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International Accounting Standards

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Moderator: MARK J. FREEDMAN
Panelists: DAVID J. CONGRAM
MARK J. FREEDMAN
ELIZABETH ROGALIN

Summary: International accounting standards for insurance are in the midst of being overhauled. Attendees learn about the status of recent developments in international accounting standards for insurance. Specific topics include an update on IASB developments related to the international accounting standards for insurance and International Actuarial Association-related activity.

MR. MARK J. FREEDMAN: This session is the first of two panel discussions at this meeting on International Accounting Standards (IAS). This panel provides the introductory material, and the next panel provides some case studies as well as an example of a company's preliminary conversion efforts. Elizabeth Rogalin is an actuarial manager in KPMG's New York office. She's responsible for providing life and health insurance actuarial services. Elizabeth is going to cover the basics of what's been going on with IAS and how the principles generally work.

I'm an actuarial partner of Ernst & Young out of Philadelphia. I've worked a lot in the financial reporting and mergers and acquisitions (M&A) areas. Over the last couple of years I've spent a lot of time with International Accounting Standards. So I'm going to speak about earnings volatility in a fair value type environment.

David Congram is a former actuarial partner at Ernst & Young, out of Toronto. Currently, he works for Liberty Health in Toronto. He'll not only provide a Canadian perspective on all of this, but he's also going to provide the perspective of the

International Actuarial Association (IAA) since he's on the drafting committee of actuarial standards for that organization.

MS. ELIZABETH C. ROGALIN: I'm going to give a brief overview of the basics of where the international accounting for insurance is going today. I will say here, and I will probably repeat at several different points in the presentation, that all of this is subject to change as a final standard evolves.

Stepping back, the original goal for International Accounting Standards was to develop a single set of high quality, understandable and enforceable global accounting standards and eventually to harmonize the standards worldwide. The original project of international accounting goes back to the late 1980s. The insurance standard is still missing, however, from the standards that have been developed. There are over 40 International Financial Reporting Standards in existence and none yet for insurance. There has been considerable progress in developing discussion points for an eventual insurance standard. There has been an issue paper. There is now a draft Statement of Principles that has been released, but it is not yet finalized. Even though not finalized, it forms the basis for most of this discussion.

For the immediate future, who is concerned with the application of International Accounting Standards? First of all, the European community (EC) is going to require, beginning in 2005, that public companies filing consolidated financial statements report them under IAS. It is also expected that a number of European countries will extend that requirement to non-public companies. In addition, there are other countries around the world that are also going to be following IAS, primarily Australia and South Africa. Canada has expressed their intention of moving toward IAS in the future. The FASB has expressed the intention of eventually converging with IAS. That is obviously a more long-range timeline.

As we've said, the European companies will be required to start reporting under IAS beginning with year-end 2005, with a transition that will probably involve restating ending balance sheets back to 2003. The immediate problem for insurance companies, of course, is what to do in the interim. We're going to discuss this more later, but there will be a phase-in. Insurance companies will have to perform some kind of interim reporting in the period between 2005 and when an ultimate insurance standard is issued, which at the moment is believed to be 2007. The discussion points on that have revolved around whether they would continue to use local GAAP in that interim phase for their insurance business, what that local GAAP might mean, whether they might need to adjust it for some obvious differences that will be expected to emerge, whether they could use a single form of the local GAAP for all entities, and whether that could be U.S. GAAP.

Now, in speaking of an insurance standard, one of the things that we need to make clear is that a lot of the business currently written by insurance companies will not qualify as insurance under IAS standards. The biggest difference here will be that kind of business written by insurance companies that we can think of as investment contracts, for example, deferred annuities, which will not transfer enough insurance risk to qualify under the definition. These financial instruments will fall under the accounting prescribed in IAS 32 and IAS 39. The IAS 32 and IAS 39 do exist and have been issued, although revisions to them have also been exposed.

In the definition, IAS 39 does specifically exclude insurance business. The first step for a insurance company looking at the transition and at the conversion to be done will be to identify and separate that business qualifying as insurance from that business knot. Under IAS 39, it addresses financial instruments, both assets and liabilities. In looking at the categories of the key provisions of IAS 39 as it is currently written, the asset categories, for example, closely follow an investment accounting familiar to the U.S. GAAP FAS 115. For example, categories such as held to maturity, available for sale and available for trading are identified. A key difference is that although held to maturity assets will be at amortized cost, currently IAS 39 provides an option for available for sale assets in which the changes can be run through either the income statement or the equity. That option will probably be eliminated under the draft IAS 39 that has been exposed.

