

# Insurance Industry Asbestos Reserve Estimates Are Unreliable

By **Jonathan Terrell** (March 12, 2024)

I condemn the failings of insurance regulators in allowing underfunded insurance company reorganizations. They have caused incalculable harm to the insurance industry and financial losses to policyholders.

When a company or individual buys an insurance policy, they make their own decision about the strength of the insurance company. But when the insurance company counterparty is engineered into a different entity without the financial resources of the original counterparty, and this takes place under the noses of state regulators and with their full approval, a grave failure of public policy has taken place.



Jonathan Terrell

In this article, I focus on 25 years of asbestos reserving by the insurance industry, as reported by AM Best, to illustrate why the actuarial and auditing opinions upon which regulators rely to wave through disastrous reorganizations such as the now-bankrupt OneBeacon Insurance Co. and Royal & Sun Alliance Insurance Group PLC are materially unreliable and must be challenged vociferously by affected policyholders.

The credit rating agency AM Best publishes an annual report examining insurance industry loss reserves for asbestos and environmental claim liabilities. These types of liability are referred to as "long tail" because claims can and do occur long after the end of the period covered by the relevant insurance policies. Environmental and especially asbestos liabilities have been the cause of significant losses to the insurance industry, and the reason that many defendant companies and insurance companies alike have become insolvent.

The recently published report and the more than 25 years of these reports that I have before me offer a unique insight into the reserving practices of the insurance industry from a consistent set of data over a long period.[1]

Analysis reveals how consistently wrong the reporting and opinions of insurance company actuaries and their auditors have been in setting realistic levels of loss reserves. Given that reality, regulators should be far more circumspect before waving through insurance company reorganizations that depend entirely upon those estimations.

I hope this piece gives explanation as to why actuarial and audit opinions should be treated with deep skepticism.

It must be acknowledged that the forecasting, reporting and auditing of mass tort liabilities is not an easy matter given the long-tail nature of the claims. Disclosures in the notes to every set of insurance company financial statements make the challenges clear.

At the same time, asbestos is a very mature mass tort — 25 years ago it was already described as the "Energizer Bunny of mass torts" because it kept on going. Therefore, forecasting, reporting and auditing asbestos liabilities should be a lot more reliable than for a more recently emerged class of torts, and these challenges in no way excuse the grave deficiencies in reporting that I highlight in this article.

## Inaccurate Estimates

Under both statutory and U.S. Securities and Exchange Commission accounting rules, insurance companies are required to accrue their full estimates of future liability to the extent that such liabilities are reasonably estimable, and it is probable that they have been incurred.[2]

In each of the 25 years from 1998-2022, every insurance company in the U.S. was required to put up its best estimate of asbestos liabilities, which the credit rating agency AM Best then aggregated in an annual report examining insurance industry loss reserves for asbestos and environmental claim liabilities. AM Best specializes in the insurance industry.

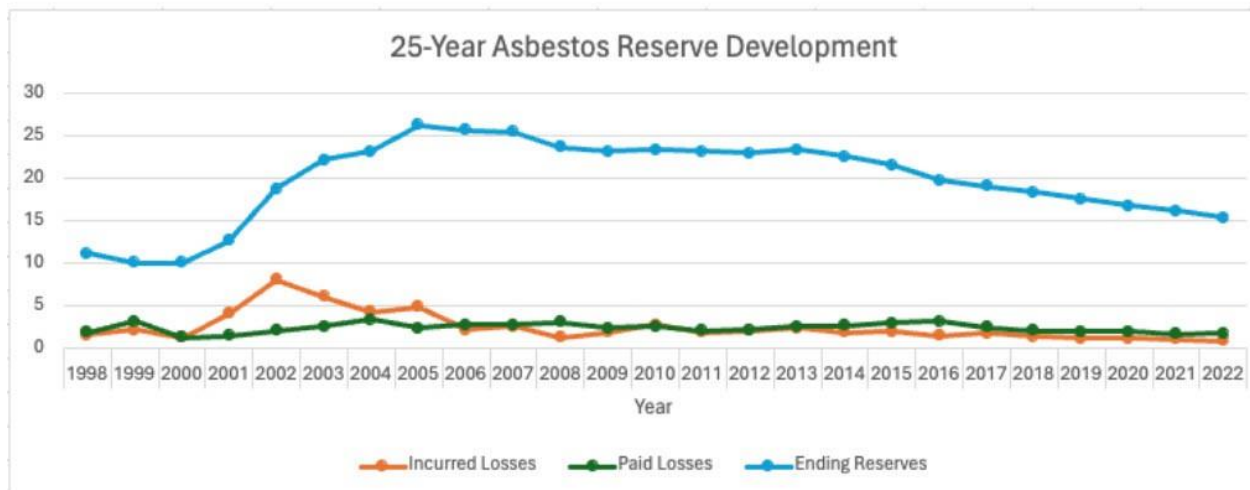
There is always a lag in collecting and compiling the necessary information from every U.S. regulated property and casualty insurance company. AM Best's December 2023 report dealt with the statutory year that ended 2022. The blithe complacency of the AM Best report illustrates the failings of the information in reports and opinions of insurance company actuaries.

