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Update on Fair-Value Reporting

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Summary: Initiatives are under way in the U.S. at the Financial Accounting Standards Board, and internationally at the International Accounting Standards Committee, to explore and develop a fair-value- or market-value-based accounting approach. This panel discusses recent developments and emerging thinking on this subject.

Topics include:

- *Objectives of fair-value reporting for insurers in contrast with other industries.*
- *Recent developments at the Financial Accounting Standards Board, the International Accounting Standards Committee, and in Canada.*
- *Limitation on estimating fair value.*
- *Alternatives to fair-value reporting.*

Mr. J. Peter Duran: What sort of adjustment for risk should be built into the system? Is it correct to, let's say, value liabilities based on the discounted value of the expected cash flows, or should there be some risk premium built into the system in some way? Should there be a gain or loss at issue? Should that be permitted in the framework of a market transaction in which an insurance contract has been issued? Should there be an immediate gain or loss allowed to be recognized in the fair-value reporting framework in such a case? The opinions differ among the various participants at this meeting.

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Do we need to take into account cash-flow scenarios? If we're discounting expected cash flows and they're path-dependent, should that be taken into account in the valuation? It would seem so to me. And do we look at homogeneous groups of liabilities or individual liabilities? When we value a block as a liability and do a liability valuation on a block of insurance contracts, are we doing something different than we would do if we were valuing each insurance contract separately and then adding up the sum?

The FASB has identified in one of the exposure drafts on present value-based measurement two measurement objectives for assets and liabilities, a fair-value measurement objective and an entity-specific measurement objective. In essence, the fair value is based on *market* estimates of cash flows and *market* adjustment for risk, while the entity-specific value is based on the reporting entities' assumptions with respect to cash flows.

We have proposed five criteria that a fair-value reporting framework should meet: independence, objectivity, consistency (as between asset and liability valuation), applicability, and simplicity.

That's an overview. Our first panelist will be Bob Reitano from John Hancock, who is going to speak about the advantages and disadvantages of fair-value reporting.

Mr. Robert R. Reitano: I'd like to review a simplified version of the fair-value reporting model, starting with the balance sheet. On the balance sheet, we'll define fair value for assets as "market value" if publicly traded. Usually, when you say publicly traded, you mean actively publicly traded as opposed to publicly traded securities that might trade once a month. Otherwise, we will use the term "fair value." I will talk more about that in a moment. On the liability side, we will use "fair value" also.

Next, I will talk about an income statement. Income statements arise from a simple identity that income is a change in your fair value of surplus, which is by definition the change in the fair value of assets minus the fair value of liabilities. That just comes from the simple identity that your surplus or equity is assets minus liabilities.

So, what is fair value? For assets, the market's conventional answer is that when your assets are priced using relative valuation methods, we would say that they reflect the assets' characteristics and reflect the market's prices for comparable assets. An example that we all are familiar with is matrix pricing. Many private placement instruments are priced using matrix pricing. The elements within the matrix represent publicly traded prices of securities with either similar maturity structures or quality structures and perhaps embedded options. Another example is

model pricing, whereby you calibrate your pricing model—and many of these are option-adjusted-type calibrations—in order to reproduce prices of publicly traded securities. Then you utilize those models to price the securities that aren't publicly traded.

When is a value fair with respect to liabilities? First of all, the asset approach is a natural; in other words, it uses relative valuation tools. I called this the "direct paradigm" in a paper titled "Two Paradigms for the Market Value of Liabilities" in the October 1997 issue of the *North American Actuarial Journal*. Alternatively, we can "fair" value the equity of the surplus of the company and solve for liability. Again, surplus is equal to assets minus liabilities. Correspondingly, liabilities are assets minus surplus. If you know the value of assets and the value of the company's equity, then you can derive the value of liabilities. This approach was introduced by Dave Becker a number of years ago, and I refer to this, creatively, as the "indirect paradigm."

With that as background, let me talk about some of the advantages and disadvantages of fair-value reporting. The first advantage is that fair-value reporting gives the value of, and the risks in, your assets and liabilities. You get an immediate recognition of losses, real and predicted. By predicted, I mean you might have a shift in interest rates, do a valuation of your liabilities and assets, and find you have an unrealized potential loss or an unrealized potential gain. It also gives you information on the market-based cost to hedge some of your financial risk. If you're valuing assets and liabilities using the relative valuation tools that one uses in the financial markets, then, implicitly, you're valuing embedded options or other characteristics of those securities consistent with what it would cost you to hedge some of those risks.