Let's turning to the liability side of the balance sheet. Under the current IAS 39, there are two categories. One is liabilities that are trading that will be carried at fair value. The other category is other liabilities that will be carried at amortized cost. As it's currently written, business traditionally written by insurance companies that doesn't qualify as insurance under the DSOP will fall into this other liability category and be carried at amortized cost. One of the problems has been defining exactly what that would mean. In addition, one of the IAS 39 revisions outstanding would allow companies to designate certain of their liabilities as trading and carry them at fair value. That business that fails to qualify as insurance could be designated as trading and then carried at fair value.

There are a number of issues that remain to be resolved. In particular, a number of issues regarding practical implementation of this guidance remain outstanding. There are numerous groups that are working on those issues, and we'll have some more information on that later.

Let's start with the basic definition of an insurance contract. The insurance contract is defined as that which exposes the insurer to risks of loss. Those risks of loss are identified as death, survival, sickness, disability, property damage, injury to others and business interruption. Two things stand out from looking at this definition. First, this definition covers both life and non-life, property and casualty coverages. The insurance standard developed will apply to insurance business generally. Second, it applies to the contract itself, not to the type of company writing it. So, to the extent that a company is writing this kind of business that is not traditionally thought of as an insurance company, they would still be subject to this guidance.

Taking a brief look at the accounting systems that were considered in looking at an insurance standard, we can identify two major categories. The first is deferral and matching, which is not the direction the DSOP is going in. The second is the asset and liability approach. Within the asset and liability approach, there are two subcategories that we've identified as fair value and entity-specific value.

The first of deferral and matching is similar to U.S. GAAP. The focus is on the income statement. Expenses are deferred to match future income. There will generally be no profit at the point of sale. It will instead emerge over the life of the business. In direct contrast to that is an asset and liability framework. Under this framework, the emphasis is on the balance sheet. Changes in the values of the assets and liability flow through the income statement. You can have a profit or a loss on the sale of the business.

Entity-specific value is a form of a fair value subcategory under the asset and liability approach. The value of the asset or liability is determined by the circumstances of the company that's holding it, so, effectively, the cost to the company, over the life of the business as the liability emerges is consistent with an IAS 39 approach. In contrast to that is a fair value method in which the value is determined based on what a third party would pay under a settlement approach, and what it would cost to unload the liability.

The difference between those two is the source of the assumptions. In an entity-specific valuation, you have to consider the costs to the company holding the liability. For example, you would have to consider experience and expected experience mortality expenses. In a fair value approach, you're looking at a third party valuation. You're looking to an external value, common industry experience, or an expected value to a third party, for example, reinsurance rates.

Continuing on the valuation approach currently being held, the asset/liability entity-specific valuation starts with the present value of all future cash flows. This is basically a probability-weighted approach. The expected present value over all possible outcomes is the goal. This implies stochastic modeling. In addition, after projecting the future cash flows they're going to be discounted at a risk-free rate. The DSOP calls for that risk-free rate to be that of government securities. Only in the case where there isn't an available government security rate would you turn to a corporate rate. Finally, having discounted the cash flows, or in performing this calculation, the company will need to include market value margins. Market value margins can be inserted into the calculation in one of two ways. The preferred way would be to adjust the cash flows directly. The alternative would be to adjust the discount rate, the risk-free rate.

In thinking about market value margins, the obvious comparison would be provisions for adverse deviation (PADs) under a U.S. GAAP environment. The key difference between them would be that PADs in U.S. GAAP are judgmental. In the IAS framework, the market value margins need to be correlated directly to the market price of risk. The DSOP is quite clear that this is required. Unfortunately, it is still being worked out as to exactly how this will be handled in practice.

I've tried to summarize the expected or current view of the international accounting for insurance contracts for some common U.S. GAAP products with some notes referring to changes or differences from U.S. GAAP. I've broken these into several categories. First, for variable annuities with a significant insurance component that are presumed to pass the insurance definition of the DSOP, they would be following the entity-specific value model we've just gone through. In the case where the variable annuities do not have enough insurance risk to qualify, they would fall under the accounting for IAS 39. There are two alternatives. One is IAS 39 as written, where they would be classified as other liabilities and carried at amortized cost. The more likely view at the moment is that IAS 39 would be revised to allow them to be trading by designation, which would fall to fair value.

One of the issues raised in the DSOP with regard to variable annuities and other similar business is how to handle the fact that they are performance linked, that is that the crediting rates, presumably, and the valuation of the liabilities depend on the assets associated with them. Under the DSOP, the assets and liabilities have been de-linked, in that the risk-free rate used in the model that we just considered obviously is not related to the company's book of assets or expected earned rates. Performance-linked business provides a particularly difficult situation where that clearly doesn't seem to make sense. How that is to be handled is being discussed.

Fixed annuities, on the other hand, will presumably not qualify under the insurance definition and will go directly to IAS 39, other liability. As IAS 39 is written now, it requires amortized cost. In the case of a fixed annuity, that would seem to imply a constant interest rate method for the liability calculation. Alternately, if they could be designated as trading under a revised IAS 39 approach, they would be valued at fair value.

