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Summary: International accounting standards (IAS) for insurance are in the midst of being overhauled. Attendees learn about the status of recent developments in international accounting standards for insurance.

MS. MARIA MERCEDES TORRES-JORDA: Welcome to Session 23, which will cover current developments in international accounting standards for insurance. We have three presenters today: Kim Yeoh, Francis de Regnaudcourt and me. Kim is going to give us an overview of international accounting standards requirements for insurance companies. Kim is a Fellow of the Society of Actuaries, a Fellow of the Canadian Institute of Actuaries and a CFA charter holder. She has extensive experience in investments, valuation, financial reporting and corporate areas in Canada and was involved in a U.S. GAAP conversion. She's currently a corporate actuary at AEGON USA working on the International Financial Reporting Standards (IFRS) conversion and other special projects.

Francis is going to talk about some of the practical considerations that crop up as a company implements IFRS. Francis is a Fellow of the Society of Actuaries, a Fellow of the Canadian Institute of Actuaries and a CFA charter holder. He's also the head of life special projects in the retail life area of ING in the United States. Francis has practiced as an actuary in Canada and the United States in pensions, in individual

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Note: The chart(s) referred to in the text can be found at the end of the manuscript.

life insurance and in consulting as well as in insurance company management. For five years he was a life insurance analyst with Moody's. Francis chairs the insurance task force of the CFA Institute's Global Financial Reporting Advocacy Committee, which has considerable interaction with the IASB and their staff. In his special projects responsibilities at ING, he participated in an impact analysis project that was, in effect, a first dry run of fair value accounting.

Finally, I'm going to focus on the accounting and profit emergence for investment contracts, which companies will need to address by 2005. I'm an Associate of the Society of Actuaries and a manager in the insurance and actuarial advisory services practice of Ernst & Young. Prior to joining Ernst & Young, I was chief actuary at a life insurance company in Argentina. During the last two years I have been doing extensive research in the actuarial aspects of fair value accounting and IFRS, and I have helped several companies in both Europe and the United States with their conversion efforts. Our first speaker is Kim Yeoh.

MS. ENG KIM YEOH: I'm first going to give some background behind IFRS, and I will fill you in on what's happened so far since the beginning of IFRS—the beginning of time, as you may like to look at it. I will talk about what's going on in Phase I, the phase that we are in right now, and by the end of the session, hopefully you'll know what this jumble of letters and numbers means: Exposure Draft (ED) 5, IFRS 4, IAS 32 and 39. At the end of the presentation, I'm going to talk a little about the future of insurance accounting, also known as Phase II.

The IASB is the International Accounting Standards Board. The International Accounting Standards Committee (IASC) was set up in 1973. It was reorganized and renamed International Accounting Standards Board in 2000. It's a private sector standard-setting organization. Its stated objectives are to develop a single set of high quality global accounting standards that require transparent and comparable information in financial reporting and other financial statements to help capital markets and other users make economic decisions. It talks about high quality a lot. Two other key words that come up a lot in international accounting are "relevant" and "reliable."

Another objective of the IASB is to promote the use and rigorous application of these standards. The third objective is to bring about convergence of national accounting standards with IFRS to high quality solutions. Convergence in this case would be the IASB working with the FASB to come up with convergence between U.S. GAAP and international accounting, but they also have to work with other national accounting standard setters, like people who set U.K. GAAP, Dutch GAAP and French GAAP. This is one of the big reasons why international standards would be important to you even if you don't work in an international company or if you don't have international business. International standards will likely influence changes in U.S. GAAP some time in the future. That may take a while, but it may happen eventually—both FASB and IASB are publicly committed to this.

When I talk about IFRS, I refer to all the standards set by the IASB and its predecessor organization, IASC. Some of these are referred to as IFRS, and these would be the ones set since 2000. The ones prior to that would be referred to as IAS, or when I talk about financial reporting standards, I refer to all of them together. IFRS is important because, first of all, most EU-listed companies are required to adopt IFRS from 2005 onward. This was proposed by the European Commission in 2001, and it affects about 7,000 companies in Europe. Of those, about 300 currently use U.S. GAAP, about 300 use IFRS, and the rest of them use their own national accounting standards, for example, U.K. GAAP, Dutch GAAP and French GAAP. There's a whole hodgepodge. You really get to see why international standards are important.

