SOCIETY OF ACTUARIES Financial Reporting Section

The Financial Reporter

ISSUE 75 DECEMBER 2008

Actuaries
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SFAS 157 Adoption Impacts

by Rony Sleiman and Tricia Matson

Disclaimer: The authors are not CPAs and are not purporting to give accounting advice. They are describing a developing area of interest and concern for actuaries as identified by the American Academy of Actuaries' Life Financial Reporting Committee (LFRC). Companies should seek advice from their accountants in the application of all FASB standards.

Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements,* became effective Jan. 1, 2008. The Financial Accounting Standards Board (FASB) issued the standard on Sept. 15, 2006, and encouraged early application. The standard does not provide new accounting guidance on assets or liabilities that should be measured at fair value; rather, it prescribes the methodology to be used to fair value any items currently reported at fair value under existing US GAAP guidance. It defines fair value as an exit price—"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

A typical balance sheet has relatively few line items that are fair valued using an actuarial analysis; therefore SFAS 157 had a relatively limited impact on actuarial valuation. The actuarially-related area most significantly affected relates to fair value of derivatives embedded in annuity contracts. More specifically, under SFAS 133, *Derivative Instruments and Hedging Activities,* equity-indexed annuities and certain guaranteed living benefits offered in conjunction with variable annuities fall into this category.

SFAS 157 is designed to answer the question of how to fair value an asset or liability. The following items are key requirements that are now explicit in fair value models under SFAS 157.

One of the requirements is that when directly observable prices are not available, the valuation should consider and include an adjustment for risk

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CHAIRPERSON'S CORNER

REFLECTIONS AND A LOOK TO THE FUTURE

This is my fourth, and final, letter as Section Chair. By the time you read this, the SOA Annual Meeting will have occurred, and Rod Bubke will be the new Section Chairperson.

I began my year as chairperson with several desires. I felt that the Section Council should be very active, and constantly experimenting without fear of failure. I wanted to set some priorities, and to always keep those priorities in mind, regardless of what else was happening. I referred to the resulting priorities as the Big Three: research, continuing education and the principle--based approach (PBA). I hoped that we would develop some large projects that would require us to recruit teams of Section members to work with Council members in order to get the projects done. I wanted us to begin to develop a new, major, continuing service to members—such as the GAAP seminars—every year or two. And, of course, I hoped that the Council would effectively respond to the unexpected events that would undoubtedly occur. This was just part of my dream.

With such a dream, it was crucial that I not lapse into a perfectionistic mentality. While we did not make each of those a reality, I congratulate and thank the Section Council (their names are on the inside front cover of this newsletter) and other volunteers for what we have accomplished.

1. The Section sponsored close to 10 sessions at both the Spring Meeting and the Annual Meeting. In recent years, our sessions have received relatively favorable ratings, and I am thankful to the organizers and the many volunteer speakers from the Section who have provided that valuable continuing education.

2. The Section's accomplishments in research have traditionally lagged far behind its accomplishments in continuing education. Last year's chair, Henry Siegel, took us to a new level with the International Financial Reporting Standards (IFRS) research project, which was completed this year. Our Council's research leader, Sue Deakins, has further advanced us in research with a large principle-based approach (PBA) research project, which is just getting started, along with several other major research projects. If we continue to pursue this level of activity and learn from our experiences—with the help of SOA research actuary, Ronora Stryker—the Financial Reporting Section will become an important force in research.

3. We increased the number of liaisons in order to be better connected with the "outside world." Our Board Partner, Ed Robbins, and SOA staff actuary, Mike Boot, have also provided frequent insight into external events and trends.

4. The Section Council developed a new service, which will premier before this newsletter is published: the Valuation Actuary Forum. I expect that, as we learn from our experiences, this will become an annual event that is as helpful to valuation actuaries as the Chief Actuaries Forum and the Smaller Insurance Companies Chief Actuaries Forum are to their participants. The potential is exciting!

5. We have presented one webcast, FAS 157, and we have three more planned before the end of the year: Reviewing and Validating Actuarial Models, International Financial Reporting Standards and Market Consistent Embedded Value. We are progressing well toward meeting the demand for webcasts.

6. We performed a survey of valuation actuaries, and we will soon be sharing the results of this survey with the membership. We appreciate the considerable efforts of those who completed this survey.

7. We also performed a survey of Section members. We thank those who completed this survey, which will enable the Council to better serve our members in the future.

Thinking of the future, Rod Bubke has been very involved in the overall work of the Section Council, as well as making numerous individual contributions. He is ready to take the reins as chairperson of the Section Council. He will work with a fantastic trio of third-year Council members—Craig Reynolds, Sue Deakins and Jason Morton. I have been extremely impressed at some of the things that these Council members have accomplished during the past year. The second year trio of Steve Malerich, Basha Hoffman and Dwayne McGraw are well positioned to step up to another level and guide the incoming Council members. Newsletter editor Rick Browne and Web coordinator Kerry Krantz belong on their own dream team. Finally, SOA staff members Mike Boot, Ronora Stryker and Christy Cook have played indispensible roles in the work of the Section. The possibilities for meeting the needs of financial reporting actuaries boggles the mind, and next year's Council is ready to lead the way.