Continuing to payout annuities, again assuming that there's a sufficient insurance element, they would be qualified as insurance under the IAS. In looking at U.S. GAAP, given an asset/liability approach, assets such as deferred acquisition cost (DAC) or an additional liability, deferred profit liability in the case of payout annuities that we're familiar with from U.S. GAAP, disappear. Another change from U.S. GAAP would be that the assumptions are no longer locked in on this business.

Turning to traditional business, whole life non-participating business will presumably qualify as insurance. It will follow the entity-specific valuation model. This would be considered similar to a gross premium valuation with updated assumptions, no DAC and market value margins instead of PADs. Whole life participating business is also an interesting situation where presumably it is possible to argue that the dividends in a whole life participating product prevent insurance risk from passing through to the insurance company in sufficient amount to qualify as insurance under the DSOP. In that case, it would fall under IAS 39 treatment, assuming that it could be designated as trading, would fall to a fair value calculation, and then within the projection of future cash flows the expected policyholder dividends would need to be included. Finally, we look at term insurance and health insurance. Both of those presumably qualify as insurance. They will also follow the entity-specific valuation model, again, gross premium valuation, no DAC and market value margins instead of PADs.

Just to summarize, those companies most affected by this immediately, of course, will be those that are public companies listed in EU or Australia, because they need to immediately incorporate IAS as it becomes effective. In addition, from a U.S. perspective, it's of interest to any companies that report to European or Australian parents, have European or Australian subsidiaries or are looking to make any acquisitions in those areas. In addition, companies looking to compare themselves to their peer group will want to become familiar with IAS as their peers are reporting on this basis. There are more long-range considerations as U.S. GAAP is expected to at least consider moving in the direction of and ultimately converging with IAS.

MR. FREEDMAN: The introduction of the principles discussed in the DSOP will lead the fundamental changes in the way profits emerge for insurance contracts. It's critical that companies understand how their reported profits will change and the reasons for these changes. First I'm going to discuss the likely gains or losses that will occur at the issue of a contract. Then I'm going to talk about the volatility that will likely occur after issue. I'll briefly talk about how we, as financial reporting types, will have to prepare our clients and companies to discuss these issues on a real-time basis to outsiders.

Gain or loss at issue is a function of, first, how competitive the product is. This should be pretty obvious—the more competitive the product, the lower the profit at issue. If you take a whole life product, a more competitive product would mean a lower gross premium, and since, as Elizabeth stated, the liability is a gross premium reserve, the liability is going to be higher with a lower premium. So that means that the lower the premium, the lower the profit at issue. Now in reality, competitiveness is usually not the main driver of initial profit or loss.

Elizabeth talked a little bit about a performance-linked product. In the DSOP, there is a definition for this. For the most part, these would include participating contracts and variable contracts. So, for non-performance-linked products, the greater the investment component, generally the larger the loss at issue. This is caused by the risk-free discount rate requirement that Elizabeth talked about in her presentation.

A GIC is not technically an insurance contract under the DSOP. So technically, the accounting is going to come under IAS 39. On the other hand, it's a very easy product to understand. A lot of insurance products have GIC-like characteristics. I will discuss a fairly typical example of how a GIC writer would price its product by leveraging its own credit standing. The company is a AA company. It credits a rate to the policyholders at 590, which is 25 basis points higher than the AA spot rate net of defaults. It justifies the credited rate by investing in corporate A's at six percent. So, it would earn a spread net of defaults of 10 basis points. In my example, the five-year Treasury is five percent.

The reserve at issue is simply the present value of the future cash flows. So, the future cash flow is the thousand-dollar premium accumulated at 590 for five years. If the valuation rate is the Treasury spot rate of five percent, the reserve at issue is 1,044, meaning there's a loss of 44 plus whatever acquisition expenses there are. A large loss at issue isn't intuitive at all, since the only way a AA company would break even under these rules would be to credit a rate that would be a drop less than the Treasury rate. If it credited a rate lower than the Treasury rate, it wouldn't sell any business, because a policyholder would never deposit money. They'd more likely buy a bond from the government, which has a higher credit standing.

The only way really to get around this is to allow the insurer's credit standing to be taken into account in determining the valuation rate. In my example, if the valuation rate is the AA spot rate of five and three-quarters, the reserve at issue is a thousand dollars, so there's a much smaller loss at issue. But right now, as Elizabeth stated, the DSOP states that for entity-specific value the risk-free rate should be used. For fair value, at least in theory, credit standing should be taken into account. This is a fairly controversial area. Insurance products are typically priced using embedded value type techniques or return on investment techniques that take into account both regulatory valuation and capital requirements. For example, if you take a U.S. term insurance policy with deficiency reserves, the premium is going to be artificially high because of the statutory reserve and capital requirements in order to hit the target return on investment. But using a fair value type calculation, which is a gross premium reserve, an artificially higher gross premium means a higher profit at issue. This is a fairly non-intuitive area. There are some techniques taken into account, such as cost of capital in developing the market value margins, but I'm not going to get into them in detail.