To adopt IFRS for 2005 means having comparative information from at least 2004. If a company is also listed in the United States, the Securities and Exchange Commission (SEC) normally requires three years of information in financial statements, which would mean that you would also have to have IFRS statements for 2003. However, the SEC recently came up with a proposal that would only require comparatives for 2004, but it would require additional reconciliation and disclosure. This proposal isn't final yet, but it's in the process of being discussed by the SEC.

So, after that general view we can look at insurance accounting. Prior to this year, the international accounting standards did not have a specific standard that addressed accounting for insurance contracts or accounting by insurance entities, but that doesn't mean they haven't been talking about it. They actually started talking about it a little while ago. In 1999, the IASC issued the insurance issues paper which listed and discussed various issues regarding insurance accounting. They talked about measurement objectives, definitions of insurance contracts and how to estimate future cash flows.

It was quite clear from the issues paper that they envisioned insurance accounting to be a fair-value-type model. The issues paper led to a lot of comments and some research, and in 2001 the IASB published a Draft Statement of Principles (DSOP). The DSOP talked about using entity-specific value, which is similar to fair value, but in some cases the assumptions would be based on entity-specific assumptions and experience. It also talked about projecting cash flows, including market value margins (MVMs), and about reflecting owned credit risk in the valuation.

The DSOP never made it out of draft stage. There were a lot of comments on it; it sparked more research, but the result was that the IASB, with a lot of prodding from industry, realized that it did not have enough time to come up with a new comprehensive statement for insurance accounting by 2005, and the result was that in May 2002, the board made a decision to split insurance accounting into two phases. Phase I would be effective for 2005, and it would only require limited improvement to insurance accounting and enhanced disclosure—quite a lot of enhanced disclosure. Immediately after Phase I is final they would talk about Phase

It and hopefully have that ready for implementation in 2007. As we stand right now, we think 2007 is probably a little bit too optimistic, and we're probably looking at 2008 or 2009, if not later.

As a result, in July of last year, ED 5 for insurance contracts was published, and it talks about a definition of insurance contracts. Because of that definition, a lot of the products that insurance companies sell actually fall under financial instruments. They wouldn't be considered insurance contracts. As a result, the financial instruments standards IAS 32 and 39 would be important to insurance companies. These were amended and finalized in December of 2003. In March of 2004, IFRS 4 insurance contracts were finalized.

So, the comment period for Phase I, ED 5, lasted through the end of October 2003. It received 126 comment letters. One of these came from the International Actuarial Association, which the SOA endorsed, and this is one of the longest. The IAA did not restrict itself to answering the questions posed by the IASB. Instead, it gave a lot of useful comments and other issues, but it was a pretty long paper.

The following are the key points of ED 5. As I said before, it only proposed limited improvements to insurance accounting, but these are the key ones that we have to recognize were in ED 5. It talks about a definition of an insurance contract as a contract under which one party accepts significant insurance risks from another party by agreeing to compensate a policyholder or the beneficiary if a specified uncertain future event adversely affects the policyholder or the beneficiary. In this case, insurance risk is defined as risk other than financial risk transferred from the holder of a contract to the issuer, the insurance company. The definition of financial risk is the risk of a possible future change in one or more of specified interest rate, financial instrument price and other variables.

It also includes nonfinancial variables, as long as, in the case of a nonfinancial variable, the variable is not specific to a party to that contract. For example, it's useful to think of weather insurance. If you get a payment because the temperature rises above 100 degrees and all your ice cream melted, and you were being compensated for that, that's insurance. But if you got a payment just because the weather rose above 100 degrees, you didn't have to incur a loss. That would be a weather derivative, and it would be a financial instrument. So there's the difference in the definition. That's a fairly simple one, but there are other contracts where it gets a little bit gray, and then you have to apply more judgment. I think Francis is going to talk about one of those.