Reflecting on three years on the Section Council, it has been much more fulfilling than I had expected. The tasks before me were frequently challenging; I got to meet and work with some wonderful people; I often experienced a sense of accomplishment; and I loved the feeling that I was contributing to our profession. I am excited about the prospects for the future. I thank each volunteer for what you have done, and I encourage you to consider running for Section Council or serving our Section in some other way. Like me, you may find it much more fulfilling than you expected. ■

Best wishes always,
Jerry

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(risk margin) if market participants would include one in pricing the asset or liability. Although SFAS 157 does not specifically provide guidance as to how a risk margin should be determined, some guidance is provided in the International Actuarial Association paper, "Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins."

SFAS 157 also requires that fair valuation techniques maximize the use of observable inputs, defined as "inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity."

Unfortunately, there are limited observable inputs from the market to assist in fair valuing insurance contracts. The majority of inputs to the valuation of insurance contracts are unobservable, and SFAS 157 states that, "unobservable inputs shall reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability (including assumptions about risk)." Therefore, assumptions should consider both the best estimate assumption that would be used by a market participant as well as an additional margin that market participants would add to the valuation as compensation for the risks associated with that assumption.

In practice, SFAS 157 has proved challenging to companies and their accountants and actuaries. …

Another key requirement introduced by SFAS 157 is that the fair valuation of a liability should consider and include non-performance risk, an adjustment for the issuing entity's own credit. SFAS 157 states, "A fair value measurement assumes that the liability is transferred to a market participant at the measurement date (the liability to the counterparty continues; it is not settled) and that the nonperformance risk relating to that liability is the same before and after its transfer. Nonperformance risk refers to the risk that the obligation will not be fulfilled and affects the value at which the liability is transferred. Therefore, the fair value of the liability shall reflect the nonperformance risk relating to that liability. Nonperformance risk includes, but may not be limited to, the reporting entity's own credit risk. The reporting entity shall consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value."

As mentioned previously, the application of SFAS 157 was meant to clarify the definition and methods used to measure fair value. In practice, SFAS 157 has proved challenging to companies and their accountants and actuaries on how to value certain types of contracts for which there is limited observable data. There is also a range of practice regarding the level of disclosures about valuation practices, and many other issues. Financial institutions and accounting firms faced significant challenges in implementing SFAS 157, and although SFAS 157 has been adopted, accounting professionals are still finding their way as they put it into practice.

The challenges in implementing the guidance and the relatively wide variation in results is, in some respects, illustrated by the adoption impacts disclosed in the first quarter Form 10-Q filings. For several large VA writers with similar blocks of business, the disclosed impact on embedded derivatives as of Jan. 1, 2008 varied by as much as $200 million.

There are a number of factors contributing to the wide range of adoption impact. Based on a recent informal survey with participants from several insurance companies that issue annuity contracts with embedded derivatives, the following results may be of interest to professionals who are closely involved in the fair value of embedded derivatives and in particular variable annuity Guaranteed Minimum Withdrawal Benefits (GMWB) and Guaranteed Minimum Accumulation Benefits (GMAB).

The informal survey was divided into four main areas:

1. Risk margin, and its impact on results.

2. Method used to include own credit risk.
3. Use of market prices, namely reinsurance information.
4. Implied volatility input parameters.

RISK MARGINS

When asked if the original SFAS 133 model (pre-FAS 157 adoption) incorporated conservatism, (which would be considered providing for some risk margin, and if so to what degree), the majority of survey participants indicated best estimate assumptions (no conservatism) were used. Some indicated the inclusion of implicit margins, while others included explicit margins on market assumptions and on non-market assumptions. The impact in basis points (change in SFAS 133 liability divided by account value) for companies using both implicit and explicit margins was mostly in the 0-15 bps range with a small number of participants estimating the impact to be greater than 15 bps.

There was a relatively wide range of impact from the addition of risk margins in the SFAS 157 valuation compared to the pre-SFAS 157 fair valuations. Of those participating in the survey,

- Approximately 40 percent indicated a 0-5 percent increase.
- Approximately 10 percent indicated a 5-15 percent increase.
- Approximately 15 percent indicated a 15-25 percent increase.
- Approximately 35 percent indicated a 25 percent-plus increase

Those on the lower end of the range tended to correspond to those companies who had included conservatism in the original valuation.

OWN CREDIT RISK

The discussion that has taken place within the accounting profession indicates a diversity of views as to how this should be applied. The responses from the survey supported this view and indicated a wide variety of data sources used in practice to adjust liabilities for own credit risk. Some survey participants indicated using published historical default rates based on credit ratings, others used market observable credit spreads such as those evidenced by Credit Default Swaps (CDS) issued by the parent company. (These were sometimes further adjusted to reflect credit spreads on GICs issued by the insurance entity). Some used market credit spreads observed on debt issued by similarly rated companies. There were also some companies who did not make a company-specific adjustment, and used an industry-wide credit spread implied by the LIBOR swap curve. As a result, the impact of adjusting liabilities for own credit risk ranged from negligible to significant reductions.

