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MEASUREMENT OF EARNINGS UNDER CONDITIONS OF INFLATION

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This session will discuss "current value" and "constant dollar" accounting and how much such concepts apply, or do not apply, to life insurance companies. Special attention will be devoted to the best measurements of inflation-adjusted life insurance company earnings, whether covered by authoritative literature or not.

MR. NATHAN H. EPSTEIN: Earnings are the life blood of every business enterprise. The success a business has in achieving its goals is measured by its earnings. The quality of the decisions made by its management is determined by the bottom line. Indeed, the long-term viability of the enterprise is dependent on its ability to generate a steady stream of significant earnings. Creditors lend to, investors buy into, and managers are attracted to enterprises that have a potent earnings generating capacity. These three groups--lenders, investors, managers--all have a vital stake in the earnings of the business enterprise.

In our business, the life insurance industry, there's a fourth vital constituency, the customer. This is due to the long-term nature of our product and the continuing ongoing relationship between company and customer. And indeed, the very first accounting system in this country, the statutory accounting system, had the customer's interest as its fundamental purpose; this system determined the solvency of the company so that the company would be able to guarantee the customer that it would be in business to fulfill its obligations.

And lest some members of the audience think that creditors don't have much of an impact on our industry, one just has to look to the events of the last two years where companies were scrambling to line up bank lines of credit, floating debt and actually borrowing money. Yes, the money lenders are in the sacred precincts of the temple of insurance, anxiously invited in by the vestal virgins of management themselves.

In 1973, the American Institute of Certified Public Accountants put out a report of the study group on the objectives of financial statements. This is known as the "Trueblood Report" that some of you may be familiar with--it has appeared in the actuarial literature. The report stated that accounting is a social system much like language and law, and as such, it tends to

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evolve by adapting to the environment. Evolutionary changes may occur which are incompatible or in conflict with current notions of what the objectives of the system should be. The report went on to state some of the very fundamental objectives of financial statements. THE BASIC OBJECTIVE IS TO PROVIDE INFORMATION USEFUL FOR MAKING ECONOMIC DECISIONS. To accomplish this basic objective, they've said that financial statements should not be limited just to the financial data in them but may be amplified in either the narrative form or statistical form with other sources of information. The overriding objective, therefore, of financial statements is to emphasize the output of useful information rather than the accounting process itself. Every accounting objective, standard, principal, procedure and practice has to serve the user's need and that has to be the benchmark of these practices.

We can ask ourselves in this era of inflation whether or not there are artificial actuarial and accounting artifices and conventions in our financial reporting system as it exists today. And even more vitally, are there regulatory rigidities that render our reports unresponsive to reality? I think the answer is a resounding yes to the latter question--we must provide useful information for the decision-making process of our four vital constituencies. Yet I believe, and the sense of the panel is, that if we had one good measure that would satisfy the user who is responsible for the earnings of the enterprise, the management group, this one useful measurement of earnings would enable them to make sound decisions and reflect the quality of their decisions; then, I think we would have an accounting system and a financial statement that would satisfy the needs of the other three user groups as well.

Bill Dreher, in his keynote address, spoke of the need of our profession to take a leadership role in explaining the effects of inflation in our industry. He also stressed the need of interacting with other professions to reach interdisciplinary solutions to the problems that confront us. I think the members of our panel here today are both leaders in their respective professions and good interdisciplinary team players. They all combine theoretical sophistication with operational pragmatism and represent, as a group, senior management and senior financial officers in our industry. They are, in order of their appearance, Mr. Fred Richardson, Senior Vice President, Worldwide Insurance Operations for the Hartford Group; Mr. Robin Leckie, Senior Vice President, Chief Actuary of the Manufacturers Life and immediate past president of the Society; Mr. Al Colles, Senior Vice President, Chief Financial Officer of the Occidental Life of California; and Mr. Robert Posnak, Partner of Ernst and Whinney in New York.

Our first speaker, Mr. Fred Richardson, joined the Hartford in March of 1980 as Senior Vice President of Worldwide Insurance Operations. This includes not only the Hartford Life, but also ITT Life in Minneapolis; Abbey Life in England; the life operations of Zwolsche in Holland; life operations of the Transatlantische in Germany and Abbey Life in Canada. Prior to coming to the home office, Mr. Richardson was group general manager of all Hartford Europe life operations as well as Managing Director and Chairman of Abbey Life. He is a Fellow of the Society of Actuaries, a CLU, a Companion of the British Institute of Management and a member of the Institute of Directors in England. I'd like you all to welcome Mr. Richardson.

