

# What Is Transurance?

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**Transurance** (trans-shure'ans) [**Trans** - over, across, above, beyond. **Surance** - shortened form of the word insurance.] 1. A type of financial or insurance contract that references an insurance policy and is used to provide funds to pay for damages that are collateral to the damages covered by the referenced insurance policy and where the payout is based on a mathematical relationship to the payout of the referenced insurance policy. 2. A collection of business methods that can be used to transfer the risk of damages that are collateral to the damages covered by a referenced insurance policy.

## Origins

Transurance was invented by Bruce B. Thomas and L. Ware Preston, III to cover Collateral Damages, i.e. those damages that occur in conjunction with traditionally insurable losses, but which are not paid for by traditional insurance. Several patents have been granted to them by the US Patent Office that cover the marketing, underwriting and claim settlement processes of Transurance.

Transurance addresses an inherent limitation of traditional insurance contracts; if damages cannot be unambiguously defined, measured and proved or are subject to discretion, they cannot be covered by a traditional insurance policy. Additionally, traditional insurance contracts often constrain the insured to use the insurance proceeds in a particular way that may be contrary to what the insured wants. Transurance can be applied to any type of insurance policy to cover Collateral Damages. This includes property, casualty, workers' compensation, health, disability, and life policies.

Transurance encapsulates several fundamental ideas:

1. Businesses and individuals always need substantially more funds than traditional insurance provides to deal with the consequences of the losses they suffer;
2. Insureds are in a better position than insurers to evaluate how much additional money they will need to manage the consequences of an insurable loss;
3. Insureds can easily express the amount of additional money that they want as a mathematical function of the loss paid by their traditional insurance;
4. It is easy for insurers to determine a price for additional coverage that is a mathematical function of a referenced insurance policy, even if they have no way of knowing how to set a price for an insured's actual collateral damages; and
5. Insureds should have the freedom to use these additional funds however they want to deal with the consequences of the losses that they suffer.

### **New Form of "Agreed Value" Insurance**

Insurers writing indemnity insurance policies agree to restore the insured to the same financial position as before the loss, subject to a variety of conditions. This type of policy works well in cases where it is relatively easy to determine the amount of the loss. When it is difficult to substantiate the extent of a potential loss, the parties can avoid subsequent disputes by using an "Agreed value" or "valued" insurance policy. In these policies, the buyer and the seller agree on the value of the insurance payment at the inception of the policy. If the covered loss event occurs, the insured gets the pre-agreed payment. The insured is under no obligation to prove the amount or extent of his damages and is not constrained to use the insurance proceeds in any particular way.

Life insurance and accident insurance are probably the most widely recognized agreed value policies used today. However, property and casualty insurance makes widespread use of this form of coverage, too. Agreed value forms are used to insure the risk of total loss to boats, planes, cargo, art, and many other items that are difficult to value after a loss.

Property and casualty insurers are continually trying to expand their coverage to address more of the economic losses that insureds face. These efforts often take the form of agreed value provisions that are included in indemnity style property and casualty policies.

For example, PURE and other insurers of high value homes provide a set amount of money for homeowners to use to make risk control improvements if they experience a loss over a certain size. Another example is an optional feature of Liberty Mutual's auto policy that in the event of a total loss pays the insured an amount equal to the value of a car that is one model year newer and has 15,000 less miles as a way to better address the total economic loss to the insured.

Transurance is a new form of agreed valued policy. However instead of a lump sum payment, the parties agree to a payment that is a mathematical function of another insurance payment. In this way, payment for Collateral Damages can be scaled to the size of the losses paid under a traditional insurance policy. Another distinguishing characteristic of Transurance is that this form of coverage works in conjunction with a traditional indemnity based policy to pay for any damages that are not covered by that policy, regardless of whether they are direct losses or consequential losses.

### **New Form of "Parametric" Insurance**

Traditional parametric insurance pays based on some triggering event that is exogenous to the insured. For example, a contract only makes a payment if there is a catastrophic event that meets certain descriptive criteria (heat, rainfall, wind speed, etc.). The advantage of parametric insurance is that the payoff is based on objective criteria that are determined by disinterested third-parties that are easily obtainable. However, structuring insurance contracts in this way gives rise to basis risk. Since the payoff is derived from exogenous factors, it may be significantly higher or lower than the insured's actual loss experience.

