SOCIETY OF ACTUARIES Financial Reporting Section

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FASB/IASB FINANCIAL INSTRUMENTS PROJECT

by Leonard Reback

The Financial Accounting Standards Board (FASB), which promulgates US GAAP reporting standards, and the International Accounting Standards Board (IASB), which promulgates International Financial Reporting Standards (IFRS) used by many other countries, are engaged in a joint project to change the accounting standards for financial instruments. Accounting for insurance contracts will not be directly affected—insurance contracts are the subject of a separate joint project. But this project will affect the accounting for many of the assets that back insurance contracts, including equity securities, debt securities, loans, derivative instruments and asset backed securities. The project will also affect the accounting for investment contracts sold by insurance companies. In the United States, investment contracts include fixed-term payout annuities, many GICs, many fixed deferred annuities, variable annuities whose death benefit equals account balance, and reinsurance contracts accounted for under deposit accounting. Many such contracts may have to be reported at fair value under this project.

Although this is a joint project, several key differences have emerged between FASB and IASB. One difference is the process of developing the project. IASB has divided the project into three separate phases—classification and measurement, asset impairment, and hedging. In July, IASB released an exposure draft expressing its views on classification and measurement. IASB expects to release a final standard during 2009 to allow early adoption for year-end 2009 reporting (although mandatory adoption would not likely be before 2012). Exposure drafts on the other two phases were planned for release during 2009, but these would not result in final standards before 2010. The new standard would replace IAS 39 *Financial*

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CHAIRPERSON'S CORNER

HOW TIME FLIES

It's hard for me to believe that this is not only my last Chairperson's article, but by the time you read this, my three years on the section council will be over. I wasn't quite sure what I was getting myself into when I said I would run for the council, but it has been a very rewarding and enjoyable experience. I have had the opportunity to meet and work with many wonderful people and actuaries. As they say, "time flies when you're having fun."

The two primary areas of focus for the Society of Actuaries are education and research. Since the Society is a section driven organization, it only makes sense then that the primary activities of the sections are education and research.

EDUCATION

A quick review of what the section has done over the last year shows that we sponsored several sessions at both the Spring and Annual Meetings. In addition, we sponsored six webcasts. This is something I am excited about. In these times of cutbacks in travel budgets, webcasts are an inexpensive way to provide continuing education opportunities to our membership. In addition, we held our second annual Valuation Actuary Forum and sponsored GAAP seminars in the U.S. and abroad.

If you have ideas for topics for meeting sessions, webcasts or seminars please get in touch with a council member. They are listed in this newsletter. Likewise, if you are interested in presenting on a topic, the council would love to here from you.

Where do we go from here? The SOA is currently looking at how it provides professional development opportunities to its members. I applaud these discussions and our organization's willingness to think a little out of the box and not just continue to do things the way we always have.

RESEARCH

I must admit, this is an area that I wasn't real familiar with when I joined the council three years ago. Over the last three years, I have developed a great appreciation for what we do as a council and how that helps move our profession forward.

Some of our major research projects include a project on Analysis of Proposed Principles Based Approach. A webcast on this research as well as meeting sessions were conducted. You should have the final report in your hands by the time you read this. In addition, a project on Credibility should be completed as well. Another important project we are working on with assistance from volunteer Actuarial Task Forces is examining the impact of the upcoming IASB exposure draft on accounting for insurance liabilities.

The council will continue to fund research it believes will be relevant and beneficial to its members. As with education, if you have ideas for research projects or would like to be involved in some way, please let a council member know.

THANK YOU

I would be remiss if I didn't take this opportunity to say thank you to some people who have provided a great service to me and the section.

First, thank you to the three council members I have had the privilege to work with for the last three years. Jason Morton has been an active member working on many items including our Annual Meeting representative. Craig Reynolds played a key role in our membership survey, Valuation Actuary Forum and other endeavors as well as serving as our section Secretary. Sue Deakins has been our leader on research and has done a tremendous job in advancing our efforts in that area.

To the returning council members, thank you for all your efforts to provide services to our members. You will be in good hands under the leadership of the new chair, Steve Malerich. Thank you Steve for all you have done and your continued efforts.

We have had two newsletter editors over the past year. Rick Browne served in that role for many years before turning the reigns over to Tara Hansen. Thank you both for your efforts to publish a high quality newsletter. Kerry Krantz is our Web site liaison and I am convinced there is none better.

The SOA staff is a wonderful dedicated group to work with. I can't imagine how the sections would function without your support and assistance. A huge thank you goes to Christy Cook, Mike Boot, Ronora Stryker and Jim Miles. ■

May the wind always be at your back,

Rod

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

Essentially, the new standard would eliminate the available-for-sale bucket and the restrictions on selling held-to-maturity instruments, while imposing additional criteria for the held-to-maturity category.

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

Instruments: Recognition and Measurement. FASB is addressing the project more holistically, and has not yet released any exposure drafts. However, FASB has publicly taken views on several classification and measurement issues. In some cases, FASB's views differ significantly from the views in the IASB exposure draft.

IASB EXPOSURE DRAFT

Currently, there are several buckets into which financial instruments can be classified—trading securities, available-for-sale securities, held-to-maturity securities, derivatives, embedded derivatives, loans, etc. The IASB proposal is to replace these existing buckets with two buckets—fair value and amortized cost. Essentially, the new standard would eliminate the available-for-sale bucket and the restrictions on selling held-to-maturity instruments, while imposing additional criteria for the held-to-maturity category.

Amortized cost would be used for financial instruments that have only basic loan features, such as standard bond instruments, and are "managed on a contractual yield basis." All other financial instruments would be at fair value. A fair value option would be permitted for instruments that would otherwise be held at amortized cost if fair value would reduce accounting mismatches. One example that it gives as an appropriate use of the fair value option would be that if insurance liabilities are held using a current value method (such as all the methods being proposed under the current insurance contracts project), then it may reduce the accounting mismatch if the related invested assets are at fair value rather than amortized cost. Once an instrument is classified as either being at fair value or amortized cost, future reclassification would be prohibited. For instruments classified as being at fair value, all changes would flow through net income. There would no longer be changes in fair value flowing through other comprehensive income.[1]

The proposal would eliminate bifurcation of embedded derivatives for financial instruments covered by the new standard, although embedded derivatives in other contracts, such as insurance contracts, would still need to be bifurcated. Rather, the embedded derivative would be included in the assessment of whether the instrument contains only basic loan features. Some types of embedded derivatives, such as standard prepayment, call or put options, would not prevent the use of amortized cost, as long as the prepayment amount substantially represents unpaid principal and interest. Interest rate resets tied to a quoted and observable index (e.g., LIBOR plus 50 bp) would also not prevent amortized cost. Caps, floors and collars would also not prevent amortized cost, as long as the variable portion of the interest rate is tied to a quoted, observable index. However, all tranches in a structured security, except the most senior tranches, would have to be at fair value.

FASB VIEWS

FASB held a meeting on July 15 at which it voted on preliminary views on classification and measurement for the financial instruments project. However, some important details have yet to be determined.

Similar to IASB, FASB's view is to have two buckets for financial instruments. But FASB would have all financial instruments on the balance sheet at fair value. The two buckets would impact the income statement. One bucket would put all changes in fair value through net income. The other bucket, which it calls Fair Value-OCI, would put changes in amortized cost in net income, with the remaining change in fair value going through other comprehensive income (OCI). For the Fair Value-OCI bucket, dividends, interest, credit impairments and realized gains and losses would all flow through net income. Effectively, the FASB view eliminates the current held-to-maturity category, while imposing additional criteria to be eligible for available-for-sale.

