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# Session 32IF
# International Accounting For Insurance

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*Summary: The financial services industry is undergoing consolidation at the domestic and foreign levels. As ownership of foreign entities increases, firms are likely to come across accounting guidelines that differ from their domestic rules. To satisfy the needs of owners, companies are seeking an international accounting standard, and several companies are considering implementing U.S. GAAP.*
*The following three viewpoints are presented:*
- *Companies implementing U.S. GAAP*
- *Consultants with significant U.S. GAAP conversion experience*
- *Members of the International Accounting Standards Insurance Task Force*

**Ms. Laura J. Benedict-Hay:** The main focus of this session will be on U.S. GAAP and the International Accounting Standards Committee (IASC) standards. I am a senior manager with KPMG in New York and will speak from a consultant's vantage point about U.S. GAAP as it applies to the international market. Bob Howe, chief actuary for the Life & Health Division of Swiss Re in London, will focus on U.S. GAAP from the perspective of somebody who has lived to tell about it. He will also address the U.K. actuarial perspective on U.S. GAAP, IASC, and other possible options. And Morris Chambers, vice president and senior actuary with London Life

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**Note:** The charts referred to in the text can be found at the end of the manuscript.

in Ontario, will share the most up-to-date information on the IASC standards, as well as the Canadian perspective.

I'd like to cover why U.S. GAAP is so popular overseas as well as some other general issues, including data, product classification, and modeling issues. These are broad generalizations based on observations we have made from working with international global clients overseas.. Every generalization has several exceptions. Although I am speaking about U.S. GAAP, most of these issues apply to a global company that is converting to any new accounting standard.

One reason U.S. GAAP is so popular right now is that it provides a method for accessing the largest capital market in the world. Merger and acquisitions activity is another reason, as is benchmarking with competitors. Most of the large global insurers and reinsurers either have converted to GAAP or are in the process of converting to GAAP.

Companies also are looking at GAAP for internal management purposes. If you're a global firm in many countries, each different country has its own version of a local statutory accounting basis and possibly local GAAP accounting basis. It is often difficult to get a consistent method of financial reporting across the board. Most of the methods being used are not as prescriptive in nature as U.S. GAAP, so U.S. GAAP helps management understand the different levels and contributions of the legal entities within their global organization.

Finally, there is no international insurance standard right now. That is changing and Morris will go into great detail about the IASC standards and where they are currently.

When we do a U.S. GAAP conversion for an insurance company, a list of liabilities present themselves. The first question people ask is, “What FASB statements do I use for these liabilities?” so we put together a roadmap for our clients (see Chart 1). The whole point is to classify your products according to the boxes along the bottom.

This task for the U.S. market is not too difficult because FASB statements were written with U.S. products in mind. But when it comes to dealing with overseas clients, it tends to be quite an onerous task to classify your product in a GAAP-friendly way. Products are often driven by government regulations and social security programs, so there is a wide variation of products. Therefore, the product classification process might take a day or two; in Europe or Australia, it could take four to six weeks. On top of that, we’re working with a regulated “tariff rate” structure. Until recently, most European countries had a tariff or a premium rate that was dictated to them by the government. If your company did business in Germany, the government would tell you the premium rate you must use for this product. It was up to you to figure out how to be profitable for that premium rate. That is slowly changing, but because premiums were dictated, there tends to be less analysis up front when selling the business. We find that when we come to a European company that has not yet implemented U.S. GAAP, the assumption support data we usually have in the United States may not be there because it was not needed at issue.

Participating life insurance and unit-linked business are two very common products in Europe, Australia, and, to some extent, Asia.. Participating life is primarily individual endowment business. Investment performance is linked to an unallocated pool of assets. In the United States, most participating business resides within mutual companies. Stock companies don't seem to have a huge portfolio of participating life business. In Europe, though, we see quite large participating life blocks.

In U.S. GAAP, a stock company has the option of classifying this type of business as either *FAS No. 60* or *FAS No. 120*. Suddenly, you're presented with this decision just as you embark on a U.S. GAAP project. Those two FASB statements have very different profit profiles, so it's a tough decision. And *FAS No. 97* also gets thrown into the mix for some participating business, so the product classification process is complicated. Quite a few products fall into this area of classification where there’s an option, but the path isn’t clear.

Unit-linked business is becoming increasingly popular and has been popular in the U.K. for some time. It is basically *FAS No. 97* business, similar to U.S. deferred annuities linked to an index. In the U.K., the FTSE bond index is popular.

Let’s move from the product classification step to data issues. Data problems affect modeling ability and the quality of the results. Everything is affected by the data that you have available, not only for U.S. GAAP but for any reserving methodology that you put together. When we move outside the U.S., many of the European and Australian companies have a statutory reserving basis that is prospective in nature with unlocked assumptions every year. So there's a pattern of many, many years of not saving historical information. The data available is very current information. If you walk into a company with a large block of *FAS No. 60* business—say it's a non-participating block of life insurance—historical data may or may not exist. If you want to create multiple issue eras, it becomes a huge problem. Implementing a *FAS No. 60* locked-in approach can be very complicated.