Transurance is fundamentally different than other types of parametric insurance because the payment trigger is the insured's own loss experience. Since the Transurance payment is a mathematical function of the insured's own insurance payment, the insured does not need to worry that the Transurance payment will be higher or lower than expected. Another difference is that most parametric insurance contracts only make payment if there is a catastrophic loss event. Transurance can make payments across the full spectrum of losses that the insured may face and scales the payment to the size of the insured's insurable damages.

## **Collateral Damages**

### **Damages Collateral to Property Insurance**

A study of large property insurance claims determined that insureds typically need 30%-50% more money than their insurance policies pay to fund their Collateral Damages. There are two broad categories of Collateral Damages; those that are clearly not covered by traditional insurance policies and those that are covered but only partially paid for by insurance.

Many types of additional costs that insureds experience in conjunction with insurable losses are clearly not covered by traditional insurance. For businesses these uncovered damages include: advertising expenditures; concessions to vendors, distributors, and employees; legal and consulting expenses; additional administrative and financing cost; lost revenues; cost of new risk management programs; regulatory costs, rebuilding to a different standard, etc. For individuals these costs include: the opportunity cost of time spent on the loss; incremental cost of rebuilding, repairing, or replacing damage property to the insured's standard; incremental cost of living expenses to the insured's standard; cost of travel to deal with loss; use of professional services; etc.

A large portion of Collateral Damages also result from losses that are covered by insurance policies but which the insured is not able to "prove" to the satisfaction of the insurer. The result of this disagreement is that on average 15% to 30% of large loss amounts claimed are not paid for by insurance. In addition to disputes over the extent and magnitude of losses, the insurance proceeds are further reduced by deductibles, amounts in excess of limits, and coinsurance.

### **Damages Collateral to Liability Insurance Policies**

Liability policies are designed to pay for awards or settlements where the named insured is found legally liable for acts defined in the policy and for defense of suits alleging liability for these acts. Liability policies do not pay for damages experienced by the named insured such as the opportunity cost of management time devoted to defending the suit, loss of reputation, changes to operations or products or services, product recall, fines and penalties, etc. Not all acts for which liability is found are covered by insurance and insurers impose limitations on payments for defense costs. In aggregate these collateral damages are always at least 20% of the losses paid by a liability policy.

## **Damages Collateral to Health Insurance Policies**

Indemnity health insurance policies pay for the insured's medical expenses. They do not cover all of the other damages that an insured may experience when a health condition arises.

## **Using Transurance**

### **Example**

The following example demonstrates the simplicity of Transurance. An insured knows he will need at least 20% more money than his insurance policy will pay if he suffers a loss. To manage this shortfall, the insured purchases a Transurance policy that will pay 20% of whatever the traditional insurance policy pays. Because the Transurance policy payment is a mathematical function of the payment from the traditional insurance policy, the insured does not have to prove the Collateral Damages he sustained, and the insured can use these additional funds in any way that he wants. Although the insurer would not know how to price coverage for the insured's actual collateral damages, the insurer does know how to determine a price for 20% of the damages covered by traditional insurance.

### **Structuring Transurance**

Although Transurance is conceptually simple, structuring a Transurance contract involves multiple considerations that should be tailored to the risk transfer objectives of the buyer and seller. These considerations include: the legal form of the contract; the parties to the contract; the reference to the traditional insurance policy; the mathematical relationship between the Transurance contract and the insurance policy; and the conditions necessary for payment.

*Contract Form* - A Transurance contract may be structured so that it meets or *does not meet* the legal requirements of an insurance policy, based on the relevant laws and regulation and the needs of the parties to the contract. If the Transurance contract will be structured as an insurance contract, consideration must be given to whether it will be formed as a standalone insurance policy; as an endorsement to a traditional insurance policy; or as a coverage part of a traditional insurance policy.

