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INTERNATIONAL FINANCIAL REPORTING

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- 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?
 - 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. ROBERT M. SMITHEN: I'm Rob Smithen from Manufacturers Life, which is a Toronto-based mutual company that operates in a number of international countries. Both our panelists are consultants with considerable experience in a variety of international areas.

We're going to run the gamut here and try to cover a lot of the world. We'll be taking you from highly regulated countries like Japan and Singapore and Germany, to ones where there's very little insurance law, like Hong Kong. We'll talk about areas that have opportunity for expansion and profit. And ones that are almost impossible to get into. And maybe at the end of it you can find some common thread. I'm not sure whether we've come up with anything that has any consistency or not, but hopefully it will be of interest.

Although we will be talking about most of the continents in the world in some way, shape, or form, there's nobody here who has any particular expertise on Australia, so we've left that out. Although if there are questions, I think probably we can handle a few of them.

I decided that Canada was not international and so I won't be talking about what's going on in Canada, which is a lot right now. But if anybody wants, by all means ask me at question period.

I think the reason we're here, and the reason this has now become such an interesting area, is we are all exposed to reading the papers every day about what's going on in the world. And it really has become a global marketplace. It's starting to become so for insurance. I guess it has been to some degree, outside the U.S., for a number of years.

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And it's starting to expand. And there's a lot more interest in North America in internationalism.

Generally the Australian, Canadian, and European companies are fairly expansionist, while historically the American companies have been somewhat like ostriches, to a degree at least, by keeping their heads in the sand, although there have been some very notable exceptions.

I think it now appears there is starting to be a lot more interest by the American companies in foreign expansion. And a lot more desire to learn. Maybe we can get some questions from you later or comments from you representing your companies as to some activities the Americans are looking at or doing. We will not be commenting on that directly.

I think we have a lot to learn from international companies. I know Manufacturers Life has picked up a tremendous amount of experience from having operated in the international markets. Let me give you some examples of things we've picked up that we have applied in other areas of our company.

A lot of them come from the U.K., which tends to be a fairly innovative insurance market. Steve may not agree with me, but it is, at least compared with the Canadian Market Unit linked products, which we call variable products, which certainly came to Manufacturers Life through our U.K. operation. And as I was discussing with somebody earlier, I thought South Africa was the country that initiated them, but he said Holland, so I am sure that somewhere overseas, variable products made their mark. Also, Steve will talk about the concept of embedded values, which is certainly an important concept being developed now in the U.K.

The U.K. also set standards before any North American country did for pricing for AIDS. There's a lot about integration of banks or other financial institutions and insurance companies that has not happened in North America, but that is happening overseas in Australia and in Europe. We all have a lot to learn from that experience. And I don't think we, at least I'll speak for myself, have studied it enough yet.

Not only do you learn a lot if you operate internationally, but it's fun. It's a lot more exciting to work in a company where you have offices in Hong Kong and Singapore and Indonesia and London and Cyprus and the Caribbean than it is being in one location. It attracts people. It makes it a more invigorating environment and it certainly helped us get better and more qualified staff. We do move our staff around to some degree, and it's been a good experience for them and for the company.

Another benefit of operating internationally is investment opportunities. You don't have to operate internationally to have investment opportunities. But you tend to look more outward if you are operating in a variety of territories. We have a London investment office that covers the world from an international investment view point. We invest in many foreign securities. We take currency risks in a lot of areas like Japan, Germany, France, Holland, etc., areas we would never look at without our internationalism. And we have done very well by it.

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I guess lastly the most important benefit of internationalism is generally the markets we're talking about, and it's not true in all of them for sure, offer greater profit opportunities than the North American markets do. Canada is particularly saturated from an insurance point of view and very hard to make profit. And the same's true in much of the U.S. You can still find niche markets in the U.S. Certainly in some of the territories we're talking about they're still relatively underinsured and relatively unsophisticated with really good opportunities for good bottom-line enhancement.

I'll shut up now and turn it over to our two speakers and then I'll come back on later. Harry Miller is going to talk first. He is going to cover Japan, Mexico, and Chile, quite an unusual threesome. But that's where his experience lies. Harry's an associate member with the Houston office of Milliman and Robertson. He's been with the firm since 1981. He's a Fellow of the SOA and member of the Academy. And he holds a masters and bachelors degree from the University of Texas. Harry's been active in the merger and acquisition and management strategy areas recently. He's worked with several clients who have looked at acquiring companies in Latin America, as well as clients who were trying to understand how to better manage their foreign subsidiaries.

I'll introduce Steve at the same time, so they can just go on one after another. Steve Taylor-Gooby came here for this meeting from London, and I really appreciate his coming this far. He's a principle with Tillinghast Life division and practice leader for the division's financial reporting practice. He's a Fellow of the Institute of Actuaries and Associate of the Society, and a member of the American Academy. Steve has developed specialized expertise in the areas of nontraditional reinsurance and performance monitoring, but more important to our talk is his expertise in the area of financial reporting, including U.S. GAAP and value added systems. He is a member of the Institute of Actuaries' working party set up to develop actuarial standards for calculating embedded values for inclusion in insurance accounts. In 1990, he was appointed practice leader for Tillinghast Life division financial reporting practice. He is responsible for coordinating and developing the firm's services in the areas of performance measurement, financial analysis, and control as well as statutory reporting. So he'll give us a very good picture of the European financial reporting picture, and compare it with U.S. GAAP.

MR. HARRY R. MILLER: I've worked internationally and gone around and looked at the various countries, the companies that are involved there, and the different practices. What struck me is that if you look past the surface, down to the underlying principles that the company used or the actuaries used, they're really very consistent, very much the same. And I've always found it helpful in working with these different areas to sort of keep your eye on this one point: that underneath you're really dealing with the same thing. There's only so many ways you can discount with interest and the basic principle of life contingencies underlie all these products.

Before I get in and talk about the different countries, some of the interesting items that I found in working with the different countries, and not to underestimate their importance, is just some of the practical problems in logistics and different cultures and different technologies. If you're looking at a country in Latin America, for example, does your computer system have enough fields and the reporting columns to handle billions and

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trillions of pesos? Getting those converted into Japanese yen? There are considerations like that. And also in working with the Mexican companies, we found it's a real interesting problem of how do you send a FAX to a Mexican company after 3 o'clock in the afternoon when all the clerical staff have left? And all you have left is managers and professionals trying to transfer you around on a telephone when your Spanish is less than perfect. It gets to be quite an interesting task.

The first country that I will discuss is Japan. What I'd like to do is give you just sort of a brief overview of the country and some of the issues that we've seen, some of the items that we've dealt with, and some of the items that might be of interest to you. If you are thinking of looking at operating a company in one of these countries, then this will help you understand the opportunities and the potentials that exist.

The Japanese insurance industry consists mostly of mutual companies. It's a highly concentrated industry, in that the top five companies comprise the vast majority of the market shares. This is not unusual in a lot of the countries that we've looked at. And if you look in comparison to the market penetration of the top life insurance companies in several other countries, you can see the difference. In Japan the top five companies comprise about 62% of the market share, compared with the U.S., where that figure is only 24%. So you see that in the U.S. market where most of us are used to dealing, we have a wide open, highly competitive marketplace. In a lot of the foreign countries, that does not exist. The other two countries that we will talk about are Chile and Mexico, which are very similar. They'd be right up there with 50-70% in terms of the market share of the top companies. So it's a very different environment when dealing in some of these countries. Ease of entry into the country may be a lot more difficult. Your competitors may be a lot bigger. It may take a lot more effort to get into the country and develop your market there.

Another item about Japan that we noticed is that the distribution system is still primarily agents. Most of the agents are part-time agents of which a very high proportion are females. So female part-time agents are the primary distribution system in Japan. This is a lot different from the U.S. There are various cultural reasons why that has developed. But you have to change your thinking and approach the insurance potential in Japan from a different perspective.

Some of these countries have a lot of market potential, while others do not. Some are highly saturated with insurance; some are not.

Japan has premiums per capita of almost \$1,500 U.S. So you can see the per capita premiums in Japan are fairly high. The U.S. is down around the 600 level. A lot of the other countries, such as the Latin American countries, are down in the range of \$13 and \$7 per capita in terms of insurance premiums. So the amount of insurance that's left to be sold or possibly sold in these countries varies greatly. And that means that one must take a little bit different perspective, or approach, to these countries.

