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### Financial Reporting of Multinationals

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*Summary: As U.S. companies expand abroad, and as foreign companies enter the U.S. market, there are issues to be addressed with regard to financial reporting methods. Descriptions of the problems that arise and how companies are managing in a multireporting environment are presented.*

**Mr. Mark J. Freedman:** As U.S. companies expand globally and as foreign companies enter the U.S. marketplace, there are issues to be addressed with respect to financial reporting. Some of these issues are quite complicated from a technical point of view, and some of them are quite complicated from a practical standpoint. My experience has shown that nothing's easy when it comes to this subject. Our panel is going to discuss some of the practical and technical issues, all from a different vantage point. Our speakers are Ed Bonach from Allianz Life Insurance Company of North America, a subsidiary of Allianz, the large German insurer; Michael Terne from American Life Insurance Company (ALICO), part of American International Group (AIG) which has a large overseas operations; and Phillip Whitefield from Lincoln National, U.K., a subsidiary of Lincoln National. I'm from Ernst & Young, LLP.

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Ed Bonach is going to speak first. He's an FSA, and senior vice president and chief financial officer (CFO) of Allianz Life Insurance Company of North America. As a member of the Allianz Life team for 19 years, Ed has served in a variety of actuarial and management leadership roles and has worked closely with the company's German parent. He's held his position as CFO since 1993 with overall responsibility for financial management of the company. He oversees the actuarial and the accounting, tax, and information systems areas. Ed will address the type of reports Allianz uses to assess financial performance and how they pull it off, and he'll talk about the practical side and how important the people issue is.

**Mr. Edward John Bonach:** I'm going to try to provide some insight, as Mark said, on how we can climb this financial reporting mountain for multinationals. With the array of languages, cultures, and financial reporting standards in the various countries, along with time differences and distances, it poses some daunting challenges for companies like ours and yours. My thoughts primarily will be shared from the perspective of my experience as part of the Allianz group worldwide. As Mark said, we are headquartered in Munich, Germany. Allianz AG, which is the ultimate parent of my company, Allianz Life Insurance Company of North America, is one of Europe's largest insurers and one of the five largest insurance groups in the world.

Allianz has operations on six continents and in more than 50 countries through more than 100 consolidated and affiliated companies. Even though Allianz still receives a majority of its business in its domestic market, with about half of premium income coming from Germany, we have above-average growth outside of Germany, and, coupled with our strategy of worldwide diversification, we are achieving more of a global balance. Additionally, there's a growing balance between property/casualty and life insurance with property/casualty still the more dominant of the two. You might ask, Why am I telling you all of this? First of all, it's to give you an idea of the breadth of the operations and the lines of business that need to be consolidated into one shareholder report or one set of management reports. At the same time, these financials are consolidated to provide management with useful information to evaluate the different subsidiaries' management and profitability, along with determining where the shareholder funds should be invested for optimum returns.

Can all of this be achieved in one system? Let me explore this further. For public reporting purposes Allianz produces its annual report to shareholders in conjunction with German accounting standards, as this is their domiciliary base. These German accounting standards pose some special issues. All of the insurance products are reported under a basis that mirrors more our U.S. statutory accounting, although it has some aspects of U.S. GAAP. Even though Allianz in Germany and other parts

of the world has some products that follow *Financial Accounting Standard (FAS) No. 97*, like universal life (UL), all monies are received and reported as premiums, so they are reported more on a statutory or an *FAS No. 60* basis.

They do allow for some deferral of acquisition cost, but the amounts that are deferred are generally less than under U.S. GAAP, and amortization occurs somewhat more rapidly than U.S. GAAP as well. Probably the most substantial difference is how investments are reported. Assets are held on what is called the lowest-value-ever principle. That means that if you buy a stock in 1980, and it was at \$20 a share, then in the October 1987 crash, or maybe I should say October 1997 crash, it dipped to \$5 a share, but now it stands at \$50 a share, that asset continues to be carried on the insurer's books at \$5 a share or its lowest value ever. In other words, the difference of \$45 is an embedded or unrealized gain, and this amount is commonly referred to as the so-called hidden reserves. In German accounting this amount was not even publicly disclosed until recently. They are starting now to footnote what the true market value of their assets is, but it's not with respect to all of their assets yet, so it's very difficult to get any idea of the size, value, and overall profitability of a company.

You may think that with the European Union that might help standardize financial reporting principles across the European community. However, with the current difficulties that they are encountering with reaching consensus on a single European currency, I wouldn't necessarily hold my breath on any clear-cut financial reporting unification in the near term. The Europeans have historically focused their reporting on solvency. German accounting is no different. Even though there has been progress in allowing insurance activities across borders, the taxation and law continue to be controlled by the specific countries. On top of that, there are varying industry or insurance structures across Europe. For example, in Germany, all life insurers essentially operate like mutual companies here in the U.S. with their participating policies. The dividend payments on those policies, however, are mandated by their insurance regulations to where at least 90% of the profits earned by the company are to be paid out in dividends. Competition in their markets have forced the multiple to be closer to 98% of the profits being paid out as dividends.