Also, when one company gets either merged or acquired, data may get lost in the process. We're struggling with that with some of our clients right now. How do you go back and set historical assumptions? And, finally, a reinsurer tends to have even more problems, in that it is very dependent upon the ceding company to provide timely data in some reasonable format. Reinsurers may or may not get it. In Europe, the reinsurers haven't been as aggressive in getting electronic data as they are in the United States, but that is changing.

Data also affects the assumption-setting process. Generally, there's a lack of company experience studies. The availability of best-estimate pricing assumptions tends to be scarce—again because of the tariff structure dictated by governments. This too is changing.

Industry studies are limited. It seems that whenever a new tariff rate comes out, a new industry study comes out as well, so there is some support. But, when you're doing a U.S. GAAP conversion, you're trying to support your assumptions with company experience. and that's often very difficult.

Finally, one very current and very real issue for all Europeans is the imminent European Monetary Union (EMU). How does one set a long-term interest rate assumption? If I ask 10 actuaries what their view of the long-term interest rate is, I will get 10 different opinions, ranging from the very pessimistic to the very optimistic. All of these assumptions will be valid and backed by very strong opinions. So the EMU is a huge issue for most global insurers and reinsurers.

Let's move into modeling issues. A model is only as good as the data one has. But, let's assume that the data is reliable and think about systems requirements. A great place to start is the valuation system. Again, in Europe, statutory reserving tends to be very current, best-estimate type of assumptions that are unlocked. Compared to a *FAS No. 60* historical type of locked-in approach, European valuation systems would require quite a bit of modification to be able to handle the U.S. GAAP. They're not typically set up for multiple issue eras and can't handle all of the assumptions. For instance, our valuation systems cannot handle lapses if you're doing a first-principals calculation as opposed to a factor-driven type of reserve.

Many Europeans perform embedded-value calculations, which is an attempt to find the value in the statutory reserves on a current best-estimate basis to get closer to a fair value.

Finally, profit testing systems are not usually robust enough. If there's any profit testing done, it might be a few model points here and there. The system probably won't be able to save the amount of data necessary to do the issue era modeling you might need for historic GAAP.

What if you decide that you want to modify your information technology (IT) systems? You'll probably find that all IT resources are stretched, especially with the year 2000 conversions, but Europe has an additional stress factor: the Euro. Not only does this change require system modifications, but new products are being developed to support that new market. Most companies seem to be using outside consultants more. That may be a good short-term solution, but it's probably not the best long-term solution for any company.

With respect to asset issues, segmentation of assets is not very prevalent in Europe and Australia, except possibly for the unit-linked business. Investment in equities are much more common. It wouldn't be unusual to see a company with 30% or 40% in equities, something that is very unlikely in the U.S. because of risk-based capital requirements. That brings in another question. How do you set interest rate assumptions when you have 30% or 40% in equities? With bonds, there is an emphasis on government securities, but in the European market there is no real market for mortgages, collateralized mortgage obligations, or commercial mortgages. The flavor of the asset portfolios tends to change outside of the United States.

As for *FAS No. 115* asset classification of debt and equity securities, as in the United States, "available for sale" is the most common. Under this classification, unrealized gains and losses go through equity and not earnings. There is some scope for *FAS No. 115* shadow adjustments, but these aren't perfect offsets. That creates an inherent mismatch in U.S. GAAP between assets and liabilities, because the assets are at market value and the liabilities may not be.

For real estate investment buildings, most European financial reporting models carry real estate at cost or market value, whereas in U.S. GAAP you use depreciated costs. A lot of Europeans are not happy about this because it makes real estate appear to be an unsatisfactory investment.

Global reserves is another touchy issue. Many European insurers and reinsurers, especially in Switzerland, have hidden reserves stored away for a rainy day. They use the term "equalization," which means the money is there to equalize earnings. These reserves are not allowed under U.S. GAAP and are often removed, which is a sore spot for a lot of Europeans.

U.S. GAAP also doesn't allow AIDS reserves. In Canada, I believe that AIDS reserves are required on a statutory basis, so the Canadians are not happy about their removal.

Another interesting area is foreign currency. *FAS No. 52*, the foreign currency standard, was adopted quite a few years ago. If a global insurer or reinsurer is doing business in 30 or 40 countries, it means that every change in liability has to be split between the portion going through earnings and the portion going through equity. It's very complicated. I was working with one insurer that had 40 functional currencies. They had to model all their businesses in the different countries and figure out the different splits. That adds quite a lot of time and effort to your GAAP work, something we don't have to deal with here in the United States.

The reporting requirements can cause quite a bit of trauma for Europeans. For example, the Germans aren't required to report their statutory reserves for nine months after the close of the year, so they're used to having time to put their financials together, analyze the results, and make sure they're correct. U.S. GAAP speeds that process up greatly, partly because of U.S. investors. The Europeans are struggling to try to meet the reporting requirements time line. Even if they had the ability to modify their systems and get the data, the time line falls during their most busy period. Doing year-end work can be very difficult. This means more estimates, of course, and an expanded role for the actuary. This would be good news for actuaries if they were bored, but chances are at year-end they're not.

