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Fair Value Accounting: Trouble-maker or Life-saver?

by Larry Rubin, Xiaokai (Victor) Shi and Nadezhda Toskova

Fair value accounting (also known as mark-to-market accounting) has been in the center of criticism in this financial earthquake. It is blamed for everything from the sub-prime crisis, the credit crunch, problems with credit-default-swaps, failures of Freddie Mac and Fannie Mae, AIG's liquidity crisis, bankruptcy of Lehman Brothers, multi-billion dollar write-downs, equity market volatilities, concerns of variable annuities business issued by insurers, and even, most extremely, the global economic recession.

This accounting method has certainly been blamed for causing violent tremors in its financial epicenter.

For some background, fair value accounting in the United States, defined under FAS 157 "Fair Value Measurements" and effective for fiscal years beginning after Nov. 15, 2007, assigns values of financial instruments according to current market prices or the latest market information of the same instruments or similar types. Fair value accounting originated partially due to the savings and loan crisis in the late 1980s and early 1990s in the United States[1], which lacked appropriate, accurate and effective accounting rules to value the savings and loan business. Financial assets or liabilities, according to FAS 157, could be assigned into the following three categories:

- Level 1 fair values: observable market prices in liquid market.
- Level 2 fair values: comparable securities with observable market prices.
- Level 3 fair values: unobservable market inputs.

FOOTNOTES:

1 The S&L crisis in late 1980s and early 1990s resulted in failures of 747 saving and loans associations in the United States.

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This newsletter is free to section members. Current-year issues are available from the communications department. Back issues of section newsletters have been placed in the SOA library and on the SOA Web site *(www.soa.org)*. Photocopies of back issues may be requested for a nominal fee.

CHAIRPERSON'S CORNER

IF IT'S NOT BROKEN ….

As I begin my year as Chair of the Financial Reporting Section Council, we are experiencing unsettled and trying economic times which raise many questions for financial reporting actuaries. One might say the economy is broke. Before I began my career as an actuary, I was a high school math teacher and coach for nine years. As a football and basketball coach, when I found a play that worked I kept using it until the other team figured out a way to stop it. In other words, if it's not broke, don't fix it.

Unlike the economy, the financial reporting section council isn't broken. Due to the terrific leadership of our past chair Jerry Enoch and other past leaders as well as past and current council members and volunteers, the council is in a good position. Therefore, since it's not broke, we don't need to fix it. That's not to say we don't have a lot of work to do and there isn't much to be accomplished, because there is.

Last year, the council focused on the Big Three, research, continuing education and PBA. The first two of those, research and continuing education, are the heart and soul of what the section council does. For 2009, in addition to our work on PBA we have added a fourth member to our group, IFRS and international issues, so this year we have the Big Four.

CONTINUING EDUCATION

This is one of the pillars of what the sections of the SOA are all about. As companies may look to control travel expenses and with the expanded continuing education requirements, it is imperative that the section council provide efficient and effective opportunities for education for our members.

One way to provide such opportunities is through webcasts. Webcasts provide an opportunity for multiple individuals at a company to participate in continuing education at a relatively low cost. Many good sessions at the Spring and Annual meetings and Valuation Actuary Symposium will have approximately 70 attendees. When you consider a webcast that has 125 companies register and assume an average of five people per site, you are reaching 625 attendees. So you can see how efficient webcasts can be. A webcast that discussed the impact of the financial crisis on financial reporting was recently held in mid-December. In addition, webcasts on IFRS and market consistent embedded value (MCEV) are being planned. I would like the council to continue to develop frequent, valuable webcasts to provide service to our members.

In addition to webcasts, the council needs to continue to provide sessions at meetings that provide a service to our members. Last year the council gave birth to the Valuation Actuary Forum. While continuing to nurture that new educational opportunity, is there another topic that can serve as the next annual seminar that the council can sponsor along with the successful Basic and Advanced GAAP Seminars?

RESEARCH

Research is the other pillar of section activities. Sue Deakins has done a terrific job as our research coordinator. Working with Ronora Stryker, SOA research actuary, there are currently several research projects underway. Building on our use of Actuarial Task Forces to analyze impacts of IFRS, a project is in its early stages to analyze the impacts of PBA on reserves. This project is an important piece of work to move the PBA concept forward.

In addition, two other projects initiated to assist with PBA work are underway. One is examining the process of setting risk margins under a PBA approach and the other is looking at the use of credibility through a survey and statistical analysis.

Information on these and other research activities can be found in another article in this edition of the Financial Reporter.

PBA

We are continuing to define what the section's role should be in these initiatives. As mentioned above, research is certainly an area where we believe the section can provide value. The above projects along with any others that may be pursued will provide valuable information to move the work forward as well as to practicing actuaries once PBA becomes a reality.

In addition, the section can and will be involved with educating actuaries on PBA. With VACARVM being effective in 2009, the section will be sponsoring a session on the topic at the upcoming Spring Meeting. In addition, a session on Principle-Based Capital is being planned. I would also like to thank Karen Rudolph for providing updates in the *Financial Reporter*.

INTERNATIONAL ISSUES

As work on IFRS and potential convergence with US GAAP continues, it is important that actuaries are informed of developments so they can have input into the process. The section's role can be similar to that on PBA, i.e., research and education. The section conducted a research project on the impacts of IFRS based on the Discussion Paper. It is planned to repeat this project when the Exposure Draft is issued. As mentioned above, a webcast is being planned to provide an update on IFRS and a session at the Spring Meeting will compare IFRS with FAS 157.

I would like to thank Henry Siegel for his informative updates on international issues in the *Financial Reporter*. In addition, the section is working with Jim Milholland on his work with the IAA. He will provide updates to the section council and in articles in the *Financial Reporter*. The first of these updates can be found in this issue.

There is a lot going on and much for the section council to do. I am happy to have such a dedicated and hard working council to get this work done. However, there is too much for the council to do alone. Thank you to all who have volunteered to help the section in any way. If you would like to participate, please don't hesitate to contact me or any council member.

Finally, I would like to say a big thank you to Rick Browne, our newsletter editor. This is Rick's last edition in this role as he passes the baton to Tara Hansen. This is an important role in providing a quality publication to our members and Rick has done a fabulous job. ■

Rod Bubke, FSA, MAAA, is VP – Insurance and Annuity Valuation at Ameriprise Financial Inc. He can be contacted at rod.l.bubke@ampf.com

In the December 2008 issue of *The Financial Reporter*, the SOA incorrectly listed Jerry Enoch's author information. The correct information is: Jerry Enoch, FSA, MAAA, is vice president and chief actuary at Alfa Life Insurance Corp. He can be contacted at *jenoch@alfains.com.* The SOA regrets any confusion created by the error.

This article reviews the arguments of both the opponents and proponents of fair value accounting.

OPPONENTS OF FAIR VALUE ACCOUNTING

The strongest opposing voices are from brokers dealers, retail banks, insurance companies, specialty lenders, thrifts, mortgage writers, investment companies and hedge funds, who face massive asset write-downs in this market meltdown and furiously blame the fair value accounting method of contributing to or even causing their current troubles.

In the past several months, especially after the AIG liquidity crisis and Lehman Brother bankruptcy, financial service companies have vigorously called for the suspension of fair value accounting rules. Many of them have believed that fair value accounting is the primary driver of the financial crisis. For example, the following is one remark typically heard on the street *"... probably 70 percent of the real crisis that we face today is caused by mark-to-market accounting in an illiquid market. What's most fascinating is that the Treasury is selling its plan as a way to put a bottom in mortgage pool prices, tipping its hat to the problem of mark-to-market accounting without acknowledging it. It is a real shame that there is so little discussion of this reality."*[2]

An article[5] published in *The Economist* did not explicitly criticize fair value accounting, but pointed out three practical problems …

Criticism from well-known public figures or those in the academic world, who are viewed as neutral in this debate or as outsiders, has attracted the broadest attention. For example, former FDIC Chair William Isaac's criticisms of fair value accounting are widely quoted by journalists. He placed much of the blame of the subprime crisis and credit crunch on fair value accounting. Isaac[3] recently wrote in *The Wall Street Journal* that:

"The country's 10 largest banks were loaded up with Third World debt that was valued in the markets at cents on the dollar. If we had marked those loans to market prices, virtually every one of them would have been insolvent.… When there are temporary impairments of asset values, due to economic and marketplace events, regulators must give institutions an opportunity to survive the temporary impairment. Assets should not be marked to unrealistic fire sale prices. Regulators must evaluate the assets on the basis of their true economic value (a discounted cash flow analysis). If we had followed today's approach during the 1980s, we would have nationalized all of the major banks in the country, and thousands of additional banks and thrifts would have failed. I have little doubt that the country would have gone from a serious recession into a depression. The Securities and Exchange Commission and bank regulators must act immediately to suspend the Fair Value Accounting rule."

