NEW DISCLOSURE RULES FOR PROPERTY AND CASUALTY INSURERS

By

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BY

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Over the past thirty years, property and casualty insurers that write slow developing lines of business, such as general liability, medical malpractice, and reinsurance, have made large and unexpected additions to their loss reserves, catching investors and others by surprise. For the industry as a whole, reserve increases for so-called "long tail" casualty risks have been offset over the last decade by reserve decreases, but for many individual insurers, which must account for the changes in a single reporting period, they have spelled financial disaster.

While investors recognize that reserves for long-tail casualty risks are volatile,[2] until recently they have had no idea of the extent of variation in the underlying estimates. Disclosure statements were typically couched in broadly-worded generalities that said the reserve estimates were subject to many unknowns and uncertainties and that actual results could differ materially from the estimates, but did not say by how much. Two recent developments promise to provide a welcome degree of clarity. The first is the adoption of Actuarial Standard Of Practice No. 36 ("Standard No. 36"), which governs the actuarial opinions insurers are required to submit to state regulators. When there is a significant risk of a material adverse deviation in the reserves, *Standard No. 36* requires the appointed actuary to identify the specific items of risk and, most importantly, quantify the minimum amount of adverse deviation that may occur. *Standard No. 36* has been incorporated into the disclosures rules of the National Association of Insurance Commissioners ("NAIC"), which take effect at year-end 2004.

The second development is a proposed rule by the Securities and Exchange Commission ("SEC") which requires publicly-traded insurers to quantify the variability in their reserve estimates by specifying the upper and lower range of variation, the probability that the ends of the range (rather than the selected estimate) will occur, and the standard deviation of the data.[3] Taken together, *Standard No. 36* and the SEC proposal represent a seachange in the disclosure requirements for casualty insurers. By requiring insurers to put a dollar figure on the variability in the reserves, the new standards provide a financial baseline for shareholders to assess the significance of future variations against whatever measure they deem appropriate, including earnings and capital.

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2 Investors cannot "expect equivalent certainty in a balance sheet's statement of loss reserves and its statement of more determinable items, such as outstanding principal and interest on debt instruments." *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d 1226, 1231 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992).

3 See *Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies*, 67 Fed. Reg. 35620 (2002) (to be codified at 17 C.F.R. Pts. 211, 231 & 241 (proposed May 10, 2002), 2001-02 Fed.Sec.L.Rep. ¶ 86,638.

This article will consider the impact of the new disclosure requirements on casualty insurers, beginning with an overview of the market for long-tail risks and the effect of prior reserve adjustments on the financial condition of casualty insurers. After reviewing *Standard No. 36*, the article will compare the disclosure rules of the NAIC with the reporting requirements of the SEC, and will conclude by examining the effect of the new reporting standards on the disclosure statements of publicly-traded insurers.

I

LONG-TAIL CASUALTY RISKS

Long-tail casualty risks are insurance policies where there is a substantial delay, or tail, in the reporting and settlement of claims.[4] For many slow-developing claims, the delay can be fifteen to twenty years, and for some toxic torts, such as asbestos and pollution exposures, it can be fifty years between the time a policy is issued and a claim is ultimately settled and paid. *See In re Joint Eastern & Southern Districts Asbestos Litig*ation, 878 F.Supp. 473, 490 (E.D.N.Y. & S.D.N.Y. 1995), *aff'd in part, vacated in part*, 78 F.3d 764 (2d Cir. 1996). Because of the length of the delays, the settlement cost of many long-tail risks cannot be reliably estimated by traditional actuarial methods, which require a large volume of relatively stable and homogeneous data, like that generated by automobile collision policies.[5] As a result, reserves for long-tail risks are subject to much greater variability, and pose a much higher risk for investors, than reserves for fast-closing lines of business that are usually settled and paid within a year.

A. The Domestic Market.

According to A.M. Best, long-tail casualty risks accounted for $118 billion of the $420 billion in premiums underwritten by domestic property and casualty insurers in 2003.[6] Although they comprise only 38% of the premiums, long-tail risks have a much greater impact on the financial condition of companies specializing in these risks, representing 79% of the reserves and 134% of the surplus. Because of their variability, long-tail risks can quickly turn a profitable year into a loss or, for smaller, less diversified companies, wipe out all or most of their capital. Many insurers write little if any long-tail business, and thus have little variability in their reserves, while others write predominantly long-tail risks and have a high degree of variability. The disparity in types of risks assumed by domestic insurers can be seen from a table of the 25 largest property and casualty companies in 2003:

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4 *See Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d 1226, 1229 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992).

5 *See* C.K. Khury, *The Actuarial Method--How Much Art, How Much Science*, The Actuarial Review, Aug. 1985; Casualty Actuarial Society, *Statement Of Principles Regarding Property & Casualty Loss and Loss Adjustment Expense Reserves* (1988) § II.

6 *See* A.M. Best Property-Casualty Reports Database (2004). Long-tail casualty risks include Workers Compensation, Commercial Multiple Peril, Products Liability (Occurrence and Claims-Made), Medical Malpractice (Occurrence), Other Liability (Occurrence and Claims-Made), and Reinsurance (Nonproportional Assumed Liability).

TABLE 1
TOP 25 PROPERTY & CASUALTY COMPANIES[7]
(In Millions)

		Written Premiums	*Total Reserves*	*Long-Tail Reserves*	*Capital Surplus*	*Pretax Income*	*Long-Tail Reserves As % Of Surplus*
1.	State Farm Auto	32,234	18,296	0	39,981	1,769	0%
2.	Allstate	22,962	13,990	211	16,101	3,101	1%
3.	Nationwide	11,294	6,416	2,159	7,157	1,060	30%
4.	State Farm Fire	9,849	4,370	2,076	4,604	845	45%
5.	Continental Casualty	7,403	16,283	11,816	6,046	-2,242	195%
6.	Zurich American	6,931	8,767	6,927	3,676	319	189%
7.	Federal	6,625	8,682	7,080	6,294	619	113%
8.	National Union	6,114	6687	5,439	6,899	424	79%
9.	American Home	6,028	6,388	5,152	3,622	316	142%
10.	GEICO	5,930	3,605	87	4,124	868	2%
11.	Progressive Casualty	5,871	2,133	10	2,218	839	1%
12.	Liberty Mutual	5,838	9,982	6,944	6,123	84	113%
13.	American Family	5,542	2,745	240	2,686	70	9%
14.	St. Paul Fire	5,274	8,450	4,419	5,076	1,109	87%
15.	United Services Auto	4,423	2,274	12	7,808	681	0%
16.	Farmers Exchange	4,393	3,256	765	2,149	16	36%
17.	Hartford Fire	3,579	5,681	3,737	7,896	85	47%
18.	Erie Exchange	3,563	3,222	1,016	2,429	584	42%
19.	Travelers Casualty	3,474	7,076	4,673	3,046	731	153%
20.	First American Title	3,184	571	0	747	308	0%
21.	General Re	3,129	11,801	10,094	5,435	1,087	186%
22.	Fireman's Fund	3,008	3,720	2,379	2,859	82	83%
23.	Everest Re	2,965	3,857	2,996	1,716	255	175%
24.	Metropolitan Property	2,961	1,518	0	1,996	334	0%
25.	Transatlantic Re	2,945	3,506	1,861	1,851	279	101%

For investors, the ratios of long-tail reserves to surplus and earnings are key measures of financial stability. Nine of the top 25 firms had a ratio of long-tail reserves to surplus over 100% and twelve had a ratio of long-tail reserves to earnings over 1,000%. Since reserve adjustments of 10% or more a year are not uncommon for long-tail risks, when they occur, they have a material impact because they have to be absorbed in a single reporting period, even though they represent many years of underwriting activity.[8] Over five hundred companies write predominantly long-tail business, so the financial condition of a large segment of the domestic market depends on highly variable reserve estimates. The variability of long-tail reserves can be seen from a table of recent reserve adjustments by long-tail casualty insurers on policies issued *at least a decade earlier* (from Schedule P of the Annual Statements):

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7 *See* A.M. Best Property-Casualty Reports Database (2004).

8 Each year, insurers revise their reserve estimates for all prior underwriting years as new data becomes available. Under GAAP, changes in reserve estimates for prior periods are recorded in the year the change occurs, not the year the estimate was originally made. *See National Distillers and Chemical Corp. v. Stephens*, 912 S.W.2d 30, 32-33 (Ky. 1996); AICPA, Accounting Principles Board Opinion No. 20, *Accounting Changes*, ¶ 31 (1971).

TABLE 2
ONE-YEAR DEVELOPMENT IN ESTIMATED LOSSES
FOR ACCIDENT YEARS 1993 AND PRIOR
(000 Omitted)

	Company	*Evaluation Date*	*Prior Year Estimate*	*Revised Estimate*	*One-Year Change*	*% Of Change*
1.	Quadrant Indemnity	2003	-105	1,062	1,167	1,111%
2.	Executive Risk Specialty	2002	369	3,545	3,176	861%
3.	Chubb Custom	2003	-302	866	1,168	387%
4.	Discovery Specialty	2003	-245	113	358	146%
5.	Quadrant Indemnity	2002	-3,282	-105	3,177	97%
6.	Chubb Custom	2002	-3,478	-302	3,176	91%
7.	Nationwide Indemnity	2003	418	784	366	88%
8.	Starr Excess	2002	-5,018	-1,413	3,605	72%
9.	Executive Risk	2002	90,529	141,286	50,757	56%
10.	Hartford Fire	2003	2,332,980	3,388,729	1,055,749	45%
11.	Genesis	2003	3,994	5,745	1,751	44%
12.	Nationwide Indemnity	2002	291,665	418,036	126,371	43%
13.	Hartford Accident	2003	1,837,714	2,629,954	792,240	43%
14.	Other Hartford	2003	1,450,944	2,076,451	625,507	43%
15.	Chubb Indemnity	2002	8,393	11,572	3,179	38%
16.	Chubb National	2002	8,396	11,572	3,176	38%
17.	Executive Risk Specialty	2003	3,545	4,713	1,168	33%
18.	Swiss Re America	2003	1,500,769	1,978,096	477,327	32%
19.	St. Paul Protective	2003	44,427	56,143	11,716	26%
20.	Great Northern	2002	113,566	138,947	25,381	22%
21.	Westport	2002	271,250	329,971	58,721	22%
22.	Pacific Indemnity	2002	572,407	680,279	107,872	19%
23.	Great Divide	2003	748	876	128	17%
24.	Phoenix	2002	1,462,093	1,679,748	217,655	15%
25.	Standard Fire	2002	1,416,998	1,627,940	210,942	15%
26.	Travelers Indemnity	2002	4,901,311	5,627,371	726,060	15%
27.	Travelers Casualty	2002	5,992,660	6,879,548	886,888	15%
28.	Other Travelers	2002	3,439,284	3,951,275	511,991	15%
29.	Federal	2002	3,232,912	3,681,211	448,299	14%
30.	USF&G	2002	3,352,142	3,797,754	445,612	13%
31.	Executive Risk	2003	141,286	159,955	18,669	13%
32.	Westport	2003	329,971	371,191	41,220	12%
33.	Atlantic Mutual	2003	382,136	428,968	46,832	12%
34.	AIG Specialty	2002	72,186	80,481	8,295	11%
35.	XL Reinsurance	2002	300,732	334,102	33,370	11%
36.	American Re	2002	3,432,363	3,803,703	371,340	11%
37.	Discover Re	2002	11,374	12,587	1,213	11%
38.	Chubb Indemnity	2003	11,572	12,740	1,168	10%
39.	Chubb National	2003	11,572	12,740	1,168	10%
40.	Employers Nevada	2002	46,071	50,548	4,477	10%

The reserve adjustments in Table 2 covered policies issued between the 1940s and the early 1990s, which means the reserves had been evaluated at least ten times, and in some cases as many as thirty or forty times, before the most recent evaluation. And the estimates still kept changing. For the industry as a whole, the cost of adjusting prior-year reserves is considerable, amounting to $22 billion in 2002 and $17 billion in 2003.[9]

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[9] *See* Standard & Poors, *U.S. Commercial-Lines Insurance Midyear Outlook 2004* (June 8, 2004). S&P believes the industry obscures the adjustments by conveniently discovering "a reserve surplus in one line of business that masks deficiencies in another." Standard & Poors, *Insurance Actuaries--A Crisis Of Credibility* (Nov. 19, 2003) at 1.