The distribution of the life premiums as a percent of the gross domestic profit gives you an idea of how much insurance there is, and how much insurance potential there is. Again, Japan is very high on the list. The U.S. has half of the insurance that Japan has.

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Here again the Latin American countries typically fall down around the 1% gross domestic product level. So there's a great deal of difference in opportunity.

A lot of the premiums, as a percent of the gross domestic product, are high. This has a little bit to do in terms of the types of products that are sold in these various companies, and where the emphases are placed.

In that light, Japan is very heavily into the savings type product. They have whole life products, term products, variable life products. The endowment products are a much bigger seller than they are in the U.S. Annuities are virtually nonexistent in my experience. Universal Life (UL), I believe, has not been approved in Japan, although some companies are trying to get it approved. So the distribution of products, the variation of products, will differ among the companies.

Looking at product profitability, we are seeing a lot of the similar trends in the U.S. The newer products in Japan appear to have lower profitability than the older product lines. The question remains in Japan, as the competition increases and the regulatory body moves toward a little more deregulation of the insurance industry, in terms of allowing maybe a little more rate competition, will the profit margins that are seen in Japan and some of these other countries hold as this regulation decreases? The regulatory environment in Japan is much different from the U.S. The Ministry of Finance regulates the insurance industry in Japan and they are incredibly concerned with stability and keeping the playing field level for the companies in Japan. You have one regulatory body versus 50 regulatory bodies in the U.S. So there is a big difference there.

In terms of financial reporting, what's the difference between the Japanese accounting financial reporting statements and the U.S.? I have not seen any Japanese companies that produce GAAP financial statements. So I believe that they only produce statutory financial statements. The primary concern of the financial statement tends to be solvency. The financial statements are very conservative in Japan. The reserve bases are basically net level reserves. They have a choice between aggressive and a conservative accounting treatment. My understanding is it's generally the conservative treatment that wins out.

As I understand it, the big companies tend to try to pull down their earnings as much as possible. And part of that, I believe, is due to the consumers movement in Japan. They want to show that notwithstanding their rates, they're not making that much profit. So there won't be as much pressure to reduce the premiums in the future.

In the investment category, common stocks in Japan are held at the lesser of book value and market value. I've heard rumors that the amount of unrealized gain that exists in some of the Japanese insurance companies may be as much as the capital and surplus of the companies themselves. So you have a lot of hidden earnings potential in the balance sheet in some of these companies. You have the difference in that the Japanese companies invest more heavily in foreign securities. Up to 30% of their funds can be in foreign securities. There's no mandatory securities valuation reserve (MSVR) account in Japan as with the U.S. Instead they have what's called an article 86 account, which

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functions a lot like the MSVR account in the U.S. Among other things, all the capital gains and losses flow through this account, and therefore they do not directly reflect the income statement and you do not have any unrealized gains per se, since all your common stocks are held at book value. This is true for all practical purposes in Japan.

Most companies tend to hold net level reserves. Their commissioners reserve valuation method (CRVM) is based on the Zilmer method, which the current methodology basically grades into net level after five years, as opposed to the CRVM in the U.S. which grades in over the premium paying period. So there's a much more conservative basis.

There are no deficiency reserves per se in Japan. I asked once why there were no deficiency reserves, and the answer I got was because the Ministry of Finance makes sure there are none. Of course, premium levels are set high enough to avoid those. Actuarial reserves that you see are the same basic types that you see in the U.S. Claim reserves, benefit reserves, dividend reserves. There's not a lot of differences there.

One of the biggest differences is the conservatism in the statement, and the way investments are treated in the statement. Other than that, there's a lot of similarities between the countries.

Now move over to Mexico which is like going from one extreme to another. From Japan, a country with low inflation rate, low investment rates, long-term outlooks, and very conservative cultural approach to business, to Mexico, the free-wheeling, fun-loving, vacation spot of Latin America.

The industry in Mexico is, as I mentioned earlier, relatively concentrated also. Five companies predominate the market, and there are seven or so mid-sized companies. And the remainder of the 35-40 total companies are smaller companies. A lot of those will probably disappear over the next few years. All the companies are stock companies. I'm not aware of any mutual companies that exist in Mexico. I may be wrong on that. But all the ones that we have looked at have been stock companies.

The foreign insurers have a fairly limited role. They tend to be concentrated at the higher income levels. This is beginning to change as the Mexican regulatory environment is loosening up. In January of this year, they allowed up to 49% ownership of companies by foreign insurers. They are loosening the strings on the reinsurance possibilities in the Mexican market. So there are some opportunities there for foreign insurers having a greater influence in the Mexican market.

Mexican companies are by and large composite companies, in that the same company can provide both life and nonlife coverages on the same charter. That produces some interesting wrinkles in the financial statements. It takes a while to get past those when you first start looking at them.

The distribution system is similar to that in the U.S. The compensation levels and structure appear to be very similar to those in the U.S. Overall, in looking at the Mexican insurance market, it is very much influenced by the U.S. and Canadian markets.

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And, what you see is the basic U.S. and Canadian type products modified to fit the unique circumstances of the Mexican marketplace. The insurance premiums per capita are fairly low. The insurance is currently concentrated in the upper income markets. And even with that happening, the average size policy is fairly low in Mexico. A lot of the higher income Mexican individuals purchased foreign-denominated insurance in the U.S., which I still do not believe is legal to be sold in Mexico. But that's one of these items that occurs regularly with everybody's eyes closed, I guess.

The companies tend to provide a lot of very high-level fringe benefits, so group insurance plays a very predominant role in the Mexican market. As I mentioned, the products are very similar to the U.S. and Canadian markets, except that a lot of them are indexed to match the high inflation so that they will vary with the high inflation rates. But other than that, there are very similar type products to the U.S..

Mexico is one of the more profitable of the Latin American markets. And again we're seeing the same pattern of the UL new product margins being a lot lower than the old traditional products. Regulation is provided through the National Commission of Banking and Insurance at the federal level versus the state level. From an actuarial prospective, an independent actuary must provide an opinion on the reserves and financial statements for the company. This opinion statement is a lot more in depth than the U.S. statement, but a lot more narrow. They have the following types of reserves in Mexico. They have the basic policy reserves, and the reserves for dividend accumulation which cover all of the excess interest elements. Any excess interest credits go into this dividend accumulation reserve versus the basic policy reserve. That's not included in the actuarial opinion nor are claim reserves covered by the actuarial opinion. But the actuarial opinion cannot provide as much reliance on accountants or the inside people in terms of verifying policies inforce. So the actuaries wind up doing a lot more auditing type work in terms of going back and verifying that policies are actually inforce and less in terms of verifying that claim reserves are adequate, as about all the policy reserves are taken care of and calculated correctly. It's a little different perspective there.

The statutory financial statements are not as in depth as those in the U.S. A lot of the supplemental schedules that you're used to in the blue book are missing. The statutory-based financial statements are prepared by most companies. They do not comply to GAAP, but we have not seen any companies that provide specific Mexican GAAP financial statements. A lot of them provide GAAP financial statements for their parent companies in the U.S. or for the banks that have lent them money.

For investments there is no MSVR or reserves or asset reserve account in the Mexican companies. There is no need. A long-term investment in the Mexican insurance companies currently is probably 120 days. So it's all cash and short-term securities. Some of them have stretched out to a year. They're going long in their portfolio.

One interesting aspect is that even though they have all of these casualty type coverages, that most Mexican companies do not set up any incurred but not reported (IBNR) reserves, since it is a reserve that is not required by law. They do say we have a provisional reserve that we set up which takes care of that. One of the most interesting items to get through is the fact that they did not set up the IBNR reserve. Also if you

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look at the statements of most Mexican insurance companies comparing assets with the reserve liabilities, you'll see that reserve liabilities generally exceed the invested assets. And that is because on the casualty coverages there's a difference in the timing between the premium accounting for the reserves and the income statement. They have to set up the entire annual premium in the reserve liability, but they do not get the due premium asset in the reserve liability, i.e., they have to set up this entire liability on the liability side and the due premium is not as well defined as in the U.S. Chile is sort of half way in between Japan and Mexico. The marketplace is effectively split into social insurance annuity writers and life companies. There are a small number of companies which are highly concentrated. The top three appear to have more than two thirds of the market share. The products they sell are primarily the social insurance annuity. Effectively their social insurance system is funded through the private insurance marketplace. They have some life coverage, some mortgage term products, and some health insurance products. The regulatory environment is such that you should be glad you're not practicing in Chile regularly.