Finally, U.S. GAAP requires additional financial statements that the Europeans may or may not be used to, and the management discussion and analysis required by the SEC is extensive and time consuming,

I'd like to wrap up with some of the cultural differences I've observed in doing work overseas. When I walk into a new company, it always astounds me how we're using the same actuarial terminology and yet they mean different things to different people. Last week I met with representatives of a Korean company whose meaning of the word "participation" differed from our meaning. You can't take for granted even the most basic words. The "locked-in" concept is difficult to grasp, and there is often strong resistance to it. Many people feel that this is not the right way to do things. I often hear, "GAAP makes no sense when we start to talk about locked-in assumptions."

The inherent asset/liability mismatches in U.S. GAAP make many people unhappy and some deem them to be unacceptable. Finally, under *FAS No. 97*, the income statement presentation changes for unit-linked business, and there's a loss of premium income. This is a key marketing statistic for many Europeans who use it as a measure of their size. Often they have a problem with an entire *FAS* classification merely because of the loss of premium income.

U.S. GAAP is not science; it's just life according to U.S. GAAP. It becomes even more artful as we move out of the United States. There are many advantages and disadvantages to U.S. GAAP as an international accounting standard.

**Mr. Robert W. A. Howe:** I've been involved in two major U.S. GAAP conversions. The first question I'm usually asked is, "Why do U.S. GAAP at all, because it's such a painful process?" My current employer is in the top 200 companies worldwide, so it feels right that we should be closer to the U.S. market. It's not just a question of ego. The U.S. is the world's largest capital market. We felt that, at some stage in the future, we might need access to capital or wish to exchange paper if we make an acquisition, and U.S. paper is much more acceptable than Swiss paper.

Also, as a multinational company, we'd be interested in widening our shareholder base. Right now, it's very heavily dominated by individuals in Switzerland. That doesn't sound like a very broad shareholder base. Those are the more obvious reasons. The less obvious ones are internal consistency. When we produce our consolidated accounts, we add up the local statutory accounts and the role of different companies around the globe and make a few modifications. We have a mixture of gross premium methods and net premium methods. We have some people who calculate by looking at market value years and others using book value years. We have some markets that have a principle of matching assets and liabilities and others that don't. So what do our consolidated accounts mean? They mean nothing. U.S. GAAP, despite all its faults, at least is well codified. It's an ideal opportunity for us to take a consistent approach with all of our companies around the world.

U.S. GAAP is something that our board of directors is interested in. I remember telling the board one year that we had some problem with our disability business in the U.K. "I've strengthened the reserves, but don't worry," I said. "I've managed to find some margins elsewhere, so profits aren't affected." First the board members said, "That's good." Then they wondered, "What else don't we know about that management has hidden from us?" The board always fears that things are going on in the business that management hasn't owned up to yet. At least with U.S. GAAP, business issues should emerge early. And if the issues emerge early, management will be forced to act earlier.

It's not all good news, though. Being under U.S. GAAP is like living in a goldfish bowl—there's nowhere to hide. Everything you do is obvious. Whatever management does, shareholders know about it. This is pretty tough on management, because when anything goes wrong, it shows on the numbers. It does force you to take action, sometimes faster than you would like. Sometimes it's better to sit back and think about a problem, get some consultants in to analyze it, and come up with a more considered answer. Under U.S. GAAP, we feel that management is being pushed all the time. Because we can't smooth our results, more volatile share prices are likely, and we view that as bad.

Let me say a few words about the European perspective on "smoothing." First off, insurance is long-term business. We're setting contracts of 20-30 years. Despite all of our actuarial skill and years of experience, if we're honest, reserving is a huge estimation process. We don't know what the future holds, but we're making assumptions about it using our intellect and knowledge. But it's still an estimating process and, from time to time, we want to change those estimates. Sometimes we want to change our computer models. Whenever that happens, there's an impact on the balance sheet and we don't like the idea that this change flows through as earnings. After all, this incident did not occur in that particular year, it's just a change in our view about the future. Therefore, if we're honest, we use our discretion to smooth results. I don't see that as bad. If I've been keeping my eye on developments, I might notice some bad news in one and some good news in another. It's quite sensible to offset them if you're taking a long-term view. In Europe, we think it's perfectly sensible and appropriate to smooth our results. We do it all the time.

That view is also governed by the sorts of investment products we have. A lot of our insurance companies have a very heavy focus on the investment products. As Laura mentioned, they tend to be something that we call "with-profit" contracts. The bonuses declared each year are not codified, but are up to the discretion of the actuary and the management of the organization. The bonuses don't follow the investment market up and down. They tend to smooth their way through and take a long-term view about the bonus additions. Even with the investment credits given to the policyholder, a lot of our contracts are smoothed.

Laura mentioned equalization reserves, or catastrophe funds, if you like. I happen to work for a composite company where 60–70% is non-life. We know that one day there's going to be a catastrophe. That California earthquake will happen at some stage in the future. We must have the money put aside for that, and we do not want to volunteer it up to be taxed, so it gets put aside in equalization reserves. When that big event happens, we will draw on it and pay out the claim. We think that's a perfectly legitimate thing to do.

