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## **RISK RETENTION FUNDING ARRANGEMENTS. A FRAMEWORK FOR A DECISION-MAKING PROCESS**

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**Summary:** The paper discusses the nature and role of risk retention as a risk management technique. The key types of risk retention are presented, concerning the intention of their application (unplanned and planned risk retention) and the nature of funding arrangements (unfunded and funded risk retention, including pre- and post-loss funding). Furthermore, the paper examines particular funding arrangements that a company may consider for a given risk exposure. For that purpose, the available funding arrangements are classified into traditional and non-traditional. Within non-traditional funding arrangements closer attention is paid to finite risk programs, contingent capital facilities and captives.

**Keywords:** risk retention, risk management, alternative risk transfer.

### **1. Introduction**

Risk management is at present perceived as an important tool of corporate financial management and the dominant view is that it plays a key role in the value creation process. The purpose of risk management is to identify the risk that the company faces and to apply the best technique of minimising the impact of risk on the company and the way in which it achieves its main goal. To obtain this, a company may apply different tools. Risk retention is one of these.

The paper aims at laying the foundations for proper consideration of risk retention as a risk management tool. Risk retention finds a fully justified application for managing certain risk exposures and may prove to be more efficient than other tools. Risk retention is also present to some extent even if the company uses other risk management tools. However, the primary goal of the paper is to discuss numerous risk retention funding arrangements. In order to understand the nature and purpose of applying particular funding arrangements, the discussion on the nature and types of risk retention is developed.

The problem discussed in the paper is important for at least two reasons. First of all, risk retention is not widely discussed in the literature but – as will be explored later – it often accompanies other risk management tools. Secondly, recently numerous

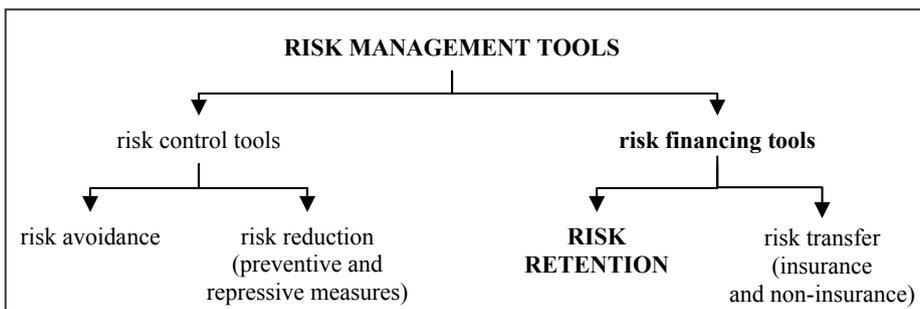
innovative risk management tools were developed and most of them serve as advanced risk retention structures. These innovative solutions form novel perspectives and are an interesting opportunity to corporate end-users. As these solutions are not broadly known, the paper aims also at describing their main features.

This paper represents mostly a conceptual analysis of current state of affairs and the currently available literature. The structure of the paper is as follows. Section 2 and 3 discusses the nature, scope and types of risk retention and introduce the main types of risk retention funding arrangements. Section 4 discusses traditional funding arrangements, whereas section 5 is devoted to non-traditional ones. Section 6 concludes the study.

## 2. A definition and scope of risk retention

A company is forced to take on risk and accept risk as a part of a cost of doing business. However, as with any other costs, a company should manage risk to minimise its impact on the value creation process [Berk and DeMarzo 2007, p. 925]. Managing risk means applying a procedure which begins with risk analysis followed by the selection of appropriate risk management tools. Risk analysis includes a risk identification stage which aims at figuring out the most important risk exposures. Afterwards, a company should conduct a risk assessment stage which is related to judging risk from its frequency-severity perspective and the impact of possible loss burden on the company's financial stability [Bodie and Merton 2000, p. 263]. A properly conducted risk analysis helps to decide which tools of managing risk are most suitable from a cost/benefit trade-off perspective.

The tools of risk management are grouped into classes in order to underline their nature and purpose of application. The most common is the distinction of risk control and risk financing tools [see also Culp 2006, p. 33; Rejda 2001, p. 44; E.J. Vaughan and T. Vaughan 2003, p. 16; Williams and Heins 1989, pp. 197-198]. This classification



**Figure 1.** Risk retention as a risk management tool

Source: Author's own study.

will be central to further considerations in this paper. Each class covers particular tools that may be applied individually or together. Risk retention belongs to the risk financing tools, as presented in Figure 1.

