ARM – 56
Risk Financing

Presented by:
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Sponsors

- I would like to thank the following organizations for sponsoring the course, which allows their employees/members to have the registration fee waived:
  - University of California, ERM University
  - Golden Gate RIMS
  - Alliant
  - Bickmore
  - HIRMA

Introductions

- Instructor: Erike Young
- Participants
  - 160 participants
    - Higher Education
    - Hospitals
    - State/local government – Risk Pools
    - Insurance
    - Consulting
    - Manufacturing
    - Real estate
- Locations
  - Majority from California/west coast
  - Alaska to Maine

Course Schedule

10/24	Introduction and Chapter 1
11/7	Chapter 2
11/14	Chapter 3
11/21	Chapter 4-5
12/5	Chapter 6
12/12	Chapter 7
12/19	Chapter 8
1/2	Chapter 9-10
1/9	Chapter 11
1/16	Course Review

Recordings

- For those who cannot attend the live presentations, each webinar will be recorded and typically posted for viewing within 24 hours. I know that due to the different time zones, these recordings are important will get them posted as soon as possible. In some cases, it could be within several hours. The recordings will be made available on a secured YouTube channel, and upon request, available for download. Please note that if downloading, the recordings are approximately 60 mbs each.

- Each participant will use their email to login at www.armstudygroup.com to access the material.

Structured Review

How to make the most of this review:

- Take notes in course guide, but don't waste effort copying slides. (Slides are be available for download)
- Questions are important. Yet time is limited to cover all of the material.
- Goal is to cover all chapters in 10 weeks – average of 1 chapter per meeting
- The primary purpose is to pass national exam.

Studying the Material

SUGGESTION: Read the Educational Objectives in the course guide BEFORE reading the text.

- Educational Objectives
- Terms and Phrases
- Text Exhibits
- Chapter Summary
- Optional
  - – Course Guide Review Questions
  - – Course Guide Application Questions

Studying the Material

SUGGESTION: Divide material in the text and course guide into units for EVERY Educational Objectives.

- Have an answer for ALL Educational Objectives
- Review all exhibits
- Use same terms and phrases
  - – (EX: The text has 4 Pre-Loss Goals and 6 Post-Loss Goals; then so do you!)
  - – This course requires memorizing content, not creating NEW examples.
  - – Use acronyms to keep the lists separate.
- Test questions frequently interchange information..

Scheduling the Exam

75 Multiple Choice Questions – 2 Hours
71% pass ratio

	Institutes Approved On-Site Testing Centers Register through Mar 15, 2014	Prometric Test Center Early Registration Register on or before Jan 15, 2014	Prometric Test Center Standard Registration Register after Jan 15, 2014
Exam Fee:	$165 Register now	$190 Register now	$255 Register now
Registrations accepted through:	Mar 15, 2014	Jan 15, 2014	Mar 12, 2014
Cancellation deadline:	Mar 15, 2014	You must cancel 3 or more business days prior to your scheduled Prometric appointment	You must cancel 3 or more business days prior to your scheduled Prometric appointment
Cancellation Forfeiture*:	$130	$170 **	$170 **
Cost to Transfer:	$80	$105	$105

* If you cancel your registration before the deadline, you may receive a credit up to: the amount you paid less the forfeiture amount. If the exam fee paid was less than the cancellation forfeiture, the entire exam fee is forfeited.

** Prometric registrations must be canceled at least 3 business days before your Prometric appointment date. Changes made to Prometric appointments are subject to a rescheduling fee.

Chapter 1

Introduction to Risk Financing

Introduction to Risk Financing

Educational Objectives

After learning the content of this assignment, you should be able to:

- Describe risk financing and its importance to organizations.
- Describe common risk financing goals for organizations.
- Explain how to evaluate a risk in order to select a risk financing plan.
- Explain how enterprise risk management (ERM) takes a holistic approach to managing risk.

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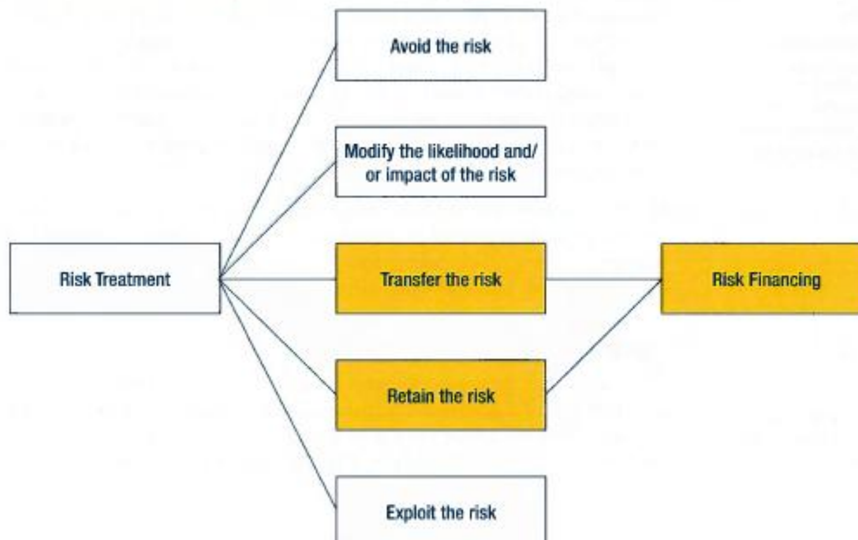
Risk Treatment Techniques and Risk Financing