MR. FRED RICHARDSON: Thank you, Nate. Because I am very nearsighted, I'm very glad that our chairman asked you to come forward, because when I first looked down, I wondered if there were as many of us as there were of you. The conclusion I have drawn, of course, is that the actuarial profession in general has concluded that Universal Life is going to solve all their inflation-related problems and they have all gone to attend the Universal Life session which is competing with us. As I understand the role that I have on the panel, it's to bring a general management point of view to the topic. I am indeed relieved not to be expected to discuss any of the technical aspects of inflation accounting while sharing a platform with Bob Posnak, the man who wrote a book on insurance GAAP accounting, making it sound like fun. So my remarks are not made from either an accounting or an actuarial technical point of view but strictly from the viewpoint of the accounting tools corporate management needs to prosper. Inflation accounting, for better analysis and better management, has been a hot topic in western societies over the past decade. Generally, the debate has centered on a means to adjust historic cost to current cost, short of total indexing. There have been practical results with current cost accounting adjustments agreed on in both Britain and the United States. The adjustments, in general, have related to inventories, depreciation, working capital, and debt amortization and have not been applied to the insurance industry. This leads to two questions: From a management point of view, should we be concerned with the impact of inflation on our earnings? And do we need inflation accounting for our earnings to assist in management decisions?

Clearly, the answer to the first question is an unqualified yes. No one could doubt that the steady deterioration of the real value of the dollar has a profound impact on how any company could view its earnings. In a business like life insurance, where our products are traditionally measured in long-term fixed dollars and are matched by fixed dollar assets, the implications are enormous and frightening. Would some form of inflation accounting in the insurance business assist management with this problem? To this question, I would give a <u>qualified</u> yes. Qualified, because on the one hand, I remain convinced that total indexing would lead to total confusion. And on the other hand, a rigid system which will not make any concession to inflation leads to, indeed forces, management decisions which are not in the long-term interests of the industry. With statutory accounting and GAAP accounting, we already have one more system than is the ideal number. In this decade of double-digit inflation, statutory accounting has become a figures fairyland presumably intelligible only to wizards and the actuaries of mutual life insurance companies (with apologies to my fellow panelist, Robert Leckie, who works with Canadian statutory accounting, which as he will no doubt point out makes a lot more sense). GAAP accounting, with its fixed assumptions and rigid asset valuation rules, clearly falls far short of inflation accounting. So what adjustment to GAAP would be helpful to management in inflationary times? Unfortunately, the critical change that would be required would be both controversial and extremely painful. Nevertheless, I'm convinced we should face up to that change. We should carry our assets at market value or at a value based on current assumptions. And we should carry our policy liabilities based on realistic current assumptions as determined by the company actuary, who has his own built in "due" caution approach to it.

Because of the drastic impact this would have on balance sheets, such a change, to put it mildly, would be a shock to the system. But consider the evidence that our present amortized accounting has led us--indeed forced us--into serious management error with devastating impact on our industry. Our commitment to long-term debt was extended well beyond its place in a sound investment reaction to the real world, so that today our balance sheets on a market value basis are badly impaired. Our savings products have rapidly become outdated with their commitment to fixed dollar guarantees backed by fixed dollar assets losing out to other institutions better attuned to the real world of inflation. With proper balance sheet accounting, we would long ago have shifted our investment policies and our products and we would have maintained our share of the market. Perhaps, most importantly, neither we nor the insurance commissioners would have complacently lived with an early twentieth century nonforfeiture reserve and loan value regulations, which in inflationary times, throttle our industry and destroy policyholder values, which do not exist in any other country in the same form.

The industry would have "evolved" under inflationary pressures. Instead, by damming up the inflation impact through amortized accounting, we now face a revolution in the industry with lapsation, replacement, and borrowing, sapping our cash flow and our new savings are flowing to other institutions in growing volume. The experience in Britain is valuable in assessing the practical results of carrying balance sheet assets on a current basis. During the '70s, Britain had double-digit inflation in almost every year, which reached a high point of 24% in the mid-decade, a much worse inflation scenario than we have yet experienced in the United States. British statutory accounting requires market value asset accounting and permits actuarially sound flexible liability accounting. As a result, the British industry did not have a revolution. It evolved. Products geared to inflation came to the market. Investment portfolios shifted to include substantial real estate, common stocks and other inflation hedges. Realistic matching of assets and liabilities was achieved. Throughout this period, industry sales adjusted for inflation showed real growth. There was no run on loans, no replacement problem, in fact, none of the most frightening symptoms of our strain of the inflationary disease. However, they had plenty of problems, particularly in the expense area; but a realistic accounting approach to balance sheets prompted management decisions to meet the situations as they developed. Now, I believe that this is the only really important change in our accounting that is necessary in inflationary times which will provide a sensible tool for management decisions. Since we did not wish to kill the patient with the cure, we would have to administer this particular medicine gradually over a period of years and perhaps compromise on the actual dosage. However, carefully administered, it would amount to euthanasia for a limited number of companies already suffering advanced cases of the disease, thus relieving them of a lingering and more painful death with even greater suffering to the policyholder. However, since, if inflation continues at current high levels, the disease will be terminal for the industry, we should face up to this cure and decide how to administer it skillfully and compassionately.