Let's consider some examples of changes in risk for which fair value reporting would reflect a change in value. Obvious things that come to mind include changes in interest rate spreads, rate volatility, option efficiency, or any of the parameters one would use in a valuation model. The extent to which those parameters may change provides usually unrealized and sometimes realized losses. When I say realized and unrealized, I don't mean it in the strict accounting sense. For fair-value reporting, I think of an unrealized loss as a loss that would reverse itself if the assumption that drove it reversed itself. For example, if you have a bond and spreads widen, technically you have a loss associated with the fact that that bond is now being valued at wider spreads. I would consider that to be an unrealized loss because, if the company subsequently becomes upgraded, that loss reverses itself. Other kinds of losses, for example, a default, would not be reversible once you get paid off.

This is an advantage of fair-value reporting because it provides valuable information for investors and clients, and we all know that these stakeholders get impatient waiting 5–15 years for these kinds of losses to work their way through the statutory or GAAP financial statement. So, having an immediate recognition of these parameters would be important.

Unfortunately, this also leads to our first disadvantage: Under fair-value reporting, an insurance company looks very similar to a hedge fund, which we've heard a lot about in the news. An insurance company has a long position (its assets) and a short position (its liabilities). It has an equity leverage somewhere between 10:1 and 20:1 when you look at the ratio of liabilities to equity. And, when you're looking at the effects on equity of changes in the asset and liability valuations, you have a model that doesn't look too different from an underleveraged hedge fund.

If the fair value of liabilities exceeds the fair value of assets, it brings up some natural questions. Is the company insolvent? Should it be taken over? Should it be dissolved? Before you answer those questions, think back to the late 1970s and early 1980s. It's fair to say that any number of insurers might have been technically insolvent if one did a valuation using the methodologies proposed for fair valuation because assets were basically too long in those days. Liabilities had shortened, either because of lapses or loans, and the put options were rearing their ugly heads. In reality, the answer depends on how you evaluate fair value. Using the indirect paradigm, by definition, if the fair value of liabilities exceeds assets, that means the fair value of your equity is less than zero, and you are insolvent. If you're using a direct paradigm, it depends on the driving force. You could argue that, for potentially reversible changes in parameters, a company wouldn't be insolvent as in 1979–80. It's certainly going to be on everybody's watch list. However, if the company took losses associated with concentrations in its asset portfolio and subsequent losses, then I think the answer is, yes, it probably is insolvent.

Now for some more good news. The second advantage is that, with better information, there'll be less chance of insolvency. This is the early warning system justification for fair-value reporting. The fair values provide early warnings, and the changing risk profile gets immediately recognized in the company. The big hope is that risks are identified before becoming fatal. For example, I doubt that many insurance companies would have had such long bond portfolios in the late 1970s if they had been doing fair valuation of their liabilities. That's my optimistic side. The pessimistic side of me says that if they had valued liabilities in those days, they may well have ignored the put options and decided that their assets could have been a lot longer than they were. So, I don't know which side reigns.

There's also a disadvantage associated with this advantage, as there always is. It's that some risks don't get highlighted. If you go through all that work and effort, you would think that absolutely everything there is in the world to do with risk would be reflected. The obvious example is concentration risk. There's nothing in a valuation that would necessarily reflect the fact that you were overconcentrated in your assets. That wouldn't show itself until you took a loss associated with that concentration, and then it's too late.

In general, risks get highlighted only after some loss; for example, duration exposures, credit exposures, options, etc. You make the list. Most of those look fine unless you wanted to price them. If you wanted to misprice them, then you're dead at issue, as they say, in a fair valuation system. But if you price them reasonably well, then your fair valuation is going to be fine at issue and nothing will occur until there's an adverse change in one of the parameters for which you are underhedged or exposed. I think what we really need is not fair-value reporting, but fair-value sensitivity calculations. We need a multisector type of duration, spread duration convexity, etc. We need to know not only the fair value of a company, but also the characteristics of that fair valuation. From the mathematical perspective, we need to know not only the point estimate of our fair value, but also all of its partial derivatives.