There are also critics from the academic world. Richard Epstein, professor from University of Chicago, also wrote about the fair value accounting and credit crunch. He noted that, *"Unfortunately, there is no working market to mark this paper down to. To meet their bond covenants and their capital requirements, these firms have to sell their paper at distress prices that don't reflect the upbeat fact that the anticipated income streams from this paper might well keep the firm afloat."*[4]

An article[5] published in The Economist did not explicitly criticize fair value accounting, but pointed out three practical problems of the fair value accounting rules (i.e., the

FOOTNOTES:

2 Newt Gingrich, "Suspend Mark-To-Market Now!" Sept. 29, 2008, Forbes.com

3 William M. Isaac, "How to Save the Financial System", Sept. 19, 2008, The Wall Street Journal

4 Richard Epstein, "Greed, Or Incentives?" Sept. 23, 2008, Forbes http://www.forbes.com/2008/09/22/libertarian-mortgage-lease-oped-cx_re_0923epstein.html

5 "Accounting: All's fair," Sept. 20, 2008, The Economist http://www.economist.com/finance/displaystory.cfm?story_

circuit between stock price and banks' capital adequacy; problems valuing level 3 securities; and inconsistencies in the treatment of assets and liabilities).

In summary, the following have been the most commonly used basic rationales from opponents who call to modify or suspend fair value accounting:

- When a company is in financial turmoil it has to sell its assets at distress prices that do not reflect anticipated cash flows;
- Market prices of many intricate financial derivatives (level 3) are highly reliant on complex computer models, which in turn are highly subjective to model risk, thus distorting the real fair value;
- Fair value accounting does not provide a true view of long-term value. Financial items valued under mark-to-market rules have distorted the companies' balance sheets;
- Mark-to-market has triggered the margin calls for many mortgage-backed securities (MBS), thus exacerbating the financial crisis;
- Fair value accounting has caused market volatility to increase dramatically;
- Fair value accounting has prompted huge asset write-downs and has decreased companies' capital due to distressed financial conditions, thus triggering credit downgrades and pulling companies' stock prices down; and
- Fair value accounting destroyed public confidence. Relaxing fair value accounting is one way to restore investors' confidence and the health of capital markets.

PROPONENTS OF FAIR VALUE ACCOUNTING

However, there are also supporters of fair value accounting or at least voices against suspending it.

The standard setters, SEC (who has the authority to relax the accounting rule)[6] and FASB (who issued the FAS 157 standard), both defend fair value accounting when facing calls to suspend rules blamed for exacerbating the global financial crisis. All this comes despite the same regulatory bodies recently encouraging companies to rely more on their own judgment[7] in determining fair values in distress situations.

Some defenders of fair value accounting have expressed strong concerns that suspending fair value accounting rules will throw the U.S. financial system off its long-run equilibrium path. For example, Arthur Levitte,[8] former chairman of the SEC, wrote in *The Wall Street Journal*, *"… to ask for a suspension in fair value accounting is to ask the market to suspend its judgment. … it is accounting sleights-of-hand that hid the true risk of assets and liabilities these firms (banks) were carrying, distorted the markets, and have caused the investors to lose the confidence for our markets to function properly. … Fair value does not make markets more volatile; it just makes the risk profile more transparent." He further added that "… it may be painful for some companies, and even for the markets as a whole, as we transition to fair-value accounting. But it is the rough medicine we must take in order to vastly improve financial reporting, bring transparency to the market, and restore investor confidence."*

There are also worries that, in removing fair value accounting, investors would go back to darkness again. Federal Reserve Chairman Ben S. Bernanke expressed similar concerns. He said that, according to Bloomberg news,[9] removing the rule would erode confidence that firms would own up to losses. He also commented that if it is suspended "*… nobody knows what the true mark-to-market price is.*"

Though rare, there are some supporters from the traders/asset managers. For example, according to the same Bloomberg news cited above, one investment strategist

FOOTNOTES:

[6] As part of the "Emergency Economic Stabilization Act of 2008," U.S. government reiterated the SEC's authority to relax the fair value accounting rules. See the Section 132 "Authority to Suspend Mark-to-Market Accounting" of this Act.

[7] FASB and SEC have issued a joint Staff Clarifications on Sept. 30, 2008, saying that "when an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable."

[8] Arthur Levitt Jr. and Lynn Turner, "How to Restore Trust in Wall Street," Sept. 26, 2008, *The Wall Street Journal*

[9] Jesse Westbrook, "SEC, FASB Resist Calls to Suspend Fair-Value Rules," Sept. 30, 2008, Bloomberg News *http://www.bloomberg.com/apps/news?pid=newsarchive&sid=agj5r6nhOtM*

[10] Neal Lipschutz, "Point of View: Don't Shoot The Accounting Rule," Oct. 1, 2008, Dow Jones Newswires

Larry Rubin, FSA, MAAA, is a partner at PricewaterhouseCoopers. He could be reached at *larry.rubin@us.pwc.com*

Xiaokai (Victor) Shi, FSA, MAAA, is a senior associate at PricewaterhouseCoopers. He could be reached at *victor.shi@us.pwc.com*

Nadezhda (Nadya) Toskova, is an associate at PricewaterhouseCoopers. She could be reached at *nadezhda.toskova@us.pwc.com*

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who oversees $500 billion in assets has commented that, *"Suspending the mark-to-market prices is the most irresponsible thing to do. ... Accounting does not make corporate earnings or balance sheets more volatile. Accounting just increases the transparency of volatility in earnings."*

Some also argued that fair value accounting is NOT the cause of the current financial crisis. For example, Neal Lipschutz, a managing editor of *Dow Jones Newswires*, is one of those against suspending the rule. Here is what he wrote in an article titled "Don't Shoot the Accounting Rule."[10] *"Two things played big roles in creating the credit crisis: an abandonment of mortgage lending standards in the U.S. and opacity in mushrooming niches of the capital markets. So why would we now—in the middle of the worst of the crisis that those factors precipitated—want to dilute accounting standards and create less transparency for investors? Ask the 60-plus members of the House of Representatives who think shooting the accounting rule commonly called mark to market will help get us to a solution. It won't. Restoring confidence is the key to unfreezing the credit markets that make the whole economy go, and lower standards don't restore confidence. But legislating the problem away in favor of a less rigorous standard that might vary in its application from company to company isn't the answer."*

There are also proponents from major accounting firms. Beth Brooke, global vice chair of Ernst & Young, was quoted by *The Wall Street Journal* expressing the opinion that *"Suspending mark-to-market accounting, in essence, suspends reality."*[11] Similar remarks were made by Sam DiPiazza, chief executive officer of PricewaterhouseCoopers, during an interview with *Financial Times, "To suggest you don't track and report fair values means you end up in a world where management still knows the real prices, as do market counterparties, but not the investors."*[12]

Some market analysts hold similar opinions. An analyst from JPMorgan recently wrote, in the same Bloomberg article mentioned above, that, *"Blaming fair-value accounting for the credit crisis is a lot like going to a doctor for a diagnosis and then blaming him for telling you that you are sick."*

The following points summarize the arguments of proponents:

- Fair value accounting has not caused the financial crisis, but has been telling the truth;
- Without mark-to-market giving early warnings, the problems of credit-default-swaps could have hurt the financial sector even more;
- Fair value does not increase volatility, it only unveils the problems;
- Swift write-downs, in fact, help to re-establish stability;
- Suspending fair value accounting is suspending the market judgment;
- Suspending fair value would not restore market confidence. On the contrary, without fair value, the already low transparency will diminish even further, sentencing investors to financial darkness.
- Current fair value accounting is not perfect, but there is no better alternative especially when valuing complex derivatives and structured products. Alternatives are mark-to-myth accounting;
- Legislating accounting rules in favor of less rigorous standards could only result in even worse problems; and
- Japan's lost decade of the1990s was prolonged by lack of fair value accounting (through which banks were able to ignore their problematic loans). The

United States certainly does not want to bring upon itself a decade-long recession by suspending fair value accounting.

