

Structuring Property Transurance Coverage: A Case Study
By Bruce B. Thomas and L. Ware Preston, III

Despite their best efforts, organizations still face many uninsurable costs when a covered property loss strikes. Many expenses are too difficult to describe or quantify to include in a traditional insurance policy. Other costs are not provable or are deemed too discretionary to be covered by traditional insurance.

These “collateral damages” typically range from 15 percent to 40 percent of insurance recoveries, and they have been increasing as companies become more operationally and financially leveraged. Property Transurance is a new type of property coverage that is sold by Arch Insurance Group. Property Transurance provides companies with funds that they can use to pay for these costs, as they see fit, without qualification in a simple and cost-effective way.

Buyers simply specify an amount of money that they would like to receive in addition to their property insurance recovery. This amount is specified in terms of a percentage of the loss paid by their property insurance policy. For example, an insured that buys 20 percent Transurance coverage will receive 20 percent more than the amount it receives from its insurance policy to pay for the collateral damages it anticipates.

The premiums charged for property Transurance are typically the same percentage multiplied by the buyer’s insurance premium. Thus, in the previous example, the company would pay 20 percent more in premiums to buy 20 percent Transurance coverage.

Transurance provides coverage for a new class of risk on the same economic basis as traditional property insurance, but without all the hassle and limitations, since the underwriting and loss adjustment processes are largely administrative. No proof of collateral damages is required, because Transurance claims are automatically paid as a percentage of losses paid by the referenced insurance policy.

Experienced risk managers know they will have significant collateral damages if they have a property loss. Not buying Transurance, now that it is available, would be the equivalent of taking a quota-share retention, which is not something that they would typically recommend. However, Transurance also offers risk managers an opportunity to reassess and restructure their current property insurance programs to better suit their companies’ needs.

Risk managers often set policy limits (for layered programs) by considering worst case loss scenarios. They set deductibles by thinking about their company’s “pain threshold.” Below this threshold, the company is able to manage losses without having any insurance. Above this amount, the company will find it increasingly difficult to finance the costs of an insurable event. Using this same thought process, Risk Managers can now

consider the impact of collateral damages on their company as a way to help them structure their Transurance coverage.

Consider the following example:

ABC, Inc., a manufacturer, pays \$400,000 for a policy with a deductible of \$50,000. The company has multiple locations, and although it has a blanket limit of \$200 million, the company's maximum foreseeable loss is \$100 million, which would involve the destruction of its main plant. The upper bound of ABC's pain threshold is \$1 million.

Sue Brown, ABC's risk manager, is interested in Transurance because she experienced large property losses and collateral damages at her previous employer. Although ABC has the most comprehensive coverage available, Sue recognizes that a portion of any sizable claim that ABC may have is likely to be disputed, particularly as it relates to business interruption and extra expense coverages. Despite her best efforts, Sue knows that ABC is likely to receive 10 percent to 20 percent less than the amount it submits in its proof of loss.

Based on her knowledge of the company, she also is concerned that ABC would experience business continuity costs of 10 percent to 20 percent of any insured loss events in excess of \$5 million. At this point, manufacturing operations would be significantly impaired, management would be distracted, revenues would be lost and many additional expenses incurred as the company attempted to recover from the loss.

Although Sue believes that ABC's risk management practices are sound, the company is extremely cost-conscious. She would like to make a good case to the CFO for reasons ABC should buy Transurance. The best way to win the CFO's support, she feels, is to discuss the collateral damages ABC would suffer in the event of a large property loss.

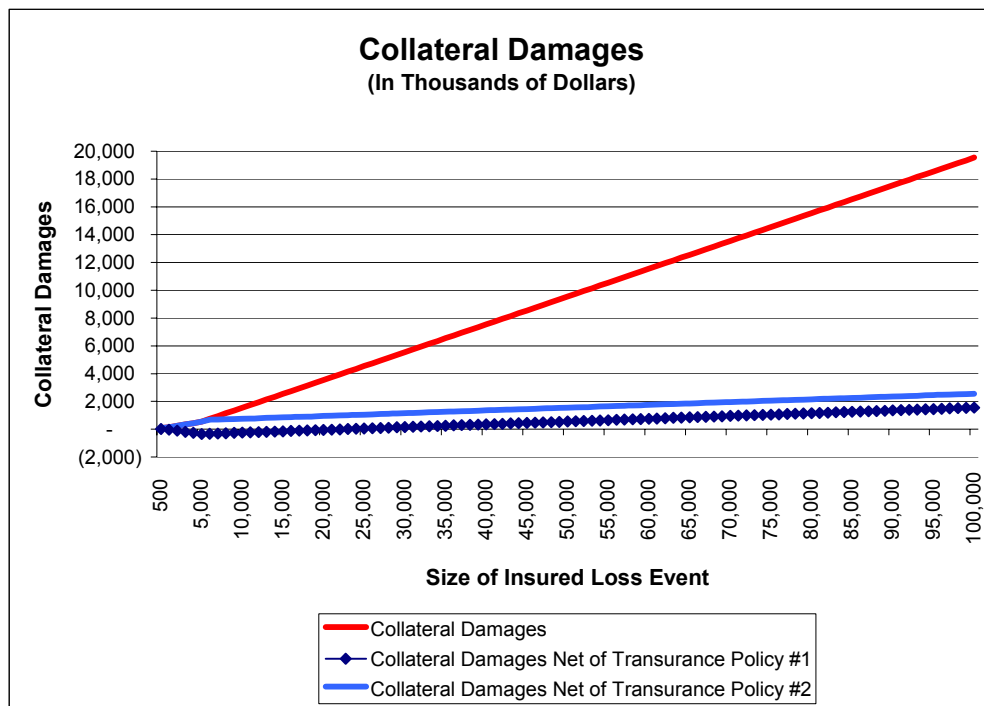
To this end, Sue has compiled a spreadsheet of information to help her estimate the amount of collateral damages ABC would experience with an insured property event of any size. To be conservative, she has chosen to use the lower bounds of her collateral damage estimates in her computations. She makes all of her assumptions explicit so that the CFO can assess her work and help her determine the best use of the Transurance coverage that is available to ABC.