You layer on top of this the different cultures, the wars that have taken place, and the differences that cover generations and centuries, and you can see our financial reporting mountain starting to get even steeper. Furthermore, even if Europe gets unified, we have the rest of the world to deal with in multinational financial reporting. In my opinion, the key question here is can you do effective financial reporting for multinationals through one system of reports, or do you also need people? Let's explore this more by looking at some of the issues that we face in the Allianz group as well as the objectives that we try to utilize in that group.

Certainly, a key objective that we have is to consolidate financial results to cover our shareholder and statutory reporting requirements for the public and legal domain. At the same time we have to consolidate results because of those weaknesses or issues with German accounting that we use for internal management purposes. The internal management reports are on a different basis than our shareholder or public reporting, which I'll explain more. A second objective with financial reporting in the group is to evaluate the performance and profitability of the various group companies and their managements. The third objective is to assist in the analysis of risks and opportunities for each of these entities and their respective markets. Last, but certainly not least, the financial reporting system is intended to be a tool for allocating capital and making those capital allocation decisions in the group.

The reporting approach that we've taken in the Allianz group is to seek to determine what is called the underlying operating performance of each unit. The accounting principles that we utilize are very similar to U.S. GAAP accounting. We do include the change in market value of assets on an annual basis into our income statement. A key issue that we had to face is whether or not to report this as a separate line item or have it as part of another. In my opinion you need to keep that change in market value of assets on a separate line and disclose it as such, especially if you are not also looking at the market value of liabilities. In our process we do not go and value the liabilities at market. What we do is to show income from operations again much like U.S. GAAP. Then we have a separate line for change in the market value of assets that's irrespective of if they are considered available for sale or trading or the other distinguishing characteristics that we would have in the U.S. We then have a separate line following that for realized capital gains and losses, and, as I said, we do not value liabilities at market. More of the U.S. GAAP principles are there as well.

It's almost as challenging of a task to define required capital or target surplus across a multinational group. That difficulty is seen in the travails that we've had in trying to decide what standard we will use. We did explore a formula type approach. We looked at the NAIC formula and rating agency formulas. Different countries have their minimum capital requirement formulas that are, in some cases, quite simplistic. We decided that we couldn't come up with one formula without potentially having it be misunderstood or misleading. If we did come up with a formula, we thought it might consist of too many compromises that would not be effective tools for financial reporting and decision making. Therefore, what we do is to allow the companies to define their own level of required capital however they see appropriate, and that capital is the amount that they feel is necessary to run their operations over a reasonable time frame. We don't define the length of time that's needed. If it's over the next year or the planning horizon where we are normally

looking at three to five years, again that's the company's discretion. In our case, in the U.S. companies, we use a combination of the NAIC risk-based capital and our own target formula as well as monitor the rating agencies' formulas.

The proviso that we have is that if you need the capital—and say you need a certain amount—you're expected to meet the company's hurdle rate of return on it, and at the same time to the extent that your company's required capital is less than the actual company's capital, that difference is considered free capital, and it's subject to call by the shareholders or dividend payment and redeployment in the group for optimum returns. Each of the operating subsidiaries' performance is also compared to the plans that they develop annually, along with looking at peer company comparisons in the subsidiaries's respective markets. These comparisons are facilitated through a formal process called the strategic analysis and dialogue. The subsidiaries's executives meet with Allianz's top management to discuss market trends, opportunities, risks, and issues while revealing current strategies and developing new ones to capitalize on the company's strengths and the market opportunities of that respective subsidiary. This strategic process then culminates with the development of an annual plan, and we also look at a longer-term plan at the three-year time horizon. This is again reviewed with Allianz top management prior to its finalization.

The strategic discussions start in July. The plan then is developed in the latter part of July through August, submitted in September, and finalized in October. These discussions seek to ensure that the plan that's developed is consistent with the strategies that were discussed earlier in the year. Supplementing all of this are regular meetings of the group's financial officers and executives to communicate corporate objectives and results, along with issues and opportunities that they face. We also review subsidiary activities and financial performance, and we try to foster a mutual understanding of what's happening in the different markets and ensure that there's some know-how transfer within the group.

That brings me back to the key question that I posed earlier. Do you accomplish financial reporting on multinationals through people or reports? I'd like to submit to you that you need both. Financial reports are a key. You need to have a basis that does give a fair representation across the different cultures and companies as far as what the underlying operating performance is. But unless you really know the company's strengths and weaknesses, its markets, and its strategies, the financial reports alone can be misunderstood and oftentimes lead to inappropriate decisions and actions. And I think in today's world of technology, video conferencing, and frequent flier miles that you can do effective financial reporting for multinationals by using both people and reports.

**Mr. Freedman:** Next to speak is Mike Terne. Mike's an FSA and vice president and chief actuary of ALICO. As chief actuary, he's responsible for all actuarial areas including U.S. GAAP, U.S. statutory reserves, and tax reserves for business in about 50 countries. Mike has been doing international work since 1986, starting with CIGNA Worldwide from 1986 to 1989, and he has been with AIG since 1989. Prior to that, he was with a consulting firm and a few insurance companies. Mike's going to discuss some of the logistical issues and technical problem areas in performing the various financial reporting functions in a multinational.