If I have another minute, let me just touch on several other areas where management should and, from our experience, can adjust their approach. These adjustments do not require any further change in the fixed dollar accounting system. Fixed maintenance expense margins are a serious threat to earnings (particularly in stock companies that cannot adjust their dividend formula). This problem can be approached in several ways. For example, inflation factors could be included in the expense loadings to establish expense reserves in the same way that you establish benefit reserves. The right to review expenses can be written into contracts after some period of years as well as the right to adjust them or benefits or premiums. Management should alter their view of earnings targets. The earnings sought should be a real rate of return on investment. For instance, if you anticipate 8% inflation and you want a real rate of return of 6%, then you'd better set your objectives at 14%. This simple type of management approach will, I believe, work much better than indexed accounting. You simply set targets based on inflationary assumptions and then you test the results against reality. As an example of how this works in practice in our international operations, we assume a higher inflation rate in the United Kingdom than in the United States, and incidentally, a higher inflation rate in the United States than in Germany. So we seek 2-1/2% greater rate of return on our investment in Britain than we do in the United States, and we seek 2% less in Germany than we look for in the United States. From a management point of view, I think it's very instructive to note how effective this approach can be. We introduced the British differential in 1976 and management has delivered that differential ever since. The same general principle applies in other areas--sales targets, minimum premiums, productivity measurements. We use regular fixed dollar accounting, but adjust targets to "real" rates of advance. An accounting system requires the consistency to provide something better than a continually shifting target for management to shoot at. It must also be sufficiently realistic so that management will make decisions which are in keeping with the real world. GAAP, with a proper balance sheet approach and a common sense adjustment of earnings and other targets, meets these requirements. Both our current U.S. accounting standards fail in adequate reality, and we are feeling the negative impact of the management decisions which have been forced on us by that unreality. Thank you.

MR. EPSTEIN: Our next speaker, Robin Leckie, graduated from the University of British Columbia in 1953 with an honors degree in mathematics and joined the Manufacturers Life, where he has risen in a successive series of positions to the position he now holds as senior vice president and chief actuary. Robin has been president of the Canadian Institute of Actuaries and is immediate past president of the Society of Actuaries. His paper, Some Actuarial Considerations For Mutual Companies, is a landmark paper.

MR. ROBIN LECKIE: Inflation has had a drastic impact on the life insurance industry. The higher and more erratic the inflation, the more disturbing the consequences. Our charge is to identify the considerations affecting the life insurance earnings and their measurement. Earnings of life insurance companies have always presented problems, at least in terms of how they should be accounted for and their significance to management, or those with a stake in the company. Accountants resolved some of their problems with a redefinition of stock company earnings to meet GAAP. Whether this has added understanding or uncertainty, I will leave for others to judge. Whichever may be the case, there is an obvious inadequacy if the influence of inflation is not considered.

To rectify the omission, the accounting profession in the United States has brought out FASB Statement 33. I understand the ACLI's accounting committee will be sending out shortly a questionnaire to all life companies on the value of Statement 33 for life companies. The accounting profession in Canada has recently made proposals to provide supplementary disclosure to life insurance company statements to reflect the influence of inflation on monetary values. At the moment, this is just at the discussion stage.

This morning, I would like to express my view on the information needed to report on and interpret the performance of life insurance companies in an inflationary era. I say information rather than accounting so as to broaden the reference, to go back to first principles when necessary and not be bound by inappropriate conventions.

Let me start by quickly touching on the consequences of inflation on our business:

1. Inflation depreciates future benefits and puts a premium on immediate benefits. For example, permanent insurance--the policyholder looks to early values; the agent seeks higher first year commissions; the company desires an earlier realizable profit. Needless to say, these objectives are in conflict.

2. Increasing inflation leads to higher interest rates, which in turn leads to a shortening of term. All this leads to misunderstandings of average money versus new money, to replacement of existing business, to disintermediation in favor of those with fixed rate options, etc.

3. Inflation leads to uncertainty and volatility, which in turn really shortens time horizons and plays havoc with fixed rate options such as policy loans.

4. Other fairly obvious characteristics include higher expenses, the decreasing influence of mortality, worsening persistency and other characteristics not considered particularly favorable to the insurance business, and it certainly hasn't helped to have a tax act which compounds the problem.

So far as particular lines are concerned, participating permanent life insurance, usually considered to be an inflation adjustable form of insurance, hasn't weathered well in the last few years. Non-participating permanent life insurance has proved to be a totally unsuitable product for the policyholder, but a nice money-maker for the company, provided the policies can be kept inforce. Annuities could have been a reasonably stable product for an insurance company even with inflation, assuming the company immunized its investments, or at least could have been in the absence of a Standard Valuation Law. Possibly the worst hit has been health insurance, which is subject to rapidly escalating claims, which, coupled with intense competition and management optimism, seem to produce fairly consistent losses. On the bright side, if one can call it that, inflation produces gaps in coverage which can be filled by new sales.

Before I list my suggestions for information requirements, I would like to comment on a characteristic of a mutual company's growth which has some relevance. A mutual company's capital, that is, its surplus, is self-generated. It can be fairly easily shown that surplus cannot grow much faster than the net after tax return earned on the surplus funds plus a small contribution from policyholders. My estimate is that competition and other factors will limit the contribution component to the equivalent of approximately 2% to 3% growth per annum. Add that to the net rate of interest, which might be 7% or 8%, and you will see that the surplus cannot increase by much more than 10%. That in turn implies that a company cannot grow much faster than 10% per annum, which in turn is saying that a mutual company cannot grow to match the recent inflation rate, at least without weakening its relative surplus position. Unfortunately, this runs counter with most axioms of management and certainly with a dictum in the insurance business that growth is survival. Companies with plans for a negative real growth rate are few and far between. The two concepts place us in a rather interesting straightjacket.