FASB's proposed criteria for financial instruments to be eligible for Fair Value-OCI are not as fully developed as IASB's proposed criteria for amortized cost eligibility. Although the FASB criteria will be based on similar elements as the IASB criteria, the specific guidance may differ. Eligibility for Fair Value-OCI will depend on two criteria:

1. Management's intent with regard to the use of the instrument.
2. Cash flow variability of the instrument.

FASB did decide that certain instruments would have to be held at fair value with changes through net income. Equity securities and derivatives would be at fair value and changes in value would flow through net income. Hybrid instruments with embedded derivatives that are currently bifurcated under FAS 133 would also have to be at fair value with changes going through net income in their entirety. Currently, only the embedded derivative on such hybrid instruments is required to be held at fair value through net income.

With respect to management intent, the FASB discussion seemed to indicate an intention to allow Fair Value-OCI only if management intends to hold most of the assets in the portfolio until maturity or near maturity. That may preclude many insurance company assets from being classified under Fair Value-OCI.

POSSIBLE IMPLICATIONS FOR INSURERS

This financial instruments project most obviously impacts invested assets and debt. It appears that this project will require certain additional instruments to be held at fair value through net income, relative to current accounting standards. Examples are structured securities, such as CDO and MBS, other than the most senior tranche. This may create artificial accounting mismatches between assets and liabilities if liabilities are not at fair value through net income. And currently, both IASB and FASB are working on a revised accounting standard for insurance contracts. Since fair value is not one of the measurement bases under consideration, such mismatches seem likely. For example,

the insurance contracts discount rate may be inconsistent with fair value. This also means that using a fair value option for invested assets may not alleviate asset liability mismatches as well as IASB seems to believe.

The project would also impact accounting for investment contracts sold by insurance companies. Most GICs and term certain payout annuities would probably qualify for amortized cost under the IASB exposure draft, since such contracts usually include only basic loan features. Their cash flow variability may also be low enough to qualify for Fair Value-OCI treatment under FASB's views. Although this would require fair value of such instruments to be reported on the balance sheet, net income would only be impacted by amortized cost, similar to current GAAP accounting.

Some other investment contracts[2] may need to be held under fair value, with changes in fair value flowing through net income. For example, if FASB adopts the basic loan features criteria similar to IASB, it is unlikely that many fixed deferred annuities would qualify for treatment other than fair value through net income. Since interest credited rates are often not tied to an observable index, this would not be a basic loan feature. Also, specified surrender charges may mean that the possible prepayment amount includes an element other than unpaid principal and interest. Similarly, many variable annuities without excess death benefits

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and many reinsurance contracts that currently use deposit accounting likely have features other than basic loan features. Such features would force such contracts to be accounted for at fair value, with changes in fair value flowing through net income.

It should be noted that under the joint insurance contracts project, the US GAAP definition of insurance contracts might change, and some of these contracts may qualify for insurance accounting. However, neither FASB nor IASB has taken a public view on this issue, so it is unclear to what extent, if any, the definition will change. Also, the financial instruments project may be completed before the insurance contracts project. So, even if the insurance definition does change, U.S. insurers may need to deal with implications of the financial instruments project on deferred annuities and deposit accounting reinsurance contracts during the interim period.

CONCLUSION

The joint IASB/FASB financial instruments project will likely have profound effects on insurance companies' GAAP financial reporting. It will affect how actuaries value investment contracts for GAAP purposes and it will affect asset-liability management. Also, the project could set precedents for the insurance contracts project. It is important that actuaries' views are heard on this issue to ensure that the resulting standard genuinely improves financial reporting. ■

You can view and participate in a discussion of this article in the SOA Financial Reporting Section subgroup page at ***LinkedIn.com.***

FOOTNOTES:

[1] There is one exception to this, but it is probably not of much significance to actuaries. Equities purchased strictly for strategic reasons could be classified at fair value through other comprehensive income, but would then never yield any net income.

[2] Although these instruments are treated as investment contracts under U.S. GAAP, many are treated as insurance contracts under IFRS. Thus, they would be out of scope from an IASB perspective. However, it remains to be seen where the dividing line between investment contracts and insurance contracts will be under the joint insurance contracts project.

CAN THERE BE MORE THAN ONE "FAIR VALUE"?

by Patricia Matson, Albert Li, and Hui Shan

For many companies in the United States, significant changes in their accounting practices are appearing in the horizon, given the proposed IFRS conversion roadmap from the U.S. Securities and Exchange Commission (SEC) on Nov. 14, 2008. For U.S. Subsidiaries of certain foreign filers, International Financial Reporting Standards (IFRS) is currently the basis upon which they prepare their financial statements, as the parent company is domiciled in a location for which IFRS has been adopted. In light of the increasing focus on IFRS for U.S. insurers, as well as the significant issues that have arisen with respect to the application of fair value to various types of contracts issued by insurance companies, the purpose of this article is to compare and contrast existing and near future differences in fair value requirements between generally accepted accounting principles in the United States (US GAAP) and IFRS. The focus of this article is on fair value requirements as they relate to actuarial valuations of insurance contracts (including certain contracts classified as investment contracts), and therefore ignores implications on investments held by insurance companies.

For insurance companies, fair value accounting for insurance liabilities has been a major concern and challenge. Under current US GAAP guidance, there are specific instances in which fair value accounting is required with respect to actuarial valuations, including:

- Embedded derivatives in certain annuity contracts,
- Embedded and freestanding derivatives related to certain reinsurance contracts,
- Valuation of insurance contracts for which the fair value option (per FAS 159) has been elected, and
- Fair valuations required for purchase accounting and goodwill impairment testing.

The US GAAP guidance that governs how fair value should be determined is contained in Financial Accounting Standard No. 157, Fair Value Measurements (FAS 157).

Unlike US GAAP, current IFRS guidance does not contain a single pronouncement governing how fair value is to be performed. Instead, the requirements for performing fair value are contained within the individual pronouncements that require fair value. For insurance contracts that meet the definition of a financial instrument, this guidance is currently contained within International Accounting Standard 39, "Financial Instruments: Recognition and Measurement" (IAS 39). However, the IASB has issued an exposure draft called "Fair Value Measurements" (FVM ED), which will provide comprehensive guidance where fair value is determined to be the appropriate accounting across all other IFRS guidance. Many of the concepts in the proposed FVM ED are similar to FAS 157.

This article shows a comparison of application of FAS 157 (and the similar FVM ED) and IAS 39 to valuing one of the most common insurance contracts that requires fair value: a Guaranteed Minimum Accumulation Benefit (GMAB) feature embedded in a variable annuity. Note that for purposes of this article, we have assumed that such a feature would be classified as a FAS 133 embedded derivative under US GAAP, and as an IAS 39 embedded derivative under IFRS. We realize this treatment may be different in practice, but is used to illustrate the differences in the fair value concepts. In addition, we have focused on the main differences between FAS 157/FVM ED and IAS 39, and largely ignored differences between FAS 157 and the FVM ED. These differences are relatively less significant for valuation of insurance contracts. Lastly, we have intentionally taken a somewhat extreme view on potential interpretation differences between FAS 157/FVM ED and IAS 39 in order to highlight these differences, but recognize that interpretation of the guidance varies from company to company and is dependent on facts and circumstances. This article is not intended to represent a suggested or correct interpretation of the guidance.

In calculating fair value for GMAB feature under FAS 157/FVM ED and IAS 39, there are some specific differences of particular interest to valuation of insurance contracts:

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Patricia Matson FSA, MAAA, is a principal with Deloitte Consulting LLP. She can be contacted at pmatson@deloitte.com.

