Insuring Collateral Retained Losses

By L. Ware Preston, III and Bruce B. Thomas

According to the property claim experts, insureds should expect insurance to pay only 76% to 87% of the final amount that they claim.[1] Adding expenses and damages for things that are not claimed because they are clearly not covered by insurance, it is reasonable to expect that property insurance pays for only 65% to 75% of the total economic damages that insureds face from property loss events. This implies that insureds should expect a recovery shortfall that will amount to 30% to 50% of the property insurance payment. This is a large amount of money that insureds cannot reasonably ignore.

This shortfall is *collateral* to every insured property loss, no matter how broadly the policy is worded and no matter how skillfully the claim is handled. For example, if an insured collects $5 million from insurance, it should expect an uninsured loss (not including deductibles) in the range of $1.5 to $2.5 million. If the insured collects $10 million, it should expect an uninsured loss in the range of $3 to $5 million. For purposes of this article we refer to these uninsured losses as *collateral retained losses*.

For most insureds, *collateral retained losses* associated with a large property loss will be many multiples of the deductible. This is a material loss that they have not yet factored into their risk financing program. Given the magnitude of *collateral retained losses* and the fact that they occur in conjunction with every insured property loss, corporations must take a more proactive approach to this issue if they want their risk management practices to be taken seriously. Ignoring *collateral retained losses* in favor of an ad hoc approach after a loss occurs is imprudent and makes a mockery of the very principles of risk management. But what realistically can a company do?

While traditional property insurance is incredibly valuable and is many times cheaper than holding extra capital, it does not work well for covering damages that are hard to define and measure, or that require the insured to exercise judgment about mitigating the effects of the loss. One cannot insure *collateral retained losses* by eliminating deductibles and increasing insurable limits or by incorporating additional policy wording that requires even more judgment. Given these limitations, it is understandable that property insurance, by itself, will not suffice to make an insured financially or operationally whole after a loss.

In terms of planning a financial response to this risk, there are only two options. One can explicitly self insure *collateral retained losses* by setting aside funds, or one can purchase insurance for these losses.

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[1] A survey of property claim experts conducted in December of 2009 revealed that on average insureds were paid only 76% to 87% of the final amounts that they claimed. Many damages that the insureds suffered were not claimed because the insureds had no reasonable basis for including them in their insurance claims. The survey findings are written up in the article entitled *Not Fully Paid: Property Claim Experts Speak Out,* which is available for download at TransuranceServices.com.

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In theory, one might change the firm's capital structure by increasing debt and equity so as to have more cash on hand to fund these losses. In practice, this rarely makes sense. Self-funding highly infrequent losses is expensive and shareholders do not like companies retaining large amounts of seemingly idle cash. Thus, the economically preferable solution is to insure *collateral retained losses.* But how does a company insure losses that traditional insurance cannot cover? How does one insure losses that are difficult to contemplate, difficult to quantify, and subject to discretion?

If *collateral retained losses* will be at least 30% of whatever is paid by the property insurance, why not buy a supplemental insurance policy that pays 30% of the amount paid by property insurance and rely on the insured's capital structure for the balance of any additional funding that is necessary? This would be much more financially efficient than holding capital for the entirety of this risk.

Assuming that this supplementary insurance coverage cost the same as the property insurance it references, there are only two valid reasons for not buying it: either the traditional property insurance has no value or the supplemental coverage does not exist. Fortunately, neither of these reasons is valid. Companies purchase property insurance because it has tremendous value, and there is no question that insurance is much more preferable than maintaining extra amounts of cash to pay for large, unexpected, and highly infrequent loss events. Also, this form of supplemental insurance does exist. It is called Transurance.

Transurance pays a percentage of the loss paid by the property insurance. For example, a 30% property Transurance policy cost 30% of the cost of the property insurance and pays 30% of whatever amount is paid by the property insurance. Unlike traditional property insurance, the insured does not have to prove the collateral damages it sustained, and there are no restrictions on how the proceeds can be used. To receive a Transurance policy payment, the insured simply has to prove that it received payment under the referenced insurance, and it can use the Transurance payment for anything.

Transurance referencing property insurance is available under various trade names from several insurers and many other insurers have indicated an interest in offering this coverage. Risk Managers should contact their broker to find out more about Transurance, or contact Ware Preston at 203.356.1583 WP@TransuranceServices.com or Bruce Thomas at 203.445.0830 BT@TransuranceServices.com. More information about Transurance is available at www.TransuranceServices.com.

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Not Fully Paid:

Property Claim Experts Speak Out

By Bruce B. Thomas and L. Ware Preston, III

Very little information about the process of settling large property insurance claims is captured or disseminated. While this is partly due to the infrequent nature of large losses, it is primarily the result of a claim settlement process that is highly confidential and is limited to a small cadre of experts who are directly involved in the claim process.

For most risk managers, resolving a large property insurance claim is often a first time experience where lessons are learned the hard way. A better understanding of property claim practices would help improve risk management practices.

To gain insight into the claim settlement process, we surveyed sixteen claim experts about their experiences working on behalf of insureds and insurers to settle large property claims. For the purposes of our investigation, we defined large property claims as those where the paid claim amount was more than ten million dollars and included a business interruption component.

We surveyed independent adjusters, accountants, claim experts at insurance brokerages, attorneys who specialize in property insurance claims, former insurance company claims adjusters, and several insurance company executives. Collectively, these claim experts had more than four hundred years of experience and had resolved more than two thousand large property claims.[1]

Key Findings

- Resolving large property claims has become more difficult over the last 20 years.
- Large property claims involve many people and a lengthy process.
- There are many reasons for claim disputes, even after all the facts are known.
- Insureds often experience expenses and lost earnings that are not covered by property insurance.
- Insureds often believe their insurance covers more than it does.
- Property insurance usually pays 76% to 87% of the amount claimed.

[1] We are very appreciative of the time these professionals spent answering our questions and their willingness to share their experiences and knowledge with us. In return for their help, we pledged that we would not release their individual responses or any information that would enable third parties to determine who the respondents were or for which companies they worked.