How should we account for the implications of inflation? I will list my suggestions under three categories: first, information of a non-accounting form; then, changes sufficiently important that they should be incorporated as part of statutory reporting; and finally, some possible inflation adjustments.

The first group is made up of fairly obvious things like the various production reports which should be provided on both a nominal and a real basis. These would include amounts of insurance and number of policies and watching carefully premium income. It is also obvious that you want key indicators. You've got to watch closely those which are particularly inflation sensitive: lapse rates, unit expense rates, policy loan usage; things like this. Another extremely important measure is the present value of future expected profits, with the calculation specifically separating out the influence of changes in persistency rates, unit expense rates, and changes in interest rates.

The second category includes changes which should be considered in statutory accounting. I will restrict myself to two suggestions, both of which are now part of regular reporting in Canada. For your information, Canada has adopted an approach to financial reporting in which statutory and GAAP are one and the same thing, which apply to both stock and mutual companies, so we are all reporting on the same basis with one report.

The first suggestion then is to augment common stock dividend income by amortizing into income some portion of realized and unrealized capital gains and losses. In Canada, the percentage is 7%. The advantage of the proposal is that it provides a more reasonable return to current policyholders for stocks held on their behalf. Another advantage is that it neutralizes the impact of trading, thus giving to the investment department the flexibility to keep the portfolio up-to-date. If you have a realized capital gain, only 7% of it goes into income in that first year and you would continue to amortize it in future years, similarly unrealized; it's only 7%, so it's immaterial whether you sold it or not. All amounts credited to income become a part of a bulk adjustment addition to the book value of the assets. I've proposed that a similar type of augmentation be made for realized and unrealized real estate gains and losses. We don't do that in Canada, but I would suggest that we should; it probably will be incorporated into the law in the next few years.

The second change (it's a controversial one) is to get rid of the Standard Valuation Law in the United States, including the new dynamic valuation law. It should be replaced with a valuation considered appropriate by the Valuation Actuary, given the nature of the liabilities and the anticipated earnings power of the company's assets. This provides the flexibility needed to cope with the circumstances of uncertain inflation and volatile securities markets. It is interesting to note that the professional judgement this forces upon the actuary in turn forces the actuary to keep abreast of the implications of inflation and other factors as they affect the earnings potential of the company.

Now, the third category is those proposals which relate directly to inflation accounting adjustments. I have no strong recommendations except a cautionary concern. Let us not move to expensive accounting niceties which do not add significantly to comprehension, but do add significantly to accounting and auditing bills. Three points I would like to make are:

1. Why not consider taking policy loans from the assets side of the balance sheet and subtracting them from the policy liabilities? After all, they are in fact negative liabilities and their growth distorts real growth and the value of income earning assets. Alternatively, if we can't do that (and accountants just hate double negatives which in fact that is), then we should treat policy loans as to what they in fact are. They are a form of segregated asset. We normally think of segregated asset as one which moves with the underlying value of the securities, but in fact, a segregated fund is a fund in which the policyholder has elected where his assets will be located and in what form, and that is exactly what a policy loan is. I think it is an absolute abomination that we have been including the interest on policy loans in the determination of the interest on our income earning assets and as a result distorting our portfolio interest and providing a terrible return, an increasingly unfortunate return to our non-borrowing policyholders.

2. Go slow in making monetary value adjustments. In Canada, the CICA has proposed to adjust annually for market value book value differences and for differences arising out of a recalculation of actuarial liabilities using market interest rates. In other words, we would have to do a market value calculation of our assets every year, and we would have to then do a calculation of our liabilities based on the interest rates used in calculating the market value of the assets. I'm not sure how market interest rates defined for this purpose would be determined. I'm just not sure how they would be defined. But it certainly sounds like an awful lot of work for a marginally valuable benefit, which in itself is capable of considerable misunderstanding.

3. Whatever inflation accounting adjustments are settled upon, they should be incorporated in the supplementary schedules rather than as part of the regular historical accounting reports. Certainly, that is what is being proposed in Canada. If we have to have it, then let's put it in the supplementary. And, I guess I'm going to add a fourth, which wasn't down in my notes, but let us not move to a market valuation basis for assets. That's a comment triggered by the previous speaker.

MR. EPSTEIN: Our next speaker, Al Colles, attended the University of

Illinois where he graduated in 1948. He then joined the Lear Siegler Company as divisional controller. He then was with Ernst and Whinney or the former Ernst and Ernst, coming to the Transamerica Corporation in 1965. Since 1970, he has been with Transamerica Occidental Life in Los Angeles, rising through a series of positions to his present position as Senior Vice President and Chief Financial Officer. He's a member of the Institute of Certified Public Accountants and a member of the Financial Executive Institute.

MR. A. R. COLLES: I'm here today not necessarily with the blessing but at least with the permission of the chief executive officer of my company. He's a distinguished member of your organization, even though I refer to him with a certain degree of peril as a reformed actuary. But I don't mean to insult him by that designation or insult you, but merely to point out that a CEO may have a different outlook on operations than an actuary.