GO BACK TO BASICS

Both sides of this debate have strong arguments and supportive facts. This article, however, would like to revisit the two primary purposes of financial reporting rather than immediately joining the debate in favor of either side: 1) providing investors with comparable information with which to make decisions, and 2) providing regulators with the information necessary to determine if financial institutions can fulfill their obligations when they are due. It is possible that the financial crisis has demonstrated the inability of a single set of financial reporting rules to serve both purposes.

Regardless of suspending or keeping fair value accounting, market players and regulators have to join efforts in securing *both* the investors' rights to gather comparable and reliable information, and the regulators' needs to understand the risks posed to the financial system. Accounting in itself should not serve as a tool to conceal financial problems, nor mislead with unreliable information.

If an accounting or financial reporting framework serves to maximize investors' benefits, it must evolve in ways that information being provided is as transparent and objective as possible, no matter whether this information is based on fair value or book value. If fair value accounting were to be abandoned, one must find an alternative that, for sure, better serves investors' interests. If it serves to provide information to regulatory authorities it must provide both information that is a reliable estimate of future obligations and the resources needed to meet those obligations. ■

FOOTNOTES:

[10] Neal Lipschutz, "Point of View: Don't Shoot The Accounting Rule," Oct. 1, 2008, Dow Jones Newswires

[11] Judith Burns, "Auditors Resist Effort To Change Mark-to-Market," Sept. 30, 2008, *The Wall Street Journal*

[12] "Politicians rail against fair value accounting," Sept. 30, 2008, Financial Times *http://www.ft.com/cms/s/0/b7bc1b2e-8f24-11dd-946c-0000779fd18c.html*

Call for Papers–Living to 100 Symposium IV

The Society of Actuaries will present its fourth triennial international Living to 100 Symposium in January 2011 in Orlando, FL. We encourage anyone interested in preparing a paper for the symposium to get an early start on pursuing the research and analyses. We are seeking high quality papers that will advance knowledge in the important area of longevity and its consequences. To learn more, visit ***www.soa.org,*** click on Research, Research Projects and Calls for Papers and Data Requests.

Report on the International Actuarial Association

by Jim Milholland

Jim Milholland, FSA, MAAA is a retired Partner from Ernst & Young. He can be reached at *actuary@milholland.com*

The most recent meeting of the IAA was held in Limassol, Cyprus this past November. The meeting took place against a backdrop of an ever-worsening global economy and public concerns that financial reporting, and what many perceive as unreasonable requirements of fair value measurement, may have contributed to the credit crisis. Although not a specific topic of discussion in the meeting sessions, the influence of current economic conditions on the discussions was apparent.

ACCOUNTING COMMITTEE DISCUSSIONS RELATED TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

The liveliest discussions of the Accounting Committee related to topics on Phase II of the International Accounting Standards Board's (IASB or the Board) Insurance Project. The IASB intends to have a uniform global standard for accounting for insurance contracts issued by 2011 to be in effect soon thereafter, possibly 2013.

The Board's preliminary decisions regarding the insurance standard are presented in a Discussion Paper, in which the Board states its view that the measurement of insurance liabilities should be a current exit value (CEV), which, if it is not fair value, it is very close to fair value. A CEV may be estimated from current estimates of future cash flows, discounted at market rates and with a margin for risk.

The Accounting Committee of the IAA has organized a number of task forces on various topics related to the anticipated insurance standard, including discount rates, revenue recognition, and the boundary issue (about which more will later be discussed in this article).

DISCOUNT RATES

It was the discussion about discount rates that perhaps best illustrated the confluence of actuarial sensibilities, emerging accounting principles and the current economic environment. Many actuaries have concluded that the Phase II standard will require discounting at risk free rates with certain adjustments. Discussions on discount rates related to which adjustments to make to risk free rates and how to quantify them. Adjustments for credit standing and for liquidity were the most discussed.

Some actuaries believe that credit-standing has no role in the measurement of liabilities. It seems to them counterintuitive, if not simply inappropriate, that a company with a deteriorating credit situation would lower its liabilities and show more capital than it otherwise would. How can financial statements among insurers be comparable if the weaker companies get to report lower liabilities?

One can only imagine the effect on liabilities of the increase in credit spreads that has occurred in recent months. Nonetheless, US GAAP requires that credit standing, or the probability of nonperformance, be taken into account in fair value measurement, and the IASB, which is still deliberating about a uniform standard on fair value measurement, has not taken consideration of credit standing in the fair-value measurement of liabilities generally, or for insurance contracts specifically, off the table.

At the time of these discussions in Cyprus, there was no hotter topic among accountants than liquidity, centering around the extent to which the discount rates should reflect liquidity characteristics of the contracts being measured. Contracts that are not liquid, annuities for example, would have a larger factor than contracts that offer cash values. Illustrations of profit profiles for annuities demonstrate how significant the factor can be to emerging profit and loss at issue.

Much of the objection to fair value reporting in the current environment relates to liquidity. Previously deep and easily observed markets have suddenly frozen and provide little if any relevant observable data on values. Many accountants and others object to the use of a limited number of observable transactions as fair value indicators, on the grounds that they do not represent transactions in a normal market and are likely forced sales. So while many accountants are trying to dampen the influence of liquidity in the extreme on asset valuation, many actuaries are trying to get liquidity factored into liability measurement. These perspectives are reconciled by their desire to consider liquidity in discounting as it reflects an orderly, active market.

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CONFLICT & CHANGE MANAGEMENT SEMINAR

An Advanced Program Tailored for Actuaries in All Stages of the Profession

This seminar is being jointly sponsored by the Society of Actuaries' Management & Personal Development, Financial Reporting and Product Development Sections, and held adjacent to the 2009 Life Spring Meeting.

Many of us resist change when it isn't our idea. How do you cope? How do you lead others?

Immediately following the Life Spring Meeting, join Dr. Liz Berney, facilitator, consultant, and teacher of the **Accelerated MBA program** at George Washington University. Dr. Berney will discuss key tactics and strategies for managing conflict utilizing the **Harvard Negotiation Program tenets.**

