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. Identify loss exposures.
2. Measure and analyze the loss exposures.
3. Select the appropriate combination of techniques for treating the loss exposures:
   1. Risk control
      - Avoidance
      - Loss prevention
      - Loss reduction
   2. Risk financing
      - Retention
      - Noninsurance transfers
      - Commercial insurance
4. Implement and monitor the risk management program.
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 it 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
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 deductible is a provision by which a specified amount is subtracted from the loss payment otherwise payable to the insured
  • An excess insurance policy 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

<table>
<thead>
<tr>
<th>Type of Loss</th>
<th>Loss Frequency</th>
<th>Loss Severity</th>
<th>Appropriate Risk Management Technique</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Low</td>
<td>Low</td>
<td>Retention</td>
</tr>
<tr>
<td>2</td>
<td>High</td>
<td>Low</td>
<td>Loss prevention and retention</td>
</tr>
<tr>
<td>3</td>
<td>Low</td>
<td>High</td>
<td>Insurance</td>
</tr>
<tr>
<td>4</td>
<td>High</td>
<td>High</td>
<td>Avoidance</td>
</tr>
</tbody>
</table>
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 becomes 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 cost of risk
  • 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