Risk control refers to techniques that reduce the frequency and severity of risk. Risk financing tools provide funding for covering the outcome of risk and finding a reasonable application if risk control tools proved to be ineffective [Rejda 2001, p. 44; E.J. Vaughan and T. Vaughan 2003, p. 16]. Risk financing tools include risk transfer and risk retention<sup>1</sup>. Risk transfer allows the risk (and the burden of losses) to be shifted to another party. The most common example of risk transfer is insurance whereby the company transfers the risk to the insurer. However, non-insurance transfer mechanisms also exist, for example derivatives in their hedging function. Risk retention is a tool whereby the company retains part or all of the losses that can result from a given risk exposure. Furthermore, risk retention may be applied solely or in conjunction with risk transfer. Such situations are common and a good example is partial insurance which is created by adding in the insurance contract instruments restricting insurer's liability (e.g. deductibles). Those elements of insurance contract are sometimes defined as forms of risk retention as they result in a company's obligation to cover part of the losses [Banks 2008, p. 66].

Risk retention implies that the company's owners (shareholders) ultimately retain the risk. Therefore, the scale of risk retention and the consequences of applying such a method may influence the level of the rates of return expected by the owners. This problem is important from the corporate finance perspective and provides a reason for a closer analysis of risk retention. Particularly, the types of risk retention should be examined with respect to the intention of applying risk retention and sources of funds used to cover the outcome of retained risk as it may influence the company's financial position.

### 3. Types of risk retention

#### 3.1. Unplanned and planned risk retention

The company may apply risk retention as a risk management tool deliberately. However, there are also circumstances that result in risk retention without the intention to do so. As a consequence, unplanned or planned risk retention may occur in a company, as presented in Figure 2.

Unplanned risk retention occurs if the company is retaining the risk unconsciously, without taking any action against the risk. Therefore, unplanned risk retention is referred to as unconscious or passive. Unplanned risk retention may result from [E.J. Vaughan and T. Vaughan 2003, p. 17.]:

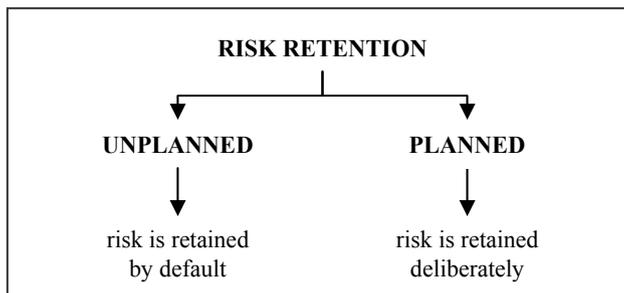
(1) errors and omissions in risk analysis; a company simply fails to recognise risk exposures or the scale of risk was inappropriately assessed;

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<sup>1</sup> Risk retention is sometimes associated with risk finance [see also Culp 2006, p. 33].

(2) errors and omissions in implementing risk management tools other than risk retention; the other tools were inadequate or implemented with delay;

(3) impossibility to identify all of the company's risk exposures, mainly due to the dynamics of the company's environment; a certain level of risk retention is common place and somehow inevitable.



**Figure 2.** Types of risk retention considering the reason for retaining the risk

Source: Author's own study.

Planned risk retention occurs when a company is aware of the risk exposure and the burden of loss and deliberately plans to retain a part or all of it. This means that the company consciously chooses risk retention to finance the outcome of risk with cost/benefit trade-off in mind and takes appropriate actions to prepare itself for the risk outcome. Therefore, the planned risk retention is often called conscious or active. In particular, planned risk retention may result from [E.J. Vaughan and T. Vaughan 2003, p. 17]:

(1) a conscious decision to retain risk rather than to avoid, reduce or transferring it; in such circumstances the risk retention is perceived as voluntary;

(2) an inability to apply other tools, even if required; in such circumstances risk retention is perceived as involuntary.

It is worth noticing that risk retention is even recommended in particular circumstances. First of all, it is recommended for low-frequency and low-severity risk exposures. Then, the worst possible loss is not serious and may be easily funded by the company. Secondly, risk retention is recommended for risk exposures that are frequent (and thus predictable) but not severe at the same time. In such circumstances, the company may easily prepare itself for covering the loss burden whereas risk transfer may be too costly [see Rejda 2001, p. 46].

