

CHANGING BUSINESS STRATEGIES TO REDUCE THE TOTAL COST OF RISK

Analysis of railway risk has shown historic railway business practices and contracting methods can increase expenses with little risk reduction or liability mitigation. This paper will examine strategies to obtain benefits from a well-executed and managed “contractual risk transfer” (CRT) protocol that many railways incorporate into their contract terms and conditions but then neglect to enforce or actively manage. As a result, they do not achieve the risk mitigation and cost savings they seek.

INTRODUCTION

Historically, railway risk management efforts have focused on establishing insurance programs that protect the enterprise from catastrophic property losses and large third-party and employee liability claims at a cost the railway can afford, considering its appetite to directly assume smaller claims. Acknowledging that a majority of claims are uninsured and are treated as a normal business expense, Marsh proposes a more holistic approach to risk management that recognizes each loss, whether insured or not, as a detriment to the financial performance of the railway business and hence, should be minimized or eliminated¹. More recent analysis, as part of efforts to reduce TCOR, reveals that railways may initiate or incorporate business practices to contractually transfer the risk to other parties as a means to protect themselves. However, if they fail to coordinate the contract terms and conditions with their insurance programs, or fail to actively enforce contract terms and conditions, they may negate this additional layer of protection. The use of Safety Management Systems (SMS) methodologies to identify hazards and mitigate risk across all departments of the railway is an effective strategy

to manage TCOR. Since SMS is an integral part of new railway safety laws worldwide, its use throughout the railway’s business activities should not be ignored. This paper proposes that many of the same SMS methods that address physical and human factor risks should be used to identify and mitigate business practice risks when establishing contractual risk transfer.

COMPONENTS OF RISK MANAGEMENT

A railway risk transfer program is composed of property and casualty insurance, usually constructed in towers in which multiple insurers underwrite specified percentages of each layer of coverage in the tower, with the railway self-insuring the least costly and most prevalent claims. To mitigate the self-insured exposures, railways create executive safety and loss prevention programs in both the operational and occupational areas of their business. Included are third-party agreements and contracts that share or transfer risk to parties that enter the railway property or perform services for the railway, globally referred to as “contractual risk transfer.”

When assembling contract transfer instruments, it is very important that none of the contract language be in conflict with the overriding insurance policies that provide the catastrophic insurance coverage. Once contract language is conformed, including verification of definitions of terms used, then it becomes equally important to monitor compliance with the contractual requirements over the life of the relationship to assure the protections negotiated and agreed to are actually available in the event of a loss. At the end of the processes, the goal is to transfer the risk of loss at the lowest-possible cost to all parties of the contract or agreement. In many cases, this represents a major change by the railway whose historic business strategy is to transfer all risk to the third party, regardless of its ability to pay or survive a major loss.

CRT BEST PRACTICES

The recommended methodology for identifying the steps needed to move from your current CRT practices to the railway industry’s CRT “best practices” is called GAP Analysis. It is the process of analyzing the differences or shortcomings (the gaps) between current practices in transferring risk by contract compared

to the railway industry’s “best practices” in doing so. Identified gaps can then be bridged by following the steps illustrated in Figure 1.

CRT “best practices” must include other party insurance requirements that reflect common insurance industry practices and approaches to providing insurance coverage. The use of vague and antiquated terminology, and ambiguous language that’s susceptible to more than one interpretation or that have no meaning in current insurance industry practice is widespread in the railway industry and must be avoided. Other party insurance requirements should also be built upon existing case law to avoid unnecessary litigation.

Best practices must include a methodology that identifies exposures to risk of loss based upon modelling so that bias is avoided. Being able to recall and assess the relative frequency and severity of events lies at the heart of intuitive analysis.

However, absent modelling which drives comprehensive analysis, some events will be given undue emphasis. Events that are fresh in our mind, for example, tend to dominate our assessments. A bad experience with a type of operation may intuitively suggest to us a high likelihood that all (or most) of our experiences will be bad, so we end up making a decision based on a very small sample. Modelling exposures to risk of loss helps mitigate this bias. Modelling drives analysis that leads to comprehensive understanding of the risks to be mitigated.

Determining exposure to risk of loss, appropriate limits of insurance, and transferring risk of loss by contract can be problematic because:

- A large uninsured loss can result in business failure.
- Increased premium spend because the risk transfer levels purchased (attachment point and total limit purchased) are not properly quantified

via historical loss analysis and industry specific benchmarking data.

- In the absence of adequate insurance, claimants and plaintiffs will expand their search for “deep pockets” to enhance their opportunities for financial recovery.

Modelling is one of the methods used in SMS plan development and implementation.

COMPLIANCE BY OTHER PARTIES TO INSURANCE REQUIREMENTS

Commercial insurance policies represent a railway’s best chance of recovery for liabilities falling within the indemnity provisions of its contracts. Verifying that the other party has required coverage in force, and monitoring ongoing compliance are critical steps in transferring risks of loss by contract. The most common method of verifying compliance is to require the other party to furnish a certificate of insurance and to assure that the insurer

Figure 1: Gap Analysis



EXAMPLE A

A large North American railroad had less than 20% compliance with the insurance coverage and limits it required of other parties to help ensure they could fund the indemnity portion of their contracts and agreements.

