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

INSURING BUSINESS CONTINUITY

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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.

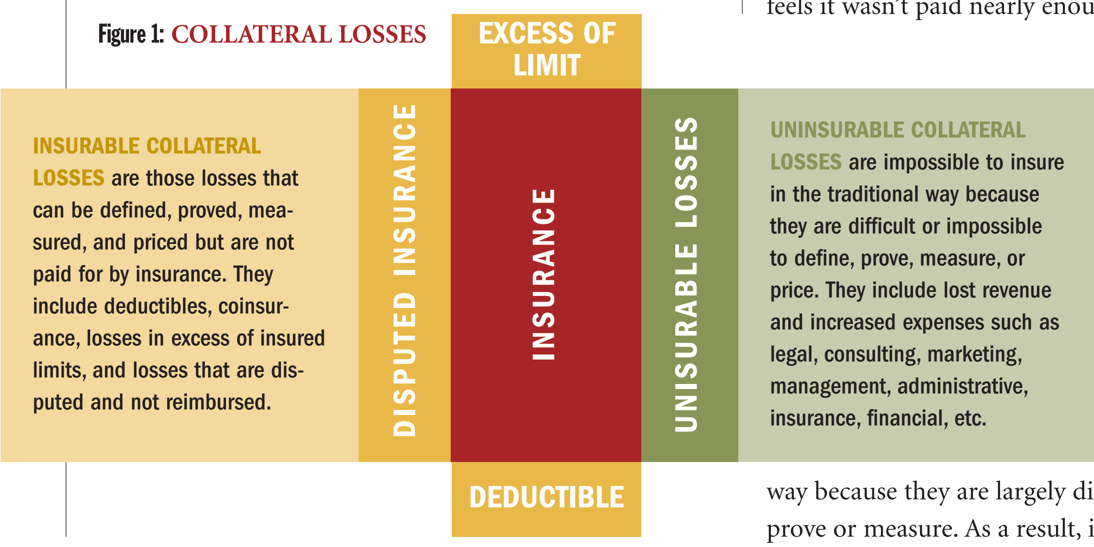
COLLATERAL LOSSES

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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