At any rate, it was almost exactly seven years ago that Meno T. Lake chaired a session called, "The Impact of Inflation on Life Insurance Companies." In his introductory remarks, he mentioned several things we needed to develop new ways of looking at. And one of those was our "constant dollar" earnings. I might have agreed with him then, at least in a lukewarm fashion, but the intervening years have changed that, as these earnings have been prepared by us but not used in any meaningful way internally. For example, we prepare information on this basis in our annual profit plan for eight years. Every year we do this--two years back, the current year and five years forward. We have done that for more than seven years and I do not recall one comment or question in all of the profit planning meetings that we have had during that time. The reasons for this are elusive. But certainly part of it is because the method is flawed, at least for our industry, and the figures are not meaningful to management. For example, our "constant dollar" earnings last year were only about 3% different from our historical cost figure. We then had a horrendous 36 million dollar "loss from decline in purchasing power of net monetary items." Since this, for all practical purposes, is the change from the historical cost figure, it has to be meaningful and understandable if the entire effort is to be those things. Unfortunately, I believe this item is deficient on both counts. First of all, its entire validity depends on the definition of monetary items. For instance, deferred acquisition costs in our industry are defined as monetary; and they are defined as non-monetary in the property insurance industry. There are some good arguments for this, but there are some good arguments for different definitions too. Logic would seem to indicate that deferred acquisition costs should be treated the same in both industries. It would seem for this purpose that the accounting profession has accepted the actuarial premise in our industry that these are really a part of the reserves and hence are monetary since the reserves are monetary. But why are the reserves monetary? Only because the whole exercise doesn't make any sense at all if they are not, since they are funded by monetary assets and not matching them would really give you meaningless results. Why are unearned premiums non-monetary in the property insurance industry, since it can be argued that life insurance reserves have a lot of the same qualities? I don't know, but I do know that for my company to have more than three times the invested assets and more than twice the shareholders equity as our property and casualty affiliate and find that its "loss from the decline in purchasing power of net monetary items" was more than ours, doesn't make any sense to me. This happens because property-casualty deferred acquisition costs and unearned premiums are defined as non-monetary and unearned premiums are by far the largest number.

The following is a quote from Transamerica Corporation's latest annual report. "While the 'constant dollar' method may be the best technique yet devised to deal with the effects of inflation on financial statements, the adjusted information must be used with care. Income from operations determined on a constant dollar basis is an attempt to report financial statement elements in dollars having the same general purchasing power. This is based on a little-understood concept that a business earns profits only after income has been reduced to give effect to the loss of purchasing power of its capital." Now, in that last sentence, I think you could at least find it more understandable if you just indexed the capital of the company from year to year instead of all this non-monetary/ monetary exercise.

Another major problem, though, with "constant dollar" information is the use of the Consumer Price Index as the basic measurement tool. This index has been found to be faulty even to measure the effect of inflation on the consumer, let alone corporate earnings or the loss of purchasing power of corporate capital. I'm not sure what the right one is, or if there is even a right one, but this one sure isn't it. Finally, the reward for this calculation or that this calculation makes for leverage completely destroys its validity. It is possible for a company to show a bigger and bigger gain from this source by additional borrowing right through insolvency and into bankruptcy. What kind of a gain is this? The "current costs" method has more appeal to me as a method, but I don't think it's very applicable to our industry, so I see no reason for us to spend any time on it here.

The accounting method that I believe would be of great value to our industry is the "current value" method. It has a lot of theoretical appeal to many accountants as the best replacement for historical costs. It has never been seriously considered because of the difficulty of arriving at fair and "generally accepted" values. I don't know if we accountants will ever be able to solve that problem as well as the related one of preserving the relationship between the balance sheet and the income statement. The difference between current value balance sheets at the beginning and end of a period should reflect the economic income for the period. How to translate this into an income statement that has something besides a bottom line would not be easy. In addition, some would say that this may not even represent "accounting income" because the latter comes from transactions and not from changes in values. At any rate, I think we are a long way from day to day use of this method. We already calculate ordinary reserves on three bases and this would add a fourth, plus including another one for group, pension and reinsurance reserves.

What I suggest is something like the "discounted cash flow accounting" discussed in Volume II of "Objectives of Financial Statements" published by the AICPA in 1974, which I believe is pretty well described by the name. This can be applied to blocks of business, individual products, and so forth. We have an actuarial report monthly that calculates present value of profits strain and commissions on ordinary and reinsurance new business. Meno Lake likes another report done periodically that compares the amount of future profits generated in a period to the profits realized in the same period. We also track the present value of profits on business produced in any given period and compare this to the previous periods. Inflation is automatically taken into account by adjusting the discount rate. The results of prior periods can be and are updated for this as well as any changes in mortality, persistency and expenses. We also calculated the return on investment on ordinary production each year. There is no easy way to translate these results into return on equity, but we have demonstrated by modeling that if the production of many continuous years has a constant return on investment, the return on equity that emerges will be higher than that.

