



Covering It All

Transurance offers an innovative approach to insuring traditionally uninsurable losses.

by Bruce B. Thomas and L. Ware Preston III

In theory, insurance proceeds are supposed to restore policyholders to the same position that existed before a loss occurred. In practice, this is impossible. Most insurance requires policyholders to retain a portion of their loss experience in the form of deductibles and retentions, coinsurance and amounts in excess of the insured limit. Moreover, many losses that are caused by insurable events are effectively uninsurable because they are so difficult to define in an insurance policy and because it is impossible to prove the full extent of those losses after they have occurred. Policyholders often have considerable discretion over some types of collateral costs, making them impossible to quantify and subject to significant moral hazard.

Anyone who has ever suffered a large loss knows that the economic cost of insured loss events is generally much greater than the amounts recovered from insurance. Consider for example a large property loss, such as a factory building, caused by a fire. Since the factory is a physical thing, the existence and extent of the property loss can be readily determined. Nevertheless, the indirect or collateral costs associated with this loss, even with business interruption and extra

expense coverage, are generally not covered by insurance. These costs may take the form of lost revenues, expenses and resources necessary to recover from a loss, which are often discretionary in nature, and expenses necessary to prosecute an insurance claim. In addition to the costs that are clearly covered and those that are not, many types of loss do not fall into either of these categories. These types of collateral costs require significant judgment and typically lead to coverage disputes.

The insurer will involve its own experts, and a negotiation process will ensue until the parties can settle on an amount of money to be paid. Generally, this amount is more than the insurer would like to pay and less than the amount of the loss that the policyholder thinks is due. Insurance for large corporations is subject to a great deal of negotiation, and at some point, it is better for both parties to settle the claim and move on.

Since collateral losses are becoming an ever larger part of most companies' loss experience, it is in both parties' interest to try to cover these costs. The more they attempt to cover these losses in a traditional insurance policy, however, the more coverage disputes they have. Insurers already spend about 40% of every premium dollar

Key Points

- The indirect or collateral costs associated with typical commercial losses are generally not covered by insurance.
- Transurance permits insureds to select a functional relationship between insurable losses and losses that are correlated but uninsurable.
- Because of its functional relationship with traditional policies, transurance includes almost no transaction costs.

they earn on transaction costs, and it is difficult to justify spending an even greater percentage by covering collateral losses. Spending more and more money on the underwriting and loss adjusting processes is a waste of resources that only makes the solution worse than the problem.

Transurance is a new class of insurance that has been designed specifically to cover collateral losses. It differs from traditional insurance in that it permits insureds to specify a functional relationship between insured loss recoveries and other losses that are correlated but uninsurable. Transurance meets all of the requirements necessary to qualify as insurance from a legal and regulatory perspective. Although it can be applied to any type of insurance, its greatest potential is as a supplement and complement to commercial insurance.

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How Transurance Works

Transurance is based on traditional insurance policies. By permitting insureds to select a functional relationship between insurable losses and other losses that are correlated but uninsurable, transurance permits companies to objectify the uncertainty associated with collateral losses. In this way, transurance makes uninsurable losses insurable.

The best way to understand the benefits of transurance is with an example. Consider the following. A risk manager is concerned about insured losses that might range from \$0 to \$1,000. The risk manager recognizes that there are likely to be collateral losses that are uninsurable over this range of loss experience, and he or she would like to examine what effect a transurance policy might have on the

net loss experience.

The risk manager has the following choices:

- Purchase an insurance policy for a premium of \$30 that contains a deductible of \$50 and an insured limit of \$1,000.

- Buy the insurance policy and supplement it with a proportional transurance policy, which pays 30% of the losses paid by the traditional policy and costs 30% of the insurance policy's premium, which is \$9. Thus, the combined cost of insurance and transurance would be \$39.

"Transurance Supplements Insurance" (below) illustrates these two options over the relevant range of loss experience.

The relationship between insurance and transurance is symbiotic. Although transurance cannot exist

without insurance, insurance cannot address collateral losses that are not insurable without transurance. Transurance makes insurance more worthwhile as well, since collateral losses often make insurance unprofitable for insurance companies and unsatisfying for insurance buyers.

With traditional insurance, the buyer can increase or decrease the deductible or the limit, but that is all. For a given level of loss, traditional insurance is limited to losses that can be defined and proved. Transurance expands insurance coverage so that it can cover costs that are collateral to insurable losses.