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Survey Results by Question

	Average Response
Settling claims has become …?	More Difficult
How many of the physical damage claims are fully settled:	
Before Property is repaired or replaced?	34%
1 - 6 months after property is repaired or replaced?	37%
7 -12 months after property is repaired or replaced?	21%
More than 1 year after property is repaired or replaced?	8%
How many of the time/element claims are fully settled:	
Before the end of the period of liability?	17%
1 - 6 months after the period of liability?	43%
7 - 12 months after the period of liability?	25%
More than 1 year after the period of liability?	14%
The insured experienced losses that were not covered by insurance.	Often
The insured thought they had more coverage than they really had.	Often
Insurers disputed physical damage claims because:	
There were upgrades to improve functionality.	Sometimes
The insured used internal labor to make repairs.	Sometimes
Internal overhead was applied to labor.	Sometimes
The insured overpaid for repairs.	Sometimes
There were gaps in coverage.	Sometimes
There were differences in judgment about coverage.	Often
Insurers disputed business interruption claims because:	
It was unclear if there was a loss of earnings.	Sometimes
The length of the interruption period was unclear.	Sometimes
They disagreed about the quantification of the loss.	Often
Insurers disputed extra expense claims because:	
Of interest expense on borrowed money.	Sometimes
They disagreed about the quantification of the loss.	Sometimes
They disagreed about what was covered.	Sometimes
What percentage of the physical damage claimed amount was paid?	87%
What percentage of the business interruption claimed amount was paid?	76%
What percentage of the extra expense claimed amount was paid?	82%
What types of the insured's employees were actively involved in the claim?	
Risk management	Always
Operational management	Often
Accounting/financial management	Often
In-house counsel	Sometimes
Executive management	Sometimes
What types of outside professionals were hired by the insured?	
Accounting experts	Often
Investigators, engineers, forensics experts	Often
Outside counsel	Sometimes
Environmental monitoring/ consulting experts	Sometimes

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Difficulty of Claim Settlement
Most survey participants said that the difficulty level of settling large property claims had increased. Some participants said that claim settlement had stayed more or less the same. Only one said that it had gotten easier. The respondents who said they felt claim settlement had become more difficult offered the following reasons.

- Insurance companies do not offer as much training to claims adjusters as they used to, and compensation has not kept pace with other functional areas leading to fewer employees who stay long enough to gain extensive experience and judgment.
- Claims adjusters within insurers do not have as much settlement authority as they used to have.
- Insurance companies rely more heavily on statistics, computer models, and settlement committees than on individual judgment and experience.
- Competitive pressures and lower interest rates have forced insurers to be more hard-nosed about paying large claims.
- More insurance companies participate on large property programs now, and each has a seat at the settlement table.
- With more insurance companies and more outside experts being relied upon by insurers and insureds, there are more parties involved in resolving large claims than ever before.

Time to Settle
Although most claims settle within a reasonable amount of time, the claim experts we surveyed indicated that it is not infrequent for property claims to take significantly longer. 29% of physical damage claims were not fully settled within six months of the property being repaired or replaced, and approximately one in ten physical damage claims took more than a year after the property was repaired or replaced to settle.

Time/element claims were even more difficult to resolve. According to the survey respondents, 39% of these claims had not been resolved within six months of the end of the period of liability and 14% of these claims were still unresolved one year after the end of the period of liability.

Insured Expectations/Uninsured Damages
Survey respondents explained that there are all sorts of reasons why some portion of damages from property losses are not covered at all or are only partially covered by property insurance and that this is a routine occurrence. They said that insureds often think they have more insurance coverage than they actually have. If insureds think their policies "cover everything" then they are bound to be disappointed by the extent of their actual coverage after they have experienced a large property loss.

The claim experts surveyed also noted that the insureds' expectations about the extent of their insurance coverage diminished significantly during the course of claim settlement.

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They said that in addition to using their expertise and judgment to resolve claims, their roles also involved managing the insured's expectations.

What to Leave In, What to Leave Out

Survey participants said that the amount claimed depended on who filed the claim and how much expertise they had. Unassisted, insureds tended to claim many items that were not covered by insurance, while those with more experience were quick to filter out those expense items and whittle the claim down to amounts where there was a reasonable basis of insurance coverage.

Even after the insured and the insurer(s) were in agreement about all of the facts pertaining to the damages sustained, a significant amount of knowledge and expertise was required to determine what damages were covered and the extent of that coverage. This observation was as pertinent for the physical damage portion of claims, as it was for business interruption, and extra expense components.

With physical damage, judgments must be made about the extent of the damage, necessary repairs, and functional upgrades as well as the meaning of the coverage terms in the policy. With extra expense, judgment was required to understand "normal" expenses as well as the meaning of the policy wording. The business interruption component of large property claims was said to require greater experience and knowledge given that one can never substantiate actual damages. Assuming that there is agreement that there was a period of business interruption, companies often disagree over how the business would have performed if there had been no loss event.

Although this survey pertained to large claims, a number of the survey participants pointed out that similar amounts of judgment were required to settle smaller claims, too.

Extent of Human Resources Involved

Although survey respondents said it was common for many people working inside and outside of the insured company to assist in claim settlement, they indicated that this had as much to do with the size and complexity of the claim as it did the size of the insured company. Smaller insureds would be unlikely to have experienced risk managers, and ten million dollars might be large enough to warrant the active involvement of executive management. For the largest companies, the loss would need to be much greater to warrant that level of executive management attention.

Not Fully Paid

According to the claim experts we surveyed, the average amount paid in relation to the final amount claimed was 87% for physical damage, 76% for business interruption and 82% for extra expense coverage. However, many of them said that these percentages were substantially lower if one used the initial claimed amount rather than the final claimed amount. The consensus was that the total economic damages from a large

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property loss go well beyond what is covered by traditional property insurance and that the difference between the final amount claimed and the amount paid was just the tip of the iceberg.

In addition to the amounts retained by the insured in the form of deductibles, amounts in excess of sublimits and policy limits, and co-insurance penalties, there were many other damages that insureds documented but did not ultimately claim. Organizations also sustained economic damages that could not be documented but which show up over time in the form of lost revenues or higher expenses. The use of management time or outside experts to remediate damages and settle claims is an obvious example of this type of damage.

Implications for Risk Management

The survey responses indicate that property insurance typically pays for 76% to 87% of the final amounts claimed and that there are large damages sustained by the insured in addition to this differential that are not covered. Given the significant amounts of damage that are not claimed, it is reasonable to infer that property insurance usually covers only 65% to 75% of the total economic damages associated with these events. This implies that most insureds will sustain significant financial damages for which they are not prepared.

If the objective of risk management is to plan for unusual events that may cause substantial harm, then the results of this survey indicate that it is no longer enough to buy property insurance and hope for the best. Evaluating the claim assistance that insurance brokers can provide to resolve large property claims is a good start, but risk managers should also consider if other experts may be needed.