*Contractual Parties* - The buyer of a Transurance contract may be the insured under the traditional insurance policy or it may be a third-party that will be adversely affected if the insured has a loss. The seller may be the insurer of the traditional insurance policy or it may be another entity that is desirous of assuming the risk of collateral damage from the buyer.

*Reference to Insurance Policy* - Consideration must be given as to whether the parties will reference the all the paid losses under a traditional insurance policy or some portion of the paid losses under that policy. A *qualitative coverage subset* will be used if the parties desire to impose qualitative limitations on the losses paid by the referenced insurance policy, from which the Transurance payment will be derived. Qualitative limitations may exclude losses paid by the referenced insurance policy from certain coverage parts, types of coverage, perils, locations, etc.

*A quantitative coverage subset* may take the form of deductibles, retentions, limits, and coinsurance that are applied to the paid losses of the referenced insurance policy.

*Mathematical Relationship* - The parties must decide what mathematical function to apply to the referenced paid losses that will be used to determine the Transurance payment. This relationship may take the form of either a proportional or nonproportional mathematical function that scales the potential Transurance payment based on the size of the referenced paid loss. 10% is an example of a proportional mathematical function.

*Payment Conditions* - The Transurance contract may be structured so that it pays the amount of the specified mathematical function that is applied to the referenced paid loss. If the contract is structured in this fashion, the buyer does not have to prove the nature or extent of his Collateral Damage to receive a Transurance payment, only that he received payment under the referenced insurance. Alternatively, the Transurance contract may be structured so that a payment limit is derived from applying the specified mathematical function to the reference paid loss. If this is the case, then the buyer will have to prove the nature and extent of its Collateral Damages to the standard described in the Transurance policy.

*Type of Referenced Insurance* - All types of insurance: property, liability, workers compensation, disability, life, health, surety, etc.

*Premium* - The premium for Transurance is set by the Transurer by applying the payout function to the premium the Transurer believes is appropriate for the referenced insurance. For example, if the Transurer believes an appropriate premium for the referenced insurance is \$10,000 then the premium for Transurance that pays out 10% of the loss paid by the referenced insurance is \$1,000 (10% times \$10,000).

### **How Buyers Are Using It**

By changing these parameters, buyers can purchase Collateral Damage coverage while also achieving a variety of other objectives. A standalone contract may offer better terms and conditions and allow buyers to access insurance companies that are not parties to their traditional insurance contract.

Large companies have used qualitative and quantitative coverage subsets to target just the Collateral Damages that they are most concerned about. For example, a large commercial bank has purchased a Transurance policy that references only paid insurance losses on some of its largest property exposures. This reduced the cost of the Transurance, while ensuring that the bank had additional coverage if its largest facilities experienced insurable property losses.

Managers often have difficulty getting all the funding they need for risk improvements. By structuring Transurance contracts as an endorsement to their traditional insurance policy and specifying that the Transurance proceeds must be spent on risk improvement initiatives, Risk managers have used Transurance contracts as a way of funding their risk management objectives. If their companies do not use the money for risk improvements, there is no Transurance payout,

so the companies are essentially forced into upgrading their facilities. This is good for the insureds and good for the insurers because it reduces the possibility of future losses.

Buyers have also purchased Transurance contracts as a means of funding betterments and upgrades that cannot be known until the time of the loss. Rather than be forced into making particular upgrades after a loss as some "green building" policies do, buyers often prefer the flexibility of using the Transurance proceeds for whatever they want. To this end, they have structured the Transurance contract so that the only payment condition is proof of payment under the referenced insurance policy.

### **How Sellers Are Using It**

As an optional endorsement to their existing policies, insurers are offering Transurance to satisfy insureds that want more comprehensive coverage. In this way, insurers can differentiate their products, retain customers, and increase the premiums they receive from exposures they already like.

Other insurers are offering Transurance as a separate policy to access insurance exposures that would otherwise be inaccessible to them due to competitive pressures. In this way, they can form new relationships with insureds, get a better understanding of loss experience in key markets, and earn additional profits.

Additionally, a Transurance payout can be included into a traditional insurance policy. Structured in this way, Transurance helps insurers differentiate their products, and acts as a meaningful incentive for customers to continue buying coverage from a particular insurer and to maintain good loss histories.