RECORD OF SOCIETY OF ACTUARIES
1994 VOL. 20 NO. 1

ACCOUNTING FOR INTERNATIONAL VENTURES, NAIC, SEC, OTHER REGULATORY AUTHORITIES

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- Accounting models for actuarial reserves and related items for selected countries in the Far East, Europe, and Latin America
- Significant issues related to those accounting models
- Issues relating to consolidation of results into U.S. parents' accounting statements

MR. EDWARD L. ROBBINS: I want to make a disclaimer right up front—that although each of us has had some extensive experience in the respective market that we're going to be talking about, it's very difficult to be an expert in this area. It's somewhat like a foreign language, in that there's no end to the learning process. We're not, as you say, in-depth experts on every issue dealing with those countries, but we have had some extensive experience. After the formal session, we'd be delighted to attempt to answer any questions you have.

We're going to cover basic insurance accounting models and, to some extent, their consolidation into U.S. models. I'm going to lead off with accounting practices in Latin America. I've had a fair amount of experience in Latin America: 11 years as the international operations actuary at Pan American Life and some experience since I've been with Peat Marwick, with several of my clients having significant Latin American operations.

Next, Sue Collins will speak of accounting practices in Europe. Sue is with Tillinghast/Towers Perrin. She has just returned from two and a half years in the U.K. on assignment. She has been the chairperson of the Society of Actuaries Program Committee. While she was in the U.K. she wangled her way into being the chairperson of the 1993 Annual Life Convention of the British Institute of Actuaries.

The anchorman will be Jim Bridgeman. Jim is the actuary for Aetna International and he'll talk about Aetna's experience with respect to accounting models in the Far East. Jim speaks with significant experience in that area. He also served for ten years on the editorial board of the *Transactions* of the Society of Actuaries through 1990.

I just want to tell you that in case you become a little bit impatient with each of our presentations, each of us came to an independent conclusion that we had to frame the external environment before we got into our particular area of accounting practices. This is because the accounting practices necessarily wrap around whatever external regulatory and economic environment that's intrinsic to the area that we operate in. So each of us is going to develop the environment and then head into the accounting practices.

Let's jump into Latin America. I had a difficult time trying to figure out what might make a good, coherent presentation of the environment as far as Latin America was

concerned, because it is an entire continent with very diverse countries. You have the entire spectrum of first world to third world countries, so to some extent you're even talking about whether the insurance industry is a viable industry in that country, let alone talking about esoteric concepts such as accounting models.

What I thought I would do instead is move quickly through some of the commonalities in Latin America, where two or more countries are engaging in the same type of unusual practice that's unfamiliar to U.S. actuaries. Then I would like to move to an in-depth study of what is going on in a very fascinating country right now—Chile. Here are some of the commonalities.

First, it's typical in Latin American jurisdictions to have only one balance-sheet calculation for actuarial reserves and related items for all regulatory and tax purposes. There are typically none of the complications of statutory GAAP and tax bases, and, just to take statutory for a moment, regarding 50 states with their statutory variations, formula reserves versus cash-flow testing, etc. In Latin America, it's typically one set of reserves and they're formula based.

Second, for those who are familiar with statutory reporting in the U.S., you could look at an income statement presentation in Latin America, and it would look very much like ours: premiums and investment income at the top and reserve increases, benefits, expenses, and so forth at the bottom. Formatwise, structurewise, and frameworkwise, it's not really much different just about wherever you go in Latin America.

A third commonality, which is somewhat unusual for a U.S. actuary to encounter, is what's known as obligatory investments in some Latin American countries and exhibits supporting those obligatory investments. What do I mean by an obligatory investment? For example, some countries will require you to invest in the local currency equal to the reserves and related items, which is not a bad idea at all. That eliminates currency risk between your assets and liabilities. However, they go beyond that to require that you undergo the onerous responsibility of investing in certain types of bonds that give preferential low interest rates to the government; for example, low-income-housing bonds. It's a form of welfare tax on the insurance industry.

In an economy where the local interest rate might be 20%, they might require you to invest in 12% low-income-housing bonds, for example. Of course, you must adjust your pricing and so forth accordingly and additionally show supporting schedules to that respect. That, by the way, has been liberalizing over time, and the interest spread is becoming less onerous. There's a concept called the "Apertura," the "opening" if you will, under which some liberalization is occurring. The winds of free enterprise are blowing through Latin America now, and many of the very restrictive, somewhat socialistic practices of the past are beginning to free up a bit. The climate is becoming more attractive than it was. The obligatory investment situations, typically in Guatemala, Honduras, and Colombia, are freeing up some.

There are some countries with very onerous contingency-reserve requirements, what we would call above-the-line-type liabilities—much like our asset-valuation reserve, mandatory-securities valuation-reserve-type items. They can be very large. I know of one company in Mexico that was put in receivership and had huge amounts of

surplus in excess of its policyholder liabilities for the receivers to play with at the time of liquidation. It was legally insolvent, but it had plenty of assets to support its obligations.

In Mexico, and often in Nicaragua, there was a contingency-reserve requirement that was simply a reserve whose contributions were dictated, but whose inventory was not dictated. The contributions were a percentage of premiums and so forth and the reserve never had a cap. I understand that Mexico's formula is a bit more sensible now. I haven't followed what's happening in Nicaragua anymore.

I said earlier that I'd mention features common to two or more countries. If you'll excuse me, I lied. There's one particular thing that I want to mention to you that might catch on in other countries of Latin America. I know at least one country where it's operating. Mexico has a concept called the "movimiento extraordinario." It translates as "extraordinary activity." What it means is, on December 31 of each year, you must remove from your in-force all policies where the premium is due beyond the grace period. That affects reserves, pending surrenders, due premiums, and other related items. It's a substantial administrative nuisance and it also makes very difficult the task of quarterly trending. It's a fairly nasty process and, to my understanding, it applies to property and casualty (P&C) operations as well as life operations.

The last commonality I will mention is that there's a great emphasis on formula reserving as opposed to cash-flow-testing-type econometric studies.

Let's switch gears now and head down to the southern end of the South American continent, to Chile. I will give you an in-depth view of what's going on there. There are some very exciting things happening in Chile. It's a series of events that many Latin American countries and some other countries in the world are looking at very seriously and perhaps wanting to emulate.

First of all, Chile now has a privatized social insurance system that is working rather well. You're looking at a Latin American country whose currency is reasonably stabilized. It has a working privatized social insurance system where 30 reasonably stable, solid insurance companies are actually carrying the insurance risks for the system, and this has been a great source of capital formation in the country. The economy is booming right now. It's a successful economy at the moment by many measures.