B. Judicial Inflation.

Given the variability of long-tail risks, it is not surprising that insurers writing slow developing business have been forced to make large adjustments to their reserves over the last twenty years, and that hundreds of firms have withdrawn from the market because of reserve related problems, many involuntarily.[10] The problems began in the 1970s, when courts started recognizing new forms of liabilities and juries began awarding larger and larger verdicts. The resulting "judicial inflation" increased the tail for many types of risks from three to five years in the early 1960s to fifteen to twenty years in the 1980s.[11]

The most striking example of judicial inflation was the emergence of asbestos claims in the late 1970s. When they first appeared, the conventional wisdom was that the date of loss was the date of exposure to asbestos fibers. During the 1980s, courts allowed claims based on the date of manifestation and later ruled they could be based on either exposure or manifestation,[12] creating what became known as the "triple trigger" doctrine where claimants could effectively recover from any policy ever in-force. Efforts to limit asbestos claims through the use of exclusions met with limited success. Insurers, for example, thought they had limited their exposure by excluding "asbestosis," a medical term that referred to a particular disease, but this and other defenses were rejected.[13]

In the 1980s, the courts further expanded asbestos liability by including the cost of removing asbestos from buildings, a risk never contemplated by underwriters.[14] By the early 1990s, asbestos claims had become a cottage industry, with trial lawyers taking to the airwaves to solicit business from anybody who had the slightest exposure to asbestos, even if it occurred in the 1940s or 1950s. The result was more than 200,000 asbestos claims by 1993,[15] and a loss development tail that grew like Pinocchio's nose, from fifteen to twenty years in the 1980s to fifty years or longer in the 1990s.

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10 The NAIC currently lists over 500 active insolvencies, more than 300 of which are property and casualty insurers. *See* NAIC, *Contact List For Insurers In Receivership*, Update: January, 2002.

11 Judicial or social inflation is the "impact on insurance costs of societal changes such as changes in claim consciousness, court practices, and judicial attitudes, as well as in other noneconomic factors." ASB, Standard Of Practice No. 13, § 2.3 (1990). *See* W.K. Olson, *The Litigation Explosion; What Happened When America Unleashed The Lawsuit* (1991).

12 *See Keene Corp. v. Insurance Co. Of North America*, 667 F.2d 1034 (D.C.Cir. 1981), *cert. denied*, 455 U.S. 1007 (1982).

13 *In re Celotex Corp.*, 175 B.R. 98, 109-10 (M.D.Fla. 1994); *Owens-Illinois, Inc. v. United Insurance Co*., 625 A.2d 1, 19-20 (N.J.App.Div. 1993), *rev'd in part on other grounds*, 650 A.2d 1000 (N.J. 1994).

14 See *Carey Canada, Inc. v. Aetna Casualty & Surety Co*., 1988 W.L. 16927 (D.D.C. 1988).

15 *See* Deborah R. Hensler & Mark A. Peterson, *Understanding Mass Personal Injury Litigation: A Socio-Legal Analysis*, 59 Brook.L.Rev. 961, 1004 (1993).

Asbestos was only the beginning. In the early 1990s, insurers were hit with another wave of claims on policies written decades earlier, this time under the Superfund Law, which imposed strict and retroactive liability for environmental clean-ups. Because all but "sudden and accidental" pollution was excluded from most policies, insurers believed they did not have any significant exposure. In the late 1980s, the exclusion began to unravel as courts bent over backward to find coverage.[16] The result was another round of massive reserve increases to reflect the cost of cleaning-up the environment, estimated at between $100 billion and $750 billion.[17] All casualty companies were affected by these factors, but excess writers and reinsurers were hit the hardest. The problem was compounded by spiraling inflation which had the effect of both increasing capacity and the cost of restoring bodies and buildings by more than 20% a year. Jury awards in malpractice and other cases also skyrocketed with runaway inflation. As a result, the number of claims breaching the attachment point of excess policies at both the primary and reinsurance levels began to expand exponentially.

Taken together, these factors had a cataclysmic effect on property and casualty insurers in the 1980s. According to *The Economist*, over 200 casualty insurers became insolvent in 1985 alone.[18] Firms that survived the decade were only able to do so because of enormous capital infusions from parents or affiliates. The list of insurers who recorded massive additions to reserves reads like a *Who's Who* of the casualty business, including such stalwarts as Hartford, Cigna, Chubb, St. Pauls, Travelers, Wausau, Crum & Forster, General Re, Skandia, and Fireman's Fund.[19]

Spurred by the unprecedented wave of insolvencies, the House Energy and Commerce Subcommittee on Oversight and Investigations held hearings to determine the cause of the bankruptcies. In a February 2000 report, the Subcommittee found that "misstating and underreporting loss reserves by truly gargantuan proportions has been the biggest problem, yet at least [thirty-three] states do not require that reserves...be certified by a qualified actuary," a condition it said was "astonishing."[20] The clear implication of the report was that if actuaries had been on the scene, most of the insolvencies could have been avoided, a conclusion supported by the actuarial community which actively lobbied for a larger role in the reserving process.[21]

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16 See, e.g., *Clausen v. Aetna Casualty & Surety Co*., 380 S.E.2d 686 (Ga. 1989); *Hecla Mining Co. v. New Hampshire Insurance Co*., 811 P.2d 1083 (Colo. 1991).

17 M.J. Fisher, *Insurer Solvency Threatened By Pollution Cleanup Liability*, National Underwriter at 2, 26 (Oct. 22, 1990). A subsequent A.M. Best study lowered the estimated clean-up cost to $56 billion, allowing insurers to decrease reserves and increase profits in the 1990s. Whatever the ultimate liability may be, it will involve staggering obligations that were never considered or priced by underwriters.

18 *See The Economist*, June 6, 1987.

19 *See Best's Insurance Reports Property-Casualty* (1985) at 1133, 575, 522, 1980-81, 2214, 2324, 724, 1026, 2062, and 939.

20 *Failed Promises: Insurance Company Insolvencies*, Report of Subcommittee on Oversight & Investigations of Energy & Commerce Committee, U.S. House of Reps. (Feb. 1990).

21 Issues Digest, American Academy of Actuaries, at 22-23, Sep. 1990.

II

STANDARD NO. 36

A. Background.

Unlike life and pension actuaries, who had been reviewing reserves and valuing assets for clients for years, property and casualty actuaries played a relatively minor role in the reserving process until 1990. Before then, most property and casualty insurers used outside accountants who had little actuarial training or expertise to review reserves, rather than qualified actuaries. In the early 1980s, a number of outside auditing firms began hiring actuaries to review the reserves of large insurance clients, but the practice was uneven and many smaller insurers continued to rely on accountants. All this changed when hundreds of casualty insurers were declared insolvent, and Congress placed the blame on a lack of actuaries.

In response to the House subcommittee report, and a related study by A.M. Best,[22] the NAIC changed the Annual Statement form for property and casualty insurers in 1990 to require a statement of actuarial opinion by a qualified actuary. Similar to rules that had been adopted for pension plans and life insurers two decades earlier,[23] the NAIC provision required the Board of Directors to appoint a qualified actuary to render an annual opinion on the reserves. The NAIC rule required the actuary to state in writing that the reserves met the requirements of the insurance laws of the domiciliary state, were computed in accordance with accepted reserving standards and principles, and made a reasonable provision for all unpaid claims.[24]

Insurers began submitting actuarial opinions to regulators in 1991, but they were not the panacea that many had envisioned. In the years immediately following the adoption of the NAIC rule, casualty insurers made another round of massive reserve additions for asbestos and pollution liabilities, virtually all of which were attributable to policies issued decades earlier. None of the countless actuarial reviews that had preceded this latest wave of reserve adjustments gave any inkling of the adverse development that was recorded in the mid-1990s. Among the more notable losses reported after the NAIC rule took effect were:[25]

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22 *See* A.M. Best, *Insolvency Study: Property/Casualty Insurers* 1969-1990 (1991).

23 In 1974, Congress required enrolled actuaries for pension plans to submit actuarial opinion to the Department of Labor and the Internal Revenue Service. *See* 29 U.S.C. §§ 1023(a)(1) & 1024(a)(1)(A); 29 U.S.C. § 1023(d). A year later, a similar requirement was adopted by the NAIC for life and health insurers. *See* Actuarial Compliance Guideline No. 4, § 3.

24 *See* NAIC, Annual Statement Instructions, Property & Casualty ¶ 12 (1991).

25 Douglas McLeod, "ITT To Take Big Charge To Bolster Hartford's Reserves," Business Ins., Oct. 5, 1992, at 1; Leslie Scism, "Cigna Will Take Pretax Charge Of $1.2 Billion," WSJ., Oct. 3, 1995, at A3; Leslie Scism, "Insurer Planning To Boost Reserves By Over $1 Billion," WSJ, Dec. 12, 1995, at A4; David Lenckus, "Aetna's Reserving Turns Up Pressure," Business Insurance, Jul. 17, 1995; Leslie Scism, "Fireman's Fund Doubles Its Reserves For Pollution Claims To $1.4 Billion," WSJ, Jun. 23, 1995, at A6; Sara Marley, "North American Re To Benefit From $700 Million Infusion," Business Ins., Apr. 10, 1995, at 1; Leslie Scism, "American Re Posts $198.5 Million Loss After Big Reserve For Pollution Claims," WSJ, Jan. 30, 1996.

- A $1.1 billion loss by Hartford in 1992;
- A $1.2 billion loss by Cigna in 1995;
- A $1.1 billion loss by Nationwide in 1995;
- A $1.1 billion loss by Aetna in 1995;
- A $800 million loss by Firemen's Fund in 1995;
- A $700 million loss by North American Re in 1995;
- A $347 million loss by American Re in 1995.

