

IMPLEMENTING ERM



RISK OPTIMIZATION

- How do we decide how much risk to retain and how much to transfer?
- Do we have an appropriate risk financing policy to guide decisions on hedging and insuring risks?
- Can we demonstrate that our risk retention decision is consistent with other corporate financing decisions?

OVERVIEW

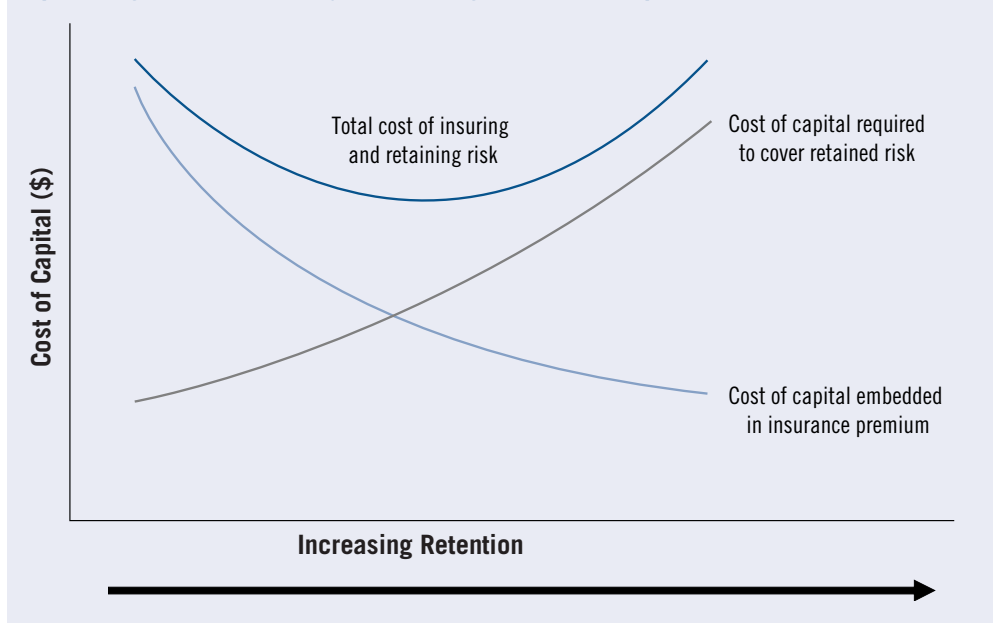
Companies use a variety of forms of capital to bear risk and finance their operations. Ultimately, shareholders bear all the risks that have not been transferred to lenders and insurers. In this context, insurance is just another form of capital — a very specific form of contingent capital that becomes available when a company experiences a defined loss. As such, decisions about the types of insurance to purchase and the amount of risk to retain are as important as decisions related to the amount of debt and equity a firm needs. In fact, risk managers' insurance purchasing decisions should be based on a rigorous corporate finance framework that determines the trade-offs between purchasing an additional unit of insurance and the consequent change in the firm's cost of capital.

THE TOWERS PERRIN APPROACH

Managing insurance through the prism of corporate finance sounds complex. In reality, decisions are made on the basis of a "simple" criterion: If the cost of buying an extra unit of insurance is greater than the cost of the extra risk capital used to retain risk, don't buy it.

Although this criterion may seem simple, in practice the analysis involved can be complicated. Towers Perrin uses robust analytics built on a sophisticated

Optimizing Risk Retention by Considering the Cost of Capital



financial and actuarial foundation to provide important insights that compare and contrast alternative risk financing programs.

We help clients:

- Determine appropriate retention levels across all classes of risk by comparing the cost of insurance to the cost of alternative sources of capital
- Improve risk financing decisions by evaluating integrated risk relationships, benefits of internal hedges and optimization of alternative risk financing programs

- Save on insurance costs through innovative use of traditional and nontraditional sources of contingent capital
- Enhance corporate governance, monitoring of risk controls and alternative risk response treatments, and the use of directors and officers insurance by aligning the organization and creating a transparent line of sight to retained risks.

Clients that have undertaken a rigorous retention optimization exercise are able to produce a formal Risk Financing Policy Statement, which may provide both quantitative and qualitative validation of risk transfer and optimization decisions. This policy can be used as a communication tool to explain risk transfer decisions across many different classes of risk — from directors and officers liability to hazard risks.

A RECORD OF SUCCESS

Towers Perrin is a recognized industry leader in the area of enterprise risk management (ERM) and risk financing. We work with hundreds of clients around the world to:

- Determine appropriate levels of risk retention and transfer
- Compare the trade-offs between the long-run cost of capital to retain versus transfer risk
- Compare the opportunity cost of different forms of risk capital, recognizing the value at risk, tolerance for risk, capital structure of the firm and consideration of insurance as a form of contingent capital
- Obtain premium savings, create better use of market capacity and closely match retained risk with tolerance for risk.

ABOUT TOWERS PERRIN

Towers Perrin is a global professional services firm that helps organizations improve their performance through innovative human capital and risk and financial services solutions.

Towers Perrin's Enterprise Risk Management practice offers clients the ability to understand the full spectrum of risks faced by their organization and to create additional value by actively managing their key risks.

To contact Towers Perrin or learn more about how we can assist your organization, please visit www.towersperrin.com/rfs/riskoptimization.