First, a word about the estimates reported. Not only must insurance company management take responsibility for its estimate, but their professionally qualified actuaries must sign off on it; then independent actuaries must approve it, and every five years, on behalf of the state, yet another set of insurance regulators must sign off too. In addition, an independent auditing firm must conclude that the company is materially adequately reserved.

With so many highly qualified professionals looking at the estimate, what could possibly go wrong? As it happens, a lot.

## A Quarter-Century of "Pay as You Go"

The following graph summarizes 25 years of industry data derived from the AM Best reports.



The orange line graphs incurred losses by year in billions, which are the amounts added to the reserves because of actuarial reviews each year. The fact that losses were incurred every year illustrates the fact that in every single one of those 25 years, the actuarial estimates were light, and the industry was under-reserved for asbestos liabilities. And not

by a little.

The industry added a total of \$63.1 billion to its asbestos reserves over the 25-year period. In other words, going all the way back to 1998, industry reserves should have been \$63.1 billion higher. Instead, they were a measly \$11.2 billion — instead of \$74.3 billion, nearly seven times higher!

One could argue that 1998 was too early in the life of asbestos to know the future. So, I look at the same data in 2007. Industry reserves at the end of 2007 were \$25.5 billion. Yet in the 15 years leading up to 2022, \$25.6 billion more in asbestos losses were incurred by the industry. Back in 2007, the reserves should have been \$51.1 billion, nearly double what was reserved.

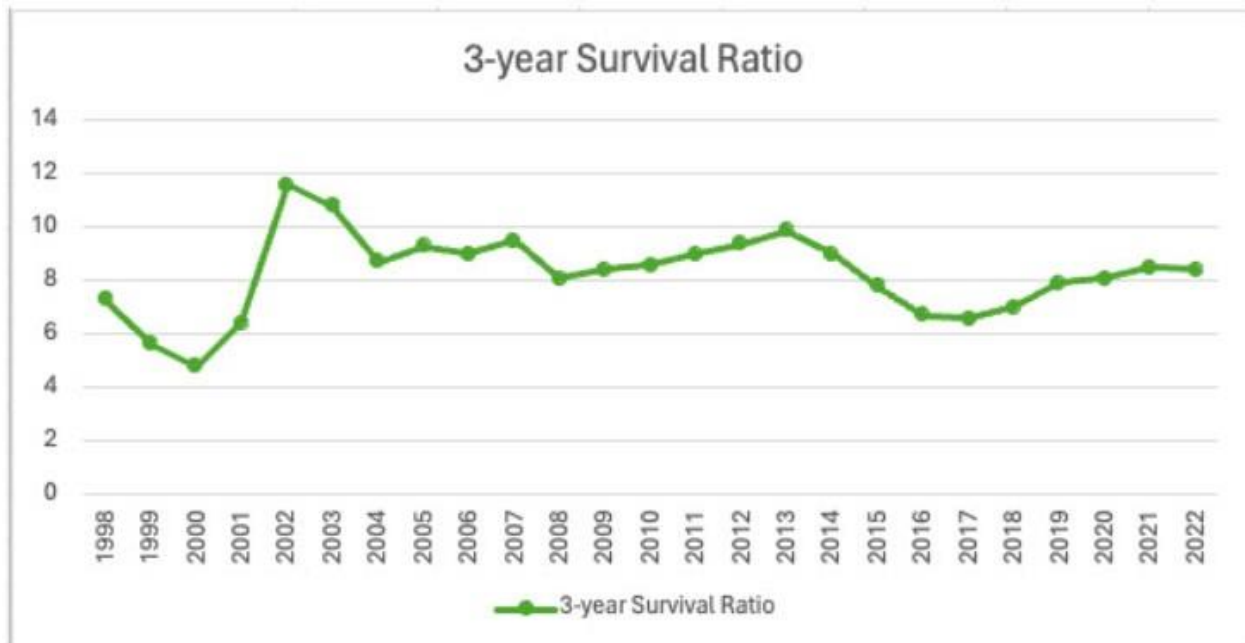
Even when we look at 2017 when industry reserves were \$19.1 billion, we can see that they should have been \$28.7 billion based on losses incurred in the five years to 2022, or 50% higher.

The second line I want to draw your attention to is the green line, which maps industry net asbestos payments by year — a total of \$60.1 billion over the 25-year period. It's shocking how closely it follows the "incurred" line. Other than a brief period in the early 2000s when the industry was making a more concerted attempt to realistically reserve for asbestos liabilities, the two lines are very highly correlated.

In other words, instead of complying with accounting and actuarial standards, the industry has been following a "pay as you go" approach to asbestos liabilities.