B. The Actuarial Standards Board.

Shortly after the new NAIC rule took effect, a subcommittee on reserving of the Actuarial Standards Board began considering a standard of practice for written statements of actuarial opinion.[26] The stated purpose of the standard was to address the growing list of subjects that had been added to the Actuarial Opinion section of the Annual Statement form, including discounting, loss portfolio transfers, financial reinsurance, and reinsurance collectibility. While the new topics "gave a sense of urgency for such a standard to be developed, it was also recognized that actuaries often render statements of actuarial opinion, whether or not there are formal requirements. Accordingly, it was determined that a standard of practice was needed with a more universal application than the current NAIC requirements...."[27]

In February 1998, the Actuarial Standards Board circulated an exposure draft of *Standard No. 36*.[28] Five types of actuarial opinions were recognized by the Board--determinations of reasonableness, determinations of deficiency, determinations of redundancy, qualified opinions, and no opinions. *Id.* § 3.32. Most of the substantive requirements of *Standard No. 36* were set forth in Section 3, including provisions dealing with the content of actuarial opinions, materiality, considerations for selecting an appropriate methodology, the effect of uncertainty on actuarial estimates, and the collectibility of ceded reinsurance. After soliciting comments from the profession, the Board circulated a second exposure draft in February 1999, and a third draft in September 1999. Following a final round of comments, and a public hearing in San Francisco, the final version of *Standard No. 36* was published by the Board in March 2000. It took effect on October 15, 2000.[29]

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26 The Actuarial Standards Boards ("ASB") is an independent body established in 1988 by the American Academy of Actuaries, the American Society of Pension Actuaries, the Casualty Actuarial Society, the Conference of Consulting Actuaries, and the Society of Actuaries to promulgate standards of practice for the actuarial profession. The standards "are intended to provide actuaries with a framework for performing professional assignments, and to offer guidance on relevant issues, recommended practices, documentation, and disclosure." ASB, *Proposed Introduction To The Actuarial Standards Of Practice*, Exposure Draft (Oct. 2003) at § 3.11.

27 *See Standard No. 36,* App. I at 17.

28 See ASB, *Proposed Actuarial Standard Of Practice,* Exposure Draft (Jan. 1998).

29 See ASB, *Proposed Actuarial Standard Of Practice,* Third Exposure Draft (Sep. 1999), Transmittal Letter To Members, at vii.

C. Uncertainty In Reserve Estimates.

The most notable feature of *Standard No. 36* is its explicit recognition of the uncertainty inherent in the reserving process. Unlike the *Statement of Principles* of the Casualty Actuarial Society, which because of its generalized nature only makes a passing reference to uncertainty,[30] *Standard No. 36* provides specific guidance "to direct actuarial practice" in the area.[31] In the introduction to a lengthy section entitled *Uncertainty*, the standard observes that "[a]ctuarial estimates are inherently uncertain because they are dependent on future contingent events," reminding actuaries that "[e]ven when appropriate actuarial techniques and assumptions indicate . . . the stated reserve . . . is reasonable, the actual amount necessary to settle the unpaid claims can be significantly different from the stated reserve amount." *Id*. at § 3.6.

The Uncertainty section of *Standard No. 36*, covers five subjects--sources of uncertainty, aggregation of data, expected value estimates, ranges of estimates, and adverse deviation.[32] The most significant are the last three, which provide:

> "3.63 *Expected Value Estimate*—In evaluating the reasonableness of reserves, the actuary should consider one or more expected value estimates of the reserves, except when such estimates cannot be made based on available data and reasonable assumptions. Other statistical values such as the mode (most likely value) or the median (50th percentile) may not be appropriate measures for evaluating loss and loss adjustment expense reserves, such as when the expected value estimates can be significantly greater than these other measures.
>
> The actuary may use various methods or assumptions to arrive at expected value estimates. In arriving at such expected value estimates, it is not necessary to estimate or determine the range of all possible values, nor the probabilities associated with any particular values.[33]

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30 *See Statement Of Principles Regarding Property & Casualty Loss and Loss Adjustment Expense Reserves* (1988) § II(3) (the "uncertainty inherent in the estimation of required provisions for unpaid losses...implies that a range of reserves can be actuarially sound.)"

31 *Standard No. 36* explains the difference between the general provisions of the *Statement of Principles* and the specific guidance in a standard of practice as follows: "The Statement of Principles does not set forth standards for reserve analysis. Principles are not intended to contain guidance that would direct actuarial practice, whereas a [standard of practice] does specify professional practice requirements and must go through a specified due process, including exposure, response to comments, and review and approval by the independent Actuarial Standards Board." *Standard No. 36,* App. II at §3.2.1.

32 Eight sources of uncertainty are identified, including erratic historical development data, the emergence of unusual types or sizes of claims, changes in claim frequency or severity, and changes in the external environment such as inflation, coverage litigation, judicial decisions, legislative changes, and attitudes towards settlements. *Id*. at § 3.61.

33 *Standard No. 36* defines an Expected Value Estimate as "[a]n estimate of the mean value of an unknown quantity where the mean value represents a probability-weighted average of the quantity over the range of all possible values." *Standard No. 36* at § 2.6.

"3.64 *Range of Reasonable Reserve Estimates*—The actuary may determine a range of reasonable reserve estimates that reflects the uncertainties associated with analyzing the reserves. A range of reasonable estimates is a range of estimates that could be produced by appropriate actuarial methods or alternative sets of assumptions that the actuary judges to be reasonable. The actuary may include risk margins in a range of reasonable estimates, but is not required to do so, except as may be required by ASOP No. 20. A range of reasonable estimates, however, usually does not represent the range of all possible outcomes.

"3.65 *Adverse Deviation*—The potential variation in the actual amount that will be needed to pay unpaid claims gives rise to uncertainty in the reserve estimates. An adverse deviation occurs when such a variation results in paid amounts higher than provided for in the reserves. The actuary should consider whether the future paid amounts are subject to significant risks and uncertainties that could result in a material adverse deviation. When the actuary's analyses break down the reserves into various segments or claim groupings, for example, by line of business and accident year, the actuary should consider the combined risks and uncertainties associated with the reserves that are the subject of the opinion."

The heart of *Standard No. 36* is § 3.33. When there is a significant risk of a material adverse deviation in the reserves, § 3.33 requires the actuary to state in an explanatory paragraph the amount of deviation that is considered material and describe the major factors and conditions that give rise to the uncertainty, as follows:

"3.33 "*Significant Risks and Uncertainties (Explanatory Paragraph).* When the actuary reasonably believes that there are significant risks and uncertainties that could result in material adverse deviation, the actuary should also include an explanatory paragraph in the statement of actuarial opinion . . . .The explanatory paragraph should contain the following:

"a. The amount of adverse deviation that the actuary judges to be material with respect to the statement of actuarial opinion; and

"b. A description of the major factors or particular conditions underlying risks and uncertainties that the actuary believes could result in material adverse deviation.

"The actuary is not required to include in the explanatory paragraph general, broad statements about risks and uncertainties due to economic changes, judicial decisions, regulatory actions, political or social forces, etc., nor is the actuary required to include an exhaustive list of all potential sources of risks and uncertainties."

Several observations are in order. *First*, the Actuarial Standards Board rejected what had previously been a common approach to reserve disclosures--i.e., broadly worded generalities that alerted users to a risk in the reserves but provided few details. In place of generalities, *Standard No. 36* requires a discussion of the specific risks that could result in a material adverse deviation in the reserves.[34] *Second*, for the first time, actuaries are required to quantify the amount of deviation they consider material, providing users with a basis for comparing the potential adverse deviation against traditional measures of financial performance, such as earnings and surplus. *Third*, although a material adverse deviation could significantly alter the financial position of an insurer, the possibility is "viewed as a disclosure and not in any way as a qualification" because actuaries, unlike accountants, do not recognize the concept of a "clean opinion."[35] *Finally*, a provision that encouraged actuaries to use probability assumptions to measure the variability of reserves was eliminated from *Standard No. 36*. According to the Subcommittee On Reserving, "[r]eferences to probability assumptions, probability models, and scenario testing were deleted" from the final version "to reduce the concerns that actuaries will be expected or required to measure risk."[36] The section that was deleted had provided: [37]

> "3.76 *Probability Assumptions For Adverse Deviation*. "The actuary may make probability assumptions regarding the likelihood of adverse deviations in considering whether there is a significant risk of material adverse deviation. The use of such probability assumptions is one way to represent the actuary's confidence in the loss and loss adjustment expense reserve estimate based on his or her consideration of the uncertainty. While probability models, scenario testing, or other modeling techniques are tools available to help the actuary consider the implications of uncertainty, the actuary is not required to use such tools to develop an opinion regarding the risk of material adverse deviation."

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34 The American Academy of Actuaries has identified eleven risks that should be addressed under § 3.33(b)--construction defects, cumulative injury, mass torts, high excess layers, large deductible workers compensation claims, recent legislation, tobacco, medical malpractice legislative issues, new products and markets, coverage disputes, mold, and terrorists attacks. *See* American Academy Of Actuaries, Property and Casualty Practice Note, *Statements Of Actuarial Opinion On P&C Loss Reserves As Of December 31, 2003* (Dec. 2003) at 28.

35 *See* American Academy of Actuaries, Property and Casualty Practice Note, *Statements Of Actuarial Opinion On P&C Loss Reserves As Of December 31, 2004* (Dec. 2004), at 41. *See infra* at 29.

36 *See Standard No. 36* at Introduction ¶ 10, and Appendix II at § 3.33.

37 ASB, Third Exposure Draft, *Proposed Actuarial Standard Of Practice* (Sep. 1999), at § 3.76 In the First Exposure Draft, the last two sentences of § 3.76 provided: "These probability assumptions should represent the actuary's confidence in the loss and loss adjustment expense reserve estimate based on his or her evaluation of the uncertainty. While probability models, scenario testing, or other modeling techniques are tools available to the actuary to help quantify the uncertainty, the evaluation of risk will rarely be determined solely by statistical analysis." ASB, Exposure Draft, *Proposed Actuarial Standard Of Practice* (Jan. 1998), at § 3.76. Before being eliminated altogether, interim drafts made "it clear that the actuary is not *required* to use quantitative methods to develop his or her opinion regarding the risk of material adverse deviation." *Id*. at App. I. § 3.76 (Emphasis added).

