Introduction to Risk Financing

Activity 1— Describing Risk Financing Techniques

Questions	Answers
1. The uncertainty about outcomes, some of which can be negative.	
2. This risk financing technique is often used by organizations that risk losing money when converting from one currency to a different currency.	
3. This type of risk from accidental loss, including the possibility of loss or no loss, is often financed using insurance.	
4. This risk financing technique transfers the potential financial consequences of certain specified loss exposures from the insured to the insurer.	
5. This risk transfer mechanism features a contractual provision that obligates one of the parties to assume the legal liability of another party.	
6. This risk financing activity entails acceptance of the potential benefit of gain, as well as the burden of loss, that arises from a particular risk.	
7. This category of risk is usually financed through hedging instruments such as futures, forwards, options and swaps when insurance products are typically not available.	
8. A deliberate assumption of a risk (and its consequences) that has been identified and analyzed	
9. A bakery may use this contract to hedge its exposure to fluctuations in the prices of wheat by agreeing to buy the wheat in the future at a price agreed	

upon today.	
10. This type of retention is the assumption of a portion of the cost of a loss by the organization and transfer of the remaining portion.	
11. Insurance policies represent a mix of two risk financing techniques for losses: retention of the amount below the deductible and this kind of risk financing technique of the insured portion of loss above the deductible.	
12. Because it can be the most economic risk financing technique, this type of risk financing is sometimes preferred even when insurance or contractual (noninsurance) risk transfer is available.	
13. The International Organization for Standardization (ISO) defines this as a form of risk treatment involving contingent arrangements for the provision of funds to meet or modify the financial consequences should they occur.	
14. This type of retention includes a pre-event arrangement that ensures that funding is available to pay for the consequences of an event after it occurs.	
15. This is the inadvertent assumption of a risk (and any consequences) that has not been identified or accurately analyzed.	

Answers for Activity 1— Describing Risk Financing Techniques

Questions	Answers
1. The uncertainty about outcomes, some of which can be negative.	What is risk?
2. This risk financing technique is often used by organizations that risk losing money when converting from one currency to a different currency.	What is hedging?
3. This type of risk from accidental loss, which includes both the possibility of loss or of no loss, is often financed using insurance.	What is hazard risk?
4. This risk financing technique transfers the potential financial consequences of certain specified loss exposures from the insured to the insurer.	What is insurance?
5. This risk transfer mechanism features a contractual provision that obligates one of the parties to assume the legal liability of another party.	What is a hold-harmless agreement?
6. This risk financing activity entails acceptance of the potential benefit of gain, as well as the burden of loss, that arises from a particular risk.	What is retention?
7. This category of risk is usually financed through hedging instruments such as futures, forwards, options and swaps when insurance products are typically not available.	What is financial risk?
8. A deliberate assumption of a risk (and its consequences) that has been identified and analyzed.	What is a planned retention?
9. A bakery may use this contract to hedge its exposure to fluctuations in the prices of wheat by agreeing to buy the wheat in the future at a price agreed upon today.	What is a futures contract?

10. This type of retention is the assumption of a portion of the cost of a loss by the organization and transfer of the remaining portion.	What is a partial retention?
11. Insurance policies represent a mix of two risk financing techniques for losses: retention of the amount below the deductible and this kind of risk financing technique of the insured portion of loss above the deductible.	What is risk transfer?
12. Because it can be the most economic risk financing technique, this type of risk financing is sometimes preferred even when insurance or contractual (noninsurance) risk transfer is available.	What is retention?
13. The International Organization for Standardization (ISO) defines this as a form of risk treatment involving contingent arrangements for the provision of funds to meet or modify the financial consequences should they occur.	What is risk financing?
14. This type of retention includes a pre-event arrangement that ensures that funding is available to pay for the consequences of an event after it occurs.	What is a planned retention?
15. This is the inadvertent assumption of a risk (and any consequences) that has not been identified or accurately analyzed	What is an unplanned retention?