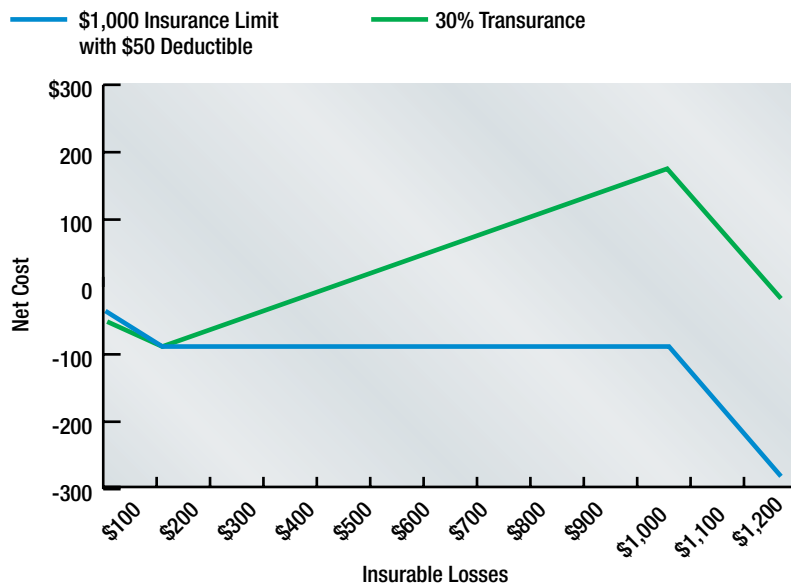
Buyer Value

Because there are no traditional financial or insurance products that deal specifically with collateral losses, companies are left with two relatively unappealing choices. They can self-insure by maintaining larger cash balances than they would otherwise need, or they can try to finance these losses after they have had a large loss. Maintaining higher cash balances for many years just in case one has a large loss is a very inefficient way to finance infrequent losses. It also does not make sense to rely too heavily on one's ability to obtain cheap financing after a large loss. Given how financially and operationally leveraged companies are these days, these events often call into question the company's viability and prompt credit reviews.

Transurance supplements conventional insurance by giving the policyholder the ability to objectify more of the uncertainty associated with insurable events. Where losses are difficult to quantify or prove, it enables insurance buyers to select the right level of coverage based on their judgment of how significant collateral losses are likely to be. Two competing desires will inform their decision. On one hand, buyers want assurance that they have enough coverage to be made reasonably whole after a significant loss. On the other hand, they will not pay for coverage that they do not need.

Given that buyers do not have to

Transurance Supplements Insurance



The chart above illustrates how insurance and transurance policies impact a company over a range of insured loss experience. The X axis represents the amount of insured loss that the company might experience, and the Y axis represents the net cost of each of these options, which includes any insurance and transurance recoveries minus premiums paid, insured loss and the deductible. In this example, the policy has a premium of \$30, a deductible of \$50 and an insured limit of \$1,000. The blue line in the chart shows the range of loss experience mitigated by insurance. Note that the \$30 cost of insurance premiums and the \$50 deductible prevent the insurance option from reaching the \$0 cost line, even without considering the possibility of collateral losses.

By contrast, the green line shows that a 30% proportional transurance policy added to the original policy provides significant benefits to the insured over the complete range of loss experience. Transurance not only makes up for the premiums and the deductible that the insured paid, but also offers the ability to cover additional collateral losses that the insured is certain to have, but are either difficult to prove or cannot be covered by insurance.

Source: Risk Innovations LLC

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demonstrate need in advance, substantiate loss experience after the fact, or worry about possible conflicts with traditional insurance, transurance imposes almost none of the expense and hassle of buying traditional insurance. This simplicity and ease of use create two additional benefits for insurance buyers.

First, transurance is significantly cheaper than conventional insurance, if it is sold at the same rate as the underlying insurance, due to the buyer's expense savings. When one considers the cost of insurance, people normally think of their insurance premiums. This makes sense for individuals because their transaction costs are relatively small. Large companies, however, also need to recognize the amount of costs that they incur to buy their insurance and the costs that they are expected to bear as part of the loss adjustment process.

Second, transurance gives insurance buyers extraordinary freedom to select the level of coverage that they feel is most appropriate. Policyholders can opt for greater or lesser transurance coverage based on how the purchase relates to their underlying insurance structure and their desire for collateral loss protection.

Finally, transurance creates a new source of risk capital for insurance buyers. To the extent that companies buy transurance from insurers other than the same companies who are providing their traditional insurance, transurance can help diversify the policyholder's credit and counterparty risks. Combined, these advantages make transurance extraordinarily useful and valuable to commercial insurance buyers.

Insurer Rationale

Transurance has so many benefits for the insurance buyer that it is tempting to think that it must be bad somehow for insurance companies. However, transurance is equally attractive to insurers. Piggybacking off of conventional insurance, transurance eliminates the need for complex coverage definitions, lengthy underwriting and involved loss adjustment processes.

Selling, underwriting and loss adjustment activities are reduced from days, weeks and months to minutes. As a result, transurance is at least as profitable as conventional insurance, even if it is sold at the same underlying rate.

Transurance also can assist insurers who want to diversify their loss exposures. For a given amount of capital, transurance exposures are effectively more diversified. This is because a transurance policy is essentially a fractional insurance policy that enables coverage providers to write more exposures with a given amount of capital.

Transurance is also an attractive way for insurers to enter new markets. Where insurers do not have the expertise or resources to underwrite and service traditional insurance, they can piggyback on the knowledge and capabilities of the primary insurer to underwrite these additional types of risks and gain experience in new markets.

Policyholders routinely suffer

adverse consequences that are correlated to insurable losses but not covered by their insurance. This makes the insurance loss adjustment process difficult and contentious. The difference between the totality of loss suffered and the amount actually paid by insurance is usually both material and uncertain. Business people realize, often from exasperating experience, that insurance covers only a portion of their "insurable" losses. In effect, insurance leaves a large residual risk that cannot be insured by conventional means without compounding the problem.

For losses that are collateral to insured losses, transurance is a solution. Transurance leverages the hard work and expense of buying commercial insurance to enhance a company's existing insurance so as to cover collateral losses. By eliminating most of the transaction costs of commercial insurance, transurance is an efficient way of insuring losses that would otherwise be uninsurable. **BR**

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