The Value of High-Excess Commercial Insurance (working title)

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Abstract

Firms use property-casualty insurance as a source of contingent capital. That is, instead of setting aside capital to fund rare but extreme events, firms will purchase insurance. High layer excess insurance, in particular, serves this purpose. Firms rarely access these layers, and the expected value of claims in those layers is minimal. As such, the insurance policy's primary value is that it allows the firm to deploy the capital that it would otherwise need to set aside to weather an extreme loss event. This paper describes an approach to measure this value.

Introduction

Commercial insurance programs are often depicted as "towers." (See Figure 1) The lowest floors of the tower are typically comprised of retained risk. The middle floors include commercially insured working layers. The "penthouse" is generally high-layer excess insurance. Each of those layers has a cost to it.

- The cost of the lowest layers will have a reasonable degree of predictability. The cost for this layer will be principally be the expected loss with a minimal capital charge volatility. There may also be frictional costs associated with risk retention such as increased audit and actuarial fees and claims administration costs from legal counsel and third party claim administrators.
- The middle layers will provide coverage for claims with a degree of regularity. The amount of claims may not be reasonably predictable in a single year but it would be predictable over a longer-term time horizon. They insurance coverage provides value to the insured by smoothing claim volatility over time. There may be multiple insurers in the higher working layers.
- Insureds may not expect to ever require coverage from the highest layers. The expected claims will likely be close to $0. The coverage does not smooth claims volatility for the insured over time but rather smooths claim volatility across insured risks. There are often multiple insurers in this layer, each with a pro-rata share. Yet, there will be a cost to this layer. In this paper we explore the *value* of the coverage in this layer. Measuring this value provides the insurer a basis upon which to assess the cost established by the insurer.

Measuring Value

The value of this layer is not in the expected loss but the protection of capital that this layer of insurance provides to the insured.

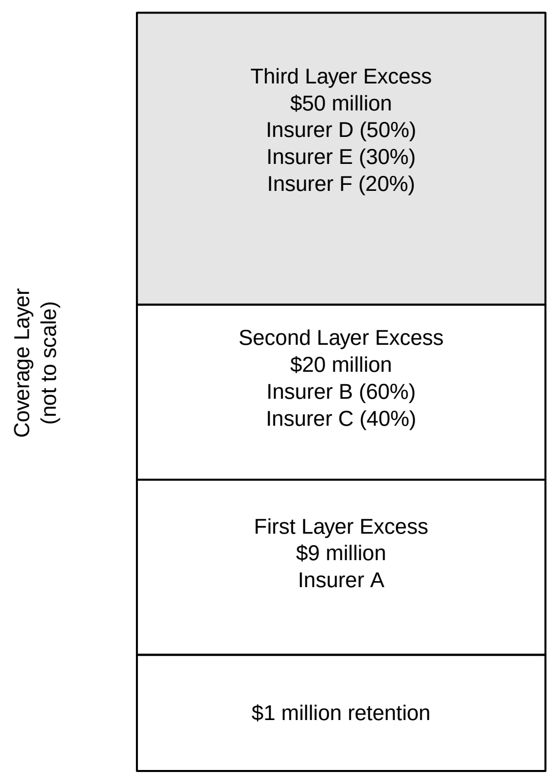

Figure 1: Example Insurance Tower