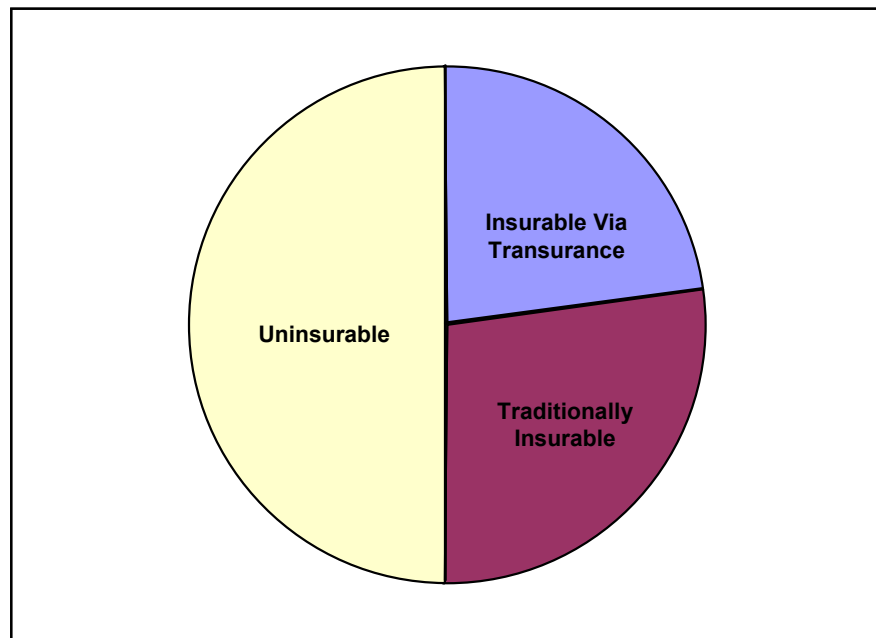


## **Making More Operational Risk Insurable** **By Bruce B. Thomas and L. Ware Preston, III**

Financial institutions are more operationally and financially leveraged than ever before. Most of the time this is highly advantageous, but greater interdependence and leverage makes it critically important for companies to take advantage of all means of managing operational risk, including ways to make more operational risk insurable.

Basel II defines operational risk as “The risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.” A large portion of operational risk is not insurable because it arises directly from the care that the organization takes in managing the people, processes, and systems in its internal and external business environment. Attempting to insure the risk of loss from these activities would induce moral hazard; the company would not be as concerned about managing these risks, and the resulting losses would make these transactions uneconomic for insurers.

### **Operational Risk**



### **Insuring Operational Risk**

Insurance can be used to cover the portion of operational risk that is sufficiently fortuitous to be considered outside of management’s control. However, traditional insurance is limited further to those loss events that can be defined well enough to include in an insurance contract and to that portion of losses that can be objectively measured.

While these restrictions limit the amount of operational risk that can be covered by traditional insurance, a new form of insurance called Transurance makes a larger portion of operational risk insurable. Transurance supplements traditional insurance recoveries to fund costs that are consequential to covered losses but which are not covered by traditional insurance.

### **Transurance**

Transurance is an “agreed value” form of insurance that is expressed as a percentage of the loss recovery from a traditional insurance policy. For example, a company might specify that it wants a 20% Transurance policy referencing its property insurance. The insured will pay 20% of its property insurance premium to purchase this additional coverage and will receive 20% of the loss payment it is entitled to from its property insurance policy. Furthermore, Transurance payments track payments from the referenced property insurance.

Essentially, Transurance provides insurance buyers with an opportunity to super-size their insurance loss recoveries. In effect, the parties to the Transurance policy described above have agreed that the insured will pay 20% more in premium to get 20% more loss recovery. Like life insurance, the insured decides how much coverage to buy, does not have to prove the amount of the damages, and can use the proceeds without restriction.

Transurance can be used to expand the portion of a financial institution’s operational risk that is insurable by paying for:

- The difference between claimed amounts and amounts that are reimbursed by the traditional insurance policy;
- Losses that are quantifiable but which are not covered by Traditional insurance; and
- Losses which are impossible to quantify because they impact the firm’s on-going business via increased operating expenses, increased capital costs, opportunity cost, and revenue losses.

Since Transurance pays as payments are made by the referenced insurance, it has the added benefit of at least partially offsetting the difference between the estimated ultimate cost of an insurable event and the expected insurance recovery.

### **Recalibrating Deductibles**

One obvious use of Transurance is to pay for insurance deductibles that risk managers feel are out of alignment with their true needs. Whether artificially high deductibles are the result of a loss the company has already experienced or some loss that adversely affected the entire insurance industry, Transurance can be used to change a deductible into a “disappearing” deductible since it pays more as the loss recovery increases. As the loss increase, Transurance may pay much more than the deductible.

Companies that have experienced dramatic growth may feel that they have outgrown their deductible. In this situation, risk managers may decide to increase their insurance deductible and buy Transurance coverage on the restructured insurance program. Used in

this way, Transurance can decrease the total premiums they pay while increasing their insurance limits and the financial value of their combined insurance program.

### **Sublimits and Policy Limits**

It is not unusual for risk managers to be concerned about the limitations imposed by coverage restrictions. Here, Transurance may help alleviate that concern by making funds available to pay for the uncovered portions of these losses.

### **Quota Share Substitute**

Since the Transurance percentage determines the premiums charged and the loss reimbursement due, Transurance may be substituted for a quota-share participation. In fact, there are several reasons why it may be preferable. Fully placing a given layer may adversely affect the pricing and the coverage terms. Moreover, the insured can use the Transurance proceeds as they wish, and they do not have to prove these damages.

### **Business Interruption**

Risk managers in financial institutions are often concerned that they will not be able to substantiate business interruption losses to the satisfaction of their insurers. In this situation, adding Transurance coverage can help supplement or complement traditional business interruption coverage. While the Transurance payment may not exactly match the actual losses sustained, there is no additional hassle in getting this payment, and the amount of the payment is easily determined.

### **Contingent Business Interruption**

Many businesses are dependent on third parties to provide key operational components such as man-power, systems, and office space. Companies can buy Transurance policies on the insurance policies of these suppliers to ensure that they are financially protected from the collateral damage that would ensue if these business inputs were disrupted by insurable events.

Used in this way, Transurance may function as another type of contingent business interruption coverage. To the extent that companies are concerned that they may have a difficult time proving contingent business interruption losses or are worried about restrictions that may be placed on the use of the insurance proceeds, Transurance may be considered a superior substitute for this type of coverage.

More information about Transurance can be found at [TransuranceServices.com](http://TransuranceServices.com). Bruce B. Thomas and L. Ware Preston, III are managing directors at Transurance Services, LLC. You can contact them by calling Bruce at 203-445-0830 and Ware at 203-356-1583.