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Risk Financing

- Risk Financing
  - A conscious act or decision to act that *generates funds* to pay for losses or offset the variability in cash flows.
  - Primarily applied to Hazard and Financial Risk
    - Hazard Risks arise from accidental loss (loss or no loss), techniques include
      - Insurance, insurance-linked contracts, internal funds, and contracts
    - Financial Risks are speculative (chance of loss, no loss, or gain)
      - Hedging techniques – Futures, forwards, swaps and options

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Risk Financing

- Two Risk Financing Techniques
  - Transfer – includes insurance and non-insurance techniques that shift financial consequences of loss to another party.
  - Retention – absorbing loss by generating funds within organization to pay for loss.
- Hazard risks usually require both retention and transfer
  - Example: Insurance with a deductable or self-insured retention (SIR)

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Risk Transfer

- Insurance
  - Technique that transfers the potential financial consequences of specified loss exposures from the insured to the insurer
    - Insurance is a funded risk transfer
    - May include services such as claim handling and defense costs

- Contract (Non-Insurance Risk Transfer)
  - Done through contracts
  - Hold Harmless or indemnity agreements

- Hedging
  - Hedging is a financial transaction in which one asset is held to offset the risk associated with another asset.
  - Futures Contract - an exchange-traded agreement to buy or sell a commodity or security at a future date at a price that is fixed at the time of the agreement.

Risk Retention

- Retention is usually the most economical risk financing technique available.

- Mainly used for predictable, frequent, low severity exposures
  - Auto, workers' compensation, etc…

- Sometimes retention is used because exposure cannot be insured or otherwise transferred, or too costly

Risk Retention

- Planned retention or Unplanned
  - Planned – Deliberate decision to assume a loss exposure and financial consequences
  - Unplanned – Inadvertent assumption of a loss exposure because it was not identified or accurately analyzed.
- Complete or Partial Retention
  - Assume full cost of loss or partial cost (deductable)
- Funded or Unfunded
  - Funded retention is similar to escrow account
  - Unfunded is a pay as you go system

Retention Funding

- Funded (Pre-loss funding)
  - Money is set aside in advance (escrow account)
  - Disadvantage is money is tied up and has opportunity cost
- Unfunded (Current-loss funding)
  - Money to fund loss is provided at time of loss (pay as you go) or immediately after loss
  - Most commonly used because of low cost, but there may not be enough money in budget to pay for losses
- Unfunded (Post-loss funding)
  - Pays for losses after event using borrowing or other method to raise capital.

Risk Financing Goals

- Main financial goal of an organization is to:
  - Maximize their market value by maximizing present value of expected future cash flow*
- Managing the cost of risk involves minimizing the cost per unit of risk transferred and retaining risk when a sufficient return would result.
- Return from retaining risk can be measured in terms of the savings in risk transfer costs

Risk Financing Goals

To achieve the financial goal of maximizing market value, most publicly traded organizations should pursue risk financing goals. (Although their overall goals may differ, privately held and not-for-profit organizations should also do this.) Common risk financing goals include these:

- Pay for negative financial consequences of an event
- Maintain liquidity
- Manage uncertainty
- Comply with legal and regulatory requirements
- Minimize the "cost of risk"

Text 1.7-1.9

Minimizing the Cost of Risk (TCOR)

- Administrative Expenses
  - Claims administration, risk management consulting, insurance premium taxes
- Loss Control Expenses
  - Resources utilized to minimize losses such as safety staff and equipment
- Retained Losses
  - Different types of claims can have long-tails, meaning
- Transfer Costs
  - Insurance premiums

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Selecting a Risk Financing Plan

- Frequency and Severity Characteristics of Hazard Losses
  - Most large organizations experience a predictable amount of small losses
    - Most appropriate for retention
  - Catastrophic losses are low frequency, but high severity, unpredictable
    - Most appropriate for transfer

