# Finite Risk Solutions in Switzerland

Within the Swiss market there is a growing demand for finite risk solutions. We are conscious of the rapid pace of development all around the world - new and promising markets, shorter product cycles and increasingly heavy flows of capital demand faster, better and more differentiated information, and the increasing scale of risks demand ever quicker reaction times and new integrated solutions.

Finite risk concepts offer more than traditional insurance cover. This means large and, more recently, medium-sized companies are able to participate to a greater extent in the good risk experience, dealing with uninsurable risks and profit from professional asset management.

Finite risk solutions distinguish themselves by the insured financing which constitutes a substantial portion of the risk on its own. These are tailor-made solutions for national and international corporate customers and are not offered by either banks or traditional insurance companies. Each policy is designed specifically with the customer's individual needs in mind.

In addition to covering conventional insurance risks, companies can also insure against other risks which have an impact on their balance sheet. One such option involves models protecting the insured company against unforeseeable events or other traditionally uninsurable entrepreneurial risks. This may be the case in retrospective (loss portfolio transfer) or prospective (anticipation of future loss) programmes.

## Multiple uses

Finite risk contracts are written over a period of several years - the risk compensation is thus evaluated on an individual basis over time. Depending on the volume of risk transferred and the level of self-financing and service, a finite risk solution will involve banking or insurance-related techniques. In finite risk contracts, a fixed ratio of premium to risk protection is arranged. The latter can be made up of an event related limit, an annual limit or a contract sum for a contract term of several years. This enables a company to protect its balance sheet by budgeting for risk, regardless of the actual risk experienced. The client participates in profit sharing to a substantial degree, determined and paid out when the contract reaches its full-term. The profit is calculated on the basis of the periodic premium plus the interest earnings, less any claim payouts and proportionate costs.

Experience shows that finite risk concepts are used in three areas: firstly, as a substitute for existing traditional insurance solutions, secondly, as insurance for traditionally uninsurable risks (supplementary to existing insurance); and finally as combined solutions. Figure 1 outlines an example taken from the Swiss market for each of the three categories in solutions have been provided for medium-sized companies.

## A substitute for Traditional Insurance Solutions

Let's take the example of long-tail claims within liability insurance for hospitals. Liability claims in the healthcare sector are characterised by long and drawn out settlement periods. Furthermore, the risks may involve a high claim potential. The experience in Switzerland has shown that many years can pass from the time the claim is reported by the insured party until it is settled in full. During this period, the insurer posts insurance provisions to its balance sheet. The related assets are professionally invested by the insurer's asset management team.

An alternative finite risk concept can offer the customer substantial added value compared with traditional forms of insurance. For instance, the parties may agree that the customer will finance a certain risk spectrum themselves. The contract states that the insurer will isolate a certain risk area for the customer. This risk and the corresponding premiums are then the customer's responsibility. This means that in such a

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scenario, the relevant premiums and the capital gains earned on the provisions for their risk area are de facto and credited to the customer.

If the release of provisions results in settlement gains, or if the actual loss experience is better than expected, the customer is left with funds and capital gains that no longer need be used for claim payments. A finite risk solution thus guarantees that the customer receives all the interest earned on loss reserves. In addition, added value may be earned as follows:

- Planning for long-term risks becomes more accurate. The conditions (extent of cover, sum insured and deductible) and the insurance premiums are stipulated at the beginning of the contract term for several years, thus guaranteeing the stability of the customer's cash flow, regardless of the actual loss experienced. The same applies to retrospective insurance cover which provides financing for uncovered losses of unknown scope from previous insurance periods.
- The customer may determine his own level of risk retention. Cover is provided from the outset. The insurer continues to offer professional services even for the portion of the risk that the customer finances himself, so that the relationship remains unchanged. The customer pays a fee to the insurer for the services rendered.
- However, for catastrophe losses that – either individually or on aggregate – exceed the customer's risk participation, the customer still has traditional insurance protection according to the solidarity principle.

