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### International Financial Reporting Standards

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Recorder: SAM GUTTERMAN

*Summary: Investment bankers, stock analysts, rating agencies, and other organizations have always encountered difficulties in assessing the profitability of insurance companies with significant international operations. The absence of a single international financial reporting standard has prevented insurance companies from receiving the full benefit of participation in global financial markets.*

*Topics covered include the need for worldwide Generally Accepted Accounting Principles, accounting and reserving standards, and, in particular, the work being done by the International Accounting Standards committee and the International Organization of Securities Commissions.*

Mr. Sam Gutterman: I'm going to talk about International Financial Reporting Standards following up on Session 125PD, "International Valuation Coming Soon to a Country Near You" held at this meeting. That session particularly challenges both Mo and I as members of the International Policy Committee of the SOA. Be that as it may, I would like now to turn our attention for this session to International Financial Reporting Standards.

As a very brief introduction, Mo and I will serve as your panel on this topic. We are both members of the International Actuarial Association's Insurance Accounting Standards Committee (IASC) as is at least one other individual here, Bruce Moore. Mo has served the profession as president of the Canadian Institute of Actuaries (CIA), a vice-president of SOA, and later in 1999, he will begin his term as president-elect of the International Actuarial Association (IAA), and president the following year.

I would like to give a brief outline of our presentation. We'll begin with a discussion of the background of the current IASC Insurance Project. Although we will be focusing on insurance, particularly in a question and answer period, for which I hope

to have a significant amount of time available, we can also entertain any other questions you have on any of the other areas, beyond strictly insurance.

Mo will begin with a history of the IASC and, as well, of the International Actuarial Association. I will then follow up with an aspect of the issue that is not often discussed—the need for such an insurance accounting project. I'll follow that with a very brief review of current practices in the area and what I think the key issues are.

Mo will then describe the International Actuarial Association's position to date. This is still in draft form and is evolutionary in nature. Finally, we'll talk a little bit about the implications of these developments.

Mr. Morris W. Chambers: I recognize a handful of faces for whom this topic is somewhat old hat. If they will indulge me, I'll undertake a short review of how we got to where we are today, wherever that may be. There is, associated with this activity, a real montage of acronyms, a veritable alphabet soup of initials, which represents the participants in recent and current international accounting developments. Most prominent among these is the IASC. It is an association of the professional accounting bodies in over 100 countries. It was formed in 1973 and is based in London in the U.K. The IASC does not include national accounting standard setters, such as the Financial Accounting Standards Board (FASB), except as invited observers. Some of those standard setters are at the table, but they have no vote. A unique exception to that is Canada, where the standard setting function itself is conducted from within the professional organization, the Canadian Institute of Chartered Accountants (CICA).

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

Lurking in the background of the international accounting scene is a rather shadowy group known as the G4+1. The G4+1 comprises the national standard setters of the U.S., the U.K., Australia, and Canada, plus the IASC. New Zealand has recently joined this group, but in the spirit of college football's Big Ten, it staunchly continues to identify itself as the G4+1. Several European bodies have asked to join, but they have been turned down. The G4+1 is a 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 does add intellectual rigor to national deliberations, and it permits sharing of scarce resources and reduces accounting arbitrage among members. Continental Europeans have looked upon it suspiciously as a breeding ground for nefarious Anglo-Saxon plots. It does have some influence over the IASC since G4+1 members could, by

influencing their country's IASC representatives, effectively block any developments within the IASC.

The principal driver of IASC activity over the past few years has been an agreement that it reached with the International Organization of Securities Commissions (IOSCO). With the rise in active trading of shares in international stock markets, IOSCO became concerned about the lack of consistency in financial reporting for jurisdictions within which these markets operated. Consequently, in 1994, IOSCO asked the IASC to develop IAS that would be imposed on, or available to, multi-national corporations who wish to register their shares for trading on multiple international exchanges. The IASC, not surprisingly, has taken up this task with some enthusiasm, because successful completion promises to make the IASC a much more formidable force to be reckoned with in financial circles.

Critical to obtaining IOSCO endorsement was completion, before 1999, of so-called core standards in 12 subject areas. With the adoption late last year of IAS 39, which deals with recognition and measurement of financial instruments, the initial goal has been met. Insurance, however, is not part of the core package. Nevertheless, the financial instrument standard is important because it includes insurance contracts within the definition of financial instruments. But then, it excluded insurance from consideration for the time being. Another of the completed standards, IAS 37, has also excluded insurance.

I should note at this point that the topic of financial instruments is being considered on another front. In the fall of 1997, a Joint Working Group was created to develop, what its chairman has described rather effusively as, the "grand unifying theory of financial reporting for financial instruments." The Joint Working Group represents 10 accounting standard setting bodies: Canada, the U.S., the U.K., Australia, New Zealand, Japan, France, Germany, the Nordic countries as a single representative, and the IASC. Some members of the group hope that an exposure draft will be ready by the middle of 2000; others consider that timing to be somewhat overly optimistic.

