Artex | Alternative Risk

Case Study

Loss Portfolio Transfers

ACHIEVE CERTAINTY IN AN UNCERTAIN WORLD

Over time, many companies have accumulated significant amounts of accrued contingent liabilities, either through normal continuing operations or because of one or more acquisitions. These liabilities often arise from the assumption of risk in the form of large deductible or self-insured programs for workers' compensation, general liability, professional liability and other similar exposures. These balance sheet liabilities can have a material impact on a company's earnings due to the uncertainty of the related amount and timing of payments for legal expenses or indemnity payments to third-party claimants.

Loss portfolio transfers (LPTs) are structured transactions that package and transfer a portfolio of known and unknown losses to a commercial insurance company in exchange for a fixed amount of consideration or premium. With an LPT, the company is relieved of its balance sheet liability (as well as any required related collateral) and, as a result, can clean up its balance sheet and achieve certainty of expense for what previously was uncertain and potentially volatile expense recognition.

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WHAT COMPANIES ARE GOOD CANDIDATES?

- Companies with typically no less than $2 million of accrued liabilities for any one line of self-insured losses. Accrued liabilities include both known losses (case reserves) and potential or unknown losses (IBNR). The commercial insurance marketplace responds increasingly efficiently to portfolios over this amount, with target transactions often best suited in the $5 million to $50 million range.
- Companies that have inherited large portfolios of claims through mergers or acquisitions, that have liabilities from discontinued operations, or that have liabilities on the balance sheet of a subsidiary that they wish to sell. In each case, the LPT cleans the balance sheet, and removes the uncertainty related to potential future development and additional expense from the portfolio of claims or losses.
- Companies that desire relief from the time and expense associated with administration or oversight of the ongoing claims process.
- Companies with large liabilities that are exposed to the volatility that stems from the uncertainly of when and for how much estimated losses will ultimately be incurred, due to the changes in cost that can come from medical cost inflation, statutory or judicial changes in workers' compensation benefits, or a particular state's tort reform efforts or lack thereof.

BENEFITS OF AN LPT

Often, a portfolio of losses arises from an insurance program with a commercial carrier in which the program features a large deductible or self-insured retention prior to the insurance carrier paying a claim. These programs frequently include the requirement to provide collateral, such as letters of credit, in order to reduce or eliminate any credit risk to the insurer. These outstanding collateral instruments can be costly and can erode the credit capacity of the company—credit that may otherwise be better deployed for ongoing operations or to support the growth of the company. Because an LPT succeeds in transferring the self-insured liabilities to a third-party insurer, the company is relieved of its requirement to maintain collateral in favor of the legacy insurance company.

COST AND STRUCTURE OF LPT TRANSACTIONS

Every transaction comes with costs as well as benefits, and LPTs are no exception. The company can expect to incur various costs related to the transaction, including:

- Broker fee commissions or fees
- Potential fees related to the administrative burden of compiling data and responding to insurer's requests for information

In addition, companies should be aware of the fact that the LPT process requires that both parties to the transaction conduct a thorough analysis of claims and potential future claims, which may shed light on possible under- or over-reserving practices.

CLIENT SITUATION

The client was a firm that was recently sold via merger/acquisition, with an asset sale only. Before the acquired firm could be dissolved by the board of directors, the legacy liabilities needed to be transferred to a third party. These legacy liabilities had built up over a 10-year period for its E&O coverage under a large deductible. Complete finality was required in order to liquidate the firm and transfer any remaining assets/profits to the original owners.

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HOW WE ACHIEVED THE CLIENT'S OBJECTIVE

Shown to the right is a typical large-deductible insurance program structure.

In this typical structure, the insurance company agrees to pay all covered losses up to the issued limits of liability on behalf of the insured. The insured agrees to reimburse the insurer for all amounts under the agreed-upon deductible. In order to relieve the insurer of credit risk related to the collectibility of reimbursements, the insured is required to post collateral in favor of the insurer.

With the LPT, pictured to the right, the insured pays a premium to the carrier (either the same carrier that issues the deductible coverage or an unrelated third-party carrier) in exchange for the carrier assuming the portfolio of losses or contingent liabilities. The insurer assumes responsibility to make all future payments for losses under the program, effectively stepping in the shoes of the insured, as shown below. (Usually, the limits of liability for any one claim is agreed upon and, as a result, the insured may still be exposed to a large claim in excess of the agreed-upon limits).

SUMMARY OUTCOME

1. The LPT provided a mechanism to transfer and assume the insured's liabilities with the insurance carrier.
2. It provided the finality solution required for the purposes of dissolving the company.
3. It provided for substantial capital relief—a collateral release of over $7 million.