D. A New Methodology.

The concern that resulted in the elimination of § 3.76--the lack of a generally accepted method for quantifying reserve variability[38]--has recently been addressed by a new methodology developed by two former presidents of the Casualty Actuarial Society.[39] The new process employs a function, called the coefficient of estimation, to place loss reserve estimates on a continuum of all possible estimates that can be calculated from a universe of data, allowing actuaries to say, for example, that the selected estimate is in the middle or at the high-end of the range of possible estimates, or, if more precision is desired, in a certain percentile of the range.[40] The purpose of the new methodology was described by the developers as follows:

> "Loss reserve estimates are stated as point estimates. The user of these estimates generally has no idea of the underlying variability associated with the reserves. Some actuarial reports contain discussions that could be interpreted as providing some idea of the underlying variability. However, this is the exception rather than the rule. The NAIC, during the past several years, has been taking various steps to try to deal with this issue. The... latest move by the NAIC on this subject...requires that a Statement of Actuarial Opinion contain statements about the variability associated with loss reserves. The *Dataray* process provides an important tool that an actuary can use in expressing the variability associated with loss reserve estimates and thus comply with the new NAIC requirements." *Id.*

The new methodology has two important features. *First*, it produces a default reserve estimate from historical data without any additional assumptions by the actuary. *Second*, if an actuary decides that future reporting patterns will differ from past patterns, and makes his estimate accordingly, the methodology shows the probability of the new estimate using the original patterns, thus quantifying the effect of the decision to depart from historical patterns. While an actuary is able to override historical patterns, the methodology calculates the difference attributable to actuarial judgment, a feature that effectively requires the actuary to demonstrate the soundness of the decision to depart from historical data.

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38 Concern about § 3.76 "focused on the difficulty in quantifying the probabilities involved in determining whether there is a significant risk of material adverse deviation, and several commentators suggested that the section be removed until such time as actuarial science develops generally accepted quantification techniques." ASB, Second Exposure Draft, *Proposed Actuarial Standard Of Practice* (Dec. 1998), App. I at § 3.76.

39 See C.K. Khury & Irene K. Bass, *A Probabilistic Framework for Evaluating Materiality and Variability In Loss Reserve Estimates* (2003).

40 The new methodology "is a patent-pending process that is applied to an array of loss development histories. It produces an empirical frequency distribution of all possible outcomes of aggregate ultimate losses resulting from the application of the loss development method. More specifically, [it] is an approximation algorithm for creating the frequency distribution of all possible outcomes, as produced by the application of the loss development method. It can be produced to any degree of precision desired by the user." *See* Bass & Khury Website (http://www.bassandkhury.com).

Use of the new methodology to measure the variability of reserve estimates would be a significant improvement over *Standard No. 36*, which only requires actuaries to state the amount of adverse deviation they deem material. While useful, the current formulation does not fully convey the variability in the reserves, which may be significantly greater the amount deemed material for financial reporting purposes. If a firm has $100 million in reserves and $10 million in income, the potential adverse deviation may be much greater than the amount that is material to earnings--in this case, $1 million or less. Fortunately for investors in publicly-traded insurers, the shortcomings of *Standard No. 36* are remedied by recent SEC pronouncements on critical accounting estimates, which require insurers to quantify the range of reasonable variation in their reserves and demonstrate the sensitivity of financial results to such variations.

III

THE NAIC DISCLOSURE RULES

The NAIC, which has been grappling with the effect of reserve inadequacies on insurance insolvencies since the 1970s, has recently incorporated the requirements of *Standard No. 36* in the Actuarial Opinion section of the Annual Statement insurers are required to file with regulators.[41] Last year, the NAIC voted to overhaul its Annual Statement Instructions for written statements of actuarial opinion to promote "the regulatory mission of minimizing the impact of insurance company failures for the protection of consumers."[42] The new rules will take effect at year-end 2004 and will be supplemented by additional requirements in 2005.

The decision to modify the Annual Statement instructions was made by the Casualty Actuarial Task Force of the NAIC, which formed an Actuarial Opinion Instructions Working Group in August 2001 to develop a set of recommended changes. *Id*. at 1. After meeting with regulators, actuaries, and other parties, the Working Group proposed a series of changes to the instructions in May 2002. The proposals were approved by the Task Force with minor revisions. According to the Task Force, "[t]he most heavily debated issue that the Working Group dealt with was the degree of disclosure desired. There was a constituency of regulators favoring more disclosure within the Opinion than is reflected in the revised Instructions. There was a constituency who favored delay and further study. Despite debate on this issue, there was clear consensus among regulators that delay in implementation was not advisable." *Id*. As a result of the internal disputes, the Working Group decided not to include "critical disclosures" in the Actuarial Opinion, which is available to the public, and recommended they be placed in a confidential summary for regulators beginning in 2005. *Id*.

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41 The NAIC is a consortium of insurance commissioners responsible for establishing uniform rules for determining the financial condition of insurers. The "NAIC has adopted a uniform annual reporting form, known as the convention blank (or convention form annual statement), which, in turn, has been adopted in every State as the required annual report form for insurance companies." H.R.Rep.No. 1418, 88th Cong., 2d Sess (1964), *reprinted in* 1964 U.S.C.C.A.N. 3013, 3022.

42 NAIC, *Regulatory Guidance On Property and Casualty Statutory Actuarial Opinions* (Oct. 5, 2004) at 2.

A. Adoption Of Standard No. 36.

The revised NAIC instructions broaden the disclosure requirements for actuarial opinions submitted to regulators. The opinions must be attached to the Annual Statement and supported by an Actuarial Report that clearly explains "the findings, recommendations, and conclusions" of the actuary, "as well as their significance."[43] The appointed actuary must discuss the results of the actuarial review with the Audit Committee or Board of Directors of the insurer and make the actuarial opinion and supporting report available for their inspection and review. *Id*. at ¶ 1. The actuarial report must also be maintained for regulatory examination for seven years.

From a disclosure perspective, the most important change to the NAIC instructions are the provisions requiring additional commentary on the risks and uncertainties in the reserves, much of it based on *Standard No. 36*.[44] On October 5, 2004, the Task Force issued an advisory memorandum to "provide clarity and timely guidance to companies and to appointed actuaries regarding regulatory expectations" on the new rules (the "Regulatory Guidance").[45] Among other things, the *Regulatory Guidance*:

- Noted that it was no longer permissible to "provide disclaimers, exclusions, reliance, and caveats about general uncertainty without explicitly identifying one of the five types of opinion" that was being issued under *Standard No. 36*--i.e., a determination of reasonableness, a determination of deficiency, a determination of redundancy, a qualified opinion, or no opinion. *Id*. at 80.

- Strongly encouraged "the appointed actuary to present his or her analysis in a form that clearly and plainly conveys the risks and uncertainties that underlie the exposures" to the Board of Directors or Audit Committee of the insurer. The Board "should be aware of differences between the actuary's estimates...and the carried reserves. The Board should be aware of the actuary's opinion regarding the risk of material adverse deviation, and the standard by which the actuary determines material adverse deviation" under *Standard of Practice No. 36*. *Id*. at 78.

- Reminded actuaries that while *Standard No. 36* "only requires the actuary to disclose the amount of adverse deviation judged to be material *if* the actuary reasonably believes that such risk exists, the Instructions require the actuary to disclose such a materiality standard in all cases. This provides perspective for the regulator to interpret the actuary's judgment. The actuary is also required to comment on the basis for choosing this standard." *Id*. at 80.

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43 NAIC, *Annual Statement Instructions Property and Casualty*, *Actuarial Opinion* (2004), ¶ 7.

44 According to the Task Force, the substantive changes in the NAIC Instructions "formally acknowledge regulatory reliance on Actuarial Standards of Practice of the Academy of Actuaries..." NAIC, *Regulatory Guidance On Property and Casualty Actuarial Opinions* at 1.

45 NAIC, *Regulatory Guidance On Property and Casualty Statutory Actuarial Opinions* (Oct. 5, 2004), attached as Appendix 9, Property and Casualty Practice Note for Statements of Actuarial Opinion, American Academy of Actuaries (Dec. 2004).

- Provided a "bright line indicator" of 10% to determine materiality. This specific delineation, however, did not "relieve the actuary of the obligation of independently establishing his or her own materiality standard. In fact, we would expect an Appointed Actuary would choose a more restrictive standard in the great majority of situations." *Id.* at 81.

B. Confidential Disclosures.

Unfortunately for investors, the Working Group, with the concurrence of the Task Force and NAIC, rejected calls for more disclosures in the Actuarial Opinion, recommending instead that they be placed "in a confidential Actuarial Opinion Summary, separate from the Statement of Actuarial Opinion," which will appear in 2005. *See Regulatory Guidance* at 78. At the request of the actuarial community, the NAIC agreed to withhold the opinion summaries and actuarial reports from the public because they contain "significant proprietary information."[46]

The Task Force did not identify the disclosures omitted from the Actuarial Opinion but they apparently included, among other things, the range of estimates developed by the appointed actuary, a comparison of the actuarial estimate to the carried reserves, and a description of the reserve elements or management decisions responsible for any adverse development in excess of 5%.[47] Beginning next year, similar information will have to appear in the Actuarial Report,[48] which must be produced to regulators on two weeks notice but only if they agree to keep it confidential. The relevance of the information being withheld from the public is apparent from the *Regulatory Guidance*, which describes the importance of Actuarial Reports as follows:

> “Exhibits alone rarely convey professional conclusions and recommendations, or the significance of the actuary’s opinion or findings....A narrative section should provide clearly worded information so that readers are able to appreciate the significance of the actuary’s findings and conclusions, the uncertainty in the estimates, and differences between the actuary’s estimates and the carried reserves." *Regulatory Guidance* at 81.

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46 NAIC, *Annual Statement Instructions Property and Casualty* (2004), ¶ 7. *See* NAIC, *Property And Casualty Actuarial Opinion Model Law* § 3(B) (2003). The nature of the proprietary data was not disclosed by the NAIC. While workpapers or software frequently contain proprietary data, summaries or reports normally do not. Generally accepted actuarial methodologies are "in the public domain" and a report describing their application or use "would be no more informative...than a discussion of the differences between cash and accrual methods of accounting." *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d 1226, 1243 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992).

47 *See* American Academy of Actuaries, Property and Casualty Practice Note for Statements of Actuarial Opinion (Dec. 2004), Appendix 10 at 90.

48 Actuarial reports supporting Actuarial Opinions issued for the 2004 fiscal year must contain a comparison of the carried reserves to the actuarial estimates, a statement of the best estimate or range of reasonable estimates that support the Actuarial Opinion, and an "extended" explanation of the reasons for any adverse development. *See* NAIC, *Annual Statement Instructions Property and Casualty, Actuarial Opinion* (2004) ¶ 7.

The decision to withhold critical information from the public was controversial. According to the Task Force, "[t]here was a constituency of regulators favoring more disclosures within the Opinion," but regulators "who favored delay and further study" prevailed. *Id*. at 78. The ostensible reason for omitting the disclosures--the need to protect proprietary data from competitors--is problematic.[49] Disclosure of the selected estimate or range of reasonable estimates would not reveal the underlying assumptions or methodologies. A reserve analysis using the loss development method, a common form of actuarial analysis, involves a staggering number of possibilities for even a small insurer. The numbers involved (known as googols or googolplexes depending on the number of zeroes) are so large that even the cleverest competitor could not possibly divine the combination that produced the estimate. As for the text of the reports, it would be highly unusual--and professionally reckless--to disclose proprietary data or procedures in an Actuarial Report. In short, there is no reason why investors, who after all own the company, should not have access to the same material information as regulators and directors.

