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"FAIR VALUE" FINANCIAL REPORTING

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Panelists: JAMES E. HOHMANN
RICHARD S. ROBERTSON
MARK WESTON*
Recorder: DOUGLAS G. WOLFF

- FASB activities
- American Academy of Actuaries response
- Alternative approaches to the "fair value" of liabilities

MR. J. PETER DURAN: Mark Weston is a CPA and a partner in the Boston office of Ernst & Young. He has responsibility for a broad spectrum of clients in the financial services and insurance industries. He also serves as a consultant to the ACLI and is involved in advising senior insurance executives on practical implications of critical industry issues such as market-value accounting.

From 1989 to 1992, Mark served in the national accounting office of Ernst & Young. While in that role, he specialized in financial services and insurance and business combination matters. He was a member of several AICPA and FASB emerging issues task force working groups, including the NAIC Marketable Securities Task Force and Emerging Issues Task Force working groups on accounting for collateralized mortgage obligations, planned sales of acquired operating assets, business combinations and present value, and future profits resulting from the acquisition of a life insurance company.

From 1981 to 1983, he was a practice fellow at the FASB, so he brings that special perspective to the presentation. Mark is a graduate of the University of Illinois, with a degree in accounting, a member of the AICPA, and a member of several CPA societies. Mark will speak on the new FASB Pronouncement *SFAS 115*, "Accounting for Certain Investments in Debt and Equity Securities."

Jim Hohmann is a principal in the life practice of Tillinghast's Chicago office. He's been with Tillinghast since 1986, specializing in the life and annuity area, with particular emphasis on financial reporting, appraisals, and asset/liability management.

Jim's project experience at Tillinghast includes comprehensive business modeling, profit studies, financial reporting systems development, and asset/liability analysis. He has more than 14 years of experience in the insurance industry. Prior to joining Tillinghast, Jim was an actuarial consultant with a major CPA firm. Jim is a Fellow of the Society of Actuaries and a Member of the American Academy of Actuaries. He is currently a member of the Academy's Committee on Life Insurance Financial Reporting. He graduated from Northwestern University and holds an MBA from the University of Chicago. Jim will speak on the activities of the American Academy of Actuaries COLIFR and on general principles in the area of fair-value accounting.

- * Mr. Weston, not a member of the sponsoring organizations, is a CPA and Audit Partner of Ernst & Young in Boston, Massachusetts.

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Dick Robertson is executive vice president at Lincoln National. His responsibilities include risk control, asset/liability management, investor relations, and corporate actuarial.

He began his career with Lincoln National in 1963. He served as chief reinsurance actuary from 1966 to 1974, and as chief financial officer of Lincoln National Corporation from 1974 to 1992.

Besides his company responsibilities, Dick has taken an active role in the development of insurance accounting and tax issues. He is a former member of the Financial Accounting Standards Advisory Committee and has been a leader in the development of standards for measuring and managing life insurance surplus. He's a Fellow of the Society of Actuaries and was President of the Society of Actuaries from 1985 to 1986. He is chairperson of the Society's Committee on Complaints and Discipline.

Dick is going to be speaking about Lincoln National's view of the developments in the area of "fair-value" accounting. He will also talk about some of the potential methods for evaluating liabilities on a fair-value basis, which is a subject, of course, of great interest to us actuaries.

MR. MARK WESTON: I think everybody's interest in market-value accounting has been heightened during the last year or two. Certainly everyone has a certain amount of nervous anticipation on seeing the latest Brown Book. Have you all seen it yet? It just came out. It carries a May date but is really just getting distributed now to most people. It's a fairly lengthy document. We have all probably seen some various exposure drafts or preballot drafts, and some substantial changes came through in the final statement. Overall, the FASB's objective was to improve the financial reporting, and to some extent it has done that. Although there are also some interesting and challenging aspects of it that are going to cause us many headaches. Perhaps the most troublesome one, and we'll talk about it later, is the idea that it really doesn't address liabilities. That is of great concern to most people, because the issues of market-value accounting really get to the heart of the way that insurance companies manage their assets and liabilities. By just addressing the asset side, some problems are created. *SFAS 115* addresses the accounting and reporting for investments, securities, and equity securities. *SFAS 12*, "Accounting for Certain Marketable Securities," previously addressed those assets that have readily determinable fair values and all investments in debt securities. It's not really addressing loans. *SFAS 114*, which came out at the same time, talks about loan impairment, and you need to take a look at that as well.

Essentially, *SFAS 115* in broad conceptual terms requires three categories. There is a "held-to-maturity," a "trading," and an "available-for-sale" category. This varies from the old *SFAS 60*-type approach, where you had the "held-for-investment" and the "trading" categories. Very few people had trading securities, so everything, almost by default, went into the "held-for-investment" category.

Approximately a-year-and-a-half ago, the SEC really got into the act by reviewing what insurance companies were doing. In large part, this followed what happened in the savings and loan banking industry. The SEC started to challenge registrants' practices, and it said that if companies had portfolio turnover rates in excess of 10%

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or 20%, how could they really be holding things for investments or until maturity? Unfortunately, when you go back and look at some of the literature that was out there for investments among the various industries, it wasn't always consistent. For example, a guide for the savings and loans said that for the held-for-investment category, an asset was to be held for the foreseeable future. Others talked about long term, but *SFAS 60* for insurance companies said "held until maturity."

Walter Shuts, the new chief accountant, saw high-portfolio turnover rates and realized that something was being sold that was not "to maturity." This helped the SEC because it was saying that it wasn't really introducing new accounting rules; it was enforcing existing accounting rules. Practice was such, however, that if companies didn't really have the intent to sell something in the foreseeable future or long term, they left it in the held-for-investment category.

The SEC started to beat on registrants on a case-by-case basis, allowing them to move something over into the available-for-sale category. But it let people use an aggregate approach by using a lower-of-cost or market-type valuation. Most people were in a net appreciation status when that happened, so it wound up just being a balance-sheet reclassification without any real impact on the surplus.

During this whole time period, the SEC has been moving toward an approach similar to *SFAS 115*. This was clever, because it started moving some of the larger insurance companies, so that it would be harder to argue that *SFAS 115* didn't make sense when some very large insurance companies were already following some of the practices of *SFAS 115*.

There are a few things that *SFAS 115* doesn't apply to, such as securitized loans. But mortgage loans converted to mortgage-backed securities are subject to the provisions. *SFAS 115* supersedes *SFAS 12* on accounting for the equity securities. It also amends *SFAS 65* for the mortgage banking activities, and it's effective for fiscal years beginning after December 15, 1993. I'll be talking about transition provisions a little later. But, essentially, it hits most people in 1994.

Going back to May 1986, the FASB added a project to reexamine accounting for financial instruments. This was going to have several phases to it. The FASB was going to use a building-block approach to accounting for financial instruments. These things get very complex and they have various elements. The FASB was going to try to break them down into building blocks, and if a new type of security came out, you might take blocks A and C and D, put it together, and that's how you would account for it. The next one might use B and F, and that would be how you would account for it. This was a very complex project. But along the way, it was first going to look at some of the disclosures. Many of you have probably seen or dealt with *SFAS 105* on disclosures of information about financial instruments with off-balance-sheet risk. Then *SFAS 107*, "Disclosures about Fair Value of Financial Instruments," was issued in December 1991. The issuance of *SFAS 107* ended the disclosure aspects of the FASB's project.