Albert Li is a manager at Deloitte Consulting in New York City, NY. He can be reached at ali@deloitte.com.

Hui Shan is a consultant at Deloitte Consulting in Hartford, CT. He can be reached at hshan@deloitte.com.

1. Whether and how to reflect reporting entity's credit risk,

2. Whether and how to incorporate risk margin,

3. Method for determining equity return scenarios, and

4. Time zero value.

Each of these is discussed in further detail below.

Credit risk: FAS 157 states that the fair value of a liability should reflect the non-performance risk relating to that liability. Non-performance risk includes, but may not be limited to, credit risk of the liability. Adopted IFRSs do not at present use the term 'non-performance risk.' However, IAS 39 requires the fair value of a financial liability to reflect the credit quality of the instrument.

In particular, FAS 157 states that "discount rates should reflect assumptions that are consistent with those inherent in the cash flows." Hence, in a present value technique, if cash flows do not reflect credit risk, discount rates should incorporate credit risk; if cash flows have already been adjusted for credit risk, discount rates can be risk free. In contrast, IAS 39 does not specifically mention reflection of credit risk in cash flows. IAS 39 defines "credit risk" as an input to valuation techniques, which can be reflected in discount rates in measuring fair value. In particular, IAS 39 states, "The effect on fair value of credit risk (i.e., the premium over the basic interest rate for credit risk) may be derived from observable market prices for traded instruments of different credit quality or from observable interest rates charged by lenders for loans of various credit ratings."

In our GMAB example, we have adopted representative credit-adjusted discount rates as of Dec. 31, 2008 (referred to as "adjusted discount rates," versus "unadjusted discount rates" that do not have a component for own credit risk).

Risk premium: Paragraph B2 of FAS 157 notes that one element of a fair value calculation using present value techniques is "the price for bearing the uncertainty inherent in the cash flows (risk premium)." Thus, if there is significant uncertainty in cash flows, a risk premium should be considered, which would increase the present value of expected liability cash flows as a result. FAS 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)." Beyond this, FAS 157 provides very little specific guidance on how a risk premium should be determined. Since most actuarial inputs cannot be calibrated to observable market prices, it is appropriate that a risk premium is considered for those items which could significantly affect the present value of cash flows.

IAS 39 mentions a dealer's margin for the initial recognition of the financial instrument. Specifically, IAS 39 states, "the entity has a practice of taking delivery of the underlying and selling it within a short period after delivery for the purpose of generating a profit from short-term fluctuations in price or dealer's margin", which is a margin built in the actual price. However, for valuation purpose, IAS 39 does not specifically mention a risk margin or risk premium component.

In our GMAB example, under FAS 157, we added a risk premium to the lapse assumption. We did not add any risk premium to the mortality assumption since mortality assumption does not have a material impact

on the GMAB fair value. We did not incorporate any risk premium for IAS 39 valuation.

Equity return method: Both FAS 157 and IAS 39 generally require the use of market observable inputs to the valuation (for example, risk free rates would typically be used). However, unlike FAS 157, which requires use of observable market inputs to the maximum extent available, IAS 39 appears to explicitly allow for use of historical market volatility in the valuation. Paragraph AG82, item (f) states, "Measures of the volatility of actively traded items can normally be reasonably estimated on the basis of historical market data or by using volatilities implied in current market prices."

In our GMAB example, we stochastically modeled annual equity returns for the guaranteed term of 20 years in order to project variable account values, fees and claims. The mean equity return was assumed to be the observable risk-free rate for both FAS 157 and IAS 39. We used a term structure for volatility assumptions, which used actual implied volatility for five years for both FAS 157 and IAS 39. For IAS 39, the volatility graded to a long term value of 15 percent, based on historical volatility data, in year 10 and remains at 15 percent thereafter. For FAS 157, we used a long term implied volatility of 36 percent extrapolated from actual implied volatilities.

Time zero value: FAS 157 defines fair value as equal to exit price, whereas IAS 39 specifies that fair value is exit price, but in the absence of observable market data, transaction price is assumed to be fair value at initial recognition only. Therefore, under FAS 157, a gain or loss at issue can occur. For our GMAB example, the time zero value for both FAS 157 and IAS 39 are zeros, meaning that the actuarial present value of collected rider fees is equal to the actuarial present value of guaranteed benefits. However, this occurs for different reasons. Under IAS 39, actual rider fee is used and a margin is added to the lapse rate such that time zero value is zero. Under FAS 157, the lapse rate margin is predetermined as a market participant 'risk premium,' as required by FAS 157. The ascribed fee is then solved for such that time zero value is zero (this is a typical approach used for GMABs).

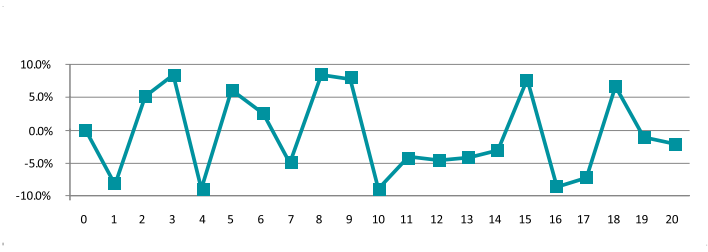
Here are some of the general assumptions used in our modeling exercise:

- 50-year-old male with initial deposit of $100K,
- GMAB benefit guaranteed at $100K in 20 years,
- Annuity rider fee = 30 bps of account value,
- Lapse assumption = 6 percent for all years,
- Mortality table: US Annuity 2000.

As described above, our example shows one possible interpretation of the guidance, and is intentionally extreme in certain respects to highlight the impacts on results for our simple example. It is not intended to provide guidance on what is a correct interpretation.

The fair value calculation was performed using our risk neutral stochastic model at annual intervals from time zero to year 20 under both FAS 157 and IAS 39. The actual equity returns experienced from year one to year 20 are arbitrary inputs, designed to demonstrate how the fair valuation moves over time in a sample volatile market environment. The following graph shows the equity market movement that drives the account value growth in our example:

Table 1: Actual Market Movement



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We modeled the following sensitivities to the fair value progression over the 20-year period:

- Sensitivity 1: credit-adjusted discount rate (where the credit adjustment is on average around 450 basis points), market drop of 20 percent in year 1.
- Sensitivity 2: same time zero calculation as in Sensitivity 1. Instead of an extreme market drop of 20 percent in year one, beginning year two, future volatility assumption increased—45 percent was used for IAS 39 from year two through five and then the volatility graded down to 15 percent from year five through 10; volatility remained at 45 percent for all years for FAS 157.
- Sensitivity 3: same assumptions as in Sensitivity 1. Instead of a fully market observable credit adjustment to the discount rate, we used a spread of 100 basis points. Under FAS 157, we recalculated a higher ascribed fee to maintain the zero inception value. Under IAS 39, we used the actual rider fee. This resulted in the present value of claims exceeding the present value of fees, and so we recognized a loss at time 0.
- Sensitivity 4: same time zero calculation as in Sensitivity 3. Instead of an extreme market drop of 20 percent in year one, beginning year two, future volatility assumption increases similar to that in Sensitivity 2 were reflected in modeling.