On to the third advantage. Fair valuations are informative and fun. I say fun because there may be a couple of new Fellows in the room, and they still, at least hopefully, think this stuff is fun. It forces us to rethink the liability model, abandon our best-guess calculations and sensitivity models, and adopt the market-based relative valuation approach. We're going to need a deeper understanding of the financial markets for these calculations, and I think that's a good thing. It also forces us to model contract holder behavior and think about what drives it. And we're going to have to start monitoring, in more detail that we have been, the emerging experience relative to those valuations. Finally, fair-value reporting improves our risk pricing. We're going to be assured that the charge is at least equal to market price for our financial risks.

That brings us to disadvantage 3a. You can tell I didn't want to have more disadvantages than advantages, so I have three disadvantages: 3a, 3b, and 3c. Disadvantage 3a is that the fair-value calculations are sophisticated, but they also require a lot of judgment. In my opinion, you can't prescribe methods and assumptions in detail, and I know that that's a big negative for many constituencies. In my mind it isn't, but I think that some could interpret it that way.

Values are not necessarily going to be comparable from company to company. That's another big negative for some parties. And these issues raise an inevitable

question: Will the results be believable? Are actuaries going to be trained to perform the calculations in terms of both their technical knowledge and their market judgment? Are accountants, auditors, regulators, and analysts trained to evaluate what we produce? Another spin on this is, can the results be manipulated or disguised?

Disadvantage 3b is that many fair-value assumptions have no market-based comparables. We can't go into the market to validate that this particular judgment is the correct one. What we can do, potentially, is identify comparables in the market that make us feel better or worse about the judgments we make. For example, what's the proper spread of the liability? It's easy to infer at issue. It's difficult to update, and there is no unique way of updating how one evaluates the progression of the liability spread. There are a lot of valid approaches to this problem, but I don't think there's a best one at the moment. I sure have seen some poor ones.

If you think of the direct approach and look at liability as corporate debt, then the question becomes, how do you evaluate the illiquidity premium associated with that? And then there's the conundrum, how will policyholders behave? You might say the mortgage-backed security (MBS) market has already addressed some of those issues, but this market is consistently wrong in its assumptions about behavior, so we don't want to learn anything from them.

Disadvantage 3c is that fair valuation in the calculations involves a lot of unresolved issues, or at least a few. One is, should we use the direct or indirect paradigm? These approaches do give you different answers as to value, and I think they're probably always going to.

There's a question of taking the long versus the short position. Is the value of the liability to be insured on which we should add the option to be associated with the state guarantee funds, or is it relative to the insurer—the issuer of these guarantees?

We also have some questions about valuation constraints. Can the fair value of liabilities be less than the cash surrender value (CSV)? A lot of people say this is a crucial issue. Many will say, "No way! It can't happen." But one already sees a comparable situation in traded securities, where you can have an MBS trading for more than par. You might think this is kind of a conundrum. Why would anybody pay a buck or two for a security that is fully callable for a buck tomorrow? The answer is that nobody expects those thousands and thousands of mortgagors to roll their mortgages tomorrow. It's the same situation with CSVs, and I think it's equally defensible to have a fair valuation of liabilities below the CSV.

So, my summary judgment is that it's basically reminiscent of the anecdote on democracy. Fair-value reporting is probably the worst approach to valuation ever contemplated, except for any other method I can think of. Fair-value reporting is not the end-all system. But, even though it doesn't give all of the answers, it does give us the first meaningful step.

Mr. Wayne S. Upton Jr.: I have to start with the disclaimer that the opinions I will express are solely my own. Official positions of the FASB are reached only after extensive deliberation and due process.

I'd like to talk about the FASB effort in the area of fair value, paying some special attention to the problems of life insurance companies in particular. I have a quote from *FAS Statement 133* on derivatives, in which we said, "the board believes that, ultimately, all financial instruments should be carried in the balance sheet at fair value." Then comes the $64,000 question—"when the conceptual and measurement issues are resolved." That's a view held not just by the FASB. It's widely shared by other national standards setters and by the International Accounting Standards Committee (IASC), but it's reasonable to ask why.

Why would one reach the conclusion that we ought to move all financial instruments to fair value someday? It's important to focus on the fact that what we often call a "historical cost model" isn't, never has been, and never will be a true historical cost model. What we have is a mixed attribute model that's a pig's breakfast of historical costs and transaction prices adjusted for depreciation and amortization. We have some things in the balance sheet that are always at current value and others that are driven by any number of factors. So, to say we've ever had a historical cost is probably a misstatement. We have a mixed attribute model in which different things get carried at different amounts.