In September 1992, the FASB released an exposure draft on accounting for investments on equity securities. In December 1992 and January 1993, the FASB had three sets of public hearings on this. I think the FASB received more than 600

comment letters on this project. I can tell you from my experiences at the FASB, that is a tremendous amount of comment letters. Somewhere up to, I guess, 75,000 copies of an exposure draft can go out. And often you might get only about 150 comment letters back. This exposure draft created much controversy, as you're all aware. *SFAS 115* carries a May date, but it's really being released in June. You'll be working with it very soon.

The objectives for this are interesting, because the FASB really tried to resolve several problems with the current accounting and reporting practices. If you go back through the history, you'll see that the accounting profession has been somewhat sporadic and erratic in its dealings with accounting for securities, so there has been a fair amount of inconsistent literature out there. Critics of the lower of cost or market (LOCOM) argue it really isn't evenhanded, because you're penalized on the down side but don't get anything on the upside. But I've talked to a number of people who have said that's just fine because they think they can manage the down side better, and would not like to deal with the volatility that we'll see as a result of *SFAS 115*.

Also, many people have argued that there is greater relevance with fair-value accounting, particularly the regulators and many of the board members at the FASB. But I think a couple of things really started this whole thing. Gains-trading is where people pick the winners and sell those with appreciation and record the gain. This leaves the losers, those who had a net depreciation in their portfolios that are accounted for by using amortized costs. There's a related issue with the impairment or other-than-temporary impairment. Are any of you familiar with that? One of the things that the SEC really tried to pick on was that people were not recognizing decreases in the value of securities on a timely basis. And in the words of Walter Shuts, "People were recording losses, too little, too late."

Accounting based on intent has been very troublesome to many people. You know us accountants; we like everything nice and neat and orderly. Intent is very hard to get your hands around. Matter of fact, the prior chief accountant at the SEC, in some letters to the profession, talked about cycle analytical accounting, and it was hard to get your hands around that. So it's been very troublesome. Well, what happened with *SFAS 115*? There is no way to do this conveniently. Ultimately, the FASB decided on an approach that resolved the inconsistent literature and the fact that LOCOM was not evenhanded. It partially addressed the greater relevance of fair-value information, and left gains-trading and accounting based on intent unresolved. To me that was a personal disappointment, after having spent time at the FASB. I do think that the FASB, if it was going to pursue and finally issue a statement, should have gone all the way with this. I realize that it was under extreme pressure to get something out, but I think it took a step back in an opportunity to really improve financial reporting. This only partially does it.

So what does *SFAS 115* do? It establishes a standard of financial accounting and reporting, as we looked at for investments in equity securities that have readily determinable fair values. By the way, they switch from market value to fair value during the exposure period. I think in the Board's minds, there really isn't any difference. But people were concerned as to whether they could look up something in the paper and find the exact value. The FASB wanted to get away from that and said it was talking about fair value. There are techniques that can be used to come

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up with the fair values, and you don't necessarily need to find it exactly right there in the paper.

The fair value of an equity security is readily determinable if the sales price or bid-and-ask quotations are currently available on a securities exchange or an over-the-counter market. If it's traded in a foreign market, it's determinable if that foreign market has as sufficient a size, scope, and breadth as the U.S. market. The fair value of an investment in mutual funds is readily determinable if the fair value per share is determined and published, and is the basis for current transactions. I think that's relatively noncontroversial.

SFAS 115 does not apply to a few types of equity securities. It doesn't apply to those that are accounted for under the equity method or investments in consolidated subsidiaries. So if you had a 25% interest in a company, that wouldn't be subject to this. *SFAS 115* doesn't apply to enterprises whose specialized accounting principles already are of fair value, i.e., mutual funds. And *SFAS 115* doesn't apply to not-for-profit organizations. However, it does apply to cooperatives and mutual insurance companies. Mutual insurance company accounting is another whole project that the FASB recently issued a pronouncement on; some of you are probably following that fairly closely, also.

At acquisition, you're supposed to classify the debt and equity securities into one of those three categories that we just talked about: held to maturity, available for sale, or trading. Subsequently, at each reporting date, you go back and look and reassess that classification to see whether it is still appropriate. A held to maturity security is classified and measured at amortized cost, similar to the way that those that had been held for investment were previously. But, this occurs only if the reporting enterprise has a positive intent to hold those securities until maturity, and there are some restrictions and some clarifications added that would say that you don't have that positive intent. We will soon talk about those additions.

The sale or transfer of a held-to-maturity security due to one of the conditions on this laundry list won't be considered inconsistent with the original classification. But many people are still going to say it didn't go far enough. For example, if you have evidence of a significant deterioration in the issuer's credit worthiness, and you think that it's going to go downhill and you sell it, that wouldn't call into question the rest of the securities in the held-to-maturity portfolio. During the exposure process, a number of people asked, "Do I have to wait until it's actually downgraded publicly?" FASB said, "No, you don't have to wait until then. But you can't just say you think it's going to go down, and sell it. You have to have a hard basis." I suspect that people like me, auditors, and the SEC would probably challenge you if you had a fair amount of selling and you didn't have good documentation for it.

Just a change in the rates would not be a valid reason for selling. However, a change in tax law that eliminates or reduces the tax-exempt status of interest on a debt security would be a logical reason for selling that security.

A major business combination or major disposition would be a valid reason for selling a security. For example, you acquire a new company and want to realign the portfolios. If you sell a significant part of the business and have to realign the

portfolios, that would be okay also. But it can't be an overall realignment. Really, it's just an alignment to bring you back into that kind of a risk-type situation that you were in before. It doesn't give you an open hand to do whatever you want.

A change in statutory or regulatory requirements significantly modifying either what constitutes a permissible investment, or the maximal level of investments in certain kinds of securities that causes you to sell, would be okay. A significant increase by a regulator in the industry's capital requirements that causes a sale, or a significant increase in the risk weights that debt securities use for regulatory risk-based capital provisions that causes a sale, would be okay. As you can see, a number of these things are external to the company and are being thrust upon it. If you had sales for those reasons, it wouldn't be considered inconsistent.

There is another little phrase in here. It says that, in addition to all that, if there are changes in circumstances or other events, for example, that are isolated, nonrecurring, and unusual for you, that couldn't have reasonably been anticipated and that caused you to sell or transfer, that would be okay and wouldn't call into question the rest of your classification of your portfolio. But I think that this is going to be a very tough one, because if you start having much activity, many sales, and many unusual, isolated, nonrecurring events, how are you going to explain them? So, I think that this is going to be very rare. I think this is something to watch and see how practice develops. I'm particularly interested in what kinds of interpretations might come out from the FASB or other accounting groups and the SEC on exactly what these words mean. I think this is very restrictive at the moment.

If you don't have the intent to hold things to maturity, then you classify them as in one of the other categories (i.e., available for sale). Reasons such as selling the securities for changes in market interest rates and related changes in the securities, prepayment risk, increased demands for loan surrender of insurance policy or payment of insurance claims may not work. If you would generally make them available for that, you couldn't classify them in the held-to-maturity category. Changes in availability of and the yield on alternative investments, changes in funding sources, or changes in foreign currency risk also may not qualify as legitimate. All the kinds of things that people have used in the past as arguments as to why they might change or make some tune-ups in their portfolio won't be allowed for you to classify securities as being held to maturity.