We've experienced some difficulties with U.S. GAAP. First, the conversion is a traumatic event, not because U.S. GAAP is that difficult, but because converting to any new valuation or accounting method causes a huge strain on an organization. Typically, you want to know what the answers will look like before you spend 10 million pounds to alter your computer systems, so you do some modeling work and approximations until you get a feel for it. For a while, you're running two valuation and accounting systems in tandem until, at some stage, somebody has the courage to do away with the old one and step across to the new.

We don't like locked-in assumptions, as Laura suggested. We think we can manage them, but my concern is that you're ignoring bad news because you have some good news, and saying, "Let's not change the reserves." At the end of the day, you'll become complacent as an organization and won't do the detailed analysis you ought to be doing to understand your book and reprice your products.

European investment products just do not fit in the U.S. GAAP environment. As an international company, we operate in many markets, have many different products, and operate in many different currencies. U.S. GAAP was developed for the U.S. market. Not many U.S. companies have a significant presence overseas. We find that U.S. GAAP is not flexible enough and does not adapt well enough to unusual products.

Who agreed to *FAS No. 115*? How can you have such a mismatch in treatment between your assets and liabilities? Can I manage it? Yes. I can go and distort my investment activity to produce the right results. I can tell my investment department what realized gains we ought to take this year. But that's no way to run an investment department. The investment department's job is to maximize the total returns, not to distort its activity to produce a good set of books. I don't like *FAS No. 115*. I have to be very honest about that. And, if you want my support for US GAAP as an international accounting standard, you'll have to change that one.

On some practical issues, I'm ignorant. I can read all the FASBs. I can talk to the consultants. But what do people do in practice? How do you "flex" your results? Don't tell me you don't flex them, because I'm sure you do. You know how to do it, and I'm not in on the secret yet, but we'll get there in the end.

We don't have enough data. Typically, our European clients will tell us what the reserves are on their local statutory basis. I know how to convert that to U.S. GAAP but don't have the source data. It causes a particular problem for us. Investment markets are very volatile. Bond yields that used to be stable in the U.K. moved two percentage points this year. U.S. GAAP does not adapt well to volatile investment conditions. I keep getting lectures about lawyers: "If you get a U.S. listing wrong, they'll be after you; they're out there just waiting for you." The lawyers certainly worry me.

The final comment is about international accounting. Let's be honest, most life accounts aren't helpful. If you look at a set of U.K. accounts, what do they tell you? Nothing. If you look at a set of Australian accounts, there's several different sets of numbers. Which are the right ones to look at. If we're honest, most life accounts are designed to demonstrate solvency to keep regulators happy. They're not very good at informing shareholders about what is genuinely going on in the business.

Because we recognize that, every country seems to come up with a different solution. There’s a focus on embedded-value methods in the U.K., policy premium methods in Canada and Australia, and who-knows-what in the U.S. Every group of actuaries seems to come up with a different solution. They're always similar, so why can't we work together to come up with a solution that we all can buy into?

If we're looking to a set of international accounting standards, U.S. GAAP already exists as an international standard. It's no accident that many European companies, not just insurers, are preparing accounts on U.S. GAAP. Not all of them have disclosed it, but the fact is that we're producing U.S. GAAP numbers. I don't know yet what we're going to do with them. We might file them away or go for listing, but there are a lot more companies doing U.S. GAAP conversions than there are companies who've actually done them formally for listing. It is the international standard, but for it to be acceptable within the European market, it needs to be modified and flexible enough to allow actuaries and accountants to use our discretion. We have to get it past our auditors, so let's have some flexibility here.

Let me give you a little background on what's going on in the U.K. The actuarial profession has a preference for what we call “embedded values.” We take the in-force book of business; project it forward by looking at all the cash flow, reserves, and solvency; and try to answer two questions: (1) What does the shareholder have to put into this business and (2) how will the money emerge to the shareholder in the future? Then we discount that back at a risk rate of return that tends to be driven by when companies are bought and sold, the price they go for, and the implicit discount rate. There is a market-related factor here, but I have to be honest with you, the accountants hate it. They dislike in particular the fact that you are discounting cash flow at a risk rate.

For a while, our five major companies in the U.K. made a modification to embedded value called “achieved profits.” The work is done in the selling process and it allows you to recognize 60–70% of your profits when you sell the contract. When you're projecting your cash flow, you have to put in a risk loading. When we asked the companies what risk loading we should use, they said reinsurers set the price, so look at what they choose. For administrative, we’re supposed to look at the price that the third-party administrators choose. Having these specific loads, we then discounted the cash flow at an investment rate instead of a risk discount rate. I think that experiment is more or less being abandoned now, and industry in the U.K. is moving toward a pure embedded value approach.

However, this approach has a lot of glitches. It's very easy to manipulate embedded value earnings, because you're looking at the difference between two balance sheets. For it to be acceptable, it will have to be very well codified and require very heavy disclosure of assumptions. We will have to capitalize any change in assumptions and bring it out as an opening adjustment. A number of insurance companies are owned by banks and, because the insurance company is a small part of their operations, they are already consolidating embedded value earnings into their consolidated accounts.