One of the standards addressed early by the IASC was "Accounting for Employee Benefits," IAS 19. An exposure draft of the proposed standard had been published just about the time that the International Forum of Actuarial Associations (IFAA) was founded in Brussels in 1995, as a section of the IAA. The timing of the establishment of the IFAA was truly fortuitous, because it created a global organization through which actuaries could present a uniform position in identifying certain actuarially inappropriate elements in that draft accounting standard. While not successful in rectifying all of the problems with that standard, the IFAA did ultimately have a significant influence on it. When it was finally adopted in January of 1998 as IAS 19, many of the IFAA's proposals had, in fact, been incorporated. There is some expectation that the most significant remaining issue could be modified in the future, after the insurance issues are dealt with.

I've referred to the IFAA and, in order that I not get confused myself and not confuse you, I should remind you that in 1998 at the Birmingham Congress, the

IAA sort of turned itself inside out. It became the IFAA, but retained the name IAA, so that now the IAA is an organization of organizations. In the rest of my comments, while I may be referring to either the IFAA or the IAA, I'll only use the term IAA.

The IASC has turned its attention to insurance accounting as a special topic, and it has formed a steering committee to develop proposals. Reflecting the degree of recognition achieved early by the IAA, Paul McCrossan of Canada has been appointed to that IASC Steering Committee as a nonvoting observing member representing the IAA. More recently, Paul has been recruited to serve as one of the three or four members of its technical drafting team. I think having an actuary on a technical drafting team for an accounting standard is something of a coup.

I should also point out that a related topic, discounting, has been pulled out as another special topic and Sam has been selected as the IAA's liaison to that accounting standard development team.

Meanwhile, in 1997, the IAA had formed a committee whose specific charge was to prepare IAA positions on insurance accounting and to monitor the work of the IASC. The committee, again chaired by Sam, includes representatives of 21 different actuarial organizations from 17 countries around the world. The IAA committee has met seven times in the past 30 months, most recently on August 28 in Tokyo. During that period, the committee, which does much of its work through the Internet facilities, has prepared and delivered a number of commentaries on, and responses to, accounting proposals of the IASC and the G4+1.

At this juncture, if Sam will permit, I'd like to jump to a somewhat different, though related topic. Sometime in 2000, FSAs are going to receive a proposal for a change in the Constitution of the SOA. I've referred to a number of submissions that have been made by the IAA to the IASC and to other bodies. In those submissions, the IAA identifies those organizations that have endorsed the position being taken. At the moment, the SOA Constitution, in particular Article X, essentially bars the Society from making public pronouncements of any kind. It doesn't quite say that, but it makes the bar that you have to leap over so difficult, that it is literally impossible for the SOA to make a public pronouncement in a timely fashion, as is required for something like these submissions.

As the largest actuarial organization in the world, the SOA name certainly should appear on those documents; particularly since the SOA representatives on the committees of the IAA have been very deeply involved in the preparation of those documents. I guess my plea to you is, when you receive that material, vote and give your support to these constitutional changes. The changes will give the Board of Governors, with some very high requirements of super majorities for approval, the right to speak on behalf of the SOA in respect to this sort of material. Undoubtedly, there will be those who will say that this is a plot. It will give too much power to the Society Board and it opens the door for the Board to get involved in backing candidates in the 2000 election or other improper activities.

Nothing could be further from the truth. It is really, in my view, (and I have to confess that I've been pushing this for some time) an attempt to have the SOA represented where it should be, which is on the world stage where these kinds of proposals exist. In particular, in this case, it is with respect to the IASC. So if there were such a thing as a platform, I would stand on the platform and plead that, when the opportunity arises, vote for this change in the constitution.

As I said, the IAA Committee, which does much of its work through the Internet, has prepared responses and commentaries on proposals to the IASC and the G4+1. The submission of those materials has been with the noticeable absence of the name of the SOA.

The IASC Steering Committee on Insurance had set an aggressive timetable for itself in preparing these insurance materials, but nevertheless, the schedule does incorporate the IASC's due process. The point outline of the project essentially clarifies the scope thereof, and it was approved on schedule, by the IASC board in 1998. The Steering Committee is currently running about a year behind schedule with respect to the next stage, its Issues Paper. The Steering Committee has met three times in the past year to develop this document, and it is expected to be made available by the end of November of 1999. I understand that, without the examples and the appendices, which are likely to be voluminous, the paper will comprise about 200 pages of material. The Steering Committee's Draft Statement of Principles is to be published soon, with IASC Board approval of the final Statement of Principles still expected in the third quarter of 2000. An exposure draft of the standard itself will now probably be submitted for Board approval in the first quarter of 2002; and the final International Accounting Standard for Insurance is expected in the first quarter of 2003.

Mr. Gutterman: I intend now, briefly, to deal with the need for an International Insurance Accounting Project. There are obviously several needs that are being addressed, otherwise the Steering Committee would not have spent two-and-a-half years, to date, without publishing anything. There are obvious motives to undertake this, such as the growth of multinationals.

Just by a raise of hands, how many people here are associated with an insurance company that has operations in more than one country? Just about everybody. The others are obviously consultants.

There has been an increase in the number and size of the capital markets. I'll add a little more about this later. There is a current lack of IAS. They don't exist. There are many countries without any standards at all. Dozens of them are making use of the IAS.