**Mr. Michael Terne:** Basically, in order to adjust your expectations of what's to come, I offer the following comments. This presentation will not occupy itself with esoteric, mathematical symbols. At my age, I resist engaging my remaining cerebral functions in an effort to cope with integrals and their like. Likewise, minimal, if any, reference will be made to binomial lattices, partial differential equations, and option-adjusted spreads. While I'm willing to deal with these concepts, I really don't want to this afternoon.

What we are going to do is discuss the more mundane, yet often highly frustrating practicalities of operating a life insurance company, whose business is spread globally, except in the U.S. We start in Japan, proceed through South America, hit some of Africa, proceed through Western and Eastern Europe, Russia, Turkey, the Middle East, and Pakistan to Bangladesh. One of our most impressive operations, by the way, is Bangladesh. Another of them, Nepal, the home of Kathmandu and Everest, will come on line soon. As Mark said, I'm vice president and chief actuary of ALICO. That position entitles you to be kicked around routinely by senior management if anything goes wrong on their GAAP results, and, believe me, at American Life AIG that is a true state of affairs.

Another disclaimer: What we have here is material that's from my experience and observations over ten years or so. What I'm saying may or may not be relevant to ALICO or any other specific company. Any numerical data referred to are hypothetical or rule-of-thumb. Actually, I don't believe I refer to any numerical data, so we don't have to worry too much about that. In any event, it will, not be derived from actual financial ALICO data. So if you were hoping for that, forget it. At the risk of oversimplifying we have four levels of financial reporting that we worry about. We have local statutory and regulatory reporting, U.S. statutory, U.S. GAAP, and U.S. tax.

Local statutory and regulatory reporting is the primary responsibility of the local actuarial division; although assistance can be provided by corporate actuarial on request. I am responsible for U.S. statutory reporting. Even when we base it on the local statutes it's still my responsibility. If the local people make a mistake, once

you sign off on it, you've bought it. You can't blame them. I find that's an extremely important concept to work by; otherwise the finger-pointing is almost endless and circular. Once you sign off on it, it's yours. I don't care where the mistake was made. It's corporate's responsibility. Depending on a particular state's laws, you may or may not have to restate your branch balances.

When I was with CIGNA they had to restate their overseas branches into U.S. Commissioners Reserve Valuation Method (CRVM) and CSO, according to whatever the appropriate requirements were at that time. ALICO had more foresight. We relocated to Delaware eons ago and inserted in the law a provision that we could utilize overseas reserves in our balances and our blue book. That saves a large amount of labor. However, before you go hog wild on that, what it basically does is enable us to use the local interest rate, the local mortality rate, and Zillmer adjustment instead of CRVM. That's the sum and essence of it. It does not excuse you from doing the normal cash-flow testing. If you have inadequate reserves, once you do the cash-flow testing or if you find something else wrong with it, you have to change the local reserves. In some of our reserves, when we bring them in, the local statutes get changed. We put up our own U.S. statutory reserves, period. Some of them we can bring in without any problem. It all depends.

The Zillmer expense allowance, in particular can cause a problem because it does not have as many internal limitations as the CRVM allowance does. I've seen several instances in Zillmer expense allowances that were way too high and resulted in inadequate reserves and very low reserve requirements for many years. We could, in effect, change those by either replacing the Zillmer allowance or going to U.S. reserves. The offset to this Delaware provision is that we cannot issue contracts to U.S. citizens or residents. We can get into a lot of trouble if we do that, so our company has to be more careful overseas in issuing contracts to expatriates or people overseas. We cannot issue to the wrong person inadvertently because the states are very interested in that. The subsidiaries are held as an investment, the same as in the U.S., but, again, local reserves can force a change in that value if you feel the reserves on those subsidiaries are undervalued. That's important in our company because the adequacy of reserves is a major issue. Just because it's a subsidiary, in effect, does not exempt it from any scrutiny that a branch may have. In effect, subsidiaries and branches are managed and treated the same by our company with little difference across the board. Of course, there is a tax and a blue book difference.

With U.S. GAAP reporting, again, that's the responsibility of corporate actuarial. As with the domestic business, assumptions and methodologies are determined usually in accordance with underlying economic facts and the standards of the FASB. Local actuaries may supply data and information, but sign-offs and reports do not replace

reliance on the local or regional actuaries. The only reliance used is in regard to the accuracy and completeness of the local master file, which I'll come back to later. This may seem trivial, but in practice we find it necessary to define clearly and accept these responsibilities; otherwise you have the issue of who did what, when, and where, and it can be a real mess.

Finally, tax reporting: There we get lucky. We will not accept much responsibility for this; it goes up to New York, where AIG has a corporate tax department that handles all our tax problems or other issues. Trying to figure out the tax position of ALICO or a country within ALICO is truly an exercise that boggles the mind, given AIG's tax position and the branches here, and subsidiaries there. We even have an aircraft leasing company that feeds into the mix. We have never had too much responsibility on that side other than doing the actual mechanical computations.