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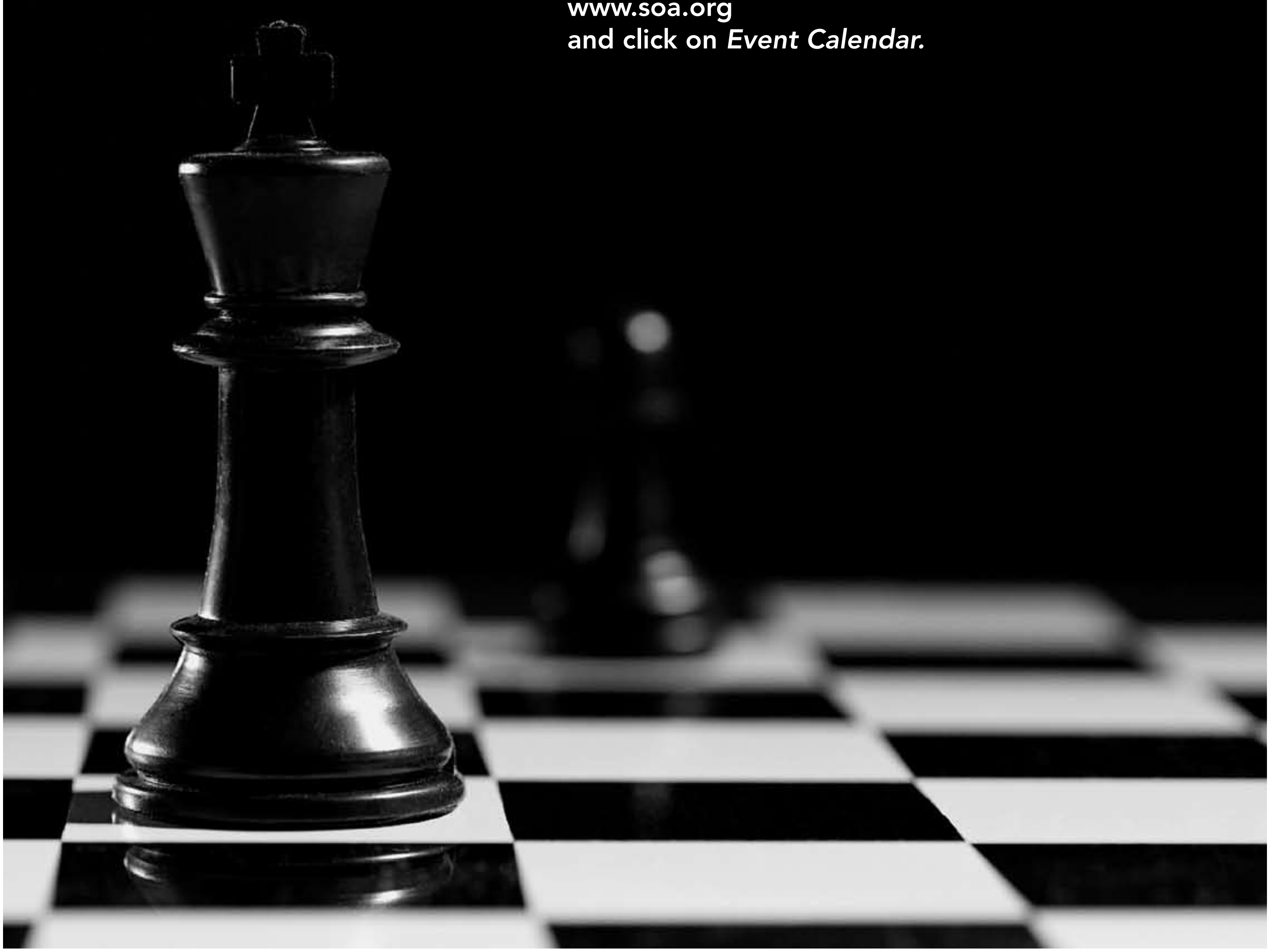

REVENUE RECOGNITION

A presentation on revenue recognition by Kevin Griffith, an accountant from the London office of Ernst & Young, provoked much discussion as well. The presentation clarified why revenue recognition is important to liability measurement. It is apparent from the IASB deliberations on revenue recognition that without revenue there is no profit. The IASB is releasing its discussion paper on revenue recognition in December. The paper is expected to favor an approach called "customer consideration." Under customer consideration, the measurement of the obligation is calibrated to the value of the consideration and there is revenue as the liability for the obligation is decreased by performance or by delivery to the customer.

In the case of an insurer, it is not sufficient to collect a premium and record a liability for less than the amount of the premium in order to have a profit. What is necessary is that there be some performance under the contract, or delivery to the customer, that allows revenue to be recognized. It seems likely that revenues on contracts with long-tail liabilities will extend over the claims-payment period. In fact, it is not clear if there will be revenue before claims are settled. For there to be revenue during the exposure period, a case needs to be made that the insurer has performed under the contract by providing protection during the coverage period.

What happens with life insurance is also unclear. In particular it is not clear how revenue is recognized when there are future premiums. Is there revenue recognition as deaths occur in each premium period, or is there a guarantee of future insurability that must be considered in revenue recognition? If so, is there performance when the guarantee is sold (on premium payment) because the guarantee is delivered or is there revenue only as the guarantee plays out over time?

THE BOUNDARY PROBLEM

The boundary problem relates to the difficulty some Board members have in distinguishing between renewal premiums—for example, the renewal of an automobile policy—and recurring premiums on, for example, level term insurance. Many Board members see future premiums as an asset for which recognition is dubious, but they see the need to recognize a liability for guaranteed insurability. The preliminary decision of the Board is that future premiums are not considered in the measurement of insurance liabilities unless they must be paid in order to maintain insurability or if the contract liability is greater if they are considered. It seems that revenue recognition and consideration of future premiums in the measurement of liabilities are linked and that the Board's insurance projects and revenue recognition projects are interdependent and the projects will need to be synchronized.

CONCEPTUAL FRAMEWORK

Another Board activity that raises issues relevant to the measurement of insurance liabilities is its project on the conceptual framework that comprises the fundamental concepts that underlie the principles found in the standards and other pronouncements. A part of this project is a review and possible revision of the concepts related to elements of financial reporting and recognition of the elements. Elements include assets and liabilities. The definitions of assets and liabilities, both those within the existing framework and those being used by the Board for discussion purposes, are found in the following table.

	CURRENT DEFINITION	DISCUSSION DEFINITION
Asset	An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have.
Liability	A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	A liability of an entity is a present economic obligation for which the entity is the obligor.

The working definition of an asset that emphasizes access that others do not have rather than control may make the Board more receptive to seeing future premiums as an asset that can be recognized, although to be sure, recognition is a set of considerations apart from the definition. The proposed definition of a liability may make it easier for the Board to accept future dividends on participating contracts as part of liabilities, something it has been reluctant to do except when dividends are a clear legal or constructive obligation.

OTHER ACTIVITIES

The space remaining does not allow for an exhaustive report on other activities, but three items of note must be mentioned.

STOCHASTIC MODELING

With the support of the Financial Reporting Section and others, the Accounting Committee has sponsored the development of a monograph on applications of stochastic modeling in insurance. With the likely need to use stochastic modeling to comply with the international insurance standard when it is adopted, this will be a timely and useful publication. The monograph is being written by experts from Milliman and reviewed by a select group of members of the Accounting Committee. It should be available sometime in 2009.

INTERNAL MODELS

The Solvency Subcommittee of the Regulatory Committee has nearly completed a *Guidance Paper on the Use of Internal Models for Risk and Capital Management purposes by Insurers.* The guidance should help actuaries build and maintain models in a proper control environment and prevent models from becoming "black boxes." The guidance may apply equally to financial reporting when, as expected, internal models will be the basis for measurement of liabilities. This paper is also expected in 2009.

RISK MARGINS

The long awaited paper on risk margins should be released before year end. In fact, it covers much more than risk margins. Its title is *Measurement of Liabilities for Insurance Contracts: Current Estimates and Risk Margins.* The paper has been a major undertaking and will be a valuable primer to actuaries seeking an introduction to setting assumptions, selecting discount rates and quantifying risk margins.

NEXT MEETING

The next council and committee meetings of the IAA are scheduled for the end of May in Tallinn, Estonia. There will be much to report on following that meeting. ■

A NOTE FROM THE AUTHOR

I appreciate the opportunity that the Financial Reporting Section has given me to continue my involvement with the International Accounting Association and to report to you on the activities of the IAA. In my reports I will focus on topics of particular interest to actuaries involved in financial reporting. These are primarily, but not exclusively, the activities of the Accounting Committee of the IAA. I have chosen to write the reporting topically, allowing the reports to reflect my perspective on the activities. These reports can be seen as expanding the reporting that has previously been included in Henry Siegel's articles on international financial reporting.

This issue of the Financial Reporter *contains the first report, with additional reports to follow as least semiannually, corresponding to meetings of the IAA. Readers whose interest is piqued by the reports can request elaboration of topics touched on in the reports, which may form the basis for additional articles from me or from a colleague involved with the IAA.*

Upcoming GAAP Developments

by Leonard Reback

Leonard Reback, FSA, MAAA, is vice president and actuary, Metropolitan Life Insurance Co. in Bridgewater, NJ. He can be contacted at 908.253.1172 or lreback@metlife.com.