Now, many folks hit on the FASB for this and said that just was not reasonable. So the FASB said it recognized that companies have the asset/liability management process and that perhaps companies could essentially break that portfolio down into a couple of pieces. Then, identify some securities that wouldn't be touched, except for these remote-type situations, and then some other ones that you would use for asset/liability management so that you could have an approach to managing your portfolio, and still retain for a significant portion of the portfolio the historical cost basis of accounting. If I have an asset/liability approach to managing my portfolio, does that mean I can never have anything in the held-to-maturity category that uses the historical-costs approach? The FASB's response was negative. But I've heard many critics say that it's really impractical to say, "Out of these ten securities, I'll stick these three over here. I might sell them sometime, so I'll put them in the available-for-sale category. I'll never touch these other seven securities, so I'll put them in the

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held-to-maturity category." It may be somewhat impractical to make that kind of a split, although many probably will do it if they have to. Time is going to tell just how significantly this affects portfolio management.

Some things would be considered maturities and really wouldn't cause you to have a problem or wouldn't taint the rest of the portfolio. If the sale of the security occurs near enough to the maturity date that interest rate risk is eliminated, basically that's 90 days, you wouldn't necessarily have a problem. That follows the FAS *SFAS 105* principle. Another example is if the sale of the security occurs after the enterprise has already collected a substantial portion and 85% of the principle was outstanding at acquisition. The FASB says that that's okay and close enough to a maturity-type approach. So selling these securities wouldn't taint the rest of your portfolio, since they have collected a substantial portion, and have used 85% of the principal that was outstanding at acquisition.

For investments and debt securities classified as available for sale, and separately for securities classified as held to maturity, you have to disclose information about the contractual maturities of those securities as of the most recent date of presenting financial information. You can combine maturity information into appropriate groupings. You'll have to disclose the fair value and the amortized cost of debt securities based on at least four groupings: those within one year, one year through five years, five years through ten years, and after ten years. You're going to see many disclosures, although I think public companies probably already have been disclosing most of it through some of the other requirements from the SEC and the AICPA.

Securities that aren't due at a single maturity date, such as mortgage-backed securities, can be disclosed separately rather than allocated among the several maturity groups. If allocated, however, you have to disclose that.

Here comes the laundry list. For each period which the results of operations are presented, you have to disclose the proceeds from sales of available-for-sale securities, the gross realized gains and the gross realized losses, and on the basis that cost was determined in computing realized gain or loss. You also must disclose the gross gains and gross losses included in earnings from transfers of securities from the available-for-sale category into the trading category. The change in net unrealized holding gain or loss on available-for-sale securities that has been included in a separate component of shareholders' equity during the period, and the change in net unrealized holding gain or loss on trading securities that has been included in earnings during the period also must be disclosed.

For any sales or transfers of securities classified as held to maturity, the amortized cost amount of the sold or transferred security, the related realized or unrealized gain or loss, and the circumstances leading to the decision to sell or transfer the securities, shall be disclosed in the notes of the financial statements. Remember, before that the FASB, even in the document, thinks these should be rare, and the SEC thinks it should be even rarer that this would ever happen.

SFAS Statement 115 is effective for fiscal years beginning after December 15, 1993, so essentially that means 1994, unless adopted earlier. There's a little bit of a tricky transition provision in here: The Statement will be done as of the beginning of an

enterprise's fiscal year. You can't go back and restate the interim periods. The date of adoption is when you classify the securities under these new categories. Earlier application, as of the beginning of a fiscal year, is permitted only in financial statements for fiscal years beginning after issuance of this Statement, which haven't been released yet. Many people wanted to be able to adopt it in 1993, so the FASB made the change at the end, and permitted people to initially apply this Statement. You can apply it on December 31, 1993, but it's as of the end of the fiscal year, not as of the beginning. Another way of saying this is that you can't restate.

You take the effect of the adoption as a cumulative change in accounting principle. The effect on retained earnings includes the reversal of amounts previously included in earnings that would be excluded from earnings under *SFAS 115*. The unrealized holding gain or loss, net of tax effect, for securities classified as available for sale from the date that *SFAS 115* is first applied, is an adjustment of the balance of the separate component of equity. You can't give the pro forma effects.

In summary, remember that the assets go into three categories. The held-to-maturity category continues to use the amortized-cost method. If you have a trading type of security, it belongs in the trading category. It will be marked to market and the change in the value goes through income. If it's available-for-sale, it gets marked to market, but the change in appreciation/depreciation goes into the separate component of equity, and that is where you will get the volatility in the capital and surplus, because the only things that you don't have to mark to market are those that are in the held-to-maturity category.

MR. JAMES E. HOHMANN: I am a member of the American Academy of Actuaries' COLIFR. Specifically, I'm a member of the AICPA and FASB subcommittee. Peter asked me to give a historical perspective of the Academy's response to this issue; primarily to put a setting for what's going to happen in the future, and to give you some inclination, at least to the extent I can tell at this point, where the Academy is going to head on this issue.

It's interesting, with the Statement just out, that we're somewhere at a cusp or a point where the Academy has given input to various bodies, and it's now time for us to look at what's come out of all of this. Actually, at this point, it is time to react and try to be as proactive within that context as we can. So we want to move forward, and I'll give you an idea of some of the things that are going on at the Academy, some of which will be based on input from all of you.

In any event, I'll try to give you a brief history of our activities, dating back to when the exposure draft was further released in September, and carried through our last COLIFR meeting, which was last week.

I want to give you some background on the committee and our response. Furthermore, I'd like to give you some idea of the discussions that occurred at the AICPA and FASB subcommittee meetings of COLIFR, and some of the issues that we talked about, including how we chose to address the issues and our response. Then, I want to tell you exactly what was in our response. Beyond that, we also had testimony before the FASB from Arnold Dicke and Mike McLaughlin, members of our subcommittee. They went to the meeting on January 7 and testified. Then, I'll talk a little

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bit about a follow-up letter that we sent on March 16. Finally, I'll talk about the FASB decision and the future American Academy of Actuaries activity.

Beginning with the background of our involvement, I think it's fair to say that our committee, at the meeting held October 1, 1992, was very heavily influenced by the exposure draft released in September. We had quite a bit of discussion. We talked about some of the dates that were involved. For example, we needed to have a written response by December 8. There was going to be a formal hearing on January 7. So, to be included in that, we had to meet certain deadlines. We had some discussion of whether there should be a response by the Academy. We quickly concluded that there should. But we didn't know exactly the form or substance of it. Furthermore, we talked a little bit about how to meet these deadlines. But in the end, we delegated to our COLIFR subcommittee on FASB and AICPA issues.

So as a result of that, our subcommittee met a total of three times prior to issuing a written document. And in those three meetings, we had quite a bit of discussion. Let's talk a little bit about some of those things.

We first talked about what was actually in the exposure draft. It's kind of interesting to look at the FASB view of the issues. Ten issues were actually cited under eight major headings.

Those issues were the intent as a basis for accounting, and that's already been reviewed somewhat by Mr. Weston. One of the issues is the idea of including liabilities within the scope. The idea of gains-trading, the effect on insurance company financial statements, and the appropriateness of that depiction of this behavior are several of the issues. Transfers between categories is an issue. Effective date in transition is an issue. The proposed statement on impairment of loans and other-than-temporary impairment are two more issues. What they're actually looking at there is a crossover between this exposure draft and other documents that have previously been issued or that were being issued concurrently. Last is the whole area of disclosure.

