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My name is Peter Christie. I am currently a consultant on insurance related matters. Since the early 1970s until 3 or 4 years ago I was involved in counseling and representing the large accounting firms on insurance and self-insurance issues. For most of that period I held leadership roles in Minet, which was the company that acted as the insurance broker to the majority of large accounting firms worldwide, including all of the Big 8 and their successors. When in 1997 Aon acquired Minet, as Vice Chairman of Aon my responsibilities included Board responsibility for our Global Professions Practice, which included the Big 4.

After retiring from Aon in 1999 I continued various involvements with the Big 4 until 3 or 4 years ago. I do not currently represent or advise any of the Big 4 and I have no first hand knowledge of their current arrangements. However, I hope my substantial involvement in these issues for close to 30 years will prove of some assistance to the Commission.

This note is in the main structured around section 3.4 ('Consider insurability and liability risk') of the Commission's Working Discussion Outline.

The role of insurance in ensuring audit firm viability.

Those considering the liability exposure of large accounting firms[1] often focus on the availability of insurance. The absence of insurance or the inadequacy of insurance is often analyzed within a framework that implicitly or explicitly assumes that the existence of insurance would be a solution, or at least sufficient mitigation, to the problem of auditor liability. Before discussing the availability of insurance to the large firms, I will argue that even if available, insurance does not and cannot provide any more than a 'band aid' solution, and that robust, sustainable solutions will need to be found elsewhere.

The net risk bearing capacity of the insurance industry is not unlimited. It does not, with minor exceptions, provide unlimited amounts of cover[2]. For insurance to 'ensure' or even meaningfully enhance the viability of the Big Four it needs to remove from each of

[1] I have assumed the term 'the largest auditing firms' applies principally to four largest firms, and I use the term 'Big Four' to refer to those firms. Where the context requires this will also refer to the predecessor Big 6 and Big 8. Some of my comments will also be applicable, to different degrees at different times, to other major firms.

[2] And in any event the insurance company's assets limit such unlimited cover.

the Big Four enough risk so that the residual risk, if any, can be absorbed by the insured without threatening the firm's survival. Therefore, to analyze the effectiveness of an insurance solution a preliminary view needs to be taken of how much risk transfer is needed to provide reasonable comfort that a Big Four firm will not fail. I use the term risk transfer rather than insurance, to emphasize that what is required is a net transfer of risk away from the profession to third parties, at least on a medium- term basis, so that the insurance has enhanced the ability to bear risk. It is also necessary that any insurance solution be structured on a basis that creates a reasonable expectation of sustainability. These features are distinguishable from an insurance program that principally acts to 'smooth' earnings or provide what is essentially a financing mechanism.

The problem with professional liability claims arising from audits of the world's largest companies is that there is no ability to realistically compute either the amount of a possible future claim or the likelihood of it happening[3]. At the same time few will believe such mega claims cannot happen, and indeed most would speculate it is only a matter of time before they do. I believe that if one fixed a figure of insurance protection that would ensure, or materially enhance, the probability of a firm surviving one or a number of such events the amount of insurance required would exceed the risk capacity of the insurance markets, by multiples.

This inability of the insurance industry to solve the problem of 'mega' risk is not unique to audit risk. For example, it is posited in 3.4.2.1 of the Outline that smaller auditing firms are able to purchase professional liability insurance to cover professional liability claims. I am certain that in fact most of the smaller auditing firms are not able to purchase coverage in sufficient amounts to cover their *potential* liability. Again the operational risks of corporations often exceed by a large margin the available insurance. Financial institutions, energy companies, pharmaceutical companies and many others face potential exposures in excess of their insurance and not infrequently they pay claims in excess of their insurance. Insurance does not ensure the viability of the larger participants in those industries – only their own capitalization supported by their earning power does that.

In summary, I believe that if one is looking to enhance the viability of the Big Four one will need to look to other solutions than insurance. In my view even if insurance were available to the Big Four, it would not remove the possibility of the failure of a Big Four firm due to liability exposure.

Insurability.

Putting aside my argument that the insurability of the Big Four is of minor relevance to the viability of each of the Big Four, is there a way in which the Big 4 could tap a substantial proportion of the insurance markets risk bearing capacity, and if not, why not?

[3] As a crude example one might view the market capitalization of one's largest client to be an indication of the amount of ones' maximum claim.

This question can only be sensibly addressed based on some view or assumption about the point at which one looks to transfer risk to the market. At different 'transfer points' one may get very different answers. I suggest as a working hypothesis that true risk transfer should take place at a point where the firm's capacity to bear risk is approaching what the European Commission's study calls the 'tipping point'. In this way the insurance acts as a true addition to the firms' resources rather than an aid in managing the firms' resources[4]. Determining what that figure might be is for others but one can get some crude sense. Presumably The Big Four has the capability today to manage the liabilities they have already recognized. This is, in the aggregate for the US, roughly represented by the $1.3bln mentioned in 3.4.1.1 of the Outline, and some greater figure worldwide.[5] This figure is of course an aggregate figure and does not reflect the risk bearing capacity of any one firm.

