

About Your Collateral Damages

By Bruce B. Thomas

Your risk manager just told you that if your company suffered an insured property loss it would need much more money than its insurance would pay. She recommends that your company consider purchasing a new form of insurance, called Transurance, which pays a percentage of the amount paid by insurance as a way to deal with this shortfall. In support of her assessment she shows you a new study by Transurance Services, LLC that suggests that commercial insureds will need 30% to 50% more money than their property insurance provides to deal with the consequences of a large loss.

Like most financial managers, you do not have much experience with large property losses so your first response is to get additional information. Is she right? Perhaps the study is flawed, maybe the risk manager misunderstands the study findings, or maybe it is incorrect to take the findings and apply them to your company in particular. You have never heard of Transurance, and wonder why you need a new form of insurance to deal with something that you thought was already covered. Before doing anything, you need to know a lot more.

Property Insurance Claim Study

The study¹ the risk manager is referring to is a survey of property insurance claim experts designed to help illuminate what happens to companies when they suffer large insured property losses. Participants in the survey had an average of 29 years of experience settling property claims and included independent adjusters, accountants, claim experts at insurance brokerages, attorneys, insurance company claims adjusters, and several insurance company executives. Collectively, these claim experts had four hundred and sixty-one years of experience and had resolved more than two thousand three hundred large property claims.²

Among the study's key findings are several issues of concern to executives and financial managers.

- Insureds often believe their insurance covers more than it actual does.
- When companies experience a property loss, they typically have expenses and lost earnings that cannot be covered by property insurance.
- After all the facts are known about a loss, there are still many reasons for claims to be disputed.
- Settling large property claims is complicated, involves a lot of people, and is time consuming.

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>.

² For the purposes of the study, large property claims were defined as those losses where the paid claim amount was more than ten million dollars and included a business interruption component.

- 29% of physical damage claims are not fully settled six months after the property has been repaired or replaced.
- 39% of time-element claims are not fully settled six months after the period of indemnity.
- Even after the claim has been whittled down to those amounts on which there is a reasonable basis for thinking that coverage exists, property insurance typically pays only 76% to 87% of the amount claimed.

Judgment and Experience Required

As the study makes clear, a great deal of judgment is involved in settling insurance claims. Insurance policies do not say “you claim it, we pay it.” Instead, they are lengthy documents that require a great deal of experience and expertise to understand. To be covered by property insurance, losses must fit within the coverage definition of the insurance policy, and the policyholder must be able to prove the extent of the loss. This sounds much simpler and straightforward than it is.

With every large insurable loss there are numerous costs that are obviously not covered by insurance. No one bothers to separate these items from other operating costs because there is nothing that can be done about them. As a result, these costs are invisible to all but the managers who are directly responsible for them.

Conversely, companies are very aware of the out-of-pocket expenses that are deemed to be potentially covered by insurance because they are separately identified and tracked. During claim preparation, a fair number of these expenses are typically excluded from the claim because the experts involved cannot find any reasonable basis for claiming that they are covered by the insurance policy. Of the loss amounts that are included in the insurance claim, a fair number are still disputed by the insurance company. Either the insurer disputes that the item is covered, contends that only a portion of the item is covered, or challenges the amount of the item as being unreasonable.

Expect Recovery Shortfalls

According to property claim experts in the study, insureds should expect insurance to pay only 76% to 87% of the final amount that they claim. Adding expenses and damages for things that are not claimed because they are clearly not covered by insurance, insureds should expect that property insurance will pay for only 65% to 75% of the total economic damages resulting from insured property loss events. This implies that insureds will need other funds, equal to at least 30% of the property insurance payment, to fund the portion of the loss that cannot be covered by property insurance.

With a better understanding of the issues involved, you realize that what the company’s risk manager is saying is true. Although property losses are rare events and nobody ever wants to admit that something really bad could happen to them or their company, it is your job as a financial manager to examine potential problems and find solutions before they manifest.

You think about the impact of retaining these uninsured collateral losses on your company. The company's premium for its property insurance policy is \$1 million, the policy limit is a \$100 million, and it has a \$100 thousand deductible. The company is well prepared to pay for its deductible. In fact, it could handle several times that amount without difficulty, but after that, the company would need additional financing.

Securing the last round of debt financing was not easy, and you hate to think how much more difficult it would be if you had to try and raise even more money in this economic environment while facing significant operating issues. Debt covenants would be breached, debt holders would want additional assurances and security, and dividend payments would be restricted.

If the company suffered a loss that resulted in total economic damages of \$25 million, it would only receive an insurance payment in the range of \$16 to \$19 million. This would result in \$6 million to \$9 million of *collateral retained losses* for which the company would have to find additional financing. A much smaller loss event, such as \$5 million would result in a smaller amount of collateral retained loss, but it would still be a significant problem. Even \$1 million of collateral retained losses is far more than anybody had contemplated, and self-funding this amount would be very disruptive.

