Risk Financing through Risk Retention has come to be recognized as an effective tool for managing risks. Retention is resorted to when no other risk management treatment is available. Read on to explore the concept with special reference to Self Insurance and know the opportunities for CAs in Risk Management.

Risk Financing Through Risk Retention

Punita Ahuja

A large service sector company engaged in providing services of warehousing and related activities was spending huge amount of money as insurance premium for the stocks stored in its godowns at various locations throughout the country. The stocks stored in various warehouses are normally insured/indemnified against risk of fire, floods, theft and burglary. The payment of insurance premium was huge, resulting in higher rate to be charged from its depositors. But then the growing competition in market forced the company to think about controlling its expenditure. And this led the company to the idea of RISK RETENTION namely self-insurance. The company, under the advice of Risk Management consultants, launched a self-insurance scheme on selective basis in such a way that ensured savings in insurance premium payment. Besides, the company invested its funds by creating a fund with an amount calculated on the basis of premium amount of stock kept in the godown and previous experience of claim in selected areas where company had opted to go for self insurance. This helped the company to improve its financial base to a great extent. All this is done in number of years through what is termed as Risk Retention, one of the steps in risk management process.

Causes of Risks

At a broad level there are three causes of risks:

1. Opportunity- Exploring the upside

2. Uncertain outcomes - Not meeting expectations

3. Hazard - Risk of bad thing happening

Business must take risks, but what risk management attempts to establish is how much risk should be taken so as to protect the organization and ensure its continuance.

Risk management is the process of identifying, analyzing and evaluating the risks and selecting the best possible methods for handling them.

Risk identification

The most important element of and the first step in the risk management process is the identification of risks & exposure to loss. This involves a systematic and careful analysis of all major and minor potential loss

The author is a Member of the Institute. She can be reached at pahuja3@rediffmail.com

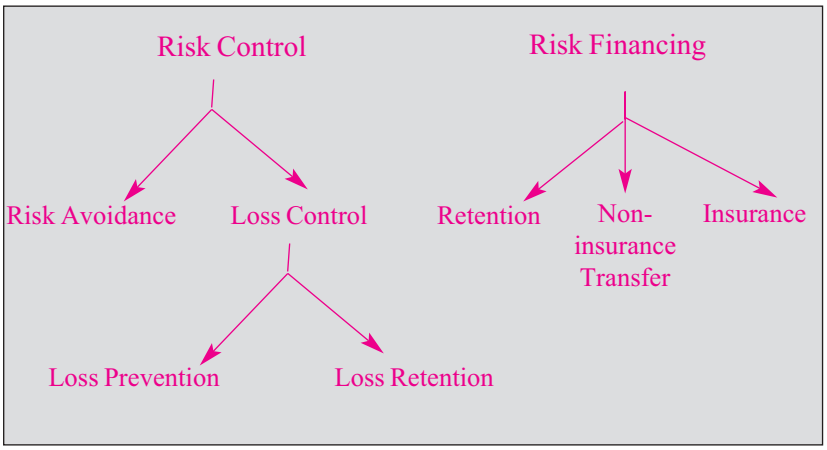
exposures. It includes that the organization must identify the potential risks confronting it. It may be personal risks, property risks, liability risks, etc.

Risk analysis

Once the risks are identified, they should be analysed and evaluated. Evaluation process includes estimating the frequency of occurrence and severity of loss. Frequency of loss relates to the probable number of particular losses that may occur during some given period of time. Severity of loss refers to probable magnitude of losses that may occur on the occurrence of losses. This will enable ranking of various loss exposures according to their relative importance.

Selecting appropriate technique

It depends upon frequency and severity of loss where frequency and severity of loss is low the method of retention is best. The techniques are broadly classified under two categories: -

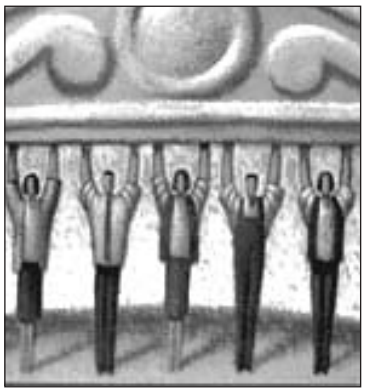


Later, the selected technique is implemented in this stage. This step will be helpful in modifying the programme if found necessary in the light of record of experience.

Why Risk Retention

This leads to the concept of risk financing. Risk financing relates to employment of techniques providing for funding of losses subsequent to their occurrence. Risk retention is one of the techniques of risk financing.

Risk Retention refers to financing of losses internally– either fully retained or partially retained. Losses that occur when prior planning for their financing has been done are also retained. Retention is resorted to when no other risk management treatment is available or is very expensive. Further non-insurance transfer may be unavailable. Thus retention can be effectively used when the potential losses are highly predictable. It is also said that "the more risk averse the less the retention". Self-insurance is very popular way of risk retention. It is very useful especially in the first few years of implementation of the risk retention concept. Risk financing provides the means for reimbursing the losses and for funding to reduce the uncertainty of losses. Creating a separate fund enables to prevent dependency of the organization's other funds being used for funding loses. Such risk financing will be very effective with implementation of risk control measures to have minimal losses. The fund keeps building up over years.



