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INTERNATIONAL FINANCIAL REPORTING

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Recorder: HENRY W. SIEGEL

- o What are the principal characteristics of financial reports for insurance companies?
- o What is the role of the actuary in the preparation of these reports?
- o What is the regulatory structure within which these reports are prepared?
- o What quirks of the regulatory structure or the reports themselves would be particularly important to a U.S. company planning to own and manage an overseas subsidiary?
- o What quirks of the regulatory structure or the reports themselves would be particularly important to a U.S. company trying to interpret the financial statements of an overseas insurance company in anticipation of preparing a purchase offer?
- o What quirks of the ownership of regulatory structures or the business environment would be particularly important to a U.S. company trying to plan the process of acquiring or forming an overseas subsidiary?

MR. HENRY W. SIEGEL: Marshall Field started his insurance industry experience in 1948 with Pearl Assurance. He then joined Phoenix Assurance as Pension Superintendent, rose to be a Director in 1980, and retired from that position in August 1985.

Along the way, he found time to be Chairman of the Life Offices Association from January 1983 through 1985. He served on the Fowler Inquiry into the provision for retirement in 1984 and chaired the group of 18 organizations asked to make recommendations on the marketing of financial services in 1984. This was a precursor to the Financial Services Act in the U.K., which Marshall says the government mangled after he gave it the best recommendations.

As a result of these efforts, he was awarded the CBE in June 1985, which, for those of you who, like me, need translation, means Commander of the British Empire. He has been a consultant to the Securities and Investment Board since it started and is currently a Director of the TSB Trust Company.

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He was appointed a consultant partner of Bacon & Woodrow, one of the preeminent British consulting firms, in May 1985, and at approximately the same time became President of the Institute of Actuaries, having served in various offices previously. He's Vice President of the International Actuarial Association and, most importantly, in my opinion, because this is something that sounds wonderful, he's a Liveryman of the Worshipful Company of Actuaries.

This is one of the Guilds that helps run the city of London, and he tells me that the actuarial company is number 91. You'll be pleased to know that the insurance companies' company is number 92, which is as it should be!

Marshall is going to talk about developments in financial reporting in the U.K.

MR. MARSHALL HAYWARD FIELD: The Worshipful Company of Actuaries is interesting. It consists of the modern trades in the city, actuaries, insurers, airline pilots, and so forth, all taking their part in the government of the city of London, and it's much better to get the new people in than let it be run by the decayed old organizations that no longer represent anybody. It used to be people like fan makers and that sort of stuff.

Anyway, it's a pleasure to be here. And, as ever, coming to the United States and going round the world, I'm impressed that wherever we insurance people get together, the problems are really the same, and we're talking about them at the same time. It's just that we come to the problems in a different context, and they're approached from a different point of view, and the objective is different.

So that's why I hope that what I tell you may be of interest. What I tell you, I don't think will help you very much in the United States. But it might put your situation in a context that you can see there are other ways of looking at and other objectives of handling things. It may be the same problem, but with a different perspective, a different slant.

For some 200 years the question of the financial reporting of life assurance business in the U.K. (in the sense of providing shareholders with meaningful information about the progress of their company) started and ended with recording as profit the amount actually transferred from the life assurance fund to the shareholders account. The balance sheet often showed a nominal figure or no figure at all for the value of the business.

It was realized, of course, that potential profits were being retained and that value was being built up, but there was no recognized need to calculate the amounts or to publish them. Certainly, the question of profit recognition was of little concern to actuaries. One reason for this is that many of the companies in the market were mutual (where the question did not arise) and many of the others were the life branches of the major composite insurers where other considerations dominated. Of the 30 largest companies (by size of fund) in 1988, 16 are mutual, nine are composite and only five are proprietary.

I should also explain that most business in the U.K. until quite recent times was written on a with-profits basis and, of course, on the U.K. pattern of with-profits, that is, with periodical distributions of bonus in the form of reversionary additions to the sum assured. Such bonuses were usually compound, that is, with each year's bonus addition being related to the sum assured and all previously declared bonuses. Increasingly, in recent years, companies have used a higher rate for the bonus on bonus than for the bonus on the sum assured.

A feature of the system is that distributions of reversionary bonus caused the stockholders to benefit from their share of the distribution immediately, whereas policyholders were credited with a guaranteed increment to the policy benefit but only receivable when the policy eventually became a claim. Thus, the stockholders received a measure of profit quite early on, but even so, much surplus was held back and retained within the fund to emerge in later years.

The type of business involved financing but on a revolving basis; few, if any, with-profits companies needed to come to the market for capital for their expanding U.K. life operations. Thus, there was no pressing need to justify financial progress.

From the 1960s significant changes occurred. First, the new class of unit-linked policy appeared, often promoted by newly established companies. Here the need for capital was more explicit and had to be justified, particularly as the business had to stand on its own or stand in competition with other quite different spheres of business; e.g., banking. Stockholders would not be content to subscribe additional capital with no concrete indication of there being a prospect of return or a buildup of value.

Second, the significant investment in common stock and real estate in with-profits portfolios produced large capital gains -- albeit unrealized -- and some means had to be found of distributing these equitably to policyholders when they left the fund. The solution was the terminal bonus: an additional bonus paid on maturity and death claims on a discretionary but equitable basis. As time passed, policyholders became accustomed to a major part of their bonuses being in that form.

From the stockholders' angle, however, a move from reversionary bonus to terminal bonus caused a significant deferment in the timing of their profit allocation as that (often quite substantial) element had to wait for policies to become claims. A much greater amount of stockholders' potential profits were being retained in the fund.

Third, takeover activity, as the decades passed, became stronger. There had been many mergers between the U.K. composites since the 1950s, but they were usually for reasons other than the life assurance account. Also, many of the smaller proprietary life companies had been taken over, but even so, the larger companies did not feel threatened.

However, in the 1980s, larger companies became targets (e.g., Eagle Star, Equity & Law and Sun Life), and it came to be recognized that some measure of defensive protection was needed. The defense by Eagle Star against the hostile bid from Allianz and the documents supporting its eventual acquisition by BATs were among the first by a major company to draw significant attention to the value of the life account. A similar approach was made in the later and recommended bid by Sun Alliance for Phoenix. Matters came dramatically to a head in 1989 with the acquisition of Pearl by AMP of Australia.

Thus, in comparatively recent years there has been a growing appreciation that traditional accounting methods would not suffice. The newer unit-linked companies and the companies now owned by conglomerates needed to show that there was value being added and a stream of earnings, if not profits; and with AMP/Pearl there came a startling demonstration that to be successful a defense should be prepared long before the attack.

An immediate consequence was that the Commercial Union followed the lead of the Royal in the mid-1980s of including in the Chairman's Statement (but with no change to the presentation of the accounts) an indication of the "going concern value" of the company's life business.