There is a need, in fact, a demand, for increased transparency in terms of corporate accounts overall. This is increasing and fueling the need for IAS in general. Where is this demand coming from? There are several sources. One is financial analysts. Second is investors and, in some cases, even management.

The need is also fueled by product changes. The panoply of insurance products, worldwide, is wide ranging and not particularly well served by any particular accounting standards. Attempts have been made to apply U.S. GAAP in certain countries. Some applications are extremely difficult.

Capital markets are obviously very important in this effort, and are becoming more important as time goes on. The importance of the U.S. markets in particular, especially New York managed and monitored by the SEC, leads to the question of whose standards will be international. Although Mo has suggested that they will be those of the IAS Committee, there are at least some, particularly in the U.S., who may disagree with that. As a matter of fact, in the Monday, October 18, 1999 issue of *The Wall Street Journal*, had a first page headline that says, "U.S. Accounting Board Faults Global Rules." It goes on to say that Federal Reserve Chairman, Alan Greenspan, has already said that the world needs reliable, high-quality accounting to ward off future financial disasters. One global set of rules would also better protect Internet day traders, who are increasingly plunking money into foreign companies in countries such as Russia and South Korea. For now, it's looking increasingly that there will be two sets of accounting standards dominating global markets, the U.S. rules and the international ones.

This is an issue that is really not yet decided and some people have waited for the SEC to indicate whether they would accept IAS rules. I think the jury's still out. There will be a great deal of politics involved. There are a lot of compromises up ahead, but whatever the source of the IAS, I think there will be a set, thereof, maybe two.

Then there's a trend toward multiple listings. Many companies are listing, or seeking a listing, on multiple stock exchanges or bourses. The problem with that is, how many sets of books will one company prepare?

One question that has been asked is, "What's the problem with what we have now?" A number of people have asked that. I made a presentation last month and one actuary from one company said, "Boy, we're pretty satisfied with what we have now in accounting. Not only is it producing relatively stable results, but if we also make changes, we might add other problems such as adding more subjectivity."

There's also a concern with lack of transparency. Insurance accounts are complex and difficult to understand. How many people other than actuaries really understand, particularly life insurance, financial statements? Not many. I don't think there's a real need for an additional set of books. Personally, I think people who are struggling now on monthly reporting, on statutory regulatory accounting, generally accepted accounting, tax accounting, and in some cases, management or economic value-added accounting, aren't particularly looking forward to an additional set of accounting rules. But as Mo indicated, there are no rules. So far, we haven't had to worry about that. In fact, the IASC doesn't have any specific industry rules. It's now permanently struggling with that issue. Indeed, one of the issues that the SEC has raised is that the IASC rules are not as robust or

comprehensive as those in the U.S. There are no industry-specific standards, so that is something that the IASC is trying to deal with in industries such as insurance. I won't bore you too much with U.S. GAAP practices, because I am presuming most of you already know this, but clearly its basic foundation is in historical cost methods, with deferred acquisition costs amortized with various rules, and an emphasis on matching. As I have understood it, one of the principles of accounting was matching revenue and costs. But each standard, *SFAS 60*, *SFAS 97*, and *SFAS 120* of the FASB in the U.S. has different fundamental philosophies about what is revenue and about whether insurance is a service industry or a risk-bearing industry or a mutual industry. They have different definitions, some of which are of liabilities, some of which are actuarially related, calculated, net-level based, locked in, have provisions for adverse deviations or not, or are account-value based (something that accountants certainly can count). The point here is that these standards represent a wide variety of different philosophies, and none of them are consistent with the concept of fair value.

Some people have indicated they feel Canada is the closest to using fair values, because its regime is prospective in nature, other than for accumulation products. Bonds are valued at amortized cost. Liabilities depend on actual assets rather than, as fair value type rules are, on a replicating or synthetic portfolio. Liabilities, in some cases, reflect part of what could be allocated surplus or part of their provision for adverse deviation. However, there is a strong reliance on actuaries. The GAAP liabilities equal statutory liabilities and equal, in most cases, tax liabilities. Supplemented by dynamic solvency testing, there is a strong rule for actuaries, which I deem to be good, for improvement of the profession as well as the accounts.

In the U.K. there are mixed practices. Over the last couple years, I think we've seen two or three generations of accounting rules introduced. In fact, there is the additional element of embedded values disclosure. A recent industry position in the U.K. deals with achieved profits, which I won't go into, because it also is not fair-value based.

I have heard it said, by the CFO of one multinational insurance company, that Australian accounting is a fair-value-based system, but that's not really true. Its basis is that insurance is a service contract, that margins for services should be the basis for measuring revenue, and that revenue should be related to the primary profit center or carrier. Term insurance mortality, endowments, annuities, and interest are aspects of the Australian system that are not treated in a manner consistent with a fair-value method. Their approach uses best estimates with margins. Interestingly, no profit is recognized at issue of an Australian contract, which can be considered fair value on an entry-priced basis. In fact, if you accept the premise that the price of a product is the fair value of that contract, then at issue you shouldn't have any profit. Assets, in Australia, are marked to market.

I think the conclusion is that in today's world, not only is insurance accounting complicated and difficult, but also the methods utilized are expanding rather than contracting.