The following is the comparison of fair values under the two measurement regimes:

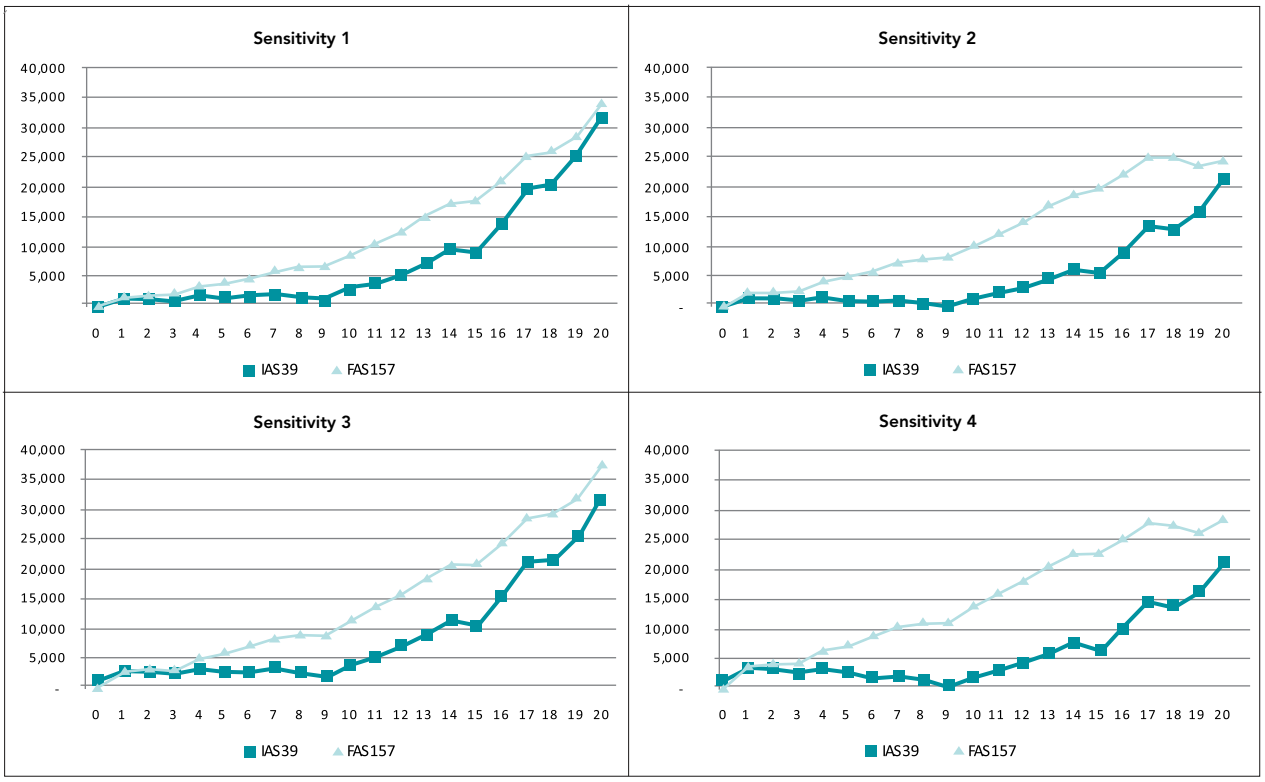
OBSERVATIONS

The fair values of the GMAB liability under IAS 39 are consistently lower than those under FAS 157 for most of the periods because of the lower implied volatility structure assumed when compared to FAS 157. The difference is magnified in the increasing volatility sensitivities (2 and 4), since the difference in volatility assumptions is further magnified. The use of a lower credit spread (sensitivities 3 and 4) slightly increases the liability, but does not significantly impact the results for either FAS 157 or IAS 39. The reason this is the case is that under FAS 157, we ascribe a higher fee at issue to offset the impact, and under IAS 39 the impact is largely taken as a loss at issue, so it does not impact the liability.

CONCLUSION

Clearly the individual facts and circumstances of each company and each valuation will drive the choice of assumptions regarding volatility and nonperformance risk. As a general rule, use of more implied volatility data as a discrete input to comparable valuations (which may result under FAS 157/FVM ED as compared to IAS 39) will create higher liabilities in the current environment, as well as more volatile liabilities if you hold all other assumptions constant and consistent between valuation bases. Introduction of credit spreads representing a market participant's view of non performance (versus a more stable, long term credit spread measuring probability of non performance) will result in lower liabilities in the current market environment, but will also drive more volatility if you hold all other assumptions constant and consistent between valuation bases. ■

Table 2



VALUATION ACTUARY SURVEY RESULTS

by Craig Reynolds and Mike Sparrow

Craig W. Reynolds, FSA, MAAA, is a principal with the life insurance consulting practice of Milliman in Seattle, Wash. He may be reached at *craig.reynolds@milliman.com.*

Mike Sparrow, FSA, CERA, MAAA is VP and CFO Vice-President for the annuity business segment at Nationwide. He can be reached at *sparrom@nationwide.com.*

In 2008, the Society of Actuaries (SOA) Financial Reporting Section Council conducted an online survey of appointed actuaries to gather information on current practices related to asset adequacy analysis. After some delay, we have summarized key results of the survey. More complete results have been shared with the participants in the survey.

In addition to discussing the results here, we have also, where applicable, compared them to those from a similar survey conducted by the American Academy of Actuaries in 2004. The 2008 survey reflected responses from 139 individuals, and the 2004 survey reflected 202 responses. In each case, not all participants answered all questions, which is not surprising, given the length of the surveys! Thank you to all participants for participating.

The 2008 survey's participant profile exhibited a wide diversity of company types and sizes. Not surprisingly, the majority of participants came from insurers, though about one in five came from consulting or accounting firms. Most respondents in the "other" category worked for fraternals or not-for-profit health insurers. (See Figure 1) With respect to company size, a meaningful number of participants represented companies in all three categories of small, medium and large assets under management. (See Figure 2)

Figure 1: Survey Respondents

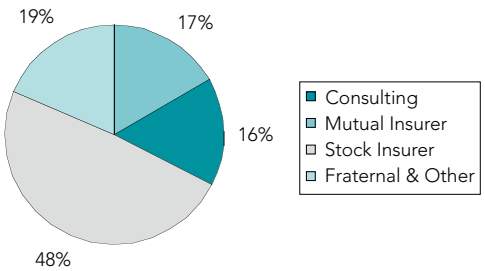
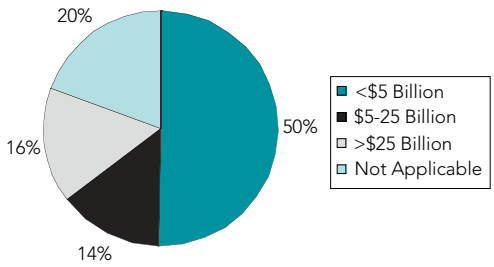


Figure 2: Company Size

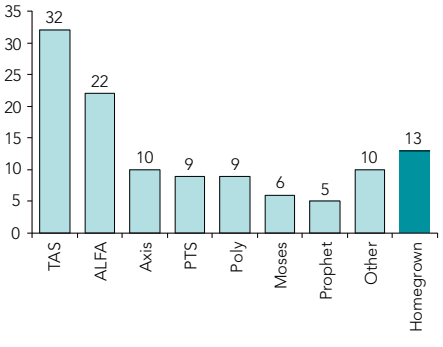


The results presented herein should not be viewed as definitive examples of standard or appropriate practice. Rather, they represent common practices from a non-scientifically selected subset of U.S.-appointed actuaries. Thus, while the information may be interesting and useful, it should not in any way be interpreted as a definition of appropriate practice.

SOFTWARE

At the center of all actuarial analysis today is a highly developed business projection platform. With the undercurrent of technology advances and increasingly complex products and investments, it should be no surprise that actuarial software usage continues to evolve.

