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Risk financing guidelines

handbook

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Handbook

Risk financing guidelines

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PREFACE

This Handbook was prepared on behalf of Standards Australia/Standards New Zealand Committee OB-007, Risk Management. It relates to a particular type of risk treatment known as risk financing.

This Handbook should be read and applied in conjunction with AS/NZS ISO 31000, *Risk management—Principles and guidelines* as the underlying purpose is to help organizations of all types to manage risk effectively, in those situations where risk financing is an appropriate form of risk treatment.

It is not the purpose of this Handbook to turn all consumers of risk financing into technical specialists or to provide an advanced textbook for risk financing technical specialists. Rather, it has been prepared with specific goals for each of three groups of end user in mind.

This Handbook is intended for:

(a) Directors, managers or risk specialists with responsibilities for implementing their own organization's risk financing arrangements. For this group, the objective is to help them become well-informed consumers, providing the knowledge, understanding and confidence to work with their external advisers to explore and test options and make decisions consistent with good governance.

(b) Expert providers of risk financing services (including those involved in related legal issues) with the objective of providing additional background knowledge to their formal training, and an awareness of some of the risk financing issues beyond their own domain.

(c) Students of risk management seeking to gain a sound understanding of this form of risk treatment and its relationship to the overall risk management process and to other controls.

This Handbook explains the role of risk financing and describes a wide range of risk financing techniques. These include the most common techniques (insurance and self funding) and other less frequently used methods, such as those offered by the capital markets. Each description explains where the particular technique may be suitable as well as pointing out factors which may affect its reliability.

This Handbook also explains the interrelationships between risk financing and other risk management techniques (such as setting risk criteria, assessing risks and implementing other types of risk treatment in parallel, to improve the efficiency of the risk financing arrangements).

A basic approach to selection of an appropriate risk financing mix is provided (although risk financing arrangements tend to be very specific and need to be tailored to the organization concerned and the particular risk being financed).

Section 3 explains the key points that need to be considered in order to maximize the effectiveness of any particular risk financing program and provides practical guidance in respect of each.

Implementing risk financing arrangements requires a mix of specialist expertise and skills. Most organizations that do not want to rely entirely on external risk financing suppliers (such as insurers) engage either advisers or intermediaries to assist decision making and transacting the risk financing arrangements (the use of an insurance broker is one such example).

The scope of expertise of such specialists is often particular to their type of risk financing activity and may not include a broader understanding of either risk management or the wider aspects of risk financing.

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0 INTRODUCTION

Risk financing refers to arrangements to ensure the availability of funds, where needed, following the occurrence of an unintended event.

Implemented effectively, risk financing may lessen the effect of the event upon achievement of the organization's objectives or even create new opportunities. It will be unusual that risk financing can lessen all of the consequences of the event.

The cost of implementing risk financing will reflect the method chosen, its reliability, and the scale of the potential consequences of the risks being financed.

Coherent risk financing arrangements require that risks are accurately assessed and both the need for and parameters of any risk financing determined after considering other treatment options or combinations of options.

Risk financing decisions need to be reached through application of the risk management processes described in AS/NZS ISO 31000, *Risk management—Principles and guidelines*.

Risk financing methods continue to evolve with some being more complex than others. The cost of any particular method can vary significantly over time — even though the risk being financed is unchanged. This gives further emphasis to the importance of applying the step, Monitoring and Review, within the AS/NZS ISO 31000 risk management process (see Figure 1).

An increase in cost of one risk financing method (e.g. as a result of cyclical movements of global capital markets) can act as a stimulus for the development of alternative methods.

The expertise required to implement various forms of risk financing differs markedly. Small and medium sized enterprises (SMEs), such as those with fewer than 50 employees which constitute 98%* of organizations in New Zealand, will often trade the cost of engaging the expertise needed to implement a particular risk financing measure against any variations in the underlying cost of the method itself.

Whatever risk financing method is selected, the crucial test is that, within an acceptable level of certainty, the method chosen will ensure funds, in the amounts required, will be available when needed.

However, it is not uncommon to find that those responsible for risk financing decisions will subordinate this crucial test to considerations of the transactional cost of the proposed method. Errors of judgement in this respect can have serious consequences. Whereas the costs of risk financing may impact on organizational performance at the margin, risk financing arrangements that do not deliver the funds required when needed, can result in organizational failure.

The central purpose of this Handbook is to—

(a) assist the reader to understand the functions and limitations of risk financing as a type of risk treatment;

(b) provide guidance on risk financing nomenclature and underlying concepts (as they stand at the time of publication);

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* Statistics NZ. Business Demography Survey. February, 2008.