I think one of the most significant issues is whether to move to fair values. It certainly appears that, at least for financial instruments, fair value is intended to serve as the basis of a new accounting paradigm. That is, if there is a liquid market in an instrument, whether it be a commodity, a debt, a security, or whatever, then the appropriate method of accounting is proposed to be something that you can validate against a market. But there are significant areas of resistance to this concept. I don't want to belittle that resistance because the politics associated with fair value are or will be fierce. I'm sure that it will, if it hasn't already, hit the U.S. Congress as it has for some other accounting issues.

I'll just mention one other such issue very quickly, which is banking. If anyone follows the debate in the banking industry (and I encourage you to at least look at it), you will find a very representative sample of the debate on the IASC web page, which is, <http://www.iasc.org.uk>. There you will find, and be able to download a statement by the Joint Working Group that Mo mentioned, specifically on banking issues and also a banking industry response. These represent fairly thick documents, but I think it would be very fruitful reading. The banking industry has said that they are in favor of a modified historical type of accounting. It doesn't understand the need for radical change. It contends that fair values are not sound and that they lack relevance for investors and management. The values can be very subjective and fair values place too much focus on trading and short termism. They are also volatile. Those are the issues that fair values have to come up against with bankers, but what is interesting is the bankers in these discussions focus their attention primarily on their banks' liabilities. I think there's general agreement that fair values are a sound basis for assets.

Interestingly enough, I think the one position that the IAA has come out with (and Mo will elaborate on) is that if assets are valued at fair value, liabilities should be also.

Another point made is that this is a significant change, particularly in insurance. Fair-value reporting is untried in its true form. That means that everyone will be disadvantaged. Some in insurance feel, as does the banking industry, that it is less objective and comparable. Whether or not that is so, how much manipulation can be introduced is an issue. The underlying question here is, whether it's really impractical for liabilities to be determined using fair-value principles. That's the central focus on the debate.

Going back to other key issues, comparability is one. Multiple systems or more than one system is, I think, unacceptable in today's global capital markets as money goes back and forth from country to country and, in fact, between stock market or bourse to options or futures markets. I think that some people in the insurance area will argue that continued nonuse of fair values will result in lower capital valuations for the insurance industry. If based on statutory values, which is what embedded values are, and since worldwide statutory values differ and are very inconsistent, non-comparable results will emerge.



Transparency is another issue. I had mentioned that the current systems are difficult for most people, and even some actuaries, to understand. Financial analysts, with whom I speak regularly, complain that most GAAP systems do not provide enough information. They like embedded values to some extent because they provide more information and give them source data that they can utilize. The fundamental cause of reporting problems in the insurance industry is the long-term nature of our business, at least the life insurance business. An additional cause is the different experience and different products, both worldwide and varying company to company.

Earlier I mentioned that another key issue that the banks have raised is objectivity. Estimates have to rely on judgement, by necessity. I find very interesting in my discussions, as a member of the IASC Discounting Committee, the comments of individual accountants asking, "How do we estimate this, and how do we find out the fair value of a liability? We can't look it up in a market. How do I touch and feel a fair value?" I think the actuarial profession can overcome this concern to a great extent, but there will remain a fear of manipulation, whether by management or by actuaries. I think this may be, in terms of potential problems with objectivity, the prime reason why fair values for liabilities might not be implemented.

I won't go into the role of the actuary because Mo will be covering that shortly. I think the issues of whether actuaries can avoid conflict of interest situations and whether standards, as developed by the IAA or other organizations, will be strong enough, will be crucial to overcoming this concern. I think there will be a significant discussion regarding reliance on the actuaries' professionalism.

Another key issue is relevance. Fair values may not reflect the current assessment of value. I think that the concern of many people, is that one should not be too conservative. Areas that most likely will change significantly under fair-value accounting will be loss reserves for property/casualty contracts. I think casualty actuaries are just waking up to the fact that this, as well as elimination of European equalization reserves, could result in significant changes to their calculations in the balance sheet of property/casualty companies.

The other relevant question is, Should we reflect risk? This is a big issue. If you were at the economic value-added session, (8PD, "Economic Value-Added vs. Value-Added for Life Companies") the comment was made that the market doesn't recognize risk, or doesn't place any value on risk. I think this is a challenging statement with which many actuaries disagree, but the actuarial view is not universally held.

Another key issue is smoothing. I think the SEC is fighting this battle right now. It has expressed significant concern about companies trying to smooth earnings and trying to hide earnings. What is the value to investors? What is the purpose of a financial statement? Smoothing, in some people's view, doesn't reflect reality. It's a historical construct that is not meaningful. Finally, it is responding to yesterday's paradigm rather than to today's.

As a lead-in for Mo, I'll just state that one of the fundamental questions that has been resolved is, What is insurance? I think the answer is that insurance is a financial instrument. That's the reason why this is relevant to many of the fair-value discussions, in general, because they are very much tied, at least in the insurance liability side, to what is an appropriate fair value in an area where there is not a liquid market.