In terms of specific topics, we have several here. One that we have the greatest amount of difficulty with is data quality and reconciliation of policy master files. You would be surprised at how many operations out there don't recognize the concepts. This obviously becomes quite difficult from the point of view of being able to sign off on the completeness of the actuarial reserves and a few other good things. On the other hand, it's very time-consuming and difficult to retrofit everything out there with the appropriate techniques once they proceed without them. Our largest operations have reconciled the master file, etc., but several of them haven't, and although it would appear to be a trivial problem, it can assume major proportions. We had a company several years ago that we had management responsibility for, but we didn't get the numbers from them. They dropped six policies. We detected that in the U.S. We called them up, and they said there was no problem. They turned out to be six deferred annuities; \$3.5 million of reserves were dropped. Not a happy consequence. It's very hard, however, to obviate this problem in practice. It is not easy. You have to go country by country and take a team and sort it all out.

All our GAAP work is mostly centralized in the U.S. Sign-off responsibilities are taken very seriously. Once we sign off on something, we bear the responsibility. The assumptions that we use from overseas are a mixed bag. The overseas interest assumptions are often aggressive. Unfortunately, that's not only in premiums but also in reserves, where they might use the same interest rates because of tariff regulation. That's fairly common.

The mortality assumption is a serious problem. Most jurisdictions have a mortality table. Generally, however, it's an aggregate table. They don't have a valuation table, per se, like we do, and, more importantly, they don't have a select-and-ultimate table, which is highly significant, we have found, both in reserving and



reporting earnings. They'll swear up and down they do not have select mortality, but a few years back we managed surreptitiously to get three years of data on the entire Japanese life industry out the backdoor of the Life Insurance Association of Japan. We spent a long time analyzing that data, and we learned that they actually have a ten-year select period. This makes a rather large difference in the way you reserve and report your financial results.

We have other problems with projected mortality on the annuity side. One of our countries for their annuities wanted to use some other country's mortality table. I don't know what you do with that. It's very difficult when they come to you and say, "We'd like to pick up this 20-year-old Swiss table and use it for our annuities." What does that mean? I don't know. But none of them project mortality improvement. Whether it's in South America or in Europe, they just don't seem to have that concept, although there has been some indication from our local actuaries that there is mortality improvement on these annuities. But it's a definite problem. If you push it on them too much, then their products, of course, drop out of the marketplace because they're priced higher.

We don't usually have any difficulty with withdrawals and lapses. With expenses, many operations do not have a straight-up expense study. Even Japan didn't. The Life Insurance Association of Japan produced a voluminous amount of data for the Ministry of Finance (MOF), but it was not useful to us, so we instituted our own functional expense study and finally got some interesting results. They still fight over that study every time it's done, about how expenses are distributed.

Another item is reserving for bonuses and dividends, which can be controversial. For GAAP we tend to reserve their bonuses and dividends at the levels anticipated when the profit margins were developed for the product. If they do change significantly later on, it might cause us to change that basis. This is especially relevant because overseas there are places where the terminal bonus is a relatively significant part of the benefits paid, unlike in the U.S.

From one, shall we say, unnamed country I used to receive 20-year projections, and they just forgot about that terminal bonus that was payable in the 25th year. Of course, that knocked all the profit margins out of the product. Statutorily, we will carry reserves for bonuses and dividends, even though it's not really statutory accounting, because of the significance again of some of these dividends and bonuses. We will carry that on a statutory basis as well to avoid unusual fluctuations and results in the future.

In the past in some countries, especially in Japan, we have mandated sudden premium and reserve changes. Say reserves are at 6%, and interest rates, say, were

dropping. Now they're at 4%. But mortality was also dropping, so the MOF promulgated a new mortality table. The MOF would force you to compare each policy in force to see whether it was better with the new assumptions or the old assumptions, with the foreseeable result being that all the endowment products would stay on their 6% basis. All the term products, of course, went to the lower mortality. Likewise, if interest rates went up, you had the same kind of process, but all of the endowments would go to the higher interest rates. This was both a retrospective and prospective change that had real economic consequences because it took significant cash flow and profitability right out of the existing in-force block. They don't do this, by the way, if things go the other way. So, once you're there, you're locked in. We've had some real problems with this. I don't think the MOF will do it again in the near future; nevertheless, this is a matter of concern that we've had, and it's a very difficult thing to deal with. It's almost impossible to deal with it on an a priori basis.

Cash-flow testing: We essentially have to develop it for separate countries. Each country has its own model. This is extremely tedious. We're working our way through the countries out there, but they aren't amenable. You can't group them together. They have their own products and their own currencies. You can't introduce a foreign exchange rate because that's difficult to handle. They sometimes have their own investment methodologies. So you have to be very careful of that. They'll swear that they have no callable bonds. The next thing you know, 33% of them are callable. They're constantly doing things like that. We develop option-adjusted cash flows where we can; that's basically on yen- and dollar-denominated investments. We have a fairly elaborate system that does that. Where we can't utilize that in other countries, we will have a Macaulay-type duration or just projection of cash flows out on a more static basis. We look at the option-adjusted durations. We look at the present values as well as the individual cash flows out for at least ten years when we do our analysis.

