

# Role of insurance in corporate finance

[Economics](#), [Insurance](#)



In recent years there has been considerable growth in the use of credit derivatives, which protect lenders against the risk that a borrower will default. For example, bank A may be reluctant to refuse a loan to a major customer (customer X) but may be concerned about the total size of its exposure to that customer. Speculators in search of large profits (and prepared to tolerate large losses) are attracted by the leverage that derivatives provide. By this we mean that it is not necessary to lay out much money up front and the profits or losses may be many times the initial outlay. " Speculation" has an ugly ring, but a successful derivatives market needs speculators who are prepared to take on risk and provide more cautions people like our farmer and miller with the protection they need. For example, if an excess of farmers wish to sell wheat futures, the price of futures will be forced down until enough speculators are tempted to buy in the hope of a profit. If there is a surplus of millers wishing to buy wheat futures, the reverse will happen. The price of wheat futures will be forced up until speculators are drawn in to sell. Speculation may be necessary to a thriving derivatives market, but it can get companies into serious trouble. Most businesses take out insurance against a variety of risks. Insurance companies have considerable expertise in assessing risk and may be able to pool risks by holding a diversified portfolio. Insurance works less well when the insurance policy attracts only the worst risks (adverse selection) or when the insured firm is tempted to skip on maintenance and safety procedures (moral hazard). Insurance is generally purchased from specialist insurance companies, but sometimes firms issue specialized securities instead. The idea behind hedging is straightforward. You find two closely related assets.

You then buy one and sell the other in proportions that minimize the risk of your net position. If the assets are perfectly correlated, you can make the net position risk free. The trick is to find the hedge ratio or delta that is the number of units of one asset that is needed to offset changes in the value of the other asset. Sometimes the best solution is to look at how the prices of the two assets have moved together in the past. On other occasions a little theory can help to set up the hedge. For example, the effect of a change in interest rates on an assets value depends on the assets durations. If two assets have the same duration, they will be equally affected by fluctuations in interest rates. Once you have set up the hedge, you can take a long vacation, confident that the firm is well protected. However, some hedges, such as those that match duration's, are dynamic. As time passes and prices change, you need to rebalance your position to maintain the hedge.

Reference: <http://classof1.com/homework-help/corporate-finance-homework-help>