It's one of the complaints about *FAS Statement 115* that I've always found to be humorous. People say, "You have the asset and the liability side of the balance sheet driven by different measurements." Congratulations. It was always so. We just changed. That's not a ringing defense of *FAS Statement 115*, and I'd rather not be constrained to have to do so, but it does focus our attention on this question of a mixed attribute model and the problems associated with it.

One of the key problems in a life insurance context, is the disconnect between the asset and the liability sides of the balance sheet. The view of many is that that disconnect ought not to exist. I suppose I probably share that view, depending on what we mean by disconnect. If it means that I measure the assets and then plug in the liabilities to make them agree with one another, then that's not measurement in any scientific sense of the word. That's just the plug-in-the-accounting sense of the

word. When talking about measuring assets and liabilities consistently, the board typically wants you to use the same measurement attributes for both. If we move the asset side of the balance sheet to an attribute that we call fair value, we want the liability side of the balance sheet to move, likewise, to that same attribute. Then, any volatility that occurs, theoretically at least, would result from the assets and liabilities themselves, rather than a false volatility that some have been concerned with.

Another concern about our existing mixed attribute model is that it's largely realization-driven. For example, I have a portfolio of securities. If I want gains this month, I just pick up the telephone; if I don't want gains this month, I don't pick up the telephone. I can cherry-pick gains and losses in order to control reported income.

That leads to a couple of undesirable results, one of which is that the investment analyst community, in looking at insurance companies, largely ignores realized and unrealized gains and losses. That's as bad as relying on the cherry-picked one. But the ability to cherry-pick damages the credibility of the reported result altogether, and that ought to be an undesirable situation to all of us.

Finally, and most important, a mixed attribute model obscures the impact of market forces. Market forces are real and affect real companies in real ways. They ought to be incorporated in the financial statements to the extent that we can do so.

What then do we think fair value means? The official definition that you find in *FAS Statement 133* is our standard on derivatives. This is the definition of fair value that the FASB, and others, have been using for some time: "The amount at which an asset or a liability could be bought or incurred or sold in a current transaction between willing parties, other than a forced or liquidation sale."

We went on and talked about some notion of measuring financial liabilities and identified at least one objective—that we would look at, in the case of derivatives, interest rates consistent with settlement in an arm's length transaction.

The IASC definition of fair value is very similar to ours. Although there is no distinguishable difference between the two definitions, I think it's useful to decompose or deconstruct those definitions, paying careful attention to each element, because experience shows that the term "fair value," without these constraining factors, takes on sort of a Calvinistic tendency. All of a sudden it's "fair," as in appropriate or justifiable, for things that aren't really attached to a notion of a market.

We need to start out with the idea that fair value is a price. And we are attempting to set a price. Markets, after all, are information systems, and the information that they communicate comes to us through prices. So, any attempt to construct a number that does not satisfy the notion of a price fails immediately to be a fair value.

Second, it's the price of a current transaction—a transaction that could take place today between a willing buyer and a willing seller—not one that we hope might take place at some point in the future or an average of several transactions over time. We're looking for the amount at which it would transact today. Third and fourth, we're looking for a transaction that would truly settle or transfer the insurer's obligation.

Our definition of "settlement," both in the U.S. and in the proposed IASC literature, involves complete separation of the liability from one entity and transfer to another. Reinsurance, by and large, would not qualify under this definition, except in the most limited cases. Most of the transactions that we see are not true settlements because the original insurer is not removed from either primary or residual obligation.

Because we won't see those transactions in the marketplace, we're going to have to construct some notion of what we think fair value would be if we could see one of these transactions. Here are some alternative approaches. CSV is one approach. The family of embedded-value approaches, popular in the U.K., is used there as supplementary information or an alternative. Then we have an array of present-value approaches.

One of the key points to keep in mind as we walk through these alternatives is a real desire to focus on measuring the liability, rather than measuring the liability and something else. One of the problems that has come up, for example, is in the context of the so-called indirect methods because we measure the assets that we think we can identify and somehow measure the equity. We never know for sure whether some other factor, real or financial, has sneaked into the process.