The aforementioned reasons for unplanned and planned risk retention in a company justify the statement that risk retention is a residual or a default risk management technique. It is a residual technique because any exposure that is not avoided, reduced or transferred, is retained by the company. Furthermore, it is a default technique because if the company fails to identify particular exposure, the risk is also retained.

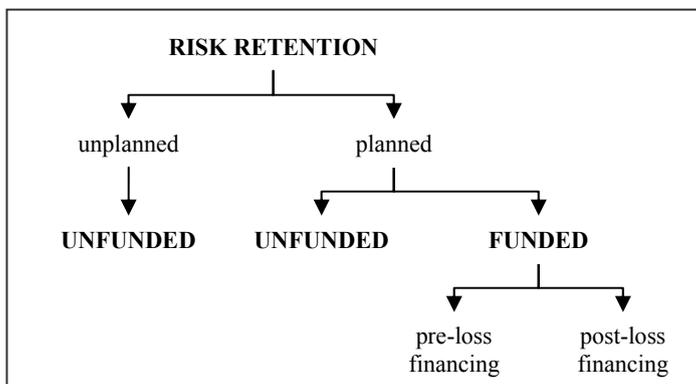
### 3.2. Unfunded and funded risk retention

The decision to retain the risk means that the company will be forced to cover the losses when they occur. This means that if the company actively uses risk retention as a risk management tool, it should be prepared for loss coverage. In other words, the company should prepare appropriate sources of funds. From that perspective unfunded and funded retention should be identified.

Unfunded risk retention occurs if the company retains the risk and does not prepare a particular source of funding. However, the company remains prepared for risk coverage if it intends to cover the consequences of loss from current cash flows when those losses occur. Here, the risk retention is less formal, as it involves no specific funding arrangements.

In a funded risk retention, unlike in unfunded, the company earmarks funds for loss coverage. Funded retention may be accompanied by budgetary allocations to meet the losses and may involve the accumulation of funds. In the case of funded retention, the company sets aside liquid or semi-liquid assets or a source of raising the cash to cover the loss in the event that a loss occurs [Culp 2006, p. 33; E.J. Vaughan and T. Vaughan 2003, p. 18]. The decision about segregating assets for loss coverage depends mainly on the expected company's cash flows and the expected size of losses that may result from the retained exposure.

In terms of unplanned risk retention, the retention is always unfunded (see Figure 3). In such circumstances the company obviously is unprepared to cover the losses as it retained the risk unconsciously. In terms of planned retention, both unfunded and funded risk retention may occur. Unfunded retention is fully reasonable if the risk analysis proved that the risk exposure is a low-frequency and low-severity one. Also, there are exposures with high-frequency, but low-severity and thus can be covered from the company's current cash flows.



**Figure 3.** Types of risk retention considering attitudes toward a loss coverage (funding)

Source: Author's own study.

Depending on the type of funding arrangements, the funded risk retention may involve a pre-loss or a post-loss financing, as depicted in Figure 3. This distinction is based on the judgement when cash is actually raised to pay for the loss.

Pre-loss financing means that the cash to pay for the loss is raised in advance of the loss event. This means that the company applies funding arrangements that tie up cash in a dedicated economic reserve to cover a possible future loss. If the loss does not occur, the economic reserve is earmarked for the next possible loss event or released with the funds flowing back into the company's free cash flows.

Post-loss financing means that the cash to pay for the loss is raised after the loss event. This means that the company applies funding arrangements that form an additional source of funds applicable on pre-negotiated terms. Post-loss financing should be perceived as the economic equivalent of buying a put option on additional capital. If a risk event causes a future loss, the company exercises the option and acquires capital on pre-negotiated terms. If no loss occurs, the facility expires unused. In exchange for giving the company the right to raise additional capital, the capital provider of post-loss finance will charge the company with a commitment fee that should be associated with the economic equivalent of a put option premium [Culp 2006, pp. 122-123].

A further study will discuss numerous funding arrangements applicable in a planned retention within pre-loss and post-loss financing. The funding arrangements will be analysed in two classes: traditional and non-traditional. Non-traditional funding arrangements will cover some innovative tools that companies may apply in risk financing.