The way the social insurance system works in Chile is that during the worker's active working life he/she contributes deposits to a so-called private mutual fund, what they call an administrator of pension funds (AFP). When he retires, he must get three competing bids from three private insurers that bid to sell him an immediate life annuity. He doesn't have to take the lowest one, but he is obligated to get three competing bids. That's basically how it works.

From time to time in recent months, you may have read some articles in *The Wall Street Journal* on why certain social insurance systems in the world may be far superior to the one we have in the U.S. I think Jim can speak to the social insurance system in Malaysia perhaps, or Singapore, which I believe has mandatory advanced

funding. I'm really not sure of that, but *The Wall Street Journal* mentions the privatized system in Chile and how well it's working.

The second unique feature that I want to speak to is a concept called the UF. The word is Unidad de Fomento, translatable as "development unit." It's equivalent to our CPI. It reflects the peso value of a basket of goods and services, but the major difference between our CPI and the Chilean UF is that the UF absolutely pervades the Chilean economy. Just about all monetary instruments, assets and liabilities both, are denominated in UFs instead of the local peso currency. Life insurance, fixed investments, and life annuities are virtually all denominated in UFs and are supported by UF assets.

Every morning, the daily newspaper in Santiago gives you the value of the UF in peso currency so that a person knows what his/her bond is worth today, more or less, and he knows what his monthly annuity check is going to be in pesos. Another example: KPMG Peat Marwick quotes audit fees typically on a multiyear basis. In Chile we now quote our audit fees in UFs instead of in pesos. It is virtually a parallel currency in Chile and it has served, over time, to help stabilize the currency. Chile is really a fairly stable currency country now, and that's saying quite a bit for Latin America.

Moving now to the life insurance products sold in Chile, the majority of insurance companies in the Republic of Chile participate heavily in the social insurance system. At the one company I'm familiar with, about 70% of premium volume comes from the social insurance system via single-premium immediate annuities (SPDAs). Along with SPIAs are social-insurance disability-income annuities, some group insurance, and also a fair amount of traditional business; nothing remotely approaching the volume of social-insurance-driven business, but the traditional business is there. Chile has a reserve modification method that is virtually identical to the commissioners reserve valuation method (CRVM), and it is denominated in UFs. The accounting approaches have to accommodate to the UF, this so-called Chilean CPI.

To begin the discussion of accounting practices in the country, a U.S. accountant would easily recognize the general format of the income statement and the balance sheet, but there are some significant differences that I will describe. First, the statutes and regulations prescribe a mortality table and an interest formula to use. Notice I didn't say *interest rate*. I said *interest formula*. These are not minimum standards. These are *the* standards. You cannot deviate from them.

This heavily regulated environment really goes so far as to impact on things like incurred but not reported (IBNR) reserves. They have formulas for that and for claims in course of settlement. They get down to that level of micromanagement of the actuarial reserves.

Let's move to a rather interesting accounting adjustment: quasi-market valuing of assets and liabilities via the CALCE adjustment. CALCE translates more or less as fit. Maybe we would call it mismatch reserve. Is that beginning to sound familiar?

Basically, assets that support the long-term single-premium coverages are denominated in UFs just like the liabilities are. There's a problem in Chile in that you don't have enough assets of really long cash-flow durations to match the far-out durations of the

single-premium immediate annuities. What happens is that that gives rise to an adjustment. It's a quasi-adjustment of the assets and liabilities to market, to the extent that one is in support of the other.

Let me stop here for a moment. I'm saying something rather incredible. Do you realize that Chile has addressed the concept of market valuing assets and liabilities on a reasonably consistent basis? This is something the FASB has yet to get a grip on in the U.S. Chile has done it successfully with a minimum of fuss. (It's amazing what you can accomplish in a dictatorship.) Anyway, I think the important thing is that we should not only look to Canada and Europe for ideas. We should not be prejudiced by the form of government in the country where the concept arose to judge the value of the idea. The Chileans have done some incredible things, and it is worth a look.

By the way, they didn't do it all themselves. Sometime after the Pinochet dictatorship overthrew the Communist government in Chile in the 1970s, economists from the Milton Friedman School of Economics at the University of Chicago were hired to transform the Chilean economy, and they virtually had a research lab to work in. The economy was in shambles at the time. They built it from the ground up—something politically difficult to do in a democracy—but you can see how it can work a little easier when you have those kinds of unilateral powers. But it's working. Now that Chile has a reasonably democratic form of government again, that type of social system tends to stay in place politically.

To give you a feel for the effect of the CALCE adjustment, let's take a look at this equation: $CALCE\ Adj = BV(L) - CV(L) - [BV(A) - CV(A)]$. The CALCE adjustment is an adjustment between book value and quasi-market value, for both assets and liabilities. If you actually have normal T-account for assets and liabilities, the CALCE adjustment actually gives the same net surplus, but it formats it so that normal earnings reflect CALCE value, and the CALCE adjustment brings the balance sheet back to book value. If you want to work out the algebra, you will notice that that comes out to book and book.

The Chileans did exactly the opposite of what the FASB and the AAA through the Committee on Life Insurance Financial Reporting (COLIFR) are doing. Market or quasi-market appears to be the earnings base, and book appears to be the balance sheet base. The difference between book and market ends up being in the separate portfolio of equity, whereas market is the way earnings proceed. I'm talking about the local books when I say this, of course, not consolidation up into the parent's U.S. GAAP financial statements.

Let's look at how the CALCE value of an asset is calculated by law. At each valuation date, the asset cash flows are divided into ten tranches. "Tranche" means cash flows coming in or going out at certain future intervals. The asset cash flows are divided into those ten tranches. The liability cash flows are similarly divided into those ten tranches.

Basically, let's take a look at the asset cash flows in tranche nine versus the liability and cash flows in tranche nine. Let's say that for a particular bond asset you have $100 of bond asset cash flows in that tranche and $80 of liability cash flows in that

tranche. That means roughly that 80% of those asset cash flows in that tranche are valued at market and 20% are at book.

For the liabilities, on the other hand, if you have $100 of liabilities and $80 of assets in a particular tranche, then $80 of those liabilities are going to be valued more or less at market and 20% at a very conservative 3% interest rate. So those liabilities that are not supported by assets in that tranche are valued conservatively. It hangs together pretty well.

The last unique item I want to touch on is an item called the monetary correction. It's a far simpler concept than the CALCE adjustment. The CALCE adjustment gets very complex. The monetary correction is far simpler. At the beginning of a year, you start with a peso value, for example, of $1,000 for bonds, and borrowed money of $400 for capital and surplus of $600.