More significantly these developments have resulted in vigorous action now being urgently promoted by the largest companies through the industry-wide trade association, the Association of British Insurers (known as the ABI) and with the two professions, the actuaries and the accountants.

The U.K. recognizes that it is not alone in this matter, nor is it in the vanguard: we have noted U.S. GAAP and its developments, and we have observed progress being made in Australia and Canada. What is different in the U.K. is the pace of change of view and the impetus now being applied.

U.S. GAAP is the forerunner, and being careful to say nothing about its value in the context of U.S. business, it has often been observed that it fits ill with U.K. business conditions.

First, with-profits business in the U.K. is backed largely by common stocks and real estate, and not coincidentally, the bonus declarations are based heavily on the judgment of the actuary. A discretionary rather than a formula approach is the norm.

Second, the U.K. standard of solvency, which also relies on the judgment of individual Appointed Actuaries who are required to exercise prudence in setting their standards, causes large mathematical reserves to be held with a significant holding back of the release of what would otherwise be profit. The cost of this retention of profit should be reflected somehow in the profit recognition process.

Third, the U.K. tax assessment is such that significant adjustments have to be made.

Thus, it seemed to us that the U.S. GAAP approach held no promise for us in the U.K.

However, early experiments in putting a value on the business relied on a technique of discounting the stockholders' profits expected to be distributed from business already on the books and adding to this the value of the net assets. It should be noted that, by discounting expected distributable stockholders' profits, full account is taken of the effect of the reserving basis. The embedded value, as the combined figure is called, is a figure moderately well-accepted by accountants as an indication of value and is used internally by a number of companies and actually published by a number of others.

I should interpolate that another figure, the appraised value, is calculated as the embedded value plus a further figure representing the value of profits that might be forthcoming from business yet to be written. This addition to the embedded value is called the existing structure value or, less accurately, goodwill. The appraised value is now generally regarded as a good starting point for an evaluation of an acquisition value for the operation.

The embedded value approach has the advantage, as I have mentioned, that it takes fully into account the deferment of profit distribution on account of the statutory valuation standard and also that it can be calculated on freshly determined assumptions each year, thus resulting in no locking in of profits or losses. However, this flexibility causes some accountants to have misgivings and, in particular, there is concern at the use of a stockholders' risk rate of return for the discounting.

Some companies have taken a step further and have taken the difference in successive years' embedded values and called the difference the embedded value profit and have used it as a proxy for earnings. This has not found general favor with the accountants as, they say it does not conform with accepted accounting principles -- relying, as it seems to do, on discounting future profits rather than taking credit for work done. Nevertheless, at least one financial journalist has started to apply multiples to embedded value profit figures.

The Institute of Actuaries set up a working party in 1988 to study the professional issues in calculating and reporting embedded values, and a draft report was discussed at an open meeting in November 1988. The general conclusion was that there was no need to lay down prescribed bases for such calculations but that actuaries should ensure that their assumptions, appropriate to the situation in question, were fully set out -- this is, of course, a general requirement on all actuaries, but it is one not easy to observe in a situation where the results may become published by the actuary's principal.

With the growing use and publication of embedded value profit and the greatly increased concern to show a figure for earnings as opposed to distributable profits, a further working party, to be joint with the accountants, was appointed, but this was quickly overtaken by the initiative, earlier this year, of the major composite companies through their trade association and following the AMP/Pearl acquisition of late 1989. Now all the participants are working together on the one project, which I refer to as the ABI initiative.

This concerted effort certainly has the advantage of conserving resources and of harnessing enthusiasm, but the need for a quick solution may impair the quality of consideration. A further, but perhaps illusory, advantage is that all the mutuals will be totally unaffected by the consequences. I regret this exclusion as I believe that the members of mutual life companies should also receive more meaningful information about the progress of their fund.

The objective of the ABI initiative is to establish general agreement on a means of producing a figure for stockholders' earnings to which might be applied a conventional price/earnings ratio. The figure would need to conform to accounting principles, and it may be difficult to observe all the actuarial niceties. However, it will be necessary to find a solution that is of wide and satisfactory application, as otherwise, it will be difficult to persuade those companies that are already reporting embedded values or embedded value profits to make the change to a different and, perhaps to them, less attractive method. If the companies cannot be persuaded, and there are some big names among them, the market would face the confusion of two standards, perhaps both operating side by side.

Actuaries and accountants in the U.K. have, of course, been talking together in this area for several years, and their views are not as far apart as it might seem to a casual observer at the several conferences where these issues are frequently discussed. Much of the problem lies in the different use of words, and it could be that the embedded value approach, which has intuitive appeal to actuaries, could be made presentable to accountants by adopting a description of the process that less overtly seems to anticipate future profits.

An area of difficulty mentioned earlier is that of the scope for discretion available to the actuary (or even the directors of the company as regards the risk discount rate) in calculating an embedded value. Actuaries know that such latitude is important in safeguarding equity between generations and classes, but to the accountant it seems to open the door to manipulation. There must be scope for reconciling these views.

Nevertheless, the search is on, and the hope is to have something to report later this year and certainly in time for the new approach to be used and understood by analysts and commentators for the publication of accounts for 1990. Bearing in mind the length of the discussions that have taken place in the U.S., in Canada and in Australia, it is an ambitious program. It is very much a case of "watch this space."

I make one further comment in conclusion. It is unusual these days for any U.K. speaker to get so far without a reference to the impact of the European Community and the various Directives that are being formulated. There is, indeed, a Draft Directive on Insurance Accounts which promises to make quite significant changes. It will bring consistency of accounting treatment and a standardized format of presentation across Europe, and the problems of achieving that, with the different national styles of life assurance business, are formidable indeed.

However, it would seem, contrary to the hopes of some working in this area, that by the time the Draft emerges from the political negotiations, it will not also provide the solution to the business problems I have been referring to. It will not itself, I think, cause the accounts to be very much closer to being true and fair. That is a problem that will remain to be solved by the U.K. industry and the two professions.

MR. SIEGEL: I have to apologize. I forgot the most important part of your biography. Marshall is a Fellow of the Institute of Actuaries. I guess you can't be President without achieving that, but I did forget to mention it and I apologize.

Our next speaker, Bill Kerrigan, is from Metropolitan Life. He's a 16-year veteran of that institution, with a variety of financial reporting and actuarial positions. He's an FSA and six months ago he was named Chief Financial Officer of his company's international operations. Metropolitan has a thriving operation going on in Spain, and Bill is going to talk about financial reporting there.

MR. WILLIAM D. KERRIGAN: Buenos dias.

We are here a little bit early to start out in Spain. At our company in Spain, which is a 50/50 joint venture with Banco Santander, the hours would normally start about 9 or 9:30 in the morning, work till about 2 or 2:30, and then there would be a lunch for most of the people, of about two or two and a half hours. They would come back to the office at about 4:30, work till about 8:30, then maybe do something else and have dinner at about 10:00. So while we're starting off a bit early for Spain, we'll get right into our topic.