Similarly, there's a problem when we look at the prices paid in business combinations, because very frequently a strategic factor or element creeps in that we wouldn't otherwise expect to see. We have to keep our minds focused on measuring the liability that we have in front of us. Accounting, after all, is a process of measuring a bunch of assets and liabilities, rather than attempting to capture the value of the entity taken as a whole.

One candidate is CSV. It certainly is the price of a transaction, so it meets that criterion, and it's easily measurable. It's not very popular among many who've examined the effects of fair value because CSV largely doesn't change with the changing interest rate environment. However, it's an observable transaction that happens every day.

There are a couple of downsides to CSV, one being that it's not a worldwide phenomenon. The American practice of having nonforfeiture values and contracts has not been adopted in all countries. So you have to ask yourself what you'd do if you didn't have a CSV if you hitched your wagon to this star.

The more subtle difficulty with CSV is that it rests on an option that the insurer has no ability to realize. The insurer cannot initiate a transaction to retire all of his or her policies for CSV. They're not callable at that amount. That raises a real question about whether this is an appropriate value, and the board, by and large, at least tentatively, has rejected cash surrender or demand-type valuation and looked instead to values that are based on the characteristics of a portfolio. That raises the interesting question of whether our definitions of assets and liabilities, which were developed in a different world, are equally useful in a fair-value context.

I won't spend a lot of time on embedded value, but it means somewhat different things to different people. It's largely similar to U.S. business combination accounting, in which there's an attempt to attach a value to the stream of distributable profits emerging from a book of business while typically pegging the liability to the regulatory liability.

That raises several significant problems, the biggest of which is that the embedded-value approach could be measuring something else. Are we recording some sort of an internally generated intangible when we go to an embedded-value approach? Finally, there's the list of present-value approaches, which are often the only choice. You could say that embedded value is, in fact, a subset of a present-value approach. We're all familiar with the mechanics. We always stumble, though, on the ultimate question: What do we think about discount rates, risk adjustments, and things like that? I have, on many occasions, said that the rate earned on assets is irrelevant to the measurement of liabilities. I no longer believe that in its entirety. There's no question that, if I promise to deliver 100 shares of IBM stock, the value of that promise is highly correlated with the value of IBM stock. The problem, of course, is that almost no insurance obligation comes anywhere near that level of correlation. We're faced with the problem of the guy in the Hertz ad who's constantly having to say, "Well, not exactly." As it turns out, experience has told us that "not exactly" can be very important.

What are some of the other questions that we have to deal with in an insurance context? Clearly we have to talk about acquisition cost. What's the role of acquisition cost in a fair-value model? Why would you even consider the notion of deferred acquisition cost (DAC)? The answer is that you either have to consider it or admit that it was never an asset and shouldn't ever have been on the balance sheet in the first place. That is a dilemma that we all have to come to grips with. Either we believe that there's some kind of an asset that's created when we create a book of long duration or short duration insurance contracts and that DAC represents something about that asset, or we have to conclude that we've been wrong for the past 20 or 30 years in ever capitalizing DAC in the first place. It's not as simple a question as it seems.

First, there's the question of whether, in a fair-value world, you recognize gain or loss on sales. There are those who believe, and I think Paul is one, that there's absolutely nothing inconsistent about the notion of recognizing any gain on sale in a fair-value model. There are others who remember some of the problems that occurred during the Baldwin United days and are a little nervous about recognizing a gain or loss on sale. This is clearly an issue that has to be resolved.

Another issue is the insurer's credit standing and, in particular, changes in credit standing. If there is an issue that is controversial internationally, the question of credit standing and the fair value of liabilities is probably the biggest one on the list. If you believe you're in a fair-value model, and a company declines from a AAA to a C rating, what do you believe that does to the fair value of its liabilities? Do they remain unchanged? They can no longer be settled for the same amount, other than at CSV. They've taken on a different character.

But that has some potentially counterintuitive implications. As the company's credit standing declines, what happens? If you're in a fair-value world, you wind up recording a debit to the liability. And, because we still believe that the debits have to equal the credits, you have to put a credit someplace, probably in the income statement or in a statement of changes in equity. People find it troublesome that a company might make profit from a decline in its credit standing. Others aren't disturbed by it at all. They view a company as having two sets of owners, those who own liabilities and those who own equity, so a decline in credit standing is just a transfer of wealth from the debt holders to the equity holders. Maybe it's not net income, but it's a change in their relative positions.