Every aspect of financial reporting reserving is regulated down to the smallest detail. The regulatory philosophy appears to be: define to the 'nth degree and go away. And if you find something wrong, don't tell us about it. Because we won't change it. We've written it all down, it's all cast in stone, and that's it. The primary goal of the regulation appears to be to get identical calculation from every company for a product. And so that means they define exactly what to do for every aspect. And sometimes various inconsistencies appear where a benefit on one coverage would be reserved one way, while that same benefit on another coverage would be reserved differently. And the reason would be that somebody left out a piece of the formula in the regulation. And so you have incorrect reserves from actuarial perspective, but when the companies are asked about this they say they are not going to try and get it changed. Please don't ask us to do that. We know it's there.

The most interesting item they have in line with their regulatory philosophy is that they are now putting in asset liability matching into the regulations. So the regulations define specifically how you will do asset liability matching. So much for the valuation actuary concept in Chile.

All of the accounting statements are expressed in terms of both unit funds and currency equivalents, which is an interesting switch since you see both the dollar amounts and the unit amounts in the financial statements. Again, statutory basis financial statements are the primary financial statements prepared. And in the financial reporting area, you see some of the similar items where the regulations have gotten overly specific. And a lot of the regulations dealing with the older products do not deal appropriately with the newer products: the interest-sensitive type products and the annuity products. And it's a big question at this point of what's going to happen in the next couple of years, with the regulatory environment of Chile: Are these regulations going to collapse under their own weight as these new products start coming on the line and building up?

Rob was making a comment about the banks and insurance companies being a lot more interconnected outside of the U.S. What we've seen in Chile, for example, is that the government has been talking to the banks about taking equity positions in some of these

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insurance companies for forgiveness of the loans that were made to the government. So it's like, well, we've got this insurance company that went bankrupt. We'll trade you an insurance company for the loan that we owe which is one way of banks getting into insurance. They might want to think about trying that in the U.S. with all the insolvent insurance companies that various states are dealing with now.

To some, I think, like I said, it's very interesting to work with these different areas. I think you have to approach it with the right mind set, in terms of being flexible, being willing to sit down and listen and understand the various cultural differences, and the various problems that the actuaries and the insurance companies executives are facing in these countries. But if you take that time, if you do listen, and you do talk with them, I think you'll see that a lot of things are very similar. You can commiserate about a lot of the same problems that they are dealing with. And it can be a very rewarding and interesting experience.

MR. STEPHEN PAUL TAYLOR-GOOPY: You'll be able to tell from my accent and some of the strange words and phrases I'll be using later on in this talk that I'm an English actuary. I'm taking that as my qualification to talking to you about U.K. and Europe.

I am very well aware that the U.K. is part of Europe. Nevertheless, there are some significant differences between the insurance markets. I think it's actually worth talking about them separately.

In putting together this presentation, I asked myself the question as to why North American actuaries might be interested in financial reporting in the U.K. and Europe. And the first thought is maybe they wouldn't be. But I'm pleased to see that some of you have turned up. And so I can only assume that there is some interest.

Three particular reasons came to my mind, and I structured my talk from these three reasons. The first is that if any of you have to read and interpret the local financial statements produced by U.K. and continental European companies, and there are a number of reasons I can think of why you might have to do that -- an exhaustive treatment of this would actually take several days. So I'm just going to take up a few of the particularly striking differences between the European companies and U.S. companies in the financial statements they produce.

The second area is if you work for a company that has European subsidiaries, and you've ever tried to apply U.S. GAAP to the contracts that are written in these countries, you will note that there are some particular problems. This is an area that stirred up a lot of controversy in the U.K., especially with the introduction of FAS 97. There's been some particular problems in applying that to U.K. contracts, and I'll address that briefly.

And the third area that I want to talk about is in constructing internal management accounts and monitoring the progress of subsidiaries such as you may have in Europe. There are a number of particular problems in pulling together the financial statements, and the results of these companies. And I should be talking about why some of the

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obvious solutions don't work, and talking a little bit about other solutions that companies have developed with multinational corporations for monitoring their European subsidiaries.

The first topic is how to read local financial statements. It's a big subject. And again I just thought I'd run through some of the reasons why you might have to do this. I guess not many North American actuaries actually have to do this very often, unless they live in Europe. But there are some reasons why you may have to. The first one is for acquisition screening. The first thing you would do, apart from getting all the news about particular target companies, is to get hold of their accounts and try to get a feel for their profitability and the value of the company. I think anyone not familiar with the life insurance industry would think this is a very simple and straightforward task to get a feel for profitability and value of a company, just by looking at their accounts. I can assure you that this certainly isn't true. It wouldn't take me very long to demonstrate that, particularly outside North America, the accounts can be very misleading as to the true profitability and value of the company.

Another reason is if you have European subsidiaries, particularly ones that are growing rapidly and will be asking for capital. Then the capital needs are determined solely by the statutory accounts and the customs for drawing up the statutory accounts in each country. So those then are needs to project and do your business planning on the basis of the local statutory rules and regulations.

And the third reason that you may have to do this is if a subsidiary is thinking of raising local capital, or if you hope to invest in a subsidiary. Then the local banks and investment community are unlikely to be impressed with U.S. GAAP figures and are going to want to look at the local statutory figure.

In looking at the published financial statements of U.K. and continental European companies, the first feature that you'll notice is the complete lack of detail, although this does actually vary quite considerably among the 12 countries that form the European community.

In general, the amount of detail that's produced is closely tied in with the method of supervision and regulation of companies in each of the countries. I note two basic types. The first type is where companies are supervised with the supervisors looking solely at the accounts produced under normal company law. Now this used to be the case in most European countries. Part of that's declining. And more countries are now going for the second type, where there are special returns produced for the supervisory authorities. This is particularly true in the U.K., Ireland, and Germany.

Now the accounts produced under normal company law are surprisingly uninformative. You would usually get new business figures and total premiums sometimes split between single premium and annual premiums. You'll get a figure for the total actuarial reserves and a figure somewhere for the statutory surplus arising. Some of these will even have splits of assets by type. But you'll be lucky to get a lot more than that. It's pretty difficult, I'd say, to actually form any opinion as to how much a company's worth or how well it's doing.

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In the countries where companies must produce special returns to the supervisory authority, these accounts will always invariably produce much greater detail. In particular, it's probably worthwhile just considering these returns produced by U.K. companies in the departments of trade and industry. There's a wealth of information available, including full product description, specimens, surrender values, maturity values of maturing contracts and account surrender values. These new business figures split by product line, revenue premium, claims and expenses which have also split by product line. Also showing are gross revenue net of reinsurance by product class; actuarial reserves by product line; the full description of reserve, methodology, and bases. This is something that you may not realize is important, but I'll come to that later.

Also, you will find full schedules full of the different asset types and the various yields on the assets held by the insurance companies.

Even given all this information, it's still a nontrivial exercise, actually trying to get some basic pieces of information that you would like to have in assessing the strength and profitability of a company. For example, expenses are split by acquisition expenses and renewal expenses. That's a pretty unreliable split. And it's a nontrivial exercise trying to get a policy's expense levels.

Even where you have special returns to the supervisory authorities, that's not always as helpful as you might think. For example, in Germany, the returns are very detailed and give a good picture of profitability even by product line. However these returns are confidential to the companies and the federal supervisory authority for insurance companies, the Bundesaufsichtsamt Für das Versicherungswesen (BAV). You cannot get hold of them. So you are no further forward. You are just left with the accounts produced under company law which are particularly uninformative.

One point that I want to bring out, which I hope has come out already, is that the European community is not one nation. It's consists of 12 sovereign states, each with it's own laws and customs. And even more than 12 languages.