Most importantly, risk managers would be remiss in their duties if they did not ensure that they have the financial resources necessary to remediate damages in full. Risk managers must consider how they will finance all the collateral damages that are not covered by traditional property insurance.

***Transurance Services, LLC** is dedicated to the commercialization of Transurance, a simple and practical means of insuring damages that are collateral to insured losses but which are not paid for and cannot be covered by traditional insurance. Its founders created Transurance to solve this systemic risk issue, and they have filed patent applications on the business methods that enable Transurance.*

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What are Collateral Damages?

By Bruce B. Thomas and L. Ware Preston, III

Managers who have experienced a property loss know they need *at least* 20% more money than they will be paid by their traditional property insurance. Consider the following types of damages that routinely occur in conjunction with insured property losses but which are not paid by traditional property insurance.

- Deductibles
  Deductibles are much more financially painful after a loss. CAT deductibles and business interruption deductibles are often substantial.

- Losses in excess of sub limits or policy limit
  While one's policy limit may stand-out like a bright red line, it is easy to forget all of the other limitations specified by an insurance policy. For example, one may have some coverage for claim adjustment expenses, but for larger claims, the coverage is rarely sufficient.

- Policy exclusions
  Even when properties are covered against a specified peril, insurance policies have many other types of exclusions that prevent a full reimbursement for losses that the insured sustains.

- Interest cost required to finance a loss until the insurance payment is received
  Large losses are typically complicated and take many months, even years, to resolve. In the mean time, the insured must finance all of the cost associated with the loss. This cost is not reimbursed.

- Amounts claimed but not paid by insurers
  Large losses involve many people with different areas of expertise who are each applying their knowledge and best practices to the situation. The discretion they employ and the judgments they make are often second-guessed by claim adjusters working for insurers. Typically, claims made are 20% higher than the amounts for which the claims settle.

- Ongoing lost revenue
  Companies are often frustrated with business interruption coverage because these losses are difficult to prove and the coverage is determined off of an historical base. Also, companies may lose revenues without ever suffering a qualifying business interruption event. For example, several trucks filled with cosmetics were stolen en route to retailers during the holiday season. The company was reimbursed for the cost of the lost merchandise but not for their advertising expenses or for the lost sales that resulted.

- Improvements, betterments, or rebuilding to a different standard
  After a loss, companies typically want to rebuild to the current standard or to a future standard, but the upgraded equipment exceeds the replacement cost provisions of their property insurance policy. There may also be financial penalties for not rebuilding or not rebuilding at the same location.

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- Community impact costs
  Companies must take care to maintain their relations with the communities around them. Actions must be taken for the sake of reassuring the community, even when it is obvious to insiders that there is no impact.
    - A fire at a manufacturing plant caused fears that ground water and air may have been contaminated. The company was confident that there was no contamination but hired a firm to test air and water samples to help reassure local officials and the community at large.
    - Historic buildings may have to pay large one-time assessments or incur other community fees and costs if they choose not to rebuild with the same materials or seek a different design.

- Management and employee impact costs
  Recovering from a substantial loss takes a toll on everyone affected by it and companies find it is in their interest to provide extra benefits and services to employees who must work substantial overtime to maintain and restore operations.
    - After hurricane Katrina, a large telecommunications company found it needed to set up tent cities for the families of its employees and provide free shelter, food, and healthcare, so that its employees could focus their attention on restoring the company's operations.

- Impact on customers and suppliers
  To maintain relations with their customers and suppliers after a large loss, companies often find that they need to make business arrangements that they would normally consider sub-optimal. In effect, the party that has suffered the loss finds it has the added burden of making its business counterparties whole.
    - A university found that it needed to provide extra services and benefits to student residents after a dormitory fire.
    - After a tornado destroyed a plant where a manufacturer had concentrated the production of a key component, it had to reveal trade secrets and enter into a long-term relationship with a new and unproven supplier at a higher per-unit cost so that it continue to supply product to its customers.

- Fixing or improving risk management
  Good risk management entails determining how a loss occurred and ensuring that procedures are implemented to ensure that similar losses do not happen again.
    - A storage company suffered a fire of suspicious origin at one of its warehouses. Its customers demanded that it increase security at all of its facilities, but its insurers were only willing to pay for increased security at the affected facility.
    - After a fire, a company learned of a design flaw in the construction of one of its components. Given that all of its locations were built to the same standard, it needed to make improvements at each location.
    - An oil refinery needed to undertake a long-term, independent investigation into its safety practices after an explosion killed several employees and destroyed its facility.

Although the types of Collateral Damage will vary from claim to claim, one can be confident that the amount of Collateral Damage will be at least 20% of whatever is recovered from their property insurance.

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Transurance helps companies protect themselves from losses that aren't covered by their traditional property and casualty insurance policies.

INSURING BUSINESS CONTINUITY

BY BRUCE B. THOMAS, CMA, CFM, CPA, AND L. WARE PRESTON, III

AFTER A LONG SERIES OF HIGH-PROFILE DEBACLES, companies are finally beginning to practice what the Boy Scouts preach—"Be Prepared." Whether they describe them as disaster recovery or business continuity plans, most businesses now have organizational and operational initiatives designed to mitigate damage from adverse events and resume operations with minimal disruption. But how will they finance the implementation of these plans? A new insurance product called Transurance helps companies pay for business continuity expenses that are collateral to insured property and casualty losses but aren't covered by those policies.

KEEP THE BUSINESS GOING

Because they work in such an increasingly connected and leveraged world, business managers must contemplate how various events might affect their company and its stakeholders, which include customers, employees, suppliers, capital providers, and regulators. The purpose of thinking through a variety of scenarios isn't to imagine everything that might go wrong but to evaluate how the firm's human, physical, and financial resources could be deployed most efficiently to deal with some major setback.

In addition to the immediate acts of restoring plant and equipment and resuming operations, managers must confront the long-term effects and indirect implications of any event. Large losses often force companies to rethink and redesign their businesses. Managers may realize that they need to change hiring practices, safety programs, inventory control protocols, distribution systems, how they relate to customers and regulators, and their organizational and financial structures. A complete business continuity plan must envision both operational and strategic changes and the steps that may be required to restore the company's reputation. It also must contain a financial component because costs to restore operations and continue the business may be considerable.

If the event that triggers activation of the business continuity plan is uninsurable—for example, a botched conversion to a new computer system—then the company has no choice but to rely on its own capital structure for financing. On the other hand, if the event is covered by property or casualty insurance, as in the case of a fire, then some or all of these costs can be covered by Transurance.