The board has tentatively concluded in the present-value project that the relevant measurement of a liability always includes a company's credit risk. It is either measured in initial recognition or remeasured after initial recognition. Remeasurement, we believe, is a fresh-start concept, (as opposed to amortization, in

which we're just running something off) that is roughly comparable to locking and unlocking. But when you're measuring a liability, the board has concluded that the relevant measurement of fair value should always include the entity's credit risk.

There's an ongoing debate between those who are largely skilled in finance theory and those who are largely skilled in actuarial theory about the proper role and price for risk. I've often threatened to put three finance theory people and three actuaries in a room and lock the door, and believe whoever comes out alive. The finance perspective holds that there is no risk that is priced other than nondiversifiably in a capital-asset-pricing-model sense of that word. The actuarial theory says, "You have to be kidding. Nobody takes on uncertainty for free." These theories are fundamentally in conflict with one another. It's an issue that we have yet to resolve fully.

Mr. W. Paul McCrossan: I'm going to touch on recent changes in Canadian financial reporting that have allowed for a single set of financial accounts to be used for published financial statements for regulatory purposes and even for income tax purposes. I'll also touch on recent developments concerning a possible new set of international insurance accounting standards.

This is the first time that most of you will have been exposed to the potential that can arise from adopting new international accounting standards. In my view, the IASC's insurance accounting project poses a historic opportunity for accountants, actuaries, regulators, members of the insurance industry, investors, policyholders, and the public at large. That's a very heady notion that deserves some elaboration. I will start with the assertion that none of the existing financial accounting or regulatory bases convey sufficient information to enable even for those expert in the field to assess the current financial position and the expected future financial condition of insurers. That does not imply malice on the part of previous generations. Rather, it's the result of attempts to protect the public by regulators on the one hand, married with attempts to graft historical cost-based accounting onto a long-term, future-oriented business on the other.

The IASC's current international accounting project for insurance has the potential to cut through this Gordian knot, but the standard will first have to meet three criteria: It will (1) have to become generally accepted throughout the world as the gold standard for insurance accounting, (2) become recognized as the appropriate platform on which to build a new regulatory international regime, and (3) be future-oriented rather than historical-cost-oriented, most likely through the embedding of fair-value reporting techniques.

For this to happen, in my opinion, there must be an active agreement among the four key players in the insurance industry—the accountants, the actuaries, the regulators, and the industry itself—to work cooperatively on the project and make decisions, at the margin, consistent with each other's principles to accommodate each other's needs. We're not there yet, but at least the main players are at the table in the IASC project.

Because actuaries are supposed to be oriented toward the future, let me take a crack at outlining what constraints there might be for such a project to succeed. My first thesis is that all existing national standards are too nation-specific to form a robust, internationally uniform, financial reporting platform. Therefore, I conclude that any standard that meets my three objectives cannot look like any existing national standard.

My second thesis is that the current trends of rationalization and globalization inside the insurance industry and integration across the financial services sector will accelerate. This leads me and the IASC steering committee to conclude that any new standard must be based on accounting for insurance contracts rather than for insurance enterprises.

My third thesis is that, because insurance is a future-oriented endeavor, the financial information needed by the users of insurance financial reporting must be oriented toward the future rather than toward historical cost. This leads me to the conclusion that, to meet my three objectives, the information about the assets and liabilities associated with insurance contracts must be both current and future-oriented. Although this conclusion would not mandate fair-value accounting, fair-value accounting would satisfy the conclusion.

My fourth thesis, which is also shared by the IASC steering committee, is that insurance contracts are financial instruments. Because a decision has been made that accounting for other financial instruments should be on a fair-value basis, consistency problems will arise at the borders between insurance contracts and other financial instruments from every decision not to implement a full fair-value platform.

My fifth thesis is that the application of fair-value accounting to insurance must lead to assets and liabilities that reflect the price at which a willing buyer and a willing seller would trade the asset or the liability. Because the market sets prices based on the best information available, this means that actuarial liabilities cannot be determined on the basis of prescribed future experience, but must reflect best estimates of future expected experience or even the probability distributions of

future expected experience. This conclusion is likely to cause trauma among some regulators.