Another area Elizabeth talked about was this whole performance-linked area, which includes variable and participating products. Term, non-participating whole life, endowments, GICs and immediate annuities are not performance linked. Some hybrid products, such as universal life and single premium deferred annuity (SPDA), aren't clearly classified as performance linked. It turns out that, under the rules of the DSOP, the classification of these hybrid products as performance linked tends to give more favorable accounting treatment than non-performance-linked products. For example, for variable products you could take into account the present value of the future spreads you get between the earned and credited investment returns. But this is in contrast to the situation with non-performance-linked products with large investment components. In these products, as I illustrated in the GIC example, you can't take all of the future spread between what you earn and what you credit into account. In particular, the future spreads between the earned and the risk-free rate cannot be taken into account.

Let's go back to that GIC example, but change it. It's now a separate account product where the deposit goes into the separate account, and the contractual mortality and expense (M&E) charge is 10 basis points. The separate account purchases the same bond as in the prior example, and, therefore, the credited rate is the same. So the policyholder is basically getting what they got in that earlier example, the 590, and the insurance company invests in that six percent bond and takes the M&E as a profit. But because this product is performance linked, the entire profit can be capitalized so the initial reserve is a little lower than the premium, which is a much better result at issue than with the prior example, especially when we discounted at the risk-free rate. What you do here is you take a thousand dollars accumulated at the risk-free rate less the M&E for five years, and then discount it back at the risk-free rate and get $995.

As Elizabeth stated, you need provisions for risk and uncertainty in the assumptions. Those are generally done by putting margins in the assumptions, PADs in the assumptions or lowering the discount rate. The present value of the provisions for risk and uncertainty are a component of the reserves. The larger the provisions, the larger the reserve at issue, and the lower the profit at issue.

Now I'll address volatility of results after issue. As I stated previously, reserves for variable products are reduced by the present value of all future M&E charges, which are based on the future market value of assets. This causes a lot of volatility in earnings, much more so even than what's in U.S. GAAP. There are two buffers in U.S. GAAP. The first is that the amortization K factor is less than a hundred percent. The other is that a lot of companies use mean reversion types of techniques for variable DAC amortization. In fair value when determining future equity returns you're stuck.

You can't make an assumption as to what you think equity returns are going to be, but you have to assume they're at the risk-free rate. There's no judgment at all, and also there's no K factor that's going to buffer the impact of any of this. There's going to be a lot more volatility in variable type products in fair value IAS than in GAAP. Just as in GAAP, single premium variable products are going to be more sensitive to equity return assumptions than level premium products, because the M&Es earned off of future premiums are a good portion of the total M&Es in a level premium product that isn't as sensitive to equity assumption changes. Life products are not as sensitive as annuity products because the mortality gains tend to offset the M&E losses as equity markets move up or down, or vice versa. If they move up or if they move down, then the mortality goes the other way. Unhedged guaranteed living and death benefits in variable annuities, which are fair valued, are going to exacerbate the problem even more.

As I mentioned before, the requirement to discount liability cash flows at the risk-free rate tends to cause a loss at issue on investment-oriented, non-performance-linked products. In addition, this requirement is going to cause earnings volatility because as bond credit spreads change, the insurer's fair value of assets is going to change. This will cause earnings volatility. If you could take credit spread into account in calculating your liabilities, there would be a little mitigation of this impact.

Insurance companies tend to mismatch, especially with SPDAs, in pursuit of excess returns. With a change in interest rates, this is going to lead to different changes in the value of the liabilities than in the movement in the asset values, causing either a profit or loss to flow through the income statement.

Earnings volatility is going to naturally occur as experience differs from valuation assumptions. This natural volatility is inherent in all current accounting systems. But assume experience provides evidence that the valuation assumption should be changed, then there will be a significant one-time earnings impact due to changes in the assumptions. That'll flow right through the change in reserves and come through income.

There's going to need to be a completely new way of communicating all of this to the public. The balance sheet may change materially from the valuation date to the earnings release date to the stockholder analyst's meeting date. Because of this, companies are going to probably need to disclose the sensitivity of a movement of x percent in interest rates and y percent in equity markets to the value of their surplus. The key components of profits will need to be disclosed. These include profit from new business, profit from changes in assumptions and profit from changes in provisions for risk and uncertainty. Key assumptions will need to be disclosed. There will be a need to show reserves both with and without provisions for risk and uncertainty.

