year adverse development in excess of 5% of surplus in three or more of the past five years. This and an explanation are provided in Item E of the AOS. The information contained in Item E enables the regulator to obtain an understanding of why the company's recorded reserves continue to show adverse development over time. The concern, of course, is whether the company is consistently understating reserves and therefore overstating surplus. Depending on the result, the information provided in Item E could trigger additional regulatory review in assessing the company's financial health. As shown in Table 60, Fictitious' loss and LAE reserves have developed favorably in each of the past five years. As a result, Smith has responded with the following in Item E of his AOS:

> E. The Company has not had 1-year adverse development in excess of 5% of surplus in at least three of the last five calendar years, as measured by Schedule P, Part 2 Summary, and disclosed in the Five-Year Historical Data, on line 74, of the Company's December 31, 2011 statutory-basis Annual Statement.

In those cases where there has been adverse development in excess of 5% of surplus in three or more of the last five years, we have seen explanations in Item E vary from providing vague detail to very specific reasons for the changes. The more detail that can be provided as to the root cause, the easier time the regulator will have in his or her review.

To illustrate we have provided sample wording in the 2011 AOS of a fictional company that experienced one-year development in excess of 5% of surplus during 2008 through 2010:

> The company had one-year adverse development in excess of 5% of statutory surplus in three of the past five years. The exceptional values occurred in years 2008 through 2010. The exceptional values resulted from a strengthening in loss reserves made by management to reflect unexpected trends in asbestos and environmental claims on excess liability policies written by the company from 1968 to 1986.
>
> These trends include increased likelihood of exposure to higher-layer policies as a result of greater than expected emergence of reported claims on underlying policies, and efforts by insureds to expand coverage periods and expose additional policies.
>
> It should be noted that in 2011 the company entered into a retroactive reinsurance agreement whereby 100% of this run-off business is ceded to an unaffiliated reinsurance company. Going forward, this reinsurance agreement will mitigate the impact of adverse development of loss reserves on the company's statutory surplus.

The regulator reading the above will determine whether additional steps are necessary to understand the cause of the adverse development and impact on the company's financial health. While the regulator may gain comfort that the company's balance sheet is protected against future adverse development as a result of the new reinsurance agreement, we expect that the regulator would want to understand the impact of such development on the financial health of the company's unaffiliated reinsurer.