ABC's Property Insurance Program
(In Thousands of Dollars)

Property Insurance Policy		Proposed Transurance Policy #1	
Insurance Deductible	50	Transurance %	20%
Insurance Premium	400	Transurance Deductible	-
Loss Pain Threshold	1,000	Transurance Premium	80
Business Continuity Threshold	5,000		
Lower of MFL or Insurance Limit	100,000	Proposed Transurance Policy #2	
		Transurance %	20%
		Transurance Deductible	1,000
		Transurance Premium	48
Collateral Damage Estimates			
Claim Settlement Shortfall as a % of Insurance Recovery	10%		
Business Continuity Expense as a % of the Insurable Event	10%		

Sue has modeled the effect of two different 20 percent Transurance policies. Policy number one contains no Transurance deductible, and it pays 20 percent of the amounts paid by ABC's property insurance. Policy number two contains a \$1 million Transurance deductible, which decreases the Transurance premium by \$32,000. However, the tradeoff for this premium reduction is that policy-one pays \$1 million before policy-two begins to pay.

The accompanying graph shows that ABC's exposure to collateral damages is significant and that both of the Transurance policies would substantially cover these damages. While neither policy covers the damages precisely, Transurance policy-one reduces the collateral damages to less than \$1 million until the loss event reaches \$73 million. Transurance policy number-two does not start to pay until ABC is approaching its pain threshold of \$1 million. At its maximum foreseeable loss of \$100 million, Transurance policy number one would have reduced ABC's collateral damages from \$19.6 million to \$1.6 million. Transurance policy number two would have reduced these damages to \$2.6 million.



Sue shows this information to her CFO. She explains that in the past, risk managers only looked at the traditionally insurable portion of insured loss events because there was nothing they could do about the uninsurable costs that went along with them. Nevertheless, these collateral damages represent real costs to ABC in the form of cash outlays or lost revenues. Now that Transurance exists, ABC must consider the total cost

of an insured loss event and determine the best way of financing the collateral damages that exceed its pain threshold.

They discuss the collateral damages ABC is likely to face and the merits of the different Transurance policies that ABC could buy. Since the Transurance is priced at the same rate as ABC's traditional property insurance, it is clear to the CFO that it has at least as much value as the insurance they have already purchased.

Sue points out that while Transurance is not a substitute for their property insurance, she feels it's a better value for the simple reason that negotiating coverage and claim settlements are expensive and time-consuming activities. In comparison with the work required for ABC's traditional property insurance, the purchasing and settlement processes of Transurance seem hassle and cost free.

Transurance policy-two is attractive because its cost is 40 percent less. On the other hand, Transurance policy-one does a better job of preventing ABC from hitting its pain threshold of \$1 million. The CFO prefers policy-one because he thinks ABC's real collateral damages could be considerably worse than what Sue has estimated.

Although the first policy costs more than the second, it seems like the safer bet to the CFO. The chances are that any insured loss event will have all sorts of costs that they cannot possibly envision in advance. ABC will need money for repairs, and it will find uses for any money it has. The worst that can happen from buying the extra coverage is that ABC gets back a little more money than it needs—a risk that the CFO is comfortable taking.

While the CFO is comfortable with this rationale, he is not certain what ABC's president will think. The president is fond of asking difficult questions to stimulate thinking, and the CFO thinks that it is useful to present him with policy-two as well. At \$5 million of insured loss, the Company's property insurance is considerably less expensive. Losses of this size are rare, but it is at this level that insurance makes the transition from being valuable to being invaluable.

More information about Transurance can be found at 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.