Generally speaking, credit adjustments could be divided into two general approaches. One is to use broad industry data, based on the possible argument that there is limited to no observable data on a specific company's nonperformance risk. Even CDS and GIC spreads are limited because they: (1) may be issued by a different legal entity, with a different risk profile, within the overall organization; and (2) frequently have a much shorter term than the embedded derivative liabilities. The other general approach is to use available company specific data despite its limits, based on the possible argument that it is observable and though imperfect, should be considered to the extent feasible.

Although not a specific survey question, there is also considerable variation in how credit adjustments are applied to the valuation. Most companies apply the credit adjustment as an increase in the discount rate, though a small number make adjustments to actual cash flows to reflect the default risk. Some companies apply the adjustment only to the claim payment component of the valuation, since it is the claims, not the policyholder payments that are subject to the risk of insurer nonperformance. Other companies argue that the policyholder will not pay the fees if a default occurs, and therefore apply the adjustment to all cash flows. Lastly, there are companies that only apply the adjustment to the valuation if the embedded derivative is in a net liability position.

MARKET PRICES

Companies were asked whether they have entered into discussions with reinsurers or other counterparties

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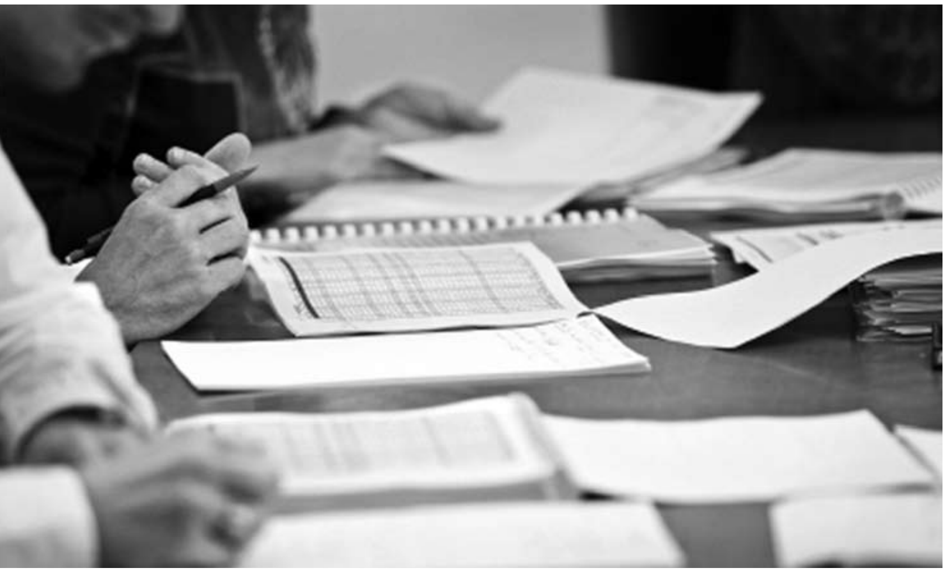

for all or a significant portion of the risks comprised in their products, and if so, to what extent they have considered these reinsurance discussions in their SFAS 157 valuation. About half of the participants indicated that no discussions had taken place. Some are in early stages with no pricing indication. Survey participants with evidence of market prices due to reinsurance (i.e., those that were in the final stages of a reinsurance transaction) indicated that significant consideration to reinsurance has been given in the valuation. However, there were only a small number of companies in this situation. Most other respondents did not consider reinsurance pricing in the valuation, though a few gave reinsurance quotes some consideration.

In light of the SFAS 157 requirements that any observable market data be considered in determining fair value, it appears that the reinsurance market is a potentially important source of market data for embedded derivatives in insurance products. Though quotes are not necessarily indicative of an exit price, deals that are near final or actual transaction prices, generally must be considered. In addition, most reinsurance transactions are done via coinsurance, which is not the same as a sale. It will be interesting to see what impact reinsurance prices have on valuation results as the reinsurance market for some of these benefits becomes more robust.

VOLATILITY PARAMETERS

When asked about implied volatility parameters used in the SFAS 157 valuations, survey participants indicated numerous methods. The majority of respondents indicated use of 10-15 year implied volatilities, at least for the S&P index, which is typically the longest period for which observable data is available. Practice after the 15-year period varied, with some companies grading to a long-term historical volatility, and others extrapolating the implied volatility (typically by holding the 10- or 15-year volatility constant thereafter). It appears that use of a long-term historical volatility would require some additional risk margin component, since it is not reflective of observable data. However, no matter what method is used, the company needs to support its assumption and demonstrate that it is indeed market-consistent.