IV

SEC DISCLOSURES

If the NAIC is reluctant to require insurers to disclose the details of their reserve estimates to the public, the SEC has no similar misgivings. In a series of recent pronouncements, the SEC has made clear that publicly-traded insurers, which account for more than half of the long-tail risks underwritten by domestic companies, must disclose the effect of critical accounting estimates on their results of operations and financial condition, including their sensitivity to changes in assumptions and estimates. While the pronouncements apply to estimates by all businesses, the reserves of property and casualty insurers were cited as a prime example of a critical accounting estimate.[50] The disclosures must appear in the Management Discussion and Analysis section of Annual Reports on Form 10-K, where companies are required to discuss important business and financial issues "with investors in a clear and straightforward manner."[51]

A. Cautionary Advice.

The initial SEC pronouncement on accounting estimates was a December 12, 2001 release that provided "cautionary advice to companies regarding the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation." *Id*. at § II. The importance of a clear and straightforward discussion of critical accounting estimates was explained by the SEC:

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49 *See* Note 46, *supra* at 15.

50 See *Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies*, 67 Fed. Reg. 35620 (2002) (to be codified at 17 C.F.R. Pts. 211, 231 & 241 (proposed May 10, 2002) at n. 53.

51 *Commission Guidance Regarding Management's Discussion and Analysis Of Financial Condition and Results of Operations*, Fed.Sec.L.Rep. ¶ 87,127 (Dec. 19, 2003) at § I(A).

> "[W]e believe it is appropriate to alert companies to the need for greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation. We encourage public companies to include...full explanations, in plain English, of their 'critical accounting policies,' the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported...using different assumptions."[52]

B. Proposed SEC Rule.

Five months after issuing its cautionary advice, the SEC proposed a detailed rule on critical accounting estimates (the "Proposed Rule").[53] Among other things, the Proposed Rule requires companies to disclose the methodology and assumptions underlying their estimates, the effect of the estimates on financial results, and the sensitivity of the estimates to reasonable alternative assumptions. While the rule is still under consideration, it is similar in substance to other recent pronouncements and its key provisions may already be required for insurers with a significant volume of long-tail policies.[54]

The Proposed Rule requires both qualitative and quantitative disclosures. Qualitative disclosures include a description of the estimate, the methods and assumptions employed, and the effect of reasonable alternative estimates on reported results, as follows:

> "A company first would have to identify and describe each critical accounting estimate in such a way that it gives the appropriate context for investors ...and reflects management's view of the importance of the critical accounting estimate. A company would have to disclose the methodology it used in determining the estimate. It also would have to disclose the assumptions underlying the accounting estimate that reflect matters highly uncertain at the time the estimate was made as well as other assumptions underlying the estimate that are material. We recognize that a critical accounting estimate may involve multiple assumptions. The proposed disclosure would focus in the first instance on those that are about highly uncertain matters because they have the greatest potential to make the accounting estimate highly susceptible to change....If applicable, the company would have to describe why different estimates could have been used in the current period and why the accounting estimate is reasonably likely to change from period to period in the financial statements." *Id*. at 85,420.

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52 *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, 2001-02 Fed.Sec.L.Rep. ¶ 86,609 (Dec. 12, 2001) at 85,098.

53 See SEC Proposed Rule, *Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies*, 67 Fed. Reg. 35620 (2002) (to be codified at 17 C.F.R. Pts. 211, 231 & 241 (proposed May 10, 2002), 2001-02 Fed.Sec.L.Rep. ¶ 86,638.

54 *See* Section IV(D), *infra* at 20.

The teeth of the Proposed Rule is the requirement for quantitative disclosures that demonstrate the sensitivity of financial results to reasonable alternative assumptions. Companies have two choices in their sensitivity analysis:

> "First, the company could choose to assume that it changed the most material assumption or assumptions underlying the critical accounting estimate and discuss the results of those changes. Second, the company could choose to assume that the critical accounting estimate itself changes. In addition to providing two choices of methods to demonstrate sensitivity, we allow a company to determine the amount of the change that it assumes for this analysis rather than attempting to standardize those amounts. Under the first choice, a company could select the alternative material assumption or assumptions to use as long as the alternative represents a change that is reasonably possible in the near term. "Reasonably possible" means the chance of a future transaction or event occurring is more than remote but less than likely. "Near-term" means a period of time going forward up to one year from the date of the financial statements. Under the second choice, the company would use the upper and the lower ends of the range of reasonably possible estimates which it likely determined in formulating its recorded critical accounting estimate. It would substitute the upper end of the range for the recorded estimate and discuss the results. It would do the same for the lower end of the range." *Id*. at 85,421.

The SEC release accompanying the Proposed Rule gives a detailed description of the expected form a sensitivity analysis should take:

> "For purposes of the sensitivity analysis, a company should disclose, if known or available, the likelihood of occurrence of the changes it selects, such as estimated probabilities of occurrence or standard deviations where applicable....Under the first choice for demonstrating sensitivity, we would provide that a company choose its most material assumption underlying the critical accounting estimate and alter it at least twice to reflect reasonably possible, near-term changes. A company would have to complete the analysis assuming a positive change in the assumption. It would also have to complete the analysis assuming a negative change. In some cases, a company may not be able to select a single most material assumption to use for purposes of these analyses, or it may believe that using a single assumption would not provide meaningful sensitivity information for investors. If that were to occur, a company either could select the second choice for analyzing sensitivity (*i.e.*, using the ends of the range) or it could demonstrate the effects of near-term reasonably possible changes in more than one material assumption underlying the critical accounting estimate. If the company chooses the latter course of action, it also would have to disclose clearly the separate effect of each changed assumption....In general, we believe the impact of a positive change and the impact of a negative change would both have to be disclosed where a company is assuming changes in its most material assumption (or assumptions). There may be cases, however, where both types of changes would not be applicable." *Id*.

C. SEC Interpretation.

The most recent SEC pronouncement on critical accounting estimates was an interpretation issued on December 19, 2003 that provided further regulatory guidance on the disclosures required in the Management Discussion and Analysis section of Annual Reports ("the SEC Interpretation").[55] Since one of the main objectives of the section is "to provide information about the quality and potential variability of a company's earnings and cash flow," (*id.* at § I[B]), the SEC included a separate section

> "regarding accounting estimates and assumptions that may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance." *Id.*

When accounting estimates and assumptions have high levels of subjectivity and deal with highly uncertain matters, such as long-tail casualty risks, the disclosure should provide

> "[G]reater insight into the quality and variability of information regarding financial condition and operating performance. While accounting policy notes in the financial statements generally describe the method used to apply an accounting principle, the discussion in MD&A should present a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time.
>
> "A company should address specifically why its accounting estimates or assumptions bear the risk of change. The reason may be that there is an uncertainty attached to the estimate or assumption, or it just may be difficult to measure or value. Equally important, companies should address the questions that arise once the critical accounting estimate or assumption has been identified, by analyzing, to the extent material, such factors as how they arrived at the estimate, how accurate the estimate/assumption has been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future. *Since critical accounting estimates and assumptions are based on matters that are highly uncertain, a company should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect. Companies should provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors.*" *Id.* at § E. (Emphasis added).

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55 *See Commission Guidance Regarding Management's Discussion and Analysis Of Financial Condition and Results of Operations*, Fed.Sec.L.Rep. ¶87,127 (Dec. 19, 2003). According to the SEC, interpretations represent the views of the Commission on "the federal securities laws and SEC regulations." SEC Website (www.sec.gov). *See* Note 57, *infra* at 20.

D. Quantifying Variability.

Viewed together, the SEC pronouncements require publicly-traded insurers to quantify the variability in their reserve estimates. Although the Proposed Rule remains under consideration,[56] the disclosures required are similar in substance to those described in the SEC Interpretation, which was issued a year later. Both the Proposed Rule and SEC Interpretation require a description of the methodologies and assumptions used to develop the estimates, a review of the accuracy of prior estimates, and an analysis of the sensitivity of reserve estimates to reasonable alternative assumptions that would have a material impact on the financial condition or operating performance of the registrant. The SEC Interpretation discusses the disclosures generally, while the Proposed Rule describes them in detail.

For investors, the most important feature of the SEC pronouncements is the requirement for a sensitivity analysis that measures the effect of reasonable alternative assumptions on financial results. Because reserves are the most important item on the financial statements of casualty insurers--representing about two-thirds of all liabilities--sensitivity analyses may already be required for long-tail writers, even though they are not currently mentioned in the SEC industry guide for property and casualty insurers (the "Industry Guide").[57] The Industry Guide, which was adopted in 1984,[58] requires many of the items in the recent SEC pronouncements, including a discussion of significant reserving assumptions, an explanation of recent changes in reserving assumptions, and a comparison of original reserve estimates with successive reestimations over a ten-year period.[59] While informative, the Industry Guide does not address the most critical issue surrounding *current* reserve estimates--their sensitivity to other reasonable assumptions that could produce a materially different financial result.[60] This shortcoming has now been remedied--directly by the Proposed Rule, more generally by the SEC Interpretation.

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56 In response to a query from the authors, the SEC staff recently said the Commission was trying to evaluate whether the proposed rule was necessary. According to the staff, the December 2003 "interpretation may have come too late for a quick evaluation"and the SEC wanted to see if companies "get it right" before deciding whether a new rule was necessary. Telephone interview with Todd Hardiman, SEC Contact Person, October 18, 2004.

57 "Quantitative disclosure should be considered and may be required to the extent material if quantitative information is reasonably available." *SEC Interpretation* at § III(B)(3). While they do not have the force of law, interpretations are entitled to judicial deference. "Because Congress has 'delegated authority to the agency generally to make rules carrying the force of law'...we are required to defer to the Commission's construction of the statute unless that interpretation is unreasonable" *Walton v. Rose Mobile Homes*, 298 F.3d 470 (5th Cir. 2002).

58 See *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, Fed.Sec.L.Rep. ¶ 72,420 (Nov. 27, 1984). An industry guide was issued because the SEC "had become concerned that the existing disclosures about loss reserves and the effects of adjustments to loss reserves estimated in prior years were inadequate, thereby impeding the ability of investors to fully evaluate the financial condition and results of operations" of property and casualty insurers. *Id*. at 62,088.

59 Securities Act Industry Guide 6, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property and Casualty Underwriters*, Fed.Sec.L.Rep. ¶ 3830 (2004) § 2.

60 Among other things, a sensitivity analysis using the new methodology (see *supra* at 12-13) could advise investors, for example, that based on past history there was a 10% chance of an adverse deviation of up to $100 million, which, if it occurred, would result in a similar reduction in future pretax income.