Implications for ERM

The company has never experienced big losses such as these before, and you would like to imagine that with all of the safety measures you have in place they could never happen. But large losses do happen, and they happen even in companies with top-notch loss prevention programs. The fact is that bad things do happen to good companies. If such losses were impossible, the company would not buy insurance at all.

You think back to the previous summer when the ERM experts were in your offices helping the executive team identify and assess the company's important risk issues. It occurs to you that they never mentioned the existence or the magnitude of collateral retained losses. No, in fact, they dismissed all the insurable events from consideration by saying that they were already covered by insurance. They were affiliated with your insurance broker, and it concerns you that they did not identify or quantify the one risk that they were uniquely qualified to know about.

You start thinking about the loss prevention initiatives that the risk manager suggests at the beginning of every budget cycle. They were never deemed to be a good use of the company's resources before, but maybe its time to take another look. Including the impact of *collateral retained losses* in the cost-benefit analysis might change the outcome of this analysis.

Given the magnitude of *collateral retained losses* and the fact that they occur in conjunction with every insured property loss, your company needs to proactively address this issue. Ignoring these 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 that your company has adopted. Something must be done to fund these losses, but what?

Financing Collateral Retained Losses

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 exercise of 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.

Your company could change the payout parameters of its insurance policy by lowering its deductible or by increasing the limits of its insurance, but neither of these actions will reduce the recovery shortfall in question. Neither of these actions helps to define, prove, or measure losses that will otherwise remain uninsurable.

Similarly, it does no good to go back to your insurance broker and ask them to define all of the things that cannot be defined or to get rid of the judgment that will be required to settle potential insurance claims. The risk manager is working with one of the world's largest insurance brokers, and the broker says that she has done everything she can to ensure that your policy is state of the art.

This is not a performance issue so it is useless to say that the company will just ask for more money from its insurer, that it will fight harder to get a larger claim payout, or that it will sue the broker for non-performance, because none of these things solve this problem. Collateral retained losses will exist even if the insurance policy performs exactly as it was intended. The experts in the study were recounting their own experiences fighting to get the highest claim payments, and they still ended up with a significant shortfall in comparison with their clients' true economic needs.

In theory, your company could change its capital structure by increasing debt and equity so as to have more cash on hand to fund these losses. In practice, this would not make much sense because self-funding highly infrequent losses by setting aside large amounts of cash is very expensive and does not sit well with shareholders.

It would be so much easier and more financially efficient if you could just buy more insurance for this risk. The risk manager did say that there was a new form of insurance called Transurance available. With a solid understanding of the problem, it seems like an opportune time to evaluate the solution that she is proposing.

Transurance

Transurance is a supplemental insurance coverage that pays a percentage of the loss paid by a referenced insurance policy. It is a means of super-sizing an insurance recovery to help pay for the additional loss costs that cannot be covered by traditional insurance. For example, a Property Transurance policy pays X% of whatever amount is paid by the property insurance policy in return for X% more premium.

This seems pretty straightforward. If the company wants an insurance payment that is 30% larger than the property insurance payment, it simply buys a 30% Transurance policy. In return for getting 30% more insurance payment, the company will have to pay 30% more premium or \$300 thousand.

Unlike traditional property insurance, the insured does not have to prove the damages it has 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 a payment under the referenced insurance, and then it can use the Transurance payment for anything.

Given that the Transurance premiums cost the same amount as the property insurance that it references for a given amount of payout, it is clear that the Transurance policy has the same value as the traditional insurance policy. There are only two reasons why it would not make sense for the company to buy a Transurance policy: either its traditional insurance policy has no economic value or the company simply does not have enough cash to pay the additional premiums.

The first reason for not buying Transurance is illogical since your company would not purchase property insurance if it did not have any value. In fact, your company's property insurance has tremendous value since it is many times cheaper than maintaining extra amounts of cash to pay for large and highly infrequent loss events.

The second reason for not buying Transurance is only logical in the short-run, and it is analogous to deferring an oil change. While staying uninsured for these additional damages, is not a good decision per se, it may make sense under extreme conditions where the company simply does not have the financial resources at the moment to pay for it.

Buying a 30% Transurance policy would fund your company's collateral retained losses, but it would also largely deplete the company's cash reserves, causing other problems. Nevertheless, a 20% Transurance policy would fund the majority of the collateral retained losses and still leave the company with a sufficient liquidity cushion should there be any unforeseen short-term need for cash. The company can increase its Transurance purchase over time, as its finances improve.

Bruce Thomas is a managing director at Transurance Services, LLC and may be contacted at BT@TransuranceServices.com Transurance is available from different insurers under various trade names, and risk managers should contact their broker to find out more about purchasing Transurance. More information about Transurance may be found by at www.TransuranceServices.com