We quickly decided that the only thing that we would focus upon was what FASB calls issue number 3. This is the inclusion of liabilities within the scope of the document. We had quite a bit of discussion. It was quite interesting to have our first meeting. When we looked at the whole document, we found ourselves pointing to different paragraphs and saying, "What do you think this means? Could this be true? Is this actually what they're trying to do? Do they realize that they're missing the liabilities side?, etc." We formed our own opinions, I'm afraid, as to exactly what some of the intent was. We thought that a good way to respond at one point would be to contact virtually everyone under the sun. We said that this was going to affect banks and savings and loans. We said that this was going to affect, of course, all the insurance companies, etc. And at one point, we wondered if it would make sense to contact all of these. At that point, I think practicality overwhelmed us. We realized that there was only a certain amount that we could do in the timetable that was articulated to us. So, we decided to focus primarily on the liability issue.

Our first decision, of course, was that we must respond. Second, we decided that we should send a letter. Third, we should testify. As previously mentioned, we

decided to limit our response to issue number 3, the inclusion of liabilities. Fourth, we had quite a bit of debate on this issue. We decided that we would not be an advocate for either current book-value reporting or proposed fair-value reporting, but rather, we wanted to come at this, not from an industry perspective per se, but strictly as a professional body. Therefore, we thought we should deal with certain issues included in the exposure draft without any type of bias. We eliminated as much bias as we could. We wanted to be very, very matter of fact.

Some of our discussion, as I mentioned, talked about whether we would include liabilities. Why was this happening? We had ideas, such as the held-to-maturity category is very narrow. As a result, we quickly concluded that any companies doing reasonable asset/liability management would find that the vast majority of their assets would not be in this particular situation, and, therefore, would have a change of accounting method.

Furthermore, we said we've already got *SFAS 107*. That gives disclosure on many liabilities and assets already. Why do we really need this? We did, however, talk quite a bit about the political climate. Mark talked about the pressure from the SEC, etc., on this particular issue. There were letters from the big six accounting firms on the issue. A number of different things occurred that were pushing this forward. We concluded that this would not go away.

So, we decided that we needed to address this issue head on. We did form a couple of opinions as to what the FASB was thinking. This did actually have some effect on our response. We concluded that the FASB must be thinking that most insurance companies hold to maturity and that most of the assets would fall into this category, and, therefore, would not have a huge impact. We also concluded that they were not as cognizant of the long-term liability structures that we have. So, within that context, we formulated the response.

We thought that one of the things that we'd have to address is that if, based upon our comments and the comments of all of the other interested bodies, the FASB was going to go ahead and require fair-value calculation of assets, we must at least talk about the topic of fair-value liability valuation.

Obviously, once we got into that issue, we realized that it's extremely complex. That is actually one of the issues that the FASB came up with. One of the reasons why it had struggled with this for so long is that it found it was very complex and there was quite a diversity of beliefs as to what were appropriate ways to measure the fair value of liabilities. One of the things that we found ourselves discussing early on was the idea that actuaries already do valuations that are at least related. We talked about the idea of merger and acquisition situations in which actuaries do appraisals, and we talked about the fact that in these appraisals we're actually looking at a bundle of assets and liabilities. We place a value on that bundle. So if we can put a value on the bundle, and then we can look at market values of the assets and support thereof, presumably we can back into available liabilities. All of our discussions were very general at this point, however.

We decided that even though we knew that actuaries had done work in this area, there were option-pricing techniques and other ways of trying to approach this issue.

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For example, Arnold Dicke brought to the table several times the idea of using an interest-maintenance reserve (IMR) type of approach in GAAP reporting to mitigate somewhat the gains-trading effect, which we thought was rather important to the FASB.

So we went through and talked about a number of these things, but in the end, we decided it was not our charge to propose any particular methodology. Nor did we think it was even practical to propose any particular methodology. Based upon the discussion, we felt that actuaries do have quite a battery of tools available to them and that if fair-value liability valuations were at some point to be required, actuaries should be the ones performing those valuations.

Finally, on a housekeeping basis, we realized that we needed to communicate closely with the Committee on Property Liability and Financial Reporting (COPLFR), the ACLI, and the Society of Actuaries committees as well. We did so in the process.

I am now going to talk a little bit about our actual response. As I mentioned before, we thought that there were certain perceptions, and we may have misread them after talking with Mr. Weston, that the FASB had. Perhaps it was saying that there are a couple of categories to use for classifying investments. Right now, you're treating everything as being held to maturity, when, in effect, there's a fair amount of trading going on.

On the other hand, we thought that the FASB figured that most of our assets would fall into the held-to-maturity category. Nonetheless, we thought that we needed to stress that life insurance obligations are long term. We thought that might have been something that wasn't quite as high in FASB's minds as it was in ours. Also, the asset/liability management function would tend to minimize any inclusion in the "held-to-maturity" category because of the strict definition that was there. Overall, we were trying to say that this point had a huge effect on the industry and needed to be addressed in that context.

We reiterated our position that assets and liabilities should be valued consistently as a result, of course, of showing some numerical example in the appendix. Then we noted that many fair-value calculations are already available through disclosure of *SFAS 107*. We were arguing at that point, what's the need or what's the hurry?

We also raised other points. If fair valuation of liabilities is correct, actuaries have the tools. Again, we weren't trying to say that we had specific methodologies, but rather we had the tools that we thought could be adapted to the past. The second point is if fair valuation of assets is required, then we thought that fair valuation of liabilities should be required, or at least permitted. We were very concerned with the total exclusion on this particular issue.

Finally, while our main point in our letter issued December 7 was that assets and liabilities needed to be treated consistently, we did, in a second appendix, give some other options. We felt that one other option would be to modify the definitions of the various asset categories.

For example, perhaps we could modify the category so that held to maturity would be a bit broader and, therefore, mitigate. We thought deferring implementation was a viable option. Let's *SFAS 107* play out and see what types of information are being provided there. Let's see how useful it is to financial statement users. Then, of course, there was the idea of deferring trading gains if gains-trading was a focus here. We felt that perhaps some kind of an IMR vehicle should at least be on the table to mitigate that without a wholesale change in the valuation of assets and no change in the valuation of liabilities.

As I mentioned, I'm a member of COLIFR, but there were, of course, other responses. I'll briefly tell you a little bit about what the COLIFR did. In general, the COLIFR approach was very similar to our approach, but a little bit stronger in a sense that it advocated keeping the book-value reporting. It indicated that research is underway on its part, and that it would be drafting standards as it completed its research. It suggested that it would be a good idea to defer until 1995, at which point it expected to complete its research and draft some standards for a fair valuation of liabilities, if it's necessary to go that route.

The ACLI, of course, responded as well. I suspect that most of you have seen the response of the ACLI. Its response was more direct than the COLIFR's response. We talked mostly about retaining the book-value reporting basis. It indicated that insurers will react in certain ways to the new mandate. For example, they may shorten their asset portfolios. The shortening could lower the return on capital and affect the industry's ability to attract capital. Also, it indicated that insurers might not be providers to certain market segments that they historically provide capital to. So it thought that it would have a broader effect on the capital markets as well.