The inclusion of sensitivity analyses in the Proposed Rule was opposed by two parties with ties to the insurance industry who responded to a request for comments by the SEC:

- The American Insurance Association ("AIA"), which represents 410 property and casualty insurers, supported the objectives of the Proposed Rule but believed they should be "achieved through better *qualitative* disclosure instead of the proposed quantitative disclosures." The AIA was concerned that sensitivity analyses will "cause readers to question the overall accuracy of the financial statements." With regard to disclosing a range of estimates, the AIA said this approach was "misleading because it does not reflect the probabilities of each possible outcome within the range and identification of the endpoints of a subjective process are not reliably definable or determinable."[61]

- PriceWaterhouseCoopers echoed the sentiments of the AIA, arguing that the process of generating a range of outcomes could "be subject to abuse because preparers will want to be seen as having applied judgments that are "middle of the road" positions. One way to promote that notion is to describe the ends of the range as neatly bracketing the estimate currently in use, potentially making the objective of adding to investor understanding a zero-sum game."[62]

The concerns expressed by the commentators are similar to those that resulted in the elimination of the Probability Assumptions section of *Standard No. 36*--the perceived lack of a generally accepted actuarial method for quantifying reserve variability. As previously noted, most of the concerns have been allayed by a new methodology that calculates probabilities for current reserve estimates produced by the loss development method.[63] The new methodology allows insurers to develop the quantitative data needed to comply with the SEC requirements, including data on the upper and lower range of variation in the reserves, the probability that the ends of the range rather than the selected estimate will occur, and the standard deviation of the data.[64]

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61 Comments of American Insurance Association, July 19, 2002 at 3. SEC Website (http://www.sec.gov/rules/proposed/s71602/pschwartz1.htm).

62 Comments of PriceWaterhouseCoopers, July 19, 2002 at 2. SEC Website (http://www.sec.gov/rules/proposed/s71602/pricewaterhouse1.htm).

63 The loss development method uses the historical development experience from more mature underwriting years to derive loss development factors which are applied to reported losses in less mature years to project the amount of ultimate losses. *See Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d 1226, 1229-30 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992).

64 *See supra* at 12-13 and 20, Note 60. The developers of the new methodology emphasize that while the model is a useful tool, it "does not eliminate the inherent uncertainty of reserve estimates." *See* C.K. Khury & Irene K. Bass, *A Probabilistic Framework for Evaluating Materiality and Variability In Loss Reserve Estimates* (2003).

V

DISCLOSURES BY PUBLICLY-TRADED INSURERS

Publicly-traded insurers, which conduct business through wholly-owned subsidiaries and affiliates, are subject to the concurrent jurisdiction of federal and state regulators, each of which has its own disclosure requirements. Operating companies have to comply with the disclosure rules of the NAIC, which have been adopted by all fifty States and the District of Columbia,[65] while the holding companies have to meet the reporting requirements of the SEC. The regulatory authorities have markedly different approaches to disclosure, much of it due to different regulatory objectives. States have "the mission of minimizing the impact of insurance company failures for the protection of consumers,"[66] while the SEC has the goal of ensuring that material information affecting the business and financial condition of public companies, including the quality and variability of earnings, is disclosed to investors.[67]

The different regulatory objectives are evident in the disclosure rules for reserve estimates, which both federal and state regulators agree are critical to the financial condition of insurers. The NAIC favors a paternalistic approach, where insurers disclose critical data on actuarial estimates to regulators, who review the information on a confidential basis on behalf of policyholders, while the SEC insists the information be publicly disclosed to investors, so the market can make its own judgment. Thus:

- The SEC requires a public disclosure of the methodologies and assumptions underlying reserve estimates, while the NAIC allows insurers to place the information in a confidential report for the eyes of regulators but not the public.

- The SEC requires companies to disclose the judgments and uncertainties affecting their reserve estimates; the NAIC requires actuaries to provide similar information in an actuarial report that is only available to regulators.

- The NAIC requires actuaries to disclose the difference between the carried reserves and the actuarial estimates in a confidential summary, while the SEC requires that material differences be disclosed to the public.

- The SEC requires insurers to quantify the effect of alternative assumptions on reserves and earnings; the NAIC requires actuaries to give a range of estimates, but considers the information proprietary and confidential.

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65 *See* NAIC, *Compendium Of State Laws On Insurance Topics*, State Laws Related To Annual Statement Filings (1996). In 1945, Congress formally ceded the business of insurance to the States under the McCarran-Ferguson Act, 15. U.S.C. § 1011 (1945).

66 *See* American Academy of Actuaries, *Property and Casualty Practice Note for Statements of Actuarial Opinion as of December 31, 2004*, Appendix 9 at 78.

67 *Basic Inc. v. Levinson,* 485 U.S. 224, 230 (1988). *Commission Guidance Regarding Management's Discussion and Analysis Of Financial Condition and Results of Operations*, Fed.Sec.L.Rep. ¶ 87,127 (Dec. 19, 2003) at § II.

A. NAIC Disclosures.

The new NAIC disclosure rules for actuarial opinions take effect at year-end 2004. Although most of the information required by the new rules is already covered by *Standard No. 36*, a standard of practice does not carry the force of law, and compliance to date has been uneven, to say the least. In 2003, for example, actuarial opinions were submitted for ten property and casualty insurers that were subsequently declared insolvent because of inadequate reserves.[68] A review of the seven opinions submitted for the soon-to-be insolvent companies (four were related and used the same actuary) revealed that:

- All of the opinions said the reserves made a reasonable provision for unpaid claims as of December 31, 2002 and were prepared in accordance with accepted actuarial standards and principles. Within a year, all the companies were insolvent.

- Three of the seven opinions warned of a material adverse deviation in the reserves, but four did not.

- Of the four opinions that did not warn of a material adverse deviation, three involved companies that wrote predominantly long-tail business.

- Of the three opinions that warned of a material adverse deviation, two of the actuaries did not quantify the amount of adverse deviation they deemed material, as *Standard No. 36* requires.

Lack of compliance with *Standard No. 36* was not limited to insolvent companies. A review of opinions filed in early 2003 for thirty of the largest solvent insurers found that only twelve warned of a material adverse deviation in the reserves, while eighteen did not. Thirteen of the eighteen opinions that did not warn of a material adverse deviation were for companies that had just increased prior-year reserves by more than 20% of surplus. Compliance improved in 2004, with most of the largest long-tail writers saying there was a risk of a material adverse deviation in the reserves,[69] but there were conspicuous exceptions.[70]

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68 The companies were Reciprocal of America (Virginia), American National Lawyers Insurance Reciprocal (Tennessee), Doctors Insurance Reciprocal (Tennessee), Reciprocal Alliance Risk (Tennessee), Washington Casualty Company (Washington), Security Indemnity Insurance Company (New Jersey), White Hall Mutual Insurance Company (Pennsylvania), Commercial Casualty Insurance Company of North Carolina (North Carolina), Pacific National Insurance Company (California), and Fremont Indemnity Company (California).

69 Companies warning of an adverse deviation included American Home, Berkley Insurance, Commerce & Industry, Continental Casualty, Converium Re, Dorinco Re, Employers Re, Fireman's Fund, GE Re, General Re, Hartford Accident, Hartford Fire, National Union, St. Paul Fire, Swiss Re America, Travelers Casualty, and Travelers Indemnity.

70 Subsidiaries of publicly-traded insurers that did not warn of a material adverse deviation as of December 31, 2002 (and their percentage of long-tail reserves to surplus) included Everest Re of the Everest Re Group (175%); Federal Insurance and Pacific Indemnity of Chubb Corporation (113% and 153%); Evanston Insurance of the Markel Corporation (142%); and Zenith Insurance of Zenith National Insurance Corporation (182%).

Compliance with *Standard No. 36* will presumably be universal next year when state regulators assume responsibility for the disclosures. Even if it is, the actuarial opinions will be of limited value to investors. As we have seen, most of the important reserve information was relegated to confidential reports and summaries that are not available to the public.[71] What is left--the seemingly anomalous conclusion that reserves are reasonable but subject to a material adverse deviation--raises more questions than it answers.

B. SEC Disclosures.

In 2003, there were fifty-five publicly-traded insurance holding companies that wrote long-tail risks through operating subsidiaries and affiliates. According to A.M. Best, subsidiaries of publicly-traded holding companies accounted for over half of the long-tail risks underwritten by domestic insurers--$61 billion of $118 billion--with the top twenty holding companies accounting for $55 billion, or 47%.[72] While most of the subsidiaries wrote other types of risks, and several holding companies had subsidiaries engaged in other lines of business, long-tail risks were material to the overall financial results of every holding company.

TABLE 3
TOP 20 PUBLICLY-TRADED INSURERS WITH LONG-TAIL RESERVES IN 2003
(IN MILLIONS)

					Long-Tail Reserves	
	Holding Company	*Pretax Income*	*Net Capital*	*Long-Tail Reserves*	*As % Of Income*	*As % Of Capital*
1.	AIG	13,908	71,253	16,920	121.7%	23.7%
2.	Berkshire Hathaway	12,020	77,596	16,597	138.1%	21.4%
3.	Travelers	2,229	11,987	14,806	664.1%	123.5%
4.	CNA	-2,352	8,952	11,968	508.9%	133.7%
5.	Chubb	934	8,522	9,981	1,069.1%	117.1%
6.	Hartford	-550	11,639	9,160	1,665.4%	78.7%
7.	St. Paul	819	6,225	6,406	782.2%	102.9%
8.	Everest Re	491	3,165	3,101	631.2%	98.0%
9.	W.R. Berkley	489	1,683	2,794	571.1%	166.1%
10.	White Mountains	372	2,979	2,645	710.4%	88.8%
11.	ACE Limited	1,696	8,835	2,510	148.0%	28.4%
12.	American Financial	278	2,076	2,449	881.0%	118.0%
13.	Safeco	441	5,023	2,322	526.3%	46.2%
14.	Transatlantic	387	2,377	1,959	506.6%	82.4%
15.	Cincinnati	480	6,204	1,841	383.5%	29.7%
16.	Odyssey Re	378	1,390	1,572	415.6%	113.1%
17.	Ohio Casualty	108	1,146	1,308	1,215.4%	114.1%
18.	Markel	280	1,382	1,191	425.3%	86.2%
19.	Zenith National	101	383	839	830.3%	218.8%
20.	PMA Capital	-68	464	826	1,228.3%	178.1%
	Totals & Averages.....	32,442	233,280	110,310	340.0%	47.3%

71 *See* Section III(B), *supra* at 15.

72 *See* A.M. Best Property-Casualty Reports Database (2004); A.M. Best Insurance Reports Property-Casualty (2003). Since Annual Statement data is unavailable for foreign insurers, the long-tail reserves and ratios of long-tail reserves to income and capital in Table 3 are understated for holding companies with foreign subsidiaries, such as AIG and ACE.