The actuarial profession is pushing towards an embedded value-type methodology. Whether it will succeed, I don't know. One of the debates we could have revolves around the balance between the best answer and the answer that's most likely to succeed. I would suggest that those are two are different concepts.

**Ms. Benedict-Hay:** I'd like to thank Bob for a very honest and frank discussion on the advantages and disadvantages of U.S. GAAP. Now we'd like to move on to Morris Chambers, who is going to enlighten us about the IASC's most recent standard and time line.

**Mr. Morris W. Chambers:** Any discussion of the activities in the arena of international accounting for insurance these days is replete with acronyms. My introductory remarks are going to deal with the ancestry of certain organizations to which I do not belong. In this new spirit of disclosure, I will declare that I am relying on information provided to me by an accounting colleague and, therefore, take no responsibility for it whatsoever.

Most prominent among the sets of initials currently is IASC. Based in London, IASC is an association of the professional accounting bodies in more than 100 countries. It's marking it's 25th anniversary this year. The IASC does not include the national accounting standards setters such as the FASB, except as invited observers. An exception to that rule is Canada, where the standards-setting function is conducted from within the Canadian Institute of Chartered Accountants (CICA).

For most of its lifetime, the IASC has played second fiddle to the strong national accounting standards bodies like FASB and the CICA. Its principal role has been to establish standards for application in jurisdictions where there are no standards. However, in some countries that have standard bodies such as Mexico, the IASC standards known as International Accounting Standards (IAS) have been used for specific subjects that were not covered by the national standards.

Lurking in the background of the international accounting scene is a shadowy but powerful group known as the G4+1. It comprises the national standard setters of the U.S., the U.K., Australia, and Canada, plus the IASC itself. New Zealand has recently joined this group but, like the Big 10, it continues to be known as the G4+1. Several European bodies have asked to join, but they've been turned down. G4+1is the forum in which national standard setters with a common heritage and facing common issues collaborate in finding common solutions. It does not develop standards itself, but it adds international rigor to deliberations, permits sharing of scarce resources, and reduces accounting arbitrage among its members. It does have some influence over the IASC, though, because G4+1members could, by influencing their country's IASC board members, effectively block any developments within the IASC.

The principal driver of IASC activity during the past few years has been an agreement that it reached with the International Organization of Securities Commission (IOSCO). With the rise and active trading of shares in international stock markets, IOSCO became concerned about the lack of consistency of financial reporting for the jurisdictions in which these markets operated. Consequently, in about 1994, IOSCO asked the IASC to develop international accounting standards to impose on multinational corporations that wish to register their shares for trading in multiple international exchanges. The IASC has undertaken this task, the completion of which promises to make the organization a much more formidable force to be reckoned with in financial circles.

Critical to obtaining IOSCO endorsement is the completion by 1999 of so called “core standards” in 12 subject areas. Eleven are now complete, with the last financial instruments currently in the exposure draft stage. Insurance is not part of the core package; however, the developing financial instrument standard is important because it defines an insurance contract as a type of financial instrument. Insurance is excluded from consideration for the time being, though.

One of the completed standards, IAS 37, involving provisions, contingent liabilities, and contingent assets, also has excluded insurance. One of the standards addressed early on by the IASC in this regard was accounting for employee benefits. An exposure draft of the proposed standard was published about the same time the International Forum of Actuarial Associations (IFAA) was founded in Brussels in 1995. The timing was fortuitous because it gave actuaries a global organization through which to present a uniform position when identifying inappropriate elements of this draft accounting standard. Although not successful in rectifying all of the problems with the standard, the IFAA ultimately had a significant influence on the IASC standard. When finally adopted in January 1998 as IAS19, many of the IFAA's proposals had been incorporated and there's some expectation that the most significant issue remaining unaltered could be modified in future.

In June 1998, the International Actuarial Association (IAA), which had been an association of individual actuaries, reorganized an association of actuarial associations. The IFAA, which had been a section of the IAA, disbanded after this change, and its subcommittees became committees of the IAA. Consequently, I will use IAA to refer to both organizations from this point on. The IASC has turned its attention to insurance accounting as a special topic, and a committee has been formed to develop proposals. Reflecting the degree of early recognition achieved by the IAA, Paul McCrossan has been appointed to that IASC steering committee as a nonvoting member representing the IAA.

In 1997, the IAA formed a committee whose specific charge is to prepare IAA positions on insurance accounting and monitor the work of the IASC in that regard. The committee is chaired by Sam Gutterman and includes representatives of 21 different actuarial organizations from 17 countries around the world. At a June 1998 meeting, the principal discussion centered on a lengthy issues paper that Sam had assembled. That document identified 22 different issues, most with several subissues. About six of the topics have been assigned to member organizations for further development and three have been discussed accurately on the committee's Internet list server.

