

## **Using Transurance to Enhance Insurer Claims Paying Ability**

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

With credit markets roiling the financial world, risk managers are increasingly concerned about the credit worthiness of their insurers. Insurers may have adequate claims paying ability ratings now, but will they hold up over the life of the policy obligations? While risk managers may not be entirely comfortable with their current panel of insurers, replacing an insurer may increase insurance premiums substantially and may disrupt long-standing relationships over problems that may prove to be fleeting.

Nevertheless, risk managers need to weigh all of the alternatives carefully. In addition to maintaining the status quo and replacing of one or more insurers on their existing insurance programs, risk managers should consider how Transurance may be used to enhance the claims paying ability of their insurers.

### **Transurance**

Transurance is a form of insurance that pays a cash benefit that the insured may use to pay for costs that it incurs as a result of an insured loss, but which are not paid for by a traditional insurance policy, i.e., “Collateral Damages.” There are many different ways of structuring Transurance policies.

Using Standard Transurance, the insured selects a Transurance percentage that specifies the amount by which it would like to increase its traditional insurance payment. By multiplying this percentage times the premium of the traditional insurance policy, one also determines the Standard Transurance premium.

Alternatively, Transurance may be structured in a way that is more similar to traditional insurance. In this case, Collateral Damages are defined in some particular way and must be proved in order for the insured to receive payment. However, the amount of the Transurance payment is limited to a percentage of the loss paid by the traditional insurance.

### **Collateral Damages**

Standard Transurance may be purchased to pay for any type of Collateral Damages. The insured does not have to prove any specific damages in order to receive a Standard Transurance payment and may use the money in any way that it desires, including to alleviate a claim payment shortfall.

While insureds will always have Collateral Damages that are more than 15% of its traditional insurance payments, these damages are typically much higher than this percentage. Not purchasing Standard Transurance is the equivalent of taking at least a 15% quota-share retention. Most executive managers and board members would be shocked if they knew that the companies they manage were uninsured by this amount

when this insurance was readily available. Moreover, Collateral Damages will increase dramatically to the extent that insurers are financially incapable of paying a claim in full.

### **What to Do**

Risk managers who want to enhance the claims paying ability of their insurers can replace one or more insurers whose claim paying ability is suspect. While this is an obvious solution, it may substantially increase the cost of the insurance program. The cost and efficacy of this approach should be compared against the cost and benefits of using Transurance to improve the claims paying ability of the insurers on the program.

### **An Example**

Consider the following example. The insured's existing insurance program cost \$1 million and offers \$100 million of limit, underwritten by four insurers, A, B, C, and D, each taking a 25% quota-share participation. Each of these insurers is highly rated in terms of its claims-paying ability, but there are rumors that insurer A may be experiencing some problems. The insurance broker has found another insurer, insurer E, that can take insurer A's place on the program, but the cost of the program will increase by 20% or \$200,000. The risk manager wants to understand how Transurance can be structured to deal with this issue and how the cost and benefits of this coverage compare with the potential cost of replacing insurer A.

### **Standard Transurance Solution**

The insured could simply pay another \$200,000 to buy 20% Standard Transurance. The Standard Transurance policy would reference the policies of A, B, C, and D and would pay an additional 20% of any amount paid by these policies. While this alternative would cost the same as replacing insurer A, it pays the insured 20% of whatever claim payments are made, even if the insurers are able to pay the insured's claim in full, and this money can be used to pay for any type of collateral damage that the insured experiences.

### **Credit Enhancement Transurance Solution**

Another alternative would be for the insured to purchase Transurance that pays only if one or more of its existing insurers are unable to meet their payment obligations (i.e., "Credit Enhancement Transurance"). The Credit Enhancement Transurance payment would be the amount of the claim not paid, subject to a maximum payment equal to the Transurance percentage multiplied by the total claim payments that were made by all of the insurers on the program.

Because Credit Enhancement Transurance pays only to the extent that the traditional insurers are unable to pay in full, it is significantly cheaper than Standard Transurance. The cost of this coverage equals the Transurance percentage times the traditional insurance premium times the underwriter's view of the probability of the insurers being unable to pay in full plus a capital charge. For the purpose of our example, we will assume that the cost of this coverage is 5% of the traditional insurance program's cost or \$50,000 (i.e., \$1,000,000 x 20% x 25%).

## **Loss Scenario**

To compare both the cost and the benefits of these alternatives, imagine that the insured suffers an agreed loss of \$50,000,000. Insurers A (the one rumored to be in financial difficulty), B, C, and E are all able to make full claim payments of \$12,500,000 apiece. However, insurer D, which was not thought to have any financial problems as of inception, was taken over by regulators and is only able to pay \$4,375,000.

## **Comparing the Alternatives**

Regardless of whether the insured had replaced insurer A with insurer E, it would receive claim payments of only \$41,875,000. If the insured had kept A on the program and purchased 20% Standard Transurance, it would receive a Transurance payment of \$8,375,000 (20% of \$41,875,000) and would receive total claim payments of \$50,250,000. Since the insurance premiums in both alternatives cost \$1,200,000, retaining the existing panel of insurers and purchasing 20% Transurance is clearly the superior option.

Had the insured purchased 20% Credit Enhancement Transurance, it would also be much better-off than if it had just replaced insurer A. In the loss scenario described, the Credit Enhancement Transurance would have paid the full amount of the shortfall from D of \$8,125,000 (\$12,500,000 less \$4,375,000). Note that the amount of the claim that insurer D did not pay was less than the \$8,375,000 limit of the coverage (20% times the \$41,875,000 paid by the insurers in total). The recovery from A, B, C, D and from Credit Enhancement Transurance would equal \$50,000,000. This alternative is clearly superior to replacing insurer A, because it pays \$8,175,000 more and costs \$150,000 less.

## **Conclusion**

It does not make sense to place coverage with an insurer that will not be able to honor its commitments, regardless of how cheap the premiums are. However, if an insurer seems reasonably able to pay its claims and the cost and disruption of replacing that insurer is significant, then each of the alternatives should be thoroughly consider.

In addition to the potential cost and disruption of each coverage option, risk managers should evaluate the impact of each option on credit quality and credit diversification. It is most advantageous if the insured is able to purchase Transurance coverage from an insurer that is not already on its program or if the Transurer's claims-paying ability is superior to the other insurers on the program.

Finally, it is worth considering some loss scenarios and thinking about which options are best in terms of maximizing claims payments and minimizing collateral damages. As the "worst-case" loss scenario above shows, retaining the existing panel of insurers and supplementing the program with Transurance is superior to replacing one of the insurers, if that action causes the cost of the insurance program to increase substantially.

While supplementing the program with Transurance is clearly advantageous, the choice of what type of Transurance requires more thought. Credit Enhancement Transurance is significantly less costly than Standard Transurance. However, Standard Transurance

payments will be made even if all of the insurers are able to pay the claim in full. If one altered the example above to assume a full payment by all of the insurers, Standard Transurance would pay \$10 million (20% x \$50 million) while Credit Enhancement Transurance would have paid \$0. In this case, the additional \$10 million could be used to pay for other Collateral Damages that the insured is certain to have.