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SYNTHETIC DEBT AS RISK FINANCE MECHANISM

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1. Introduction

Risk finance mechanisms play an important role in preventing the possible outcomes of risk on cash flows volatility

- → in the case of risk occurrence, a company needs funds to restore its assets and continue operations
- → by implementing various risk finance mechanisms companies acquire an access to additional sources of funds
- → accordingly, implementation of risk finance mechanisms helps to maintain cash flows equal to those possible to achieve in the case of undisturbed activity

Purpose of the study:

- **→ to identify features of synthetic debt as risk finance mechanism**
- **→ to identify examples of synthetic debt applicable in corporations**

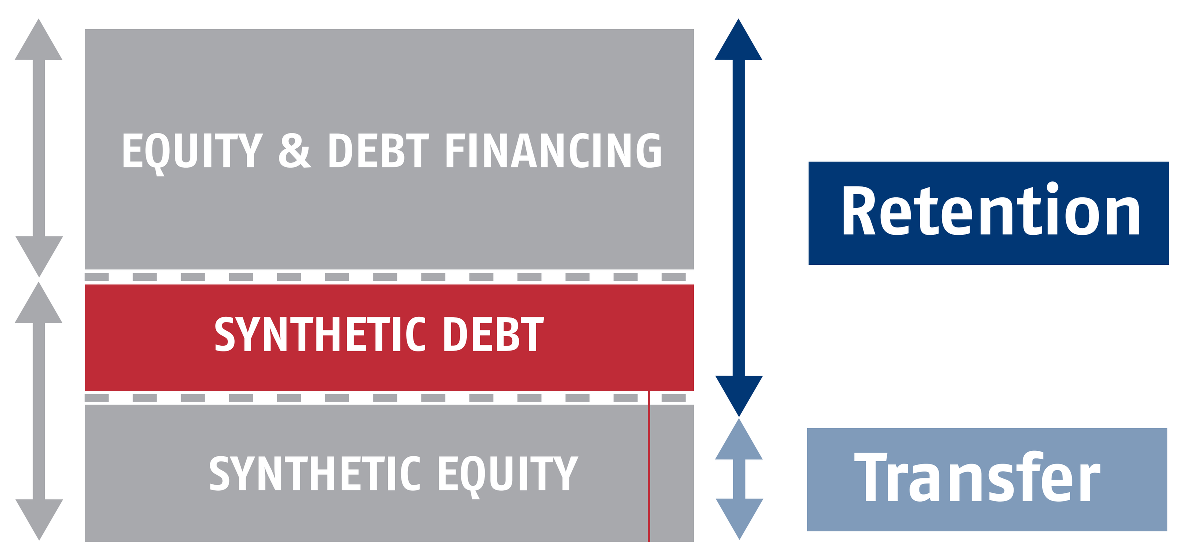
2. Risk finance mechanisms – general characteristics

the risk is ultimately financed by a company exposed to risk		the risk is ultimately financed by an entity to whom the risk was transferred to (insurer, derivative partner)
Retention	⟷	**Transfer**
formal or informal capital of reserves	various instruments that combine retention and transfer	insurance, derivatives

3. Extended view on company's capital structure

balance sheet risk finance
(sources presented in company's balance sheet)

off-balance sheet risk finance
(sources not presented in company's balance sheet)



SYNTHETIC DEBT
is an off-balance sheet source of risk finance within risk retention

4. Why off-balance sheet retention represents synthetic debt?

- → in terms of risk retention a company's equity holders eventually bear the costs of adverse risk occurrence
- → in this context, risk retention is similar to traditional debt finance
  - – retention represents fixed rather than residual claims
  - – by implementing retention tools a company acquires alternative source of borrowing funds

5. Examples of synthetic debt finance

Captive	– A form of economic capital reserves which are formally set behind a company (as a separate entity) – As a company is an owner of the captive, it remains a form of risk retention
Finite risk programs	– A formal economic reserve constituted before or after the occurrence of a given risk – The capital reserve is formed and kept by a third party (which is contractually obliged to cover any shortages of capital reserve, up to a predefined limit)
Contingent capital facility	– A form of option on issuance debt/equity, on predetermined conditions – In the case of risk occurrence, a company has a right to issue additional debt/equity which is sold to contractually agreed partner (usually a bank)
Multi-line, Multi-year and multi-trigger products	– Innovative insurance-type contracts, with higher level of retention expressed by high caps (limits), co-insurance features or coverage exclusions

The examples of synthetic debt instruments belong to so called ART (Alternative Risk Transfer) mechanisms, which have developed recently and represent innovative routes and approaches to transferring insurable risk

6. Conclusions

- → extended view on company's capital structure helps to highlight the importance of off-balance sheet sources of funds available for risk coverage
- → the inclusion of synthetic debt opens new directions of estimating company's risk retention capabilities and programming risk transfer application
- → synthetic debt as risk finance mechanisms belong to ARTs, which requires well-developed financial markets and appropriate skills and understanding by both sellers and end-users
  - – emerging markets (such as Polish market) still face many barriers of wider use of these mechanisms (in particular legal barriers)
  - – most feasible examples of synthetic debt on emerging markets are multi-line, multi-year and multi-trigger solutions

7. Relevant literature

1) Banks, E. (2004), Alternative Risk Transfer. Integrated Risk Management Through Insurance, Reinsurance and Capital Markets, Chichester: John Wiley & Sons.
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4) The Picture of ART, Swiss Re, Sigma 1/2003.

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