#### **4. Traditional risk retention funding arrangements**

Traditional risk retention funding arrangements should be associated with instruments and solutions that the company may apply independently. They include simple solutions arranged to fund the expected losses. In particular, the following arrangements should be distinguished:

- (1) company's current net income,
- (2) credit lines,
- (3) earmarked accounts (reserves),
- (4) self-insurance.

The company's current net income acts as a funding arrangement if the company plans to treat losses as expenses. It has several consequences worth considering. If losses are treated as additional expenses, the company's income statement is unduly affected by chance results [see Williams and Heins 1989, p. 233]. If the loss-frequency is fluctuating or loss-severity is high, the company is exposed to the risk that the expenses will exceed revenues. It should also be noticed that in such circumstances the company may face a risk of losing liquidity – such expenses may

require cash outflows. Therefore, a company planning such a funding arrangement must also be prepared for covering cash outflows with appropriate cash inflows in order to maintain the required liquidity level. From the liquidity point of view, the additional funds may be obtained [Culp 2006, p. 33; Ross et al. 2005, pp. 394-397]:

(a) internally – from current cash reserves or in the form of cash inflows arising from the divestment of company's assets (particularly from sale of securities or other assets, including real assets);

(b) externally – in the form of cash inflows from additional debt or equity issuance.

The availability of internal sources of funds has several consequences. Excessive reserves of liquidity reduce profitability. Profitability will also be reduced if the company is forced to divest cash of its assets as these assets will not earn the expected rate of return.

The availability of external sources of funds is related to the company's current financial situation. If the financial situation of the company is poor, additional debt finance may not be available. The creditors will simply refuse to grant a credit. If the loss burden is high, the financial situation of the company may even worsen. The equity issuance will be even more difficult to raise due to the low elasticity of such funding – raising additional capital from equity issuance is time-consuming. Also, additional debt or equity finance have further consequences, resulting from the changes in the capital structure and the cost of capital<sup>2</sup>.

Taking all the aforementioned arguments into account, the conclusion is that this funding arrangement is recommended only for low-frequency and low-severity exposures and for companies in good financial condition. It is also worth noticing that it represents a special example of traditional funding arrangement which actually means no funding at all. Thus, it should be perceived as planned unfunded risk retention.

The following examples of traditional risk retention funding arrangements should be perceived as treatments aimed at eliminating the problems that may result from unfunded risk retention (no advance funding). The company may arrange a credit line prior to the loss occurrence and thus omit the risk that the creditors refuse to grant the credit or that they will demand higher interest rates. However, borrowing is recommended only for low-severity losses. A credit line is arranged in advance and in this case the company meets extra costs including the charge for holding the credit line open. If the funds are used, the company meets additional cost of funds borrowed in the form of interests to be paid.

In order to avoid fluctuations in the statement of income and earned profits the company may constitute an economic reserve. A company may create a liability

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<sup>2</sup> Changes in the capital structure due to a higher level of debt raise financial distress costs. Therefore, the capital providers require higher rates of return which influences the cost of capital components [see also Ross et al. 2005, pp. 433-461; Ogier et al. 2004, pp. 98-131].

account that will be credited periodically with an amount equal to the expected losses. If the risk occurs, the account will be debited with the amount of losses. This funding arrangement causes the profit to be periodically reduced. However, such account is a paper entry that does not provide liquidity. Therefore, a company may opt for a more conservative funding arrangement in the form of earmarked assets account. In addition to creating a liability account, a company establishes a corresponding asset account consisting of liquid or semi-liquid assets [Williams and Heins 1989, pp. 233-234].

The company may also apply self-insurance which is a special case of economic reserves. The term “self-insurance” is widely used for the programs that companies operating in the USA may apply to manage certain risk exposures instead of using insurance [see also Williams and Heins 1989, pp. 237-238; *The Picture...* 2003, p. 17]. Self-insurance occurs when the company is raising funding reserves for loss coverage and applies techniques used by insurers to ensure that the raised fund will satisfy the burden of loss. Therefore, the company engages in the same types of activities as a commercial insurer dealing with its own risk. In other words, if a foundation of funding reserve involves operations on the law of large numbers and predictions regarding future losses, the reserve is referred to as self-insurance [E.J. Vaughan and T. Vaughan 2003, pp. 42-43; Williams and Heins 1989, p. 227; Rejda 2001, p. 48]. Self-insurance programs may be applied by companies that are large enough to permit a combination of a sufficiently large number of exposures. Moreover, the self-insurance plan requires an accumulation of funds to meet losses that occur with a sufficient capital to safeguard against unexpected deviations from predicted losses [E.J. Vaughan and T. Vaughan 2003, p. 43].