We get investment strategies from the investment department, and we analyze them ourselves. If we have problems or comments, we refer back to the investment department. The asset reserve and the interest maintenance reserve are developed and handled pretty much according to the U.S. type of perspective, except that in some countries that already have them on a local basis we may try and synchronize them somewhat to avoid discrepancies between the two bases. We also have synthetics, swaps, and options, among other things. Equities are a real problem that we avoid like the plague because they're a measurement problem. We really don't know how to measure them. We've talked to a lot of people, including some at the Wharton School, and have come up empty. There simply isn't an easy way to consolidate the equities into your work. The alternative is to give it a 25% haircut as the U.K. and some other states require. We find that severe. Real estate property

has the same problems as equities, but you don't have liquidity, so that's a really interesting feature. Fortunately, we don't have too much of that. One of our operations did have some of that, but they're relatively small.

Swaps, collateralized mortgage obligations, synthetics, and options and futures can be handled by our assets systems. Finally, interest scenarios: We use the New York 7, adjusting it as necessary. We also use historical patterns, developing an expected pattern of future yield curves operating on the basis of parallel yield shifts consistent with investment strategies that will be applied. Again, that's typical of what you do in the U.S. It's mostly stress tests that we get caught up on.

Here are some selected problem areas. When you're dealing with people who speak and write in a foreign language, obviously it doesn't help, for instance, to get documents in Japanese, French, Italian, Arabic, etc. You can't handle that. It's extremely expensive to get them translated, and unless you get a reverse translation made, it doesn't do you much good because you don't know what errors are in that translation, and, believe me, having seen some of that material translated, the way it comes out is counterproductive, especially when you're dealing in Korea or Japan or somewhere like that.

The adequacy and the validation of data and information on both sides of the balance sheet is a laborious process. As I mentioned before, the investment data can be especially difficult at times because people will throw in wrong values or leave out crucial data. In Japan, for example, their yield was reported simply as a coupon yield at times. It drove us crazy for several years, but we finally sorted it out. Audit trails: Again, these tend to break once you hit the boundaries of the U.S. We can get back to their extracts, but, again, their master files can cause a real problem. A key one is inadequate local regulation. You would think with inadequate local regulations you could have a field day. Well, you can't because while they're inadequate or nonexistent now, in a few years they will probably hit you retroactively. They think nothing of that.

Let's take Russia and Poland, for example. Poland follows the European Union guidelines because they want to be a member, and we found that Switzerland and other places that are not members tend to pick up that kind of regulatory bias. With Russia, we don't know what happened, literally. They do have some regulation now, but it does seem to be lengthy and haphazard. Saudi Arabia didn't regulate us for a long time, and then, all of a sudden, the Saudi banking department decided to regulate us. That's a tricky state because mortality insurance is against Islamic law, and the bank wasn't happy with investment contracts either. It's difficult to argue with the Saudis.

Some other things that we run into: the local reporting based on the U.K. paradigm of the life fund is not common anymore. Most of the newer states tend to adopt U.S.-type accounting standards and practices, e.g., Hong Kong, and China, but certainly in Bangladesh, Pakistan, and Kenya we have the remnants of the U.K. process. This can be a problem. On a statutory basis it tends not to be a dramatic problem. You can handle it. On a GAAP basis, however, you have the problem not of a solvency-oriented report but of a real report based on earnings. These life funds will generally have restrictions on the distribution process to shareholders. It depends on how that restriction is implemented. For example, in Bangladesh and Pakistan, and, I believe, Kenya, they basically say that the increase in surplus in the life fund in any one year is automatically split into policyholders' and shareholders' pieces. Then you can do what you want.

Many companies in England, on the other hand, although I don't know if this was codified, had a situation in which 10% of the bonuses were paid. That's different because bonuses don't necessarily bear a one-to-one relationship to earnings as we know them, and it leads to interesting side effects as well; those companies always could make their budget because, if in doubt, they raised their bonuses, and that raised the earnings reported to the shareholder—the parent company in the U.S. That's fantastic. Of course, one could say that when one normally raises bonuses, one would expect earnings to take a hit, but not in that system. It was a great system. They never missed their budget target. Right until that company went under the waves, it never missed a budget target. On the basis of this we also have what they call the U.K. global return requirement, which is a fantastic piece of mechanics.

If you run a branch in a country that handles this, they make you report your entire company based on their reporting system, which is fascinating because now most of it is a pain in the neck. But in the U.K. they run resilience and matching tests on your asset/liability position. If you ever want to see reserves shoot upward, you apply that test to any group of products that has interim cash value guarantees, and you will see the most amazing skyrocketing of required interest and reserves you have ever seen in your life. It goes through the roof. You have to go down three percent, and up three percent, both with lapses and without lapses, and you take the highest present value. When we had that we would run up literally huge amounts of excess reserves. We, like everybody else, got out the requirement by forming a separate account. Other companies just became subsidiaries, and that's also fine.