Though not part of the survey, another area of diversity is the extent to which local volatility, or volatility that varies depending on the index level, is used in the valuation. Some companies assume volatility that varies only by term, and therefore does not incorporate local volatility. Others use a full volatility surface, considering both term and index level. It appears that use of the term structure only would require some additional risk margin component.

CONCLUSION

Based on the results mentioned above, the survey showed that companies adopted diverse practices in the following key areas:

- Risk margin.
- Adjustment for own credit.
- Use of market prices (namely reinsurance).
- Approach to implied volatility.

This is further illustrated by one question from the survey. When asked about the impact on the ascribed fee (the portion of contract fees allocated to the embedded derivative such that the embedded derivative liability at issue is zero), for the most recent cohort, pre-SFAS 157 and post SFAS 157, the range of impact was dramatic, particularly for GMABs. Responses ranged from a 5-40 percent increase for GMWBs, and from a 15-350 percent increase for GMABs (results were skewed by one respondent). This wide range of impact is related to all the issues discussed above.

Interpretations of the standard and its application can have a significant affect on the financial results for companies. Subtly different interpretation may result in materially different financial results, and therefore consistency of interpretation is important to provide useful information to shareholders. Fair value of insurance cash flows is limited to only a few areas of companies' balance sheets today, but this will change dramatically with the planned movement to IFRS, which seems to be headed to a fair value-like framework.

Financial institutions may benefit from additional disclosure related to assumptions used in the determination of the fair value of liabilities, and discussion of management's process to confirm these values. This may lead to a higher level of financial statement precision, increased consistency and comparability in fair value measurement, and may give analysts and investors a higher level of confidence in reported balances.

The authors would like to thank Mark Freedman, Dave Rogers and Matt Frazee for their contributions to this article.

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Principle-Based Reserves Update

by Karen Rudolph

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During the National Association of Insurance Commissioners' (NAIC) Fall National Meeting in Washington, D.C. several notable things happened, certainly not the least of which was the continuing crisis in the financial markets. The meeting took on a different tone than originally anticipated. Nonetheless, progress was made on certain proposals. I have summarized these below.

STANDARD VALUATION LAW

The Life and Health Actuarial Task Force (LHATF) discussed the proposed revisions to and amended the Standard Valuation Law (SVL). As a result, the amended version was exposed for adoption, which is one step closer than having exposed the SVL for comment. The industry may still comment using the usual channels. Opinions vary as to the importance of the NAIC's action since a critical component of the valuation package, the Valuation Manual (VM), remains a work in progress. If the revised SVL is adopted during conference calls following the fall meeting, the NAIC will have succeeded in meeting its Dec. 31, 2008 deadline for a revised law enabling principle-based valuations.

In contrast to prior exposed versions, this version has removed the specified statutory reserve floor from the SVL and empowered the VM to specify the statutory floor appropriate for the product or contract.

VALUATION MANUAL

LHATF received reports from subgroups on various portions of the VM.

- VM-00 Introduction, General, Procedures, etc. was amended and released for comment.
- VM-01 Definitions for Terms was amended and released for comment.
- VM-20 Requirements for Principle-Based Reserves for Life Products was amended and released for comment.
- VM-30 Actuarial Opinion and Memorandum Requirements was amended and released for comment.
- VM-31 Reporting and Documentation Requirements for Business Subject to a Principle-Based Reserve Valuation.

Amendments to VM-20 were integrated into the document during LHATF VM-20 subgroup conference calls during the months between the summer and fall meetings. These amendments are paraphrased below.

- The interest scenarios used in stochastic analysis will come from a prescribed generator (yet to be identified).
- The prescribed net spread on reinvestment assets shall be 4 percent of the appropriate Treasury spot path plus 0.25 percent. This item will remain on the issues list and a drafting note in VM-20 will indicate the 4 percent and 25 basis points are placeholders.
- The disclosure requirements for mortality assumptions were expanded and updated to reflect the recent changes incorporated in VM-20 dealing with the process to determine prudent estimate mortality assumptions.
- In demonstrating the impact of margins on the deterministic reserve, for assumptions that are prescribed (i.e., interest rate movements, equity performance and net spreads on reinvestment assets), the prescribed assumptions shall be deemed to be the prudent estimate assumption, and the equivalent of an anticipated experience assumption for these risk factors will be Scenario 9 (the base scenario) from the set of scenarios used in the stochastic exclusion test; 8 percent annual return for the path of S&P 500 returns; and actuarial judgment shall be used in determining the anticipated experience assumption for net spreads on reinvestment assets.
- The prescribed path of U.S. Treasury yield rates to be used for the deterministic reserve calculation shall be equal to the interest rate yield curves in Scenario 12 from the set of prescribed scenarios used in the stochastic exclusion test. The prescribed path of S&P 500 returns shall equal the 10-year treasury rate path in Scenario 12 plus the prescribed net spread added to each rate.
- The number of scenarios in the stochastic exclusion test has been updated from 12 to 16. The extra scenarios involve a wider range of interest rates in later years. The stochastic exclusion test is now based on anticipated experience rather

