

# Client Letter December 2002

## Asbestos Reserves

A.M. Best, an insurance rating agency, has developed a Measure called the "Survival Ratio" to measure the number of years it would take an insurance company to exhaust both its asbestos and environmental reserves for losses and loss expenses. This survival ratio is calculated by dividing the amount of the company's reserve by the amount claims paid annually. Berkshire's survival ratio is 29.1. That means that if Berkshire kept paying claims at the same level that they are now (actually the ratio is figured by averaging the last three years payments) their reserves would last 29.1 years. For the insurance industry as a whole a average survival ratio is 13.1.

AM Best estimates that the industry is currently unreserved by \$35 billion to \$55 billion for claims due over the next 20 years. The industry is currently paying \$1.7 billion per year in asbestos claims, so it would take somewhere between 20 to 32 years to pay all existing claims if payments stay at the same level they are today. The problem is that the industry carrying enough reserves to fund the current level of payments for 13.1 years.

One reason used by insurance companies to justify a lower level of reserves is discounting. If a claim is to be paid over a number of years, the present

value of the money needed to pay those claims can be considerably less than the total amount needed to pay the claim because the money can be invested until it is paid and the income received from investing the money help to pay those claims as they become due.

For example look at the table for Employers Reinsurance. The assumed return for this table is 6%. That is what the company earned last year in interest and investment gains. Their asbestos reserve at the end of 2001 was \$980 million, and the third quarter of this year they added 150 million of additional resaves.

The survival ratio is calculated by dividing the amount of the company's reserve by the amount claims paid annually.

## EMPLOYERS REINSURANCE

In Millions of Dollars

Year	Investment Income From Original Float (6%)	Claims Payments	Original Float Plus Income From Float
2002	\$59	\$94	\$945
2003	\$66	\$94	\$1,066
2004	\$64	\$94	\$1,036
2005	\$62	\$94	\$1,005
2006	\$60	\$94	\$971
2007	\$58	\$94	\$935
2008	\$56	\$94	\$897
2009	\$54	\$94	\$857
2010	\$51	\$94	\$815
2011	\$49	\$94	\$769
2012	\$46	\$94	\$722
2013	\$43	\$94	\$671
2014	\$40	\$94	\$617
2015	\$37	\$94	\$560
2016	\$34	\$94	\$500
2017	\$30	\$94	\$436
2018	\$26	\$94	\$368
2019	\$22	\$94	\$296
2020	\$18	\$94	\$220
2021	\$13	\$94	\$139

**Total Claims paid in Twenty years \$1,880**

You can see from the table that with a uniform return of 6% and no further additions to the reserve account they could pay \$1.9 billion in claims over the next twenty years and still have \$139 million left in their reserve account.

But there are problems with this sort of discounting. First of all we do not know for sure when the claim will have to be paid, payments tend to escalate as time passes, and we do not know exactly what the money will earn for the period it will be

held.

In last years chairman's letter Warren had this to say about the practice.

*"Surprises in the insurance world have been far from symmetrical in their effect on earnings.*

*"Because of this one-sided experience, it is folly to suggest, as some are doing, that all property/casualty insurance reserves be discounted, an approach reflecting the fact that they will be paid in the future and that therefore their present value is less than the stated liability for them.*

*Discounting might be acceptable if reserves could be precisely established. They can't, however, because a myriad of forces - judicial broadening of policy language and medical inflation, to name just two chronic problems - are constantly working to make reserves inadequate. Discounting would exacerbate this already-serious situation and, additionally, would provide a new tool for the companies that are inclined to fudge.*

*"I'd say that the effects from telling a profit-challenged insurance CEO to lower reserves through discounting would be comparable to those that would ensue if a father told his 16-year-old son to have a normal sex life. Neither party needs that kind of push."*

We have no idea if the above table is an example of the sort of push that Warren talks about. But we can see that it might be, while it looks alright at first glance and might be acceptable to that sex starved CFO, there is absolutely no cover for the asymmetric risk.

None of this will come as a surprise to anyone who follows Berkshire. Warren has been talking about bad reserving policy in the industry for years. What surprised me was the size of the variation.

Berkshires reserves for "environmental and latent injury claims" have increased from 1.9 billion in 1998, to 6.3 billion in 2001 an increase of \$4.4 billion in just three years. Berkshire's after tax earnings before investment gains for the three year period was only \$1.56 billion. So if there is a gray area between a 13 year and a 29 year survival ratio it is huge. A little math tells us that if buffet had wanted to carry the same level of reserves as the rest of the industry. He could have reported earnings from operations that were \$2.4 billion higher or \$3.9 billion instead of \$1.5 billion for the three year period.