What I'm going to do is give a brief overview of the financial reporting requirements and some of the regulation in Spain.

First, I'd just like to give you a little picture of the Spanish insurance market because it might be a little bit new to some of you. For a potential investor looking at a market, one of the major factors is the potential market size. As you can see on Chart 1, life insurance sales have been on quite a rapid rise in Spain.

In 1988, life insurance premium, which for most of Europe includes pensions, rose by more than 75%, reaching almost $7.7 billion. For comparison, in the U.S., life and pension considerations in 1988 totalled about $177 billion.

Another important factor to consider is whether this growth is going to continue. In order to answer this question, you really have to look at what has been causing the growth.

Basically, some of the things we considered in evaluating the insurance market in Spain are the low saturation of the insurance market, the economic growth within the country, the aging of the population, tax incentives, and agent turnover.

From Chart 2, you can see the real growth in the Gross Domestic Product (GDP) in Spain, which has been around 5% in 1989, 1988, and 1987. This is a good indicator, not only of the general vitality of the economy, but also of the prospects for life insurance sales. More money through the economy means that there's more potential income for insurance products. And in Spain the growth has been quite rapid.

One of the other indicators that goes along with the GDP that we've been looking at is the ratio of life insurance premium to the GDP. And, as you can see in Chart 3, this has

CHART 1

Total Life Insurance Premium ($ Billions)

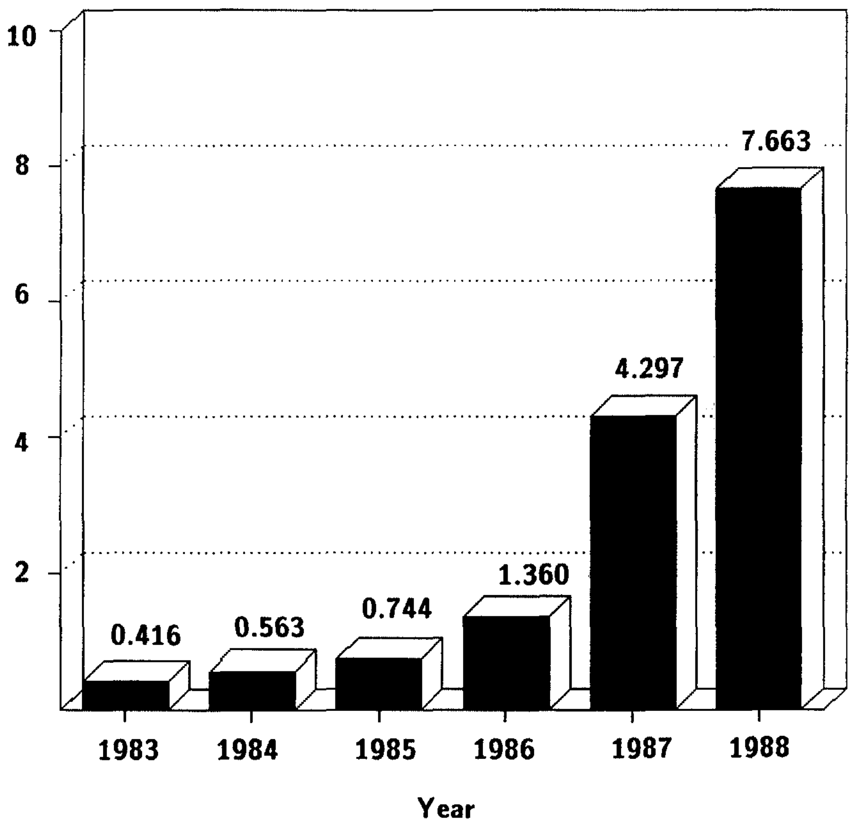


CHART 2

Real Growth in GDP

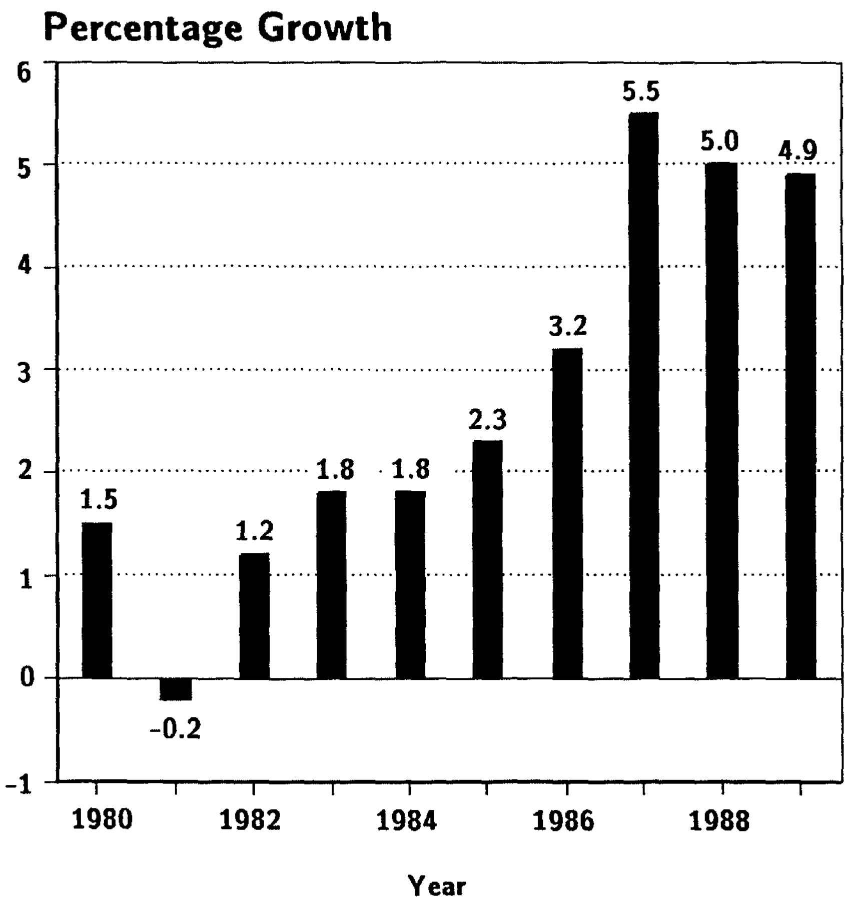
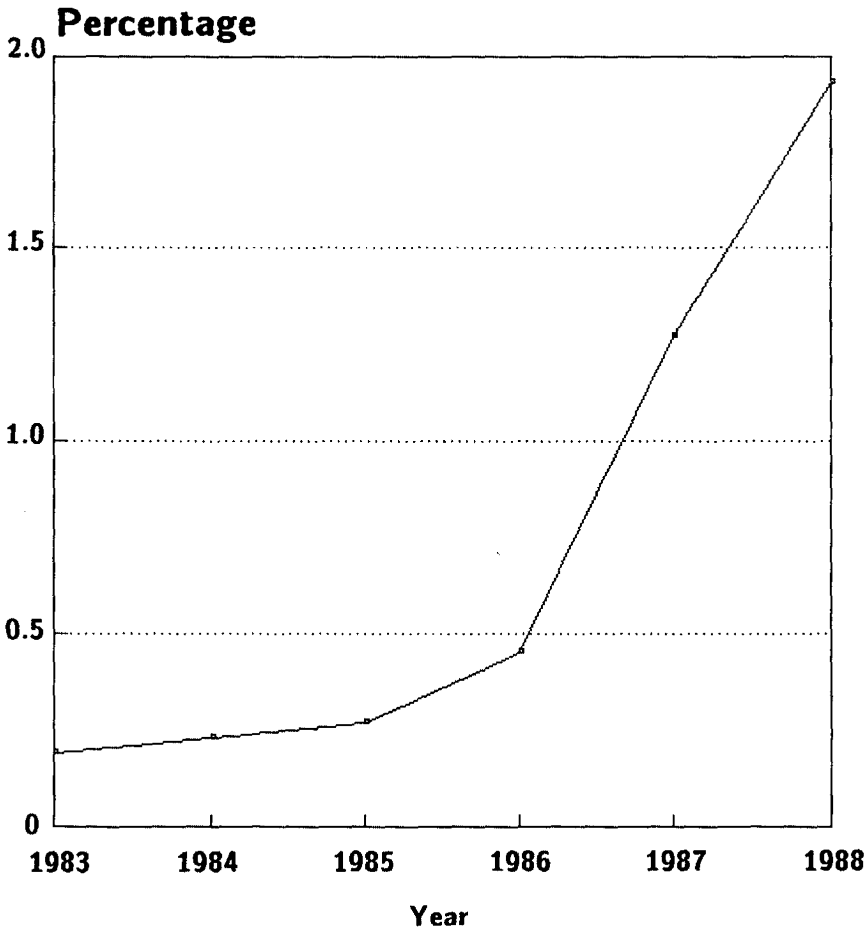