Risk Financing Goals

Activity 1—Describing Common Risk Financing Goals – True or False

Questions	Answers
1. Risk financing is usually related to offsetting the negative financial consequences of a sudden event, such as a flood or an earthquake.	
2. Although publicly traded organizations are expected to pursue risk financing goals to maximize their market value, privately held and not-for-profit organizations should avoid risk financing goals.	
3. The ability to quickly pay for damages that arise from the consequences of an event is important from a public relations perspective.	
4. Real estate is a good example of a liquid asset.	
5. An organization with good credit and a high borrowing capacity would be considered to have relatively greater liquidity.	
6. The higher an organization's retention, the lower its need for liquidity.	
7. In theory, investors value a publicly traded organization by projecting the size of its future cash flow, which is then discounted to adjust the expected cash flows to the present.	
8. The greater the level of uncertainty in a firm's cash flows, the lower the discount rate that would be used to discount future cash flows to present value.	

9. The higher the discount rate used to discount future cash flows to the present, the lower the present value of those cash flows and thus the lower the value of the firm.	
10. Sarbanes-Oxley includes requirements that senior executives take personal responsibility for the accuracy and completeness of corporate financial reports by preparing them personally.	
11. Sarbanes-Oxley is an international requirement for firms all over the world.	
12. The combined code on corporate governance issued by the London Stock Exchange (LSE) is the Sarbanes-Oxley equivalent in the United Kingdom.	
13. Compliance with the provisions of the combined code, like compliance with the provisions of Sarbanes-Oxley, is required by statute.	
14. The primary measure used by many organizations to gauge the effectiveness of their insurance risk management program is the cost of risk measure.	
15. Risk financing is usually related to offsetting the negative financial consequences of a sudden event, such as a flood or an earthquake.	
16. An organization usually seeks to maximize its cost of risk in order to boost its net income.	
17. When calculating the cost of risk for a loss that has been transferred by insurance, retentions such as deductibles or coinsurance should be excluded in the cost of risk.	

18. Cost of risk serves, at least in part, as a personal performance measure for many risk management professionals.	
19. Retaining some types of losses that have significant delays in claim reporting and settlement offers an additional benefit because the firm can earn offsetting investment income.	
20. Deferring loss payments over time increases the organization's cost of risk.	
21. The best way for an organization to analyze its loss control expenditures is to ask its employees.	
22. In the context of measuring the cost of hazard risk, transfer costs include the cost of insurance premiums.	

Answers for Activity 1—Describing Common Risk Financing Goals

Questions	Answers
1. Risk financing is usually related to offsetting the negative financial consequences of a sudden event, such as a flood or an earthquake.	True.
2. Although publicly traded organizations are expected to pursue risk financing goals to maximize their market value, privately held and not-for-profit organizations should avoid risk financing goals.	False. Although they may have other overarching organizational goals, these firms will also benefit from pursuing risk financing goals.
3. The ability to quickly pay for damages that arise from the consequences of an event is important from a public relations perspective.	True.
4. Real estate is a good example of a liquid asset.	False. Liquid assets are those that can easily be converted into cash at its fair market value, and real estate does not meet that definition because it takes time to transfer title and the sales price is uncertain.
5. An organization with good credit and a high borrowing capacity would be considered to have relatively greater liquidity	True.
6. The higher an organization's retention, the lower its need for liquidity.	False. The opposite is true -- the higher the retention, the greater the need for liquidity.
7. In theory, investors value a publicly traded organization by projecting the size of its future cash flow, which is then discounted to adjust the expected cash flows to the present.	True.
8. The greater the level of uncertainty in a firm's cash flows, the lower the discount rate that would be used to discount future cash flows to present value.	False. The discount rate is a measure of risk, and the greater the uncertainty in the cash flows, the greater the risk and hence the higher the discount rate that should be used.

9. The higher the discount rate used to discount future cash flows to the present, the lower the present value of those cash flows and thus the lower the value of the firm.	True.
10. Sarbanes-Oxley includes requirements that senior executives take personal responsibility for the accuracy and completeness of corporate financial reports by preparing them personally.	False. They are required to certify and approve the integrity of their financial reports, but not to prepare them.
11. Sarbanes-Oxley is an international requirement for firms all over the world.	False: it has been recommended as a benchmark, but individual countries determine their own rules.
12. The combined code on corporate governance issued by the London Stock Exchange (LSE) is the Sarbanes-Oxley equivalent in the United Kingdom.	True.
13. Compliance with the provisions of the combined code, like compliance with the provisions of Sarbanes-Oxley, is required by statute.	False. Sarbanes-Oxley is mandatory, but the combined code is voluntary.
14. The primary measure used by many organizations to gauge the effectiveness of their insurance risk management program is the cost of risk measure.	True.
15. Risk financing is usually related to offsetting the negative financial consequences of a sudden event, such as a flood or an earthquake.	True.
16. An organization usually seeks to maximize its cost of risk in order to boost its net income.	False. Organizations should seek to minimize, not maximize, the cost of risk to boost net income.
17. When calculating the cost of risk for a loss that has been transferred by insurance, retentions such as deductibles or coinsurance should be excluded in the cost of risk.	False. Retentions are included in the calculated cost of risk, along with the premiums paid for the insurance.

