

A stylized sun logo consisting of a central circle with several rectangular rays extending upwards and a curved line below it.

Financial Statement Disclosure

**Valuation Actuary Symposium
Session 4
September 18, 2006**

Robert Frasca

Source

- *Financial Statement Disclosure: The Needs and Practices Related to Financial Risk*
- Commissioned by the Society of Actuaries, Financial Reporting Section
- Published November 2005 and available on the Society of Actuaries website.

Summary of Topics

- Disclosure practices around financial risk
- Disclosure requirements and practices observed in the US and elsewhere
- The relationship between disclosure practices and the basis of accounting

Quality of Disclosure

- Forward looking statements
- Quantitative measures vs. qualitative
- Sensitivity tests
- Comparability across companies
- Disclosure of assumptions

Basis of Observations

- Form 10-K Disclosures (also 20-F, 10-Q and Annual Statements)
- 25 life insurance companies
- 1999-2004
- US domestics and foreign filers
- Large and mid-size

Summary of Conclusions

- Volume and quality of disclosure has increased markedly over the last 5 years
- Quality is uneven from company to company and from risk to risk
- The extent of disclosure is not necessarily commensurate with the size of the risk
- Prescribed practices improve comparability, but differences still remain
- Disclosure practices tend to be reactive

Risk of Equity Market Decline

- Primary impact on general account equity holdings has long been recognized
- Increased disclosure appears to coincide with market crash of 2000-2002
- 9 of 25 companies disclosed sensitivity to market movements in 2000. 80% did in 2004; 90% in 2005
- Disclosure of sensitivity to secondary (asset-based revenue) and tertiary (DAC) effects has increased

Risk of Equity Market Decline Potential Improvements in Disclosure

- Sensitivity tests to all relevant items (primary through tertiary) and a description of each
- Aligning sensitivities with common market benchmarks to improve comparability across companies
- Providing probability based sensitivity measures (e.g., value-at risk, confidence intervals)

Risk from Benefit Guarantees

- Close relative to equity market risk
- Governed by SOP 03-1 (GMDB and GMIB) and SFAS 133 (GMWB and GMAB)
- SOP 03-1 contains sample disclosure, but observed practice still varies
- Disclosure of assumptions under SFAS 133 is less complete than under SOP 03-1
- Size of disclosure may not be commensurate with the risk

Risk from Benefit Guarantees Potential Improvements in Disclosure

- Adopt disclosure of valuation assumptions under SFAS 133 similar to SOP 03-1
 - Compare with the treatment under SFAS 123
- Sensitivity tests for assumptions
- Prescriptive vs. non-prescriptive disclosure
- Disclosure of fair value for all guarantees

Credit Risk

- Disclosure existed in 1999, but it has increased considerably, primarily due to EITF 03-1.
- Now, most companies include disclosure of the following:
 - Unrealized losses by industry sector
 - Details of distressed holdings
 - Impairment criteria
 - Aging of unrealized lossesFew had previously

Credit Risk

- Differences in disclosure practice remain
 - Concentration risk
 - Exposure to reinsurers
 - Default and other detail by issuer
- EITF 03-1 has clarified disclosure requirements around temporary impairments, but some criticize the treatment of interest-rate related movements in value?

Credit Risk Potential Improvements in Disclosure

- Resolve the EITF 03-1 criticisms and separate credit risk from timing and other issues
- Increase comparability
- Ensure comprehensiveness of discussion around credit risk (e.g., reinsurer exposure)

Interest Rate Risk (ALM)

- Asset-liability management techniques are typically discussed at length, but quantitative measures of risk are limited
- Many companies disclose the balance sheet impact of a 1% parallel movement in interest rates, but some only consider the impact on assets
- Sensitivities to non-parallel shifts are virtually non-existent (exception: “gap analysis” in Canada)

Interest Rate Risk (ALM) Potential Improvements in Disclosure

- Assess sensitivity tests on both assets and liabilities
- Quantitatively discuss impact of non-parallel shifts in the yield curve
- Introduce probability-based measures of risk

Insurance Risk

- Ironically, this risk is one with the least forward-looking disclosure
- Most companies disclose reinsurance practices and often identify mortality gains/losses over the reporting period
- Few disclose sensitivities if future mortality differs from expectation
- One possible reason: US GAAP makes it difficult to convey sensitivities effectively?

Insurance Risk Potential Improvements in Disclosure

- Include sensitivity tests on mortality and morbidity, related to some convenient measure (e.g., cumulative GAAP income, embedded value)
- Probabilistic and statistically-based sensitivities may be the most appropriate here

Other Disclosure Issues

- Aggregation
- Timeliness
- Source-of-Earnings
- Market Perception

Summary of Recommendations

- Consider disaggregation where appropriate
- Provide source-of-earnings
- Use alternative measures to convey risk sensitivities, where useful
- Increase the disclosure of sensitivity tests
- Use common benchmarks for sensitivity tests
- Introduce probability-based measures of risk
- Revise prescribed disclosure rules

Accounting Basis and Disclosure Practice

- US GAAP
- Canadian GAAP
- European Embedded Value (“EEV”)
- International Financial Reporting Standards (“IFRS”)

US GAAP

- Income Statement-Based
- A mixture of principles-based and rules-based practices
- Often, current period events are not fully-reflected in the financial statements (e.g., SOP 03-1, DAC amortization)
- Disclosure needs are large, to fill in the story that the numbers don't tell

Canadian GAAP

- More balance sheet based than US GAAP
- CALM serves to reflect current period movements in the financial statements, with some exceptions (e.g., capital gains/losses, actuarial assumptions on segregated fund guarantees)
- Many observers see flexibility in the setting of assumptions as a potential door for subjectivity
- Disclosure needs focus on assumptions, the potential soft spot of the accounting basis

European Embedded Value

- Balance sheet based
- Like Canadian GAAP, subjectivity in the setting of assumptions is the potential soft spot
- Disclosure needs focus on assumptions
- Sensitivity tests around key assumptions are required and are generally consistent from company to company

International Financial Reporting Standards

- IFRS 7 provides guidance for disclosure of risk related to financial instruments
- Disclosure requirements are both qualitative and quantitative
- “Application guidance,” contained in an appendix, provides a considerable amount of direction on how to apply the IFRS 7 standards in practice

IFRS 7 Disclosure Requirements - General

- Qualitative Disclosures shall include:
 - The exposures to risk and how they arise
 - Objectives, policies and processes for managing the risks and methods used to measure the risk
 - Any changes from previous period
- Quantitative Disclosure shall include:
 - Summary quantitative data about the exposures to risks
 - Specific requirements related to certain defined risks (e.g., credit risk)
 - Concentrations of risk
 - Sensitivity tests on all market risks

Financial Statement Disclosure

**Valuation Actuary Symposium
Session 4
September 18, 2006**

Robert Frasca