Finally, you have to watch the incurred but not reporteds. Sometimes they're not required or even prohibited locally, or they may be formula driven and inaccurate. That's not surprising. Nor are premiums, by the way. That's exciting. Sometimes

the lapsed policies are held for three or four months as active policies because they're easy to reinstate.

To paraphrase Mark Twain, I think true insight is in short supply in the world, but I think I've been suitably frugal in dispensing it here. So there's no need to worry about a shortage.

**Mr. Freedman:** Our last speaker is Phillip Whitefield. Phillip is a Fellow of the Institute of Actuaries (FIA). He joined Lincoln U.K. as part of its acquisition of Liberty Life in 1995. Phillip is a corporate actuary responsible for financial reporting on many bases, including U.S. GAAP, Department of Trade and Industry returns, and embedded value. He's responsible for financial planning, experience studies, and acquisition analyses. Like many U.S. companies, Lincoln National is U.S. GAAP-driven, and Phillip did a lot of the thinking and system development work to get Lincoln's unit-linked product into a U.S. GAAP framework. That's the subject of his presentation.

**Mr. Phillip Whitefield:** I intend to give a very brief description of the design of typical U.K. unit-linked products. I will try to emphasize the major differences between U.K. products and their American counterparts. I'm no expert in American product design, so the highlights are those differences that have become apparent to me through discussing U.K. products with my American colleagues. In particular, I shall touch upon the very different tax treatment of life insurance products and how this impacts on financial reporting. Finally, I shall take you step by step through the transition from U.K. financial reporting to our interpretation of U.S. GAAP.

I will be talking about two generic product types that make up most of the U.K. regular premium business. These are the UL products, which I believe we're all familiar with, and an approved pension preretirement fund accumulation product. Both products are unit-linked with UL charging structures. The pension product enjoys tax relief on contributions and gross fund roll-off. The last product, fund roll-off, is net of tax. In the U.K. we do not have the equivalent of nonforfeiture legislation. This currently gives us a great deal of freedom in product design. Since shareholders demand a much greater return on their capital than the policyholder reasonably expects from his or her premiums, the optimum design is clearly to satisfy shareholder demands first. U.K. products, therefore, typically have heavy front-end loads designed not only to recoup initial expenses but also to contribute a significant portion of the desired profit.

Some of our competitors with less effective expense controls are not achieving this early profitability, which is the prime reason why there are currently many acquisition opportunities in the U.K. But that's another story. These heavy front-

end loads result in zero or very low surrender values that have been available in the early years of the contract. We are beginning to see for some savings-type contracts early signs of product design bowing to consumers pressures for higher early values, and I think that may be a trend in product design in future years. For efficient companies the products will be an accumulative after-tax profit position by the end of the front-end load period, which may be about three or four years.

Let's take profits by calendar year for policies sold on December 31, so I can show separately the day new business strain from the balance of profits as they come out. Let's say the front-end load period is four years. Life business is distinct from approved pension business. It's taxed either on the *I* minus *e* basis or on a profits basis, which as a method for the company as a whole gets the higher tax charge. *I* minus *e* is investment income including certain realized gains minus management expenses including commission, and that is the basis I assume here. Relief of initial expenses and all commissions are spread over a seven-year period. The net profits in those early years exceed the gross profits by a small margin. This is the impact of spreading the initial expense relief over the seven-year period.

A company would experience very different tax impacts from writing heavy-expense, low-investment products like term insurance as opposed to writing predominantly investment products like single-premium guaranteed bonds. This can provide opportunities for tax synergy and a competitive advantage in writing certain products. Life insurance policyholders, remember, get only net roll-up of fund values. In the later years the dominating feature is the impact of investment income. Gross profits include a charge made on the funds by the company in respect of its tax liability on investment income. For companies in a profit tax scenario as opposed to *I* minus *e*, this charge is a genuine source of profit. For an *I* minus *e* company this charge closely matches its tax liability, but we are left with what looks like a very high tax rate if expressed as a rate on profits. This is purely because the tax base is not profits but in this case can be a much greater value. The patterns of gross and net profits are quite different to each other. *FAS No. 97* clearly defines expected gross profits (EGPs) and suggests them as a basis of amortization. This is clearly illogical for U.K. life products, but, as you may see later, the approach we have taken means that this is not a particularly significant point.

If we consider the gross profit patterns in a unit-linked pension product, we can see the impact of the product design mentioned earlier. Much of the profit is earned in the early years. Tax on this pension business is based on profits, and policyholders benefit from gross roll-up of fund values. Remember that these are U.K. solvency reporting profits. We now go step by step through our thought process of converting these to U.S. GAAP. Step one is to replace the U.K. reserves with one that complies with U.S. GAAP. For modern products, the reserving basis makes no

difference at all. The U.K. reserves satisfy the U.S. GAAP requirements. There are some older products still in existence in which, because of guarantees issued with the contract and the U.K. reserving requirements, the U.K. reserves would have been more onerous than required under GAAP, but such products are no longer that common.