Figure 3: Liability Platform Usage



Software choice is one area where we have seen the most changes between the 2004 and 2008 surveys. In 2004, roughly one in four respondents reported using homegrown software for at least some of their cash flow testing work. In comparison, 2008 practice appears to move away from homegrown systems; about 10 percent of respondents used homegrown modeling systems for either assets or liabilities. We presume that this trend is likely to continue, as the sophistication of the required analysis continues to increase.

Liability modeling continues to be dominated by a well-established group of commercial actuarial consulting vendors. TAS and MG-ALFA® were found to be in use among half of respondents, while the remaining half used an array of different vendor platforms. (See Figure 3)

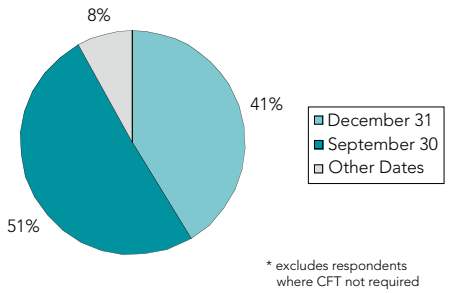
Modeling of assets using the tools provided by an integrated asset-liability modeling platform continues to be the dominant practice, garnering approximately two-thirds of practitioners. Specialized asset-only software is still in common use, with CMS BondEdge being the dominant system for asset-only projections by a significant margin.

SCENARIOS

Economic scenarios are foundational to stress testing a company's liabilities against unforeseen events. It was surprising, then, to see how little that practice had evolved between the 2004 and 2008 surveys.

With respect to the timing of yield curves, over 90 percent of respondents with interest-sensitive liabilities use year-end scenarios, September 30 scenarios, or a combination of the two for their annual cash flow testing. (See Figure 4) However, a majority of respondents continue to use a September 30 yield curve for their testing. In addition, yield curve normalization (e.g., adjusting the observed yield curve when unusually sloped) was noted by only 15 percent of participants. The bias towards using pre-dated scenarios is only slightly narrower than practice from the 2004 survey. It should be noted that this survey was conducted before the beginning of the 2008 economic crisis. We suspect that many of the companies used December 31 scenarios for 2008 testing because of the unprecedented volatility in the capital markets.

Figure 4: Projection Valuation Date



Even more surprising was the infrequency of using stochastic scenarios in cash flow testing. Only one in five of the respondents indicated that they used stochastic scenarios as part of their testing, which is (surprisingly to the authors) a *lower* percentage than observed among 2004 survey respondents. Among survey respondents doing stochastic scenarios, the most common number of scenarios used was 100

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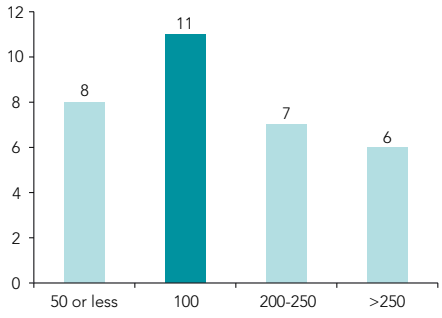
to 200. (See Figure 5) Among companies with equity-driven products, about 59 percent tested stochastic equity scenarios, though most of these simulated only one equity index. The basis of stochastic scenarios clearly favored a purely realistic approach based on historical data as opposed to a risk-neutral view. However, nearly 40 percent of respondents using stochastic scenarios based them on a purely risk-neutral approach or a mix of risk-neutral and realistic. In addition, artificial capping and flooring of stochastically generated rates was observed somewhat infrequently.

Figure 5: Number of Stochastic Scenarios Used*



* among respondents that used stochastic modeling in their cash flow testing.

For deterministic testing, about 70 percent of the respondents used 10 or fewer deterministic scenarios for most lines of business. As expected, the New York 7 (NY7) scenarios were most commonly used, though almost an equal number of respondents indicated the use of other selected deterministic scenarios as well.

As the events of the recent economic crisis have demonstrated, there is a clear need for actuaries to advance practice further on scenario-based testing of reserve adequacy.

MODELING CONSIDERATIONS

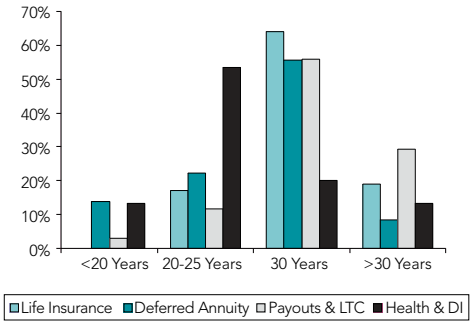
The following section reflects surveyed modeling practice across a number of diverse reserve testing decisions that the actuary has to make to balance practicality and accuracy. In many cases, certain practices dominate although differing levels of materiality or other considerations will influence the actuary's choice of methods.

First, we asked participants to tell us what portions of their liabilities are tested using each of several different methods of asset adequacy analysis. Perhaps not surprisingly, cash flow testing was the dominant method in reserve adequacy determination, garnering 76 percent usage, but a wide variety of other methods were used as well. Gross premium reserve testing was the next most popular, while loss ratios and demonstrations of conservatism saw limited application. Only 6 percent of respondents did not test reserves at all. These results are not significantly different than found in 2004, though cash flow testing was somewhat more prevalent then.

We also asked participants to tell us how they dealt with aggregation issues, and here we saw a greater variety of practices in play. Just over half of respondents run models in smaller blocks and then aggregate results to measure adequacy. Only one in five respondents run all the models in aggregate, perhaps reflecting a greater efficiency in parceling models to run in parallel. The practice of measuring adequacy at the block level was less common, but still was found in use among 14 percent of respondents.

About 85 percent of respondents reflect initial IMR in their projections, while only 52 percent reflect initial

Figure 6: Projection Period by LOB

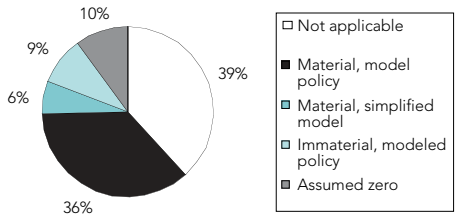


AVR. Only 66 percent of respondents reflect capitalization or amortization of future IMR amounts. For those companies that have had issues with negative IMR, 11 reflected the negative IMR in their projection, and 21 used an initial IMR value of zero.

The survey asked participants about the length of model projections across a number of product lines in each of the 2004 and 2008 surveys. The table at right shows the percentage of participants using each of a range of different projection periods by line of business (LOB). (See Figure 6) With the exception of health and disability lines, which tend to have shorter durations, a clear majority of participants (about 60 percent) projected business cash flows for 30 years. There were some variations noted. Fixed deferred annuities were more apt to have projection periods less than 30 years than for other products; similarly, payout and structured settlement annuities saw a greater use of 40- and 50-year projection periods than for other products. Again, these practices tend to be reflective of durational characteristics of the liabilities. Relative to 2004 practice, it appears that more companies have migrated to 30-year projection periods, both shortening projection lengths on payout products and extending projections on deferred annuities. We hypothesize this may be reflective of efforts to standardize models.

We also asked participants to comment on their treatment of both shareholder and policyholder dividends. (See Figure 7) With respect to shareholder dividends, only 11 percent of companies for whom such dividends were applicable included them in their asset adequacy analysis. This is similar to the 10 percent of participants who reported doing so in 2004. We also asked for more detailed information on policyholder dividends, as shown in Figure 7. While just over half of respondents offer participating policies, those offering them do tend to model actual dividend policy where dividends are material. Where policy dividends were judged to be immaterial, somewhat more respondents still attempted to model them as opposed to assuming that dividend expense would be zero.