CHART 3

Total Life Insurance Premium as a Percentage of G.D.P.



also gone up quite rapidly, and topped 1.9% in 1988. Once again, there's some room to grow if you just compare this with the U.S. figure of a little over 3.5%.

One of the other factors, in the area of the demographics is the aging of the population. Shown on Chart 4 is the ratio of the number of people over age 65 to number of people in the working group, ages 14-64. This ratio is expected to increase by about 35% over the next 30 years.

This can be viewed as a benefit to the insurance industry. A law was introduced in 1985 that reformed the Social Security organization and its welfare benefits in Spain. This had the effect of lowering pension amounts. Individuals began to look to life insurers for supplements for their pensions. The reduction in state pension benefits combined with the aging population both have the effect of making the public more aware of the need for life insurance. We believe this has served as a kind of a built in marketing tool. It's a story that's quite common in Europe with the governments increasingly pressed to provide pension benefits to their people, and it's something that their economies will have a lot of difficulty doing.

One other factor that's important to mention is that Spain is a member of the European Community, and many of the financial trade and business barriers will be reduced or eliminated in Europe by 1992. This will have a major positive impact on the growth in the Spanish market. There will be increased competition and economic activity, more sophisticated consumers and products, and fewer and larger players.

We do not believe that by 1992 there's going to be a single internal market in Europe and certainly not for the insurance market where this involves regulation taxes, reserves, and technical arguments that are extremely difficult to reconcile. But we do believe there is progress that's being made toward 1992, and that it will have a dramatic effect on the insurance market.

One of the impacts of the 1992 process in Spain is that the number of players in the market has decreased. There have been mergers and acquisitions, as elsewhere in Europe. And so, the market itself in terms of number of companies is shrinking, but the amount of the market, which each of those companies is taking, is larger.

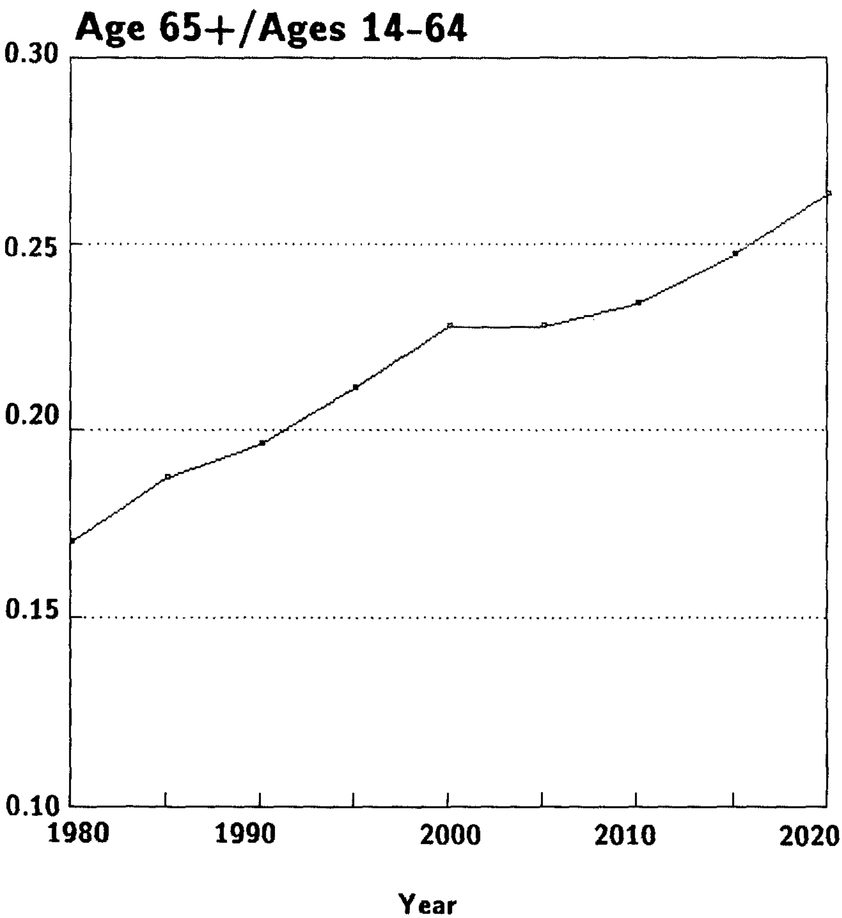
I'll move now to the regulatory environment in Spain. We entered Spain and starting selling policies in 1988. As I mentioned, we're in Spain as a joint venture with Banco Santander, which is one of the five largest banks in Spain, and we use the bank as a distribution system.

