



SOCIETY OF ACTUARIES

Article from:

The Financial Reporter

June 2006 – Issue No. 65

On the Fair Value of Insurance Liabilities: The Continuing Debate

by Luke Girard

The March 2006 issue of *The Financial Reporter* contained an article by Don Solow with the same title as above. Mr. Solow's article was a response to a rebuttal of his original article. That rebuttal and his original article were published in the September 2005 and December 2005 issues.

In his March 2006 article, Mr. Solow says, "Mr. Girard appears to agree with my argument that a policyholder, in purchasing a policy or contract from an insurance corporation, writes a credit put to the owner of the corporation." The author actually quotes my September 2005 article "The put arises because of the limited liability of the corporation, thus the company owns the put written by the policyholders. And because the company owns it, it inures to the benefit of the owner of the company." On the contrary, I do not agree with Mr. Solow that the policyholder writes a credit put directly to the owner of the corporation. The owner owns the equity interest in the company, which value includes the credit put that the company owns.

Mr. Solow ably quotes various reputable sources concerning the meaning of limited liability that the owner, not the company, has limited liability. This reminds me what Winston Churchill famously said that "Britain and America are two nations separated by a common language." There is no question that the owner benefits from limited liability just as the owner benefits from any other interest the company may own, all of which is reflected in the value of the company's equity. But the conclusion that the shareholder directly owns the credit put because the shareholder benefits from limited liability is not a well reasoned argument.

Mr. Solow asserts that limited liability does not mean that shareholders' equity cannot be negative. To the contrary this is exactly what limited liability means. We should also note that while the shareholders of a regulated insurance company benefit from limited liability, they also incur a regulatory cost, which effectively reduces the value of this limited liability benefit. See my article "On the Fair Value of Insurance Liabilities: The Regulator's Option" in the December, 2005 issue of *The Financial Reporter*.

Mr. Solow argues, "Mr. Girard takes the position that the credit put belongs on the corporation's balance sheet as a component of shareholder equity. In order for this to be true, the credit put must be shown to be an asset of the corporation." I have not argued that the credit put should be recognized as an asset of the corporation, but rather in the fair valuation of the liability.

Mr. Solow brings up the interesting example of agency risk involving a company with a Three Stooges management style. He concludes that such a company's credit risk would be higher and fair valuation would be lower as a result. The idea behind this example is that management is squandering company assets. If management is doing this, then what is preventing the owners from firing such managers and recapturing the value the Three Stooges have presumably lost? Also, if the company is regulated, then regulators could intervene resulting in losses to the owners and reducing the value of own credit risk. The same example is not limited to Three Stooges and can be repeated with Three Wise Men. Management could be increasing risk and simultaneously enhancing the value of own credit risk to the owners. This self interest is another reason why insurance companies must operate under regulatory supervision.

Finally Mr. Solow compares a company that issues a policy backed by its general resources to another policy supported by risk-free assets, i.e., a defeasement. He argues that these two policies should be valued identically. Actually, the defeasement provides greater security and thus increases value to the policyholder relative to the general obligation. The defeasement is also more costly to the issuer. Thus the two are not identical financial instruments.

I also would like to commend Mr. Solow for ably presenting the views from the other side and I also am sure the debate will continue. §



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