I'll mention briefly the discounting project with which the IAA is very much involved. One of the top discussion items in sessions regarding discounting and valuation of liabilities is the reflection of the enterprise's credit risk or credit standing; that is, whether or not the liability should be reduced to reflect a weakened credit standing. If we have time, maybe we can talk about the issue later. Obviously, it is very contentious. FASB is very supportive of reflecting such risk, but others, particularly insurance regulators, react in horror.

Mr. Chambers: From earlier drafts of this IASC Issues Paper that the Steering Committee has been working on for some time, there are some fairly good indications of what the Steering Committee will recommend when the finished product is published this year. We hope it is this year.

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. It's felt that the financial reporting consequences should be relatively similar, regardless of the type of issuing institution. As a result, the Steering Committee has pretty much settled on its definition of an insurance contract, as follows: Basically it says, in order to be an insurance contract, there must be uncertainty or risk in either 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-assurance are not deemed to be insurance. However, product warranties are.

We do know that the emphasis in accounting circles has moved from the 1980's focus on the income statement to a refocus on the balance sheet. The Steering Committee has considered two general models: a deferral and matching model, and an asset/liability (A/L) measurement model. It's likely that they will recommend the A/L measurement model, along with the use of fair values. While they have not yet considered what, precisely, the fair value of assets might be, it appears likely that it will be closely linked to market values. If that is the case, for consistency, most actuaries are arguing for the imposition of fair value of liabilities as well. Of course, how the value of the fair value of liabilities is to be calculated remains to be determined. There are strong indications, though, that the IASC Steering Committee is likely to consider fair value of liabilities to imply that an exclusively prospective valuation methodology is required.

For its part, the IAA Committee has addressed several issues in seeking an actuarial consensus. I think there is general agreement in the IAA Committee that fair value is the appropriate approach.

Earlier this year, a small subgroup of the IAA Committee prepared a discussion draft of a set of principles underlining meaningful financial statements reporting on insurance contracts that could assist in the development of accounting standards for insurance, sort of a pro-action to try to direct the IASC. The document has been discussed at the two most recent meetings of the committee, and the latest draft sets out the principles in the following fashion.

First of all, for the actuarial liabilities of a given insurance contract type, a single accounting model should apply for all jurisdictions. In other words, a GIC-type product sold by an insurance company should use the same accounting model as the same product sold by a bank.

The models (and I do use the plural because there would likely be a different model for a GIC-type contract than for term insurance) should provide demonstrated continuity between insurance and non-insurance products, which differ from each other by the addition or subtraction of specific product features.

Next, an accounting system for insurance contracts, which uses fair value of assets, should have as its goal, fair value of liabilities. Where a reliable market-based assessment is not available, fair-value liabilities should be calculated using present value techniques on a fully prospective basis.

In the valuation of these prospective liabilities, best estimates should be made for all material contingencies. If possible, these best estimates should be based on relevant, credible, company-specific experience, reflecting expected premiums, policy benefits, and applicable expenses.

They should not reflect the actual assets backing the liabilities, except where the benefits themselves depend on those assets. However, an acceptable approach would reflect the most appropriate set of assets to provide for the liabilities and we've developed the term *replicating portfolio* to identify that concept.

In the marketplace, fair-value liabilities can be observed to exceed best-estimate liabilities by a market-value margin. That market-value margin is sometimes referred to as a provision for adverse deviations, which reflects estimates of the price agreeable to two willing partners for the transferring of the liabilities. The market-value margin reflects the market's perception of the risks being undertaken. The market for insurance liabilities is not currently a deep liquid market, in which fair-value liabilities can be quantified with precision.

Therefore, it is appropriate to evaluate best-estimate liabilities and market-value margins using stochastic methods or the study of appropriate alternative scenarios. The use of a relatively narrow range of provisions for adverse deviation applied to the best-estimate assumptions is also a reasonably workable proxy, which can be used to produce appropriate liabilities, consistent with market observations in an accounting system based on the fair value of assets.

Best-estimate liabilities and market-value margins should not be locked in, but should be redetermined at each valuation date on the basis of the most credible and relevant, current information. Because of the inclusion of market-value margins, the values of expected cash flows incorporate risk assessment, the discount rates can be set at the investment rate of return on an investment portfolio, which would most closely match the liability cash flows. This is what we're referring to as the replicating portfolio. This portfolio essentially matches the assets and liabilities in such a way that changes in the market prices, that is the interest rates, affect the changes in the market values of the assets and of the liabilities as consistently as possible. This satisfies the goal of consistency in the valuation of assets and liabilities.

The best estimates in the market-value margins of future cash flows and the replicating portfolio should be developed by an insurance specialist and, frankly, it should normally be a professionally qualified actuary. In conjunction with the development of IASC Insurance Accounting Standards, the IAA is expecting to develop professional standards with respect to the determination of best estimates, market-value margins, and the replicating portfolio.

Under a fully prospective valuation system, the concept of historic deferred acquisition costs is not appropriate. Equalization provisions are not compatible with a fully prospective valuation system. A provision for catastrophes can provide for the expected cost of catastrophes over the future lifetime of in-force insurance contracts, including contract renewals. When the associated contracts are long-term in nature, such provisions are not inconsistent with a fair-value system. However, where the contracts are unilaterally cancelable by the insurer, they are incompatible with a fair-value system.

