Hospital systems, physician groups and long term care facilities establish alternative risk vehicles (ARVs) – e.g., captives and risk retention groups – for a host of financial and operational reasons. But in the end, the decision to adopt an ARV vehicle is typically driven by two primary goals: the ability to control their own professional liability insurance costs, while reducing their susceptibility to the cyclical nature of the commercial insurance market. Typically, ARVs are established in a “hard” commercial market (i.e., limited capacity and rising prices) when buyers feel particularly powerless to anticipate the cost and availability of conventional risk transfer products and, as importantly, feel like the current pricing environment is not representative of their own risk profile. So, increasingly frustrated by the commercial market’s “broad brush” approach to pricing and risk selection, some buyers look to self-insure – to remove themselves from the commercial fray – and establishing an ARV is often the most efficient financial mechanism to accomplish that.

As the market continues to experience changes in the cycle, or as other business issues emerge (like an acquisition or a sale), the on-going utility of the ARV needs to be re-evaluated. If, as is the case in today’s environment, the softening commercial insurance market is coupled with an economic downturn, ARVs and the organizations or individuals who established them, may be facing significant challenges, including limited access to capital and extremely tight operating margins. Faced with those types of challenges, there may be a strong incentive to free up capital for ARV owners. Enter the “Loss Portfolio Transfer” (LPT).

An LPT can be a very effective mechanism to immediately monetize redundant reserves of an ARV that would otherwise take years to materialize. By way of example, an ARV established by a physician group in 2002 – at the beginning of the most recent hard market cycle in medical professional liability insurance – likely finds itself substantially over-reserved in 2010. Why? Because for the past 8 years, that ARV has been establishing premiums and reserves for expected future losses based on actuarial recommendations that, in turn, are based on loss experience, trend factors and loss development factors derived in large part from the experience of the previous soft market. That past experience is likely far worse than actual loss experience after 2002, when prices increased, tort reform was passed in many jurisdictions, and risk management improved significantly. The result is that the ARV may be over-funded in relation to its actual potential liability. The ARV typically has a different time horizon than a commercial carrier for realizing the cash value of reserve redundancies – carriers, as a matter of course, manage liabilities over an indefinite period of time, while ARVs will look to monetize reserve redundancies as soon as commercially possible. Transferring reserves to the commercial carrier allows the ARV to manage this timing challenge and to immediately realize the benefit of its reserve redundancy.
Why is an LPT more effective than just releasing reserves? Because, as referenced, releasing reserves takes time and even more importantly releasing reserves does not remove the ARV’s ultimate liability for claims. If the ARV releases reserves and then experiences unexpected adverse development, the resulting financial strain could be substantial, perhaps requiring a capital call to the ARV’s owners, or causing the ARV to become insolvent. This is a significant concern of both regulators and captive managers overseeing the ARV, who may be uncomfortable with the prospect of prematurely releasing reserves. An LPT solves these issues to everyone’s benefit: the excess reserves from prior years are monetized and returned to the owners; the ARV is relieved of any future liabilities on those prior years, but those liabilities are assumed 100% by a larger, more financially secure insurance company, and the regulators are happy that the ARV has reduced its balance sheet volatility while protecting the long-term interests of its insureds.

The LPT is a simple financial mechanism that allows the owners of the ARV to monetize redundant reserves while “cleaning up” its balance sheet and re-establishing the essential financial utility of the vehicle. This makes the ARV financially stronger and more stable, hence a more attractive option for its insureds, owners and regulators. In the depths of a soft insurance market, and a down economy, an LPT may truly be the best solution.