- Interest on the funds used to finance the risk is calculated in line with an investment strategy adapted to the risk.

## A Supplement to Traditional Cover

Instead of replacing traditional cover, as mentioned above, finite risk solutions can also be used as a supplement or to cover for traditionally uninsurable risks.

**Finite Risk Solution Application Types**

This can be illustrated using the example of price fluctuations in the food industry. Differences in results can be caused by quantity or price fluctuations. If an entrepreneur wants to stabilise substantial deviations in his business results over time, he can often make use of special financial products such as exchange-traded or OTC derivatives.

If such type of financial instrument are not available, finite risk concepts can also prove very successful in managing such exposure. In the food manufacturing industry, for instance, there are a number of companies whose food production depends heavily on one particular commodity. This commodity may also be the most important source of income for the industry concerned. The purchase price for this commodity may be in a higher price segment compared with the European average. While the commodity price on the supplier side remains constant, the customers in the food industry are subject to considerable price fluctuations as a result of substantial market deregulation. Due to quota regulations on the supplier side, existing price pressure and the resulting decrease in sales cannot be offset by additional production, even with extra production capacity. Accordingly, companies that are heavily dependent on this commodity will be subjected to substantial fluctuations in their results. Furthermore, the possibility cannot be ruled out that this risk will even increase in the future as a result of political decisions or a market collapse.

*"Optimising risk management is a major challenge for both entrepreneurs and the insurance industry. Active risk management puts the relationship between the company and the insurer on a new level of quality. As part of this process, both sides strive for and achieve synergies. Developing and selling innovative, tailor-made risk financing concepts is one side of the success story, and implementing them efficiently and transparently within an existing process organisation is the other."*

A finite risk solution, however, provides insurance cover for fluctuating commodity prices. If the price deviates from a predetermined band width, the insurer pays compensation. This means that wild swings in sales can be reduced in the year's results. In turn, this enables the company to improve its balance sheet structure and enhance its value.

## Combined Solution

The combination of traditional cover with a finite risk solution can be shown using the example of an extended guarantee for a software manufacturer. IT service companies face stiff competition. In this industry it is clear that successful development of custom-made IT solutions depends greatly not only on the price but also on services such as a guarantee, online services, add-on functions, etc. The manufacturer may have to promise the purchaser in advance that he will remedy any damage caused as a result of faulty software manufacture. The contractual obligations that could result from this guarantee and the risks involved exceed the cover provided by a traditional form of insurance. In order to conclude major contracts, IT service providers must be able to offer their customers extended guarantees as part of their sales and negotiation strategy. Naturally, they want to take out an insurance policy for these additional risks.

One possible solution for this case would involve a combined business liability insurance, comprising both traditional and alternative insurance. Conventional cover would provide for property damage and bodily injury, for example, whilst the finite risk portion could guarantee the financing of loss. This could lead to the development of a new type of insurance capacity. The software manufacturer can create more value added than his competitors, to which the insurance contributes via alternative risk financing.

## Professional Asset Management

One key feature of the finite risk concept involves the corporate customer himself participating to a significant extent in the risks. As a result, the customer is assigned his share of the premium which, however, remains with the insurer until the contract expires. The ideal scope of the customer's risk exposure and the amount of the corresponding premium share are determined on the basis of the customer's specific risk infor-

mation. This may be done using computer-aided Monte Carlo simulations, for example, which illustrate the spectrum of possible loss scenarios.

The customer's share in profits is paid out when the contract reaches full-term. The profit is a combination of the cash flow from insurance, technical results within his risk participation and the capital gains on the premium share to which he is entitled. As the latter is isolated for settlement purposes with the insurer and channelled into specific investment instruments in line with the customer's individual needs, the customer can gear his investment strategy to his risk tolerance. Nowadays, leading insurers have a professional asset management team at their disposal. They are thus able to achieve a tailor-made investment strategy for alternative risk financing solutions. Implementing this type of approach calls for close co-operation between the insurance and investment specialists.

## Synergies for Both Sides

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