In 2008, many valuation actuaries were faced with the challenge of implementing FAS 157 (Fair Value Measurement) for US GAAP reporting purposes. The good news is that there isn't any new US GAAP accounting standard requiring major actuarial valuation changes for existing business in 2009. However, looking over the next few years, the accounting standard-making bodies have several major projects underway that could have a significant effect on valuation actuaries. These projects include:

1. replacement of existing US GAAP with IFRS,
2. accounting for insurance contracts,
3. revenue recognition, and
4. revising the accounting for financial instruments.

In addition, there are other projects underway that may not be as significant to valuation actuaries as the projects listed above, but which may still have some effect on actuaries.

POSSIBLE REPLACEMENT OF US GAAP WITH IFRS

In the United States, the Securities and Exchange Commission (SEC) has the authority to regulate financial markets, including setting the financial reporting standards. Since the 1970s, the SEC has delegated the responsibility for promulgating financial reporting standards to the Financial Accounting Standards Board (FASB). On the other hand, many countries throughout the world, including the European Union, Australia and Hong Kong, use financial reporting standards promulgated by a different body, the International Accounting Standards Board (IASB). These financial accounting standards are generally known as International Financial Reporting Standards (IFRS). A number of other countries, including South Korea, Canada and Brazil, have announced plans to switch from their current accounting standards to IFRS over the next few years.

In November 2008, the SEC released the "Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers."[1] Under this roadmap, if certain conditions are met by 2011, the SEC would then mandate the eventual replacement of US GAAP with IFRS. For the largest companies, known as large accelerated filers, this would occur in 2014. Other large companies (accelerated filers) would switch to IFRS in 2015 and all U.S. companies would switch to IFRS by 2016.

Mandating that U.S. companies switch to IFRS would enhance comparability of financial statements across companies that are domiciled in different jurisdictions around the globe. The SEC views this as an important goal, since capital markets have become increasingly global. However, the roadmap sets forth several milestones that need to be achieved by 2011 in order for the SEC to make the decision to switch.

Some of these milestones are technical, involving issues such as the funding mechanism for IASB's parent foundation and ability to report under IFRS using interactive data. Other milestones are more practical. For example, one of the milestones is to achieve certain improvements in existing accounting standards. Some of the projects currently underway by IASB and FASB, such as Revenue Recognition, are meant to achieve this goal. Another milestone is education and training about IFRS for investors, accountants, auditors, and other users and preparers of financial statements. Actuaries are explicitly noted as one of the groups that would need to be educated on IFRS.[2]

Although the potential replacement of US GAAP with IFRS in 2014 for the largest companies (and later for smaller companies) seems far off, it may not be as far as it seems. Adopting IFRS would likely be a much larger task than adopting a single new accounting standard, such as FAS 157. And companies are required to show three years of comparable audited financial statements, so a company converting in 2014 would need to show audited financial statements under IFRS for 2012 through 2014. 2012 is just three years away!

FOOTNOTES:

1 Available from the SEC's Web site at *http://www.sec.gov/rules/proposed/2008/33-8982.pdf.*

2 SEC Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers, p.29.

INSURANCE CONTRACTS

In May 2007, IASB released a discussion paper proposing new guidance for accounting for insurance contracts. At the time, FASB was not involved in the project. This discussion paper has been described in detail elsewhere.[3] But as a brief reminder, the discussion paper proposes to value insurance liabilities at current exit value, or the estimated price to transfer the liability to another market participant. This value would be estimated using three building blocks:

1. explicit, unbiased, market-consistent, probability weighted, current estimates of contractual cash flows,
2. current market discount rates that adjust the estimated future cash flows for the time value of money, and
3. an explicit and unbiased estimate of the margin that market participants would require for bearing risk (risk margin) and for providing other services, if any (service margin).

The current exit value would incorporate non-performance risk (e.g., credit standing), but would not incorporate entity-specific cash flows. Beneficial policyholder behavior and, unless they caused the liability to increase, universal life premiums in excess of the minimum premium needed to maintain the contract in force would also be excluded. And certain non-guaranteed elements on universal life contracts and dividends on participating contracts might also be excluded. Under current exit value, the risk margin would not be calibrated to the premium and, therefore, a gain or loss might emerge at issue.

The IASB received many comment letters responding to these proposals, and they have begun redeliberating in light of the comments. For example, at their October 2008 meeting, the IASB discussed potential alternatives to current exit value. One of those potential alternatives was current fulfillment value, which would represent the cost to fulfill the insurer's obligation to the policyholder rather than the cost to transfer the obligation. Under a current fulfillment value model, entity-specific cash flows could be incorporated. Also, non-performance risk might be excluded from the valuation, and the risk margin might be calibrated to the premium. The other potential alternative discussed was an unearned premium liability. The Discussion Paper on Revenue Recognition (see below) notes that an unearned premium liability seems similar to the model being proposed in the revenue recognition project and, therefore, might be appropriate for short term insurance contracts.

> The good news is that there isn't any new US GAAP accounting standard requiring major actuarial valuation changes. …

Another development for the insurance contracts project is that in October 2008, FASB decided to join the project. This may be beneficial in that FASB is more familiar than the IASB with the types of insurance contracts sold in the United States and, thus, can provide valuable input. Another implication of FASB joining, however, is that the project will now impact US GAAP, whereas without FASB joining, the project would have only impacted IFRS. The current schedule for the insurance contracts project is to publish an exposure draft of a standard in the 2nd half of 2009 and a final standard in 2011.

REVENUE RECOGNITION

Another joint IASB/FASB project that may be of interest to actuaries is the project on revenue recognition. In December 2008, the IASB and FASB issued a discussion paper entitled "Preliminary Views on Revenue Recognition in Contracts with Customers."[4] Despite the title, the project encompasses more than just the revenue side of the income statement; it also encompasses accounting for assets and liabilities result-

FOOTNOTES:

[3] See, for example, Freedman & Hansen, "An International Financial Reporting Standards (IFRS) Phase II Discussion Paper Primer," *The Financial Reporter*, December 2007.

[4] Available at *http://www.fasb.org/draft/DP_Revenue_Recognition.pdf*

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ing from customer contracts and expense deferral on such contracts. As a result, this project is expected to strongly influence the emergence of the insurance contracts project, even though the Boards are considering excluding some or all insurance contracts from the revenue recognition project. For example, the model being proposed in the revenue recognition project may form the basis for accounting for short duration insurance contracts. In addition, this project could directly impact the accounting for certain types of contracts issued by insurance companies, such as Administrative Services Only (ASO) contracts.

The model being proposed under the revenue recognition project is the "original transaction price approach." Under the original transaction price approach, at issue an entity would have to identify each of its "performance obligations" under the contract. Performance obligations are promises to provide goods and services to a customer. For example, the performance obligations under a term insurance contract might be the stand-ready obligations to provide insurance protection in each future reporting period for the duration of the contract. The entity would then need to estimate a standalone price for each performance obligation on a standalone basis. These prices would be prorated up or down so that the prorated value of all the performance obligations equal the transaction price (i.e., the consideration from the customer, such as the premium) under the contract.

The liability held for the contract (or asset if negative) would be equal to the prorated value of future performance obligations less the value of future premiums. This would generate a contract value of zero at issue. Revenue would be recognized as the liability declines (or the asset increases) due to fulfilling the performance obligations. Since contract acquisition costs would not be considered performance obligations, there would generally be no deferral of acquisition costs. Such costs would be recognized as expenses when incurred.