HOW TRANSURANCE WORKS

To Transure collateral losses, a company must create a relationship between the amount of collateral losses and the size of the insurance recovery it is likely to receive. For example, if a company believes it will have uninsurable collateral losses equal to 20% of the amount it recovers from its insurance policy, it can purchase a Transurance policy that pays 20% of the amount that its insurance policy pays to create a budget for collateral losses.

Transurance enables the insured and the insurer to agree in advance how large the collateral losses will be in relation to the amount of the proceeds from an underlying property or casualty policy. By predefining this relationship, business continuity costs that are coincident to insured losses but aren't covered by traditional insurance because they are too difficult to define or substantiate can now be insured.

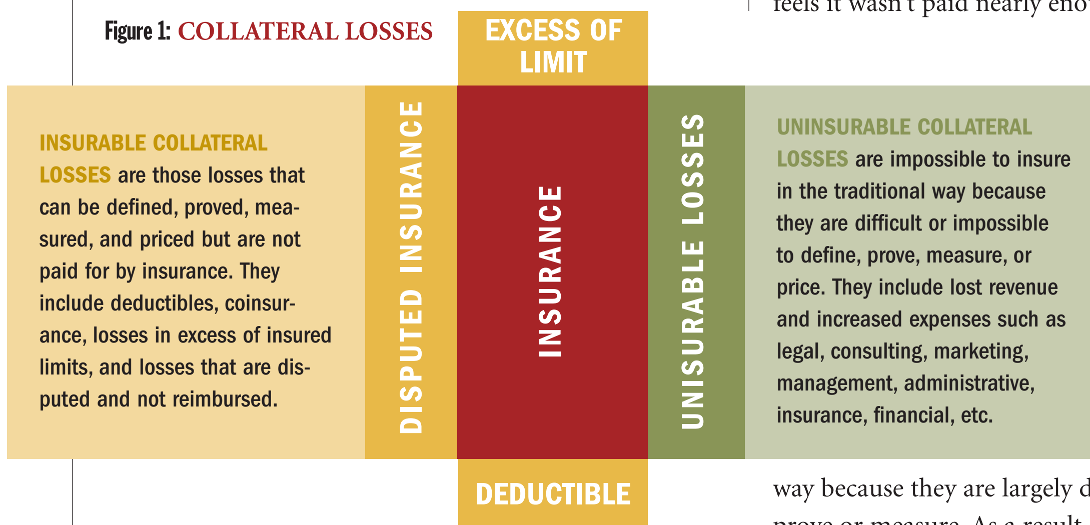
COLLATERAL LOSSES

As shown in Figure 1, there are essentially two types of losses that are collateral to insured events. The areas shown in yellow are technically insurable and include the deductible, amounts in excess of a policy's limit, and any disputed amounts. These amounts could have been insured, but the parties chose not to, or, in the case of disputed amounts, the parties found that they didn't agree on the extent of the policy's coverage after a loss had occurred.

For business interruption and extra-expense coverages, the actual amount of loss is often unknowable. As a result, substantiating these losses involves a great deal of judgment and discretion, which makes claim settlement contentious. Neither party is very happy with the outcome. The insurer feels it paid too much, and the insured feels it wasn't paid nearly enough.

There are also many types of lost revenue and extra expenses that aren't covered under any property policy, no matter how comprehensive the coverage may seem. Uninsurable collateral losses (shown in green) are very difficult or impossible to insure in a traditional way because they are largely discretionary and are hard to prove or measure. As a result, it's difficult to define these

Figure 1: COLLATERAL LOSSES



losses or to adequately prove or measure them, making it almost impossible for the insurer to set an appropriate price for this coverage.

To the extent that property and casualty policies attempt to insure these costs in a conventional way, claim settlement disputes ensue. In this case, the costs that the parties incur to negotiate coverage and claim settlement may far outweigh any benefit of attempting to insure them. As a result, many expenses associated with insurable losses are uninsurable in a traditional way. These expenses would include claim preparation and filing expenses, stay-put bonuses for management, marketing and advertising expenses, new safety programs, the additional expense of satisfying regulators and other third parties, and opportunity costs.

For large casualty losses, the money received from the insurance company is used to pay claimants and certain legal costs for defending against claims, but there are no insurance payments to help defray the cost of executing the business continuity plan. Moreover, there may be some element of discretion in determining how much of a company's legal expenses are covered under the policy.

Even though they may be preparing for large property or casualty losses, managers quickly realize that the total economic cost of such an event far exceeds the amount of money the company will receive from traditional insurance policy claims. Many of the things they will need to do to repair their business and reassure stakeholders are uninsurable in a conventional way but can be insured using Transurance.

With Transurance, managers can finance the costs of implementing their business continuity plan without ever having to "prove" or "measure" collateral losses. Also, they can use these contingency funds as they want to, without the consent or approval of the insurer. Thus, Transurance can be used to expand and to clarify insurance coverage. But it can't be used *instead* of regular insurance. While Transurance is simple enough in concept, it is new and is best understood in the context of a hypothetical example.

PROPERTY LOSS EXAMPLE

Xco is a fast-growing, global fragrance and cosmetics company with sales of $750 million. To reduce costs and improve efficiency, the company had consolidated its American fulfillment and warehousing operations at a single distribution center located in the Southeast. Manufacturing is contracted to third parties, and Xco's fragrance sales are seasonal, with 85% occurring in the last quarter of the year.

Xco's senior managers were keenly aware of the value of having a business recovery plan that contemplated a disruption at their distribution center. They estimated that if the distribution center were rendered inoperable by an insured peril, such as a fire or tornado, the total economic cost of restoring their business would exceed insurance recoveries, including business interruption and extra-expense payments, by as much as 35%.

Rather than continue to self-insure the risk of collateral losses, Xco decided to buy a Transurance policy with a payout equal to 20% of the amount recovered from their property insurance policy for a premium of $100,000. The underlying property insurance policy cost $500,000 and had a limit of $250 million per occurrence. Although Xco's management realized that the Transurance policy wouldn't match their collateral losses exactly, they were convinced that any large insured property loss would bring about substantial collateral costs and wanted to have a sizable contingency fund to deal with them.

Moreover, Xco's management felt that Transurance was an even better value than their traditional insurance because it required less effort to purchase and would be easier to file a claim. Their retailers and bankers were impressed with Xco's risk management and its Transurance policy because it helped assure them that Xco would have the financial resources necessary to resume business in the event of a large loss.