Anyway, as I mentioned, our response was combined primarily to the liability valuation and exclusion of fair value of liabilities in the exposure draft at this point. Our main message is that you need to be consistent. Value both the assets and the liabilities at book or both at market. Another alternative is that you should match up subsets where, if you have certain subsets of assets that would be at fair value, then you should have certain subsets of liabilities at fair value. We thought this was very impractical, but we thought that it was better than doing a full-scale fair valuation of assets and retaining book value of liabilities.

There was a hearing on January 7, and the Academy testified in two parts. The representatives of COLIFR were Arnold Dicke and Mike McLaughlin. We think there should be consistency on the balance sheet. We think that that's always been a premise of GAAP. To abandon it now would not be proper.

The FASB posed a number of questions. They were talking about fair valuation of liabilities, and they gave us some food for thought. We'd already considered some of the things such as reinsurance premiums that could be used as fair values of liabilities. Also, they asked about the impact of underlying assets on the valuation of liabilities. I responded that there is an impact, and the relationship is not necessarily, as he phrased it, linear. If you have a different pool of assets in the bundle of assets and liabilities, you get an overall different value were you to use actuarial appraisal techniques, for example, for the bundle. The difference would not solely be the difference in the market value of the assets.

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There was a COLIFR meeting on March 16, and several guests were at that meeting. Dick Robertson joined us, as well as Harry Garber, Frank Irish, and the committee at large. We knew that the FASB was going to be meeting on March 17 to discuss this issue again. Thus far, we felt we hadn't had an impact. We wanted to make another effort. We drafted the letter at that committee meeting. In drafting the letter, we wanted to reiterate our consistency position. We wanted to note again that we have the training to develop fair valuation of liability techniques without stating what the proper methodologies are. We wanted to convey that actuaries are the ones in a position to do these valuations, if they are to come to fruition.

Much needs to be done to determine and sift through all of the various techniques that actuaries have at their disposal to find out what is appropriate. We were committing to work with the FASB on the issue. While we didn't say it directly in the letter, it was implied that it would be an exchange for a deferral of application, so that there could be a study. We also promised, and this was a matter of housekeeping, to issue a follow-up letter on the remarks made during the testimony.

As Mark already articulated, the FASB didn't make its decision on March 17. I believe there was a four-to-three vote in favor of the exposure draft, which is not enough to carry the day. Then on April 13, there was a five-to-two vote, which is enough to carry the day.

There were some signals, however, from the FASB that it would be considering, or at least willing to listen to, issues relative to liabilities longer term, but that it would not have an effect on what was happening with *SFAS 115*. Given that signal, we have started to plot our strategy going forward.

A number of things are going on right now. There is an investigation as to whether a joint task force could be set up with the AICPA to study the market-valuation issue for liabilities. Right now that's being investigated by Barbara Snyder of the COLIFR committee. Barbara has been speaking with a gentleman named Ian McKay from the AICPA, and the early feedback that I get is that there is a favorable reaction, though nothing official has happened so far. Right now it's at the idea stage. We believe it's probably a good way to get input to the AICPA and to the accounting profession, and try to have some kind of a joint response that would be helpful overall.

Additionally, the American Academy of Actuaries is meeting with the FASB on June 18. The idea is to discuss fair valuation of liabilities and what can be done prospectively. Again, there is no way of telling where those discussions will go. But we do know that there is an agenda to at least discuss these issues.

One needs to realize the diversity of opinions with respect to fair valuation of liabilities. For example, the feedback that I get is that Walter Shuts, the chief accountant for the SEC, believes that the process should be straightforward. Then, of course, there are actuaries, perhaps some here, who believe that it's not possible to do this because we don't necessarily have a thick market to validate to. So there is quite a diversity of opinions on this issue. Obviously, we'll try to seek some kind of a practical resolution.

Another thing that's important is that the COLIFR committee has decided to undertake a cataloging task. What we're doing here, and what I've been asked to do by a fellow COLIFR member, is to ask you to spread the word. We'll probably try to do that officially through an update. We would like to know what you think, with respect to fair valuation of liabilities and the various methodologies that are beginning to circulate. Then we can do some valuation of the attributes of each of these methodologies and go to this potential joint committee or the FASB with something that's written and well organized. At this point, we believe it's very important to do that, because if you dig into the history, you'll find that one of the reasons liabilities fell off the table is because of the ideas of complexity and diversity. We don't think we'll resolve either one of those. We think that most of the methodologies that come forward will be complex. There certainly is diversity of opinion. If we can get them cataloged, and if we can talk about some of the different attributes and the applicability for various lines of business, etc., we believe that we'd be able to make some headway on that issue.

Finally, I want to mention that there are several fair-valuation-of-liability models that are beginning to circulate. For example, Dick Robertson will be talking about some of the work that he's been involved in. My understanding of Mr. Robertson's work is that it involves linking the valuation of the liabilities to market interest rates, and it also would cause some spreading of profits.

In addition, Arnold Dicke has done some work, where he's talking about extending the idea that I mentioned earlier, in which actuaries have used appraisal-type techniques for blocks of business. Is it appropriate if we can define proper discount rates in order to actually value those bundles and then subtract the fair value of the assets and get some reasonable value for the liabilities?

So that's where things stand right now, and I suspect that leads to what Mr. Robertson is going to talk about.

MR. RICHARD S. ROBERTSON: I'd like to start by talking about how my company, Lincoln National, is responding to this, what we're going to have to do, and some of the issues that we need to resolve between now and the time we publish our first 1994 quarterly statement.

The first issue is clearly to decide which of our securities should go into the available-for-sale account which, if any, are held for sale (trading), and which, if any, are going to be held to maturity. The way we have run our investment operation in the past is we've been willing to consider anything we hold as being something we might at least consider selling. If the market was right, or if conditions were such, if it seemed to be the right thing to do from an economic perspective, then we would sell. We don't really have anything that we're holding for sale as such. I would be surprised if we have any significant amount of securities in that category. As this category is defined, we may not have any at all.

Given the philosophy of being willing to sell about anything we have, unless we decide to change that, it looks to us like all or virtually all that we have will be available for sale. I know different companies may have different opinions, but I think when they come right down to it, it's going to be very difficult to make the kind of

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commitment that a company must make to say that these investments are not going to be sold, except under the very specific conditions that are laid out in the FASB standard. Who really knows what's going to be in the future? What kind of situations are we going to be facing in 10, 20, or 30 years? Do we really want to put constraints on future management of the company that would make it difficult for them to liquidate investments that really ought to be liquidated at that time?

We think that classifying an investment as held to maturity is a very strong commitment. If a company decides to sell an investment out of that category, unless the company meets the very specific conditions that are laid out in the standard, that sale will have to be disclosed, and the company will be subject to a challenge by the SEC that it, in fact, had misclassified that investment from the past. If that sale results in a charge against income, it can even be subject to allegations that it has misstated income and has had misleading statements in prior years. That is something I don't think companies are going to want to have to face in the future.

We haven't made the final decision, but I think we've pretty much concluded that we ought to have virtually everything in the available-for-sale category. Therefore, they will be carried at market values.