The significance of long-tail risks is obvious. Every public company in Table 3 has a ratio of long-tail reserves to pretax income over 100%, and fifteen have ratios of long-tail reserves to capital over 50%. Given the variability of the risks, the fortunes of even the largest and most diverse insurer can be materially affected by fluctuations in the long-tail reserves. In 2002, for example, AIG, the largest domestic writer of long-tail risks, increased its reserves for prior-year policies by $4.1 billion, reducing its pretax income from $12.2 billion to $8.1 billion; CNA Financial, the fourth largest public casualty insurer, increased prior-year reserves by $2.8 billion in 2003, turning an otherwise profitable year into a loss.[73] Though insolvency is normally less of a concern for public companies, at least nine publicly-traded insurers have filed for Chapter 11 protection since 1998.[74] The most notable failure was Reliance Group Holdings, which filed a bankruptcy petition in 2001 after the Pennsylvania Insurance Department placed its principal operating subsidiary, Reliance Insurance, in rehabilitation because of a reserve deficiency in excess of $1 billion.[75]

(1) Segment Reporting

Under SEC rules, publicly-traded insurers are required to combine related operations into business segments and make a separate disclosure for each segment that "a critical accounting estimate affects."[76] According to the release accompanying the Proposed Rule:

> "In 1989, we stated in an interpretive release, '[t]o the extent any segment contributes in a materially disproportionate way to [revenues, profitability, and cash needs], or where discussion on a consolidated basis would present an incomplete and misleading picture of the enterprise, segment disclosure should be included.' In accordance with this interpretation, we are proposing disclosure regarding the impact of critical accounting estimates on segments of a company's business. Where applicable, we believe that this disclosure would be important for investors because it would enable them to determine which reported segments' results are dependent on management's subjective estimates, and material information would be provided on a segment basis."
> *Id.* at 85,426.

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73 *See* American International Group, Inc., Form 10-K (Dec. 31, 2002) at 63, 86; CNA Financial Corporation, Form 10-K (Dec. 31, 2003) at 20.

74 Publicly-traded insurers that filed for bankruptcy because of reserve related problems include Amwest Insurance Group, Inc. (2001), First Central Financial Corp. (1998), Highlands Insurance Group, Inc. (2002), Home Holdings, Inc. (1998), Reliance Group Holdings, Inc. (2001), Trenwick Group Ltd. (2003), SNTL Corporation (2000), Home State Holdings, Inc. (1997), and Fremont General Corporation (2002).

75 *See* Reliance Group Holdings, Inc., Form 8-K (Jun. 22, 2001) at 2; Form 12b-25 (Apr. 3, 2001 at Attachment A).

76 See SEC Proposed Rule, *Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies*, 67 Fed. Reg. 35620 (2002) (to be codified at 17 C.F.R. Pts. 211, 231 & 241 (proposed May 10, 2002), Fed.Sec.L.Rep. ¶ 86,638 at 85,426.

Segment reporting is important for investors because all of the publicly-traded insurers have multiple subsidiaries writing long-tail risks.[77] By requiring companies to consolidate risks from separately incorporated businesses into a single reporting segment, the SEC ensures that the impact of reserve variations on the overall financial position of insurers is clearly understood.[78]

(2) Recent Reserve Disclosures

In December 2001, the SEC encouraged public companies to address the implications of uncertainty on estimates for recurring accounting measurements. Following this cautionary advice, publicly-traded insurers began including a section on critical accounting estimates in their annual reports. Initially, most of the disclosures used the same broadly-worded generalities that had previously appeared in other parts of the annual reports, and did not include any of the quantitative data called for by the Proposed Rule or the recent SEC Interpretation.

The disclosures improved last year, with ten of the top twenty public insurers providing an extensive *qualitative* description of the reserving process in their 2003 annual reports.[79] Qualitative disclosures, however, do not measure the sensitivity of financial results to changes in estimates, and with limited exceptions, the top public companies did not provide the quantitative data identified in the Proposed Rule. Eleven companies provided no quantitative analysis of reserve variability, and five simply noted that a hypothetical increase in the loss reserves would result in a dollar-for-dollar reduction in pretax income.[80] Three of the remaining firms provided some but not all of the elements required by the Proposed Rule:

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77 Publicly-traded insurers with multiple subsidiaries writing over $100 million in long-tail risks include AIG (10 subsidiaries), Chubb (4), Travelers (17), Berkshire Hathaway (8), Hartford (8), St. Paul (4), W.R. Berkley (4), and Safeco (5).

78 Holding companies also consolidate risks through intercompany pooling arrangements where "one company in the pool assumes business from the other companies in the pool, and then cedes the combined business (including its own business) back to the other companies according to their percentage participation in the pool." *See* American Academy of Actuaries, Property and Casualty Practice Note, *Statements Of Actuarial Opinion On P&C Loss Reserves As Of December 31, 2003* (Dec. 2003) at 55.

79 *See* Annual Reports on Form 10-K for period ending December 31, 2003 of Ace Limited at 28-30; American Financial Group at 30-32; American International Group, Inc. at 24-30; CNA Financial Corporation at 26-29; Zenith National Insurance Corporation, Exh. 13 at 36-41; White Mountains Insurance Group Ltd. at 62-69; Hartford Financial Services Group, Inc. at 21-24; Travelers Property Casualty Corp. at 86-94; Safeco Corporation at 33-42; Chubb Corporation at 30-38.

80 *See* Annual Reports on Form 10-K of American International Group, Inc. (Dec. 31, 2003) at 27; Berkshire Hathaway at 33; Markel Corporation at 72; PMA Capital Corporation at 60; Zenith National Insurance Corporation, Exh. 13 at 37. The last four companies explicitly stated that a reserve increase by a hypothetical amount or percentage would result in a charge to pretax earnings. AIG, which uses trend factors to estimate reserves, said "[a]s an example, for the lead umbrella segment of the excess casualty class of business, a 5 percent change in the assumed loss cost trend from each accident year to the next would cause approximately a $300 million impact (either positively or negatively) in the net loss and loss expense reserve position for that segment." AIG Annual Report (Dec. 31, 2003) at 27.

- CNA Financial estimated the percent of volatility in the reserves by line of business, but said the percentages did "not represent a range around the actuarial point estimate of the" reserves. It did not discuss the probabilities associated with the volatility or quantify its impact on financial performance. *See* CNA Annual Report On Form 10-K (Dec. 31, 2003) at 29.

- Cincinnati Financial, the sixteenth largest public insurer, gave the range of estimates provided by an outside actuary, noting that "each percentage point increase in the loss and loss expenses ratio would reduce pretax income by $27 million based on 2003 earned premiums." The probabilities associated with the ends of the range were not discussed. *See* Cincinnati Financial Annual Report On Form 10-K (Dec. 31, 2003) at 18.

- White Mountains Insurance Group, the twentieth largest long-tail insurer, made the most extensive disclosure. White Mountains provided the high and low ends of the range of reasonable estimates by seven categories of business, along with the carried reserves for each category. The only element of the Proposed Rule that was not provided were the probabilities associated with the ends of the range and the carried estimate.[81]

Virtually all public insurers provide an historical analysis of reserve variability in loss development tables required by the Industry Guide,[82] but it is not nearly as helpful as the sensitivity analysis required under the Proposed Rule. The historical tables show the change over time of the ultimate loss estimates for the last ten fiscal years, as originally reported by the insurer and as reevaluated each successive year. While the tables alert investors to the potential for reserve changes, they are of marginal utility in assessing the range of variability in the *current* reserves.[83] Too many variables are operating simultaneously--different fiscal years, development periods, lines of business, and subsidiaries--to make a reliable forecast from this type of summary data alone, which is presumably why the SEC wants an analysis of both current and historical reserve variability.[84]

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81 *See* Annual Report on Form 10-K of White Mountains Insurance Group Ltd. (Dec. 31, 2003) at 62-69. Following a table of ranges, White Mountain said, "[t]he probability that ultimate losses will fall outside of the ranges of estimates by line of business is higher for each line of business individually than it is for the sum of the estimates for all lines taken together due to the effects of diversification." The statement is a tautology that provides no insight into the probability that the ends of the range or selected point estimate will occur.

82 *See* SEC, Securities Act Industry Guides, *Disclosures Concerning Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, 1 Fed.Sec.L.Rep. ¶ 3830 (2004) at § 2.

83 American Financial discussed the reserve variability reflected in its loss development table, noting that seven original reserve estimates were redundant by up to 7.2% and three were deficient by as much as 10.4%. According to the Company, "this development illustrates the variability in factors considered in estimating its insurance reserves." American Financial Annual Report On Form 10-K (2003) at 31. Since the results excluded "special charges" for highly variable asbestos and pollution claims, the deficiency totals may be understated.

84 See SEC Proposed Rule, *Disclosure in Management's Discussion and Analysis About the Application of Critical Accounting Policies*, Fed.Sec.L.Rep. ¶ 86,638 (2002) at 85,421.

(3) Future Reserve Disclosures

With an additional year to address the quantification requirements of the recent SEC pronouncements, publicly-traded insurers are now in a position to provide investors with the information needed to measure reserve variability in a meaningful way, including, among other things, data on the upper and lower range of variation, the probability that the ends of the range rather than the selected estimate will occur, and the standard deviation of the data. Most of the information can be found in the actuarial reports prepared for regulators,[85] except for probability data, which can be generated by the new methodology developed expressly for this purpose.[86]

The concurrent jurisdiction of federal and state regulators raises an important disclosure issue for publicly-traded insurers, namely, do they have a duty to disclose the information the NAIC agreed was "critical" but decided to place in confidential documents, including the range of estimates of the appointed actuary, a comparison of the actuarial estimate to the carried reserves, and a description of the reserve elements or management decisions responsible for adverse development over 5%.[87] Comparisons between carried reserves and the actuarial estimate are obviously material, the NAIC itself calls them "critical disclosure items." Actuaries are required to explain their "significance" to the Board of Directors, who must be made "aware of differences between the actuary's estimates...and the carried reserves" as well as "the risk of material adverse deviation" in the reserves.[88] Although the NAIC insists that directors be fully informed, its concern does not extend to shareholders, who are left in the dark.

Fortunately for investors, the federal interest in full disclosure supersedes the state interest in regulating actuarial opinions and reports. The McCarran-Ferguson Act delegated authority over "the business of insurance" to the States, but the delegation only extends to the protection of policyholders and does not deprive the SEC of its paramount authority over securities transactions. The supremacy of the federal securities laws was explained by the Supreme Court in *SEC v. National Securities, Inc*., 393 U.S. 453 (1969), where an insurance merger approved by state regulators was blocked by the SEC. Discussing the limited reach of the McCarran-Ferguson Act, the Court held.

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85 Under the new NAIC disclosure rules, the actuarial report must contain the best estimate, range of reasonable estimates, or both. Beginning in 2005, actuaries must give a range of estimates *and* a point estimate for the reserves. *See* AAA*, Property and Casualty Practice Note for Statements of Actuarial Opinion as of December 31, 2004*, at 29, 90.

86 *See supra* at 12-13, 20-21.

87 *See* American Academy of Actuaries, Property and Casualty Practice Note for Statements of Actuarial Opinion (Dec. 2004), Appendix 10 at 90.

88 *Id*. at 78. The relevance of the actuarial reports is also clear from the *Regulatory Guidance,* which notes, "[e]xhibits alone rarely convey professional conclusions and recommendations, or the significance of the actuary's opinion or findings....A narrative section should provide clearly worded information so that readers are able to appreciate the significance of the actuary's findings and conclusions, the uncertainty in the estimates, and differences between the actuary's estimates and the carried reserves." Id. at 81.