18. Cost of risk serves, at least in part, as a personal performance measure for many risk management professionals.	True.
19. Retaining some types of losses that have significant delays in claim reporting and settlement offers an additional benefit because the firm can earn offsetting investment income.	True.
20. Deferring loss payments over time increases the organization's cost of risk.	False. Deferring loss payments reduces the cost of risk because of offsetting investment income.
21. The best way for an organization to analyze its loss control expenditures is to ask its employees.	False. The best way to analyze loss control expenditures is to conduct a cost benefit analysis.
22. In the context of measuring the cost of hazard risk, transfer costs include the cost of insurance premiums.	True.

Selecting a Risk Financing Plan

Educational Objective (EO)

Explain how to evaluate a risk in order to select a risk financing plan.

Instructions

Activity 1—Evaluating a Risk to Select a Risk Financing Plan

The four categories of loss frequency are:

- Almost nil: extremely unlikely to happen; virtually no possibility
- Slight: could happen, but not likely to happen
- Moderate: happens occasionally
- Definite: happens regularly

The three categories of loss severity are:

- Slight: Organization can readily retain each loss
- Significant: Organization cannot retain the entire loss, some part of which must be transferred
- Severe: Organization must transfer virtually all of the loss or endanger its survival

Debrief:
Review the Prouty classification system and the appropriate method for handling each of the frequency/severity combinations. Groups may have legitimate differences of opinion on the appropriate frequency or severity classification on some of these risks.

While avoiding, reducing or preventing some of these losses may be appropriate risk management approaches, the focus here is on risk financing: either retention or transfer. Risk transfer is the appropriate answer for those risks that have higher severity while retention is the appropriate answer for those risks that have lower severity or virtually no chance of occurring.

Case Study—Argot Foods

Argot Foods operates five restaurants in the coastal area of South Carolina. The restaurants specialize in local seafood and organically grown fruits and vegetables purchased from local farmers.

Argot has eight employees at its business office in Beaufort, and each restaurant employs about 30 individuals, mostly in food preparation and service.

Argot earned a net profit of $120,000 last year on total revenues of $2,400,000.

The president of Argot Foods compiled this list of risks that the company could conceivably be required to finance over the next twelve months:

1. Contamination of local waters could reduce the availability of seafood. This has occurred twice in the last five years, and both times the disruption lasted for six weeks.
2. A major hurricane in the Beaufort area could close at least two of the restaurants for three to six months. The last major hurricane occurred twenty-five years ago, but there have been two minor hurricanes in the area since that time.
3. A restaurant fire would close that location for two to six weeks.
4. The restaurant business is highly competitive and the public could lose interest in Argot Foods, causing revenues to drop.
5. Employees injured on the job lead to lost productivity and workers compensation claims expenses.
6. A Patron injured on premises or sickened from eating poorly prepared food could sue the company.
7. Spoilage and shrinkage consumes about 10 percent of the produce before it can be sold.
8. There is high turnover in the line employees (servers and cooks) which causes higher recruiting and training expenses. Currently, there is an ample supply of workers in the Beaufort area.
9. Employee theft from the cash registers and/or pilferage from the inventory can reduce the company profitability.
10. Argot has a $2,000,000 bank loan that it must refinance four months from now. Interest rates might increase and result in materially higher loan payments.
11. Argot operates three delivery trucks that pickup and deliver produce and seafood to each of the restaurants on a daily basis. Each delivery truck averages 2,000 miles per week.
12. Seafood and produce costs are highly seasonal and fluctuate with supply and demand, causing profits to gyrate from month to month.