The next issue is whether we should make some changes in the way we manage our investments. Market-value fluctuations will be significant. Right now we have about an 8-10% difference between the market value of our securities and the carrying value. Fortunately, that difference is currently on the positive side. But within the last 18 months it's been zero, and the financial markets have not been particularly active during this period of time. If we have seen a change in value of 8-10% based on the kind of investment market volatility we've had in the last year or two, clearly with the same kind of investment strategy we have now, changes in the order of 20-30% are not at all unlikely. We don't have that much equity in the company. In other words, if you put together a scenario that is a repeat of the early 1980s environment, and we were to carry all of our securities at market value, you could wind up depleting most or all of the equity of the company. Clearly, we can't live with that kind of a situation.

We have some very difficult decisions ahead. What could we do in the way of changing our investment strategy? Well, we could shorten maturities. We do scheme out of fluctuations, but look where that leaves us. We write many different kinds of insurance and annuity business. We've got immediate annuities, some that are used to fund pension plan terminations and some that are used to fund retirement programs. We don't write structured settlements as such, but many companies do. Those are very long liabilities. You cannot write that kind of business without having very long investments supporting it. If you did, you would find yourself in a difficult position if investment markets were to change. Or you would just simply be unable to meet the commitment you're making to your annuitants.

Even the intermediate-term liabilities can cause trouble when backed by shortened assets. Basic annuities that all of us are writing, such as universal life insurance and conventional life insurance, all seem to have the characteristics of durations in the intermediate range, perhaps five to seven years. There can still be very major fluctuations in the market values of five-to-seven-year bonds. A 300-basis-point move

there would probably take about 10-15% of the value up or down, depending on which way the movement goes. And, in fact, 300-basis-point movements in seven-year bonds are far more likely than 300-basis-point movements in 20- or 30-year bonds, so the risk is not at all an inconsequential one.

You can move the investments to areas that are not subject to the new standard. You could, for example, lock in the investments and make a commitment never to sell them until maturity. For the time being, we have the option of increasing the amount we have in the mortgage account, which is not subject to this standard. The problem there is that the events of the last few years have demonstrated what could happen to a company that overweighs the mortgage sector and the investment portfolio. We don't want to get ourselves in a position where we're subject to that kind of pressure on our financial security just to meet some accounting rules. There really aren't any good options available to us.

Perhaps the best we can say is that while we may be thinking of locking ourselves into something that will last for 10, 20, or 30 years, this standard isn't going to last that long. It isn't good enough. It's my belief that in about five years, the problems with this kind of accounting will become clear enough that we'll see some kind of an amendment or change that will fix most of the problems that we're talking about. Ten years is the longest I can see this accounting standard surviving. If it were judged on its merits, it probably wouldn't last about six months, but that's another story.

The only real solution, other than going back to where we were, and that's not going to happen, is to get the liability side of the balance sheet fixed up so that it is reasonably consistent with the way we're handling our assets.

The idea of developing a methodology for market-value accounting for liabilities in one sense isn't difficult at all. All the tools are in place. In fact, we're well ahead of the accountants, as is often the case. We've got an actuarial standard that tells you how to do market-value liabilities: the Actuarial Standards Board Actuarial Standard of Practice (ASP) 19 – Actuarial Appraisals. That methodology would work quite well and would give you a market value for liabilities that is, in fact, used by most actuaries when it comes to valuing an acquisition. The British are using market values of liabilities. As I understand it, the basic financial statement for our British company is a statement that puts the liabilities on a gross premium valuation basis by using current assumptions. That is what we're talking about here.

In fact, the biggest problem is not that we don't know how to do it; it's that we know how to do it several different ways, and we are going to have to reach some kind of consensus as to which way is appropriate for this purpose. This is going to take some effort going forward.

It will take some help from the accounting side until we get some agreement as to what the financial statement ought to look like when we're finished. We need to know what kinds of objectives it ought to meet. We really aren't in a position to try to say, if we're going to try to meet those objectives, here are the things we must do to get there.

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One of the issues, for example, is if you do a gross premium valuation of the kinds contemplated in ASP 19, you wind up, in essence, releasing the value of the business at the time the business is issued. In a sense, that's what market value really is. Market value is what you do or could sell liabilities for in a free market.

We don't have an active market for trading insurance liabilities, but there's enough experience with acquisitions that there's a pretty good idea as to how you go about fixing the price on a book of liabilities and the kind of constraints that might be on it. When those transactions take place, they allow the seller to realize at least a significant part of the future profits of the business, and the buyer is willing to pay a reasonable price for those future profits, subject to some real discounting or contingency loading in the valuation process.

If we were to adopt an accounting model that did that, it would be a fundamentally different accounting model than we have. We are used to an accounting model that, in essence, releases the profits that are expected to be generated by a book of business over the life of the business. There are constraints that tell us how to do that and when the profits are to be released. They don't get caught up exactly in that context, but the practical effect is that when you write a policy, you and the people that use your financial statements have expectations as to what kind of profitability that business is likely to produce going forward and under what conditions that profitability will change.

I do not believe it was the intent of the FASB to change that perception. If we were to go to a model that now uses some kind of a gross premium valuation of liabilities, you would have that fundamental change in the accounting model, and people would have to realize that once a policy is issued and the profits are released, there isn't much left of the future. In fact, if we are wrong in our assumptions, that business could actually produce losses going forward.

This suggests that perhaps we ought to be considering a different approach. One possibility is an approach that retains the idea of releasing profits over the life of the business, but where the valuation of the liabilities is allowed to move up and down as the investments that support those liabilities move up and down.

We have been doing some work on that. The paper that I prepared that was referred to a few minutes ago tries to demonstrate that you can do this. If you put certain constraints on your assumptions, you can come up with an accounting model that looks very much like our present accounting model, as long as the market-value interest rates don't change significantly. If market-value interest rates change, the value of the liabilities will move up and down in tandem with the value of the assets, provided the company has satisfactorily immunized its asset/liability management strategy. I don't know that this is the right answer either. Again, it comes back to the question as to what it is we want to produce when we're all done.

I do know that either model will be far better than the one that has been put forward by the FASB at the present time. We have some serious problems going forward. I talked earlier about how much the value of our company as measured between asset

and liabilities will change under the new accounting model and, in fact, what was really going on. For all the reasons we've been talking about, that is a phony number.

Our company does not have a value that is greater than the value we had 18 months ago, represented by the 8% appreciation of the value of our assets. We know that everybody who looks at our financial statements knows that. And, in fact, I think there is a process that goes on in the marketplace, where investors try to sort out just how much of that appreciation belongs to the stockholders and how much of that would be offset by our proper valuation for liabilities.

I am reasonably certain that investors will make the same judgment when the difference is the other way. They have in the past. We've had times in recent years where there's been an 8-10% differential in the market values of our assets going the other way. We did not typically see the market price of our company being marked down by that full difference. So I think that investors are smart enough to see through this. If we're to do our jobs as responsible managers, we're going to have to give them the tools to do it well.

We're going to publish some kind of a market value of liabilities at the same time as we do the market value of assets. We haven't decided exactly how we're going to do that, which methodology we're going to use, and how we're going to get there. But we're going to do what we can to try to help people use these statements and sort out what all this means. I know several other companies that are considering doing the same thing. In fact, one company, Capital Holding, did it last year-end. It used, as I understand it, a variation of the gross premium valuation to get there. And, I think it said it intends to continue and improve on that technique going forward.

So, one thing we'll be seeing is a number of companies presenting this kind of information so that users of financial statements can appropriately adjust the data that they're getting from the balance sheet.