On an afternoon in September, an F4 tornado spawned by a Gulf hurricane struck Xco's distribution center. Xco's business continuity team, headed by its CEO, was ready. After confirming no loss of life or serious injury, the team assessed the damage to the facility. The structure sustained damage to more than a third of its roof and siding, the automated fulfillment system was inoperable, and virtually the entire inventory was rendered unfit for sale.

These findings triggered the company's contingency plans for communicating with retailers and suppliers and alternative means of maintaining product delivery. Simultaneously, the company activated plans to repair the facility as expeditiously as possible. This was essential because the contingency plan was expensive and couldn't meet the demand for the product over an extended interval. Even with extraordinary efforts by the business continuity team, senior management, and employees, normal operations weren't restored until the following June.

Table 1 shows the losses that Xco sustained as well as how much money it recovered from its property insurance and Transurance policies. As a result of this loss event, Xco had $20.2 million of collateral losses, of which

Table 1: LOSS AND EXPENDITURE DETAIL
(In Thousands of Dollars)

	LOSSES CLAIMED	INSURANCE RECOVERIES	DISPUTED LOSSES	COLLATERAL LOSSES
INSURABLE COLLATERAL LOSSES				
Deductibles and amounts in excess of limits	500	-	-	500
Business interruption and extra expense	50,000	45,000	5,000	5,000
Plant and equipment	25,000	25,000	-	-
Inventory	15,000	15,000	-	-
	90,000	85,000	5,000	5,500
UNINSURABLE COLLATERAL LOSSES				
Claim preparation and filing				650
Supplier forfeits and concessions				2,250
Retailer concessions and other expenses necessary to maintain relationships				4,800
Marketing campaign changes				1,500
Increased borrowing cost				500
Opportunity cost of diverted management time				750
Increased insurance premiums				150
Increased operating cost of new distribution strategy				4,100
				14,700
TOTAL COLLATERAL LOSSES				20,200
TRANSURANCE PROCEEDS				
Transurance Coverage	20%			
Total Property Insurance Recoveries	85,000			
Transurance Proceeds	17,000			17,000
UNREIMBURSED COLLATERAL COST				3,200

$17.0 million was paid by its Transurance policy, leaving $3.2 million of unreimbursed collateral cost. The Transurance policy provided management with the contingency funds necessary to execute its business continuity plan and get the business back on track.

PEACE OF MIND

Since companies know in advance that traditional insurance will never pay them completely for the losses and expenses that they suffer as a result of an insured loss event, not buying Transurance is the equivalent of intentionally retaining a pro rata share of the insured loss. If management believes that their company could have substantial business continuity costs that are collateral to insurable losses, then it only makes sense to purchase a Transurance policy as well.

In an interdependent economy where supply is on demand, not stockpiled, the adverse effects of large property and casualty losses are frequently magnified and systemic. Absent immediate assurance of business continuity, stakeholders will disengage and form other business relationships. Providing assurance requires financial resources that go beyond traditional insurance. Transurance gives companies an opportunity to leverage the financial efficiency of conventional insurance and helps assure business continuity. ■

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• A records-retention company had a fire at one of its facilities and could not readily identify its cause or origin. Suspecting possible terrorism and wanting to reassure its customers, it increased security at all of its facilities. The insurance company was only willing to pay for increased security at the affected facility.

• A plant explosion caused the local community to be concerned about the potential for environmental damage. Although the company was certain that there was no reason for local residents to be concerned, it was forced to conduct ongoing environmental tests of the local air, water and soil and to hire lobbyist and public relations experts to reassure the community. The company also found it needed to dedicate a senior executive to manage the crisis, to study what the public and shareholders perceived to be a risk management failure, and to devise a plan so that it would never happen again. Insurance paid for the plant to be rebuilt but not for the community outreach.

• A tornado ripped off the roof of a major retailer's regional distribution center for the Southeast. Inventory and rebuilding efforts were reimbursed by the company's insurance, but many of the ancillary costs required for the company to work around this problem were not covered.

• A large telecom company's employees worked overtime for many months after Hurricane Katrina. Given that many of their homes were destroyed, the company needed to create a "tent city" to house and feed them and their families. While insurance covered a large portion of the company's property damages, it did not cover the extra costs the company spent on its employees and their families, nor did it pay for the lost revenues that the company experienced from losing so many of its customers.

Although there will always be some collateral damages when there is an insurable property loss, it is difficult to say precisely what they will consist of until after the loss. The most obvious collateral damages are those losses that are covered by insurance but not reimbursed by the insurer because of deductibles and limits. There is no dispute about the amount of these losses or whether they are covered, but they are not paid due to the contractual limitations of the insurance policy.

Amounts that are claimed but ultimately not deemed to be covered by insurance make up the next class of collateral damages. Collateral damages of this sort arise because of disagreement between insured and insurer as to what constitutes a covered loss or how much is covered.

Finally, there are many losses that are too difficult to define, prove or measure to be included in a traditional insurance policy. A special case of this occurs where business-interruption coverage either does not work at all or its performance is so uncertain that the coverage is not purchased. While these collateral damages might be significant, they are often almost invisible to risk managers. No one attempts to keep track of them because everyone knows that they are not covered by insurance. For large losses, a significant amount of collateral damage might manifest itself in the form of lost revenues, unidentified expenses or opportunity costs. Even for seasoned business managers, it is impossible to understand the full extent of these losses.

One of the best ways to comprehend the potential for collateral damages that fall into this least visible category described above is to consider the impact a large loss would have on a particular company in the context of its business environment.

THE BUSINESS ENVIRONMENT

Businesses can be thought of in terms of their internal and external environments. The internal environment consists of a company's physical property, plant, equipment, employees, financial capital, intellectual capital and other types of property. The external environment consists of the physical and social environment in which the company operates—the company's customers, suppliers, business partners, financial capital suppliers, competitors, community, politicians and regulators.

When a large loss occurs, every aspect of the company's business environment could be affected. In the internal environment, property might be damaged that is not fully

covered by insurance. A large loss could place undue strains on employees or make competing job offers seem much more inviting. It might also impair the value of the company's brand, its contracts and its intellectual property.

In the external business environment, a large loss could prompt an intense review of the company and its prospects. The community could become concerned about the impact of the loss, and politicians and regulators might decide that they need to make their presence felt.

COVERING COLLATERAL DAMAGE WITH TRADITIONAL INSURANCE IS IMPOSSIBLE OR AT BEST PROBLEMATIC.