Risk Retention refers to financing of losses internally– either fully retained or partially retained. Losses that occur when prior planning for their financing has been done are also retained.

How much Risk Retention

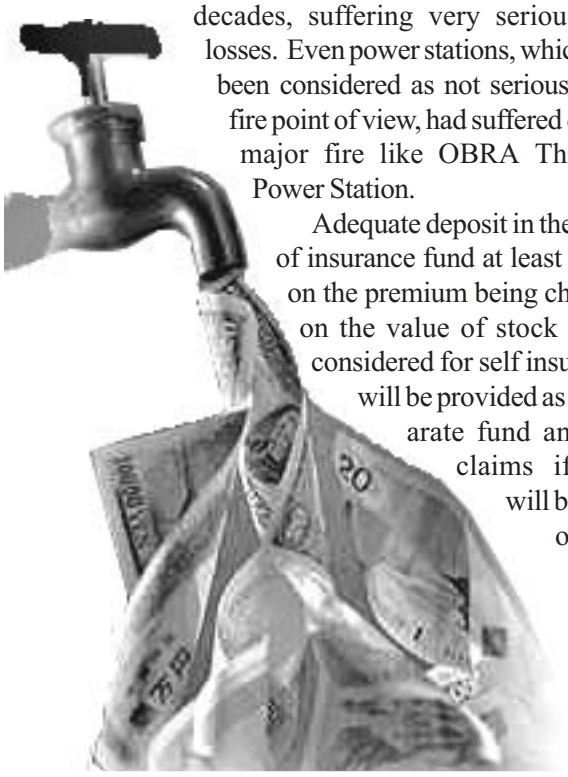
Risk retention to the account of an organization is known as self insurance as insurance relates to loss-bearing activities. If the loss is transferred to professional insurer then it comes under risk transfer. It may be appreciated that insurance is for protection and absence of claims allows an organization to carry on their activities without any interruption to their business. The premium is for the protection secured and the benefits of insurance not to be judged by comparing the premium and claims ratio. Insurance is for security and serious claims experience is not for the good health of the organization.

However, an organization builds up its own loss experience over years and through a study about the loss

proneness of their activities, it may analyse and take judicial judgments about the risks, which could be accepted by them. In the long run, an organization is likely to benefit from such a decision to retain an exposure to risk over which it has significant control. In the short run, if some accident occurs it might lead managers to question whether an efficient use of the organization's resources is being done. The risk manager can use his experience to estimate possible impact of an event to decide of the loss to the organization's account. Thus, while deciding on self insurance the organization needs to be guided by their claim experience and ensure that only those risks which are good and has good risk control measures are taken up under the self insurance. Hence it is necessary to identify carefully those areas with no loss experience.

The best or very good claims experience is expected to around 5% over a period of 10 years. Due to their return period, insurers need to build sufficient funds to payout major losses like what happened in Gujarat, Andhra Pradesh and Orissa. The return period is sometimes more than 25 years and when such perils operate they bring in huge losses to the insurers.

Further, to take only claim history as base is the right perspective for deciding on self insurance as there had been instances of risks, which were claim-free for decades, suffering very serious fire losses. Even power stations, which had been considered as not serious from fire point of view, had suffered due to major fire like OBRA Thermal Power Station.



Adequate deposit in the form of insurance fund at least based on the premium being charged on the value of stock being considered for self insurance will be provided as a separate fund and the claims if any will be paid out of this fund besides all the expenses related to the claim like survey fees, salvage disposal, legal fees if any etc.

Hence it is necessary to identify carefully those units that have no loss experience and are used for only non-hazardous items storage for consideration for self-insurance. All other units may be covered under the insurance policy.

Thus retention can be effectively used when the potential losses are highly predictable. It is also said that "the more risk averse the less the retention". Self-insurance is very popular way of risk retention.

Based on the encouraging results to be reviewed each year, this scheme can be enlarged and the premium being charged may be deposited in the reserve for dealing with the claims

Suitability of risk retention technique

Risk retention is best suited when frequency and severity of loss is low.