The problem is, we're all going to do it differently. We'll have our way of doing it. Even if we work hard to try to do it in a consistent manner, we're not going to get there. In the absence of a standard, there's going to be a considerable variation. What might be a reasonable measure of market-value surplus for Capital Holding will look much different than what Lincoln National is going to look for. That's going to be very hard on the people who have to deal with it.

One consequence of all this is there's going to be much confusion as to what life insurance or, for that matter, financial institution accounting, is really about.

There will probably be a lot of work for consultants and analysts. But in the meantime, it's going to have an adverse effect on the investor and, ultimately, on the stock price for insurance companies. The market is smart, it can sort out all these things. But it really can't tolerate confusion, and that confusion is going to have an adverse effect on how our companies perform in the stock marketplace.

So, having said all this, it's clear that it is very important to us as a company, an industry, and a profession, that we get this accounting straightened around and that we get a standard that properly, or at least consistently, values both the asset and

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liability sides. So the work the Academy is doing is going to be very important. The ACLI has decided that it will support that same kind of activity. It will contribute what it can to the effort. I hope the accountants will support us. I hope that they will do what they can to try and get this process moving forward. Ultimately, I hope the Financial Accounting Standards Board will quickly revisit this and get it straightened around to where we have something that will work.

MR. ROY GOLDMAN: Mark, when you read the scope of *SFAS 115*, you referred to equity securities. Then you talked about debt securities.

MR. WESTON: *SFAS 115* applies to all debt securities and to equity securities with readily determinable fair values.

MR. GOLDMAN: That's what I thought. But the scope just referred to equity securities. Mr. Robertson, you had mentioned that you classify your assets as those that you're going to hold for maturity. What is the process if, in fact, you decide to sell these? Won't you have to go back and figure out what the imbedded gains are?

MR. ROBERTSON: Your question is, if we classify an investment as held-to-maturity and subsequently sell it, what happens?

MR. GOLDMAN: Yes.

MR. ROBERTSON: Well, from an accounting perspective, the gain or loss would be recognized at that time. It would be necessary to make a disclosure of the fact that we have done this. Disclosure is made if the sale did not meet the criteria specified in the standard as to an appropriate sale, i.e., when it is reasonable to sell a held-to-maturity security. Presumably, we misclassified that security at issue. Now, this is one of the problems. How can we know what somebody, who's probably not even in a policy-making position, is going to do ten years from now?

MR. GOLDMAN: What are the ramifications of that if you had misclassified it?

MR. ROBERTSON: You're probably going to have to answer to the SEC.

MR. HOWARD L. ROSEN: I also have a two-part question: the first for Mr. Weston, and the second for anyone who cares to respond. I thought I heard earlier, perhaps it's just my misunderstanding, that the FASB and our accounting brethren don't really believe that there will be a material reclassification of assets from held to maturity, trading, and marketable. I was wondering if Mr. Weston could comment on that. And second, as a follow-up, if that is true, and many companies continue to have a substantial amount of their asset portfolios in the held-to-maturity category, where they have the positive intent and ability to hold those assets to maturity, can they, in general, really be considered to be looking out for the best interests of either their policyholders or their stockholders?

MR. WESTON: I'll take the first one for sure, and let someone else tackle the second part. It depends on who you talk to. I've talked to a number of people who think that they will be able to classify a significant portion of their portfolio into the held-to-maturity category. I've talked with other folks who have said that they thought very

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little would go in there. So I really think it depends upon individual companies, the practices that they have followed in their asset/liability management, and how refined they are in that. Even asset/liability management programs, at least in my experience and in talking to individuals, have varied as well. As to whether those companies will continue the same kind of philosophies that they've practiced in the past on a going-forward basis, I don't know. Some will be able to do it and have a significant amount in the held-to-maturity category. For some, it's going to create a tremendous amount of problems, and they may ultimately have very little in the held-to-maturity category.

MR. DURAN: The second part of the question related to whether a company that was to classify a large portion of its assets as held-to-maturity was really doing a disservice to its policyholders or its shareholders. Does anybody want to offer an idea on that?

MR. ROBERTSON: Well, first of all, I think Mr. Weston is right. I think you will find different companies taking different approaches. The fact is that if most investments are carried at market value, the company's surplus will be subject to very major fluctuations. Conceivably, major stress is a powerful motivating factor to put as much as possible in the held-to-maturity category.

But I agree with you. I don't believe that you can do the best job for your policyholders, or stockholders if you're a publicly held company, by making a commitment not to sell a security in the future. I don't think we know what we're going to want to do ten years from now. We don't know what asset/liability management techniques might be available to us. We don't know what our tax position is going to be. I don't think we're in a position to make that kind of commitment. So that's why I am leaning toward recommending that our company put little, if anything, in the held-to-maturity category. I think that's the only prudent thing to do. I firmly believe that it is very important that management not let bad accounting drive bad business decisions. And I see that happening here.

MR. HOHMANN: Howard, I have a quick comment. One of the things that you mentioned here came out of the statement that I made when I was talking about what we in the COLIFR perceived to be held to maturity, as being unlikely to receive many assets of insurance companies. When we were trying to rationalize what we were seeing in the exposure draft, we could only conclude that in the wider group of all financial institutions, the insurance company position must not have been properly regarded by the FASB. But that was only conjecture on our part, which affected the formation of our opinion.

The second thing I have is on the point that you brought up. I would urge anyone to get a copy of it. I thought the ACLI wrote quite a good letter to the FASB following an earlier draft of *SFAS 115*. It brought up this very issue and several others; for additional reference, people might want to get that.

MR. FORREST ALLEN SPOONER: I have a question for Jim Hohmann. I was surprised that the property/casualty folks decided to make an argument in favor of staying with book value. It seems that their position is not nearly as strong as ours. I wonder if you could tell us what position they put forward in support of that?

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MR. HOHMANN: Unfortunately, I don't have much detail on what COPLFR was doing at the time. I do know that its position was similar to ours, and ours was expressly neutral on the accounting treatment. While I would not call theirs an advocacy position of either methodology, it had a little bit of a leaning toward the book approach.

One of the interesting things that I found is that while I've only seen bits and pieces of what comes out of the COPLFR, evidently the research that it is doing as far as market valuation or fair valuation of liabilities is concerned, when it comes to discounted cash-flow techniques, and in particular when talking about discount rates, it's rather interesting that it starts with the discount rate. COPLFR moves down off of that in the valuation to bring in the risk aspects. So I found that kind of interesting. I'd urge you to do try to get a hold of more of that literature. Unfortunately, I don't have enough to give you any of the background thinking.

MR. JAMES B. DOHERTY: I just wanted to clear up one point that was made. The impression was that the U.K. uses a market-value valuation. The Department of Trade and Industry (DTI) is actually still, well, you might call it sort of a market, sort of a book-valuation method. For par-type policies, it uses a very low interest rate with a net level premium reserve method. The implicit dividend scale is in the low interest rate. That's what the current statutory requirements are. There is a move among about six of the larger insurance companies that are publishing as an appendix to their annual statement, what they call accrual basis profits, which is an attempt to be at a market-value basis. But, even at that, I guess the methodologies are still being developed. And the way they value nonpar products is by using a gross premium valuation with some pads for future reasonable expectations of contingencies. The way that that's being applied at our further Canadian branch, which is what I work for, is the effect that we've been fronting about 60% of profits on a new piece of business, but deferring about 40%. That 60/40 was a very round number. So I think even market valuation for accrual-basis profit is subject to manipulation by the opinion of the particular actuary.