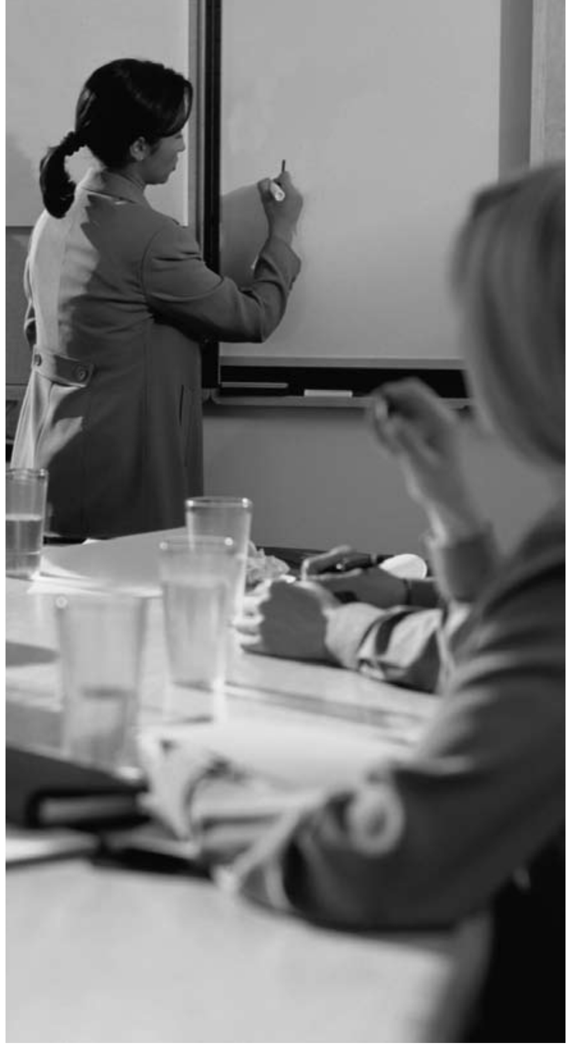
than prudent estimate assumptions. The test also appears in the C-3 Phase III proposal.

- Detail surrounding requirements for the demonstration supporting exclusion if the company elects to exclude policies from stochastic modeling but does not use the stochastic exclusion test.
- To pass the stochastic exclusion test, the ratio must be less than 4 percent. The 4 percent pass mark is expected to be continually reviewed for appropriateness by the NAIC once the valuation manual is adopted and companies submit their results of the stochastic exclusion test as part of the required documentation for a principle-based valuation.

C-3 PHASE III LIFE CAPITAL

Absent further input from NAIC's Life Risk Based Capital (E) Working Group, the American Academy of Actuaries' (the Academy) Life and Annuity Capital Work Group (C3WG), chaired by Peter Boyko, has completed their C-3 Phase III work. The Academy's Economic Scenario Generator Work Group continues to refine calibration criteria. The Academy's C3WG also provided updates to the NAIC instructions that would recognize the Phase III requirements included in the Academy's proposal. Items that have been added to the Academy's Phase III proposal that were provided to and reviewed by the NAIC Life RBC (E) Working Group are summarized below together with additional requests made by the NAIC to the Academy's C3WG:

- Language for the stochastic exclusion test has been added to the report. The Life RBC (E) Working Group expressed concern regarding the 4 percent threshold. Some members felt more testing of the concept is necessary. To the extent that any changes to the test or the benchmark are made within VM-20, the same changes would likely be reflected in the Phase III proposal.
- Language was added that required the stochastic modeling exclusion be re-analyzed at year end if the modeling had been done prior to year end and the company was within 110 percent of an action level. Whether 110 percent is an appropriate threshold for recalculation remains under review.



- The Academy was asked to provide a report specifying the differences between reserves and capital for both C-3 Phase III and Phase II.
- California and New York will provide further information to the Working Group regarding reinsurance issues.

The NAIC Capital Adequacy (E) Task Force then received and adopted the report of the Life RBC (E) Working Group. It appears as though, pending the additional requested items on economic scenario generator calibration, differences between reserves and capital, and more insight into the 4 percent exclusion benchmark, the concepts in the Phase III capital proposal are substantially complete. ■

Financial Reporting Section Membership Survey—Read the Results

by Rod Bubke

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This summer, the Financial Reporting Section Council conducted its triennial survey of Section membership. Unlike many surveys in an election year, this one had nothing to do with determining the Section members voting preferences. Rather, the purpose of this survey was to provide the Section Council with information on what is working, as well as what can be improved to provide value to Section members. Following is a brief discussion of the survey results.

One of the primary roles of the Section Council is to provide continuing education opportunities for our members. Therefore, the first portion of the survey dealt with education related issues. About half of the survey respondents said they rarely, almost never or never attend the Valuation Actuary Symposium. Over 55 percent responded in the same way for the SOA Annual Meeting and roughly 75 percent said the same about Spring Meetings. Finally, over a third of the respondents had not been to any of the aforementioned meetings in the last two years. A variety of reasons were given for this, but with the new continuing education requirements it will be more important for the Section Council to provide for alternative forms of education.