The paper continues by stating that financial statements should be presented in such a way to be more transparent to their users. Disclosure should include the effect of industry-derived best estimates to the extent that they differ from company-specific best estimates and should identify the effect of regulatory requirements, including those affecting minimum capital, additional provisions or reserves, and valuation of assets. The level of risk assumed, such as from embedded options that are not matched, or from asset/liability mismatching due to differences between the actual asset portfolio and the replicating portfolio, should be disclosed. In addition, financial reports should disclose the effect of restrictions on the distributions of surplus to shareholders whether they be regulatory or general purpose.

A final statement in the paper that has been developed states that financial reporting for insurance contracts would be more meaningful if it incorporated and disclosed an appropriate level of risk-based capital. It would be more efficient for preparers and less confusing to users if regulatory reporting and general purpose accounting could be harmonized through the adoption of consistent measures of actuarial provisions and a common robust risk-based capital formula. In other words, everybody would be a lot better off if GAAP reporting on this basis and regulatory reporting were one and the same animal. To the extent that GAAP

reporting in the reserves does not provide as strong a measurement of liabilities as regulatory reporting does today, that should be properly dealt with in the risk-based requirements associated with surplus and capital.

While not yet formally adopted by the IAA, we hope that this document will serve as the foundation of the actuarial position with respect to financial reporting for insurance contracts. There is some hope that might happen in December 1999.

Mr. Gutterman: Let's consider some potential implications of these developments; some crystal-ball gazing or whatever it is we look into when we make predictions. My first guess is that financial reporting standards for insurance will change within the five- to seven-year timeframe. That may be a bold extrapolation from current and historical events, but I think that this is, within a year or so, pretty certain. The question is, exactly what will the new standards be?

The next question is, whether they will be IAS standards, U.S. GAAP standards, or some convergence of them. In either case, I think that they will change. I think that U.S. GAAP will be changing. I don't know whether this time frame is right because the FASB is just gearing up on this issue. It is starting late, about two years behind the IASC in discussing the issue, but I think that it will rapidly catch up because one of the chief drafters for the IASC would also be the chief drafter of a new FASB standard.

Most likely, and this may be more of a guess, the results will be that insurance accounting will be more consistent with other industries, that is, some variation of fair value, but I think it's too early to tell. Nevertheless, I think fair value will influence both future U.S. GAAP and IAS standards.

Mr. Chambers: Many people have noted, and I guess that we've already said it to some extent, that the life insurance financial reporting system currently in place in Canada is probably the closest of any jurisdictions to what is expected to be proposed by the IASC Insurance Steering Committee. The Canadian system was adopted by the implementation of the Federal Insurance Companies Act in 1992.

While most current insurance reporting systems today are built on the deferral and matching approach, the Canadian system is an A/L measurement one. However, Canada's is not a fair-value system. To begin with, in Canada, the valuation of assets is a mixture of book value, or sort of amortized book value, for debt instruments and amortization to market for equity instruments. In addition, realized gains for debt instruments are amortized over the period from sale to maturity, and realized equity gains are amortized on a declining balance basis at 15% per annum for stock gains and losses and 10% per annum for real estate. To become a fair-value system, the asset side of the balance sheet will have to move much closer to market value.

CIA Valuation Technique Papers 3 and 9 require that the valuation interest assumptions reflect the current and expected future earning power of the assets that are held to support the obligations being valued. In respect of the future

earning power, a significant provision for adverse deviation for C-3 risk is imposed, particularly in VTP 3. These standards would have to be amended and, to the extent that C-3 risk provision is removed from the liabilities, a comparable increase in the risk-based capital requirements would have to be introduced. I would expect that the existing standard of practice for the establishment of provisions for adverse deviation in Canada, in respect of the decremental assumptions, would require some amendment. To the extent that the required margins are reduced, a comparable increase in the minimum risk-based-capital requirements would be imposed. Finally, of course, a standard of practice with respect to the construction of replicating portfolios would have to be developed.

This will require some change in the actuarial practice in Canada and in the interpretation of financial statements. However, with the experience that they have gained by working with a fully prospective valuation methodology since 1992, I have some expectation that Canadian actuaries with recent backgrounds in insurance valuation will be in high demand upon the implementation of an international insurance accounting regime based on fair value and A/L measurement principles. That is not, I hasten to add, why I'm supporting the direction that we're going. I support it because I think it's right.

Mr. Gutterman: I would like to make a last comment that the International Actuarial Association, I think, has made a significant contribution to the development of accounting standards for insurance. The debate is yet to play out. The players are still lining up. The opposition, in some cases, is getting fierce across national borders, but I am hopeful that the IASC will continue to listen to the advice of actuaries and in the U.S., that FASB will be also listening to the American Academy of Actuaries in their discussions. With that, I'd like to open the discussion to the floor.

Mr. Bruce D. Bengtson: I have one quick question, and then maybe one that's not so quick. Is there a Web site where some of this information can be obtained?

