Alternative Risk Financing - Developing the Market Potential of Small and Medium-Sized Companies

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Until fairly recently, it has only been the larger enterprises that have been able to take advantage of alternative risk financing (ARF) solutions, as financial service providers were geared to individual customers and had to decide on their business opportunities on a case-by-case basis. Extending the marketing strategy to small and medium-sized enterprises results in greater market penetration, which in turn increases the attractiveness of ARF solutions. This is illustrated using the example of the finite risk approach.

Comprehensive prevention measures and tailor-made insurance solutions allow companies to deal with a whole range of unforeseen events, while alternative risk financing (ARF) offers even more possibilities: the company itself participates more in the development of their risks and is able to deal with a broader range of risks, and acquires a group-wide control instrument for its risk management. The value of ARF solutions lies in the fact that they increase the efficiency of risk transfer and extend the range of risk management. In contrast to the term "ART" [alternative risk transfer], the term "ARF" emphasises the risk financing component.

Companies' Risk Management Requirements are Changing

The risk management needs of Swiss companies have increased appreciably in recent decades. At the start of the 1970s, the emphasis was on internationalization, with insurance programs developing accordingly. At the end of the 1980s and in the 1990s, companies were increasingly interested in captive and rent-a-captive solutions. The former are insurance companies that are owned by companies not involved in the insurance sector, and which insure underwriting risks arising from within the group family. Captives exist both as insurance and reinsurance companies. Rent-a-captive concepts are characterized by the fact that corporate customers rent the services from a professional reinsurer. In this way, the insured company acquires the necessary infrastructure to enable it to participate in its own risk by way of reinsurance. The motivation for implementing such concepts lies in individual profit sharing (a share in any underwriting profit), direct access to the international reinsurance market, and the fact that it provides a basis for achieving risk transparency within the insured company's own corporate family. Since the mid-1990s, increased shareholder value orientation has resulted in greater demand for solutions to stabilize annual accounts. The key words used in this context are "safeguarding earnings" and "protecting the balance sheet". In addition, the latest trend being observed among very large Swiss corporations is an interesting orientation of risk management towards global self-funding solutions.

The change in risk management requirements has left its mark on the organizational structures of corporate insurers. Traditional business activities are now being extended to include primarily alternative risk financing and asset management involving third party funds.

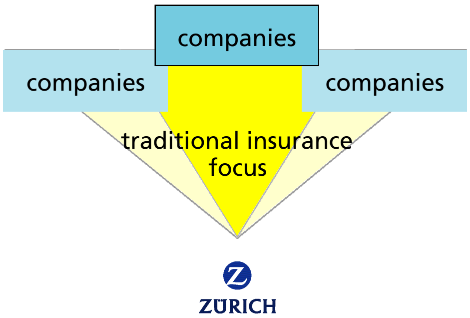
Directing ARF Marketing Strategies Towards Specific Economic Sectors and Customer Groups

Extending the traditional range of services in the market to include the possibilities that alternative risk financing offers is also of considerable interest to corporate insurers with a traditional orientation, and this irrespective of the relevant market share. In particular, insurers with a small share can use the possibilities of alternative risk financing to seize new business opportunities. Insurers with a large market share, on the other hand, often see alternative risk financing as an effective instrument for strengthening their customer relationships, as the number of policies written per account increases.

In a deregulated environment, the diversity of company-specific risk management requirements has led to segmentation of the market, with customer groups being identified that are characterized within a segment by similar risk management requirements. It has thus been possible to develop services focused on specific economic sectors.

This broadened focus on the part of corporate insurers will not only result in increased customer satisfaction, but will also have an effect on customers' competitiveness. Alternative risk financing solutions can therefore facilitate efficiency in both the buying and selling processes of corporate customers. This has been shown by Swiss practice, for example in the extension of product guarantees to promote sales processes, or in the improved handling of financing in connection with purchasing processes. This will also affect the classic understanding of the roles between the insured and the insurer, as both now have a mutual interest when it comes to achieving a good underwriting result and a transparent solution.

Once corporate customers' risk management requirements resulting from the broadened focus have been determined and



structured, we have the basic prerequisites for an ARF marketing strategy for an economic sector. Market penetration acquires a broader dimension as a result, because not only individual customers but also customer groups within a segment can be processed systematically. This should result in a more efficient and full utilization of the potential market.

A Combination of Individual Risk Transfer and Self-Funding

One alternative risk financing tool is the finite risk market service, which is characterized by a combination of individual risk transfer and self-funding. Swiss practice shows that finite risk solutions can be placed in three primary areas: as a replacement for traditional risk solutions, as a supplement to existing risk covers, and as a combination of the two. Depending on the extent of risk transfer and the degree of self-funding and service, a finite risk contract of several years duration reflects a risk solution close to that of a bank or an insurance company. It also provides for a substantial participation in the development of the risk. The risk cover may include both an event-related or an annual limit and a sum insured over the entire period of the contract, and may be applied both retrospectively and prospectively.

The market strategy of "individual consideration for medium-sized enterprises" can be illustrated well by the example of a Swiss university hospital. This involves replacing an existing traditional insurance solution with a finite risk market solution. The hospital, which for years has been faced with rising liability insurance premiums, is interested in carrying a substantial participation in the risk. As claims payments fluctuate substantially each year, a conventional retention arrangement is not attractive because of budgeting considerations. A multi-year finite risk solution to even out periodic losses (payments and reserves) in the area of the retention would allow the hospital to achieve capital appreciation in the form of interest income on the premium reserves in the self-funding portion and a multi-year guarantee of cover at a stable premium agreed at policy inception.

Should the capital appreciation obtainable with ARF instruments be eroded by the development and implementation costs, interest in such a solution would inevitably wane. Corporate insurers are therefore investigating whether individual interests can be combined to form a collective interest in such cases. The formation of a "customer group for small enterprises" may be justified either through the fact that the enterprises belong to one branch of the economy or that they represent the same kind of challenge for corporate financing. Such a community would be characterized by the fact that it could develop a potential for improvement, with no mutual impairments occurring in their market. The impetus for this may come either as a result of legal influences or from market analyses. As soon as the community of risks has reached the critical size, an ARF solution will also result in capital appreciation for each individual member.

This can be illustrated using the example of small and medium-sized enterprises united in an association. The individual companies, which, because of their business activity, have a substantial property portfolio, are exposed to an increased business risk because of fluctuations in the mortgage rate. From the borrowers' point of view, conventional financing through the credit market is only available at unfavorable conditions on account of interest rates being fixed on a semi-annual basis. After the critical size has been reached (portfolio), a multi-year finite risk solution will act as "insurance against changes in interest rates" and so lead to a smoothing of interest charges for the community members. A tailor-made risk financing solution for the community, consisting of retention, self-funding and risk transfer elements, acts for the lenders like a credit enhancement instrument. This results in lower costs of borrowing, which in turn has a positive effect on the core business.

Corporate Insurers Still Challenged

Corporate insurers have considerably contributed to the development of ARF solutions such as in the finite risk example. In isolated cases, organizational structures already exist which provide for a marketing strategy based on customer groups. Homogeneous requirements of a collective body mean that customer needs no longer have to be analyzed and structured from scratch. Medium-sized and even smaller enterprises should therefore also be able to enjoy the benefits of ARF solutions. Any successful implementation of ARF market solutions for a collective requires their agreement, as on the customer side a lesser degree of individualization has to be accepted. Even when pursuing a target customer group strategy, financial services providers are still called upon to define their risk capacity. Optimum risk handling will continue to be a constant challenge for risk management on both the supply and demand side.

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