—Bruce B. Thomas and L. Ware Preston III, co-managing directors, Transurance Services LLC

Customers, suppliers and joint venture partners could become concerned about the company's ability to make good on its commitments to them, while competitors might find that it is the perfect opportunity to expand their market share. Debt covenants may be breached, and shareholders may be concerned that the loss has significantly impaired the business.

In short, everyone and everything in the internal and external environment could be affected by the company's loss, and the company would need to expend significant financial and operating resources to stabilize things. In effect, the company that just suffered a large loss would be both struggling to recover and called upon to make every other party whole or take actions to ensure that whatever happened will not recur.

PROBLEM SOLVED

In a business environment that is increasingly leveraged and interdependent, collateral damages are ubiquitous and increasing in significance. Loss recoveries from traditional insurance are diminishing as a percentage of the total economic damages that companies sustain when they have insured loss events.

Covering collateral damage with traditional insurance is impossible or at best problematic because of the need for definition (preloss) and proof (post-loss), or it is uneconomic in cases where selection or imposition of deductibles and limits reduce the recovery.

Transurance makes collateral damage insurable by defining it as anything not covered by the referenced insurance, and by valuing collateral damage as a percentage of the loss paid by the referenced insurance.

Moreover, unlike traditional insurance, Transurance is hassle free. Insurance buyers do not have to waste time and energy gathering underwriting information, negotiating complex coverage definitions, or working through a long and involved claims settlement process.

Conceptually, Transurance may be applied to any type of insurance as a way for insureds to supplement their recovery to pay for collateral damages and for insurers to earn additional premium for taking a risk that is a mathematical function of one they already know. And it is easy for both parties.

At present, insurers seem most receptive to offering Transurance on commercial property exposures due to the relatively large premiums and the relatively short claims settlement time required for this line of insurance. However, we suspect it will only be a matter of time before it is also offered on other lines of insurance.

The beautiful thing about Transurance is that both the insurer and the insured can assess its costs and benefits in terms of something that they already know and understand. The insured gets some additional percentage of what they already bought and thought was a good value at a competitive, market-clearing price. The insurers writing Transurance get the opportunity to sell more coverage at a price deemed attractive by the market.

Both sides of the Transurance transaction stand to gain by making the insurance pie bigger with less additional effort. In effect, Transurance makes more things insurable while making insurance work better.

BRUCE B. THOMAS *is co-managing director of Transurance Services LLC.* **L. WARE PRESTON III** *is co-managing director of Transurance Services LLC. They can be reached at riskletters@lrp.com.*

Directors and Officers Transurance

By L. Ware Preston, III and Bruce B. Thomas

There are many options for structuring a directors and officers insurance program, but no matter how well the program is designed, traditional insurance never pays enough to fully cover the loss. Risk managers, attorneys, brokers, insurers are aware of this shortfall and know that it is substantial, but until now there was no real solution. Modifying coverage terms is a first step that is somewhat helpful, but risk management professionals are beginning to recognize that Transurance is a much more comprehensive solution to this problem.

Transurance is a new form of insurance that pays a pre-agreed percentage of the loss paid by a referenced traditional insurance policy. Transurance proceeds benefit the policyholder and help pay for the losses that were not paid for by traditional insurance. Some of the items not paid by traditional D&O insurance include the following.

- Uncovered investigative costs and expenses (e.g. informal government investigations or pre-indictment costs)
- Legal cost of establishing a right to insurance
- Loss within deductible or self-insured retention
- Co-insurance
- Loss in excess of limit
- Un-reimbursed defense costs due to application of insurer litigation management guidelines, application of partial exclusions; and out-of-pocket costs pertaining to management participation in the case
- Coverage concessions or "limits shaving deals" (to resolve coverage or valuation issues)
- Fines and penalties (e.g. FCPA penalty)
- Costs of remediation (hiring accounting, legal, PR professionals to help fix problems)
- Expense of additional corporate governance including third party monitors
- Other economic damages that are difficult to quantify such as lost revenues due to reputational injury; and the costs of internal investigations, IT processing efforts and management and in-house counsel time

For a given claim, the items causing the shortfall will vary, but experts agree that no matter how broad the coverage or how skillful the claim negotiation, these items always add up to at least 20% of what is paid by traditional D&O insurance. For example, if D&O insurance pays $1 million, the insured will suffer a shortfall of at least $200,000. If $10 million is paid, then the shortfall is at least $2 million, and so on.

Transurance pays a benefit equal to the pre-agreed percentage of the loss paid by the referenced D&O policy. The policyholder does not have to "prove" the extent of the payment shortfall they have experienced and may use the Transurance proceeds for anything. The premium for the Transurance is the equal to the payout percentage times the premium for the referenced insurance.

Yes, it's that simple.

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Captive Insurance Company Reports

Securitization and Catastrophic Risk

Editor's Note: At the South Carolina Captive Insurance Association (SCCIA) conference, "Securitization & Catastrophic Risk" was presented by **Stuart Silverman,** FSA, MAAA, a consulting actuary with Milliman, Inc. (stuart.silverman@milliman.com). **Dawne Davenport** of Towers Perrin in Dallas reports.

How are securitization programs being used to underwrite specialized risks, particularly catastrophic risk? This SCCIA session was designed to educate captive practitioners on what this topic is about and how captives are being used to facilitate these arrangements.

Stuart Silverman began with an overview of the increasing popularity of securitization in the insurance industry in general. Over the past 5 years, securitization as a risk financing vehicle has been growing. Funds have been raised by life insurance companies addressing embedded value, catastrophic, and other risks ranged from the low $100 million to nearly $2 billion. Reasons for the growing interest include reinsurer consolidations, concern about banks' near-term letter of credit (LOC) capacity, and unease about backing long-term liabilities with short-term LOCs.

Securitization has many benefits:

- ✔ Capacity is limited only by capital market appetites.
- ✔ Securitization as a risk financing vehicle is not subject to increasing LOC costs.
- ✔ Insurers face limited third-party credit risk compared to the credit risks of reinsurers.
- ✔ Securitization arrangements, if structured properly, may be considered operating leverage, as opposed to financial leverage, by rating agencies, thereby strengthening an insurer's ratings.
- ✔ The transfer of risk associated with extreme event mortality can effectively serve as stop-loss reinsurance, which is not easily purchased in the traditional reinsurance market.

