ART GALLERY FOR MARCH

'Trickle down' of LPT can benefit captives

By Dick Goff

ART continually benefits from the insurance version of the economic "trickle down" theory, as longstanding practices of the traditional industry are adapted for use by the alternative community often with significant strategic benefits.

I'm thinking of the example of loss portfolio transfers (LPT) that in the past have been used for one giant corporation to take over the underwriting losses of another giant corporation, for a price. This just proves that an insurance contract may be written on just about any proposition if the actuarial and underwriting stars align.

If company A, for example, wants to clean up its balance sheet by sending off known losses and the mysterious "incurred but not reported" (IBNR) losses, company B may take them over for a negotiated premium that could be somewhat fewer dollars than company A's total projected losses. This takes into consideration the time value of money, so company B would have to be pretty sure that it could invest the premium to show a profit after paying the losses.

The wild card in the transaction is the IBNR figure. Company A wants that figure to be as large as possible in order to strengthen its balance sheet by that amount. Company B looks for "fluff" in the numbers that would indicate the real losses likely wouldn't be as high as projected and that the contract will show a profit after losses are paid.

An insurance company's largest liability is the combination of known claims plus IBNR. The relationship of this liability to total assets will be a major determinant of the company's AM Best rating, bank credit rating and liquidity.

A common use of LPT is when a company may decide to stop writing a class of business with a long exposure tail (such as workers' compensation). Rather than continue administering all its policies and paying claims while no new premiums are coming in, the company is often better off by paying to make them someone else's problem.

That's the conventional world of LPT. Now we turn to ways this method is being adapted by the ART world, with some entrepreneurial advantages that may be rewarded on both sides of such transactions.

Risk retention groups (RRG) are micro insurance companies with many of the same financial challenges including constant attention to the balance sheet. RRGs continuously look for ways to improve their financial health to maintain the benevolent attention of regulators or increase liquidity to write new business.

Strategically, the LPT could help a captive or RRG to exit a line of business or even go out of business without a long "runoff" of claims on its books. LPTs can be structured with either a guarantee that no claim can come back to hunt the cedant, or with a cap that may allow excess claims to revert to the company. That distinction can make a big difference in the size of the transaction cost.

An LPT could be welcome relief for – just for example – a self-insured group (SIG) workers' compensation plan such as those that regulators are attacking in New York, California and elsewhere. LPT programs could be viewed as "regulator appeasement" plays that allow the SIG to survive and come back another day, perhaps as a traditionally fronted captive program, hypothetically speaking.

RRGs can free themselves from historic claims liabilities and use the LPT model to continue rolling away their claims every year if they wish, as a pure shareholder play by the owner-insureds.

The question for the loss assuming company is whether or not it thinks there is a lot of fluff within the IBNR figure or, if not, that an adequate investment return may be made. If a deal passes actuarial and underwriting muster it's a win-win-win for shareholders, regulators and the insurer of future losses.

LPTs even provide the opportunity for RRG program administrators to play on both sides of the table in transparent transactions without any conflict of interest. We know of an RRG program administrator who proposed to its domicile regulator to form a new captive that he would own for the purpose of assuming the RRG's losses through an LPT transaction.

The regulator was very pleased to see the potential strengthening of one of his RRG companies, but aware that the NAIC continues to kibbutz RRG operations, he said,

"We think it's a great idea but please don't ask us to approve and license the captive. Take it to a new domicile."

The ART program administrator can decide which side of an LPT transaction to play on. It's like when you picked between the Giants or the Patriots, with the LPT serving as the betting line.

Of course, LPT transactions aren't for the weak of heart. And both sides will want to use their own actuarial teams, so transaction costs can be a major factor. But these deals can clearly be beneficial in an increasingly competitive and more stringent regulatory environment.

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