Risk Financing Decisions in case of individuals: Various factors are considered before making risk-financing decisions or choosing the category appropriate to them out of three available options— risk retention, risk reduction and risk transfer. The factors include:

A. Expected cost
B. Financial position
C. Degree of risk aversion
D. External constraints

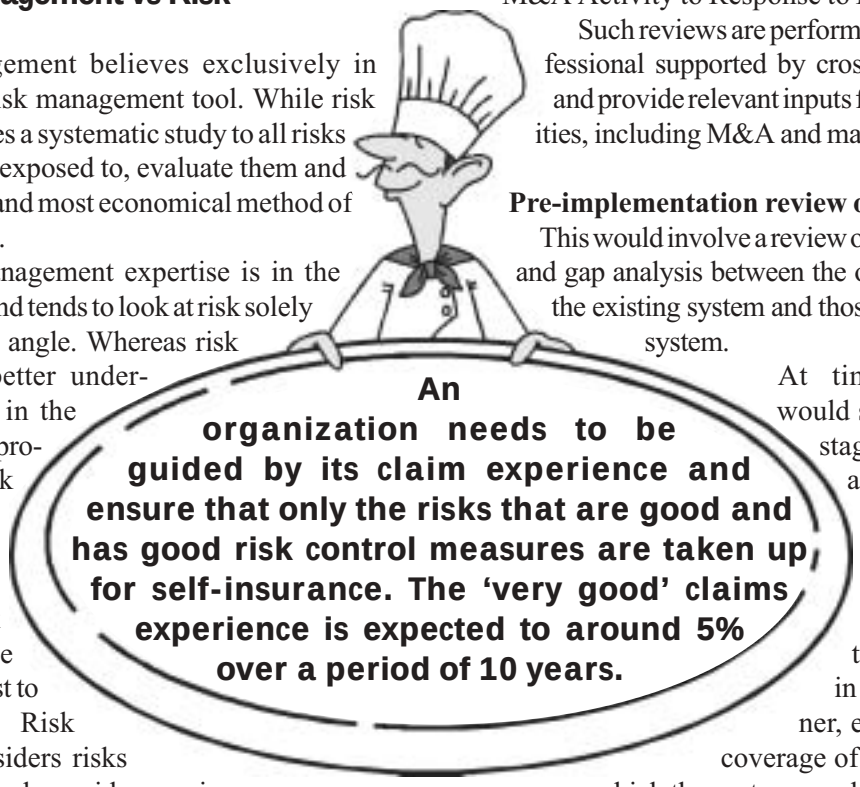
The expected value and the variability of cost of various risk-financing options are prime considerations in regard to the choice the people make. The financial position of the individual making the choice also influences his/her decision. The degree of risk aversion of the individual will also be an influencing factor in the choice of risk financing decisions. Finally, the choice of an individual of the type of risk financing he or she makes may be constrained by external factors e.g. motor owners are constrained by legislation in many countries to the purchase of motor vehicle insurance. Another example is the constraint that insurance be purchased for the purpose of protecting the collateral. When financial institution extend credit or provide loan

for home purchase or car purchase, they impose a condition that debtors purchase property insurance.

Insurance Management vs Risk Management

Insurance Management believes exclusively in insurance as the risk management tool. While risk management makes a systematic study to all risks an organization is exposed to, evaluate them and identifies the best and most economical method of handling each risk.

Insurance Management expertise is in the area of insurance and tends to look at risk solely from an insurance angle. Whereas risk manager has a better understanding of risks in the organization as a professional in risk management. Insurance Management covers all or most of the risk through insurance resulting heavy cost to the organization. Risk Management considers risks from cost angle and considers various options including insurance for the management of risks, and hence, it is cost effective.



Thus, even though insurance buying may remain a major area of Risk Management, it is not the only area of operations. Risk management is a much wider concept than insurance management.

Future of Risk Management and Opportunities for CAs

In fact companies around the world are taking a long and hard look at managing risks. In the process, they are redefining the role of Risk Management in achieving objectives and ultimately in driving shareholder value. Their main goal is not to eliminate risk but rather to be proactive in their assessment and management of risks to their own strategic advantage. They can provide their service in different roles such as: -

Business Strategy Review – Risk Perspective

Risk from all angles would be considered and the strategic responses to the same would be reviewed. Strategic options available and not explored earlier would be recommended. The review would result in recommendations ranging from Restructuring to M&A Activity to Response to Market Changes.

Such reviews are performed by insurance professional supported by cross- functional teams and provide relevant inputs for specialized activities, including M&A and marketing strategies.

Pre-implementation review of Systems

This would involve a review of the existing system and gap analysis between the objectives served by the existing system and those expected from the system.

At times, this service would start at a very early stage and may include assistance in identification of the appropriate system to be implemented as well as testing of the system in a methodical manner, ensuring exhaustive coverage of routines/scenarios, which the system would be subjected to.

Post – implementation review of systems

Different from pre-implementation review, this would involve a critical assessment of the system implemented to provide relevant recommendations to modify or upgrade the system to ensure whether it meets the objective desired to be achieved by the system.

An analysis of the system would reveal other features of the system, which could be utilized and were not earlier expected from the systems as part of the defined objectives, thus extending the objective served by the system, ultimately adding value to the system implementation.

Risk Retention

Risk Manager can view the risks from management angle, which involves cost benefit analysis of various risks whether retention of risk is appropriate or transfer it to an outsider.

Often a detailed analysis of such risk could result in significant savings for insurance companies and efficient utilization and allocation of funds. ■