



Risk Management: Risk Financing Methods

An Online Continuing Education Course for Engineers

Course Number: BS-1023

Credit: 1 Hour / 1 PDH / 1 CPD

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Introduction

This course builds on the Risk Financing component outlined in the basic concepts of *The Risk Management Process* course. The financing of risk is the determination and application of the most cost-effective method of financing, providing capital resources, and the risk factors to which the organization is exposed.

Risk financing methods may be utilized to reduce the financial impact of risk factors that can cause financial harm to the organization or exploit the financial impact of risk factors that can provide financial benefits to the organization.

Risk financing is dependent on a variety of support departments or service providers including finance, accounting, actuarial service, and auditing. The risk manager or the risk management department must be able to communicate with each of these entities effectively.

Upon completion of this course, the reader will be able to understand and be able to apply the most cost-effective method of financing for the identified risk factors to which the business organization is exposed as well as the various support departments or services needed to complete the risk management process.

Without the implementation of the risk financing process, any previous risk management actions taken will not effectively provide the lowest cost of capital for risks identified as exposures to the company.

These risk financing methods must then become a part of the overall risk management program for the organization and will thereby assist with the most effective development of the future steps in the risk management process.

Overview

Risk financing is the acquisition of funds to pay for losses at the best rate or cost. The organization's management will determine the minimum rate of return that is acceptable. This is also referred to as the "internal rate of return" and is calculated by the organization's finance department. These can be internal or external funding methods. These include:



Acceptance of risk is a willful decision to continue with the risk factors and to use funds of the organization when and where necessary should the risk factor or factors result in a financial loss to the organization. This is commonly referred to as retention of risk.

The retention of risk is generally determined by the management team. Some entities, like contractors, have a large appetite for accepting risk while others have a small appetite for risk. Regardless of management's appetite, it is incumbent upon the risk manager or risk management department to make sure that management fully understands the potential consequences of their decisions that are based on their appetite for risk and to incorporate appropriate control and financing methods to safeguard the organization's bottom line.

Of critical importance to the risk, the manager is the remembrance that any risk factor that is missed during the risk management process is an accepted risk factor which could unintentionally result in undesirable financial consequences to the organization.

Avoidance of risk can be simply stated as not engaging in the business activity that would cause exposure to the risk. While it is an effective method of eliminating the risk factor exposure, it may also eliminate potential earnings and profits that would have been available if the risk was not avoided.

Before a decision is made to avoid risk, a complete analysis needs to be made to determine if a different risk financing method could provide the desired financial security while allowing for the potential of financial reward.

The avoidance of risk must be considered very diligently in the light of the organization's appetite for risk, total cost of risk and cost of capital.

Transfer of risk includes the transfer of the liability or responsibility of a risk by using the funds of others. Insurance contracts are a method of transferring risk. This can be a full or partial transfer of liability.

While there is a variety of transfer of risk options, insurance is the most common method of risk financing because it comes at a known cost and it is readily available for most risk factors faced by an organization.

Some transfer of risk from other entities may potentially be included in any contract that the organization accepts. Keeping this in mind, the risk manager should review all contracts for any transfer of the risk of others to the organization before the contracts are signed. This should be done in conjunction with the legal team or corporate attorney before the signing of contracts.

Mitigation of risk is funding methods that reduce the impact or potential of financial loss from risk factors. This is similar in treatment as acceptance of risk in that some degree of acceptable loss is retained while using control methods to reduce the magnitude and probability of a loss occurring.

The cost of mitigation (risk reduction) control methods and the availability of funds to pay for these costs are an example of the funding of mitigation of risk. It is the responsibility of the risk manager to communicate these costs to the management team.

Exploitation of risk takes into consideration that all risk factors are bad and result in a financial loss. In the case of a product or operation that is of value to a wide customer base that would require additional marketing support, the increase of additional marketing personnel would add risk factors, but the potential profits from the greater volume of sales offset the risk factor.

As mentioned earlier not all risk is bad. When a risk factor can provide a beneficial financial result, exploitation of the risk may be warranted. Careful analysis must be given when considering the exploitation of a risk.

Regardless of the risk financing option selected, risk financing involves the use of financial information and procedures. It is not the same as accounting. The objective of financing risk is to manage business assets and liabilities to provide maximized shareholder equity.

Risk financing plans and financial ratios are critical to an effective risk management program. The various financial statements and reports of the business must be available and understandable by the person responsible for implementing the risk management plan.

This information allows for the risk management team to formulate the most appropriate risk financing methods for identified and analyzed risks. This is key to the success of the overall risk management program. Failure to fully understand these financing plans and financial ratios can lead to potential failure of the financing methods being utilized for identified risk factors.

The organization's management must understand the terms and definitions utilized in the risk management process for the program to have management's complete support procedurally and financially.

Following are key concepts that will explore each of these financing methods in more detail.

Acceptance of Risk

Acceptance of risk is the decision to retain anticipated loss expenses and to fund them internally. Keep in mind that this can involve both planned and unplanned retentions.

Unplanned retentions are those that are unknown or those who were not identified or have been forgotten. These can be some of the most costly in terms of negative financial impact on the business organization.

The unplanned retentions can be reconsidered by revisiting the risk management process for any newly identified risk factors.

Unknown or forgotten risk retentions are significant sources of potentially catastrophic financial loss since you don't get the opportunity to provide appropriate risk financing methods for them. Losses from unknown or forgotten risks could end up costing a lot more than the organization may be able to absorb. The risk manager's responsibility is to minimize the potential of loss from forgotten risks, and through due diligence attempt to minimize the potential of unknown risks.

Acceptance of risk is often referred to as retention of risk. This is normally a decision made by the management to use the organization's capital to fund known potential losses from known identified risk factors. The organization then become self-insured.

Retention can also include the formation of a captive insurance program or joining an existing one as a method of financing risk.

Captive insurance programs are an alternative to going the self-insured route. In basic terms, the business organization or a group of similar business entities create and license their own insurance company to provide coverage for risk exposures that may have no available insurer or a limited number of insurers with costly policies.

Through the captive insurance company, the organization has better control of their cost of insurance coverage, has the ability to access reinsurance markets directly and has an improved cash flow.

By direct access to reinsurance markets, the organization has the ability and option to transfer some of the exposures to loss created by the undesirable risk factors needing to be handled.

Avoidance of Risk

Avoidance of risk is a risk financing technique that seeks to eliminate any possibility of a specific risk through hazard prevention or the discontinuation of the operations that have activities determined to entail any level of unacceptable risk.

This option is most often selected when the financial loss potential to the organization is so great that the company could be forced out of business if the loss occurs.

While the avoidance of risk sounds like a simple option, there are things to be considered.

First, consider if the risk factors or hazards can be removed. If they can, the risk is avoided. This approach allows for the continuation of the benefits of an operation or venture while still

A second approach is to substitute an activity with an alternative activity that meets the same need but avoids the risk factors that need to be avoided.

The final solution is to eliminate the activity that causes the risk factors that need to be avoided.

Transfer of Risk

Common transfer of risk methods include reinsurance, the use of financial derivatives and business operations.

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