Securitization has some limitations:

- ✔ High costs are associated with securitization programs in the form of guarantee

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monoline companies which did their due diligence. At times, unwrapped tranches are purchased with no financial guarantor. Companies that invest in such securities are already familiar with structured financial transactions and perform their own due diligence. ■

Captive Likes Transurance Solution

Editor's Note: This article was written by *CICR* with input from **L. Ware Preston, III,** and **Bruce B. Thomas,** managing directors at Transurance Services, LLC. You can contact Mr. Preston at (203) 356–1583 or Mr. Thomas at (203) 445–0830. For more information on Transurance, see www.TransuranceServices.com.

Captives sometimes are at the forefront of new products. This reflects the fact that captive owners have perceived risk concerns, the commercial market doesn't offer an acceptable solution, and the captive owner can quickly respond through a captive. This case described below is one such example.

The Genesis of the Product. A couple of years ago, two insurance consultants recognized a need for a new product that would improve the amount of money an organization could receive on some difficult claims. For risk managers, this is most apparent on cases of business interruption claims, where various "gray" areas of financial loss are not clearly covered by traditional business interruption insurance. For instance, in the case of a manufacturing loss, it can be very difficult to prove that some aspects of a loss are directly related to an incident (i.e., collateral damages), but operating personnel surely believe some loss costs are related, regardless of whether a claim adjuster agrees.

The solution: develop an insurance product in the form of "agreed value" or "benefit" policy where the payout has been agreed to in advance and one does not have to prove the amount of the actual loss sustained. Transurance—so called because it is a new form of insurance that goes beyond traditional insurance—is what these consultants developed. In this regard, Transurance is similar to a life policy or an accident policy, except that these types of benefit policies specify a dollar amount that will be paid once some event occurs, whereas Transurance expresses the payout as a pre-agreed percentage of the loss paid by a referenced insurance policy. Therefore, if the underlying claim is $1,000, Transurance will pay an additional $100 (presuming a 10 percent limit was purchased).

Like the beneficiary of a life policy, the proceeds may be used as the insured sees fit without restrictions. No proof of loss is required other than proof of payment by the referenced insurance. (*CICR comment:* Take note that there must be a payment, or partial payment, from the initial insurance claim before a Transurance payment is made.) The premium for Transurance is simply the same pre-agreed payout percentage times the premium for the referenced insurance.

Transurance's effectiveness is in its simplicity. Suppose the premium for a $25 million limit of insurance is $1 million. Transurance with a payout percentage of 10 percent referencing this coverage costs $100,000 (10% x $1 million). After an insurance claim payment has been made, the Transurance payout is easily determined. For example, a $10 million paid loss results in a Transurance payout of $1 million (10% x $10 million).

Where the Captive Comes in. Conventional wisdom is that new insurance products must be introduced in the conventional market before they are adopted by the alternative market. In the case of Transurance, this product was first offered by several commercial insurers, but one of the first deals was written by a captive. Transurance has already been adopted by a large Canadian company and its Barbados-domiciled captive.

Why? This makes sense once you understand how risk managers see the problems with real life claims and then understand how Transur-

ance works. The fundamental value addressed by Transurance is that whenever there is a loss covered by traditional insurance, *the insured also incurs expenses, revenue loss, and opportunity costs that are not covered*. Many of these "collateral damages" are not reimbursed because:

- ✔ Deductibles or sublimits prevent payment.
- ✔ Traditional insurance requires definition, proof, and measurement, which can be difficult or impossible.
- ✔ Some of these damages are deemed to be too discretionary to be covered by traditional insurance.

Because the Transurance payment is pre-specified and does not require the insured to prove actual losses that were sustained, Transurance payouts can be used to cover any and all types of damages so long as they are collateral to a paid loss from a referenced insurance policy. For risk managers, this payout feature overcomes many difficult internal questions raised over the size of an insurance claim payment.

Captive owners immediately see the benefit of this product and why it makes sense for a captive to offer Transurance. One of the most important functions of a captive is to allow affiliates to retain risk and buy insurance that reflects each affiliate's specific financial objectives and its capacity to manage earnings and cash flow volatility, which often are far different from the parent's or sponsor's. This risk appetite varies significantly between subsidiaries of a large corporation and even more so between the individual subsidiaries and the corporation as a whole. Captives enable the corporation to purchase insurance from the commercial market that maximizes value of insurance at the corporate level, but without unduly constraining the insurance (risk transfer) needs of the corporation's individual subsidiaries.

By permitting captives to offer insurance to their affiliates to cover collateral losses, Transurance enhances the benefits that captives can provide to the organization without adding much additional transaction cost. Assume, for example, that an affiliate wants to buy a 20 percent proportional Transurance policy from its captive. It is just a matter of math and a little bit of administration. The captive bills the subsidiaries for an additional 20 percent of the premium, adjusts its reserves to reflect the additional liability for 20 percent of paid losses, and pays the affiliate an additional 20 percent in the event of a claim. Moreover, the Transurance premium may be discounted to share the transaction expense savings between the captive and its affiliate.

Furthermore, captive insurance companies, if properly structured and managed, may yield the tax benefits of insurance and these benefits are magnified by Transurance. For example, if a captive provides primary casualty insurance for a premium of $10 million, the Transurance premium would be $2 million. This has the effect of accelerating the deduction for collateral losses relative to not using Transurance and taking deductions for collateral losses when paid. (As with traditional insurance, the tax benefit of Transurance varies with the amount of losses and reserves held for those losses, the time it takes for losses to be paid out, the corporate tax rate, and the interest rate or after-tax corporate discount rate.)

In the captive case mentioned above, the Barbados captive issued a Transurance policy to the Canadian company's American subsidiaries covering property perils. The company realized that normal insurance proceeds cannot pay for the entire economic consequences of an insured loss, including the very nebulous "collateral damages." Providing Transurance offset some of the American subsidiaries' financial concerns. The parent also received some important tax benefits.

Some Commercial Insurers Offer It as Well. Transurance, applying to property insurance, is now being offered by Arch Insurance Group, AEGIS, and Ironshore, Ltd., with other insurers offering this coverage soon.

The Buying Process Is Restricted. As patents have been filed to protect the use of the business methods required to write Transurance, the only step that captives need to take to write Transurance for their affiliates is to obtain a license from Transurance Services, LLC, to use these business methods. Alternatively, Transurance Services offers a service of quoting Transurance on a deal-by-deal basis whereby intellectual property rights are not transferred.

CICR comment: The concept is so simple, we believe the lack of obfuscation is one reason the commercial market has such a hard time accepting it! Is the industry ready to accept a simple insurance product? Captive owners can! ■

Claims Management Technology: What Tools Are Critical?

