ART COLUMN FOR APRIL

By Dick Goff

Depending on who's talking, either the insurance industry or the capital markets caused the financial meltdown that left us with today's challenges and opportunities. One of the emerging opportunities, it turns out, appears to be a new source of liquidity – specifically provided by the private equity branch of the capital markets – to self-insured entities such as workers' compensation groups, risk retention groups and others.

It's ironic that the financial ruins left in part by insurance companies overexposing themselves to the risks of investment products can now be sifted for a new flow of credit in the opposite direction. The lesson is that smart money will find opportunities, no matter how hard it has to work at it.

Some self-insured entities have been damaged or severely limited in their ability to prosper because of restrictive regulations that require high capital reserves – they're literally sitting on mountains of cash that they can't use.

Now there is hope for self-insurers and the ART industry. That glow on the horizon is new liquidity that is beginning to flow toward self-insured entities to help them overcome their regulatory burdens and inject new energy into their operations.

One of the harbingers of that trend is Alexander Burns, a principal and chief strategist of Southport Lane, a New York City-based private equity firm that manages an investment portfolio on behalf of institutional investors.

"We saw an opportunity to help replace liquidity that may have been lost in the meltdown or sidelined by the regulatory environment," Burns told me. The firm's transactions with self-insured entities are basically reinsurance contracts funded through segregated accounts of a Bermuda captive, which acts as a reinsurer.

During recent years, "liquidity evaporated in ways no one had seen before," Burns said. "We intend to pick up the ball in areas that have been dropped by other insurers or that have suffered lost liquidity themselves."

I thought that could be a huge service to, for example, the SIGs whose capital, for lack of a more genteel description, has become constipated. A firm such as Southport

Lane can enter the picture on behalf of actuarially sound insurers with a new boost of liquidity.

"Yes, we can provide a bridge point to another pool of capital, providing additional liquidity," Burns said.

I thought of another possibility. Say a SIG wanted to collapse into a fronted reinsurer in a captive. Additional liquidity would be needed to capitalize the front market. "Right," Burns said. "You could just think of us as another source of credit."

Another way to look at this scenario is to compare it to the hedge funds' earlier operation of sidecars for CAT bonds. Private equity firms will be operating for self-insurers in the same way.

I saw this new kind of transaction as a brand new door for any self-funded structure to leverage itself into a better position to do new creative funding or improve its A.M. Best rating.

One real life example is a captive that had $8 million in reserves to support conservatively projected losses at a 45% ratio. Actual losses have been running 14%. Through a private equity reinsurance contract they were able to discount their reserves and declare a nice dividend.

A second case involved an RRG that was working out of troubled times. A private equity-financed reinsurance contract covering losses for immediate years resulted in an infusion of $1.2 million in new cash and a reduction of $2 million in liabilities.

"Simply put, this boils down to effective use of third-party capital," Burns said. "This method is less restrictive than a traditional reinsurance contract. We can be substantially more flexible and employ more tools than are generally available from the reinsurance market." Southport Lane is a corporation, and as such is set up for long-term transactions in comparison to most private equity funds, which are organized as limited partnerships that have five- to seven-year terms.

I thought that this kind of approach could be immediately valuable to self-insured organizations for a variety of purposes including cleaning up their balance sheets, having additional capital to support new business, and dispatching legacy issues that have been haunting them such as the regulated misdirection of capital.

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