The monetary correction is a direct surplus entry rather than an earnings entry. Let's say the value of those bonds, because of the UF increment, forces the peso value of those bonds up by 20%, and it forces the borrowed money reserves up by 20%. The monetary correction is what accounts for those increases in the peso value. The financial statement has to be in pesos. It can't be in UFs, so the monetary correction takes up that increase, and you have a constant peso-to-peso operating income statement in that way.

As a final comment, the local company, in my experience in the companies that I deal with, are very small in relation to the U.S. parent, so you have a real materiality issue of trying to adjust these CALCE adjustments and monetary corrections and so forth into U.S. GAAP. They're not terribly important and you can often "de minimis away" the predominance of the U.S. GAAP adjustment when you consolidate into a U.S. parent. There are some fairly broad-brush adjustments that are made, and attempts by my clients vary in terms of how precise they really wish to be.

Basically, the CALCE adjustment and the monetary correction, once in the U.S. books, are part of GAAP earnings even though they are direct adjustments to surplus on the local books.

FROM THE FLOOR: You spoke about Mexico in the first part. Are there any changes due to the NAFTA agreement?

MR. ROBBINS: In the accounting requirements?

FROM THE FLOOR: Yes.

MR. ROBBINS: I don't know the answer to that.

MS. SUE ANN COLLINS: As Ed said, I spent two-and-a-half years in our London office and the knowledge I gained there, plus recent interactions with my colleagues in preparation of this speech, will be the basis for my remarks. However, in two-and-a-half years I certainly couldn't become an expert on the U.K. market, let alone on all of the European Community (EC), so bear with me. The other point I want to make

up front is my remarks are going to be largely geared toward the life insurance industry in Europe, and I apologize to any casualty actuaries in the audience.

First I'll address the U.K. market, and everything I say about the U.K. is often true for the Republic of Ireland as well. I'll then move to the continent, and on the continent I'll deal with the ten countries that are part of the EC. My remarks will not deal with any of the Scandinavian countries or any Eastern European countries. Lastly, I'll conclude with some remarks about consolidations into U.S. parents or other SEC requirements for companies filing statements in the U.S.

As a start, I'd like to say that valuation regulations in Europe will be changing. As part of Europe 1992, which really started on January 1, 1993, the EC is issuing many directives, and companies within the European Community must comply with those. On July 1, 1994, the Third Life Directive becomes effective and this does impact valuation regulations throughout the EC. I will say a few words about this regulation to set the stage for changes that will occur subsequent to July 1, 1994 as a result of the directive.

As I said, the Third Life Directive comes into force on July 1, 1994. The greatest effect of this directive is that insurance companies authorized in one EC country will be able to sell insurance anywhere in the EC without being authorized in that country. They will do this on the basis of authorization in their home country. The financial supervision of that company will be carried out by the home country, and the other countries where they sell business will have no right to intervene unilaterally into the affairs of the company.

They (the host countries) can, however, prevent policyholders from buying contracts or prevent companies from advertising if it's deemed in the general good. However, to use this requirement they must be sure that this general good concept will hold up in a European court.

This concept is known as "single passport," in which a company is licensed and authorized in one country and can sell throughout the European Community.

The Third Life Directive also contains various other provisions dealing with premiums, reserves, and directors' responsibilities; some of those will be referred to in my presentation.

I think it's useful to contrast the position in the EC with that in the U.S. The single-passport approach seems very liberal compared with the way of doing things in the U.S. In the U.S., insurance companies do not have to meet requirements of 11 countries; however, they have to meet the requirements of 49 other states, in addition to their state of domicile. Maybe there's something that the U.S. can learn from the Europeans.

Before addressing valuation issues, it is important to understand the nature of the products, the assets, and the liabilities. The most significant differences between the U.S. and Europe occur between U.K. and Ireland and the U.S. It has to do with the nature of the products, the assets and the liabilities. Companies sell conventional business in these countries, both participating and nonparticipating, as well as

unit-linked business. (For participating business, the local terminology is with-profit business.) Unlike the U.S., with-profit business is sold by both stock and mutual companies.

With-profit products have very low guaranteed death benefits and very low guaranteed maturity benefits. There are no cash-value guarantees and there are annual and terminal dividends. The local word for dividends is bonuses. The annual bonus, once it's declared, is guaranteed. Future annual bonuses are not guaranteed and terminal bonuses are not guaranteed. The terminal bonus for a U.K.-style product can be as much as 40% of the final payout.

Conventional business in the U.K. is very much like the conventional business here—level premium term, decreasing term, nonparticipating whole life. Unit-linked business is very similar to our variable products in which benefits are tied to asset performance with few guarantees.

Because of the nature of the liabilities, the assets held by U.K. companies are very different than those held here in the U.S. Using data from 1991, U.K. insurance companies held 51% of all invested assets in equities, 26% in bonds, 12% in real estate, and 5% in mortgages. This is for the total U.K. market.

If unit-linked business is removed from these numbers and only conventional business is considered (i.e., with-profit and nonprofit business) the percentages drop. For example, the percentage of equities drops to 44%, but it's still substantially higher than that in the U.S. The bond percentages, excluding unit-linked, would increase to 31%. It's interesting to note that U.K. companies have been complying with *FAS 115* for some time now. They mark both sides of the balance sheet to market.

The role of the appointed actuary in the U.K. is very strong. The actuary has specific responsibilities aimed at ensuring that life companies are run on a sound basis and that policyholders are treated fairly.

As far as the valuation is concerned, the appointed actuary has four key responsibilities. He/she has the responsibility to calculate reserves using his own basis, subject to the regulatory minimums. An offshoot of this is that the actuary determines the surplus that can be distributed to policyholders and shareholders. The actuary also must certify that the company is solvent and the data upon which the valuation is based are, in fact, accurate.

There are professional guidance notes in the U.K. that are similar to our statements or standards of practice in the U.S. The notes are more on the nature of principles rather than legislation, and the appointed actuaries must state that they have complied with professional guidance. There are different levels of professional guidance, i.e., best practice and advisory. The professional guidance notes that deal with the valuation of liabilities are mandatory, and the actuary must say that he or she has complied with them.

Lastly, if the appointed actuary believes the company is not following his advice, he has a duty to let the Department of Trade and Industry, which is the body that

regulates insurance companies in the U.K., know. Of course, the burden would be on him to tell the company he was indeed going to do this.

Moving more to the specific valuation of liabilities in the U.K., the appointed actuary can use whatever method and basis he/she chooses provided it's based on actuarial principles. The burden is placed on the actuary to make a proper provision by using prudent assumptions and state that the liabilities so calculated are greater than or equal to the valuation that would be done if it was done on the minimum of criteria.

For conventional business, the most common valuation method is the net-premium valuation method. Reserves must cover future benefits and future maintenance expenses. The net premium is limited to the office premium, which is equivalent to our gross premium; hence there is no concept of deficiency reserves in the U.K. as there is in the U.S.