Mr. Gutterman: There's a wide range of information available on the World Wide Web. I like to go to the IASC Web page, because it updates you on the IAS. That's at <http://www.iasc.org.uk>. The IAA's Web site is at <http://www.actuaries.org>. If you look at "What's New," it will lead you to minutes of meetings of the IAA Committee. It will also provide certain papers such as the Meaningful Statements document. In terms of additional sources, maybe one of the best sources is the IAA's list server for the committee. Both Mo and I are on that, as well as more than 100 people worldwide. There are other sources, and if you need additional ones, let me know.

Mr. Bengtson: Mo, you indicated that there is going to be a potential constitutional amendment for the SOA, right?

Mr. Chambers: Yes, I got off the topic.

Mr. Bengtson: Why would it be more appropriate for the SOA to do something like this as opposed to the Academy?

Mr. Chambers: Simply because of its size and its importance. The Academy is already listed in support of these submissions. The SOA is a member of the International Actuarial Association. In the depositions or submissions that are made, we list the names of organizations that have endorsed the positions taken. The absence of the SOA name, I think, is significant, but it is significant in the wrong way. The SOA should be identified. We've contributed a great deal. It isn't that this is a political opinion. It's a research and analysis position, and it should be embarrassing to SOA members that the SOA's name is absent from these documents.

Mr. Gutterman: Let me make just a brief note that three representatives of North American organizations on the IAA Committee are here. Bruce Moore is the American Academy of Actuaries representative on the Committee. Dick Robertson is the SOA representative. Mo Chambers is the CIA representative, and I'm the chair. Feel free at any time during the course of the discussion, to let us know if you have any ideas or thoughts. We really are interested in actuarial input, so please provide it.

Mr. Bruce D. Moore: Just to add to the Academy reference, I head an Academy Task Force that works on this, and we've been careful to get people from the Health care Section, the Property/Casualty Section, the Life Insurance Section, and the Financial Reporting Councils included on that list server, to try to get fairly broad representation. If you're on the list server, you tend to receive some e-mails with attachments of a couple of hundred pages. Surprisingly, there are times when people can't read all of that. If anybody here wants to become a lot more active in the discussions on this topic, one way of doing so would be through this Academy Task Force. Feel free to contact me.

Mr. Gutterman: I think that the degree of international involvement in this is absolutely wonderful. I just received two e-mails from the Indian Actuarial Association, and they are also providing input on this issue.

Mr. Daniel J. Fitzgerald: Mo, you identified the nations represented on the IAA Insurance Accounting Committee. Is this the complete list of nations that are involved?

Mr. Chambers: It is not the complete list of nations or organizations that are involved in the IAA. It is the complete list of nations that are represented on the IAA Insurance Accounting Committee. As I said, 17 nations representing 21 actuarial organizations are officially represented. It is really actuarial organizations that are on the committee.

Mr. Fitzgerald: That leads me to my second question. If you take a look at this list of countries, in many respects, most of these are the mainstream Western European countries. Most U.S. and Canadian insurance companies are working in

the emerging markets, which are not really represented here. By emerging, I'm referring to Latin America, the Asia Pacific area other than Taiwan and Japan, and also the Central European countries. What are you doing to work with those countries, where most of the activity seems to be developing?

Mr. Gutterman: There are a couple of aspects to that. First, those people who are members of the committee, are those who tend to come to international meetings. The emerging company actuaries, because of the cost of such travel, are not as likely to travel to the meetings that are held about twice a year. There are about a dozen other countries that receive all the electronic information from the committee, including, as I mentioned, India, Jamaica, and Thailand. I think there is one recipient in Czechoslovakia. There are a number of other countries that receive all the material and are encouraged to participate, but your point is very accurate in that we don't have representatives from countries such as Argentina, Brazil, and others in South America. We don't have one from the People's Republic of China, but on the other hand, I think that we have many of the members who practice there as consultants, who are at least familiar with practices in those countries. That, however, continues to be an issue. If you have any ideas or any particular people, with whom you are familiar, who might be interested, I'd certainly be happy to hear from them.

Mr. Fitzgerald: The only reason that I mentioned that is that in my own company's experience, working in the Southern Cone of South America, we're having difficulty in those countries with people just understanding the basics of modified coinsurance. Even going beyond something as basic as coinsurance and modified coinsurance, to things like funds withheld and letters of credit, matters that we in North America take for granted, is problematic. In many respects, these Western European countries, have been doing this for years. It seems to me that this is an area where the accounting profession, as well as the actuarial profession, should lend itself in terms of this expertise.

Mr. Gutterman: This is a very good point. I think that also raises the issue of education of actuaries. I'm referring not only to actuaries who are members of organizations that are members of the IAA, but all those emerging countries that are not. That's one reason why we're trying to proselytize those countries and those emerging actuarial organizations to become active, and to become members of the IAA. Mo is currently chairman of the IAA Accreditation Committee, which has been trying to reach out and get more organizations involved. This is going to be truly a challenge in the implementation of these international standards.

Mr. Chambers: I would add that this committee isn't necessarily representative of the IAA. The IAA currently has 40 members, which probably represents 95% or more of the qualified actuaries in the world. One of its significant activities is to develop the actuarial profession, and to promote its development in those parts of the world where there are not actuaries or where there are not appropriate actuarial programs to develop actuaries. It's obviously a different committee.