In the regulatory environment in Spain, the Ministry of Finance is the key player that one has to deal with. The insurance industry is regulated by the Direccion General de Seguros, which is the Department of Insurance and is part of the Ministry of Commerce and Finance. In order to do business in Spain, both insurers and reinsurers must register with the Department of Insurance and meet certain legal and financial requirements.

Naturally, this is a fairly involved process. Foreign investors entering Spain must, of course, abide by Spanish law, have a general office in Spain, and have a representative

CHART 4

SPANISH
Aged Dependency Ratio



who is domiciled and a resident of Spain. You also have to file a business plan, financial projections, and policy forms with the Department of Insurance.

While there is quite a bit of work here, we found the market in Spain to be relatively open in terms of the regulatory requirements. They're difficult to follow, but provided the proper steps are taken, regulation itself is not something that should provide an impediment to entry into the Spanish market.

One quirk to avoid is not to expect to get much accomplished in the month of August. As in quite of bit of Europe, most of Spain is on vacation then. So if you have something with the regulators towards the end of July, you can't expect anything to come out of that process until sometime in the middle of September.

There's a body of laws and interpretations that have been built up over the years in Spain. Some of these go back to the last century. The major areas that impact insurance companies in Spain are price regulation, reserve requirements, cash value requirements, policy filing and provisions, financial reporting requirements, and taxation.

A major overhaul in the laws regulating insurance was made in 1985 in an effort to consolidate all the laws. In a number of cases, the older laws still apply, and it's hard to tell when the older laws apply and when the newer ones come in. One of the things that's critical is to have local counsel and to use consultants where necessary. This is not intended to be a plug for the consultants, but you almost certainly need local counsel and advice in order to work through the regulations.

Looking at the pricing area first, there is a fair amount of regulation in terms of the way the premium rates are to be determined. They must be based on what's called insurance technical principles. Rates are calculated based on an actuarial net premium, which is loaded for adverse deviation, for expenses and for profit. In general, there's no limit on the load that can be used.

The net premium has to be calculated using mortality and disability rates based on recognized national tables or on national or foreign experience, and you have to show how that experience is justified as the pricing basis. In addition, you can't guarantee interest rates of more than 6% if the policy duration is to be equal to or greater than five years. But you can do many other things in terms of giving participation in the interest experience of the policy.

For policies with shorter durations, interest rates can't be greater than the average rate you expect to earn on the investments backing the reserves. Thus overall, pricing is not that tightly regulated. You have to file a tremendous amount of information, but you know you can do what's needed to do to earn a reasonable profit in that country.

Reserving regulation is a little bit of a different story. It's much more regulated than pricing, as it is here in the U.S. The method for calculating reserves is specified in the law; basically, reserves have to be calculated based on the prospective method, or the present value of the future benefits less the present value of the future premiums.

Second, that present value of future benefits must include provision for administrative expenses. Third, and consistent with that, the premium for computing reserves is the net premium which is loaded for administrative expenses.

The procedure that the law prescribes begins with the net premium calculated based solely on mortality and interest. The net premium is then loaded for administrative expenses. This is what is called the reserve premium, and it's used in the reserve calculations.

As just an aside, it's from the reserve premium that the gross premium is determined, by loading the reserve premium for additional expenses. Once again, it's interesting to note that the government regulates the way you calculate the premiums, but really doesn't regulate the loadings or the amount you use in the premiums. Finally, the reserves have to be calculated on a seriatim basis and must be greater than zero for each policy.

Cash values are also regulated in Spain. There are minimum values, which are essentially based on the value of the reserve less an adjustment. That adjustment is calculated by taking a percentage of the present value of the gross premiums remaining to be paid at lapse. This percentage varies by the type of insurance as well as the premium paying period.

Just recently, there have been some regulations specifying maximum cash values that are payable in the early years of a policy. This regulation is designed to more clearly separate insurance products from banking products and purely investment type products.

The most significant example of investment products is the single premium policy. The Ministry doesn't want insurance products to have too great a savings component, competing with the banks, because insurance products do receive some special tax treatment. For example, a portion of the premium is deductible from an individual's income in calculating taxable income.

In order to make a differentiation, a maximum cash value is set for the first years. In the first year, the cash value can't exceed a refund of premiums. In the second year, the cash value can't exceed 93% of the reserve value. The regulators made dramatic changes to the single premium requirements in Spain last year that essentially wiped out the single premium market.

Finally, reduced paid up must be given as a nonforfeiture option, and the paid-up amount is calculated based on the cash value, applied as a single premium.

In the policy filing and regulation area, having entered the market, regulation follows the file and use policy. You can file a policy, and if the insurance department later on determines that you've done something improperly, it will require you to withdraw the policies.

The ministry requires the industry to file technical notes along with the policy form. The technical notes include items such as the criteria for risk selection, issue ages, and medical underwriting. They show the way cash values are computed, policy loans, surrender values, and for participating policies how the participation is to be calculated.

Moving to financial reporting, in Spain the only financial reporting is statutory reporting; there really isn't a Spanish GAAP. Spanish statutory is also used as the starting basis for taxes and then adjusted slightly.

The basics of reporting are quite common. We've covered some of the valuation rules. There are quarterly reports that must be provided to the Department of Insurance. Those consist of balance sheet and income statements, along with backup details. They're not that much different from those in the U.S.

There is some deferral of commissions over the premium paying period, up to the first year policy reserve can be deferred. Overall Spanish statutory falls somewhere in between U.S. statutory and U.S. GAAP in terms of conservatism.

In addition, the law also has minimum surplus requirements. For life products, this is roughly based on 4% of reserves plus .3% of the net amount at risk. In addition to minimum capital requirements that exist in Spain for starting a business, you have to meet the minimum surplus requirements each year.

At Metropolitan while we're a mutual company, we do have a management reporting on a GAAP basis. We take the Spanish statutory and try to make adjustments to that to put the results on our management reporting basis.

Covering taxation very briefly, you're taxed on corporate profits, but there are no premium taxes.

There are personal tax deductions that I've mentioned. These are an incentive to buy life policies in Spain. And, in terms of benefit taxation, surrender values are taxed similarly to the way they are in the U.S.

To be an actuary in Spain you have to go through a university program. There are only three universities in Spain that offer this specialization, and they're very tough to get into. The first three years are general study, and there are two years of actuarial study after that. Some of the Spanish actuaries I've talked to think that their requirements are tougher than ours.

The Spanish profession is fairly advanced; there are about 1,500 members in the actuarial society in Spain. Some topics from their latest meetings were "Is Immunization Really Possible," "New Generalized Formula for Duration," and "Transformation of Markov Processes Applied to Econometrics." So it's a fairly sophisticated market, too, in terms of actuarial expertise.

The role of the actuary is obviously essential in the areas of pricing and valuation. The Ministry of Finance requires an actuary to sign every page that's filed that has a number that's based on an actuarial valuation.