MR. DAVID J. CONGRAM: I would like to put a bit of perspective into what I see as the driving influences in terms of what's going on. Then I'll discuss the committee that I've been working on and how it fits into the IAA structure. I want to spend some time on the work that it has been doing over these last nine months so that you're up to date. I think it's important to comment on the IASB direction and how the deliberations have affected the industry. I'm going to give you a little bit of an update from the last IAA meeting in October 2002.

The first thing we have to understand is there are a number of different groups involved in implementing a common, worldwide standard for valuing insurance contracts. It's important to remember that the International Organization of Securities Commissions, which includes the U.S. Securities & Exchange Commission, has endorsed this initiative. They support it in principle and the use of IASB accounting principles or IAS accounting principles as an alternative to national GAAP for stock exchange purposes. I think that's very critical for us to make sure we highlight that.

Now naturally I think the International Association of Insurance Supervisors are keenly interested on the basis of financial reporting for insurance companies. Their role in prudential supervision clearly makes them the key setting of capital standards for the industry. I just don't believe there can be a common Basil type capital standard for the insurance industry until we really have a common financial reporting basis. However, as Elizabeth mentioned, I think the real current impetus is in the European Union wanting to unify their financial reporting. This indicates that the international standard is their preference.

I think it's also necessary to remember that they've reserved the right that, if they don't like it, they can override the approach that's used. The accounting bodies clearly have the leadership position. I think the IASB, from my short period of exposure to this, is really the decision maker. The IASB has identified insurance as a high priority leadership project. Their predecessor body had a joint working group, and they basically developed this draft standards of principles (DSOP), which the board has been reviewing during this last year with the original objective of issuing an exposure draft early in 2003. However, whether you are national actuarial bodies or international actuarial bodies, you must go through an appropriate due process and obtain consensus. It's been clear as discussions of the DSOP proposals of the IASB have moved forward that there are a variety of views held by the board members and concern that precedents may be set if the implications of some of the proposals are not fully understood. By "fully understood," I think it really means not only from the perspective of how they would apply to the insurance industry, but also how they fit into all of the companies who will be reporting on IASB.

They've also been receiving numerous presentations from different interested parties. During this year, quite frankly, there has been increasing awareness of the proposals and the different bodies wanting to make their views known to the board has been quite encouraging. Your own industry body has combined with the Germans, the Japanese and many others in making briefs. Various national actuarial bodies and the IAA have been very active in the thought process as well.

So where does the IAA fit? In my view, the valuation of insurance contracts falls within the unique expertise of the actuarial profession. This appears to have been recognized by the IASB, and they have encouraged our participation. They've been looking to the IAA as the international actuarial organization for the role of fleshing out the IASB insurance proposals. The IAA is a federation of national actuarial bodies, and these developments and others in the social insurance and pensions areas have recently led the IAA to consider whether standards should be developed on an international basis. Before this time, the IAA has really stepped away from setting standards, leaving it to the national bodies.

A paper was developed by the professionalism committee of the IAA on the topic of setting standards and a due process was considered by the council. Sam Gutterman chairs the IAA Committee on International Accounting Standards. It was formed some time ago to provide comment on the accounting standards and respond to material published by the IASB and its predecessor committee. The IAA, in March

2002, confirmed the establishment of a subgroup of this committee to begin development on actuarial standards.

While the IASB has been moving forward with developing accounting standards, if we are to play a role, we need to move forward with developing the actuarial standards that will address what the accounting bodies finally select.

The IAA, by working cooperatively with the national actuarial standard setters, has the opportunity to benefit from not reinventing the wheel. However, we do need to remember that the IAA is a federation. It's a large number of national standard setters who may not all be speaking with one voice. It is a common matrix of groups with different interests drawn together to provide an international position. I don't think we should feel we're alone in that situation either, but I do think that to the extent that we as actuaries are able to meet the challenge and respond with a unified voice, that will strengthen our influence in the debate. I really believe we have a strong opportunity in that regard.

I keep saying you shouldn't underestimate the challenge. I think it's very important for us to understand. I know how challenging it can be to obtain consensus on actuarial standards just in the Canadian profession. I've had a lot to do with Canadian standards. When we add different actuarial organizations and different languages, achieving consensus among us just won't be easy. On top of that, we have to add this moving goalpost as to the approach of the accounting profession wishes to take, which is really not yet firm. As you already heard, there are a number of questions as to just which direction it will finally take.

But nothing ventured, nothing gained. I do believe it's important that we all follow the appropriate due processes of our various organizations, otherwise we will not be able to satisfy everybody that they have had a time and opportunity to express their views. To the extent that we are successful, we will add to the stature of our profession.