Mr. Bruce Norman Maxwell: My comment is following on the previous speaker. There is definitely a question as to how readily we can reach a single actuarial voice or consensus on this issue. I think what we will obtain, presumably through the IAA Committee, is a single actuarial voice. I think we have a number of selling jobs to do. One is leftwards, in a sense, to the accountants, and one is rightwards to actuaries, even in so-called developed countries, never mind the underdeveloped countries. If we can agree on the set of principles, which is what the meaningful financial statements document is, there is a question of how far you go in laying down regulation on the detail. For example, there has been a debate on the airwaves recently about whether some assumption should be company-specific or industry-specific. How we come to a conclusion or determination on an issue like that is a potential problem. That's even before you start saying that the actuary should use a number between four and six in a particular application. I think there's a huge amount of work to do. How do you see this developing, Sam?

Mr. Gutterman: As I think I mentioned a couple of times, this is not a one-sided discussion. There is considerable debate. I know that within France there is actually a meeting discussing this within the industry. I think that in many countries, the industry has yet to really address the issue. Once they start, which I expect will be after the Issues Paper comes out, likely in December or January, all of a sudden we will start hearing some of the counter positions. The Issues Paper doesn't take a firm position on this. It doesn't say that we can't use a modified historical accounting system. It presents the issues as alternatives. The IASC wants to listen to ideas and critiques. I think this is going to be a real challenge. I am actually amazed that within the IAA Committee, there has been almost universal consensus to date on the underlying principles. Of course, that was our reason for preparing that document. But I expect that when we start discussing the details, we will have some people suddenly realizing that this will, indeed, affect them and affect their financial results. I think that at that point we will start hearing from them. I've actually looked forward to that point in time. Some regulators have expressed such concerns to me as, "How can I respond to principles?" (because they are used to dealing with numbers and results), or "What's the impact on me?" or "What's the impact on the companies that I'm trying to regulate?" I think that we're beginning to hear some of that discussion and debate. I think it's good because, personally, I don't have an answer to all these questions. I think it's fairly easy to agree in general about the principles but the devil in the details will continue to be an issue.

Mr. Maxwell: The Meaningful Statements document advocates one set of financial reports. Would you care to expand on that?

Mr. Gutterman: It's a very interesting question. Mo, do you want to start on that?

Mr. Chambers: I stated the position. I think a single set would be marvelous, but I recognize that this is a stretch for regulators. Most regulators have, for the better part of this century, lived with a system where, in financial reports for the public, liabilities are represented by one set of numbers, while in regulatory reports there is

a much stronger measurement of what the liabilities are. My view is that they can't both be right, and that the public, investors, and analysts are absolutely, totally confused by the whole thing, because of this multiplicity and inconsistency of reports. The only way we're going to clean it up is to move in the direction of a single set of financial statements, but with the protection of the public provided for primarily, through the identification of capital that must be held to preserve the integrity of the institution.

It's going to be a tough job to convince the regulators that this is the route to follow, particularly in Europe and in parts of the U.S. that has 51 regulators or so. I'm encouraged by the fact that the current chairman of the International Association of Insurance Supervisors is the Insurance Commissioner for West Virginia, and I understand that he has expressed support of this approach. That's a big step.

Mr. Gutterman: I think that's evidenced by the fact that a month ago the NAIC formed an International Accounting Task Force to look at the IASC activities and follow them. I think an advisory committee was just formed, as well. This is the first real bubbling up of ideas among U.S. regulators.

Mr. Chambers: The other aspect, that Sam has properly identified, is that the other choice is for the world to go to FASB. I don't find that a particularly palatable approach because FASB has this year publicly admitted that its standards for accounting for insurance don't work.

Mr. Jay M. Jaffe: What does all of this mean in the U.S., for example, with respect to the Internal Revenue Code and the taxation of insurance companies, and does that mess up your five- to seven-year timetable?

Mr. Gutterman: Jay, I think that's a very good question. I think that is probably the one thing that has, in most countries, most seriously impeded change in insurance accounting; that is, the potential or probable impact on income taxation. I think that is true, from what I hear from my compatriots in other countries, in just about every country. The insurance industry is certainly concerned about that. It's a relevant question. I think that's an underlying concern that is usually not voiced.

Mr. Chambers: I hasten to add though, Jay, that this is a relatively narrow area of application. It's for multinational insurance companies listing their stocks in multiple exchanges. It has nothing to do with domestic reporting today. If, as I believe, this approach, when adopted, is better and is found to be more meaningful and understandable by all users, then there's going to be a move on the part of national regulatory and reporting regimes toward that better method.

Mr. Jaffe: I guarantee, if it produces more income, the IRS will listen quickly.

Mr. Gutterman: I'd like to close by saying that I think the eventual result will benefit from further discussion and increased knowledge on the part of the people who are going to be affected. This is an area in which I hope everybody here

somehow gets involved, whether they present their ideas publicly or whether they discuss it back in their company or firm. I think that this is a topic whose visibility we need to increase because whether or not the IASC is going to go by exactly what we have said, it is going to affect insurance accounting sometime in the near or intermediate future.