You may well have heard about the pressure there is to develop a single market in goods and services in the European community. This is actually a particularly long way off in the insurance market. And this is mainly because of the separate taxation and regulation systems in each of the countries. It will be quite a few years before these are harmonized. And if anything, some countries are going in the opposite direction away from harmonization at the moment.

Just to give you a flavor of the diversity, I picked two of the countries which are on opposite extremes of the spectrum: U.K. and Germany. And I'll pull out a few of the features of those particular countries.

Now as Rob said in his introduction, in the U.K. there is a very strong free market ethic, probably a lot stronger since Margaret Thatcher has been Prime Minister than it was before. In some ways that is good, and in some ways bad. There is no regulation governing product design and particularly no specified surrender values to cash value. In general the market has been very innovative and has produced a very wide range of

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product designs, some of which have stood the test of time and some of which have failed. But in a competitive economy, these are constantly changing. And this has led to some very highly developed product designs.

Some of you who know about the financial services act in the U.K. may think that the custom of having very little regulation is changing rapidly. But this is still true in a lot of areas. The wide product innovation has, in general, led to very competitive premiums and good value for the customers, while still allowing a very good level of profitability for the U.K. insurance industry. This naturally varies considerably among companies. The very best companies are very profitable. Those that are recently entered, or working at the fringe, naturally, as you'd expect, are not as profitable. But in general, the market is a profitable one strictly compared with the U.S. market.

Another feature of the U.K. market is the very high proportion of equity investments in which U.K. companies invest. For some parts of their business, companies will have up to 100% equity backing for their participating liabilities. Naturally they can only do that if they have a very strong surplus position, as otherwise they would be insolvent on the downward fluctuations and capital values. But also, the U.K. product design is one where a lot of the risk is actually passed to the consumer, particularly the investment risk. Examples are unit-linked or variable contracts or participating contracts which have a high terminal bonus content that isn't determined until contracts get off the book. This allows a very wide-ranging investment policy. In general, that has produced very good returns for the U.K. consumers.

Moving across to the other end of the spectrum in the European community, I've singled out Germany, where in fact the regulation of the market is very tight. Premium rates, product design, even policy wording are laid down by the BAV. It is very difficult to introduce new product designs. It takes a long time. There's one company in particular that has entered the market with a strategy of product innovation. In general, they found that it takes about two years to get each product through the regulatory mill, by which time many of the competitors have often found out about the product design and have already been in position to copy it.

It is still a highly competitive market, but the competition is entirely restricted to bonus rates, as premium rates are by and large entirely uniform. And that is just one point which I'll come back to later which is that all contracts are participating in Germany.

Now it's important, I think, to understand the differences between these different markets if you are trying to interpret and read the financial statements of the companies in these countries. I'll just pick up a few more specific issues relating to the financial reporting.

In the U.K. first of all, I mentioned earlier that the returns include a full description of the actuarial reserving basis. You may wonder why that is. And that is because the reserve basis used is entirely at the discretion of the appointed actuary, of which, each company must have one. Now I say entirely at the discretion. But there is, of course, a legal, minimum reserve basis. Many companies will not necessarily follow that. They

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would prefer to allow the surplus to emerge in whatever fashion they desire, and control that, by using reserve bases often stronger than their legal minimum.

This means that if you look at the surplus position of two companies, which are apparently similar, they can, in fact, have very different financial strengths, if one has a substantially stronger reserve basis. Another thing that often confuses foreigners looking at the accounts of U.K. companies is the fund structure. Particularly for participating business, all cash flows by law have to be accounted through what is called the long-term fund, which is legally separate from the shareholders fund. And the shareholder may only be entitled to, for example, 10% of any surplus arising in the long-term fund. There are legal constraints on when cash can be transferred to the shareholders. More than one firm purchaser has been disappointed after acquiring a company which apparently has very large levels of surplus in there, only to find out that the shareholder's interest in that surplus is only 10%; and an indirect interest at that.

Another difference is the imputation tax system. U.K. companies are by and large taxed on investment income minus expenses, not on profits. That is charged to the policyholders so effectively the tax can be paid by the policyholders. And if enough tax has been paid on what is called the I minus E System, then there's no further tax to be paid and profits can be withdrawn tax free. So in valuing businesses in the U.K., there's a strict procedure that has to followed. You have to look at projections of after-tax earnings, and then gross up to get a pretax figure. Nothing else makes sense. Otherwise you'll be mixing policyholders tax and shareholders tax.

Picking up a few similar characteristics of German insurance companies, as I said, these are the other extreme. In general, the other 10 countries in the European community are somewhere in between. Ranging from countries like the Netherlands and Ireland which tend to be closer to the U.K. model, to the Germanic countries like Austria and Germany which are obviously much closer to the German model. Latin countries come somewhere in between.

Particular features that you get in Germany are a fixed reserve basis. This includes interest basis of 3.5% and modified net premium reserves with a Zilmer or initial expense adjustment.

However, an interesting feature that must be noted is that negative reserves are allowed. You won't see them on the liability side, they come across to the asset side of the balance sheet. And they're treated as what is known as a class three asset. You might think that this can actively give you a better picture, better comparability between companies as to how strong they are. But you'd be wrong there. The asset side of the balance sheet is conducted at cost. Unrealized gains are not shown anywhere. There's a particular reason why that happens. In general, German insurance companies are taxed on the disclosed profits based on assets held at the cost. And so, profits can be easily manipulated by realizing gains whenever required. And companies naturally disclosed as small a surplus as is required to pay policyholder benefits and profits to shareholders without incurring any unnecessary tax. Some German companies, I think as was alluded to earlier as in the case in Japan, have extremely strong inner reserves based on the appreciation of assets over the cost value.

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In general, there is very little disclosure in published accounts. One major source of profits in Germany is reinsurance profits. And if you don't have that information, your picture of the profitability of the company is very incomplete. As I said earlier, no market value of assets. As for the U.K. participating companies, one important point that you have to bear in mind is that all German contracts must by law be participating contracts. The participation rules are very severe as to exactly how much profit must be returned to policyholders in the form of bonuses, dividends.

By law at least 90% of all profits have to go back. In practice, for competitive reasons, about 97-98% of all statutory profits are returned to policyholders.

Now that is just a flavor of some of the differences between financial reports of companies in the European Community (EC). The main impression that I'd like to leave you with is that there is a very wide variation. If for whatever reason, you have to interpret the financial statements, I advise you very strongly to get to know the particular rules and nuances of any one country. And get to know the nuances and rules that affect these.

Some of you may be a bit surprised at what I've been saying, and you may have heard of the single European Act. This is the act which is supposedly bringing the whole of the European countries towards a single market in goods and services. And there's no doubt that some very substantial changes are happening.

There is a law for the insurance accounts director. And the intention of that is there will be uniform standards for layouts of all accounts produced by insurance companies by January 1, 1993. You may have heard a lot of talk about 1992. The year 1992 is actually taking place in 1993 which is something of a European quirk.

These accounts are very descriptive and a lot of detail is required. In particular, one thing that we don't have at the moment is that all of us will be required to sign a true and fair certificate stating that both the balance sheet and the profit and loss account are true and fair -- whatever that means. Insurance companies are usually exempted from that requirement.

Now that sounds fine, but in practice, what's happening is that there's a framework laid down, which applies to the whole European community; and regulations as to how that framework will be applied in each country are being drafted by each individual country. So, in fact, we have 12 interpretations of the uniform standard. For example, let me tell you some of the things that are happening. The Germans are negotiating very hard to retain their booking of assets at cost, and they are resisting disclosure of market values. This is probably for tax reasons. On the other hand, at the other end of the extreme, the U.K. companies are very concerned about possible takeovers. There's very little protection in the U.K. market, and the U.K. companies want to give fuller information to their shareholder as to their true value.

So we have a draft directive, which is currently bouncing around among the member states, the European Parliament and the European Commission. And the likely result is either that the law will be late, or that we'll end up with a compromise, which will result

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in bad law and the accounts may not be much more helpful than we have at the moment.