The Internet has also been the medium for discussing the IAA's draft response to the IASC's exposure draft E62 on recognition and measurement of financial instruments. The product of that IAA discussion was delivered to the IASC in September 1998. The IASC Steering Committee on Insurance met in Munich in October, where it discussed a draft of its issues paper on insurance accounting in addition to insurance specific aspects of E62. The draft document comprised more than 200 pages of material. I understand that only one-third to one-half of it was discussed, so it's likely that the steering committee will meet again.

This may present a problem, because the steering committee has set an aggressive time table for itself. It's expected that at the point outline, which clarifies the scope of the project, will be approved by the IASC board in November 1998. The issues paper will not be finalized and published before the end of 1998 but will likely be out in mid-1999. In the fourth quarter of 1999, a draft Statement of Principles will be published. Board approval of the final Statement of Principles is expected in the third quarter of 2000. An exposure draft of the standard will be submitted for board approval in the first quarter of 2001, with IASC board approval of the final international accounting standard for insurance expected in the first quarter of 2002.

In adopting its financial instruments standard, the IASC must decide whether the standard is to be applied immediately to assets held by insurance enterprises or whether they will be exempted until the insurance project is complete. The IAA committee has stated its preference for exclusion on the grounds that consistency within an entity's accounts is more important than consistent treatment of assets across all entities.

What do these developments mean for the global insurance industry in the long term? I don't pretend to be clairvoyant, but it could well mean that all of the efforts to adapt to U.S. GAAP might have to be scrapped and replaced within five years. In fact, I hope that's the case. “Surely,” you say, “the GAAP standards that we have all come to know and love will not be completely abandoned. Must not a new international accounting standard be built upon some of these most cherished precepts?” If that is so, it will be a shame because a shining opportunity will have been lost. It all depends on whether the natural resistance to change will dominate the desire for integrity in financial reporting. I, for one, would not put money on the outcome. Nevertheless, there are some indications of how this may play out.

First of all, the steering committee is likely to propose that the new insurance standards should apply to insurance contracts rather than to insurance enterprises. The motivation to follow this path stems from the fact that, in many jurisdictions, insurance companies and banks can directly issue identical insurance contracts. Therefore, it's felt that the financial reporting consequences of that issuance should be relatively similar, regardless of the type of issuing institution.

The steering committee has almost settled on the following definition of an insurance contract: An insurance contract is a contract under which one party (the insurer) agrees with another party (the insured) to make payment if a specified uncertain future event occurs (other than an event that is only a change in a price or some similar variable, such as an index). To be considered an insurance contract, there must be uncertainty or risk in the occurrence or the timing of a specific future event, or the amount to be reimbursed for the event must be uncertain. Under this definition, derivatives, gambling, and self-insurance are not deemed to be insurance, but product warranties are.

The accounting emphasis has moved from the 1980s focus on the income statement to the balance sheet. The IASC has essentially committed itself to fair value accounting. Even though they have not yet considered what the fair value of assets might be, it appears very likely that it will be closely linked to market values. If that is the case, for consistency, most people are arguing for the imposition of fair value of liabilities as well. How fair value of liabilities is to be determined remains an outstanding question.

There are strong indications that the IASC steering committee will at least imply that the prospective valuation methodology is required in determining fair value of liabilities. In my view, under such an approach, the deferred acquisition cost should not survive because it is specifically a retrospective concept and is, therefore, incompatible with a prospective valuation. Also, under a prospective system, an unearned premium reserve could be considered a valid liability only as an approximation of the real liability, which is the present value of the future obligations under the contract.

The IAA committee has addressed several issues in the hope of arriving at an actuarial consensus. There's general agreement that the fair value is the appropriate approach. Also, the actuarial view of the fair value of liabilities should reflect the earning power of the assets that are being held to support them. This may prove to be a difficult issue for the IASC. There appears to be a general opinion within the IASC steering committee that the discount rate to be used in the calculation of the present value of future obligations should be independent of the assets actually being held. That was the position taken by the IASC in adopting IAS19 for employee benefits and is the remaining issue in that standard that the IAA hopes will be modified in future.

Nevertheless, in the context of current international financial reporting practices, valuing policy liabilities by a strictly prospective methodology is pretty revolutionary stuff. A multinational insurer would prepare a single GAAP statement, for its worldwide business using fair value principles with policy liabilities calculated under a strictly prospective valuation methodology and using the actuary's best estimate of future experience with explicit margins for adverse deviation in each assumption, except perhaps for the discount rate. This approach is not used anywhere in the world today.

Many have noted that the liability valuation methodology currently in place in Canada is probably the closest to what one would consider to be a fair value determination. Indeed, the possible future international regime I just described has been in place in Canada since the implementation of the federal Insurance Companies Act in 1992. The only difference is that the valuation of assets in Canada involves a mixture of book value for debt instruments and amortization to market for equity instruments. Through cooperative efforts during the latter half of the 1980s between CICA, the Canadian Institute of Actuaries (CIA), and the Office of the Superintendent of Financial Institutions, this approach has been adopted as the single basis for both GAAP and statutory reporting in Canada. For a business sold since 1996, it's also the basis for tax determination.