The conclusion is that the distinction between self-insurance and other forms of economic reserves is very narrow and lies in the loss prediction process. If a company is facing numerous risk exposures, it can predict the loss-frequency and loss-severity accurately. If the economic reserve is created for such exposures and the company has a funding reserve large enough to cover the deviations from expected loss-frequency and loss-severity, then it should be referred to as self-insurance program.

Funding the retained risk with economic reserves may cause several problems. First of all, there is a risk that the loss will occur soon after the earmarked account is created and the loss will exceed the funds gathered. In such circumstances the company is exposed to the risk faced with unfunded risk retention; namely, the risk of profits fluctuations and liquidity risk. Secondly, earmarked assets account require high liquidity reserves which means holding liquid or semi-liquid assets that earn a lower return (the liquidity/profitability trade-off). Also, this type of funding arrangement may be possible only for strictly defined types of risk exposures due to accounting standards the company may be obliged to follow.

## 5. Non-traditional risk retention funding arrangements

### 5.1. The nature of non-traditional funding arrangements

The ideas underpinning the non-traditional risk retention funding arrangements are similar to the ideas underpinning traditional solutions. However, the non-traditional arrangements are more sophisticated and often incur a net of contractual agreements with third parties, mainly insurers. Non-traditional funding arrangements permit the avoidance of some problems that may arise from the application of traditional solutions (fluctuations or loss of profits, liquidity problems).

The non-traditional funding arrangements cover some of the structures associated with so-called ART (Alternative Risk Transfer) solutions. The ART market was born mainly due to hardening of the insurance market and promoted new forms of risk financing arrangements.

The most common definition of ART states that ART includes the customised combination of risk transfer and risk retention solutions which are designed as multi-line and multi-year cover [*The Picture...* 2003, p. 16]. ART solutions were primarily designed to facilitate funding of traditionally uninsurable risk. ARTs improve the situation of the risk bearer, and so increase the efficiency of risk retention. The efficiency of ART is based on the fact that most insurance risks are uncorrelated with traditional types of investment risk (e.g. interest rates fluctuations or fluctuations of stock price), which produces a favourable diversification effect [Hartwig and Wilkinson 2007, p. 927; *The Picture...* 2003, p. 23].

The ART solutions have at least one of the following features [Hartwig and Wilkinson 2007, p. 925; *The Picture...* 2003, p. 23]:

- (1) customisation to meet the unique needs of the client;
- (2) multi-dimensional coverage (provided on multi-year and/or applicable to multiple lines);
- (3) pay-off triggered by multiple factors, rather than a single event (with combination of insurable and uninsurable needs).

Although the ART market was primarily designed for insurers and reinsurers, the companies also have access to such solutions. Among the ART solutions available for companies there are some primarily designed to retain risk:

- (1) contingent capital facilities,
- (2) finite risk programs,
- (3) captives.

These ART solutions are subject of the further part of the study as non-traditional risk retention funding arrangements.

## 5.2. Contingent capital facilities

Contingent capital is a contractually agreed facility that is made available to the company in the case of the loss event. According to this agreement the company is allowed to raise the capital during a defined commitment period on pre-negotiated terms if a specific loss-making event occurs. The access to the capital in contingent capital facilities is conditional (contingent) upon the occurrence of (a) an insured event, and (b) an impact of a predetermined size on some measure of the company's financial performance (e.g. certain financial statement items). If both events occur, then the company is assured of a cash infusion. The contingent capital facility may be available in the form of:

(1) contingent debt – if the company plans to issue debt securities or acquire a loan,