As an example, assume that a non-renewable, single premium, one-year term insurance contract was sold on January 1st. Assume a premium of 1000 and acquisition costs of 50. Assume no interest. The performance obligations would be the stand-ready obligations for each reporting period in which the contract was in force. Assume the following:

	Expected Claims	Hypothetical Standalone Price for Coverage
Jan 1 through Mar 31	100	150
Apr 1 through June 30	200	250
July 1 through Sept 30	300	350
Oct 1 through Dec 31	300	350

The value of the performance obligations totals 1100. Since this is not equal to the premium of 1000, each price needs to be prorated by 1000/1100 = 91 percent. So the prorated performance obligation values become:

	Performance Obligation Value
Jan 1 through Mar 31	150 x 91% = 136
Apr 1 through June 30	250 x 91% = 227
July 1 through Sept 30	350 x 91% = 318
Oct 1 through Dec 31	350 x 91% = 318

At issue, the contract liability would equal the prorated value of future performance obligations of 1000 (136 +

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227 + 318 + 318) less future premium of zero. So the liability would equal 1000. While the increase in liability of 1000 equals the premium collected of 1000, there would be a loss at issue due to the 50 of acquisition costs.

As of March 31, the liability would equal 864 (227 + 318 + 318 value of future performance obligations less zero of future premium). Thus, 136 of revenue would be recognized during the 1st quarter. If claims emerged as expected, e.g., 100, a gain of 36 would be recognized for the quarter (not counting the loss of 50 at issue).

Assuming claims continued to emerge as expected, income under this example over the life of the contract would be as follows:

	At issue	1st quarter	2nd quarter	3rd quarter	4th quarter	Total
Revenue	0	136	227	318	318	1000
Claims	0	-100	-200	-300	-300	-900
Expense	-50	0	0	0	0	-50
Income	-50	36	27	18	18	50

The decreasing income over the life of the contract (after the initial loss) is due to the fact that the margins in the hypothetical performance obligation prices in this example are a lower percentage of expected claims in the later periods than in the earlier periods.

Some key issues have not yet been discussed, including those of time value of money, and situations where the amount or timing of consideration from the customer is uncertain.

The Boards have taken the preliminary view that the projected contract liabilities or assets should generally be locked-in at issue and only remeasured if the contract becomes onerous. An onerous contract situation is analogous to loss recognition or a premium deficiency. However, some Board members believe that other contracts may also need to be remeasured after issue, particularly contracts with highly variable outcomes, a category many insurance contracts would fall in. One possible remeasurement basis that has been proposed is current exit value, similar to that described in the insurance contracts discussion paper. Another possible remeasurement basis is a building block approach, in which the cost of fulfilling the contract and the discount rate would be updated, but the margin would be locked-in at contract inception.

The comment period for this discussion paper runs until June 19, 2009. The remaining schedule for the project calls for an exposure draft in 2010 and a final standard in 2011.

FINANCIAL INSTRUMENTS

In March 2008, IASB and FASB jointly issued a discussion paper called "Reducing Complexity in the Reporting of Financial Instruments."[5] The discussion paper states the Boards' short-term and long-term views on accounting for financial instruments. The paper states that insurance contracts might be excluded from its scope, although it notes that the separate insurance contracts project may result in a similar accounting approach. And invested assets backing the insurance contracts and contracts defined under GAAP as investment contracts (such as GICs, annuities that don't provide death benefits, reinsurance contracts that fail the risk transfer requirements of FAS 113) appear to be in scope.

The discussion paper states that the long term view of both Boards is to report all financial instruments at fair value, with changes in fair value flowing through net income. Although the Boards recognize that this is not possible in the short term, they propose three possible shorter term steps toward expanding the use of fair value for financial instruments. These are:

1. simplify hedge accounting rules,
2. eliminate one of the categories—either held-to-maturity (HTM) or available-for sale (AFS)—currently used to classify securities. (This would expand the use of fair value because an AFS security under the current accounting rules is reported on the balance sheet at fair value, but the change in fair value does not impact net income; HTM securities are not reported at fair value at all.), and

FOOTNOTES:

[5] Available at *http://www.fasb.org/draft/ITC_Financial_Instruments.pdf*

3. require fair value for all financial instruments unless the instruments meet certain limited exceptions.

Under the third proposal, one exception would be instruments with fixed cash flows. The other exception would be instruments that have variable cash flows only to the extent of interest rate resets to avoid lasting changes to fair value resulting from changes in market interest rates. It is not clear that many of the investment contracts issued by insurance companies could meet either of these exceptions.

The discussion paper notes that certain technical issues would need to be addressed before implementing the long term goal of fair value for all financial instruments. One of these issues is how to handle options that have positive value to the entity that issues the option. The Boards have expressed some discomfort with permitting positive values for written options. But such positive values can occur. Take for example a credit card account held by a bank. The customer has an option, but not a requirement, to use the credit card. If the customer chooses to use the credit card, that generally has positive value to the bank. The resolution of this issue may have a bearing on similar issues in the insurance contract project, such as policyholder behavior or universal life premiums that benefit the insurance company. After all, these too are options given to the policyholder that, if exercised, typically benefit the insurer that issued the options.

The other technical issue to be addressed is how third party guarantees should impact the fair value of financial instruments. For contractual guarantees, the discussion paper takes the position that the guarantee is a separate contract and, thus, should be accounted for separately from the underlying financial instrument that is subject to the guarantee. For government guarantees, however, the discussion paper notes a preliminary view that the effect of the regulatory environment should be taken into account when measuring the fair value of the guarantee. This issue may also be relevant to the measurement of insurance contracts.

FASB and IASB are jointly working on a conceptual framework for accounting.

The comment period for the discussion paper ended in November 2008. In late 2008, FASB and IASB decided to add this project to their active agendas.

OTHER PROJECTS

In addition to the projects discussed above, several other FASB and IASB projects are underway that may impact actuaries. FASB and IASB are jointly working on a conceptual framework for accounting. This conceptual framework is intended to provide the foundation for future principle-based accounting guidance. While the conceptual framework will not directly result in new accounting standards, it will likely impact standards that will be developed in the future. Although the conceptual framework project will address many topics that are of more interest to accountants than actuaries, in 2009 they are scheduled to begin addressing measurement, a topic of definite interest to actuaries.

Another joint IASB/FASB project is "Financial Statement Presentation." The Boards released a discussion paper on this topic in October 2008.[6] The comment period runs until April 14, 2009. The project is not intended to change the valuation of items, but is intended to change the way the income statement, cash flow statement, and balance sheet are organized. It may also require additional details to be reported and additional reconciliations to be provided. So, actuaries may need to provide additional information to support these requirements, if this proposal gets adopted.

FOOTNOTES:

[6] Available at *http://www.fasb.org/draft/DP_Financial_Statement_Presentation.pdf*

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IASB is also in the process of developing its version of a Fair Value Measurement standard, i.e., an IASB version of FAS 157. This is scheduled for completion in 2010. Through November 2008, the tentative decisions made by IASB in this project have been generally consistent with FAS 157. In particular, IASB has tentatively decided to define fair value as an exit value. However, if differences between the IASB standard and FAS 157 emerge during the process, FASB may decide to update FAS 157 to provide consistency.

In addition, both Boards have been addressing issues related to the current credit crisis. Examples have been new guidance for calculating fair value in inactive markets and for additional disclosures for variable interest entities. While many of these issues may not impact actuarial work, there may be indirect impacts on actuaries as new issues emerge. As a result of all this activity, the next few years are likely to bring many new challenges to actuaries working in GAAP reporting. ■

PBA Corner

by Karen Rudolph

The principle-based reserve pot continues to simmer. Dec. 31, 2008 has come and gone. Unfortunately (or fortunately, depending on your position) the working groups did not finish discussion and drafting of the Valuation Manual prior to the NAIC Winter meeting. This issue's update focuses on continuing discussions related to the discount rates used in the PBR process and the introduction of a net premium approach, whose methodology is not unlike current formulaic processes.