I referred just now to the fact there's very little protectionism in the U.K. market against takeover by foreign companies. This has led to a great deal of concern amongst U.K. companies. One of their responses has been to try to give fuller information about their value to their shareholders. A number of companies are now using what I'll refer to as embedded values in their accounts. This is very similar to doing a purchase GAAP exercise over a year and placing the value of business in force on the balance sheet.

There are about 20 companies producing their accounts in this fashion already, and the number is increasing very rapidly. A very large proportion of companies are actually doing this with their internal management accounts, and many are considering publishing. But for now they just want to shadow it for a few years first, find out how the system works, and get the wrinkles out.

A number of companies actually put the change in the value of inforce business through the profit and loss accounts as an unrealized gain. And they feel that gives a much fairer impression of the economic value of part of the company -- excluding any value of future business. And that way the company is actually adding value by its current actions. Now there's a large amount of disagreement in the industry currently as to whether this is a proper accounting standard, and many accountants actually have fundamental objections to the system, not the least of which is the use of a risk discount grade, which is said to have no parallel in any other industry or any other accounting system.

There are numerous working parties trying to reconcile the differences between the accountants and the actuaries at the moment. It looks as if we'll end up with a system of U.K. GAAP, which is very different from U.S. GAAP, much closer to the Canadian line. The system will employ much more realistic valuation methods, and more realistic determination of surplus. But there's still some way to go before those are fully developed. And sorry to say this, Robert, but we have to have some reservations about the Canadian system as well.

The second part of my talk is applying U.S. GAAP to U.K. and Continental European contracts. Now the rules were certainly not designed for the European contracts. You may wonder whether they were designed for the U.S. contracts or not? I assume they were. We certainly had -- I don't know if fun is the right word -- but certainly a lot of difficulty in developing ways to fit the U.K. contracts to the rules. Or maybe we've been trying to fit the rules to the U.K. contracts. I'm not sure which.

A few specific issues that have arisen. First is the equity investment in the customer in the U.K. market which, as I said earlier, is a participating business almost 100% backed by equity if sufficient surplus is there to provide smoothing reserves or smoothing capital value movements. This gives rise to a lot of volatility and also means a large part of the expected return comes through unrealized gains.

Then applying U.S. GAAP, what you get is very large losses above the line and large gains below the line. I remember talking to one client in the U.K., where almost every

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year when they submitted their returns, the comment came back from their U.S. parents that, don't know how you do it, but every time you guys screw up there, your investment department seems to bail you out. It is not easy to communicate.

Another problem is that it's customary not to hold bonds, or gilt-edge investments as we call them, to maturity, but to trade them actively. And this again causes considerable complications in holding assets at amortized book value.

The participating business also causes problems in applying U.S. GAAP. This particularly causes trouble in the U.K., Germany, and France. And this is exacerbated by the problems with unrealized gains, particularly where you're investing in a lot of equities. Also, there is a problem with the fund structure. The fact that of any gains made, only 10% accrues to the shareholders, causes some fairly difficult engineering to be done with the balance sheet to actually show what the shareholders' interest in the company is under GAAP.

Coming down to unit-linked products, which Rob referred to in his introduction, I believe that product was actually invented in the U.K. by South Africans, which perhaps squares the circle. This unit-linked business or variable business comes under the definition of universal life business, with cost accounting standards defined by FAS 97. And that in itself causes great problems for U.K. companies trying to implement FAS 97. To understand why, you just have to look briefly at the design of the U.K. contracts. The product design has developed pretty rapidly over the last 15 years. And the companies have managed to get away with a design which in fact offers very little risk to the shareholders after an initial period, usually two or sometimes three years. Most of the risk is passed to the consumer. If maintenance expenses rise after the third year, then deductions made from the policyholders' funds are increased. If mortality is bad, then again, deductions are made from the policyholders' funds. And they follow the actual experience so that the shareholders don't suffer. If the investments perform well, then surrender value and maturity value rise. If they perform badly, again the policyholder suffers. And the company takes very little risk. The profit signature picture there is not the most modern design. Some companies have gone to the extreme of taking almost no profit out of the contract after about the third year. So the statutory profits signature shows a large loss in year one, with initial commission and initial expenses, which is recouped through high charges over the first two years. And thereafter there is very little profit.

There has been a lot of controversy as to how to apply FAS 97 since there are several possible interpretations. But the one that appears most likely to be accepted is the most conservative on the profit signature. Front end fees are deferred, which means that no profit comes through in the first two years where all the statutory profit would come. And because the first year was the matter of an acquisition expense and a front end fee, we're just left with the small amount of nondeferrable acquisition expenses coming through in the first year with the profits being inflated further down the track. This is causing some difficulties and making life somewhat difficult for our companies with ambitious growth plans when they submit their business plans to their parents. All the new business shows no profit in the first two years, and in fact, there are losses. And it's

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not generally been well received. It's generally thought to be particularly difficult for monitoring the progress of a business.

Which brings me to my final subject, which is how to pull these together and how to get management information. If you're sitting in a multinational company, trying to keep track of subsidiaries all over the world, and particularly in Europe, there are actually very real problems in monitoring the performance and determining which companies are not performing well at an early enough stage so as to be able to intervene and do something about it.

The first problem is that "statutory" has a different definition all over Europe. So what is statutory? It's not comparable. And I think we probably all agree that statutory accounts aren't a good basis for monitoring performance in any case. Although, naturally, you have to monitor statutory as well for determining capital needs.

U.S. GAAP also was not designed for European contracts and it's generally thought that it does not work well. So although U.S. GAAP is a single system that can be applied to subsidiaries in many different countries, the general feeling of people that I talked to in Europe is that it's not a useful tool for monitoring performance.

Now, in response, companies have designed their own systems of ways of tracking performance. First of all, they would look for monitoring the value of their subsidiaries to the shareholder. And value there is defined as the present value of distributable surplus. And that's basically what the shareholder is interested in, is getting cash out the companies. So first of all it wants to see distributable surplus coming out. And the value of the company looking at the inforce business only is the present value of those distributable surpluses.

They particularly want to focus on the value of the new business. Whether new business is actually adding value or not is very important in a exit/entry decision for any particular product line.

Now setting up a management information system gives you a lot of freedom, because basically there are no rules. On the other hand, you want to make sure that it's being rigorously and consistently applied, particularly in some of your more far-flung subsidiaries.

The solution that comes up is to look directly at the value added, or value added earnings as so defined. As I said, this is the embedded value system, whereby the value added earnings are defined to be the statutory profit plus the increase in value of inforce business, measured by taking the present value of future distributable statutory earnings.

To do that, the value of the inforce business is calculated at each year end, very similar to a purchase GAAP exercise. But to be useful this has to be done by using a consistent basis at each year end, and calculating the value by objectively derived assumptions. If we do this, then we end up with earnings which have the following components. First of all, because the value of inforce business is a discounted calculation, it earns interest.

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But also, if new business has a present value of future profits greater than their outset, then it adds value to the sum.

Finally, there's another component of these profits which occurs if the value of inforce business is calculated using assumptions and these do not turn out in practice.

If we have business that generates a high statutory strain in year one, but the contract is actually profitable, then a high volume of new business contributes to the statutory loss, which is outweighed by the increase in the value of inforce business. Once the statutory loss is out of the way, if the contracts are not profitable, i.e., if they don't meet the target profit requirements, as measured by discounting distributable surpluses, then the initial statutory strain is not outweighed by the increase in the value of inforce business. And so by adding the two components together, you can actually monitor whether the new business is adding value or not.

Now again, coming back to the components of the profits, just calculating a single number each year does not in itself provide particularly helpful results unless you can also provide supporting analysis to show where the increase in value is coming from, or where it's going to. It's not increasing the way it should be, if, and I've simplified this analysis a little bit, it includes any changes in value coming from changes of basis for calculating the value of inforce, capital injections, or dividends taken out of the company.

To provide particularly useful management information, you would want to focus on the value added by new business, calculated by product line separately, so that you can actually make meaningful decisions on exit/entry decisions for particular product lines. You would also want to know whether new business is achieving your goal for profitability targets. It also helps you identify areas for action. Also, the variance analysis gives you a self-checking mechanism for whether your assumptions are actually accurate, and also whether your calculation method is accurate. So by analyzing out exactly where these miscellaneous profits are coming from, you can tell what the true experience of your business is and whether your assumptions are correct in the first place or if they need to be modified.