I am sure that you have realized that I have used the word "we" very loosely here, since all of these reports are produced by our actuarial staff. There is a lot of potential for reports like this that show economic income that automatically reflects inflation, and your profession is uniquely equipped to do this. These can be quite meaningful to management, particularly when compared to any inflation adjusted accounting income I have seen. We also pay a great deal of attention to the effect of inflation on projected earnings in our pricing formulas. Several scenarios are produced and three of these have different interest rates which simulate different inflation effects on investment income and expenses. Other variances are introduced such as a range of mortality and lapse assumptions. All of these scenarios produce a different flow of earnings and we are able to determine whether the particular product can retain at least some of its profitability under several adverse conditions including inflation. The same technique can be applied historically, but it would take a vast improvement in our accounting systems to do so on a company-wide basis. I'm again suggesting that your profession is uniquely equipped to make use of it, however, at least by blocks of business.

In conclusion, the present methods of determining inflated adjusted earnings as required by my profession have almost no useful meaning for our industry. The only worthwhile thing I see is an earnings trend that can give some indication as to how a company is faring under inflationary conditions. There have to be better methods for our industry and you can lead the way to them. Certainly, my profession shows no signs of doing so.

MR. EPSTEIN: Bob Posnak is the auditor at The Guardian. I've been trained that the last word goes to the auditor. Mr. Posnak has spent the last eighteen years on life insurance accounting and is sort of Mr. Life Insurance Accounting. His book "GAAP - Stock Life Companies" is well-known by all of us and I am sure you will all help me in welcoming Bob to the podium.

MR. ROBERT POSNAK: A bit of history. Almost twenty years ago, in 1963, the AICPA released a research study on the subject of inflation accounting. Accountants brooded for years about the subject, which frankly they didn't understand very well. With inflation rates in low single digits, no one pushed very hard for inflation accounting. Interest picked up as inflation rates climbed to double digits and financial statements became inexorably yet less useful. In 1979, the Financial Accounting Standards Board issued an exposure draft entitled "Financial Reporting and Changing Prices" and set up several task forces to study its applicability to certain specialized industries including insurance. The insurance task force which was co-chaired by one of my partners identified many of the issues unique to insurers. But the task force really had little impact on the FASB. For all practical purposes, the FASB ignored the task force and what was finally adopted has little real relevance for insurers.

Well, why do we need some sort of accounting model that takes inflation into account? Let me suggest a few reasons in place of that:

--Very real taxes are being paid on phantom inflation driven profits, leaving the merest pittance for policyholders and stockholders.

--It's no longer possible to budget, measuring control expenses by traditional techniques. Expenses are simply out of control for most of the industry.

--Long range pricing decisions have become the province of the brave if not the foolhardy.

--Many companies are shrinking in real terms.

We do have a short term kind of business in many respects and annuity writers are probably the best example of that. And I sometimes liken the kind of investment financial-type risks we are taking now to a casualty-type risk. I think it would be a great experiment to go to Lloyds and see if we can reinsure the financial risk and keep the mortality risk ourselves. So, in summary, the industry is being driven to the mat by inflationary forces and yet we don't have an accounting model that can measure the effects of these primal forces.

The inflation model we have today basically calls for restating key life insurance company financial statement items for general purchasing power changes; that is, premiums, operating income, dividends, market values of the company stock and net worth are adjusted to constant dollar amounts based on the Consumer Price Index. Now, that's an exercise anyone can perform assuming you think it's worth doing. The exercise is designed simply to point up that a dollar today isn't worth as much as a dollar was worth a few years ago, as if that fact had escaped the notice of everyone. The only other thing that is required by the FASB is a calculation of the loss in purchasing power attributable to holding an excess of monetary assets over monetary liabilities. For those of you who don't know what that is, "monetary" refers simply to such things as bonds, mortgages, reserves and so on, receivable or payable in terms of a fixed number of dollars in the future. I've never really been able to understand what the purchasing power figures really mean. Clearly, the purchasing power of a 15% bond is greater than that of a 5% bond, but both are treated the same under the purchasing power calculation. It's taken somewhat seriously. The Salomon put out a list, this is 1980 earnings, showing reported operating earnings per share, the purchasing power loss and the adjusted earnings per share, that is, less the purchasing power loss. Capital holdings earnings were reduced 68%, Liberty National 77%, Lincoln National 68% and NLT 70%, U.S. Life 59%. I notice Aetna's were only reduced 14%. I suspect that may be an error.

So, I'd sum up by saying that the inflation disclosures required by GAAP are generally quite useless for what they tell investors and are probably even less useful for management. There is one bright spot in this rather dim scenario and it is that the FASB regards its inflation accounting rules as evolutionary and experimental. In other words, the door has been left open for improvement and experimentation and possibly this panel will ultimately have some small impact on the evolution of rules for insurers.