The 1992 Insurance Companies Act was implemented with a unique dependence on the professionalism and objectivity of members of the CIA. Indeed, the valuation section of the Act requires simply that the actuarial valuations be in accordance with generally accepted actuarial practice, with such changes as may be determined by the superintendent. That's all the Act says about valuation and there aren't any associated regulations. It's been left to the CIA to establish accepted actuarial practice that is in the public interest and to ensure that its members comply with the standards. Operating on the premise that the price of freedom is eternal vigilance, the CIA has been very active in making sure that its standards and its members meet that test.

To date, the superintendent has not, as is permitted under the Act, exercised the right to override the CIA standards with respect to life insurers, though there is continuing active discussion regarding one aspect of property/casualty claims reserves. The CIA Standards of Practice require that the actuary recognize the time value of money through the application of discounting, with appropriate provisions for adverse deviation. However, the superintendent has, so far, allowed discounting of property/casualty claims reserves only to a limited extent. In fact, in areas where property/casualty companies and life companies fail to stay in business, the same valuation methodology is permitted.

The 1992 Act imposes a number of other responsibilities on the appointed actuary. Among them is a requirement that the appointed actuary meet annually with the company's board of directors, not its management, and report on the financial position of the company and if required by the superintendent on the expected future financial condition of the company. The superintendent has stipulated that this kind of report be made for all life insurance companies. For property and casualty companies, the superintendent requires the report only for companies viewed as being in jeopardy.

The CIA has been lobbying to have that element of the law amended to require the report for all companies. The CIA's position is that the report on expected future financial condition is intended to keep companies out of trouble. To require it only for those property and casualty companies that may be in trouble evokes images of the proverbial late closing of the barn door. During the period leading up to the enactment of the federal Insurance Companies Act, with its use of GAAP statements for statutory reporting, the CIA had stated it could accept the discrepancy, but only if certain conditions were met. Significant among those conditions was the insistence that, under such a reporting system, since the reserves would no longer serve as the foundation of solvency, there must be another means of monitoring the viability of the company. The office of the superintendent of insurance was, at that time, in the process of introducing a minimum continuing profitable and surplus formula similar to the risk-based capital formula used in the U.S. The CIA insisted that, on its own, such an approach was inadequate and proceeded to develop a scenario-testing approach that has been put in place as its dynamic capital adequacy testing standard of practice.

In requiring the appointed actuary to report on the expected future financial condition of a company, the superintendent of financial institutions has ruled that such a report should be based on an investigation that uses the procedures set down in the CIA's standards. In Canada, we have a regime that uses GAAP statements for statutory purposes, a prospective valuation methodology supplemented by a risk-based capital formula and a requirement for the appointed actuary to report annually to the board of directors regarding expected future financial conditions. This opinion is based on the appointed actuary's investigation using scenario testing of the company's resilience under a variety of adverse future conditions.

That brings me to another important player on this international stage: The International Association of Insurance Supervisors (IAIS). That's the international organization to which insurance regulators belong. A relatively new organization, the IAIS was formed in 1992 and obtained its charter in 1994. In 1996, it amended its bylaws to give itself standards-setting powers. Despite its relative youth, IAIS membership numbers 100 regulatory bodies in 87 countries. The international accounting developments are of particular interest to the IAIS because it is considering establishing a universal risk-based capital standard to be applied to internationally active insurance companies.

Considering the diversity of current regulatory regimes around the world, it won't be easy for the IAIS to reach consensus in that regard. Nevertheless, the first steps were taken at its meeting in Cancun. The IAIS affirmed that the development of an international risk-based capital regime was a worthy objective. In support of that objective, the IAIS has appointed liaison representatives to represent its interest on both the IASC Insurance Steering Committee and the IAA Insurance Accounting Committee and has established its own subcommittees to monitor the accounting and actuarial developments.

The traditional first-line regulatory approach to assuring solvency has been through the imposition of conservative liability requirements. The IAIS realizes that, in today's world, this is a less-than-satisfactory solution and will be pressing the IASC to address and define the fair value framework quickly. Then it will be calling on the IAA to develop international actuarial standards for application within that framework.

In summary, the goals are to have a single, international regime that uses both generally accepted accounting principals and actuarial practice as the basis for regulatory reporting and to build upon that foundation a universal risk-based capital regime, probably involving stochastic methods.

Whether that goal can be achieved remains to be seen. It will be a real struggle. Many are predisposed to the view that regulatory goals and general accounting goals are so different that the two reporting systems must necessarily differ. I believe that the goals are converging, and I'm convinced that achieving a single international reporting basis would be well worth the significant effort that it will take.

**Mr. Charles Linn:** Laura, you mentioned one of the issues for U.S. GAAP is dealing with the move to a single currency in Europe. What if you have historical data in the original currency, but your projection will have to be made using the new currency? Is this a *FAS No. 52* issue, or do you have to deal somehow with the change at the point that it occurs? Maybe this issue wouldn't even come up, because you mentioned there is a lack of data.