There's one other factor that's interesting about the Spanish Institute. There's a law in Spain that actually specifies minimum fees for services that must be paid to certified actuaries. I understand these fees are quite high, and an actuary who accepts wages below the minimum can actually be suspended from the Institute for unprofessional conduct. So Spain is more advanced than us in some ways.

I hope that gives you a brief overview of Spanish regulation. The feeling we have, once again, is that the regulation is something that can be worked with, given the proper local counsel and advice. Regulation and reporting requirements are not a major impediment to going into business in Spain.

MR. SIEGEL: Minimum salaries for actuaries is a concept that we'll have to think about. Our final speaker is Tito Gautier of Aetna. Tito started as an auditor with Peat Marwick in Hartford. After earning his CPA, he held various positions at the Hartford Insurance Group, and in November 1988 moved to Aetna, where he was Manager of Consolidated Financial Reporting. In October 1989, he moved to his present job as Director of Financial Reporting for the International Insurance Division. Tito will speak about the Far East where Aetna has a lot of activity.

MR. AUGUSTO R. GAUTIER: As Henry indicated, we're going to be taking a little trip over to the Far East. I just wanted to provide you with a little bit of perspective of how far the Far East is and why it can take 24 hours to travel there from New York. Chart 5 is a reference of where the different countries in the Far East lie in relation to Hong Kong, which is where we have our regional office.

CHART 5

Travel Time From Hong Kong to :	
Korea (Seoul)	4 hours
Taiwan (Taipei)	1 hour 30 min
Malaysia (Kuala Lumpur)	4 hours
Australia (Sydney)	8 hours
New Zealand (Wellington)	10 hours

I will first talk about the Far East area in general, then talk about some specific countries where the Aetna has business. Then I'll talk about a regional office concept to wrap it up.

The Far East is made up of many different countries. Recently some people have split it up into the northern section and the southern section. You can also divide it by how developed some of the countries are.

You have Japan in a category by itself. Then you have other countries that are called the next newly industrialized countries, which include Korea, Taiwan, Hong Kong, and Singapore. The next layer down from those you have Indonesia, Thailand, Malaysia, maybe the Philippines, and the bottom layer includes Vietnam, Laos, and Cambodia which are a little bit unstable right now.

Chart 6 includes some of the other countries in the Far East: Korea, Taiwan, Hong Kong and Malaysia. In the far column on the right you have life premium as a percent of per capita income. As you'll see later in the specific slides, the gross national product in those countries has been increasing as well as the per capita income. The individuals need more and more protection. They have more assets, they're looking for more protection, so there's an opportunity to increase life insurance coverage in addition to having amounts available for investment.

CHART 6

Pacific Opportunity				
	Life Prem % GNP	% World Life Market	Life Prem per Capita ($US)	Life Prem as % of per Capita Income
U.S.	3.6	37	621	4.0
Japan	5.0	29	981	5.0
U.K.	5.8	7	479	4.1
Korea	6.4	1.6	155	3.1
Taiwan	1.2	.4	76	1.3
Hong Kong	1.1	.1	89	1.0
Malaysia	1.4	.1	24	1.2

Now, we'll move to Korea, the biggest country in which the Aetna has operations in the Far East. In Chart 7 you can see the growth. The United States GNP has been growing around 2% per year; in Korea you're talking 12% per year from 1984 through 1988. In 1989 it dropped down to about 8%, that was considered a recession.

CHART 7

Korea	
Population	43 Million
GNP/Growth (1984-1988)	$218 B/Average 12% per Year
Income Per Capita	$5,063
Life Insurance Growth (1984-1988)	32% per Year
6 Large Local Companies	(Through 1988)

The market in Korea has been dominated by six large insurance companies. In 1988, those six companies had a total of 99% of the written premiums. Since late 1987, there have been several companies from the United States and one from Canada that have started either in a joint venture capacity, or they've also gone into starting their own companies in Korea.

The joint venture, which is the way that the Aetna decided to go has some advantages to it in that our partner basically required all its subsidiaries to move their insurance business over to our joint venture, and that did create a nice influx of premiums in the first quarter of this year.

There are also disadvantages. I'll give you an example. We wanted a GAAP audit performed of the Korean company, but our partner said all it needed is a statutory audit on Korean standards, so it didn't want to pay its 49% share of the GAAP audit. And we're only talking an additional $25,000. That's how detailed and nit-picky our partner can get on some things.

Okay, so now you've decided to go into business in Korea; what kinds of products are you going to sell there? Well, Korea is very, very restricted. The Minister of Finance (MOF) basically dictates the regulations in the different companies. You can only sell the products that everyone else has, and the prices are the same; there is no price differentiation in Korea.

There are basically three types of filing that you go with. There's "Use and File," where you basically photocopy somebody else's product, file it and start using it right away. There's "File and Use," where you have a product which meets the Korean standards and may not be in the market yet. You file it, wait for 30 days, and, if you have not heard, then you can go ahead and use it.

Then there's the last category called "Wait and See." If you really want to go out and try something really innovative, you can file, but you're going to really wait. And the wait could be considerable. For instance, one of the innovative things that the Aetna tried to do was unbundle current products, and that was not allowed.

Now that you have decided what your products are, you must ask yourself, okay, how am I going to distribute those products? The agents consist predominately of female high school graduates. They will go out and sell basically to their family. And once they run out of known members of the family, they will probably drop out. Agent turnover in Korea is somewhere in the 70-80% range as a result.

A couple of American companies tried to do something a little bit more innovative, and they went after male college graduates. As far as I know, they've been having a lot of labor problems.

I don't know how many of you have been reading the paper, but over the weekend, there has been some police and labor confrontations in Korea as they try to break up some of the work stoppages. Korea stands second in the Far East as to number of work days lost to strike with an average of 1.4 million work days lost per year, second to the Philippines.

From the actuarial standpoint, Koreans don't think too highly of FSAs. They think they've survived without them, and that they do not need them. They have their own actuaries, and they have their own exams, which from what I hear, qualify them more to be like statisticians. However, each life company is required to have an actuary.

The dislike for FSAs also goes for American companies in general. We downplay the Aetna name over there; we really display our Korean partner, which is Dongbu.

Our general manager is an Australian. We do not have Americans over there, and English is not understood that well. When you get to the Far East, you should ask the question in several different ways to make sure that you understand what is being said.

Also, measures of success are viewed a little bit differently by U.S. and Korean companies. Korean companies usually view success as size, they want to grow as big as possible. Our measure of success is the profitability of the company.

On another point, product turnover is also relatively high. It goes almost hand in hand with the agent turnover. We find that 20-40% persistency is what the average company shows over there.

From an accounting perspective, premium revenues throughout the year are recognized on a cash basis, and then at the end of the year, an adjustment for unearned premiums is done. IBNR is kind of optional. It's really not required, but if you want to include it in your liabilities you may. Also, acquisition costs are not capitalized.