It's also important for management purposes that assumptions should only be changed at and when they're indicated by and fully supported by proper variance analysis. Now that's a quick count around financial reporting developed in the months ahead in Europe.

MR. SMITHEN: I'll talk on our Pacific-Asia operation. I'll be talking about Manufacturers Life's operations, because that's the one I'm familiar with.

After that we'll open it up to questions to any of our panelists on any of the territories we've talked about or any territory we haven't talked about.

I should tell you I'm here under somewhat false pretenses. I'm the chief actuary of the company, but all of our foreign operations are very highly decentralized. And virtually

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all compliance and government relations are handled locally. I have tried to ensure that what I'm telling you is accurate by passing the comments off to our Pacific-Asia operation.

To set a little context for our own experience in Pacific-Asia in the Far East, we started off in Pacific-Asia in 1897, so we've been there a long time. We set up offices in Shanghai, Peking, Hong Kong, Japan, and India. We were successful in most of these ventures, but political events overtook us in several of the forays and we're not in many of those locales anymore.

We operate very successful operations in Hong Kong and Indonesia, somewhat less so in Philippines and a little less than that in Singapore. And probably our success follows exactly inversely to the extent of the amount of regulation by the government, i.e., the more regulation, the less successful we are and also our policyholders are. I think that's come through in what you heard from the last two speakers.

We have recently received approval to write insurance business in South Korea. We are the first non-U.S. foreign company to be so licensed, and we expect to begin writing business by the end of this year. We're trying to get a license in Taiwan, which for a Canadian company is very, very difficult, because Canada recognized communist China very early, and the Taiwanese didn't like that very much. They have very long memories, so it's hard for us to get in there.

That's a very good example of the kind of problems you face in any of the foreign territories, specifically Pacific-Asia.

We're looking at a few other territories as well, perhaps Thailand. We're not going to enter Japan for some of the reasons you heard from Harry. It's a very difficult market to get into and right now we're not interested in Australia.

Historically the Far East has been an exciting and exotic locale for us. Underwriting risks in that part of the world are kind of unique. Way back in 1902, for example, the first smoking question was asked of a Toronto underwriter in a letter from Peking. And I'll quote from that letter. "Your question for my opinion of how much opium a Chinese man may smoke and yet be an acceptable risk is a difficult one. I don't consider 15-20 pipes of opium per day at all on the side of decided moderation." Danger has also been prevalent in the Far East and still can be. We have had branch managers captured by pirates, employees captured and imprisoned during the war, and other employees called up by local militia to quell street riots. However, the booming, capitalist nature of much of Pacific-Asia economies makes it a far less threatening and far more profitable area of insurance opportunity for us and also our policyholders. I think they get good value out of most of the business we and our competitors sell in the region.

I'll run through some of the technical environment in the territories in which we operate, but I should say there isn't a lot. The countries generally have statutory income statements with perhaps a prescribed reserve basis, perhaps not. Certainly no GAAP statements unless it's required by a parent. Some discretion is allowed in certain territories on the part of the actuary and in others there is very high regulation.

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But I'll run through those fairly quickly and talk about the reporting and professional accountability. I'll also talk and give you an idea of some of the unique aspects of our operations in each territory and briefly talk about a case study of the process to get into a territory. I'll use Korea as an example, because that's the last one we've gone into.

First, our largest operation in that region is Hong Kong where we are the second leading life insurer in the territory, in terms of business income. Our total premium income is \$170 million Canadian or \$140 million U.S.

The free-wheeling, entrepreneurial spirit of Hong Kong, and it really is if you haven't been there, carries through to its regulatory environment. The insurance industry is rather loosely regulated by the insurance commissioner, a government-appointed civil servant. There are regulations but they're far from all encompassing. The annual financial reporting requirement for Hong Kong includes an audited balance sheet, a revenue account, and an annual valuation of the actuarial liability certified by a qualified actuary, which to Hong Kong means an actuary who has virtually any professional designation: U.K., U.S., Canada, Australia, etc. There are no actuarial bases mandated.

Note that the local filing may be exempt if the company is currently filing a Department of Trade and Industry (DTI) return in the U.K. Since we (Manufacturers) operate in the U.K., we file a DTI return so we don't even have to complete a local Hong Kong return. We just give them our DTI return. However, we just shut down our branch in the U.K. and we're hopeful they'll allow us to use our Canadian statement instead of the DTI statement. I am pretty sure they will. So there's a lot of flexibility by the Hong Kong regulators. I'm not aware of any U.S. company filing an NAIC statement, but they may be; I don't know.

Entry into Hong Kong used to be relatively straightforward as long as you could meet their \$3 million Hong Kong (U.S. \$600,000), a minimum surplus requirement, but not anymore. In general, Hong Kong regulations are starting to make it more difficult to get entry into the colony, and tighter regulation is anticipated. Also, the capitalization minimum is going to be increased. It's under review.

One important development in Hong Kong is the establishment of the Securities and Future commission -- the SEC of Hong Kong. It's taking on an active role in regulating investment-linked products, which is a small but growing market in Hong Kong. Perhaps because of the laissez-faire regulatory environment, Hong Kong's a booming insurance market. As is generally true in the region, the economy's booming, middle class is growing, local competition's less sophisticated than at home -- although getting better very quickly -- and life expectancy is at North American levels. These are the elements of a profitable insurance operation. Hong Kong is one territory where products of all kinds are sold: traditional par business, universal life, variable universal life. And both group pensions, surprisingly perhaps, and group life and health are offered quite a lot there.

Obviously the primary concern for anyone considering entry into Hong Kong is 1997. Hong Kong will be repatriated to China in that year. China has publicly stated they won't change the nature of Hong Kong for at least 50 years, but Hong Kong locals are

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skeptical to say the least. There's a continuing brain drain as professionals and entrepreneurs establish residency in other territories; notably Australia, Canada, and to some degree, the U.S.

Despite the threat of 1997, the economic boom in Hong Kong continues and more insurance companies are entering the market. Both because of its own potential and its proximity to China, we stay very bullish about Hong Kong. And in order to see if we are crazy or not, we've done some scenario testing to see our financial exposure to large-scale lapses, our new business slow down, etc., as 1997 approaches.

Anyone thinking of entering Hong Kong now should make sure they do such sensitivity testing. One important consideration is that there's no regulatory requirement for coverage of liabilities with local assets in Hong Kong, nor are there any exchange controls at all, which means seizure of assets is not a big concern. Our own coverage position is, I believe, 60% of Hong Kong liabilities are covered outside the territory, and that would be, I believe, typical.

Let me turn briefly to what for us is the next most exciting country in the region. And it might surprise you a bit. It's Indonesia. Indonesia is the fifth largest country by population in the world. And it's one of the most underinsured. With regard to the premium per capita spent on insurance in the world, Indonesia is the second lowest, just above China. So they really don't have a lot of insurance. It is a poor country. But it has a growing and prosperous middle and upper class. We entered Indonesia via a joint venture, which is the only way a foreigner can enter that territory, in 1985. Since then, growth rates have been unbelievable and we're confident we have put profitable business on the books.

In 1989 our new business written placed us second among local insurers and we expect to be number one within a couple of years. Most importantly with that kind of growth, statutory strain is very small and it's recovered within two years, much like the U.K. example. And so even with rapid growth rates, capital infusion is quite low.

There are 30 insurance companies operating in Indonesia, but only three of them are partly foreign owned which makes it an opportunity area for foreigners.

Financial reporting in Indonesia is more formalized than Hong Kong. Quarterly financial statements must be prepared and valuation methodology is prescribed. A modified net premium valuation basis is prescribed with a maximum allowance for initial expenses of 6% of the sum assured. Valuation assumptions are still at the discretion of the actuary who signs the reports. There's a minimum solvency margin based on paid-up capital or sum insured. There are variety of ministerial decrees and regulations laid down by the Minister of Finance governing a variety of issues. And a full insurance law is pending, although we should know that the word pending in Indonesia means anywhere from six months to 60 years.