What we can see is the beneficial impact of pretending we didn't spend the money. I am excluding expenses for the origination of the contract, which are directly variable with the level of new business written. Such expenses include initial commissions and override and certain new business-processing expenses. But, similarly, away goes almost all of our income as we capitalize the front-end fees.

To get to expected gross profits we also exclude the rest of the initial expenses. These are the costs of sales training, sales force recruitment, enticement, sales overhead, and certain marketing costs. We then add back the nondeferable initial expenses and amortize the other items in proportion to the discounted EGPs. The result is not satisfactory. Looking at the economics of the product, it was designed to generate shareholder profit during the front-end load period. The pattern we've come up with does not achieve this. The spirit of *FAS No. 97* is to recognize expenses and loads in the period to which they relate. We felt that this was not achieved by deferring our early profits, so we looked much more closely at the letter of *FAS No. 97*. Section 20 of *FAS No. 97* was quite helpful. Our initial loads are not compensation to the insurance enterprise for services to be provided for in the future. Profits, once received, are fully and irrevocably earned. The surrender values payable, or lack of them, and the positive, if small, subsequent profit support this theory.

The rationale for the legislation was helpfully set out in Section 68 of *FAS No. 97*, which says that the exposure draft reflected the board's conclusion that both initiation fees and surrender charges are assessed primarily to recover capitalized acquisition costs. This is clearly not the case under U.K. contracts, in which, because of the capital-efficient product design, front-end fees are designed to cover much more besides. And in Section 69 of *FAS No. 97*, after considering the nature of amounts assessed against policyholders under UL-type contracts, the board concluded that such amounts contribute proportionately to profitability of the contracts. U.K. product charges are well matched against specific costs, whether initial or renewal, and further margins are often taken early for profit. We considered separately what the initial loads were intended to cover. The initial loads match certain expenses, some deferred and some not, and subject to suitable expense controls there's a residual amount of profit. We consider each load in the front-end period to contribute in the same proportions to deferrable expenses,

nondeferable expenses, and profit. In coming to this determination we recognize the value of tax relief on expenses of life insurance business.

The portion matching deferrable expenses is consideration for the origination of the contract and, according to Section 20, is earned revenue. We defer these loads. The portion matching nondeferable expenses is not for the origination of the contract; otherwise the expenses themselves would be deferred. We interpret Sections 20 and 68 of *FAS No. 97* as allowing us to treat these as unearned revenues. We do not defer these loads. The component of profit is neither for the origination of the contract nor compensation for services to be provided in the future. Once received, the profit is fully and irrevocably earned, so we do not defer it. The resultant profit stream reflects reality recognizing profit in the front-end period. In U.K. accounting parlance this method would be described as satisfying the true and fair view, in that it truly reflects the economics of the product and fairly recognizes emerging profits.

As to the approach we have taken, as well as reflected in the economics of the product, it also, as I hope I've shown, satisfies both the spirit and the letter of *FAS No. 97*, which is why we have been able to obtain the approval of our auditors in both the U.K. and U.S. In fact, it received so much approval from our American auditor that he asked that I might travel 4,000 miles to spend four days in Washington, D.C., to be part of a four-man panel team.

**From the Floor:** Can anyone address the impact international GAAP standards will likely have?

**Mr. Bonach:** I'd like to believe so. We have groups from the Society and Academy and other actuarial bodies working on that, along with accounting bodies. The one thing that is hoped to be achieved is to have one basis of financial reporting primarily for the capital markets, and I think if the SECs of the world can come together, one impact will be that multinational companies can conceivably have one set of financial reports to raise capital in all parts of the world and to pick and choose what part of the world is most economical and advantageous to them. I think it will alter the capital markets and accessibility for these companies.

**Mr. Daniel Paul Schroeder:** Mr. Bonach, you alluded to some target equity. How is the free capital invested if you have a corporate unit deciding that, or is that reflected by whoever is investing that money? For example, you had that money invested in U.S. stock, and your U.S. company took the hit. Could the other panelists address target equity or capital allocation?



**Mr. Bonach:** The question about free capital within any one of the companies in our group is a shareholder decision, along with the operating companies having discussions as to where that equity is held. In many cases it is held in the actual subsidiaries, because at that point in time there is not a better-known place to invest it. How we would be evaluated is, if we had free capital, by looking at our results and return on capital or equity using only what we have defined as required, excluding that excess capital. That excess capital is expected then to achieve a market investment return commensurate with, in our case, the U.S. marketplace of investments, primarily fixed-income investments with some other investment categories like stocks, mortgages, and real estate. On the evaluation of that free capital return we do have an investment operation that handles all of the investments for the group companies in North America, and they would be looked to as far as the evaluation of return on the free capital.

**Mr. Whitefield:** Within Lincoln and the U.K., the target capital is most easily defined in U.K. accounting parlance as being an excess over the European Union solvency margin requirements. We would target holding 140% of the solvency margin requirement. As the company has made a number of recent acquisitions, it has a large amount of borrowing still on the balance sheet, and any excess capital is immediately used to repay those borrowings.

**Mr. Terne:** In my organization they don't give you any free capital. You're lucky to get capital at all, believe me. If you need capital, you beg for it. It's all held in New York City at 70 Pine Street, no questions asked.