NET ASSET EARNED RATES AND DISCOUNT RATES

The critical issues with respect to interest rates within a company's principle-based model are (1) the recognized rate of earnings on the assets in force on the valuation date and (2) the assumed rate of interest to be earned on modeled assets assumed to be purchased with investable cash in future projection periods. Because the Deterministic Reserve calculation uses a company's net asset earned rate as a basis for discounting future cash flows, regulators are particularly sensitive to this element of the process. The composition, quality and earnings ability of the company's asset portfolio on the date of valuation are unique to each company. The regulators are concerned, however, that one company's investment practices may lead to lower reserves when compared to another company with otherwise similar liabilities, but with an investment philosophy that may have given rise to lower quality assets in force at the valuation date. Likewise, these same regulators are concerned about future asset earnings rates being influenced by, for example, a company's enthusiasm with respect to anticipated credit spreads. This is a timely concern in today's economic environment. Recent discussions within the VM-20 working group of LHATF finds the regulators leaning toward an approach which indeed recognizes the company's current in force asset portfolio, its composition, quality and earnings potential. The charges for default on the in force pool of assets is expected to be prescribed. The prescribed levels will likely be some published minimum default charges plus published guidance around additional charge amounts by quality, credit rating and form (public, private, etc.)

The second critical issue was addressed by the Life Reserves Work Group of the Academy (LRWG) during the Winter National Meeting. There, Gary Falde and Alan Routhenstein presented the results of research performed by this group related to historical net spreads. This research was necessary in light of the current VM-20 language regarding what the company is to assume as earnings on assets purchased in future projection periods. Current language in VM-20 suggests using a reinvestment asset which reflects a prescribed net spread equal to 4 percent of the appropriate U.S. Treasury spot path plus 0.25 percent. Based on current rates for a 10-year asset, this represents approximately 40 basis points of net spread (net of default charges and 10 basis points of investment expense charges) over corresponding Treasuries. This requirement is admittedly a placeholder until better guidance could be given.

The research of the LRWG in this area demonstrated that, together with the 70CTE metric, historical net spreads on assets of 10 years in maturity have been roughly 55-85 basis points (net of default charges and 10 basis points of investment expense charges) over 10 year Treasuries. The conclusion of the research is that a more principle-based approach is called for in the VM-20 requirements. In short, the LRWG's recommendation for VM-20 requirements are:

i. To vary the prescribed net spreads by quality, rating and by maturity.
ii. To include an implied margin in the prescribed net spread. LRWG suggests the 70CTE level as an appropriate level of implied margin. However, in setting the 70CTE, LRWG recognizes that if each component of the net spread (i.e., gross spread, default charge, investment expense) were set at 70CTE, the resulting net spread may include duplicative margins.
iii. To include prescribed adjustments for other assets such as private placements and commercial mortgages. This recommendation recognizes that a company's in force asset portfolio may not be composed entirely of publicly traded corporate bonds, for example. LRWG feels any prescribed adjustment should take into account the relative risks and expenses associated with these other asset types.

Karen Rudolph, FSA, MAAA, is a consulting actuary with Milliman, Inc. She can be contacted at Karen.rudolph@milliman.com.

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iv. To include prescribed adjustments for securities with optionality. For example, if the call option of a bond is being modeled along the scenario path, then an option premium should be recognized in the prescribed spread.
v. To recognize a transition of current net spreads into the prescribed level of net spreads over a short grade-in period.

NET PREMIUM APPROACH

You may have heard fleeting reference to the net premium approach during recent actuarial meetings or quarterly webcasts. This methodology is indeed in the works. The concept was first presented to regulators at the Winter NAIC meeting as an addition to the VM-20 requirements. Admittedly in its early stages, the ACLI is spearheading the proposal to incorporate this methodology which attempts to meet the objective of providing a straightforward calculation with prescribed assumptions that works together with the principle-based components of VM-20. This net premium reserve would serve as a minimum floor to the Deterministic Reserve amount. Exactly how it is presented (before or after aggregating results, for example) is yet unknown.

The net premium methodology works particularly well for companies whose mortality credibility does not meet minimum levels required by VM-20. Without it, the company's gross premium valuation (GPV) reserve would use assumed mortality tables inclusive of margins where those margins are likely excessive for the purposes of GPV. For companies without minimum credibility, the valuation mortality assumption required by the current version of VM-20 includes a CSO-type margin. The GPV approach is a critical component of VM-20's Deterministic Reserve. Preliminary evidence provided by ACLI for term insurance shows the GPV approach combined with a CSO mortality assumption produces reserves greater than current statutory requirements. In an effort to address this situation, and recognizing that margins are critical to statutory accounting principles, ACLI proposed the net premium approach. This approach will be applicable to fixed and flexible premium products. It will not require calculation of various types of reserves (unitary, segmented, etc.) but rather only one type. Lapse rates will be allowed, though prescribed in pattern and level of lapse. Mortality is also prescribed as is the expense allowance and interest discount. The expense allowance amount will be an expanded version of the traditional CRVM allowance with a prescribed amortization pattern. Like CRVM, interest rates to be used in valuation will be prescribed by year of issue, but may be based on a formula different from today's Moody's averages.

In considering this approach, the following observations are made:

i. A net premium approach with prescribed assumptions provides an auditable result. Regulators are likely to view this as a component of principle-based reserves for all policies they can review and actually calculate.
ii. For companies with limited credibility in mortality experience, this methodology removes the time-consuming task of finding and blending company experience with industry experience.
iii. If minimum reserves are based on assumptions that are prescribed, regulators can be confident they know the risks that are being considered by such reserves, and companies can be comfortable their margin determination is influencing only the excess of the Deterministic Reserve (or Stochastic Reserve, if applicable) over the net premium reserve.
iv. Because the net premium approach has no provision for premium deficiencies, the net premium approach alone will not be the answer to minimum reserve levels. This is why the approach is being considered as a floor to the Deterministic Reserve. It is conceivable that a company may be able to demonstrate premium adequacy once, and calculate only the net premium approach to reserves from then on. This is not yet part of the proposal, however.

This is an interesting development and I will be keeping tabs on this element of PBA in the months to come. ■

What a Year!

by Henry W. Siegel

It's customary in columns such as this to summarize what has happened during the year, to contrast where we are with where we started and to offer some predictions for the future. Unfortunately, events have overwhelmed my ability to capture them. The collapse of Lehman Brothers, AIG and so many other financial firms, the possible, still unresolved potential bankruptcy of the Big 3 car companies and, the cherry on top, the fraud of Bernie Madoff, show clearly that nothing is impossible, nothing can never happen and nothing is beyond the realm of the conceivable. It's like the novelists have taken over the world for a year. How can anyone summarize such developments in a few paragraphs?

In fact, I look forward to reading several books on these topics.

From the perspective of insurance accounting, however, the year has been lots of talk and very little progress. The International Accounting Standards Board (IASB) and its staff have been struggling with how to respond to comments on their Discussion Paper that almost unanimously disagreed with the tentative positions they'd taken.

At the same time, the Board published discussion papers on Financial Statement Presentation and Revenue Recognition that could greatly influence the insurance standard. On the U.S. front, the SEC published a proposal for how the United States would move to have International Financial Reporting Standards (IFRS) replace US GAAP for general purpose accounting.

Most surprising to some, the NAIC has also started to look at international issues, making it a real possibility that IFRS might one day become the standard for U.S. Statutory accounting as well as for general purpose accounting.

Overall, then, this was a relatively quiet year and a fairly quiet quarter on the insurance front.

OCTOBER

The IASB's discussion of a measurement attribute for insurance was anticlimactic, like almost everything this quarter that wasn't directly connected to the economic crisis.

Staff gave the Board five alternatives. In order, they were:

1) Current Exit Value as described in the Discussion Paper.
2) Market Value as described in the CRO Forum's paper on the subject.
3) The CFO Forum's proposal which took the CRO Forum's proposal and added a liability to prevent gains at issue.
4) The Group of North American Insurance Enterprises proposal which calibrates margins to premiums to eliminate any gain at issue and, in a surprise return,
5) Unearned Premium Reserve (UPR).

In their paper, options 2-4 were described as fulfillment value proposals. Details of each proposal can be found in the Observer's Papers or on the Web site of the cited organizations.

The major difference between the proposals is in how they handle gains at issue. Options 1 and 2 would allow gains or losses at issue, Options 3-5 would not. Of course, the UPR deals only with pre-claims liabilities and board members agreed that it applied well to short-term policies and matched well with their revenue recognition positions.

The Board's discussion of the alternatives was quite expansive; Board members spoke in favor of each of the alternatives and no vote was taken.