One alternative form of continuing education is webcasts. Over one third of the survey respondents felt there aren't enough webcasts offered each year. In addition, 75 percent of the respondents indicated they had attended a webcast in the last two years and that same percentage was very satisfied or somewhat satisfied with the content and the format. This appears to be an area of opportunity for the Council to provide service to our Section members.

Another primary function of the Section Council is to fund and oversee research projects that are applicable to financial reporting. While theoretical research is important, the survey did not indicate the desire to see increased research in this area. Only about 15 percent who responded indicated we should do much more or somewhat more than what we are currently doing. The results concerning practical research were significantly different. Almost 50 percent said we should do more practical-type research. An example of this coming up is a project that will examine what the impact of principle-based approach (PBA) will have on life insurance products. The Section Council is committed to conducting research that will help financial reporting actuaries perform their duties.

The survey also included a section on communication. In general, the Section newsletter, *The Financial Reporter*, is well received and read with some regularity. However, the response related to the Section's Web site indicated there is room for improvement. Sixty percent of respondents indicated they didn't know how to rate the Web site as a communications tool and 70 percent said they very rarely or never view the site. The Council believes that with the efforts of our Web site liaison, Kerry Krantz, significant strides have been made in improving the content on site. In addition, Kerry is serving on an SOA task force looking into the redesign of the Web site that will hopefully make the site more user-friendly and useful in general. I encourage you to visit the site and check out the links to related sites of interest to financial reporting actuaries.

Finally, over 75 percent of the survey respondents indicated they were very satisfied or somewhat satisfied with the Section overall, e.g., educational opportunities, newsletter, meetings, etc. While this is a high percentage, the Council will be working to provide more value to the Section members. Our goal is to have 100 percent of our members rating the Section with a "very satisfied" response.

The Council thanks all of the Section members who took the time to complete the survey. We are always willing to hear and respond to input from Section members and invite you to contact me or any of the other Council members whose names are listed on our Web site and on the inside front cover of this newsletter. ■

Winners of the Fourth Annual FROSTie and FRUMPie Awards, Take a Bow!

by Richard H. Browne

The Financial Reporter is happy to announce the winners of the FROSTies and FRUMPies for 2007. These prestigious awards are given annually for **F**inancial **R**eporter **O**utStanding **T**reatises (FROSTies) and **F**inancial **R**eporter **U**niquely **M**emorable **P**apers (FRUMPies). The actual award ceremony took place at the Financial Reporting Section Breakfast at this year's annual meeting, at which prizes were awarded and lavish praise bestowed upon the recipients.

FROSTies

Five Financial Reporter OutStanding Treatises were awarded this year. The committee of judges chose appropriate prizes that are representative of the authors' contributions or their articles. These prizes are subject to change, based on the abilities of our procurement department and market availability.

Mark Freedman and **Tara Hansen** received the Distillery Award for effectively distilling the many-paged IFRS discussion paper down to four pages in their article, "An International Financial Reporting Standards (IFRS) Phase II Discussion Paper Primer." This article appeared in the December issue. Their prize is a bottle of Jack Daniels. Unfortunately, due to budget constraints, they will have to share the one bottle.

Also on the topic of international accounting, Leonard Reback's article, "Potential Implications of IASB's Preliminary Views on Insurance Contracts," appeared in the same issue. He received this year's Wise Man Award for explaining what IFRS Phase II will mean to us. His prize is a stuffed owl.

Ken Lasorella won the Baseball Award for his article, "Statement of Financial Accounting Standards No. 157 (SFAS 157) *Fair Value Measurements* (Including Introduction to Cost of Capital Risk Margins)" in the June issue. Ken had the highest fair (ball) value in the home run contest, and will receive a regulation major league baseball signed by the members of the Section Council.

The Substantially Unchanged Prize was jointly awarded to **Rob Frasca** and **Steve Malerich** this year. Rob's article, "SOP 05-1: Eleven (or Twelve) New Things to Consider" appeared in the June issue and Steve's article, "A Principled Application of SOP 05-1: Making Sense of the Beast" was published in the September issue. In this election year, when "change" seems to be the buzz word of the day, the appropriate prize is a "Yes We Can," or else a "Country First" button, depending on election returns.

Congratulations to our six FROSTie winners!

FRUMPies

We had a number of uniquely memorable papers in 2007 that received the FRUMPie Award.

Norm Hill and **Jim Thompson** co-authored an article in March entitled, "Principle-Based Reserves in a Smaller Insurance Company." They are the winners of the Little People Award and will receive a music box that plays "It's a Small World."

"Risk Transfer Dilemma in Triple-X Funding" by **Shanker Merchant** in the March issue, was given the X-Rated Award. His prize is a brown paper wrapper.