Now we'll move slightly south to Taiwan (Chart 8). Taiwan also has six major companies that dominate the market but, unlike Korea, Americans seem welcome and we do play-up the Aetna name there. The only problem is the Ministry of Finance only allows you to go in as a branch office rather than a subsidiary. That does present some restrictions on the type of investments that you can invest in which could affect the return you use in your product pricing eventually.

CHART 8

Taiwan	
Population	20 Million
GNP/Growth (1986-1988)	$120 B/Average 10.2% per Year
Income Per Capita	$6,045
Forex Reserves	$80B
Life Insurance Growth (1986-1988)	35% per Year (1986-1988)

In addition, because it's a branch of an American company, you're required to file a blue blank. In Taiwan, as in all our international operations, we're on lag reporting because we cannot get all the information in time to meet our normal reporting standards. Therefore, our accounting people in Taiwan have to prepare all the quarterly statutory information on a quarter lag, and then they have to prepare all the Taiwanese regulation on their regular quarter. So there's a total of eight quarterly closings that they have to go through.

Retention is better than in Korea. Retention in Taiwan is closer to the 55-60% level. The only different accounting rule in Taiwan is that the unearned premium reserve is calculated as 50% of the total premium retained as opposed to a strictly pro rata basis. The statutory equals GAAP in Taiwan, and we found that the auditors may not be that knowledgeable in auditing U.S. GAAP information.

Now we'll just move across the sea to Hong Kong (Chart 9). Hong Kong, a British Colony, is part of China, and it's returning to the Chinese government in 1997. It's an area of 400 square miles, and very densely populated. The income per capita is one of the highest in Asia behind Japan.

CHART 9

Hong Kong	
Population	5.7 Million
GNP/Growth (1986-1988)	$5.3 B/Average 11.1% per Year
Income Per Capita	$9,300
Life Insurance Growth	30-35% per Year (est.)

One of the interesting nuances of Hong Kong is the people like to invest their own money. They do not want others to invest their money for them. So life investment products are not that popular in this country.

One of the bigger business issues in trying to get a company in Hong Kong or if you're thinking of going into Hong Kong is what's called the "brain drain." That is, since Hong Kong is switching back to China in 1997, a lot of people are very concerned, and there's an exodus of about 1,000 individuals a week.

Most of the people who are leaving Hong Kong are the well off people whom you would like to sell life insurance to. Part of the reason for this is that some of the countries (e.g. Australia and Canada) that are accepting immigrants have established net worth restrictions.

Another example of this concern in Hong Kong is that more and more policies are being written in foreign currency, that is, foreign currency to Hong Kong. Back in June 1989, there were three U.S. dollars of written premiums for every Hong Kong dollar. As recently as March 1990, that ratio had gone to $20 for every Hong Kong dollar. People just want to write the policies in a currency that they know will be strong and that they can use in the future.

The accounting in Hong Kong is very interesting. There's no uniform standard; basically the domestic companies that have been working there for a number of years use what they started with, for consistency purposes. The foreign companies that come in will use the accounting prescribed by the parent company.

There are items to be aware of when researching potential acquisitions in Hong Kong; some agent financing arrangements are rather peculiar, and look into the deferred acquisition costs. We found a tendency to overcapitalize in those areas.

Malaysia is further south on the map and is much different from the other three countries I've talked about (Chart 10). As I mentioned in the introduction, Malaysia is in the second tier of countries, just below the newly industrialized countries. There is a lot of investment that is coming down into Malaysia from Japan and Korea to utilize labor in Malaysia which is less costly than in their own countries.

CHART 10

Malaysia	
Population	17.3 Million
GNP/Growth (1986-1988)	\$35 B/Average 5.3% per Year
Income Per Capita	\$2,005
Life Insurance Growth (1986-1988)	11% per Year

Malaysia overall has six FSAs in the country. Four of them work with companies and the other two are consultants. The Malaysian government does require that an actuary sign the financial statements of a company as well as any new products that the company may want to launch into the market. The government relies completely on those FSAs because it does not have anyone in the government who is able to review that type of work.

The insurance industry is regulated by the central bank, more like our Federal Reserve, as opposed to the Ministry of Finance as in other countries. Again, the agency force is made up mostly of part-time workers. Productivity may be as high as one policy per month per agent.

If you're looking into buying a Malaysian company, there are several accounting treatments you should know about. All premium income is fully recognized at the time that it becomes receivable. Also, reinsurance agreements should be looked at. We found instances where a company was recognizing cash receipts coming back from reinsurance as revenue that should have been booked as liabilities.

Also, when you're looking at Malaysian statutory to U.S. GAAP conversion, you will normally see GAAP reserves greater than statutory rather than the customary U.S. adjustment.

Finally, I just want to talk briefly about support. If you have operations in the Far East, it's very difficult to manage them from the East Coast or anywhere in the United States. If you call somebody during normal business hours, you're probably going to get a tape message saying this is such and such a company, our office hours are between 8:30 and 5:30.

So, you go to your little AT&T card and you figure that you need to stay at work until 8:30 at night or come in the morning at 5:00 to be able to communicate with them unless you want to do it via the fax. But it's also not advisable to use only the fax because of the differences in language and custom. Even though you think the people understand, you should be communicating directly as often as possible.

As I mentioned earlier, in each country there are different ways of handling actuarial and accounting issues The agency force is also different. So you may want to consider staffing a regional office with an accountant, an actuary, and possibly a marketing individual, who could help train the agency force in those different countries. They're very receptive to all kinds of training.

I know that our individuals have come back and pulled out packages we used in the 1960s, e.g., in the United States, for use now in all these different countries. A systems person would also be very helpful if you want to establish operations in Asia.

That's about it. I just want to reinforce the fact that people in the Far East are very good negotiators. You have to be very patient when dealing with them. An appropriate line that I heard about negotiating with people in Korea is they'll start nibbling at your toes, and soon you look down and your whole leg is gone! So you have to be very careful in dealing with them.

MR. FORREST ALLEN SPOONER: I don't understand taxation in Great Britain at all. I think it's investment income minus expenses. Could you just briefly explain how that works?

MR. FIELD: There are two principal divisions. Life business on the one hand, pension business on the other. Life business, as you say, is taxed on investment income less management expenses. Up to now, it's been a regular year-to-year calculation and most established companies are paying tax on that basis.

If expenses exceed investment income, you get a negative calculation, no tax on that head. There is an alternative tax which is based on profits carried through to the shareholders' account. But established companies are paying tax on that account.

There's been a recent change. Operative now -- it was in the 1989 budget -- it requires acquisition expenses to be deferred over a seven-year period for bringing into this taxation account. So that increases the tax take and will make a big difference to the newly established companies. That's had one or two hiccups in it's progress because the reinsurance consequences of that weren't taken into account, but that was corrected this year and will be done in time for the proper accounts to be done.