Throughout its 25-year history, the AM Best report has included a three-year survival ratio. These ratios are a standard actuarial measure of reserve adequacy that are used to measure how many years a loss reserve will last based on the current rate of payments. The three-year survival ratio calibrates the measure to the average of the prior three years of payments.

At the end of 2022, the industry asbestos survival ratio was 8.4, meaning that at the average payout of the three years to 2022, the asbestos reserves would last 8.4 years before being exhausted. The following graph shows the ratio as presented over the full 25 years. On average, the ratio was 8.3; the lowest was 4.8 (in 2000) and then highest was 11.6 (in 2002).



### Misleading to the Public

Asbestos liabilities will not be satisfied a little more than eight years from now. Whether forecasted at the defendant company level, at the insurance company level, or the insurance industry level, estimates are run out several decades.

What's more, it has been recognized for decades that people exposed to asbestos could develop asbestos-related disease, resulting in consequential claims upon defendant companies and their insurers. It has also long been recognized that these liabilities would last well past the middle of the 21st century.

The graph of reserve development shows amounts paid out along the green line. Notice that there is little variation. In 15 of the years, the payment is more than \$2 billion and less than \$3 billion; in five years it is more than \$1 billion and less than \$2 billion; and in five years it is more than \$3 billion and less than \$4 billion. Over the most recent five years, the payments have averaged \$1.9 billion.

You don't need to be a rocket scientist to see that something is amiss. You don't even need to be an actuary. The industry is grossly under-reserved for asbestos liabilities and has been for at least 25 years.

And what does AM Best have to say about all of this? They have propounded, based on the data, an estimate of the ultimate industry liability for asbestos. By "ultimate," they mean the total amount that will have been paid out by the industry when the last asbestos claim has been paid.

Back in 1995 their estimated ultimate liability was \$40 billion. Periodically they raised their estimate by increments up to \$100 billion, as announced in the 2015 report, where it has stayed since. After adding total industry payments to date with total industry reserves at year-end 2022, AM Best opines that the industry is 94% funded for asbestos liabilities.[3]

According to AM Best, the industry would need to add just \$6 billion more to its \$15.4 in asbestos reserves, and it would have enough money set aside to pay every asbestos insurance claim until the end of time. This is misleading to the public.

When the Pennsylvania Insurance Department approved the separation of the under-capitalized OneBeacon run-off companies from their financially mighty parent, they did so by placing complete reliance on actuarial work that included stochastic modeling of 10,000 scenarios showing there was a 93.4% likelihood that the run-off companies would fully pay claims for at least 30 years.[4] They lasted just six.[5]

Likewise, Arrowood Indemnity — comprising the U.S. operations of Royal Indemnity Company, which were separated from their parent company in a 2006 management buyout — was liquidated last year.[6] It was the same deal, with armies of actuaries testifying about reserve adequacy.

The Home Insurance Co.'s 2003 liquidation is another sorry example.[7]

In my previous guest article for Law360, "Policyholders Must Object to Insurer Reorganizations," I issued a call to policyholders. As illustrated by the analysis above, even for a mature mass tort such as asbestos, the reports are demonstrably unable to reliably estimate liabilities.

Policyholders must vociferously take actions to safeguard their interests when regulators rely on these reports to justify the spinoff of a subsidiary with responsibility for paying legacy liabilities.

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[1] [https://www3.ambest.com/ambv/sales/bwpurchase.aspx?record\\_code=338922&altsrc=](https://www3.ambest.com/ambv/sales/bwpurchase.aspx?record_code=338922&altsrc=)

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[2] Specific disclosures about reserving asbestos and environmental claims have been required under SSAP No. 65, which was finalized in 1998. The required disclosures are consistently made in Note 33, or a predecessor note, by all U.S. property and casualty insurance companies.

[3] <https://news.ambest.com/PR/PressContent.aspx?refnum=34239&altsrc=9>.

[4] <https://www.insurance.pa.gov/Companies/IndustryActivity/Documents/ONEBEACON%20CUMULATIVE%20LOG/146.pdf>.

[5] [https://www.insurance.pa.gov/Regulations/LiquidationRehab/Documents/Bedivere/BEDIVERE\\_MARCH\\_12\\_2021\\_ORDER\\_OF\\_LIQUIDATION.pdf](https://www.insurance.pa.gov/Regulations/LiquidationRehab/Documents/Bedivere/BEDIVERE_MARCH_12_2021_ORDER_OF_LIQUIDATION.pdf).

[6] <https://insurance.delaware.gov/wp-content/uploads/sites/15/2023/11/Arrowood-Notice-of-Liquidation.pdf>.

[7] [http://www.hicilclerk.org/Hicil.nsf/648AB99C75DA50BF85256EE50054208E/\\$file/E0106LIQUIDATION\\_EXECUTED.pdf?OpenElement](http://www.hicilclerk.org/Hicil.nsf/648AB99C75DA50BF85256EE50054208E/$file/E0106LIQUIDATION_EXECUTED.pdf?OpenElement).