> "The statute did not purport to make the States supreme in regulating all the activities of insurance companies; its language refers not to the persons or companies who are subject to state regulation, but to laws 'regulating the business of insurance.' Insurance companies may do many things which are subject to paramount federal regulation; only when they are engaged in the 'business of insurance' does the statute apply. Certainly the fixing of rates is part of this business...The selling and advertising of policies...and the licensing of companies and their agents...are also within the scope of the statute. Congress was concerned with the type of state regulation that centers around the contract of insurance...The relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation, and enforcement--these were the core of the 'business of insurance.' Undoubtedly, other activities of insurance companies relate so closely to their status as reliable insurers that they too must be placed in the same class. But whatever the exact scope of the statutory term, it is clear where the focus was--it was on the relationship between the insurance company and the policyholder....In this case, Arizona is concerning itself with a markedly different set of problems. It is attempting to regulate not the 'insurance' relationship, but the relationship between a stockholder and the company in which he owns stock. This is not insurance regulation, but securities regulation." *Id*. at 459-61.

Regulating the content and distribution of actuarial reports is of marginal relevance to the business of insurance. Even if the ostensible reason for denying investors critical data on the reserves had merit, which is doubtful,[89] it would not relieve publicly-traded insurers of their obligations under the federal securities laws, particularly with respect to reserve estimates that can literally make or break a company.[90]

(4) Accounting Disclosures

Another issue raised by the new disclosure rules arises from the interplay between the requirements of *Standard No. 36* and the rules governing the issuance of audit reports for public companies. Specifically, does an actuarial opinion warning of a material adverse deviation in the reserves require a qualified opinion on the financial statements? Under generally accepted auditing standards, a qualified opinion must be issued if there is a "material uncertainty" affecting the financial results *that has not been adequately disclosed* in the financial statements.[91] In evaluating the adequacy of disclosure, the materiality of the uncertainty must be considered:

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89 *See* Note 46, *supra* at 15.

90 Insurers who withhold material information on the reserves may be liable for securities fraud. *See, e.g., Ruskin v. TIG Holdings, Inc*., 2000 U.S. Dist. Lexis 11517 (S.D.N.Y. 2000): *LC Capital Partners, LP v. Frontier Insurance Group, Inc*., 318 F.3d 148 (2d Cir. 2003); *Giarraputo v. UNUMProvident Corp*., 2000 U.S.Dist. Lexis 19138 (D.Maine 2000); *In re Oxford Health Plans, Inc., Securities Litigation*, 187 F.R.D. 133 (S.D.N.Y. 1999); *In re Employee Solutions Securities Litigation*, 1998 U.S.Dist. Lexis 16444 (D.Ariz. 1998).

91 AICPA, Professional Standards, *Reports On Audited Financial Statements* § 508 (2003).

> "The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances. The auditor evaluates the materiality of reasonably possible losses without regard to his or her evaluation of the materiality of known and likely misstatements in the financial statements..." *Id*. § 508.47.

The auditing rules for disclosing the effect of uncertainties are governed by Statement of Position No. 94-6 of the AICPA, which requires reporting entities to include a disclosure about the use of estimates in their financial statements.[92] When it is reasonably possible that a near-term change in estimate will have a material effect on the financial condition or results of operations of a company, the disclosure "should include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made." *Id*. at 5. The obligation under SOP No. 94-6 differs only in detail from the requirement in the Proposed Rule for a sensitivity analysis that measures the effect of reasonable alternative assumptions on the earnings and financial position of insurers. To avoid a qualified opinion, the notes to the financial statements of publicly-traded insurers should estimate the loss or range of losses that might result if reasonable alternative assumptions were used to establish the reserves. In the absence of such disclosures in the financial statements, or an explanatory paragraph in the audit report that calls attention to the risks and uncertainties, auditors who issue unqualified opinions for long-tail insurers may be exposed to claims for securities fraud or professional malpractice. *See In re Oxford Health Plans, Inc., Securities Litigation*, 51 F.Supp.2d 290 (S.D.N.Y. 1999)*; Holland v. Arthur Andersen & Co*., 469 N.E.2d 419, 421 (Ill. 1984).[93]

(5) Safe Harbor Protection

A final issue raised by the new disclosure rules is the exposure of insurers, actuaries, and accountants who make or assist in making the reserve disclosures called for by the Proposed Rules. The rules certainly benefit investors, but the benefit will be illusory if the end result is another round of costly litigation that distracts management from its primary objective, earning a profitable return for shareholders. Fortunately for management and investors, the specter of runaway lawsuits is greatly diminished by the safe harbor provisions of the federal securities law, as the SEC explained in the release accompanying the Proposed Rule:

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92 AICPA, Statement Of Position 94-6, *Disclosure Of Certain Significant Risks And Uncertainties* (Dec. 30, 1994) at 3. The disclosure requirements of SOP 94-6 "are separate from and do not change in any way the disclosure requirements or criteria of FASB Statement No. 5" dealing with loss contingencies, which do "not distinguish between near-term and long-term contingencies." *Id*. at 5-6.

93 *Cf. Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976); *Rhode Island Hospital Trust National Bank*, 455 F.2d 847 (4th Cir. 1972); *Arnlund v. Deloitte & Touche LLP*, 199 F.Supp.2d 461 (E.D.Va. 2002); *Annixter v. Home-Stake Production Co*., 77 F.3d 1215 (10th Cir. 1996); *Seafirst Corp. v. Jenkins*, 644 F.Supp. 1152 (W.D.Wash. 1986).

> "The statutory safe harbors provide three separate bases for a company to claim the protection against liability for forward-looking statements... First, a forward-looking statement would fall within that safe harbor if it is identified as forward-looking and it is accompanied by meaningful cautionary statements that identify important factors that could cause actual results to differ materially from those in the forward-looking statement. Second, the safe harbor protects from private liability any forward-looking statement that is not material. Finally, the safe harbor precludes private liability if a plaintiff fails to prove that the forward-looking statement was made by or with the approval of an executive officer of the company who had actual knowledge that it was false or misleading." *Proposed Rule* at 85,437.

The safe harbor provisions described by the SEC were created by the Private Securities Litigation Reform Act of 1995. *See* 15 U.S.C. § 77z-2 and 15 U.S.C. § 78u-5. The law

> "adopted a statutory 'safe harbor' by adding a new section...to the 1933 Act...and a new section...to the 1934 Act,....The safe harbor has two alternative inlets: the first shelters forward-looking...statements that are accompanied by meaningful cautionary statements....The second inlet is of importance here. It focuses on the state of mind of the defendant and precludes liability for a forward-looking statement unless the maker of the statement had actual knowledge it was false or misleading." *Greebel v. FTP Software, Inc*., 194 F.3d 185 (1st Cir. 1999).

Together with the "bespeaks caution" doctrine of the common law, the safe harbor provisions have sounded the deathknell for countless private civil damage suits on the theory the alleged misrepresentations were not material or misleading, or the purported reliance by plaintiff was unreasonable, or scienter was not adequately pleaded.[94] With limited exceptions,[95] the disclosures contemplated by the Proposed Rule qualify as forward-looking statements--in fact, it is hard to imagine disclosures that are more forward-looking than estimates of contingent claims that might not be settled and paid for fifty years, if at all. The applicability of the safe harbor law to reserve estimates was confirmed in *In re Kindred Healthcare, Inc., Securities Litigation*, 2004 U.S.Dist. Lexis 775 (W.D.Ky. Jan. 12, 2004), where a complaint accusing a health insurer of making misleading statements about the adequacy of its reserves during a conference call with analysts was dismissed for failure to state a claim under Fed.R.Civ.P. 12(b)(6).

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94 *See, e.g., Asher v. Baxter International, Inc*., 377 F.3d 727 (7th Cir. 2004); *Rombach v. Chang*, 355 F.3d 164 (2d Cir. 2004), *In re Ford Motor Co. Securities Litigation*, 381 F.3d 563, 568 n.3 (6th Cir. 2004); *Greebel v. FTP Software, Inc*., 194 F.3d 185 (1st Cir. 1999); *In re Kindred Healthcare, Inc., Securities Litigation*, 2004 U.S.Dist. Lexis 775 (W.D.Ky. Jan. 12, 2004); *Lilley v. Charren*, 2001 U.S. App. Lexis 19430 (9th Cir. 2001); *EP Medsystems, Inc. v. Echocath Inc.,* 235 F.3d 865; (3d Cir. 2000); *Parnes v. Gateway 2000*, 122 F.3d 539 (8th Cir. 1997).

95 Misstatements about past variability are not protected by the safe harbor law. *See Proposed Rule* at 85,437. Similarly, statements about the value (as opposed to the sufficiency) of an existing reserve are not protected because they are representations of existing fact. *Schnall v. Annuity & Life Re (Holdings), Ltd*., 2004 U.S.Dist. Lexis 2859 at 25 (D.Conn. 2004).

> "The remaining statements...do contain assertions about present facts, namely that management believed at the time the statements were made that Kindred's current reserves and liability coverage were adequate. These statements, however, were predicated on projections of future events. The amount Kindred keeps in reserves to cover liability claims is necessarily a prediction about its future claims experience based on past claims history as well as current filings. Assertions about the adequacy of Kindred's reserves could only be verified when liability claims were actually filed, litigated to conclusion, or settled. It would seem rather beyond argument that such projections about the company's future economic health are forward-looking within the meaning of the PSLRA." *Id.* at 30-32.

Disclosures required by the SEC are more clearly entitled to the protections of the safe harbor laws than the off-the-cuff remarks at issue in *Kindred*. As a result, insurers who provide quantitative disclosures on reserve variability will not only benefit investors, they will improve their chances of deterring or successfully defending suits if a material adverse deviation occurs. If investors have been warned of this possibility, and told the probabilities and amounts involved, they will be hard pressed to claim surprise. On the other hand, if they are given nothing but generalities, an actionable claim for securities fraud may lie. *See Ruskin v. TIG Holdings, Inc*., 2000 U.S. Dist. Lexis 11517 (S.D.N.Y. 2000). There is "'no protection to someone who warns his hiking companion to walk slowly because there might be a ditch ahead when he knows with near certainty that the Grand Canyon lies one foot away.'" *Id*. at 19.

One final note. The concern that quantitative disclosures might cause investors to question the overall accuracy of the financial statements is misplaced. Investors know they cannot "expect equivalent certainty in a balance sheet's statement of loss reserves and its statement of more determinable items, such as outstanding principal and interest on debt instruments." *Delta Holdings, Inc. v. National Distillers and Chemical Corp*., 945 F.2d 1226, 1231 (2d Cir. 1991), *cert. denied*, 508 U.S. 985 (1992). What they do not know is the degree of variability in the reserves and what impact it could have on future earnings. Rather than causing investors to question the accuracy of the financials, the disclosures envisioned by the Proposed Rule would shed light on an uncertainty that already exists.

CONCLUSION

Next year promises to be an eventful period for property and casualty insurers and their investors. New disclosure rules at the NAIC will require actuaries to quantify the minimum adverse deviation in their reserve estimates and publicly-traded insurers, under the watchful eyes of the SEC, will have to quantify the variability of their reserves, providing investors with the information they need to realistically assess the value of their investment.

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