For with-profit business, because terminal bonuses are not guaranteed, no reserves are held for this. An explicit reserve is held for prior guaranteed annual bonuses. No explicit reserve is held for future nonguaranteed annual bonuses. However, there's an implicit reserve due to the conservative nature of the interest rate that is used.

For unit-linked business, the reserves are similar to those in the U.S. for investment-oriented business. It would be the account balance plus a sterling reserve. The sterling reserve would come into play perhaps in the later years of a contract when the mortality charges do not quite cover actual mortality costs. The use of the sterling reserve is to prevent any future losses arising on the contract. There's also a concept of a negative sterling reserve if a product has a front-end load. The use of a negative sterling reserve would serve to set the actual total reserve someplace between the cash surrender value and the account value.

The maximum valuation interest rate is based on the actual yield on a company's existing assets. The reinvestment rate for investments made more than three years after the valuation date is limited to a maximum of 7.2% currently. This is one aspect that will be changing with the implementation of the Third Life Directive. The Third Life Directive requires that the rate of interest that can be used after three years be limited to 7% and then it must grade to 6% over the next five years.

Regarding mortality, the appointed actuary would generally look at published tables and the company's own experience in setting the valuation mortality assumption.

The above remarks covered the basic calculation of statutory liabilities in the U.K. However, certain adjustments can be made. First a Zillmer adjustment can be made. This adjustment is similar to the CRVM adjustment in the U.S. in that it acts to spread the acquisition costs over the life of the policy. The size of the Zillmer is limited to the lower of the initial expenses that actually are in the premium basis net of tax or 3.5% of the face amount of insurance.

Reserves are subject to a cash-value floor. If the policy has some options for the policyholder, such as increasing the face amount at some point in time, the appointed actuary must consider these options when setting the reserves. There should also be

a provision for future expenses. There is no allowance for lapses in the statutory valuation in the U.K. if the effect of it would be to reduce reserves.

The key difference between the U.K. and the U.S. as far as statutory returns go is that the balance sheet is on a market-value basis. As is the case in the U.S., there is actually a couple of statements that companies provide in the U.K. There is the statutory return whose reserve basis is described above this. This statement is used to determine the solvency of the company as well as to determine what earnings can be distributed to shareholders and policyholders.

Another set of regulations is referred to as the Companies Act Regulations. They deal with returns that basically provide information to shareholders. These returns are supposed to present a true and fair financial picture of the company. Most companies, however, continue to use statutory reserves and no deferred acquisition costs in these Companies Act accounts. So the question of a true and fair view arises.

To react to this, some companies in the U.K. have for the past ten years held, in the holding company accounts, the value of the in-force business as an asset on the balance sheet. They refer to this as the embedded value. Companies doing this believe that it gives a truer and fairer view of the financial condition of the company. This treatment is not universal in the U.K.

For this reason, a couple of years ago the U.K. looked at an experimental accounting basis, known as the accruals basis. It was pushed by several of the large U.K. stock companies. Starting in 1992 several of the large companies published an alternative set of accounts on this basis. It was similar to putting the value of in-force business on the balance sheet, except it had planned margins in most of the actuarial assumptions and did not have any planned margin in the discount rate used.

Three or four companies actually published accounts on this basis. Many more companies calculated on this basis internally so they could see what the effect was. Accruals have not gained universal acceptance in the U.K., and now the appropriate committees have gone back to the drawing board and are about to release a new accounting method that is expected to be a combination of both the accruals method and the embedded-value method. It is expected to be released in spring 1994.

On the continent, the products are much more similar to those in the U.S. There is traditional participating business and nonparticipating business. Unit-linked business, or even something like universal life business, is not very prevalent on the continent at this point. The participating business is similar to the U.S. Returns to policyholders are not referred to as dividends. It's called profit sharing. There are various profit-sharing formulas in use.

Only one country on the continent has profit-sharing formulas that are prescribed by legislation. In France regulations prescribe a very detailed formula that must be used for profit sharing. There is no prescribed profit-sharing formula in other countries. However, once a company determines what the profit-sharing return to the policyholders is going to be, this must be approved in some countries.

A difference between profit sharing on the continent and dividends in the U.S. is that in most instances profit sharing will be used to increase contract values, e.g., paid-up additions. Profit-sharing amounts will not be returned in the way of cash or reduced premiums. Nonparticipating business is similar to the U.S. Again, there is level term, decreasing term, and nonparticipating whole life.

Assets, because of the nature of the liabilities, are very similar to those in the U.S. Bonds, real estate, and mortgages are the most prevalent assets on the balance sheet. Because of the guarantees and the nature of the liabilities, assets are held at book value. Bonds are carried at amortized cost.

On the continent, there isn't any concept of appointed actuary. The actuary would certify the technical reserves based on the technical notes that are generally set up when a product is introduced. Generally, the actuaries have no responsibility for the overall financial picture of the company. Contrasted to the U.K., the role of the actuary is extremely technical and he/she probably would not be part of management. In the U.K., actuaries have a very high profile and in most cases the appointed actuary would be a member of senior management.

The difference in this role is due partly to the highly regulated nature of the insurance industry on the continent, particularly in countries like Germany and Italy. In nine of the ten continental EC countries, the reserve basis is either prescribed in the regulations or needs to be approved. The same is true with a mortality table that's used and interest rates in use.

The one dissenting country here is the Netherlands. The valuation regulations in Holland are most similar to the U.K. where the actuary can actually choose the method that will be used. However, the reserve basis, although it's not required, is in most instances the same as the premium basis. In the Netherlands there is no regulatory requirement that the actuary look at the general financial health of the company, although in most cases the actuary does assume that responsibility. The accounts, however, are only certified by an auditor.

In all ten continental countries, the reserve basis is generally equal to the premium basis. In eight of the countries, the reserves must be certified by an actuary. The dissenting countries here are France and Luxembourg. In France it wasn't until recently that, even though reserves are legally prescribed, there was no requirement for them to be certified by an actuary. Until recently there was no mention of an actuary in France's legislation. Recently, legislation has been revised to state that a nonstandard mortality table could be used if it was certified by a competent actuary. However, *competent* has not been defined. I am not aware of any certifications that have taken place on this basis.

Reserves in Europe are very much formula driven. Changes are expected in these countries because of the implementation of the Third Life Directive, which contains various requirements about the valuation of the liabilities. For example, it requires companies and actuaries to use a prospective reserve method unless this method is unsuitable or a retrospective method would, in fact, produce higher reserves.