I mentioned joint ventures because to get into Indonesia, you have to go in via a joint venture. Let me talk about joint ventures very briefly in general. Because in three of the five territories in which we operate, we are 50/50 or 60/40 partners with the local

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corporation. In Indonesia it's required, but in the other two territories we did it as a matter of choice. And I think it's something that should be considered very carefully if somebody wants to enter into a region like this. Should you go in on your own or should you find a partner?

There's only one key to having a successful partnership and it's having a partner who understands the nature of the life insurance business. That's not easy. And that means somebody who's not demanding instant pay back. You'll know if you're in a growing environment and you want to grow even with relatively low statutory strain you're not going to see recovery and profits coming out for a number of years. And it's hard to get manufacturers or small business men to think in those terms.

If you can get a partner with whom you're compatible, and one who understands the nature of the business, the partnership can be mutually supportive. One partner provides the cultural input, which is very important in these territories, and the access to government officials which is equally important, while the other provides the insurance expertise. We spend an awful lot of time selecting our partners in the various territories. They have various backgrounds. One's a bank, one's an industrial company. The Korean one's an industrial company. And Singapore's a bank and our Indonesian partner is a multibusiness conglomerate.

We've been very lucky in our partnerships and would, when practical, continue that avenue of entry into most other Far East territories. Now I know there are a couple of U.S. companies that have had or tried joint ventures in the Far East and found them unsustainable. In some cases, this was due to poor partner choice. In others, there's a local view that U.S. companies focus too much on the legal niceties causing unnecessary disputes with parties in an early stage. I don't know if that's the case or not.

I'll turn now to Singapore which is one of the two most highly regulated territories in the region. It really is interesting in such a region where the countries are relatively close together, they've developed quite differently from a regulatory point of view. And here it's a regulated country in general and the insurance industry is no exception. The insurance act is modeled generally on Australia's life insurance act, and is administered by the insurance commissioner under the powerful monetary authority of Singapore, the MAS. Annual statutory returns are fairly comprehensive and not dissimilar in content to North American statements. Quarterly balance sheets and reserve accounts must be filed.

There's a stringent minimum valuation basis and minimum surrender value basis as in the U.S. A qualified actuary defined as a U.K. or American or Canadian actuary must certify that reserves meet minimum standards.

Last month, the MAS issued regulation 306, which is about as all encompassing a piece of insurance legislation that we've ever had to cope with as a company. These are just examples of the kind of things they're making us change. It came almost out of the blue and it was much more all encompassing than we expected. That's the nature of the Singapore marketplace.

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On the investment side, assets must be invested locally and companies are required to have minimum Singapore \$5 million, which is about \$3 million U.S., plus a prescribed solvency margin. There are 14 companies currently operating in Singapore, nine of which are either wholly or partly foreign owned. Profit margins are very tight, and for all intents and purposes, the market's closed to new entrants.

What about Philippines? We operate in the Philippines through a branch operation, as we do in Hong Kong. Despite the branch nature of our business, we still must file a local Philippines audited financial statement, meaning the prescribed financial reporting of the insurance commissioner. We also have to file semiannual unaudited statements. The valuation bases are prescribed with standard mortality tables mandated at a maximum valuation interest rate of 6%. Local interest rates in the Philippines are currently around 15% and have been for a number of years.

Reserves must be certified by a qualified actuary which means in the Philippines, someone who's a Fellow of the actuarial society of the Philippines. So obviously the local consulting market does a good trade.

There is a minimum solvency margin in the Philippines, and rather unusually, the Philippines government regulators request an annual mortality study and persistency study. I've not seen that anywhere else. There's a requirement in the Philippines of 100% local coverage. And it's difficult, but not impossible, to extract expenses and/or profit from the region due to it's stringent currency controls. So we have been able to get money out but it's not that easy, and that's a real issue in these territories.

Doing business in the Philippines, and to some extent the other territories, brings to mind several of the risks companies face in operating in Pacific-Asia, and indeed a number of the territories we talked about, particularly the ones Harry talked about.

It's generally an area of tremendous opportunity for both growth and profit. Such opportunities don't come freely. Risks that we in North America aren't used to, including political instability, war, and currency controls are incurred. That is, you make money but you can't get it out of the country. And that's been a real problem historically for Manufacturers Life. Or currency depreciation, which means you make a profit but it isn't worth anything. Or sudden nationalism and anti-foreign laws, particularly taxation laws. You can get hit very hard from discriminatory laws and there's not much you can do about it.

One subject I'll cover briefly is the steps involved in entering a new territory. I'll use South Korea as an example, just because it's the most recent one we have done.

Many of the issues covered here are true of much of Pacific-Asia, although it is true that South Korea is much more like Singapore in it's regulatory environment, and a harder one to get into than some of the others.

First, and I think Harry mentioned this, patience and persistence are required. If you think you have trouble with your state insurance regulators, don't even think about applying in Pacific-Asia. In Korea the approval process is time consuming and

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bureaucratic. Many forms are required in both English and Korean. Typically the ministry of finance goes through the submission documents in some detail and requests changes. The process will likely take more than a year.

Often the government will slow down the process to ensure there's a real commitment on the part of the applicant. This is really important in several of the countries in the region. They want you to show that you're really there for the duration and you're not just a fly-by-nighter. And so they make you sweat it out a lot up front, which perhaps makes some sense.

It's important to understand that the role of the bureaucrat in Korea is a very important and powerful position. He's a revered person and he has to be treated with respect and admiration or you'll get nowhere.

In Korea there are four formal stages to regulatory approval. The first is the preliminary license application. Before it can be entertained, a variety of technical and legal documents must be completed. But by far the most important requirement is a five-year business plan, including a balance sheet and revenue account projection, sales forecast by product, expense plan, and personnel plan.

At the end of this, a preliminary license is issued. If you get this preliminary license, you're going to get into Korea. It's hard to get, but if you get it the other stages are more a matter of formality. A few months after the license you get legal incorporation followed in another few months by final license application. The later application must include an update of the business plan, plus product details, including premium rates, reserves, and cash values.

These must be certified by a qualified actuary which in Korea, like the Philippines, is someone who has passed the Korean actuarial exams. Again, a shortage of such people exists.

Innovation is not the watch word in Korean insurance circles, it's much more like Germany or Japan in this way. Its regulation hinders much creativity. Premium rates are fixed. New product approval is very slow unless the existing product gets copied. There are many investment restrictions. There are rules governing the recruitment of staff from other companies, etc. Aside from the difficult regulatory environment, the largest problem in getting started in Korea relates to the labor situation there and the cultural heritage. The Korean labor situation is unique to that country. It's heavily unionized, with extensive, strong staff power.

It is very easy to cause staff problems in Korea unless one treads very slowly, which we're currently trying to do. Two U.S. life companies and two experienced U.S. life companies have run into serious problems because of the labor situation in Korea recently. Their history should be studied by any company with an interest in the Korean market. Also, Korea has a unique and ancient culture, and anyone planning to do business there better remember it. There are a variety of local customs that are strange to foreigners. The challenge to expatriate management, and that's what we have put in place in Korea, as is the case in everywhere else we operate, is managing the life

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company without contravening Korean cultural norms. This is true anywhere internationally, but at least from our experience, it is so far most true in Korea.

Now the Korean life insurance industry is going through a period of truly remarkable change. I guess the whole country's going through that change. The number of companies has increased from 6-32 in four years. Eleven U.S. companies now operate in Korea, and some of these have very little international experience.

This combination of inexperience with the intrinsic difficulties of operating in that territory leads to an interesting and unpredictable situation. Experience, of course, is no guarantee. As I said, both U.S. companies that have had problems in the region are the most experienced of the lot.

In summary, Pacific-Asia has been for us, and we hope will continue to be, a terrific experience and a very exciting and profitable one for us and our policyholders. However, anyone who believes that all the countries in the region are alike, either culturally or legislatively, will make a serious mistake. You have on the one hand the extreme of Singapore and Korea, which are very highly regulated, and on the other hand you have Hong Kong, where almost anything goes.

I encourage companies to look carefully at opportunities in that area; in fact, in any of the regions we've talked about. It really does lead to greater knowledge and greater excitement in your company. I think it will be a rewarding experience for you and hopefully for your shareholders or policyholders.

If you have any questions, we'll be happy to answer any of them.