The internal risk bearing capacity of the Big Four is subject to many variables that need to be studied. For example

- In aggregate the Big Four seem to be able to absorb in excess of $1.3bln annually. Can mutualizing the Big Four risk globally materially raise the 'transfer point' to the external market? Is that politically possible? Will attaching at that higher point in fact add much capacity?
- Is risk bearing capacity ultimately determined by the firm's fee income levels and retained capital? Is the creation of sufficient internal resource ultimately an issue of charging properly for risk? Will the competitive audit market place permit that?

However, for illustrative purposes I will assume an annual aggregate risk bearing capacity of $2bln worldwide. The correct figure is that which the profession can bear, and at which insurers think loss is an unlikely event in any given year.

The question therefore becomes – If the Big Four entered the insurance market excess of $2bln per annum of losses, would substantial risk transfer be available?[6]

Availability of Insurance to the Big Four

Item 3.4.2.7 of the Outline is

"Consider the reasons why the largest auditing firms are prevented from being offered commercial insurance".

In light of the foregoing discussion I address this issue on the basis that

- The availability of commercial insurance to the firms would 'solve' the problem.[7]
- Commercial insurance is sought to protect above $2bln per year in the aggregate.

[4] Which is a perfectly legitimate and valuable function- but it is a different function.

[5] In the time available I was not able to determine whether this is an estimate of the cost of audits in that year, or claims in that year. The difference could be material.

[6] For this discussion I am ignoring a key issue on the structure of the internal risk retention and any insurance that may be purchased. Insurance benefits are limited by time (the policy period), the triggering event (claims made or acts committed), the total amount of claims in a period (the aggregate) and the total amount applicable to one claim (the per loss limit). The interplay of all these clearly has a very material effect on the liability profile.

[7] Which as stated above I doubt.

Assessing insurance market capacity now and in the future for a given set of risks is inherently difficult. It is driven by numerous variables such as

- Prior experience with the class.
- Size of the upside opportunity.
- The buyer's loss expectations reasonably matching the seller's expectation.
- Pricing, which is itself driven by
    - Insurance industry return expectations
    - Buyer's view of affordability.
- Market capacity – there is a finite limit to the market's risk assumption capacity.
- Confidence the risk is reasonably predicable**.**

I would speculate that the 'natural'[8] market capacity for a third party liability risk that 'scores' well on the above is in the $750mln to one billion range (the appropriateness of this range can be fairly easily ascertained). My experience, which is not current but seems to conform to the current situation, is that the Big Four 'score' poorly on most of the above tests of access to the full market capacity.

- The insurance industry has lost very large sums in the past from insuring the large accountants. Although the industry is generally noted for its short memory in the case of the Big Four and their predecessors these memories are long.
- The size of the opportunity is not great compared with the exposure and the concentration of risk is very high. With only four firms worldwide auditing 99% by revenues (in the USA, and a substantial majority elsewhere) there is little risk diversification. The ability to exercise underwriting selection is minimal. It is almost a given that one is exposed to almost every major financial collapse worldwide.
- There has generally been a 'miss-match' between the seller's and the buyer's loss expectations and therefore pricing. Any one firm's evaluation of probable loss often results in a view of pricing different to that of the insurer.
- The confidence of the markets in the predictability of loss is extremely low. The largest losses are viewed as random events with both their frequency and size being highly unpredictable. Although insurers are in the business of assuming unpredictable risk they hope to increase predictability by a larger risk pool and by modeling from prior experience. Modeling techniques are of little value (in my view) in dealing with extreme events, subject to many human variables, over a small population, where history is of little predictive value.

For all these reasons the Big Four are viewed by the insurance market (particularly by those many insurers who will not write the Big Four risk)[9], as a separate target class that is expected to sustain its own risk. By this I mean that an insurer will tend not to price a Big Four firm's risk within, for example, a pool of risks including D&O and other financial risks. It is of course the basis of insurance that the occasional losses of a few are spread across a larger population of similar risks. If the Big Four represent the whole of a risk pool then the cost of risk must be borne within the Big Four. The

[8] Willing sellers and buyers with true risk transfer.
[9] Descriptions of market views are necessarily directional – the market does not have one view.

consequence of this is that the insurance function may enhance the risk bearing capacity of one firm for a time, but in aggregate the insurance industry will not knowingly permit the Big Four to permanently transfer its risk to the insurance industry.