My sixth thesis is that a rational buyer will not assume an asset or a liability without the expectation of profit over a risk-free return. This leads me to the conclusion that a fair-value liability must be greater than a best-estimate liability, just as we can document that quality premiums on assets to reflect increased risk on investment grade assets is greater than that demanded by the inherent credit risk exposure.

My seventh thesis is that the market demands far less of a premium over best-estimate liabilities than any regulator would feel is sufficient for regulatory purposes. This leads me to the conclusion that the focus of the regulators must shift from adequacy of liabilities alone to adequacy of liabilities plus risk-based capital (RBC) to meet the prudential expectations of the public if the new fair-value accounting model is to form the platform for regulatory accounting.

My eighth thesis is that company actuaries are likely to have the best tools and information to determine the best estimates of future expected experience. However, they're not currently widely regarded, internationally, as being sufficiently independent of company management to be entrusted with the determination of these best estimates. To me this means it is "fish-or-cut-bait" time for the actuarial profession worldwide. Either the international profession takes steps to ensure the objectivity of the appointed actuary or the users of financial statements will not accept that the inside appointed actuary can determine the actuarial liabilities. This may give the actuarial profession heartburn globally because it demands that the professional actuary come out from behind the safe harbor that has been so elaborately constructed and accept professional accountability on a personal level.

Canada has developed a single set of financial statements for both financial and regulatory purposes to be used for the calculation of corporate income tax for post-1996 business. The actuarial liabilities deemed appropriate by the appointed actuary are regarded as sufficiently objectively determined for these purposes, even though they involve the exercise of professional judgment by the appointed actuary. Furthermore, for over a century, the large Canadian life insurers have offered it widely throughout Asia and parts of Europe as well as in North America using products that meet local needs and traditions.

The Canadian policy premium method (PPM) platform would seem to meet my first two objectives for a new international accounting and regulatory platform. However, while PPM is a wholly future-oriented platform based on the best credible

expected experience, it's not based on fair-value concepts but rather on cash-flow matching concepts.

Let me elaborate. In Canada, the appointed actuary must make explicit best estimates of every material future contingency, except for reinvestment or disinvestment, which can be prescribed by the profession, and use these best estimates, together with provisions for adverse deviations (PFADs), to establish actuarial liabilities. Choosing the PFADs, which are designed to reflect the credibility of best estimates, is governed by comprehensive directions established by the CIA. The underlying principle is that the asset and liability values must be determined in a consistent manner in order to lead to credible results.

In Canada, the actuary determines expected future benefits, expenses, and premium cash flows reflecting all material contingencies and uses of the expected cash flow from assets that have expected defaults to match the expected policy cash flow. If the cash flows can be exactly matched, the value of the actuarial liability is the value of the matching asset. The value of the assets on the balance sheet is not determined by a fair-value process but by a combination of historical accounting and adjusted marked-to-market bases that reflect both realized and unrealized capital gains for equities in real estate. However, because the balance of any realized or unrealized capital gain is not recognized and the value of the assets on the balance sheet can be recognized in the calculation of the actuarial liabilities, the assets and liabilities are determined in a consistent manner.

The same occurs even for noninvestment assets such as deferred taxes. Accounting for life insurers in Canada requires discounting. Accounting for deferred taxes in Canada prohibits discounting. The two approaches are reconciled by the appointed actuary holding the difference between the discounted deferred tax asset (DDTA) or discounted deferred tax liability (DDTL) and the similar undiscounted amount shown in the balance sheet in the actuarial liabilities. This reflects the fact that most of the DDTA or DDTL arises from timing difference between the release of the GAAP liabilities and the tax policy liabilities.

The Canadian PPM differs from what I postulated would be a robust platform on which to build a single set of financial statements used for accounting and regulatory purposes in three ways, of which, I think, two are major and one is minor. First, assets are not held at fair value. Nevertheless, in my opinion, asset values could be readily moved to fair values without disrupting PPM.

Second, where exact matching cannot be achieved between expected future asset and liability, cash flows margins are built into the actuarial liabilities. These

margins are prudently required. However, in my opinion, they can be stripped out of actuarial liabilities and put into required RBC where they belong.

There is no deep, orderly market for insurance liabilities. PFADs are used to increase actuarial best-estimate liabilities to cover statistical misestimation using detailed professional guidance. As a consequence, the actuarial liabilities in the Canadian balance sheet are not determined by the market. My principal practice is acquisitions and mergers. So my observation is that, when companies or blocks of business are bought and sold in nonstrategic situations, the actuarial liabilities calculated under PPM are very close to the fair value of the liabilities assessed in the marketplace.