Another requirement from the Third Life Directive is that each element in the actuarial formula—for example, mortality rates or interest rates—must be prudent in its own right. This will make a difference in how the liabilities are calculated in the U.K. In the U.K. the appointed actuary only has to certify that in aggregate the reserves are greater than those that would be calculated based on the statutory minimums. Margins in one assumption could offset lack of conservatism elsewhere. This will no longer be allowed with the implementation of the Third Life Directive.
The rate of interest used in the reserves must be based on a prudent assessment of the yields on existing assets and the yields that can be attainable in the future. There's a limit for assumed reinvestment rates three years out. It starts at 7% and grades to 6% over five years. For most countries on the continent in the EC, this will be the first time there's a direct link between the yield on the assets and the valuation rate of the liabilities. It is expected, maybe not in the short run but in the long run, that companies will, in fact, recalculate their liabilities to comply with this so that they won't be at any competitive disadvantages.

Most of the preceding information regarding liabilities on the continent related to reserves in the statutory returns. The use of separate returns for regulators and shareholders is mixed on the continent. Some countries have two returns and some countries have a single return.

In the last part of my remarks, I will address how European subsidiaries get consolidated into U.S. parents. As far as statutory accounting goes, a European subsidiary would be carried as an asset, e.g., common stock, on the U.S. statutory statement. Generally, the carrying value of that asset would be the statutory book value calculated on the local basis. Most companies would not do a recalculation to a U.S. statutory and use that value on the statement. However, if the European operation were a branch, as opposed to a subsidiary, it would do a recalculation to a U.S. statutory basis.

For those European subsidiaries required to file GAAP returns in the U.S., most of them would do a complete GAAP return. *FAS 60* would apply for conventional profit and nonprofit business. *FAS 97* would apply for unit-linked business.

As far as the participating business or the with-profit business is concerned, several issues arise. As stated previously, with-profit business is sold by both mutual companies and by stock companies. Because the terminal bonus is not guaranteed, there is an item on the statutory returns that's called the investment reserve. This, by and large, is what is used to pay future terminal bonuses.

In translating with-profit business to U.S. GAAP, the issue becomes the split of that investment reserve between the portion that's for the benefit of policyholders and the portion that belongs to shareholders. Once it's determined, the portion that is for shareholders would be included in GAAP net worth. There have been 20- or 30-page papers on how the investment reserve gets split. If anybody would like more information on this topic, I can get you that at a later date. It does not make sense to even try to start on that topic now.

Under *FAS 97*, which is used for unit-linked products, there is considerable scope for judgment on how *FAS 97* gets applied. It is quite clear that the FASB was not

considering U.K. products when it drafted this pronouncement. For highly efficient products, *FAS 97* does not work very well. What I mean by *highly efficient* is a unit-linked product that has front-end loads during the first two or three years that not only pay all of the acquisition costs of the product, but also provide all the profit to the company as well. A strict interpretation of *FAS 97* in this instance would, in fact, make the GAAP accounting on the product far more conservative than U.K. statutory accounting. Companies have had a lot of trouble with this.

We have seen various treatments of these products. For the most part, it depends on how material the company is to the U.S. parent and how material the unit-linked business is in the U.K. company's own book of business. We have seen companies not defer either the acquisition expenses or the loads when the business isn't material. Some companies have been very liberal and have only deferred that portion of the load that covers the acquisition expenses. In fact, the deferral period they've used is the period over which the load is collected, which is a little bit different than what was intended by *FAS 97*. Other companies have taken a very strict interpretation and have deferred all the acquisition costs and the loads, which makes GAAP accounting very conservative.

Finally, GAAP issues arise not only for European subsidiaries into U.S. parents, but for European headquartered companies that are traded on the NY Stock Exchange, for example. The SEC requires them to file GAAP statements, so in fact these GAAP issues would arise for those companies as well.

MR. JAMES G. BRIDGEMAN: I'm going to speak about the same topics you've heard before from a Pacific Rim perspective. There are a number of things you should understand. First of all, it will be a life insurance focus. You will be looking at these things through Western eyes. I am the actuary who reviews the work performed in the Pacific Rim countries.

I intend to speak from an illustrative point of view of the sorts of things one runs into in the Pacific Rim, not from a comprehensive, organized point of view. With that in mind, I'll be speaking to issues as we have experienced them in one company. For some perspective, I tried to organize that experience into the notion that there are broadly three insurance cultures in the Pacific Rim. At least that's what I happened to have stumbled onto. I'll speak from two main examples: my experience in Taiwan and in Malaysia. If I don't drag on too long, I'll throw in a couple of other examples.

I'll speak about local accounting, the issues presented in a U.S. NAIC context by local accounting and operations, and also about some issues of consolidating into the U.S. GAAP accounts of a U.S. stock-company parent. I will not speak about U.S. tax-reserve issues or to the intricacies of Sub-Chapter F. As the other speakers have noted, in most cases the local tax basis is the local statutory basis of reserves.

The first of the three insurance cultures that we have run into use the British way of conducting and regulating insurance and accounting for it. Broadly I'll identify a second one as close to the American way of doing things. Third is what I had thought was a Japanese way of doing things. I learned on Wednesday that the Japanese way is really the German way, at least in its roots. I guess that's why we come to these conferences.

In Taiwan, first of all, the nature of the insurance environment, for me, is the most familiar of the three insurance cultures. It's very much as the U.S. might have been two decades ago. We're looking at cash value, traditional-life products sold by career agents, regulated under a filed form and rate kind of regulation, prior approval with a net-premium modified reserve, and reserves without consideration to expenses.

However, it's quite unlike the U.S. is or ever was in that Taiwan is a very high savings society. It's highly relationship oriented and family oriented in its culture, and its regulatory process is highly controlling, although those regulations are inevitably developed through a long process of discussion and consensus in the insurance community. The product set tends to be oriented toward the high savings phenomenon. There are many endowment products, limited-pay products, and products with increasing benefits and premiums; therefore, cash values flow accordingly.

There is a much heavier use of riders on top of the basic life insurance or endowment policy than in the states. Riders offer term coverage on related lives to the primary lives, not only waiver of premium, but also disability-income-type protection. Other sorts of accidental benefits are under the main product, and even scheduled medical benefits or dread-disease benefits are all attached as riders to a basic life insurance policy.

It's an environment where the business is not participating as such. However, the Ministry of Finance requires that dividends be paid. The dividend formula currently stands based on the difference between what's called the two-year bank deposit rate, which is a government-regulated rate among banks in the country, and the interest rate filed in the pricing filing for the product in question. Mortality is based on the difference between the industry-wide mortality experience and the required mortality table used in pricing the product. Regulations will be forthcoming on a required expense dividend.