Figure 7: Modeling of Policyholder Dividends



ASSUMPTIONS

We asked participants about their primary sources for liability assumptions. (See Figure 8) Company experience was clearly the most prevalent basis for determining lapse and mortality assumptions. Reliance on internal experience is most important for lapse rates because of the lack of credible external persistency data. Conversely, industry data was more heavily relied on for disability and recovery rates. Dynamic policyholder behavior is clearly an area lacking in both industry and company-specific data. The current economic cycle may yield valuable opportunities for practitioners to measure behavior experience for today's insurance products.

Figure 8: Primary Source for Liability Assumptions

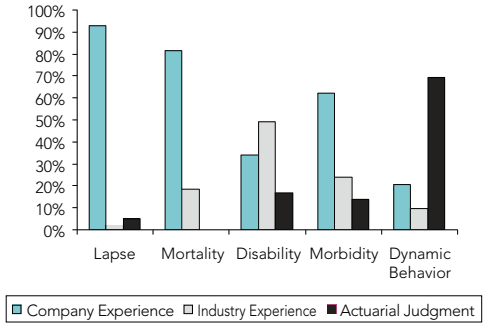


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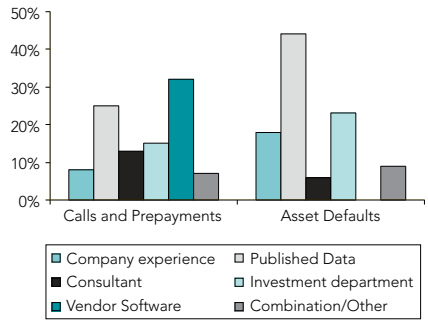
Figure 9: Primary Source for Asset Assumptions



We also asked similar questions about asset assumptions. Unlike liability assumptions, asset performance assumption settings tended to rely on external sources much more heavily. This may be, in part, because of the lesser degree of credibility of company experience. It also may be related to the availability of high-quality published studies and models from vendors that specialize in asset management tools for the broader fixed-income investment community. While reliance on company experience may be appropriate and necessary in some situations, external sources are likely to be relied on heavily for some time to come.

With any assumption, there is an acknowledgment that experience can vary from the assumed, perhaps even significantly. Stress testing is the most common actuarial technique for determining how sensitive reserve adequacy results are to a given set of assumptions. Liability assumptions are most commonly stress tested: lapse rates, life insurance mortality (and health insurance morbidity), and expense levels were the most commonly stress tested by a two-to-one margin over other assumptions in the survey. Other assumptions commonly tested included asset default rates, annuity mortality, premium persistency, and separate account returns. Among less common assumptions subjected to stress tests were reinvestment spreads, asset prepayment rates, and investment strategies. Although the responses showed biases for testing some assumptions over others, it is clear that the unique materiality considerations at each company affected the responses.

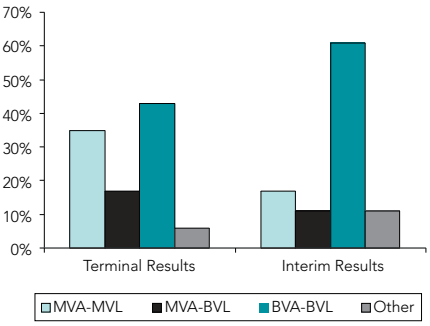
Unlike stress testing, dynamic policyholder behavior functions directly link assumptions to economic scenarios as they unfold in a projection. We asked participants about their efforts to reflect dynamic policyholder behavior. Roughly four out of five respondents reflected dynamic lapsation or variable annuity (VA) living benefit election rates for interest-sensitive and variable products, but dynamic assumptions were in limited use for other products. Dynamic premium suspension on life insurance products was employed by slightly less than half of respondents.

Finally, the survey asked participants to tell us which types of assumptions would benefit most from additional SOA research. The items mentioned most frequently were dynamic lapse, dynamic premium persistency, shock lapse, mortality improvement, mortality anti-selection, and other dynamic policyholder behavior.

ANALYSIS OF RESULTS

Once the cash flow testing process is complete, one challenge is deciding what it means to "pass." Should results be based on market value of assets (MVA) or book value of assets (BVA)? Market value of liabilities (MVL) or book value of liabilities (BVL)? Should adequacy be defined by terminal or interim results? We asked survey

Figure 10: Asset Adequacy Metric



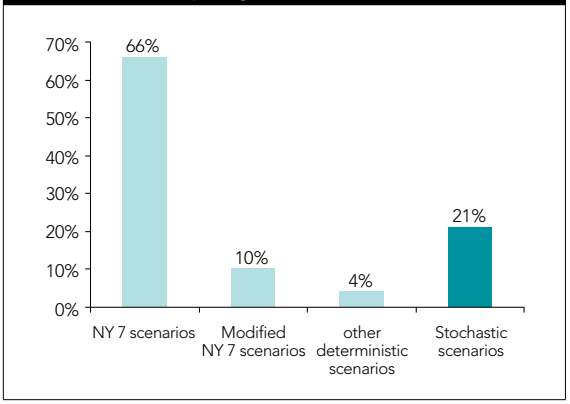
participants to define their primary measure of adequacy on an interim and terminal basis. (See Figure 10)

Over 70 percent of participants consider interim result to be important, but not critical, in measuring reserve adequacy. Fewer than 10 percent considered interim results to be critically important while 20 percent considered them to be not very important or unimportant.

With respect to using book or market values in determining adequacy, book values were relied on most heavily when examining interim results. However, practice split more evenly when examining terminal projection values. More importantly, while the data shows that a material portion of the participants rely on MVL for defining adequacy, only one participant actually calculated an option-adjusted market value. Two respondents used a gross premium reserve to measure market value and most others used either statutory reserves or cash surrender values as a proxy for the MVL.

We also asked participants to indicate which scenarios they primarily relied upon for defining adequacy. The outcome, a four-to-one reliance on deterministic scenario outcomes, was somewhat surprising given the evolution of stochastic modeling and recent momentum behind principle-based and fair value reserving. (See Figure 11)

Figure 11: Primary Scenarios Used to Measure Adequacy

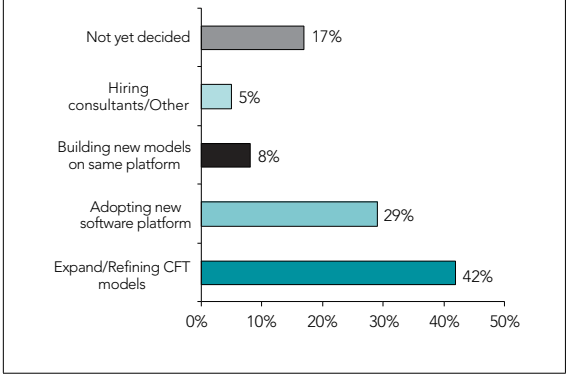


Prior to year-end 2008, most actuaries would rarely have expected to face the situation where additional reserves were needed because of reserve adequacy testing. In fact, only 35 percent of 2008 survey respondents had at some point set up additional reserves as a result of asset adequacy analysis. This is slightly more than the 26 percent who reported doing so in 2004. Among those who did set up extra reserves, the basis for extra reserves favored passing a specified number (but not necessarily all) of the New York 7; actual practice varied considerably. Passing a stochastic percentile or conditional tail expectation (CTE) threshold was almost equally popular. About one in six participants set reserves to pass each of the New York 7 scenarios.