MR. BENJAMIN GEORGE PETERS: Our company is owned by a U.K. company, which is a little bit of the reverse of what we've talked about. Is there something you can give us to understand how they're going to react to us? Maybe the opposite way?

MR. TAYLOR-GOOPY: I think, in general, U.K. companies see the U.S. market as one that's cheap to get into at the moment. Prices for U.K. companies are very high. And a company that wants to expand internationally probably sees the U.S. as an area where prices for insurance companies are currently depressed and may improve. I don't know if that answers your question or whether you want me to look at other areas?

MR. PETERS: Well one of the new things for us to get used to is the embedded value concept. Of course, it's new to everybody in the U.S., but in particular at times it feels like it's being forced on us. And we don't always understand what it means when we send them an embedded value of 100 or whatever.

MR. TAYLOR-GOOPY: I think the first thing to realize is that your English lords and masters won't be looking at the embedded value per se but the increase in the embedded value. And that's seen as a much more responsive measure of performance, unlike U.S. capital revenues income which is spread over the life of the contracts. The embedded value is seen as a way of actually measuring what is going on in the particular year up against the shareholder's target for increasing the value of the company. So it's

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a fairly stringent measure of performance, particularly if it's applied very rigidly with audit considerations taken into account. Do you feel you are actually being scrutinized very closely and insensitively even?

MR. PETERS: To some extent, but we're learning and they're trying to understand our GAAP. So it's a mutual misunderstanding.

MR. MILLER: One of the clients we work with is in very much the same boat as you. The client is owned by a U.K. parent and what we've seen as the biggest problem is just the communication problem. Send me some embedded values. What's an embedded value? How do you want me to do that? We're going to do it one way. We're going to do it the way we would normally do it in the U.S.. We'll change assumptions from year to year because we think assumptions should change because of additional experience studies we've done or because our systems have gotten better. We've gotten better information and the U.K. parent comes back and says, what's going on? Why are these changing? So it's a lot of the communication. Going back and explaining what's going on. Sitting down and talking with them. Explaining the U.S. GAAP with them, deferred taxes. What are deferred taxes? It's very different.

MR. TAYLOR-GOOPY: I think the point about assumption changes is interesting. I can imagine that some people might be suspicious of seeing assumption changes coming across the water. But, in fact, understanding how the environment is changing is a very valuable part of the process. I've always maintained it is very important to actually do the variance analysis and see exactly how experience has turned out against the assumptions. And if it's moving away from the assumptions, then there's perfectly good grounds for an assumption change.

I think perhaps one thing that it's important to understand in the U.K. is particularly that quoted stock companies are feeling very much under threat of a pro-industry takeover at the moment, especially after one particular incident late last year when Pearl, a very old, established insurer in the U.K., was acquired by A&P in a hostile manner. All the other quoted companies are feeling very much under threat. And they're probably putting a lot of pressure on you to get this information out for that very reason.

MR. MILLER: Now Steve, in the U.K., aren't there strict time limits in which a company that receives a takeover bid has to respond?

MR. TAYLOR-GOOPY: That's correct. Any attempt to take over has to be managed within the timetable and the limits set down by the takeover panel. And these are fairly restrictive as to exactly what statements the company can put out in response and what they can't. And particularly, as you say, there's a very strict timetable that has to be followed. If the bid isn't successful within a certain period, it has to lapse and then there's another year before the company can come back and make another bid.

MR. MILLER: Has this sort of thing been in the background for their push toward the embedded value? Has this been part of the reason why they've been moving toward this in the financial statements?

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MR. TAYLOR-GOOBY: I think it is the main reason why there is a move towards embedded value in financial statements. Not necessarily the timetable involved in a bid, but just the fact that companies have felt that their stockholders don't appreciate their true values. There is no GAAP in the U.K. and typically statutory statements show very small earnings whereas the companies trade on very high values compared with statutory earnings. There've been cases where companies traded on multiples of 40-50 times statutory earnings. Now in that case it was probably a very high price and probably unjustified. But even so, appraisals generally do come up with very high multiples. And there's a feeling of frustration on the parts of the management that there's no good mechanism to communicate with the shareholders and actually show what a good job they think they're doing.

MR. MILLER: Now for the \$64 question. What about Eastern Europe? What's going on there? What do you see? What's the possible regulatory model that's going to develop? Will it be the U.K. or the German model?

MR. TAYLOR-GOOBY: Well I think before we can even imagine the U.K. model extending to eastern Europe, we'd have to work out whether the U.K. model's going to be adopted in western Europe. And there's a lot of controversy going on at the moment. Lot's of battles between the various factions. The U.K. and Ireland generally support the U.K. model. The Germans prefer the more tightly regulated model. And I guess you've got the Netherlands lining up on the U.K. side.

France, Italy, and Spain are somewhere in between and probably undecided. Currently these countries have the more tightly regulated or they would say, more orderly markets. But they appreciate the benefits of free competition more, and generally there is a trend towards opening up. But it's still not clear which model will win the day by January 1, 1993. And as I said, I guess we'll probably end up with some sort of compromise.

Moving over to eastern Europe, there the market is very different. In general, there are much lower levels of wealth around. And the insurance markets are generally far less well developed and often nationalized. Some companies have already made very big strides in trying to get a foothold in the eastern European markets. But it seems to most that there's really not much to go for there. There's no infrastructure built up. And really it's going to be several years before these economies begin to develop.

MR. KENNETH FAIG: I was wondering how important, or how much time might be spent in contemplating mechanisms for disengagement in the event that a foreign enterprise proved to be unsuccessful? In my own experience, I worked for a company which was licensed in Hong Kong in the late 1960s. And through the efforts of one of our agents, the business gradually wound down, and by the 1980s we found that the authorities there wished to tax the company on it's worldwide profits based on the very few policies remaining in force.

MR. SMITHEN: Well in the region of Pacific-Asia we've been fortunate not to have to spend a lot of time worrying about disengaging because it's been successful. But just this week we sold our Caribbean operation which was one of our territories. We're in five

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countries in the Caribbean. It was one where we didn't see any future, and we had a lot of concern about whether we could run a profitable operation and give good value to the policyholders. So we sold it. In many of the territories, we've been kicked out because we were a foreigner. They don't want foreigners in certain countries. But in this case we decided to make a decision based on the economics. And in a territory like that where we were such a significant player in some of those islands, it's a very gut wrenching, emotional decision. And I guess to answer your question, it takes a lot of time and a lot of thought and a lot of sweat by a lot of people, even for something that small. Especially since we were a big part of a small territory. Now in your case you probably weren't, I don't know in Hong Kong. But in our case, at least in the Caribbean we were.

We decided if we could get a value of X we would leave the territory and we happened to get approached at the same time, actually we got approached initially. And we decided to get out. I don't know if I can say much more on it. Often political issues take over. For example, we were in Cuba when Castro took over. And you're out, that's the way it is. You're out and your assets are seized. We've had a number of examples like that. Very few examples where we've actually decided to withdraw from the territory.

MR. BARTHUS PRIEN: I'm interested in your activities in mainland China. How big a market do you have? And what kind of products do you sell?

MR. SMITHEN: If I gave the impression we're operating in mainland China, I gave the wrong impression. We certainly are not.

MR. PRIEN: I thought you said Taiwan.

MR. SMITHEN: That's right I said Taiwan. We were in Shanghai and Peking many, many years ago. But as political events unraveled we got out, before the war. However, we have relations with the, I can't remember what it's called, I think the People's Insurance Company of China, I think that's what it's called. They've in fact sent a delegation over to Manufacturers Life last year. It's one of the more interesting times that I had.

The Chinese sat on one side of a desk and we were on another, making presentations about what it's like to operate in Canada, and how we deal with the regulators. And they had one person representing the delegation. And he has about six people with him, every one of them copying every word down that we said. It was just a fascinating experience. Very different. And I can see it's going to be a very long process for us, for both sides to get comfortable with each other. But we have had dealings. And generally what you do is you try to talk to the government about how you can help them in certain areas. Like computer expertise or something like that. And we are trying to do that. We're not alone. A number of other companies are trying to do that.

In terms of whether that will lead to ability to sell insurance in their territory I really don't know. And there's certainly nothing in the near future for us or any other company.