The other key characteristic of the environment is very high interest rates. In the past, we've been quite used to seeing them in a 9% or 10% environment. They've been declining, but we are still investing at certainly something in excess of 8%. However, the durations are quite short. There are simply very few long-duration instruments available.

The Republic of China required reserve basis promulgated by the Ministry of Finance is quite similar to the CRVM of the states. However, the modification is not limited by the renewal premium of a 20-pay life product. It's limited by the renewal premium of a 20-year endowment product, consistent with most of the product set in the country. Due and deferred premiums are deducted from both the asset and the liability sides of the balance sheet in the statutory basis. The statutory assumptions are currently at 6.5% interest assumption and the 89 Taiwan standard ordinary table. There is a rather unique feature called a special claim reserve which, for most accident, medical, and short-term business, requires one to simply accumulate a contingency reserve and put it as a liability on the balance sheet. That's an annual increase equal to essentially half of a representative net premium less the actual company claim experience. To the extent your company claim experience is bad, the formula automatically lets you dip into that reserve, but that's the only way you can dip into that reserve.

We do business in Taiwan as a branch of a U.S. company, so that raises some questions of how we report reserves for NAIC purposes. To use minimum NAIC requirements, the basic life insurance reserves would come out perhaps 8% stronger for our book and mix of business than the Taiwanese basis. Some of the assumptions tend to weaken the reserves and the mortality table tends to make for stronger reserves.

We are fortunate in that the only business conducted by the particular U.S. company is its branch business in Taiwan. Therefore, we've obtained permission from our state of domicile to use the Republic of China standard in our NAIC filings with our state of domicile. The other states where we're licensed, those do not include New York for that company, have gone along with our state of domicile in that. That makes many things easy. We can use one reserve basis.

Still, some interesting questions come up in the reporting area, which largely boil down to which part of which exhibit should certain things be reported on. For example, I mentioned all of the various nonlife contingent riders that typically attach to a life policy. Should they go on Exhibit 8 or should they be forced into one of the other exhibits? We have tended to put them in Exhibit 8 for riders to life insurance policies. That creates some interesting wrinkles in the analysis of change in reserves on page seven of the convention blank. Because the tabular cost of insurance is the balancing item, and with a lot of term and nonlife coverages involved that's a pretty bizarre exhibit. So we provide to our state of domicile a restatement of the exhibit excluding the effects of the nonlife riders.

There are also some very interesting questions around cash-flow testing. Our permission to use the Republic of China basis did not extend to an exemption from cash-flow-testing requirements, nor would we have wanted such an exemption given the mismatch that we have. We test it. We can't make it go away, but we test the effects of it to know our exposure.

As I indicated earlier, a mismatch is inevitable. It's only within the last four or six months, I believe, that for the first time a ten-year government instrument became available on the market. Prior to that, anything in excess of three years was quite rare to have. We test that mismatch and measure it for its likely effect on us and make our reports accordingly. Fortunately, the embedded profitability of our book of business has tended to be able to absorb the prescribed scenarios in U.S. cash-flow testing.

One of the more interesting things is what we do about our assumptions in cash-flow testing by way of correlation of variations across the asset and liability side. In particular, with a higher interest rate trend, which is, of course, not the trend that most disturbs us, but in that test should we be assuming a great take-off in policyholder withdrawals? We've concluded tentatively at least that the answer is no, because of the government-required dividend assumptions, which we do model. As interest rates go up, we will very rapidly be required to credit higher interest rates to our customers, and therefore disintermediation risk is less important.

We are scratching our heads a bit about what sorts of economic scenarios, not necessarily interest rate scenarios, would create a liquidity demand among the individuals in the economy, which could trigger some high withdrawals. Another question that arises first in the cash-flow testing sense is what really are one's best estimates about the future of interest rates when they are starting high. The scenario prescription for the prescribed scenarios would tend to make one think that the middle of the road is interest rates staying where they started. That doesn't seem like a good best estimate. In fact, when we do stochastic cash-flow testing, which we've begun to do for that company, we need to put in a baseline. We're convinced that about 8% forever isn't even the good expected value of that stochastic universe. We debate about what sort of decline is the correct thing to put in. We try to relate it to a flow of capital model within the economy of Taiwan.

Finally, one of the key variables in our cash-flow testing is the fact that much of the government regulation, particularly the dividend rate, keys around a government-determined two-year CD rate in banks. The government does determine what that rate is and what the banks shall credit on two-year CDs. However, as near as we can tell, the government does not and cannot force banks to accept deposits at that rate. So we have a modeling question. At what point and in what scenarios should we assume that, even though the official bank rate and scenario is at a given level, we won't be able to put our money in a bank and earn that return, what will we be able to invest in?

For consolidating into the U.S. GAAP reserves of our parent, the interest assumption does become interesting. When we opened business in the country, we assumed a 6.5% interest for our GAAP reserves in a 9.5% or 10% interest environment at that time. In the light of being in a start-up mode, that sort of conservatism seemed appropriate. Now we're being pressed from two sides. On the one hand, the auditors are concerned that we not take too large a margin in our reserves, that we not, in effect back-end our profits too far. But at the same time, whatever the current level of interest rates in Taiwan is, it would seem that the best basis for modeling would be some sort of decline from where they are.

Other issues we have on the U.S. GAAP reserves, again, are lapses. It's a question of appropriate conservatism in a country and a society in which we're not familiar operating. We'd be more comfortable doing our GAAP reserves on a fairly conservative assumption directly related to the pricing, which is conservative. We are receiving expert advice that the lapse assumption is one that should be set at very close to the current experience for each new year's issues, that it should be set at that level, unless we have specific reason to think it will diverge. We assume about 20% first-year lapse rates in pricing, and we are experiencing closer to 10% actually, so that becomes an issue for our GAAP reserves.

Another issue is in how we account for the dividends to be paid in the future when one is assuming a 6.5% interest rate assumption. In our particular product set, the dividend doesn't kick in until the reference rate; the bank CD rate, is in excess of 8%. So we're paying modest levels of interest dividends now, but we're reserving for none because our reserve basis says that the future interest rates will always be below the trigger point. Again, the audit opinion or pressure has been to set up some

set of assumptions under which we will be providing for some future dividends, but not robbing all of the conservatism on our basic reserve assumption.

That leads directly toward the notion that we will, in the future, be setting our GAAP assumptions for new issues on a declining interest rate assumption, so that a higher interest rate and rather low spread early on will trigger a dividend reserve. But we can have the conservatism that we value and get a lower interest rate in place for

later durations without terribly disrupting the incidence of earnings from an auditor's perspective.