Editor's Note: This is the third and final article of three articles on claims best practices, specifically for captives, the first two appearing in the February and April 2007 issues of *CICR*, respectively. This was written by *CICR* in collaboration with **Clare Bello**, president and CEO of VCM in Pittsburgh. She can be reached at (800) 501–6248.

In our first article, we described the claims best practices for captives, beginning with the need for captive owners to take a proactive position in managing and controlling their claims. In the second article, we explored the issues facing a program to determine the best type of infrastructure needed to establish either an in-house claims solution or to find the best fit with an outsourced partner. The third need, and the focus of this final article in this series, is having the appropriate technology in place to allow proper management of claims and also to use your claims data powerfully to trend your risks and exposures.

What Technology Do I Need? When considering technology, there are five critical issues to consider when selecting a system, based on problems we have witnessed at Vertical Claims Management.

1. Customization of technology
2. Integration with other technologies
3. Balancing data collection with real-time pressures
4. Retrievability of data by client
5. Client access to technology

There are two critical areas regarding technology for the management of a captive's claims. First and foremost is the ability to collect, manage, and report meaningful claims information—normal to a claims function. Second is to use the data to analyze areas of concern within the program, which can then be utilized for proactive risk management and loss prevention mandates. This second area can be a bit more problematic in practice.

Customization of Technology. Each captive program is unique, as is the captive's insurance structure. While each line of insurance has certain basic claim information required to be collected, each captive has its own unique needs for the use of its claims data. Therefore, the technology used must be both standardized and customized. The standardization relates to the normal claim activities for insurance practitioners, which exists in most all technologies. However, the customization mandates that the technology be flexible enough to allow for specific captive purposes. This is less available. For example, in a medical professional liability captive, the claims system should be able to track vital trending information, such as injury cause and severity codes; medical specialties; and structural specifics, such as on what floors and in which unit events occur. Customization needs can be found in nearly every industry group, however.

Recommendation: It is up to the captive owner to identify the unique, tailored needs of the captive. Once identified, learn how and what the technology can and (more importantly) cannot do.

Are Insurance Brokers Professionals?

By Bruce B. Thomas

The terms “professional” and “professionalism” are routinely bandied about in connection with services, but what do they mean in the context of insurance brokerage? Given the controversies that insurance brokers have been embroiled in and the changes in their business practices and in the laws and regulations governing their services, it is a good time to consider this question.

Intuitively we understand that the word “professional” embodies two ideas. In its weak form, it means that one engages in an activity as a primary occupation. Since people who are engaged in some activity full-time are likely to have more working knowledge of it than those who are engaged in it part-time, this can be a meaningful term when it is applied to activities that could be conducted on a part-time basis. In its strong form, “professionalism” implies greater knowledge, a higher standard of care, and a higher duty to the client.

Clients are willing to pay more for services that they believe are of higher quality, and implying that one is acting as a professional is a common way of distinguishing one’s services from the average person who is engaged in a particular activity. However, the concept of “professionalism” is not particularly meaningful unless it pertains to services that require significant training, involve a high-degree of knowledge, cost a significant amount of money, or may cause significant harm if performed improperly. Clearly medical doctors and attorneys fit this strong-form definition of what it means to be a professional, but what about insurance brokers?

While placing insurance coverage does not require significant education and training, the cost of these services and the potential harm that might ensue if the services were performed incorrectly favor holding insurance brokers to a higher standard. Given that clients greatly value professionalism in the context of high risk activities, it is natural for insurance brokers to think of themselves as professionals and to conduct their services using a higher level of care. Acting with professionalism implies that insurance brokers maintain their client’s confidential information, strive to achieve and maintain a high degree of competency, and have a fiduciary duty to their clients.

Confidentiality

Of these responsibilities, maintaining client confidentiality is the easiest to uphold. Clients expect their insurance brokers will take steps to ensure that their information is not disclosed except when the broker is authorized or are legally obligated to disclose it.

Competency

Achieving and maintaining professional competency is a much more difficult standard to meet. It requires that insurance brokers perform their duties in accordance with laws, regulations, and technical standards. It requires them to educate themselves about the types of coverage that the insurance markets are offering and about the insurable risks that their clients face. Most importantly, acting competently requires insurance brokers

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to provide their clients with unambiguous recommendations based on a thorough analysis of relevant and reliable information. If there are arguments in favor of insuring something, brokers have an obligation to state those arguments clearly and concisely.

Fiduciary Duty

Insurance brokers must also act with utmost good faith toward their clients. They must carry-out their duties with integrity, objectivity and their clients' best interests being the over-riding concern. Under this duty, the insurance broker must communicate information fairly and objectively, make special efforts to disclose all relevant information so that clients can evaluate their recommendations, communicate favorable as well as unfavorable information, and refrain from engaging in any activities that would potentially impair their ability to act in the best interest of their clients.

Information Asymmetry

Insurance brokers are in a much better position than their clients to understand the insurance markets, potential claim disputes, and which risks are and are not insurable. They are hired because they hold themselves out as having this greater level of knowledge. Given this information asymmetry and the significant potential harm that might result from inaction or faulty action, clients expect their insurance brokers to provide objective information about the risks they face that are insurable.

An Implied Duty

Regardless of how they see themselves or the specific legal or regulatory requirements that they must meet, insurance brokers have an implied duty to their clients to act in a professional manner. Given the informational advantage they have over their clients, it is unacceptable for insurance brokers to withhold information about potential conflicts of interest, negative outcomes, insurable risks, or insurance products that may address their clients' needs. Moreover, it is unacceptable for insurance brokers to ignore information that may prove valuable to their clients, even if it conflicts with how insurance brokers want to portray their services.

In light of this duty, it is no longer acceptable for brokers to ignore the collateral damages that their clients will suffer when they experience insurable losses. For large property insurance claims, these damages surpass any reasonable standard of materiality since they amount to 30% to 50% of what traditional insurance pays.[1] Moreover many of the world's largest insurers have indicated an interest and a willingness to insure this risk via Transurance, a new form of insurance coverage.

Now that collateral damages are insurable, insurance brokers have a responsibility to educate their clients about the magnitude of this risk and how Transurance can be used to insure it. Anything less than this is unprofessional.

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[1] "Not Fully Paid: Property Claim Experts Speak out," Transurance Services, January 2010, by Bruce B. Thomas and L. Ware Preston, III, details this study and is available for download at http://transuranceservices.com/Articles.html where other articles about collateral damages and Transurance are also available.

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