The Longest Title Award for 2007 goes to FRUMPie recipient **Chris Perrin** for his article in the March issue, "Context-Sensitive Modeling of Elective Guaranteed Living Benefits in Variable Annuities." Chris will receive a stuffed giraffe for this feat.

"Iron Man" **Ted Schlude**, who won the Iron Man Award in 2005 and the Alphabet Soup Award in 2006 for his continuing coverage of the NAIC/LHATF meetings, has done it again in 2007. He is the recipient of the Decathalon Award for his 10-page article, "Highlights of the June 2007 NAIC Life and Health Actuarial Task Force Meeting and Other NAIC Topics" in the September issue. Ted is awarded a chocolate medal to wear around his neck until eaten.

A copy of the World Almanac will go to **Craig Reynolds** for winning the Globalization Award for his September article, "Financial Reporting for Multinationals: A North American Perspective."

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Doug Van Dam's letter to the editor in the June issue on the use of own credit rating in fair value calculations wins the Table Tennis Award for covering a topic that has been battled back and forth a lot lately. His prize, obviously, is a ping-pong ball.

"Financial Disclosures—Cleaning Up the Confusion," by **Lawrence Seller**, appeared in the June issue. He is the recipient of the Mr. Clean Award, and, of course, will receive a can of Mr. Clean cleanser.

The Scales of Justice are awarded to **Darin Zimmerman** for his December article, "A Critique of Fair Value as a Method for Valuing Insurance Liabilities." This was the most balanced presentation of a controversial topic. (His lists of pros and cons also brought back memories of studying for SOA exams.)

To all the authors who contributed articles in 2007, thanks for continuing to make The Financial Reporter a top-notch newsletter. …

The Permanent Difference Award for 2007 goes to **Rob Frasca** and **Vincent Tsang** for their article, "FASB Interpretation 48 for Actuaries" in the March issue. For their efforts, they will receive a determination letter from the IRS.

The Weatherwoman Award belongs to **Donna Claire** for her coverage of the March NAIC meeting in the June issue. For telling us the current and near term conditions, she is presented with a weather map.

Henry Siegel wrote, "The Siren Call of Models—Beware of the Rocks," in the December issue and wins the Father Knows Best Award for reminding us of the danger of falling in love with our models. For this article, he will receive a photo of Robert Young.

The Statistics Award goes to **Vadim Zinkosvsky** for best use of statistics in 2007. His article, "Risk Margins to the Non-Market Risks under FAS 157: Suggested Approach" appeared in the December issue. Vadim wins a pair of dice.

Leonard Reback and **Darin Zimmerman** are the winners of the Bifurcation Award for their article, "Insurance Bifurcation Invitation to Comment," in the March issue. Not only did their article cover the topic of bifurcation, but they bifurcated the writing responsibilities for the article between themselves, and also each bifurcated their authoring time during the year in order to write other articles for *The Financial Reporter.* For their efforts, they will receive a banana split and two spoons.

Our final FRUMPie, the Shakespeare Award, goes to Paul Margus for his December article, "The Lowly Loss Ratio," for the best use of Shakespeare in a *Financial Reporter article:*

> "There are more things in heaven and earth, Loss Ratio, than are dreamt of in your philosophy."

Paul will receive a copy of Hamlet.

Congratulations to all our FRUMPie winners!

To all the authors who contributed articles in 2007, thanks for continuing to make *The Financial Reporter* a top-notch newsletter for the actuarial community. And to all Section members, please consider authoring articles for the newsletter this year. ■

The Month That Could Never Happen

by Henry Siegel

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Nothing that happened in September could ever happen. We knew that. After all, in June we knew that …

- Goldman Sachs would never become a bank holding company.
- Merrill Lynch would never be bought.
- USC would never lose to Oregon State.
- AIG would never go bankrupt.
- We are all alone in the universe.

OK, the last is from the movie "Men in Black" but you get the point.

I first ran into "never" while reviewing GIC pricing for Equitable in the late 1970s. We were told quite convincingly that interest rates would never go over 10 percent, and certainly never over 12 percent. And we all know how that turned out. The bottom line is: nothing economic is ever impossible and Murphy's Law always applies.

These days, whenever I'm told that something could never happen, I always remind the person delivering that message that never is a very, very long time. I feel the same reaction when I'm told that something like the sub-prime collapse is a 1-in-200-year event. After all, 200 years ago, the United States only had 17 states. Something that happened yesterday might happen again as soon as our memories fade.

In general, tail-risk is much larger than our models often show.

Let's move on to international developments.

JULY AND AUGUST

These were pretty quiet months. Vacations mean that major decisions are put off. In fact, if I didn't combine the two months, I might not have mentioned August at all!

On July 9 the U.S. Securities and Exchange Commission (SEC) held a roundtable on fair value accounting. Sam Gutterman represented the Academy on the second of two panels. To the best of my knowledge, this is the first time that the Academy has ever been represented on an SEC roundtable. The specifics of the comments at the roundtable are reported elsewhere. In general, however, most participants thought that fair value was still a good measurement attribute for securities in the kinds of market we saw this year. The interesting part of this is that by September, SEC Commissioner Christopher Cox was admitting that fair value accounting contributed to some of the turmoil we've been seeing.