The next major area I wanted to speak to was Malaysia. That's very much in the British insurance culture among the three that I mentioned. The product set is built around a reversionary bonus approach, such as Sue described for the U.K., but there are many differences. The regulatory agency, the Bank Negara Malaysia, the central bank of the country, is working very rapidly and very effectively to improve the tone of the market. The sort of effective disclosure dimension of the British culture is not yet fully present there.

On the side of the reversionary bonuses and on particularly the terminal bonus side, the notion that these are nonguaranteed and will depend on equity performance is not so well known in the marketplace. They are, in fact, legally nonguaranteed, but that's not the way the sales process seems to work for most of the competitors. That is, there is a sales emphasis on very high maturity bonuses, such as Sue talked about, which would tend to kick in only for 20-year persistency and beyond. If one lapses earlier, one has no maturity bonus to deal with.

Those high bonuses tend to feature very aggressively in the illustrations, although as of January 1 the Bank Negara had put out much more stringent regulation around illustrations than it had in the past. We find already that many competitors find ways right around the regulations as written, so that's a problem.

The basic accounting model is a fund accounting model on a with-profit basis, again, from the U.K. tradition. That is, the assets of the insurance fund are a subset of the total assets of the company. The insurance liabilities are set against those assets, and this is on all lines of business, both with and without profits. The property/casualty business is in the same fund as the life business and the group business.

Also, not all of our business is participating or with-profits, yet all of the business with-profits and without profits is in that same fund. There is a nominal restriction that any transfers from the insurance fund with respect to with-profit business shall be limited to 25% of the bonuses credited in any given year; that is, the transfers out of that insurance fund into the general shareholder fund. We'll see later there is some ambiguity about just what that phrase with respect to the participating business means.

Finally, as in Taiwan, we see an environment of very high current interest rates and fairly short durations on what's available. Within that environment, the Bank Negara Malaysia required reserves are quite similar to what Sue described for the U.K. There is an up-front expense allowance on a Zilmer basis that is limited to 3% of the face

amount of the business and is also limited in that the initial valuation premium shall be at least the preliminary term premium.

The prescribed assumptions, and this is unlike the U.K. situation, are 4% interest and the 1924–29 British Assured Lives Experience Table. Because they are not formally guaranteed, the only bonuses that are provided for in the reserves are those that have been declared by the board. Compared with U.S. practice, even the bonuses that will be credited in 1994, for example, will not enter the reserves until the end of 1994, because the board will only authorize the 1994 reserves at its June or July 1994 meeting.

Also, in terms of treating the without profits business, which, as I said, is mixed in the general insurance fund, it's not clear what the regulatory intent is. We're going to try to clarify that issue and force it by actually doing segregated accounting within the insurance fund for the with- and without-profit business.

Finally, in the property/casualty area, just briefly, it is only with the 1993 year-end accounts that for the first time there was even a requirement for an IBNR component of the claim reserves on property and casualty business. Again, the Bank Negara is working very hard and with a lot of outside input to clean up one issue and one area after another. This is one that it just got to.

That sort of environment for the statutory reserves leaves us with all sorts of interesting questions on consolidating into our U.S. parent on a U.S. GAAP basis. Again, similar to Taiwan, what's the appropriate interest assumption for U.S. GAAP reserves where you're beginning high? It would seem foolish to assume continued high interest rates, yet GAAP principles want one not to build an overly large margin into any assumption.

A particularly thorny problem is this treatment of the shareholder restrictions on earnings that can accrue to shareholders. U.S. GAAP says that in a situation like this, we should treat it as a timing difference. We should do a U.S. GAAP basis calculation as if we didn't have all these restrictions and then apply the restriction to the resulting U.S. GAAP earnings and treat the difference as a timing difference between the two accounting models.

However, in our case, because of the high terminal bonuses in Malaysia, we believe that for virtually any company operating competitively in Malaysia, the present value (using GAAP assumptions) of future bonuses, including the illustrated terminal bonuses, will restrict shareholder profits much more than the 25% restriction that is built into law. U.S. GAAP seems to tell us then that we should base our reserve for dividends on a standard level premium reserve calculation for those bonuses, as illustrated or as priced.

Having said that, one now revisits the interest assumption where one wanted some conservatism. A combination of the conservative interest assumption and the use of illustrated bonuses may perhaps be overly conservative when those bonuses aren't guaranteed. Another interesting question that arises then can be found with respect to lapses. This is potentially a lapse-supported product configuration that's operating in the entire market, and more than just potentially. That's the basis for the screwy

competition that's going on right now before the Bank Negara completes its reforms. What does that mean for U.S. GAAP accounting?

Well, right now we are experiencing better, i.e., lower lapse rates than our reserve basis which, in a U.S. GAAP context, tends to allow us to leave acquisition expenses deferred longer. So it looks better on a current basis. But all we're doing is building a bigger liability for the terminal bonuses, as illustrated. Appendix B to the Audit Guide seems to say that if lapse rates are emerging inappropriately, change them. This is the one place where the door is open for unlocking in the U.S. GAAP theory, but it is in a context of deferred acquisition cost (DAC) amortization only. So we scratch our heads and look at that a bit.

It gets even more interesting if you look at it from a loss recognition point of view. We have a situation in which we use our best assumptions and keep ourselves fairly honest about that. On a present-value basis we still think our net GAAP reserves are greater than a proper gross premium valuation. However, all we have to do is project them out on the same assumptions for eight, nine, or ten years and there's a cross-over point, as we get closer to those terminals, where they become insufficient.

In that situation, Section 8.92 of the *Audit Guide* says and I quote, "In such situations, appropriate adjustments [whatever that means] should be made to reserves to eliminate the recognition of losses in later years." *FAS 60* in paragraph 37 says only "the liability shall be increased by an amount necessary to offset losses that would be recognized in later years." Well, that's good. That's exactly what we want to do, but it doesn't tell us exactly how to do it.

We've taken an approach of using a deferred or an unrecognized profit reserve along the lines of what *FAS 97* calls for on limited-pay products as a logical way to deal with this particular issue. We are looking forward to the Bank Negara putting more discipline on the marketplace as the proper solution for all of this.

Just briefly, Hong Kong is squarely in the British tradition, including a highly independent appointed actuary who, in fact, has fewer restrictions on the assumptions and procedures he or she can use than even the U.K. requires. There are some interesting issues there from the point of view of proper accounting. There are some currency considerations. The majority of the market in life insurance is in U.S. dollar-denominated products in Hong Kong for a variety of reasons. Another interesting fact, however, is ever since the 1987 stock market crash, the Hong Kong dollar has been pegged officially to the U.S. dollar and hasn't varied a hair from it since.