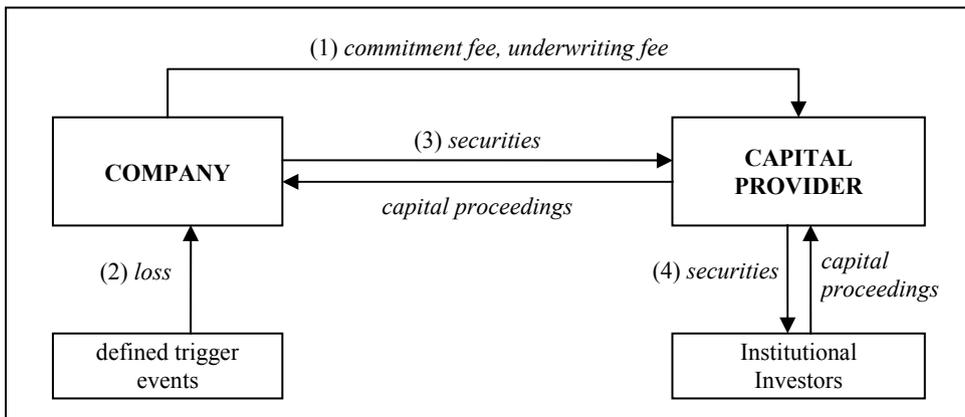
(2) contingent equity – if the company plans to issue common or preferred stock.

Contingent debt in the form of a loan is similar to the line of credit except that access to the capital is conditional upon predefined triggers. The contingent capital facility may also appear in the form of a put option giving the owner the right to sell securities (debt or equity) at a predetermined price [Hartwig and Wilkinson 2007; p. 946]. The contingent capital arrangement is made prior to the loss occurrence, but it represents a post-loss financing as the capital flows after the loss occurrence. Although contingent capital is not yet so prevalent a concept, it is present in broad risk management programs [Banks 2008, pp. 135-145].

A company wishing to apply contingent capital funding should identify the amount of capital that it wishes to raise in the event of loss. Then the events that can trigger the loss should be determined. Also, the company defines a form of securities that will be issued in order to raise capital. If the event occurs, the capital provider supplies funds by taking up securities issued by the company at the pre-negotiated price. In return, the company pays the capital provider a periodic, upfront, non-refundable commitment fee (paid even if the securities were not issued) and the underwriting fee based on the risk prediction (see Figure 4). The generic structure of contingent capital is similar to a put option. The strike price and notional size of the contract represent the issue price and proceeds that will be raised in the event of loss. The exercise of an option depends on the occurrence of loss.

Contingent capital facilities can be applied for low-frequency, but high-severity risk exposures and therefore give an opportunity to manage risk exposures that might not be possible to be covered with other risk-financing tools. However, the cost of an upfront, non-refundable fee along with the underwriting fee may be high [Banks 2008, p. 138].

The contingent capital facility allows company to acquire external funds for covering the loss and simultaneously prevents profits' fluctuations and liquidity



**Figure 4.** The generic structure of contingent capital facility

Source: Author's own study based on [Banks 2008, p. 137].

problems. In particular, the company avoids refusal of being granted a credit or the failure of equity issuance. However, a capital provider credit risk exists as the company relies on a capital provider supplying funds when called upon to do so.

### 5.3. Finite risk programs

Finite risk programs allow for spreading individual risks over time [Hartwig and Wilkinson 2007, p. 944]. Finite risk programs are used by the companies that are primarily interested in risk retention rather than transferring it. However, finite risk programs form hybrid structures integrating risk retention and risk transfer and are made between the company as cedant and the insurer [Banks 2008, pp. 72-73; Culp 2006, p. 552]. Finite risk programs have the following features:

- (1) a limited assumption of risk by the insurer – the risk transferred from the company to the insurer is limited (finite);
- (2) a multi-year contract term – this provides risk diversification over time;
- (3) sharing of the results with the cedant (company) – premiums that are not required to pay the claims are paid back by the insurer at the end of the program;
- (4) an explicit inclusion of investment income in the contract – any interest income earned during the life of the program is explicitly taken into account when calculating the premiums; this means that the time value of money is used to increase the cost efficiency of the program [Alternative Risk... 1999, p. 19].

Finite risk programs can be structured as retrospective (post-funded) or prospective (pre-funded). Retrospective finite risk programs help companies to finance past liabilities that they still carry, thereby helping companies to reduce the earnings and cash flow volatilities arising from those liabilities (help to finance the

existing liability). In retrospective finite risk programs the company must pay back the claims payments of insurer over a defined period of time. The company pays only a commitment fee or a small premium in advance of any loss. If the loss occurs and the company did not pre-fund its value in a program, the insurer provides the coverage. In this case however, the premiums on the program rise so that the present value of future premiums equals the burden of loss [*The Picture...* 2003, p. 24; Culp 2006, pp. 556-558; Culp 2002, p. 386].