So reserving makes a huge difference. This is just one type of policy and at 6.3 billion it only represents about 15% of Berkshires total reserves. It easy to understand the pressure on management to underestimate this expense. It

**ERC would increase their Survival Ratio by 17.1 years to reach Berkshire's level this would cost \$1.76 billion**

But \$1.76 billion is a big number, and it would appear to make it difficult for Berkshire to buy ERC, because you got to believe that Warren would want jack up the reserves.

As a shareholder it has to make you twitch a little. Gen Re all over again, maybe worse. If they are this short on their reserves for asbestos claims it has to make you wonder about the rest of their reserving? Is it equally understated?

While ERC may have been fattening GE's bottom line by pushing the envelope on asbestos reserves, Berkshire

has been following a radically different course. As with his investments Buffett wants a huge margin of safety. He assumes the worst and provides reserves that will carry Berkshire through any possible combination of adverse events. Its high level of reserves allows Berkshire a lot of flexibility when investing its float and this flexibility allows better investment returns. Buffett's policy of sacrificing current profits will have an enormous pay-off for shareholders in the long run. The following table assumes that Berkshire can earn 12% from investing its float a return that may seem high but is well below the company's historical record.

goes directly to the bottom line and if that management gets a lot of their compensation from stock options the temptation is big. If some one other than Buffett were running Berkshire they could have doubled or tripled reported earnings for the last three years with a little manipulation of these reserve figures.

General Electric has been trying to sell their reinsurance company Employers Reinsurance, and there have been rumors that Buffett may be interested. So far this year Employers Re has increased their claims reserves by \$2.85. Perhaps this is an effort to make the company more marketable to purchasers. But a quick look at the numbers indicates that they may have a ways to go. In the third quarter they added 150 million to their asbestos reserves. This brought their survival ratio up from 10.4 years to 12 years.

If they increased their Survival Ratio by 1.6 years with 150 million kick to the Reserves and they started with a 10.4 years survival ratio. The percentage Increase was 15.3%. To raise their reserves to Berkshire's level of 29.1 years would Require an increase of 179.8%.

A little math tells us that ERC'S asbestos reserves at the start of the period were 980 million. An increase of 179% would equal 1.76 Billion. Clearly the differences in the liabilities of the two companies so any comparison is tenuous.

## BERKSHIRE HATHAWAY

In Millions of Dollars

Year	Investment Income From Original Float (12%)	Claims Payments	Original Float Plus Income From Float
2002	\$756	\$217	\$6,839
2003	\$821	\$217	\$7,443
2004	\$893	\$217	\$8,119
2005	\$974	\$217	\$8,876
2006	\$1,065	\$217	\$9,724
2007	\$1,167	\$217	\$10,674
2008	\$1,281	\$217	\$11,738
2009	\$1,409	\$217	\$12,930
2010	\$1,552	\$217	\$14,264
2011	\$1,712	\$217	\$15,759
2012	\$1,891	\$217	\$17,433
2013	\$2,092	\$217	\$19,308
2014	\$2,317	\$217	\$21,408
2015	\$2,569	\$217	\$23,760
2016	\$2,851	\$217	\$26,394
2017	\$3,167	\$217	\$29,344
2018	\$3,521	\$217	\$32,648
2019	\$3,918	\$217	\$36,349
2020	\$4,362	\$217	\$40,494
2021	\$4,859	\$217	\$45,136

**Total Claims paid in Twenty Years \$4,340**

Berkshire's table clearly shows advantage of Buffett's penchant for big

ment imperative that GE's belief that the road to heaven is paved with smooth and ascending earnings reports

**A 12% return on its Asbestos reserve would leave Berkshire with \$45 billion in cash after twenty years, and after paying \$4.3 billion in claims.**

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insurance reserves. What you sacrifice in current earnings pays off big in long gains. The assumption used for this table would leave Berkshire with \$45 billion in cash after twenty years, and after paying \$4.3 billion in claims.

I am sure that there are differences in potential liabilities at different companies that would justify different levels of reserving. Many factors, such as aggressive settlement procedures, mix of business and level of coverage provided, have significant impact on the amount of asbestos and environmental losses a company will have to pay. Because of the complexity involved, insurance reserving would appear to be the creative CFO's dream. It may be that there were some artists at work at GE. While Jack Welch may have been a very successful CEO it now looks as though he had a very different management Philosophy from Warren Buffett.

Buffett's Management style is firmly grounded in things like large margins of safety, and the acceptance of short term pain in exchange of long term gain. This is a very different manage-