The third fact is, from time to time during the course of a year, there will be opportunities, despite the pegging of the two currencies, to lock investments in on a spot-rate basis in Hong Kong dollars at a somewhat higher yield than is available in U.S. dollar-denominated investments. It doesn't persist because of that pegging, but if one waits and does that locking in, it can lead to some interesting questions about the proper GAAP interest assumptions; i.e., do you believe those spreads and when can you lock them in?

It's almost entirely with-profit business. On a mixed model, some of our book of business is on a reversionary bonus kind of basis. Some of it is on a more traditional

dividends basis, such as what a U.S. or Canadian product would look like. The local valuation, first of all, is no problem. Whatever the actuary is willing to certify in Hong Kong is in fact the reserve. There are very few restrictions other than those imposed by professional obligation. Those are real, but those can be solved.

In U.S. GAAP, the question of the margin arises. It is participating business. The GAAP instructions would suggest one can go with little or no margin, provided one is very skeptical about that approach before finally concluding to do that. That's a matter of continual monitoring and debate for us.

Finally, Korea is, to my experience, an example of the third insurance culture, the Japanese or German model. It's extraordinarily highly regulated. In almost every step you proceed in lockstep with the Ministry of Finance. The product set is quite different than an American or British experience. There are many options in a product, many accident-driven benefits, a lot of variation in benefit, depending on cause of death. Those are just some examples of the differences. Were I knowledgeable enough, I could speak a long time about Korea, but I'm not and we don't have the time.

There are very significant valuation issues raised by lapse rates, which can be as high as 50% or more on first-year lapse rates on many products. That stems from an aspect of the insurance culture, which I don't think traces to the Germans. That is, most individual insurance products are both sold and bought by the female member of a household. It will be on the male life, but it is the spouse, the wife, who will purchase that product on a relationship basis from typically another spouse living in the neighborhood.

The newer companies in the market, which are most of the companies except the original six sisters—and these companies were all established within the last five years—have been allowed to defer up to one-half of all expenses. There's no definition of what an acquisition expense is or anything, but one-half of all company expenses have been allowed to be deferred to be amortized over the second five years of the company's existence. Exactly what you would think might happen from that situation has happened. There are many companies that, by any measure that you or I would consider normal, are in fact not solvent but are actively in business encouraged by the government. That has led to some very interesting U.S. GAAP-type accounting considerations for us. We have, in effect, taken our pain on the U.S. GAAP basis. In other words, we've been reporting on a very conservative view only true acquisition expenses and only those on a cell-by-cell basis. We don't do it on a company basis or on a line-of-business basis. Essentially every cell of every product at all times needs to be self-supporting or we will write off acquisition costs.

Those are some of the experiences in the Pacific Rim.

MR. ROBBINS: We have time for a few questions.

MR. BRUCE E. JACKSON: Just before I left, one of our clients found an advertisement for a Swiss franc annuity. It's my understanding in reading this one-page advertisement that you could purchase it by direct mail. You could be in the U.S. and

purchase a Swiss france annuity that will have tax advantages and maybe a higher interest rate than can be received there.

I was wondering if any of you are aware of that and what the accounting procedures would be. What if we set up a foreign company to do that as a subsidiary? Then you contact our agent and he'll have you purchase a policy in Switzerland. Or why stop there? We could go to the Pacific Rim or anywhere. Is that allowed? Among countries, are there even regulations to police where the policy is being purchased or where the insurance company is? Also, one of the main points for that, I guess, would be the tax rates. What are the tax rates for insurance companies in different parts of the world?

MR. BRIDGEMAN: That's a much better question than you're likely to get an answer from us. We've seen things like this in Latin America, where it is called the gray market. We don't participate in it, so I can't answer very well to how it might work. On your specific question of tax rates, 15% or 20% of profits is not an uncommon rate in the Pacific Rim.

MS. COLLINS: I can't answer your first question as well. As Jim said, we are familiar with those sorts of practices, particularly in Argentina, although I understand from July 1, 1994 those will no longer be available even in Argentina. In Europe, throughout the EC, it has been legal for some time to buy contracts. If you're located in one EC country, you could approach a company in another country and buy a contract without any penalties, and that's been available for some time. Now with the Third Life Directive, you'll be able to buy all over Europe, but I'm not sure what happens in Switzerland.

As far as tax rates, the U.K. has a very complicated tax basis. The pension business is taxed on profits at a rate of about 35%. Nonpension business is taxed on investment income less expenses, and the rate on that varies. The base rate is 25%, but then there's a different rate on growth in common stock, so it's pretty complicated. I'm not an expert on U.K. tax, but it's very complex. I can speak directly for Holland. Holland, for example, would be taxed on profits at a rate of about 34%.

MR. ROBBINS: Latin American bootleg business has existed for a long time. Apparently it's being tolerated more by the local governments now and is not labeled "bootleg business" to the extent it used to be. It is being tolerated more with the opening that's been taking place in places like Venezuela and some of the other Latin American countries. I don't have good knowledge on the individual tax rates.

With respect to your first issue, I'd like to know where the tax savings are. Are you talking about avoiding 7702, for example?

MR. JACKSON: Right. They made it sound like you could send this money over there. It sounded like there would be a big tax break. I thought why not just have the U.S. company purchase some kind of investment in a foreign market and say, well, there it is? But they said, No, there's some kind of a tax savings, maybe no taxes when it's annuitized, lower taxes for the insurance companies in Switzerland that would make this all a much more profitable deal.

MR. ROBBINS: I know this, that the reverse has taken place. When you sell a policy to a foreign national out of a local U.S. company, the 7702 issue is not a major issue. The monitoring becomes less necessary, maybe unnecessary. I have some knowledge about that.

MR. JACKSON: And not the other way then?

MR. ROBBINS: That's right.

MR. JACKSON: One last thing. Is there an idea, like in the U.S., where there's a minimum surplus requirement to start an insurance company in U.S. dollars? Can you come up with what's required in these different foreign countries?

MS. COLLINS: The solvency margin calculation is quite complex. It has some asset components and liability components. The liability components would be maybe something that would equate to 4% of the reserves and $3 per $1,000 for net amount of risk, or something like that. That would be on the conventional business. For unit-linked business, it would be a very small solvency margin.

FROM THE FLOOR: One of the things I was wondering about is who is taking the political risk in Hong Kong? Is it the purchaser or the company with 1997 coming?

MR. BRIDGEMAN: It is the company. When you ask it that way, it's interesting in that it may depend on the ethical behavior of the company. If there were a disruptive political change, which we don't believe is going to occur in the business context, if it were to occur, the enforceability of the contract, which makes it our risk, also comes into question, but clearly it's the company's risk. We're making specific guarantees in a contractual form, the majority expressed in U.S. dollar terms. We expect to honor those obligations, regardless of the change of political circumstance.