Prospective (pre-funded) finite risk programs are designed to cover liabilities that a company has not yet incurred, even on a contingent basis. In prospective programs, the company pays either annual or single premiums into a so-called "experience account". The premium is almost equal to the amount of expected loss on a multi-year basis. This fund earns a contractually agreed investment return and is used for eventual loss payments. If unused, the fund flows-back to the company. At the end of the program, the balance of "experience account" equals to the premium and the invested capital less expenses and claims paid.

The difference between the two types of finite risk programs concerns the allocation of credit risk. In the retrospective programs the insurer bears the risk of client's default, whereas in the prospective programs the company bears the risk of insurer's default [*The Picture...* 2003, p. 24]. Within prospective and retrospective finite risk programs a few standard types exist that are recommended in different circumstances [Culp 2002, pp. 387-397; Banks 2008, pp. 75-76; *The Picture...* 2003, pp. 24-26].

Finite risk programs reduce the year-to-year earnings volatility as the loss occurrence is reduced. An important feature of finite risk programs is that they serve as a cash flow timing mechanism [*The Picture...* 2003, p. 24]. They are used to manage the risk associated with loss exposures or the rate of loss, thus they offer balance sheet protection rather than capital protection. In particular, the retrospective finite risk programs allow for avoiding the problems that may arise if the company will apply risk retention with economic reserves, as discussed earlier.

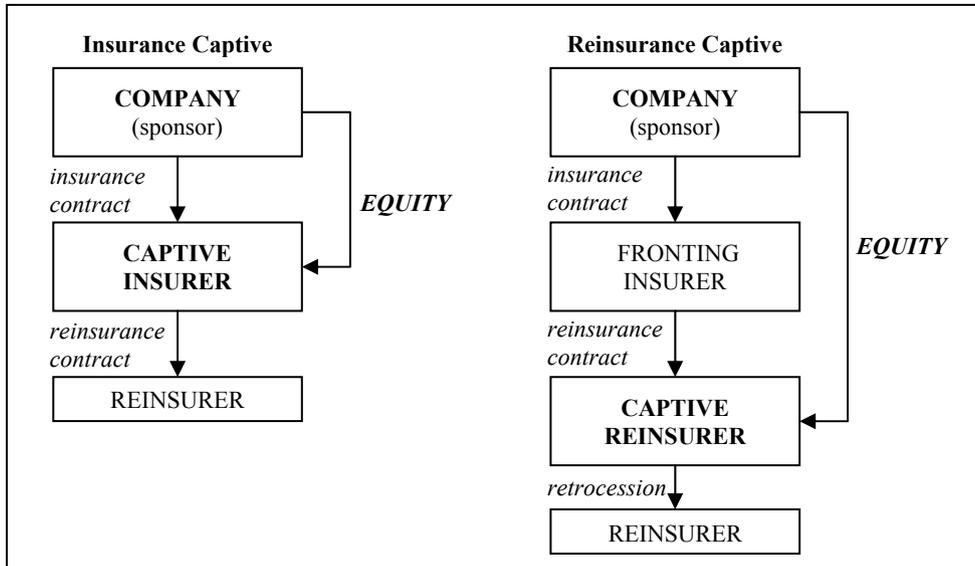
#### 5.4. Captive

A captive is an insurer (or reinsurer) owned by a parent company. In other words, a company organises an insurer (or reinsurer) whose sole or major customer is the company itself and the primary goal of the business is to insure the parent company. The company (a captive owner and insured) exercises direct control over the captive. Moreover, the parent company raises the captive's equity capital. In this sense, captives are often defined as a special case of self-insurance<sup>3</sup>. Primarily, captives are formed for financing very specific low-frequency, high-severity risks for which no cover is available on the traditional insurance market [*Alternative Risk...* 1999, p. 14].

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<sup>3</sup> Captives are the oldest form of ART solutions, dating back to the 1950s [see Hartwig and Wilkinson 2007, p. 931].

There are numerous possible captives' structures, depending on the design and purposes of contractual agreements and the structure of the parent company itself<sup>4</sup>. However, they are all raised within the two basic structures: insurance or reinsurance captive, as presented in Figure 5.