FROM THE FLOOR: Mr. Robertson, you mentioned that a shortening of asset maturity may be a safety response to the fluctuation risk. Do you see the insurance industry's competitors having to do the same thing? And if so, would this make our variable annuity products possibly more salable because they're immune to the risk? Mr. Hohmann, we've been using the cash-flow testing exercises and reserve adequacy assessment. Do you see a similar sort of exercise with a surplus account being used as a solvency test and an investment strategy test?

MR. ROBERTSON: I agree with your suggestion that these changes would be a factor making equity-based products, such as variable annuities and variable life insurance, more attractive. A lot was going on, but I would put this on the list of things that may be leading to greater sales of those products. Will competitors be subject to the same things? That's hard to say, because it depends on which competitors we're talking about. Some people worry that there are a number of companies that are not subject to the financial accounting standards, or at least they don't have public stockholders in the United States. At least we have the mutual companies roped in now. They're subject to this, although all the implications of this are not clear. But for our own companies, like Prudential, I think there is a problem of

competitive activity, or it may be that we'll have to leave to such companies many long-term liabilities that are being written; structured settlements and pension fund buy-outs, for example. That would be an undesirable result, because the market is better served by as diverse a group of competitors as is possible. And that may just have to happen.

MR. HOHMANN: The work that's been done by Arnold Dicke so far does, in fact, contemplate multiple-interest scenario testing, and, therefore, you would be able to get leverage off of some existing models. I believe that Arnold has actually written a paper on the topic and expects to have it published. I can't tell you when it will be published, because I just don't recall at this point. I think it could be in *Contingencies*. But we do expect it to be published fairly soon. But it definitely did include the possibility, and actually articulated specifically, that multiple-interest scenario testing could be used.

MR. ROSEN: Dick, and perhaps Mark, I wonder if, as we get more and more exposed to FASB, how you can do market liabilities and call it GAAP? Will your accountants accept this? Clearly related to this is that you're dealing with a part of the apple; maybe a big part of it. And it's clearly the part the actuaries ought to be groveling with, and it will wander off a bit into the accountants' world. What do you do with the other assets? How do you value real estate, mortgages, and all the rest? You probably have just as much a mismatch as you mark some assets to market and then you mark all your liabilities to market. Or maybe you're going to mark part of your liabilities to market, but what do you do with that piece? And is it, in fact, going to be GAAP, whatever this thing is that you're turning out?

MR. DURAN: Mark, do you want to take the first part of that?

MR. WESTON: Okay. Well that troubles me very much, because *SFAS 115* has selected only certain assets for the value treatment. It was mentioned earlier here that perhaps companies might shift assets over into areas that wouldn't be subject to this accounting. I could see some bad practices developing there.

Also, with respect to liabilities, part of the big challenge will be to settle on a method that people can use, and there will always be controversy about that. I remember, when I was at the FASB, how many individually right ways there were to do something. The challenge is to pick one that is probably the most reasonable out of the alternatives selected.

And we've now gone a step further, *SFAS 115* acknowledges that it introduces additional use of fair value. Until you go the full way, you always have some kind of a mismatch. And then I step back and say, well, even if we go the full way to market-value accounting, I think that introduces a high degree of subjectivity and imprecision as well. So the jury is still out for me as to where we ultimately wind up and as to whether you improve financial reporting. But you certainly won't as you're only doing pieces of it along the way.

MR. ROBERTSON: I think it is important to realize that even if we had a method that everybody liked, you couldn't use it in your financial statement until the FASB actually came out with a pronouncement that said that is what GAAP is. I think that was

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also part of your question, Jim. If we have a great method for valuing liabilities on a fair-value basis, we can't use it except in disclosures to the financial statement. We can't use it in the actual financial statement until the FASB comes out with a pronouncement that says that's the way to go.

MR. WESTON: You could use it for the *SFAS 107* for the disclosures, but you couldn't use it to book the numbers.

MR. ROBERTSON: Not on the income statement or balance sheet.

MR. DURAN: Yes. Clearly we could not prepare a balance sheet with market values of liabilities and have it certified as being in conformance with generally accepted accounting principles. *Generally accepted* is a bad term. They're not generally accepted anymore, they're currently required. In fact, I use the term *currently required accounting pronouncements*.

MR. ROSEN: What do you intend to do with your real estate and other things? Do you intend to mark that to market also?

MR. ROBERTSON: That's a problem. It's not a big number for our company for many reasons. So we've kind of put it aside and said we'll worry about the big things, then we'll come back and figure out what to do with this. We have the capability of putting something that at least is a useful proxy for market values on our mortgages and real estate and, in fact, do it for internal purposes. I don't know if that value is solid enough to want to use it at a public discussion yet. But it could be, I suppose.

MR. WESTON: There is one thing that some people whom I've talked to have been considering, and Cab Folding, who was mentioned earlier, has taken a step in that direction. He's providing additional supplemental disclosures in the financial statements. That shows an expanded use of market-value accounting for both assets and liabilities to, as Mr. Robertson was mentioning earlier, put some rationality of the relationship back into the financial statements. But it's really supplemental disclosures.

MR. ROSEN: I appreciate those answers. It seems to me, as an actuary looking at accounting, I may be disqualified to ask much more. But I would like Mr. Weston, in particular, to address this. Looking at this from a broader perspective, it seems FASB has always been focusing on income, and it is moving toward equity and capital with market-value accounting. You and I have chatted about this in the past. Well, at least when I talk to our accountants, it would appear that marking liabilities to fair value may only be a Band-Aid and will only confuse things further. Perhaps the fundamental issue is if FASB is to move to more of an equity-type accounting from an income-type accounting, it almost has to rethink many, many FASB pronouncements, because it is now going to be in a different paradigm, as the term is used. Perhaps we are addressing, as I say, the Band-Aid or only one small part of this issue. One would have to rethink the entire process to move to an equity-type accounting structure. I wonder what your comment would be on that? This liability thing may be interesting, but it may actually be further from what may be better accounting structure for the future.

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MR. WESTON: There's an argument that if you go to fair-value accounting for all assets and liabilities, you've accomplished the all-inclusive income concept as well as the equity in the total balance sheet. So, you could accomplish both goals by a complete move to fair-value accounting. As to whether it's moving, the FASB is moving toward a balance-sheet approach versus an income statement approach. Again, I think that depends on who you talk to when you look at the conceptual framework that the FASB has established. Its objective is to be neutral and even-handed. Unfortunately, what gives rise to the issues considered by the accounting profession and the FASB typically are income-statement-type items. As I said earlier, Walter Shuts commented that, "People were recording losses too little too late." And so you do that by forcing it, by getting a proper balance sheet valuation.

MR. ROSEN: Which the Statement didn't address.

MR. WESTON: And as I said earlier, it really didn't resolve the gains-trading issue, and it didn't address the other-than-temporary-impairment issue. Two of the biggest reasons that it was undertaken were still on the table.

MR. ROBERTSON: I wrote a paper that covers many of the things I was talking about, and it's going to soon be published in Lincoln National's reinsurance report.

MR. DURAN: There's also an excellent article by Mark Griffin on an approach to market valuing liabilities that appeared in the *Financial Reporter* about a year ago, which I would like to refer people to.