

## Insuring Collateral Retained Losses

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According to the property claim experts, insureds should expect insurance to pay only 76% to 87% of the final amount that they claim.<sup>1</sup> 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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<sup>1</sup> 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](http://TransuranceServices.com).

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](mailto:WP@TransuranceServices.com) or Bruce Thomas at 203.445.0830 [BT@TransuranceServices.com](mailto:BT@TransuranceServices.com). More information about Transurance is available at [www.TransuranceServices.com](http://www.TransuranceServices.com).