**Figure 5.** The two basic types of captives

Source: Author's own elaboration based on [Banks 2008, p. 90; Culp 2002, pp. 366, 370].

With an insurance captive, the company establishes a captive which is an insurance company. The risk of the parent company (called a sponsor) is underwritten by the captive insurer and then ceded on the reinsurance market. With a reinsurance captive the risk of the parent company is initially underwritten by a local direct insurer (fronting insurer). Then, the risk is ceded to the captive reinsurer in the form of a reinsurance contract and may be retroceded to professional reinsurers. This structure brings the largest benefits to the parent company. First of all, the company has access to the professional reinsurance market. The reinsurance market by nature and tradition is more flexible and offers different methods of risk handling. Secondly, reinsurers are not subject as to many legal restrictions as are insurers servicing the general public<sup>5</sup>. Consequently, reinsurers may be willing to sell coverage that its parent company could not obtain on the traditional insurance market. Additionally,

<sup>4</sup> Types of are widely discussed in Culp [2002, pp. 365-374]; Liwacz [2003, p. 78 and further].

<sup>5</sup> Direct insurers usually require a national insurance licence in each country where they operate and are subject to local supervisory controls. Reinsurers are engaged in cross-border activities and are subject to home country control [Alternative Risk... 1999, p. 14].

from a corporate finance perspective, with a captive company avoiding fluctuations in the operating statements through regular premium deductions. It may also be beneficial if considering tax regulations<sup>6</sup>.

## 6. Conclusion

Risk retention should be perceived as a primary risk financing tool as the company is always exposed to losses, even if it actively manages the risk. The reasons for unplanned risk retention explain why it is very difficult to eliminate risk from the company's activity. Risk retention is always present to some extent as it is a residual and default risk management tool.

While taking into account the risk management which promotes an active process of analysing and handling risk, the planned retention is primarily considered in the decision-making process. However, the reasons for unplanned risk retention should also be considered by companies as it has an educational dimension. The danger caused by unconsciously retained risk should force companies to put more effort on proper risk identification and proper selection of risk management tools.

As for planned risk retention, the company has to consider the costs and benefits related to each applicable risk retention funding arrangement. Traditional funding arrangements are available for all companies. However, small-sized companies should apply traditional retention funding only for low-frequency and low-severity losses. If not, the financial consequences may be severe, including bankruptcy due to a loss of liquidity. The non-traditional structures are rather designed for large companies and often offer coverage for losses that are unavailable with other risk financing tools.

The main ideas underpinning non-traditional arrangements are similar to the ideas founding traditional ones. Contingent capital facilities are similar in nature to the acquisition of external funds for covering the loss. Finite risk programs offer an opportunity to fund an advanced economic reserve. Captives promote a special case for self-insurance. However, the non-traditional funding arrangements allow for the avoidance of the disadvantages of the traditional ones, resulting from profit volatility and the problems with liquidity maintenance.

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<sup>6</sup> Captives are domiciled in off-shore centres (such as Bermuda). The domicile is selected primarily with respect to the insurance/reinsurance restrictions, however the tax requirement is also an important factor [*Alternative Risk...* 1999, p. 14; Banks 2008, p. 91].

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## **FORMY FINANSOWANIA RETENCJI RYZYKA. RAMY PROCESU DECYZYJNEGO**

**Streszczenie:** Celem artykułu jest przedstawienie istoty retencji jako formy finansowania skutków ryzyka w ramach procesu zarządzania ryzykiem. Dokonano klasyfikacji retencji ryzyka przyjmując trzy kryteria. Pierwszym kryterium podziału jest intencjonalność stosowania retencji ryzyka, co pozwala wyróżnić retencję nieplanowaną i planowaną. Drugim kryterium podziału jest aspekt czasowy z uwzględnieniem momentu implementacji retencji ryzyka, co pozwala wyróżnić retencję prospektywną i retrospektywną. W artykule dokonano również krytycznej analizy różnych form finansowania retencji, które mogą być stosowane w przedsiębiorstwie w odniesieniu do różnych rodzajów ekspozycji na ryzyko. W tym celu dokonano klasyfikacji różnych form finansowania retencji ryzyka w podziale na formy tradycyjne i nietradycyjne. Wśród form nietradycyjnych omówiono szerzej programy typu *finite risk*, finansowanie kapitałem warunkowym oraz keptywy.