How does the subcommittee approach this topic? We've taken a fairly traditional approach. First, the approach has been to identify what the issues are, then to develop alternatives or discussion papers, and to attempt to engage in discussion across the world. After those discussions then we would move to develop an exposure draft that would go through due process. Then we would develop training material once we get a final standard in place. I think all of that's pretty traditional. What I don't think is traditional, though, and less certainly from my perspective, is the novel use of the Internet and the Web site discussion groups that electronic communication now facilitates. I can work with my counterpart in Germany, in Holland, in the U.K., while working from my home in Canada. You can participate as well from your home computers, and if you are interested in this area, I would really encourage you to do so.

So how do we go through this process? We very quickly focused on the DSOP. In December 2001, it was the document that was before us and was expected to move through the IASB and into an exposure draft early in 2003. Our objective was that, as an actuarial profession, we should attempt to move at the same pace. Initially, we identified issues around the DSOP that we felt would benefit from actuarial involvement. We identified about 45 specific issues. By March 2002, we had 25 discussion papers written and read for discussion. These papers identified issues in which we felt greater clarification was needed. At the same time we were doing this work, the IASB was also going through the DSOP. It became clear that consensus was becoming harder to achieve at the IASB level. More background and education was being called for. As you've already heard, the shift to IAS 32 and 39 has taken place. The drafting group felt the implications of this shift. Before I go into that, let me go back to March 2002 and tell you some of the reaction from the reporting that we did back then.

This gives some flavor as to the types of changes being introduced and thought about. On the non-life side, there were the proposals to implement a prospective approach with discounting of claim loss reserves, unearned premium reserves no longer applicable, the elimination of catastrophe revisions and equalization reserves just captured the imagination. On the life side, there was the introduction of a prospective approach combined with removing the connection between the valuation of assets and liabilities, potential front-ending of profits, and questioning what renewal premiums can be included in a valuation, which came in for some pretty heated commentary. The approach of fair valuing assets and using a risk-free discount rate on the liabilities has garnered attention across the board.

Historically, insurers' financial statements, particularly on the life side, have used some form of smoothing of asset values and liability values. Concern was expressed with regard to the volatility of the total financial assets and liabilities but, more particularly, how mismatching of assets and liabilities could cause fluctuations in shareholder equity. Further concern was expressed in situations where interest rates were at historic lows. A number of these topics, quite frankly, are not unfamiliar in Canada, because we have been on a prospective approach for about 10 years now. For a majority of the countries, these issues are very new. I really do share the concerns, because 10 years ago I was involved very deeply in the move to policy premium method (PPM). I remember some of the reactions and issues, particularly dealing with front-ending of profits, which took place at that time. So I don't think that all of our reactions are wrong. I just think it's important for us to understand the process that we're going through.

The committee's work was on a moving target. It's been just one of the challenges we've had to face. In May 2002, the IASB, after grappling for a couple of months with the thorny issue of renewals and how many renewals of an insurance product should be taken into account in the valuation, just became too concerned. I think with some of the briefs they were receiving from industry and various international bodies, they were looking to see how to approach this in a more effective way. They came up with a concept of a Phase I and Phase II.

Phase I and Phase II have been described in concept. But I don't think they've really been defined in detail at this point in time. Basically, the concept was to try and move forward. The concept was that for Phase I the objective would be to make the transition easier and address things that were really against the International Accounting and Statistical Association (IASA) principles. That was really the driving thrust of it. For Phase II, the concept was the implementation of insurance DSOP or some variant of it. I do not know exactly how the IASA will finally decide what Phase I and Phase II should be.

The subcommittee, in a clear response to this, saw that the exposure draft was issued. We started on IAS 32 and 39. We felt we should first step back in terms of DSOP, because that was not moving at the pace that we expected. We needed to focus on some of the most pressing issues we saw within the exposure draft. That led us to a set of papers that were prepared for discussion. They included the definition of insurance, performance reporting, embedded options and guarantees, the categorization and measurement of insurance and then stochastic models. I'm not going to go over all of these, but I am going to go over one because of my particular interest in it.

I think the application of IAS 32-39 to assets and obligations could result in an inconsistent valuation of the assets and liabilities. My concern is that you could get inappropriate performance reporting caused by inconsistent measurement rather than real economic consequences. I think this is driving to the heart of actuarial science and questioning what the fundamental items are that we hold very critical.

We've talked about this classification in the DSOP and IAS 32 and the pure insurance. I want to clarify some language. I've used language more to display the four classifications; pure insurance, not principally financial risk (insurance), insurance investment (it could have 50 percent financial risk), and investment (the typical investment products under IAS 32).

I've pulled out the embedded derivatives, just as IAS 32 has done. The reason for doing this is to look over to the measurement approach and to try and use some terminology that brings that out. On the liability side, the potential management criteria could be in summary form, high level, for a Phase I and then a Phase II approach.