The other development in July was that the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) discussed revenue recognition one more time. They more or less agreed on using customer consideration as the basic method for recognizing revenue. Unfortunately, they also agreed not to adjust for acquisition costs. If applied to insurance, this would result in large losses at issue, similar to statutory accounting. They were also not able to agree on the circumstances for unlocking the revenue allocation.

Finally, in September the Board decided not to scope out insurance from the revenue recognition project. However, no one has yet figured out how the customer consideration will work for annual premium products or products with unlimited benefit periods. More will be heard on this in months to follow.

SEPTEMBER

On September 3–4, the National Association of Insurance Commissioners' (NAIC) E Committee and its International Solvency and Accounting Working Group (ISAWG) held a joint meeting to kick off its Solvency Modernization Initiative (SMI). After a day of listening to comments from the industry and the Academy, the members met in private for the second day. At the subsequent NAIC Fall Meeting, the NAIC announced seven items have been added to the ISAWG charge as a result of SMI:

1) Compare E.U. and U.S. solvency regimes, prepared by a consultant.
2) Study international solvency regimes to assess which/whether to incorporate aspects into the U.S. system.

3) Develop a document synthesizing all current NAIC regulatory principles.
4) Invite international regulators to give presentations to the NAIC on solvency developments.
5) Develop a document with critical solvency issues by October 15.
6) Charge the statutory accounting principles working group with comparing International Financial Reporting Standards (IFRS) to U.S. Statutory Accounting dealing with differences and implementation issues
7) Staff will organize an educational session on international developments at Life and Health Actuarial Task Force (LHATF).

In short, the NAIC has decided that it needs to take international developments seriously. In particular, it is very aware that if IFRS replaces US GAAP, it will once again be faced with the choice of either using IFRS for statutory accounting or doing a Codification 2 to replace GAAP with IFRS. At this point, no decision has been made on which option to elect.

On September 18, the IASB had its first discussion of insurance topics in several months. The specific discussion was an educational session on using Contract Fulfillment Value (CFV) as a measurement attribute for insurance contracts. In brief, CFV says to use entity specific assumptions for all measurements except those for which an active and deep market exists. This was largely in agreement with comments made by many with respect to last year's Discussion Paper.

Some in attendance seemed to have difficulty understanding this proposal and the conversation went in a variety of directions. No decisions were reached at this meeting, but we will be addressing the topic again in the near future.

NEXT QUARTER

In October, the IASB will again discuss measurement attributes for insurance in an educational session. On November 10–11 there will be an insurance working group meeting for the industry to give the Board input on the same issues.

In short, the NAIC has decided that it needs to take international developments seriously.

The International Actuarial Association (IAA) will have had its semi-annual meeting in Cyprus, November 1–4.

The NAIC will have the educational session for LHATF some time during the quarter and its Winter Meeting will no doubt continue to discuss international issues.

In Memory of Dan McCarthy

Dan McCarthy, FSA, MAAA, EA, died on September 26. Among the many posts he held, Dan was the international secretary of the Academy and was largely responsible for organizing the U.S. profession's response to international issues. He will be greatly missed. An extensive obituary is available on the SOA Web site at http://www.soa.org/about/membership/2008-deceased-mccarthy.aspx.

Remember: Insurance accounting is too important to be left to the accountants! ■

BOOK REVIEW

"The Analysis of Insurance Earnings: An Enterprise Approach," by John McGarry and Kevin Pledge

reviewed by Carol Marler

This book is all about granularity. The authors envision a data warehouse with information at the policy level or lower, and demonstrate how this data can be used to analyze the sources of earnings. They consider not only traditional life and universal life products, but also disability income, payout annuities, health insurance and segregated fund plans.

The key to their analysis is the data warehouse, which links each policy, not only to valuation assumptions and results, but also to general ledger accounting amounts and to projections (model output that feeds the financial plan). By conducting the analysis on a monthly basis, they are able to disregard secondary effects, such as the effect of lapsation on claims and other similar interactions.

Extensive formulas are provided throughout the book, along with numerical examples. A few typos were found, but fortunately they were in the narrative portions, not in the formulas themselves. Other analysts might have selected slightly different ways of combining data, but their approach seems reasonable.

Some special handling is needed to get the most out of the process. Investment income and administrative expenses must be driven to the policy level through some form of allocation. The treatment of new business is separated from existing in force, because the key driver of variance for this business is whether the volume of production matches plan. Once new business is put on the books, it can be analyzed with some of the same formulas as beginning in force. In the book, reinsurance is also treated separately, although the analysis of direct business and reinsurance can be subsequently combined if management prefers looking at net results.

This book provides a useful reference for actuaries who use or are considering a data warehouse for their financial reporting and analysis. ■

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