THE PROCESS

Artex is uniquely qualified to help our clients analyze the viability of an LPT, and negotiate with the appropriate insurance markets on their behalf in order to ensure the most favorable terms and conditions of the transaction.

Our process includes the following steps:

1. Identify and analyze the lines of coverage and related loss years for which the company desires a potential LPT
2. Determine the optimal program design based on amount and type of losses, actuarial data and knowledge of the insurance marketplace for LPTs
3. Identify the most appropriate markets to approach and negotiate terms
4. Present transferring company with terms provided by carrier markets, with terms subject to due diligence
5. Due diligence performed by carrier, including a review of case reserves for known open claims, the claims handling process and overall reserving practices
6. Firm terms provided allowing for the execution of the LPT

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THE **ART** OF **RISK**

At Artex, we believe there is more to alternative risk management. As a trusted leader and provider of diverse (re)insurance and ILS solutions, our global team operates at the intersection of art and science—where creative thinking meets expertise and superior outcomes are made. That's how we're able to fully understand our clients' needs and deliver the most comprehensive solutions available.

Established in more than 35 domiciles internationally, we're here to help you make empowered decisions with confidence, reduce your total cost of risk and improve your return on capital. At Artex, we believe in finding you a better way.

Mike Woytowicz
Director, Business Development

Mike leads captive feasibility and formation engagements in our Bermuda office. In addition, he provides intermediary access to Bermuda insurance and reinsurance markets, as well as strategic analysis to help clients more accurately set retentions, determine appropriate pricing for various reinsurance attachments and plan the most efficient use of capital.

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Jeffrey A. Kurz
Managing Director of Captive Insurance Sales and Consulting

Jeff is responsible for the production and project management of new business within the United States. He has over 20 years of experience in the area of alternative risk financing, including work with captive insurance companies, segregated cell captive insurers, risk retention groups and self-insured trusts, with specific concentrations in healthcare, real estate and large multinational company-related risk.

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Martin Hughes
Executive Vice President, Underwriting

Martin leads the Underwriting function, in which he is instrumental in the analysis and design of new Artex products, ranging from member-sharing captives to single-parent captives, guaranteed cost and everything in between. Martin also leads the North America strategy for segregated cell-supported facilities as well as guaranteed cost programs. Martin is based in our Connecticut office.

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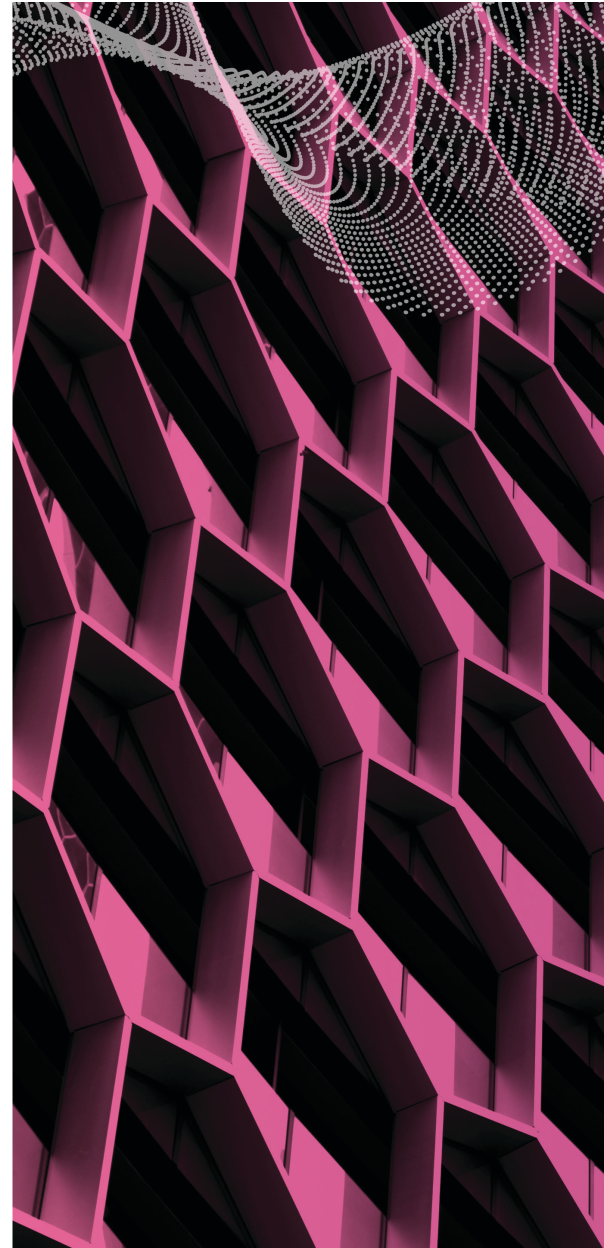

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