly
  - Opportunity cost should be considered
- Negotiation of contracts takes time and effort
- The risk manager may become lax in exercising loss control

Exhibit 3.2: Risk Management Matrix

Type of Loss	Loss Frequency	Loss Severity	Appropriate Risk Management Technique
1	Low	Low	Retention
2	High	Low	Loss prevention and retention
3	Low	High	Insurance
4	High	High	Avoidance

Market Conditions and the Selection of Risk Management Techniques

- Risk managers may have to modify their choice of techniques depending on market conditions in the insurance markets
- The insurance market experiences an underwriting cycle
  - In a "hard" market, when profitability is declining, underwriting standards are tightened, premiums increase, and insurance becomes more difficult to obtain
  - In a "soft" market, when profitability is improving, standards are loosened, premiums decline, and insurance become easier to obtain

4) Implement and Monitor the Risk Management Program

- Implementation of a risk management program begins with a risk management policy statement that:
  - Outlines the firm's risk management objectives
  - Outlines the firm's policy on loss control
  - Educates top-level executives in regard to the risk management process
  - Gives the risk manager greater authority
  - Provides standards for judging the risk manager's performance
- A risk management manual may be used to:
  - Describe the risk management program
  - Train new employees

4) Implement and Monitor the Risk Management Program

- A successful risk management program requires active cooperation from other departments in the firm
- The risk management program should be periodically reviewed and evaluated to determine whether the objectives are being attained
  - The risk manager should compare the costs and benefits of all risk management activities

Benefits of Risk Management

- Pre-loss and post-loss objectives are attainable
- A risk management program can reduce a firm's <u>cost of risk</u>
  - The cost of risk includes premiums paid, retained losses, outside risk management services, financial guarantees, internal administrative costs, taxes, fees, and other expenses
- Reduction in pure loss exposures allows a firm to enact an enterprise risk management program to treat both pure and speculative loss exposures
- Society benefits because both direct and indirect losses are reduced

Personal Risk Management

- ***Personal risk management*** refers to "the identification of pure risks faced by an individual or family, and to the selection of the most appropriate technique for treating such risks."

- The same principles applied to corporate risk management apply to personal risk management