LOOKING FORWARD

Finally, we asked survey respondents to look forward to principle-based approach (PBA) reserves. First, we asked them to indicate how they anticipated building their PBA models. Not surprisingly, most participants reported that they expect to leverage their existing cash flow testing software platform in some manner to meet the requirements of PBA. However, nearly one-third of participants expect to adopt a new platform, indicating that existing models lack certain functionality needed to meet the new, more rigorous standards. (See Figure 12)

Figure 12: How PBA Models Will Be Used



Second, we asked participants to name the five areas where they thought they had the most work to do to be ready for PBA valuation. The top responses were

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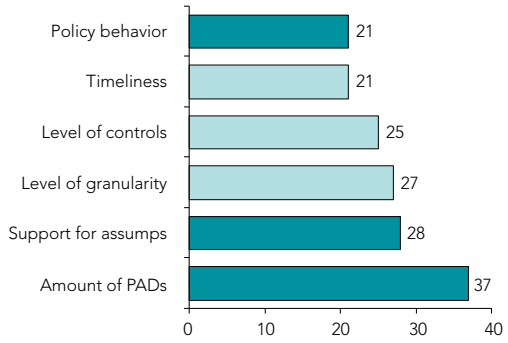
Figure 13: Areas Where the Most Work Needs to be Done for PBA



pretty evenly distributed, but share a common thread. The top responses each relate to issues of integrity of actuarial models and assumptions. Furthermore, three of the top five responses relate directly to assumption setting. (See Figure 13) Setting and justifying actuarial assumptions is clearly a challenge, given the difficulties in obtaining broad-based, credible data (both internally and at an industry level) as well as the lack of clear guidance around setting PADs, especially where assumptions are interrelated. It should be no surprise that participants called these out as areas for future SOA research.

CONCLUSION

Almost 20 years after asset adequacy analysis first came into common practice, there are still a wide variety of approaches taken to many key issues. We still see a number of areas where appointed actuaries feel that they could use more information in setting appropriate assumptions. As we look forward into a world where principle-based approaches become the dominant method of reserve determination, we believe that the profession has a great deal of work to do to make sure that actuaries have the information, the tools, and the guidance that they need to ensure that reserves are computed appropriately, consistently and efficiently. ■

PBA Corner
Principle-based update

by Karen Rudolph

NAIC's Fall National Meeting is just around the corner as this article is written. The Life and Health Actuarial Task Force (LHATF) held a conference call Aug. 26, 2009 to discuss where the members of this group stood with respect to any outstanding issues keeping them from accepting the C3 Life and Annuity Capital Work Group (C3WG) proposal specifying the C3 component of risk-based capital for life insurance. The regulators are currently considering the September 2009 draft version of this proposal. This article attempts to summarize the recent changes to the C3 Phase III proposal, initial industry comment letters to the proposal and outstanding issues identified by the regulators.

CHANGES TO C3 PHASE III PROPOSAL

Since exposure of the September 2008 version of the C3WG proposal, the document has been modified to reflect these changes:

- The initial version of the proposal had been applicable to individual life insurance policies. The scope has been redefined as applicable to all life insurance policies. This implies the new requirements would cast a wider net, capturing group life contracts as well.
- Definitions in the C3 Phase III proposal have been made consistent with Chapter 1 of the Valuation Manual (VM-01). By adopting these definitions, the C3 Phase III report and the Valuation Manual will be consistent in their terminology, thus making it easier for the practitioner and the industry to communicate on principle-based issues.
- References to the term "guidance" have been removed from the proposal to prevent confusion with guidance the actuary may find in the Actuarial Standards of Practice. Note that the Actuarial Standard of Practice on compliance with C3 Phase III is in development.
- The adjustment to the C3 amount for the factor-based market volatility risk for equity assets element has been clarified as applicable only to the Stochastic Amount, whereas before it may have been interpreted as having a wider application.
- A numerical example of the development of discount rates for fund returns has been added.
- An appendix has been added comparing C3 Phase III requirements to C3 Phase II, Actuarial Guideline 43 (VACARVM) and VM-20.

COMMENTS FROM INDUSTRY WITH RESPECT TO C3 PHASE III

The industry has had an opportunity to submit comments on the proposal. The primary concern expressed in these letters was the nearly impossible implementation of C3 Phase III by yearend 2009. Because of industry concern over its inability to comply with such a date, the regulators indicated C3 Phase III will not be required as of yearend 2009. Approximately nine comment letters from industry participants were received on the initial exposure. Other concerns expressed by these industry responses are listed below.

- The need for an undue amount of resources at a time when most companies are focusing on expense reduction.
- Technical flaws in the proposal, and the desire for a more thorough treatment of some of the technical issues presented in the proposal.
- One responder commented that, if implemented, proposal calculations would quantify risks other than C3 in the C3 component.
- Simpler criteria should be made available for qualifying for the stochastic modeling exclusion.
- Some industry participants are concerned that either: (i) the stochastic exclusion test ratio thresh old has not been tested enough, or (ii) the proposed 4 percent is too low. The stochastic exclusion test ratio, if less than 4 percent, allows the company to forego stochastic modeling in determining its C3 component for life insurance. Calculation of this ratio is detailed in the C3WG proposal.

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

- The proposal would result in inconsistent C3 risk charges when market valued assets or liabilities are included in models used to calculate C3 Phase III.
- One letter called for the proposal to allow for complete aggregation within and between lines of business.
- RBC efforts should be coordinated with efforts of the Solvency Modernization Task Force.
- The proposal does not lend itself well to the audit process.
- The proposal is inconsistent with other aspects of RBC and there remain questions of interpretation surrounding some of the requirements.
- A transition period was requested by one respondent.
- One respondent suggested the factor-based approach should be allowed if a company's total adjusted capital exceeded company action level by a specified number of multiples.

In addition to industry letters, regulators from the New York Insurance department commented on the exposure document. Their more substantive comments include:

(1) The C1 charge for equities should not be eliminated due to its incorporation in the C3 Phase III stochastic testing. In general, they do not support a proposal that may lead to a decrease in the amount of overall RBC.

(2) New York feels the appropriate amount of C3 applicable to companies using the stochastic modeling exclusion test should be floored at the factor based amount and could actually be larger, depending on the outcome of the exclusion test.

(3) For companies performing the stochastic analysis to determine the C3 component there should be a minimum amount of 0.5 percent of reserve. This is equivalent to the current formulaic C3 amount on an after-tax basis. Such a floor would imply that a principle-based C3 determination could only work to increase the C3 from today's amount.

The C3WG has communicated to LHATF its responses to each of these industry comments in detail. The groups expect to continue discussion of these comments at the NAIC Fall National Meeting.

LHATF ISSUES LIST FOR C3 PHASE III DRAFT PROPOSAL

Though these issues are not uniformly shared by the LHATF members, they are issues that will continue to be discussed during the NAIC Fall National Meeting and will need to be resolved before C3 Phase III becomes part of the NAIC Risk Based Capital Instructions.

- Options to make the stochastic exclusion test easier.
- Whether the Reported Amount should be the total asset requirement less the actual statutory reserves, or less a hypothetical reserve calculated using a methodology consistent with the calculation of the C3 amount.
- Scenario generators—there remains concern over what options should be allowed.
- The degree to which revenue sharing is allowed recognition in the C3 methodology.
- Whether the C3 Phase III requirements will be presented in the instruction manual or as a separate report.