The same week, the IASB also published a long discussion paper on Financial Statement Presentation. Comments are due in April and it is sure to receive a lot of them. Among other changes, the proposal in the paper would eliminate the traditional Balance Sheet with assets and liabilities on opposite pages and would create a consolidated income statement that combines the traditional income statement with all the items in Other Consolidated Income. At first glance, it does not appear that there are any major problems with the proposal from an actuarial perspective, but it's clear that insurance contracts will require special disclosure information of their own.

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Henry W. Siegel, FSA, MAAA, is vice president, Office of the Chief Actuary with New York Life Insurance Company in New York, N.Y. He may be reached at Henry_Siegel@newyorklife.com.

NOVEMBER

The highlights of November were the International Actuarial Association (IAA) meeting in Cyprus the first week of the month and the Insurance Working Group (IWG) meeting the following week.

The IAA meeting was notable in that the Accounting Committee's paper on Current Estimates and Risk Margins was discussed and the task force working on it announced that a final version would be out before the end of the year. It was emphasized that this paper was a research paper and not a recommendation of the IAA. This is necessary since it's unlikely that the IAA would be able to reach a consensus on how to calculate risk margins until the IASB decides what its measurement attribute would be.

December was the cherry on top of one of the most amazing years in modern financial history.

The Accounting Committee is preparing to respond to the IASB/FASB papers on Financial Statement Presentation and Revenue Recognition.

Like the IASB meeting in October, the Insurance Working Group meeting reached no consensus. This is hardly surprising since representatives of each of the three groups proposing fulfillment value approaches was well represented at the table. Furthermore, based on comments by the board members present it appeared even clearer that the IASB itself has not reached a consensus.

Other topics discussed at the meeting included what discount rate to use for liabilities and whether movements in liabilities due to movements in interest rates should be put below the line, the same way that unrealized gains on assets are. No consensus was reached on these proposals either.

As a final touch to the month, "any day now" finally arrived and the SEC published their promised roadmap for conversion to IASB. While many feel that this conversion to a single global accounting standard is a welcome idea, there are still others who doubt that a principle-based system will work well in the litigious system present in the United States. Comments are due on this release in February and it will be the task of the new SEC head (Mary Schapiro is the nominee) to deal with the reaction, whatever it is.

DECEMBER

December was the cherry on top of one of the most amazing years in modern financial history. The Madoff fraud was a calamity that affected rich and poor alike. At this writing its extent is still being determined.

For the insurance contract project, the month yielded little new. The NAIC's International Solvency and Accounting Working Group published a more detailed plan for approaching international solvency and accounting, but it was notably long on research and omitted any target dates. There was a Geneva Association meeting on the subject of international accounting and solvency that again offered little that was new.

The IASB's revenue recognition project finally produced a discussion paper and that is possibly the most important development of the entire quarter. How it will affect the insurance project remains to be seen but it could determine what measurement attribute is ultimately adopted.

WAIT 'TIL NEXT YEAR!

Next year should be much more interesting. Not only will comments be received on the three major discussion papers published late in 2008 (the SEC Roadmap, Presentation and Revenue Recognition), but the Board will make key decisions on the insurance contracts project during the first half of the year. By the end of the year, an Exposure Draft on Insurance Contracts should be out.

Of course, all of this will be taking place in the light of a new U.S. administration and how it deals with the economic turmoil it faces.

Remember: Insurance Accounting is too important to be left to the accountants. ■

What's New In Financial Reporting Research

by Ronora Stryker

Ronora Stryker, ASA, MAAA, is a research actuary with the Society of Actuaries in Schaumburg, Ill. She can be reached at *rstryker@soa.org.*

New regulations and methodologies for valuing insurance liabilities seem to be occurring at a fast pace. Recognizing these new developments and the need for information to assist financial reporting actuaries in their daily practice, the Financial Reporting Section Council has placed an emphasis on sponsoring research. In 2008 alone, the Council initiated three projects related to a principle-based approach for statutory minimum reserves and RBC that is currently under development by the NAIC.

The first project examines the proposed principle-based reserving and capital approach on U.S. life insurance products. Through a competitive bidding process, a Milliman research team was selected to work with 16 companies to model the proposed approach on their blocks of businesses and compare the results to the current formulaic approach. Following are some of the issues that will be considered in the research:

1. Size of reserve: PBA vs. current approach, stochastic PBA vs. deterministic PBA;
2. Grouping and aggregation effects in the stochastic PBA reserve;
3. Difficulties and questions encountered by the modeling companies in complying with the new reserving framework;
5. Stochastic exclusion test results; and
6. Reinsurance

The project is progressing nicely with a summary of the research findings expected to be available on the SOA's Web site in the second quarter of 2009.

The second project identifies, compares and examines the appropriateness of approaches for calculating risk margins in actuarial assumptions under a principle-based framework. In addition to summarizing the different methods, the PricewaterhouseCoopers research team discusses the relevancy of the methods as they are applied in establishing the margin for various actuarial assumptions such as mortality, lapse and policyholder behavior, expense and expense inflation, default costs, and reinsurance. This project is nearing completion with the final report expected in early 2009.

Under the proposed PBA framework, individual company experience will be used to determine the proper level of reserves and capital. The application of credibility theory will likely be required in order for actuaries to determine and evaluate the appropriateness of assumptions such as mortality and lapse levels for a company's block of business. The last PBA project underway involves conducting a company survey of U.S. life insurers on how they are currently using credibility theory as well as a statistical analysis of some of these approaches. Since this project is in the early stages, no timetable for completion has been set.

In addition to the above projects, the Financial Reporting Section, IAA, and other organizations are cosponsoring the development of an educational monograph on the applications of stochastic processes and modeling to insurance company financial reporting and capital assessment. This research will be useful to members as the U.S. insurance industry moves to the use of stochastic modeling processes in its reserving and capital requirements.

PBA is not the only research topic area of interest for the Section. Recently completed is a study examining stochastic pricing of embedded options found in life insurance and annuity products. Cosponsored with the Product Development Section and authored by Tim Hill, Dale Visser and Ricky Trachtman of Milliman, the report investigates the challenges associated with determining a fair value assessment for embedded options in two product types (universal life and variable annuity) and incorporates the process into product pricing. To peruse the report, see http://www.soa.org/research/life/research-stochastic-pricing.aspx.

Another large initiative undertaken by the Section was to analyze financial reporting for insurance contracts under possible future international accounting standards. Similar to the PBA study, companies modeled proposed international financial reporting standards (IFRS) and compared the results to GAAP values. The PricewaterhouseCoopers research team summarized some of the principal findings from the study such as:

- Income expected to be reported under the IFRS proposal can differ significantly from that resulting from the application of US GAAP, particularly at the time of contract issuance, although the overall pattern of resulting liabilities after the first year are broadly similar.

- The direction and extent of the initial profit or loss under the IFRS proposal can differ significantly from US GAAP results, depending on type of contract, product design and underlying profitability of the product. Products that derive a significant portion of their income from investment returns tend to show lower income in year one under IFRS than under US GAAP, while those with alternative sources of income tend to portray more of a year one gain than under GAAP.

These and other findings are expressed in the Executive Summary of the report available at: http://www.soa.org/research/life/research-financial-standards.aspx.

This article just begins to touch the surface on all the studies the Section has sponsored over the last few years. For more information, visit the Section's research webpage for a complete project listing at http://www.soa.org/professional-interests/life-insurance-company-financial-reporting/fr-research.aspx.

If you are interested in getting involved in Section sponsored research or have an idea for a research project that would benefit Financial Reporting Section members, please contact Ronora Stryker, SOA Research Actuary, at rstryker@soa.org or Sue Deakins, Research Leader for the Section, at Deakins.Susan@pennmutual.com. ■

> In 2008 alone, the Council initiated three projects related to a principle-based approach for statutory minimum reserves and RBC. …

SOCIETY OF ACTUARIES Financial Reporting Section

475 N. Martingale Road, Suite 600
Schaumburg, Illinois 60173
p: 847.706.3500 f: 847.706.3599 w: www.soa.org

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