Elizabeth has already described the asset valuation approach. She has referred to it the way FAS 115 has been in the U.S. I'm kind of interested in terms of exactly what the experience has been in the U.S. as to how much of the assets are really held to maturity. Certainly, as I talk to the Europeans, their indication is that the penalties related to holding assets to maturity are so high that probably most of them will be put into either held for trading or available for sale and, therefore, valued on a fair value basis. The key, from an actuarial perspective, is to say what would be a consistent methodology from the liability and asset side? Do we have consistency between the two? What happens when we move from Phase I to Phase II in terms of potential changes within that as well?

I'm not saying that we should be forced into consistency. I'm just saying that we should recognize, from an actuarial perspective, what we could see is the way the definitions are currently chosen is you could choose on your liability valuation for insurance investments and investments whether you did it on a fair value or amortized cost basis. There's potential that different companies would do it different ways. Your assets could be valued on a different basis as well. The question comes up as to comparability of companies or comparability of the earning statements. Are the earnings real or are the earnings really distorted by the measurement methodology? That is the issue that I think is raised in the discussion paper and was certainly of concern.

The discussions at the IAA meeting earlier this month focused, in my mind, on three sets of documents—the discussion papers that are being prepared by the subcommittee, information regarding what was expected to go before the IASB board in their next number of meetings, and the position that the IAA should be taking in its brief on the exposure draft. , As we discussed the definition of insurance, which was one of the papers we put up there, the first comment that struck me was this issue of consistency between the liability and asset valuation. Is that the real issue—whether we are going to move to the IAS 32 definition or stick with the definition of insurance as proposed in the DSOP? Clearly, the general consensus of the group was that the DSOP definition was far more preferable. My understanding is that a paper was going to go forward from the IASB recommending that the DSOP approach be used.

In terms of the positions of the IAA, I think the focus of the group after some discussion, which still hasn't been finalized, was really in terms of responding to the IASB at this time. Is it important to enhance the consistency of asset and financial liabilities in terms of the valuation and also to improve the measurement of financial liabilities? There were three main points covered. The insurance definition has already been raised. The second point is the embedded derivatives in insurance contracts. The third point is how to apply this to insurance contracts.

Deficiencies in financial liabilities should be addressed. There is a significant amount of material in IAS 39 as to how deficiencies in assets should be addressed, but not liabilities. It also needs to be addressed for the guidance in terms of financial liabilities included under the IAS 39 in terms of if it does have a large insurance portion, exactly how would you deal with renewals on an amortized cost base? How would you deal with performance-linked products? How do you deal with an embedded derivative that's pulled out of an insurance product?

From that brief overview, you can see there is a lot of activity and a lot of challenges. I think with a project of this size we should expect such large challenges. As time goes on, we'll start to get greater focus as to where we're going. We are crafting international financial reporting bases for the future.

FROM THE FLOOR: The way I understand the remarks by the panel is that we have a transition arrangement so that we've got IAS 32 and 39 in effect January 1, 2005 and insurance rules that may come into place in 2007. We're going to have a transition arrangement for a while, and those transition arrangements are themselves in transition. What's the likelihood that we are, in fact, going to have IAS 39 amended? If it's not amended, won't we have some kind of disaster where we have to classify insurance contracts differently for 2005 to 2007?

MR. FREEDMAN: There's an exposure draft right now for IAS 39. So, it looks like that's going to be amended. I don't know what the likelihood is that it'll pay off. I heard it's very controversial, and there are a lot of comment letters that have been received. Are there likely to be two definitions for insurance, one under Phase I and one under Phase II? I was at the advisory meeting of the board; it looks like Peter Clark is trying to get one definition for insurance in the Phase I period so we don't have to go through that twice. A lot of companies are objecting to that and want to keep whatever the definition of insurance or investment is right now in whatever their local GAAP is. It's not clear where this is going to end up. Again, it looks like the board is headed toward having the definition done once and for all and then maybe a tweak in Phase II.

FROM THE FLOOR: Elizabeth, in your presentation you referred to participating whole life as likely to qualify under IAS 39, and I think that means not as insurance. That's the first I've heard that, and I wondered if you could speak a little bit more about why you feel that's the case.

MS. ROGALIN: Let me qualify by saying there's some debate as to exactly how it would fall out. The debates, which are not resolved, are floating around the nature of the participating and whether that would transfer enough insurance risk. Obviously that depends on the insurance definition, which we've just said is somewhat fluid at the moment.

MR. FREEDMAN: I had heard the major issues with performance-linked where it had to deal with the hybrid products. I hadn't heard that there's a possibility that some of the participating contracts might be deemed investment contracts.

MR. PAUL BELL: I understand FASB is giving up their standards; Enron gave up their standards. Why are we trying to create standards in a new principled rule world?