**Ms. Benedict-Hay:** No one has dealt with this issue yet. First, if they're locked in then, to the extent that you switched to the new currency, I think you will have to address it through loss recognition analysis. But I'm not convinced that's necessarily the right answer at this point, either. The new European currency establishes a flat exchange rate for every currency. Perhaps the answer is to use the same flat exchange rate to convert your assumptions and keep your interest rate assumptions the same, except that you're modeling in a different currency. That's what I suspect will happen.

**Mr. Chambers:** Has anyone thought about the prospect of U.S. GAAP being prepared in Euro currency? It seems to me that the largest number of companies that are using U.S. GAAP internationally are based in Europe.

**Mr. Peter L. Smith:** We haven't looked at GAAP as extensively as we have U.S. statutory testing. We defined our U.S. statutory scenarios in terms of Euro interest rates, using the German rates as guidelines and grading into those. Typically, we do recognition studies annually when we do our ALM studies, and I expect we would do all of those recognition studies on a similar basis.

**Ms. Benedict-Hay:** I have a comment about loss recognition. In moving to the Euro, if you have fixed exchange rates going forward, it's possible that, were you on the cusp or had a previous loss recognition event triggered in annuities, that switch could trigger another loss recognition, although intuitively that doesn't make sense. You might want to perform a one-time loss recognition test just as you do the conversion, even if it's not on the valuation date.

**From the Floor:** I believe that's the reality of the situation because the guarantees required in those countries are based on the original interest rates in the original currency. In a loss recognition situation, we sometimes find that there may be margins in other bases. You mentioned the difference in word meanings. When you fully examine all your contracts and guarantees, there might be other margins. I agree with your perception that, if the interest rates are nominal and based on the original currency, they're applicable in the new Euro currency. In many European countries—especially Spain, Italy, and Greece—all those interest rates have come down to the German standard and it's become onerous.

**Mr. Howe:** The problem is change in investment condition, which is no different from what you've experienced in the U.S. You've seen long bond yields move a lot in the last couple of years, so, yes, the loss recognition testing on your investment conditions is crucial. I don't see any way around it.

**From the Floor:** I have a comment for Mr. Howe. Thank you for a frank presentation. I think I disagreed with almost every word of it, with the possible exception of the locked-in concept, and so would every other standards-setter in the English-speaking world. The things you listed as disadvantages to U.S. GAAP struck me as advantages.

**Mr. Howe:** They are disadvantages from the standpoint of management, not from the standpoint of the shareholders.

**From the Floor:** I appreciate the clarification. As an update on the activity of the IASC steering committee, we did discuss the question of catastrophe and equalization provisions, the whole smoothing area, at some length. The initial decision was that they do not meet the definition of a liability and therefore, do not belong on a balance sheet reported as such. It's open to further discussion, but that is the initial decision of the steering committee.

**Mr. Sam Gutterman:** What are the views of European actuaries with respect to these alternative approaches. British actuaries have principally believed or espoused the embedded-value approach. Any thoughts about approaches other European actuaries favor?

**Mr. Howe:** The U.K. tends to get labeled "Anglo-Saxon," so what the U.K. thinks doesn't always apply in the rest of Europe. Holland is usually firmly with the U.K. In the opposite camp may be Germany, which is a highly regulated market. When the insurance accounts directive was introduced with a requirement for review, the actuarial profession in Germany said, "That's what the regulators say it is." Germany would be at the opposite extreme, probably with France, which has had very regulated markets in the past. I wonder what opening up to the European market will actually mean to them. They probably recognize that there are different ways of doing things, but I very much doubt they would believe that our way is better than theirs. I work for a Swiss company, but I'm based in London. That makes things difficult. The Swiss like flexibility. They don't like telling the shareholder everything. They want to smooth their results and have hidden reserves.

**From the Floor:** I agree that the Germans are on the opposite end of the spectrum. Only the true multinational companies want to move to the U.S. GAAP basis, and the whole issue of risk-based capital is receiving a lot of resistance in continental Europe as well. However, we are working with some Swiss companies and, in general, they are very likely to publish embedded values with next year's statement as well. To that extent, they'll move a lot closer to the U.K.'s view of using embedded values as a standard instrument for notifying shareholders of developments. This should show the effects of the changes in the amount of hidden reserves during the last couple of years, which first went up but might be on the way down again.

**Mr. Howe:** For internal purposes, we do use embedded-value analysis, but there are no plans to publish that in the foreseeable future.

**Ms. Benedict-Hay:** On the U.K. basis, are you required to publish your embedded value on the Department of Trade and Industry returns?

**Mr. Howe:** No.

**Ms. Benedict-Hay:** We've been focusing mainly on Europe. Would someone who has done business in South America shed some light on this arena?

**Mr. Edward Robbins:** South America is quite a bit behind the rest of the nations that you have been talking about. It is composed of countries that are heavily regulated, similar to the way we were regulated in the old days of formula reserves, life endowment, and term insurance, pre-universal life. Argentina does have universal life, and typically, account value has to be held. From my very limited experience, GAAP conversions and cash flow testing are relatively new concepts. The IASC concepts here are not uppermost in their minds at the moment.

CHART 1
US GAAP DECISION TREE