Ideally, the industry would like clear resolution of these issues and concerns in advance of serious planning for meeting an implementation deadline. ■

The Principles Start to Coalesce

by Henry W. Siegel

On September 22, the Monitoring Board for the International Accounting Standards Committee Foundation (the oversight group of the International Accounting Standards Board) published what it believes to be widely accepted Principles for Accounting Standards. These are important enough that I thought it would be useful to reprint them here:

Relevant: Financial information must be relevant to the decision being evaluated. For purposes of capital markets participants, relevance depends on whether the information enables the user to evaluate past and present events, such that the user can draw inferences regarding future events. Further, information is relevant if it provides the user a basis against which to assess past evaluations.

Reliable: Information should be reliable in the sense of providing a faithful representation of the events on which it purports to be reporting. This requires the information to be neutral and to depict fairly the reported transactions. Reliability does not necessarily equate with certainty, as judgment, for example for some measurements or estimates of future outcomes, is an inherent aspect of financial reporting.

Understandable: Financial information is intended to provide a tool for decision-making. It therefore should be developed and presented in a way that, with reasonable effort, can be understood and adapted by users into their decision-making processes.

Comparable: Information used in decision-making is generally evaluated within a context, rather than in isolation. To facilitate its use, financial information should be prepared and presented with sufficient consistency to enable comparison of the reporting entity's performance over time and against other reporting entities.

I tend to agree that these principles are non-controversial so I suppose it's reasonable to ask, "How well do the current proposals for Insurance Contracts meet these standards?"

Relevance is a big concern. For instance, it's not clear that proposals to unbundle insurance contracts provides additional information that is relevant. We don't know where these proposals will end up. Other proposals that have been made such as not recognizing renewal premiums on life contracts or not recognizing future dividends on participating contracts have hopefully been resolved. If these elements are not recognized in the liabilities, it's clear that the numbers so produced would not be relevant.

There are many reliability issues, of course, in the calculation of liabilities. Should assumptions be conservative? Should margins be added simply to make estimates more conservative? How will any margin be calculated in a reliable manner? The reliability of any assumptions used will depend on the person doing the assumption setting. It will be important for the actuarial profession to have guidance in place to require high standards for setting those assumptions.

I will pass over understandable since to a large extent this will vary greatly with the particular user. What's understandable to an actuary may not be understandable to the man on the street. I don't believe that any deep understanding of an insurance company's performance can be gleaned from the financial statements without considerable extra disclosure and effort by the user.

Finally, comparability is necessarily difficult any time you allow companies to set liabilities based on their own view of the future. Unfortunately, there doesn't seem to be an acceptable alternative. There is no market to measure in. *The Wall Street Journal* doesn't publish market mortality assumptions. Disclosure is the only way to know what you're given.

So as you read and think about the various proposals for insurance accounting, keep these principles in mind. It might help you decide which to support.

In the meantime, both the IASB and FASB were busy for two of the three months this quarter. As a result, the commentators were busy in August.

JULY

July is always a busy month at the IASB and this July was no exception. The Board published several papers

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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.

for comment this month with deadlines ranging from September 1 through September 28.

On July 14 the IASB published for public comment an exposure draft on Financial Instruments: Classification and Measurement with comments due on September 14. The key part of this document is that it effectively eliminated the Available for Sale category of asset classification and made more usable the amortized book method. The latter method was made more practical by elimination of the tainting rules that were previously in effect.

This proposal, which FASB disagreed with, has important effects on the insurance contracts project. It is important that the accounting for assets and liabilities be consistent. For instance, if assets are held at amortized book values but liabilities reflect changes in market interest rates by changing the discount rate in reserves, there will be large amounts of earnings volatility where, in fact, very little has happened.

In the insurance contracts project, the IASB was once again unable to agree on whether the measurement attribute should be based on IAS 37 (the standard that was previously used for contingent liabilities and which the Board is in the process of rewriting) or a current fulfillment approach. They did tentatively agree, however, that for short-term (mainly P&C) contracts an unearned premium approach should be required. There was some surprise by observers that the Board required rather than permitted the UPR approach but there was little disagreement with the outcome.

AUGUST

August was mainly spent commenting on previous publications by the Board. In particular, the Credit Risk in Liability Measurement Discussion Paper generated considerable discussion both at the Academy Financial Reporting Committee and the IAA Insurance Accounting Committee. Both groups agreed that changes in a company's credit standing should not be reflected in that company's earnings. Otherwise, you get the strange result that if a company's rating goes down, its earnings go up (and the reverse if a company is up-graded). Since comments on this paper were due September 1, August was largely spent preparing them.

SEPTEMBER

At the September meeting of the IASB the Board again attempted to reach a tentative conclusion on what the measurement attribute should be for insurance. This time, the vote was eight in favor of an IAS 37 measurement and six or seven in favor of the fulfillment value. This was not viewed as enough of a majority to allow publication of an Exposure draft but the Board agreed to proceed and will include both positions in the exposure draft. The Board also recognized that FASB would publish their exposure draft on the basis of fulfillment value.

It's still not clear yet exactly what the IAS 37 approach will be. It's agreed that whatever it says it needs to be modified to produce no gain at issue through use of a residual margin. It's believed that IAS 37 will follow the three building blocks approach included in the Insurance Contracts discussion paper but that language has not yet been included in IAS 37. Furthermore, the principle in IAS 37 is the amount the entity would rationally pay a contractor to carry out the service on its behalf. To some people this sounds like exit value in disguise and exit value has been voted against on the insurance contracts project.

The IASB also discussed margins at their meeting, particularly how residual and aggregate margins should be run off over time. After a somewhat confused and confusing discussion, the board agreed, again eight to seven, that the residual margin should be released over the coverage (not payment) period. They also agreed that the residual margin should be released so that it recognizes those margins in income "in a systematic way that best depicts the insurer's performance under the contract." How to accomplish this was not indicated in the summaries of the meeting nor is it discernable in their discussion. This will probably be a challenge for the actuarial profession.

The Board also agreed that the insurer should not adjust the residual margin in subsequent reporting periods for changes in estimates. So if you double your mortality assumption, your residual margin remains unchanged.
With respect to discount rates, the board agreed that discount rates should reflect the characteristics of the liability (e.g., the rate applied to a payment should

reflect how far in the future it's expected to be paid) and use this as a principle rather than setting a particular rate for reasons of comparability. This contrasts with their decision on post-employment benefits where they stipulated use of a high-quality corporate bond rate. The staff is going to try to get more input on this subject from practitioners.

As noted above, one concern with discount rates is that if invested assets are held at amortized book, as currently proposed by the IASB, while discount rates change every quarter, we will get a huge amount of meaningless volatility in our financial statement. The partial solution included in the IASB proposal, to put all assets at fair value, has its own issues and may also create non-economic volatility.

At the same time, use of a risk free rate creates additional issues. Many products assume in their pricing that returns will be higher than risk free. An important example would be Immediate Annuities. Requiring a risk free rate might generate a loss at issue and cause companies to cut their sales of this product.

NEXT QUARTER

Next quarter we should see a resolution of all the remaining issues on insurance accounting, at least enough so the boards can publish their exposure drafts by the end of December. There is a joint meeting of the IASB and FASB in October that will no doubt be critical in resolving whatever differences can be resolved before publishing the exposure drafts.

In November there's an International Actuarial Association meeting in Hyderabad, India where discussion will begin on what's known about the IASB proposals. The Academy will also begin its work to prepare to comment on the exposure drafts. Stay tuned. ■

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

SOCIETY OF ACTUARIES Financial Reporting Section

The Financial Reporter

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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