MR. CONGRAM: The quick answer to that would be because of the industry being principle based, but I don't want to answer it that way. I'd prefer to go a little bit deeper into it. On an international basis, the IASB is looking for actuarial support once it's developed its principles that it wants to use. It's looking for a body that will be able to provide those. I think it's very clear, though, that the IAA is a federation, and the federation really takes its power from the national body, not the other way around. I think the national bodies will have to accept that.

MR. SAM GUTTERMAN: I would like to respond to the comment about participating whole life. If the definition included in current IAS 39 remains as is, that is, is not modified either in the expansion or the current project review or Phase I, it's possible that whole life might be considered included as principally financial. As a result, it might be included, but that provides little guidance in terms of how to value a participating whole life contract under that. That's an item that IAA has suggested that needs clarification and probable change. Regarding principle versus rule-based standards, that's an issue that's been debated in the last 12 months. My guess is that the IAA will attempt to be as principle-based as possible, as opposed to rule-based. On the other hand, the IAA needs to provide sufficient, appropriate guidance to actuaries around the world to try to figure out what the accounting standards or financial reporting standards mean, and how it could be implemented, at least in a reasonably comparable manner.

MR. DARIN ZIMMERMAN: I'm working a lot with FAS 133 for equity-indexed product, and in my opinion FAS 133 is just a train wreck of a regulation. It has a portion of the liabilities held at fair value and the remainder of the liabilities held at book value. There is a very, very different proportion of the assets held at market value with the remainder being at book value. It concerns me to hear that members of the IASB think de-linking the assets and liabilities is a good idea.

MR. FREEDMAN: I'll give you an example of the rationale for de-linking. Take two companies that have the same liability structure. Let's say they each issue the same GIC. One of them has assets that are all in Treasuries, and the other one has assets in junk bonds. If you link the assets and liabilities together, you would tend to get a bigger value for surplus with the company with the high yield assets than you did in the Treasuries, even though you have exactly the same market value of assets as you do with the market value of the liabilities. That's what drove the IASB into a basis where the assets and liabilities were not linked from, say, an embedded value type basis.

MR. CONGRAM: It's a better system if you can have some more appropriate linking. I generally support your comment. I don't see that the IAS proposals are completely de-linking. If you have the concept that both are being valued (I'm not taking credit risk into account at this point, but just both are being valued at fair value), then, in effect, if you have assets and liabilities that are appropriately matched, then in principle the values of the assets and the liabilities should move together. You have a concept of linking through the methodology of the measurement process you use on assets and liabilities. I think we've got to be sure that we understand that particular methodology could be used. But I would agree that I think, particularly with the performance linked products, and the de-linking of the assets and liabilities, it makes it very difficult.

FROM THE FLOOR: Elizabeth, is there any limitation or discussion about what happens when you get negative reserves using a gross premium method?

MS. ROGALIN: No, I'm afraid I haven't seen a great deal of discussion on that.

MR. FREEDMAN: I don't think there's any requirement that the reserves can't be negative. In fact, if you have a gain at issue, effectively you do have a negative reserve, and there are a decent amount of situations where there's a gain at issue.

MR. CONGRAM: You also get negative reserves if you have large acquisition costs, even if the reserve is not a profit at issue. My view on the negative reserves is you've got to look at those as an asset, and is that asset a real asset? You've got to understand a negative liability is effectively an asset, and so you've got to put on a different thinking hat when you see them.

MR. ROBERT W. WILSON: Just a follow-up on the negative reserves. It makes using Treasury rates not very conservative if the present value of the income is more than the present value of the outgo. So we might want to rethink that under those circumstances. Before the DSOP actually came out around 2000, I was fairly heavily involved at reading materials coming out. With the changes at the IASB, moving backwards, it must be becoming difficult. I know an awful lot of people that I've been involved with who have spent a fair chunk of time on IAS proposals have given up. I haven't time to waste on a bunch of accountants who can't make up their minds whether or not we're going to have cash value floors in the liabilities in the future. I would think, speaking particularly to David, this is a concern for the IAA of the wastage of resources that sort of burn out on contributing, and, thus, we may end up with something without enough input. I'm concerned that we, as an industry, are suffering to some extent from the syndrome of being too long at the front.

MR. CONGRAM: Well, I think I would come back and repeat one of your comments. If you don't participate in the development process, then you don't really have an opportunity to make sure that what comes out is reasonable and is based on good sound actuarial principles. It is difficult to participate when there is a learning process going on both from the accounting side and the actuarial side. In Canada, we went through this discussion as we moved to a prospective valuation with regard to exactly what renewal should be considered. A similar discussion is already taking place and actually going further in my mind at the IASB. We have quite a bit to learn from the accounting profession in terms of the ways they look at different items and some of the language they even use. It's a long road. We have to keep to the process. I think there is some concern about burnout, but I do think we need to continue to participate.