The railroad implemented a certificate of insurance monitoring system to manage compliance with its required insurance coverage and limits. Compliance began increasing immediately, and as improvements to the process were made the rate of compliance accelerated, reaching 100% in just a few years. The result: The railroad received from commercial insurers more than \$50 million dollars it would otherwise not have recovered.

automatically notifies the railway of any change that affects the coverage. Verifying compliance with insurance requirements using certificates of insurance can be a difficult and labor-intensive task if done manually. Therefore, a system is needed to monitor the other party's compliance with your requirements and to allow easy retrieval of documentation demonstrating that they are compliant, or shows what steps have been taken to enforce compliance. A system also allows measurement of performance. Where performance is measured, performance improves, and where performance is measured and reported, the rate of improvement accelerates.

INDEMNIFICATION CLAUSES

Contracts routinely contain indemnification clauses that require a party causing damages to make the other party whole, including legal costs. Indemnifications can be bilateral where each party assumes responsibility for its own actions and losses as is found in many track access agreements. In the absence of gross negligence, each party assumes their own losses and cooperates in resolving shared losses as prescribed in the agreements. When the injured is a third party, care must be taken if the contractual parties have grossly unequal assets and capabilities to indemnify, as the richest party, usually the railroad, could be ordered in a court judgement to make the injured whole.

In situations where a railway must invite a third party on the property, it may be a one-way indemnification invoking the "but for" argument; but for the fact that the third party was present and performing some task, the loss would not have occurred, hence all losses regardless of which party caused the loss, the invitee is fully responsible to make the railway whole.

Such one-way, all inclusive indemnifications that are not capped are problematic if the third party lacks adequate liability insurance, the corporate liability policy includes a railroad exclusion, or the limits have been used for prior claims and not reinstated. A public agency may have a statutory cap, which makes it unable to indemnify the railway except for the smallest of losses. In North America, railways require such third parties to purchase project-dedicated railroad protective liability insurance to be the primary coverage where the railway is the insured.

INTEGRATING SMS SAFETY PROGRAMS INTO RISK MANAGEMENT AND CRT

The SMS guidelines of Transport Canada² ask five basic questions when identifying and analyzing hazards and risks:

- What is the nature of business or task?
- What could go wrong?
- How bad is it or could it be?
- What can be done about it?
- How effective are the corrective or mitigating actions?

By using these basic questions, it is possible to analyze specific contract or agreement provisions and how they will interact. Creating multiple "what if" scenarios can predict how the various insurance policies will perform and when insurance coverage is no longer available, how the indemnifications and the indemnifier's insurance will provide recovery. This process should also highlight when the self-insured retention (SIR) of either party will be the only resource, and whether the responsible party has adequate resources to self-insure without risking business failure. Also, the role

EXAMPLE B

A railroad risk manager allowed a contractor to cap the limits that its insurance policy would apply to a particular contract with the railroad. When there was a loss that exceeded the specified limit, the insurer stated that the insured had limited its liability to pay the loss in the terms of the contract. Subsequently, the contractor had to pay that portion of the loss that exceeded the specified limit without the insurance it was counting on to back them up.

Always specify the limits to be provided as a floor; i.e. "Not less than \$X". This makes all limits (primary and excess or secondary) available to both parties.

EXAMPLE C

A railroad required that it be included as an additional named insured in its vendor's commercial general liability (CGL) policy. A liability loss occurred and the insurer denied coverage to the railroad. The reason payment was denied is that there is no coverage for an unrelated entity in a CGL policy. The CGL policy provides coverage for the named insured, automatic insured's, and additional insured's, not an additional named insured. As in this example, the use of outdated descriptive language in insurance requirements is widespread in the railroad industry.

Terms that convey no meaning in current insurance practice should be avoided. Contract provisions that require standard insurance practice endorsements are much more precise and less ambiguous. Standard endorsement forms and practices will generally give indemnitees all the protection they need. If there are multiple insurers, verify that language on all policies is consistent and that there are clear understandings among insurers of how the policies will interact before a loss occurs.

of SMS in CRT is presenting the railway's risk profile in its finest light when negotiating premiums with the insurance markets.

CONCLUSION

All loss payments exclusive of insurance or third-party recovery affect the railway's bottom line of financial performance. If the railway is a publicly traded company, the shareholders ultimately feel the impact. For every dollar paid out in claims, additional revenue must be generated to maintain the status quo. In a government owned or non-profit entity, these payments cause restatement of budgets and elimination of line items that provide for increased efficiency, growth, quality of service, and levels of staffing. Reducing TCOR by controlling costs related to CRT is a viable strategy to improve financial performance of the railway. Knowledge of how insurance policy coverage, terms, conditions, and exclusions will respond in the event of a loss to all parties to an agreement can foster less adversarial claim settlements. These are discussions that should occur during underwriting and insurance placement and not wait until there is a major claim. Using SMS as an analytical tool makes for a safer railway, reducing the risk exposure and the loss of employee time. It also can encourage better communication within the railway organization so the legal advisors, financial officers, technical staff, and train operations staff have inputs to achieve the optimum balance between risk transfer and internal risk mitigation. The final SMS plan filed with regulators should reflect these business relationships that mitigate hazards and manage risk.

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ENDNOTES

- 1 Michel, James and Gardiner, Robert; 2014 "Reducing the Total Cost of Risk Across the Railway Organisation." RTSA, CORE 2014, Adelaide, SA.
- 2 Transport Canada Railway Safety Management System Guidelines, publication TC-10004043, Section 2.2-Overview, published November 2010.

Marsh is one of the Marsh & McLennan Companies, together with Guy Carpenter, Mercer, and Oliver Wyman.

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