Conceptually it is not illogical that the Big Four would not be able to permanently transfer risk to the insurance industry. Clearly such permanent risk transfer can happen where the insurance industry redistributes risk from one assured, to spread the risk over a number of other assureds. However in the case of the Big Four I suggest that classic insurance function does not apply

- The size of risk presented by the Big Four is too large for the industry to knowingly spread it over other assureds. They therefore will require that the Big Four are 'self sustaining' over a relatively short period.
- With the enormous concentration of risk in just four firms the pool is too small for the insurance industry to add value by spreading risk amongst the firms.
- It is possible that if a risk is incorrectly assessed an unintended permanent transfer of risk from the insured to the insurance industry occurs. This happened in the 1980s and into the nineties when insurers lost enormous sums insuring the Big Four and insurers were either unwilling to continue (and try to recoup their losses), or the Big Four were unwilling to pay the higher premiums demanded. I do not believe it likely the insurance industry will let that happen again, and the model is of course not sustainable.

It is my view that the likelihood of the Big Four being able to access the market capacity, even excess of a retained $2bln in the aggregate is not high. It may require pricing so high that the concept of real risk transfer is not present. Paying for that pricing can presumably only come from a material uplift in fees. The insurance market may consider there is not an attractive trade off between a higher attachment, where it is less likely that a loss will occur, and the inevitable reduction in predictability. It may be after a period of profitability (if there is one) market confidence can be rebuilt but it would take a long time.

However this entire analysis is, as I say, premised on the presumption that providing more insurance is a good idea. As stated I doubt that to be the case. Even if more insurance was available from a restructured market, it seems to me highly questionable whether buying more and more but still inadequate insurance, makes any sense.

- If there is no realistic limit to the potential loss amounts the existence of more insurance will only increase the loss amounts paid.
- As the largest source of funds after an audit failure audit firms would become even more attractive targets.
- If this happens the risk transfer market will quickly withdraw again.

Alternative approaches

For the over 25 years I was involved in arranging protection for the large firms the focus was on how to avoid or manage the 'spike losses' that might imperil the enterprise, with much debate about whether a Big 8/6/5 firm might fail. It is ironic that when a Big 5 firm did in fact fail (Arthur Andersen) it failed for reasons to which insurance was irrelevant. While shielding firms from liability, or managing that liability may be essential to enhance viability it may not be sufficient in all circumstances. If it remains possible that a firm can fail for reasons other than liability claims it may be attention needs to be given to devices that will permit a firm to re-emerge. This is premised on a presumption that the public interest is to ensure the continued availability of the audit resource, and the retaining of talent in the profession, rather than the survival of a given legal entity. One wonders whether, in a different legal structure, the serial bankruptcy habits of the airline industry, and insurance to recapitalize an entity, have a role to play in ensuring continued provision of audit capability.

The concept of Financial Reporting Insurance whereby the accuracy of the financial statement is ‘insured’ with the insurance company charging a premium based on its assessment of the risk has to my knowledge been discussed since Equity Funding, in the early ‘70s. If one sees the current system as one whereby the auditing profession acts as de facto insurer of the accuracy of the financial statement the premium for which is embedded in the fee structure (or not), then spreading that cost directly over all SEC registrants, seems to be much more efficient than spreading the cost via the audit profession. Whether the commercial insurance market, or a government-sponsored entity is the best vehicle for such insurance is open to debate. The complexities of how such a scheme would actually work are daunting, and may well make the idea impractical.

Other options that have been proposed generally focus on shifting the cost to the audited company or to the investors as a whole, or packaging the risks for sale into the securities markets. There are others who have studied these alternatives in much more detail and I assume the commission will be hearing from them. However it does seem to me that a basic issue that needs to be addressed is whether the goal is to ensure the profession can bear, or transfer to others, greater losses than it does now, or whether the goal is to contain those liabilities at a manageable level.

In 3.4.2.7. the Outline raises the question of whether auditing firms should carry a certain level of insurance. At least as to the Big Four this would seem to me of little practical value unless and until the issue of availability has been resolved.

Summary.

I have taken as the framework for this paper the element of the mission of the Department of the Treasury that is stated as “ensuring the viability and resilience of the public company auditing profession.”
In my view

- Any approach that attempts to create more assets to increase the professions claims paying ability, is likely to be counter-productive, aggravate the current problem, and will not improve the audit profession’s viability.
- If the goal is to enhance the claims paying ability of the audit profession, as accessed now, commercial insurance is unlikely to be available that will materially enhance audit firm claims paying ability and viability.

- A radical restructuring of how the commercial market is accessed may increase availability but that is uncertain, and if availability is increased it will probably not be sustainable and the increase in availability will be not be material.
- A substantial increase in the viability of the profession will probably require a substantial decrease in their exposure to liability, rather than new regimes to absorb that liability.

Peter Christie

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