Investment income includes capital gains, but realized capital gains, not unrealized gains. So there's a bit of a hiccup there, particularly when you're passing out profit to departing policyholders based on unrealized gains.

Another interesting quirk on that has been that if an insurance company invests in mutual funds, those mutual funds themselves are taxed on investment income, but not taxed on gains at all. And it is the holder of the units in the fund that pays tax when those units are realized.

But an insurance company that owns units against its normal insurance account probably will never realize those units, and it was recognized that on that basis the tax on gains would never be paid. So some insurance companies put all their equity holdings, their common stock holdings, through unit trusts in order to save this capital gains tax. That also has been stopped, and there is now a regular basis on which those units are deemed to be sold and rebought with some preservation of the status quo for business already on the books. That's an extremely complicated area and has just happened.

On the pension side, business backing pension business of all kinds is tax exempt all the way through. But benefits, pension benefits paid, are taxed wholly at source. There is no capital element allowed on that.

There have been quirks that have operated quite nicely for the insurance companies over the years, in that for simplification of calculation in the old days, the total management expenses of the company were brought into the life assurance account, which actually caused many companies not to pay tax on that basis.

The taxation account for pension business, where just shareholders' profit gets taxed, was relieved of those expenses, so it artificially increased the profit emerging on that account. So, in a normal company all would be well. You didn't pay it here, but you did pay it there.

But for a traditional company, as mine was, your tax assessment brought in realized gains but not unrealized gains. But the liabilities, when we were largely a linked pensions portfolio, were brought in at market value, not book value. So the liabilities were going up very fast and the assets were not moving up at all, so I had substantial losses on that account as well. And it looked like my company was never going to pay tax again. We operated quite nicely on that basis for several decades. That also has been changed, and now the total pensions account is separated into its own operation with complicated arrangements for apportioning it, and it's another minefield.

But basically, you're right. The life assurance account is investment income less management expenses with the deferral of acquisition costs, and the pension business is tax exempt.

Here I've got to bring in Europe. In Europe, generally the insurance companies are taxed on profit emerging only. The buildup in the fund is gross. And we are moving to an environment where there will be mutual recognition of each other's businesses and sometime in the 1990s it will be possible to trade policies freely across borders. Germany, in particular, will be an interesting place because it has gross roll up. It has pretty rotten policy benefits, but it has gross roll up, and that offsets the premium rating structure.

I think that will be the trigger for harmonization of tax. We will not get harmonization of tax across Europe because that requires unanimity of voting amongst all the nations and that will never happen. But when mutually recognized trading happens, which will happen a long time ahead of tax equalization, money will flow across borders and that will sharpen the minds of the taximen. They won't want to see the outflow of funds.

So again, it's a fluid situation. We reckon we've got something to gain in the U.K. if our taxation basis improves to that of the rest of Europe. But some of our recent big advantages have now disappeared.

MR. STANDLEY H. HOCH: I had a question for Tito. Would you comment on the restrictions on both putting capital into the operations in the Far East and being able to repatriate earnings or to bring capital back?

MR. GAUTIER: I'm more familiar with the repatriation of it. In Korea and in all of these countries you have to get approval from the Minister of Finance if you want to dividend earnings out of the companies. I've noted that in some cases, certain companies instead of capitalizing earnings into the equity section, may just want to set the amount up as intercompany debt in hopes of being able to get some of the money out that way. But there will be some restrictions on that. As far as I know, I haven't heard of any problems getting money in. They keep on asking for more money.

MR. KERRIGAN: We have operations in Taiwan and Korea, too, not in Malaysia or Hong Kong, and we haven't had any problem bringing the money in. There are minimum capital requirements, but there hasn't been a problem in bringing capital into the countries.

MR. BERNARD GOEBEL: I have a question for Tito and Bill. Could you summarize how you got into these markets? Is it an acquisition of a company? You mentioned a joint venture. Was that an existing company? Did you start one up?

MR. GAUTIER: I mentioned before in Taiwan our operations are a branch office. In Korea we went in with a joint venture with one of the major conglomerates.

The government in Korea restricts what some of these major conglomerates can own. They may only own up to 49% of a life insurance company, and that's why our relationship has us owning 51% of the company.

In Malaysia, we have a 49% ownership. In Malaysia there's some other restrictions that I forgot to mention before. The government has as one of its goals that the native Malaysians will own 70% of the capital in the country by a certain period of time. I believe 1990 was one of their middle goal years, and they're behind the percent ownership by native Malaysians that they were looking for. But that's something to keep in mind in that country.

In Hong Kong we have a couple of different companies. We have a life company and then we also have a health company. One of them we own a 50% of and the other one we own a 49% share. They're also joint ventures with other parties from Hong Kong.

In New Zealand and Australia we have 100% owned companies.

In Spain we also have a joint venture with Banco Hispano Americano, we own about 44% of that company.

MR. KERRIGAN: Our situation is quite similar to that Tito mentioned. Our method of entry was based on the way that's best for that country. For instance, in Taiwan there's not, as Tito mentioned, much choice; so you enter as the branch of a stock company. For Metropolitan that means that we have a stock subsidiary of Metropolitan that is 100% owner of our company in Taiwan.

In Korea we've a joint venture also with a large conglomerate known as the Kolon group, and there Metropolitan has the controlling share in that interest. In Spain, we're in a joint venture with a bank, which is probably the common way of entering Spain, and that is a 50/50 joint venture.

All of these were start-up operations. We also have an operation in the U.K. which we acquired in 1985, known as Albany Life.

We consider the different regulations, look at the different benefits of having a partner or not, and choose the best way for each country.

MR. FIELD: Could I come in on this one? In the old Phoenix of London days we operated internationally. Our approach to that might be of help.

In the old days, we operated through the old Commonwealth, through the old empire with our own branches and then subsidiary companies, following British trade as it went right through the empire. So in Australia, New Zealand, Canada, we would have our own wholly-owned operations. But elsewhere when we regularized our position in the postwar years, we liked to get alongside some other local trader and do joint venture companies with them.

In Singapore we worked closely with Guthries and established a local company. In Hong Kong, we were with Gibb-Livingston. In Korea, we were with Malayan Banking Berhard. In Spain, we were with the Tobacolares Company. In Greece, we were with other local traders.

We liked to do that to establish, first of all, a reputation for being a company with strong local identity, and we were there because we wanted to be there, not taking the money out of the country. And we wanted to establish links with other traders to get a business operation going.

That may well have changed a bit since the acquisition by Sun Alliance, a company that thinks rather differently. It doesn't like minority-owned companies; it likes to have 100% ownership.

So philosophy may have changed. But that was our thinking, and I think it goes back generally to the way your home office thinks about its operation around the world. It's to do with company aspirations and whether you like to work with people, or whether you like to work alone.