I mentioned earlier that the world's actuarial organizations might have to move away from their safe harbors and impose severe standards of objectivity if company actuaries are to be allowed to continue to produce the best estimates that underlie the actuarial liabilities. The CIA has taken such steps for not only life insurance valuations but all valuations required by law and all valuations prepared for an auditor.

As an aside, I might mention that Canada's chief actuary was fired by the government in August, and there's a substantial body of professional, political, and public opinion that suspects he was subject to political interference with his objectivity. The professionalism and objectivity of this particular chief actuary was so well-established that the story occupied the front pages of newspapers for weeks, and the government has now invited the CIA to peer review the report prepared by his replacement to calm the political storm. This demonstrates how far the CIA has come in establishing that the professional actuary in Canada cannot be seen to be the mouthpiece of management, whether corporate or government.

Where is the IASC project now? It was approved by the IASC board in April 1997, and there have been three steering committee meetings to date. The IASC board is now considering a detailed point outline of the scope of the project. The International Actuarial Association, the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissions, and the International Financial Analysts are all represented at the table.

Unfortunately, in my view, while there is interest among all of the participants in seeing whether the project can lead to a single set of accounting and regulatory financial statements, there's no commitment on the part of the participants to give it their best shot to try to make this happen. I fear this will prove to be a fatal flaw in the end because there's no onus on the participants to try to develop a standard that

accommodates the imperatives of all of the parties, within each party's own principles, during the standards-building process.

Nevertheless, progress is being made. The steering committee will recommend that the new standard deal with insurance contracts rather than insurance enterprises, which should minimize accounting arbitrage based on corporate structure. The committee has developed a very robust definition of insurance contracts that recognizes them as a subset of financial instruments under which a payment is to be made if an uncertain future event, other than a change in a price or an index, occurs. Because pensions and other employee benefits would fall under this definition, they've been excluded from the scope of the project and will be looked at the end of the project.

However, there are immense changes ahead. The insurance industry, the accounting profession, and the actuarial profession have not yet reached a common understanding about how to estimate the fair value of insurance obligations. In fact, the discussions last week demonstrated that the parties have not yet agreed on what is an insurance obligation or what is, more properly, RBC required by prudence. The steering committee favors a fresh-start approach to the determination of actuarial liabilities, under which they would be determined using the best credible estimates of future experience. However, it wonders whether the resultant volatility might be sufficiently distracting to warrant the use of a corridor inside which gains and losses might not be fully recognized.

The steering committee considers the liability management perspective to be more consistent with the IASC framework, but it is unwilling to consider that the sale of an insurance contract could result in a profit. It favors profit recognition on release from risk over contract lifetime. Coming from a country where insurance, just as any other industry, can generate profits at the point of sale based on best estimates, I find this somewhat bizarre and incompatible with my notion of fair values, but I'm there at the table to learn. The original timetable called for an issues paper to be published before the year-end. However, the steering committee was unable to complete the study of the issues, and at least one more three-day meeting is anticipated before the issues paper can be published.

In my view, the single most important issue to be resolved is not yet, to the best of my knowledge, on the table. That is, whether the IASC and the IAIS, supported by the other key players, should formally adopt the objective of trying to develop a single set of financial statements suitable both for accounting and for regulatory purposes. Without such an up-front commitment from both the IASC and the IAIS, I believe the end product will not meet the objectives that I outlined and the opportunity for this generation.

I view the adoption of a new international accounting standard for insurance that can largely or completely supplant the existing national standards as a neat idea. But I view the adoption of a new international regulatory regime that can largely or completely supplant the existing national standards as a necessity, given the rapid emergence of the global financial services industry. Each day we see evidence of how financial events in one part of the world can cause systemic changes in the rest of the world. In my view, the international insurance industry is particularly vulnerable to such contagion.

If the IASC does not invite the IAIS to participate jointly in the development of a financial reporting platform sufficiently robust to serve both for accounting and regulatory purposes, the world's actuaries should press the IAIS to develop a new international regulatory platform that can achieve international acceptance. And the world's actuaries should concentrate their scarce resources on the project that will likely matter most to the public—the new international regulatory regime.