What should be done by life insurers? For one thing you can value assets at market. This assumes that inflationary consequences are fully reflected in market values which might well be a reasonable working assumption. Invested assets are easy; what about liabilities? Separate account liabilities are no problem, being the mirror image of the assets book; but what's the fair value of a set of guarantees of the type associated with the whole life contract or a guaranteed investment contract? I really don't know a totally satisfactory answer for that problem. Further, measuring the market values of known assets and liabilities says very little about the quality of the earnings stream that has been created, and I mean future earnings. My own preferences run to a very familiar calculation: valuation of the expected stream of future after-tax profits both on existing business and on projected new business--in short, a going-concern valuation. In theory, the calculation of future profits can take into account all of the forces associated with inflation; and the discount rate applied can readily be varied with the rate of inflation as well as risk. Inflation-adjusted earnings thus become the change in the going-concern value of the enterprise during the accounting period. And I think this is the same as what Al is suggesting with future production, however, included. I was talking to a company the other day that had hired 50% using their existing agency force as a base, had hired 50% of that base in one year and spent many hundreds of millions of dollars doing so, and I think I'd like to compare what they're likely to produce with what it cost to put that many agents on the books. The rub, of course, is that such calculation would have to be made by actuaries and as we all know, actuaries are only slightly more perfect than accountants. But with all due regard for the fallibilities inherent in such calculations, I would suggest that the relevance of the calculations outweighs their inevitable inaccuracies.

So I guess I'll just wind up by suggesting that going concern valuation, at least from my untutored point of view, is the one "right way" to measure the effect of inflation and I can think of no other approach that can do the job adequately.

MR. EPSTEIN: If there are any questions, please identify yourself and after the meeting you can get Armand's address, where you can send your question for inclusion in the record.

MR. POSNAK: I'd like to ask Fred, particularly with his Canadian, U.K. and American experience, and I think you touched on this in your talk and I've certainly seen this in the casualty environment in the U.S.; managements take the book surpluses seriously, don't they? I mean they believe the figures, don't they? Has that led to some grave consequences here or abroad?

MR. RICHARDSON: Yes, that's the real problem that I see with not getting to some form of an inflation adjustment, and I don't think I'm that far from Robin's viewpoint, except that he shudders at the thought of assets at market value or from your discounted future profits approach. The real problem that I'm concerned with is the kind of decisions management makes;

they're made on the basis of the accounts they see. Every one of us has senior management who look at the accounts, and they have to report that to a board of directors, and it's a terrible job for them to try to explain that all those accounts are nonsense; so they have to live with them, and they really do take those surplus figures seriously. Of course, those surplus figures are in some cases nonsense, and what bothers me is trying to get the assets and liabilities on the same basis. If we can put the assets and liabilities on the same basis, (the Canadians come a lot closer to it than we do and the British come a lot closer than the Canadians do to achieving that) then you get management decisions, and legislative results, and regulation results that relate to the real world that you are talking about. One of the most important management decisions is proper matching of assets and liabilities.

Robin mentioned we ought to have a segregated account for policy loans. Well, I can tell you that we have to have a segregated account for a number of the products we write, and we have them. We are setting up segregated accounts for the new products. You have to do it. It would be madness to include them in the general account. When you get back to our British company, we even break down the general account; it's all segregated. Because as you have inflation, and you have these different kinds of short-term and long-term liabilities to do proper matching, you just can't do it on a sort of actuarial look at the total company. And that's what really bothers me about the accounting; it just leads to a wrong feeling on the part of management as to what their situation is.

MR. GARY CORBETT: This is something that my thinking has evolved on over the years. I certainly, in theory, like what Bob Posnak said about current value accounting, about bringing everything to the same side, the assets and the liabilities, trying to estimate as best we can what they might be. As long as we have the standard nonforfeiture law or, indeed, regardless of the law, as long as there are guaranteed cash values, how can anybody today really project the outflow of funds that are going to be experienced on contracts which are unilaterally exercisable at the option of the policy owner, when those results will depend on future economic conditions very much. Obviously, as we've seen, as interest rates go up in the future, it will increase policy loans. I have become somewhat disabused of the notion that even I can calculate those reserves. I know accountants cannot, but I doubt that even actuaries can today. I think the flaw here is, of course, the guaranteed cash value problem which we don't have in England and, therefore, the situation is not entirely analogous. But I'd like any of the panel to comment on just whether it's practical at all to propose today that we can indeed value these liabilities when there is such a possible variation in their nature.

MR. LECKIE: In the Canadian valuation, you take into account cash values as benefits in the valuation, and you are supposed to attribute some kind of withdrawal rates to it, which I'm not sure how actuarially precise they are, and to the extent that your valuation involves reserves that are below the cash values, you would have to show the difference as a portion of what you might call an allocated surplus. You can, in fact, build a cash value floor into the valuation. Very few companies are still doing that. Ours does.

I grabbed the microphone because I want to follow along on what Gary has said and it's a concern that I have. The only concern I really have with Fred's position is that he is taking a situation in the United Kingdom which is totally different from what we have in the United States for two reasons. One is they don't have guaranteed cash values. But also they've had a totally different regulatory climate there all along and they've had a totally different role for the actuary. The actuary is in a position of trust and personal integrity and that's what the valuation and the whole management of the company is built upon. And we don't, in this country, rely on that sort of thing; we're not prepared to. I don't see any evidence that we're moving there. Well, sorry, there are slight evidences that we are moving there. There's a little more certification, where the actuary puts his signature on the line and his professional integrity on the line, but there's very little element of real trust in terms of the regulatory system in which it couldn't be properly audited. This leads me to my last comment referring to Bob Posnak's approach to a going concern valuation, which I heartily endorse. Incidentally, in our own company in Canada, we look at these book surpluses; supposedly they're more appropriate than they are in the United States because they're based on appropriate valuation. We then start adjusting them toward something that we would analyze relative to ourselves one year to another and relative to other companies. The final result is very, very different from what we start with. Half the companies wind up with negative surpluses. If you look in the United States, more than 3/4 of the companies wind up with negative surpluses. So right away, if we move to market value, we're in deep trouble in the existing system. But at least it gives you a chance to look at what is happening from year to year--your company relative to others; where your weaknesses are and where your potential problems are.