**Mr. Harry D. Dunn:** How do you get any capital, and what kind of mechanism do you have in place to deal with lobbying the regulatory authorities or those who are responsible for establishing financial reporting or reserving requirements in the local organizations for a multinational company like yourselves? It could be on the side of where it's either inadequate regulation, as you described, where they were reporting earnings based upon bonuses, or overly adequate reporting requirements like the ones you described for Japan.

**Mr. Terne:** Are you talking about lobbying?

**Mr. Dunn:** Yes, lobbying basically to try and change some of the reporting requirements in your local areas.

**Mr. Terne:** Well, AIG is one of the most proficient and ultimate lobbying organizations the world has ever seen. If you ever looked at our board of directors, you will see that Kissinger is there. I've run into him in the home office. Benson's there. Carla Hills is there. The governor of Hong Kong is there, Mr. Chun.

Edmond, whom I was with in Greece last December, had to rush back to Hong Kong to vote for Mr. Chun, and he was one of the 400 people who did that. Our CEO of ALICO in his office has framed pictures of himself with the Bushes and various people. They have a good deal of influence on the macro-political level. For example, our Japan operation was given to us by General MacArthur right after the war and has credence in certain areas. It's all legal, by the way. When it gets down to the level of the MOF or the state insurance departments, that's something else. The Bushes and the Yeltsins of the world tend not to have nearly as much influence at that level as they do at the macro-level of letting us into the country. We will fight with the MOF, and we have done that in Japan. We do fight with various ones through the political levers. Somebody will bring pressure on the Japanese government. There's just a constant hammering and pressuring at all levels.

**Mr. Helmut Engels:** If you're a subsidiary of a foreign company, like Allianz, and you have to match foreign requirements, or if you're a U.S. company that has foreign subsidiaries and you want to do U.S. GAAP, how do you make sure that everyone's using the same playbook? If financial people turn over, if you start operations in new areas, or if the GAAP rules change, how do you make sure that everyone's still in touch and not giving you the same results or the same company accounting policy all the time?

**Mr. Terne:** From my point of view as the representative of an American company, there are two ways. One, as I mentioned before, I'm responsible. I'm the one that gets punished, and that's a fact of life. That's a big incentive to make sure that they're doing something right out there. Second, I make a fair number of trips overseas, and I talk to these people and, you might say, schmooze with them, and I get a feeling of who knows what, who can do what, and whom I can rely upon. That's another effective way. Third, we simply bring them into our home office and train them, but keep in mind that the fundamental determination of the GAAP is with corporate actuarial. Where the turnover would really hurt us would be at corporate actuarial more so than overseas, where they're primarily concentrating on local issues.

**Mr. Freedman:** Mike, who does the valuations? Do you do them in various countries?

**Mr. Terne:** Most of them are done in Wilmington at our headquarters. There are some that are done overseas, and we monitor and keep on top of them, but generally they're the simpler ones. It's not easy, but you have to keep on top of it, which we tend to do.

**Mr. Whitefield:** You mentioned one of the causes being turnover of the staff. I was part of an acquisition Lincoln National made in 1995 and had to learn very quickly how to do U.S. GAAP reporting, and the way this was achieved was by sending over some experts from our Fort Wayne office to our London office to advise and train me. I've had one visit the other way to deepen my learning. We're in very close contact now with my American colleagues. The company has also taken the initiative of sending over a GAAP expert to the U.K. for a couple of years to make sure that all our GAAP reporting is being done correctly, and, indeed, after this meeting ends, I'm going up to Fort Wayne for two more days of GAAP training. What I talked about was the *FAS No. 97* reporting, which is a significant block of our business, and we have implemented what we consider to be suitable reporting for all of that business. Some percent of the portfolio is covered by *FAS No. 60* and other aspects of GAAP for which my knowledge is very incomplete. I'm going to Fort Wayne to make it more complete.

**Mr. Bonach:** I'd say that our experience is quite similar. I mentioned the regular meetings that we have as financial officers. We have a North American group that meets at least twice annually. Some of the people in that group have moved between companies. In fact, my predecessor and CFO of a life company is now the CFO of our holding company in North America. We have someone from Germany who is the CFO of our Canadian operation in the group, among many others. I spent three years in Germany learning their reporting system and helping them to understand and develop this U.S. GAAP type of reporting. The other thing that we do is use one auditing firm in the group, a public accounting firm in the group worldwide, and to the extent that there are a lot of similarities in German accounting between the U.S. statutory and GAAP, we get enough of the major components audited by a third party for consolidation purposes to get at least some assurance that these principles are being applied. Our people can then focus more on the problem companies that do not look as consistent, or on just a few of the items that are not in conformance with U.S. GAAP that company's management has to report or translate themselves into that U.S. GAAP-type of reporting.

**Mr. Freedman:** Ed, is the German GAAP valuation itself done in the U.S. or overseas?

**Mr. Bonach:** The U.S. or the German consolidated accounting is done in each of the subsidiaries and rolled up to the foreign company, so we actually do have a set of books on German accounting that we report upstream.