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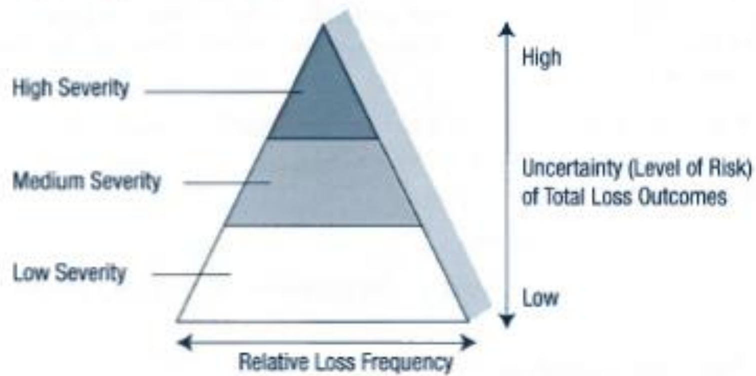
Selecting a Risk Financing Plan



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Selecting a Risk Financing Plan

The Prouty Approach

		Loss Frequency			
		Almost Nil	Slight	Moderate	Definite
Loss Severity	Severe	Transfer	Reduce or prevent	Reduce or prevent	Avoid
	Significant	Retain	Transfer	Reduce or prevent	Avoid
	Slight	Retain	Retain	Prevent	Prevent

Page 1.14 and 1.15

Categories of Hazard Risk Financing Plans

Categories of Risk Financing Plans

Retention Plans	Transfer Plans	Hybrid Plans
• Informal retention • Self-insurance	• Guaranteed-cost insurance • Insurance derivatives and insurance securitizations	• Large deductible insurance • Retrospective rating • Captive insurance • Pooling

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Financial Risk

Speculative Risk – chance of loss or gain (used to be uninsurable, now certain types can insured)

- Commodity Price Risk – crude oil prices
- Financial/Market Risk (possibility of loss or gain through the value of financial instruments, such as foreign exchange rates, securities)
- Interest Rate Risk – chance of rise or fall of interest rates which raises or lowers the organization's cost of borrowing

Financial Risk

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Managing Risk Holistically

Enterprise risk management
An approach to managing all of an organization's key business risks and opportunities with the intent of maximizing shareholder value.

Many organizations now use a holistic approach to risk management called enterprise risk management.

Enterprise risk management (ERM) is an approach to managing all of an organization's key business risks and opportunities with the intent of maximizing shareholder value.

Categories of Risk

To realize the goal of maximizing shareholder value, ERM classifies risk into four categories:

- Strategic risks are those uncertainties associated with the organization's overall long-term goals and management.
- Operational risks are those uncertainties associated with the organization's operations.
- Financial risks are those uncertainties associated with the organization's financial activities.
- Hazard risks are those uncertainties associated with the organization's reduction in value resulting from the effects of accidental losses.

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Enterprise Risk Management (ERM)

ERM differs from traditional risk management in key ways:

- ERM encompasses both hazard risk and business risk; traditional risk management focuses on hazard risk.
- ERM seeks to enable an organization to fulfill its greatest productive potential; traditional risk management seeks to restore an organization to its former pre-loss condition.
- ERM focuses on the value of the organization; traditional risk management focuses on the value of the accidental loss.
- ERM focuses on the organization as a whole; therefore, traditional risk management is both its own discipline and part of the broader enterprise risk management discipline.

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Enterprise Risk Management (ERM)

Possible Outcomes From Two Sources of Risk

		Hazard Risk (Pure Risk)	
		No Loss (good)	Loss (bad)
Interest Rate Risk (Speculative Risk)	Gain (good)	1 good-good	2 good-bad
	Loss (bad)	3 bad-good	4 bad-bad

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Enterprise Risk Management (ERM)

- Introduction
- Possible Reduction Actions
- Potential Benefits
- Environment & Life Safety
- Financial Risk
- Mission Impairment
- Stakeholders
- Reputational Risk
- Separation of Duties
- Implementation

Considering Risk in Budget Reductions in

9 Easy Steps

Created by the UC Davis Enterprise Risk Work Group

in collaboration with

UC Berkeley Internal Audit Services,

UC Risk Services, and Bickmore Risk Services

User Information

Location:

Department:

Person(s) completing this workbook:

Date completed:

This workbook will help you consider the risks involved and decide among your options for reducing your budget. It will **not** make decisions for you, but it will help you compare the benefits and risks of each option so you can make informed decisions.

The 9 Easy Steps are:

- List each action and its impact in reducing expenses or increasing revenues.
- Estimate the positive effects that may result from each action.
- Estimate the severity of each action's impact on the environment and life safety.
- Estimate the financial severity of losses or added costs associated with each action.
- Estimate the impact of each action on your ability to fulfill your mission.
- Estimate the potential adverse impact of each action on your employees, students, and customers.
- Estimate the potential adverse impact of each action on the reputation and image of your department or college.
- Determine if the action may compromise Separation of Duties. This step provides a framework for best assigning responsibilities among the staff remaining after budget reductions.
- Review your scores and note which of the possible reduction actions will be implemented.

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