What concerns me in the "going concern valuation" is that it's fine if we do it internally for our board and for our management, but I suspect, and maybe Bob will comment on it, that we are talking about something that gets legislated into the accounting handbook and on which we are expected to be audited. I don't think the valuation is going to be worth a thing, but it's going to cost a lot of money. And these valuations are only as good as the assumptions you put into them. Bob has said it should be an actuary that does it. But if it's audited and if it is relied upon, insofar as inflation adjustment accounting is concerned, I wonder whether or not it can be really provided as a meaningful document. Particularly if they then start publishing what your inflation adjusted earnings are, based on some kind of "going concern valuation," because you can't build in the level of judgment that I would think would be necessary to do it effectively.

MR. POSNAK: Robin, the only thing I would add--it's a beautiful theoretical construct with no particular objectivity possible, except that I would suspect that the Society would rise to the challenge. It would be a tremendous service to the industry and to the investing public to come up with a set of at least rational ground rules, perhaps with the input of economists so that it sounds very nice; but I think it's possible. We're going out and hiring thousands of agents and paying them a certain amount. We have to have some rational idea of why we are doing that. Maybe we don't, but we certainly should have. I would hope that this could help lead to that result a little bit. That's really all I had in mind.

MR. RICHARDSON: I could go back to the question and Robin's reply to it. I think that both the question and the reply go right to the heart of the problem. I'm very well aware when I sit here and suggest we go to market value assets that nobody's going to agree with that. What I am saying to you though is that in the condition we are in at the moment, the actuarial profession has a responsibility to start thinking seriously about regulation. The best place to start from, I think, is to see what it would do to us to really go to a true valuation of our balance sheets. Whereas going to market value on the assets would bankrupt most companies or a big percentage of them. But if you also go to a proper reserve basis, that wouldn't be the case. It would still undoubtedly leave a few with negatives, but it would give you a much more realistic picture. My proposition is that we should start thinking about the real world and what not thinking about it has done to our management decisions. Then, we must start talking about those nonforfeiture regulations because they are going to destroy the industry in the United States. They've done a big job on it already in ten years, and I don't know whether we can survive another ten years under the regulations. One of the bright spots is strangely enough not Britain where they have never had regulation, but Canada where they have had regulation. Over the last fifteen years, we've actually seen them adjusted quite a bit toward reality. And I think that puts Robin's company, at least in its Canadian operations, in a much stronger position than we are in in the United States.

MR. LECKIE: Can I add one thing, Fred, in the interest of being noncontroversial? Do you really think you can do it in the United States with state regulation?

MR. RICHARDSON: That's a good question. I'd love to hear what the audience thinks of that. Let me give you one thing that hit me last year. We in the insurance industry have put forth a recommendation for a change in state law with regard to loan interest, as you all know, going to a variable loan interest rate. The law is so complex that only members of the profession sitting around here could possibly understand what it's about. Certainly, the members of the legislative assemblies can't understand it and they aren't going to. Furthermore, it's a nonsense law. It is talking about matching interest rates to what amounts to long-term bonds these days, and, of course, interest rates on policy loans have nothing to do with long-term bonds. Borrowing money on your policy is not a long-term proposition. The thing that I found is a very bright spot in our list (a very dark spot that we should have gone about it this way); a very bright spot at least in one state. The finance committee of the legislature looked at our proposition and looked at our reasons for it. They couldn't understand the proposed legislation at all, but they understood the reasons very well, and they concluded that the reasons said to them, "Let's eliminate this regulation." Obviously, from the reasons we put forth, you should have the flexibility to do what you like with interest rates, and so that particular finance committee of that particular state reported back, "Do away with the regulation." That caused great consternation to the ACLI. They promptly lobbied against it, and they were successful; they actually defeated it. Now, I find that absolutely astonishing. The people as represented by their elected representatives have a better concept of this whole thing than we do as members of this industry; we ought to think about that. It is the only sensible thing to do. We went through this in Canada and I was in Canada when they adjusted the interest rate, removed the agreement on interest rate in Canada. I remember the arguments, and we talked about whether we'd ask for, I think it was, 7-1/2% or 8%. We debated that for a long time. I've forgotten what we asked for; but what they did was eliminate it. We were worried about whether we were asking for 7-1/2% or 8% and, in fact, Dick Humphreys was a lot smarter than the rest of us; he said there is no point in having it, and we got rid of it. I think that's the climate. The political climate right now is deregulation. And we ought to take advantage of it. We shouldn't be opposing it. We should be trying to get it. I think this profession has a big responsibility in that.