Insurance contracts under ED 5 will continue to be accounted for under local GAAP, and this includes the reserves under those contracts, any deferred acquisition cost (DAC) or value of business acquired (VOBA) and any other liabilities like unearned revenue liabilities. ED 5 also talks about the unbundling of deposit component insurance contracts. These would come under IAS 39 and would receive deposit accounting. Examples of these might be a deposit component in a financial

reinsurance contract. ED 5 also requires that embedded derivatives within insurance contracts be bifurcated, and this would be similar to Financial Accounting Standard (FAS) 133, unless those derivatives are themselves insurance contracts.

There are some restrictions on reinsurance under ED 5 in that you can't offset your reinsurance assets against your insurance liabilities, and you can't recognize a gain or loss on purchase of reinsurance. There is also a loss recognition test that's required. Catastrophe and equalization provisions are prohibited. And, in the basis of conclusions to ED 5, they sneaked in this concept called the demand floor. This says that your fair value has to be at least as great as the amount payable on demand, which would be like a cash surrender value. ED 5 also requires disclosure of fair value of insurance contracts by 2006.

During the comment period there were a lot of letters, and four common themes emerged from these letters. One of these was the significance of insurance risk. A lot of preparers found it hard to get their heads around exactly how to define the significance of insurance risk. The exposure draft did not come up with a specific number, like 1 percent or 5 percent being significant. It asks you to look at the contracts by themselves. And by the way it was written, it also reads as if a waiver of surrender charge would be an insurance risk. Some people brought up the point that if you are a mobile phone company and you waive the surrender charge on a death of a subscriber, does that mean that you're selling insurance now, too? Little things like that were interesting.

Another comment was the asset-liability mismatch, and this is where international accounting assets will probably be held as either trading or available for sale, similar to U.S. GAAP. But because of ED 5 liabilities, it would be held under the current accounting, which generally is historical cost or amortized cost method. Then your balance sheet has a mismatch between your assets and liabilities, allowing for volatility in your equity, which may not be real. There's also a lot of controversy around a demand floor. A lot of people didn't think that was economically or theoretically correct. Also, the disclosure requirements that were asked for in 2006 were controversial because, while the board asked for fair value to be disclosed, it did not define how fair value was to be calculated.

There was a lot of discussion in board meetings between November 2003, after the comment period to ED 5 closed, and February 2004. As a result, IFRS 4 was published in March of 2004. The board did take into account a lot of comment letters to ED 5, and it had consultations with various industry groups to try to solve the mismatch issue in the demand floor. As a result, the major changes from ED 5 within IFRS 4 were that the definition of an insurance contract was clarified. They clarified then that a waiver of surrender charge is not significant insurance risk because it doesn't transfer existing risk from the policyholder. It's just a risk that comes up because of the insurance contract.

The way it's written now; it also looks as if there is a difference in the amount of

payment between death and surrender. That should be insurance unless the percentage is insignificant, and there's an example that implies that a 1 percent difference is insignificant. It also clarifies the unbundling requirement. Now it says that if your current accounting addresses all your obligations, you don't have to unbundle. The result is that most U.S. contracts won't need unbundling. The loss recognition test in ED 5 has been renamed to the liability adequacy test, but the focus is the same, and the renaming was just to focus the objective of that test on the liability adequacy, not recognizing the loss. It also removed restrictions on reinsurance but requires additional disclosure for reinsurance.

Other changes from ED 5: IAS 18 for revenue was amended by IFRS 4 to allow certain acquisition costs to be set up as an asset for investment management contracts. This isn't related to insurance contracts but was amended by IFRS 4 as a result of discussions with insurance companies. IFRS 4 also clarified treatment of contracts with discretionary participation features, for example, if you had participating dividends on an investment contract, you would still account for it under IFRS 4 even though it's an investment contract.

Also within IFRS 4 there were a couple of measures introduced that try to mitigate the asset-liability mismatch issue. One of them is the option to measure your insurance liabilities with current interest rates and other current assumptions. That allows you to elect to market your insurance liabilities on a very selective basis. You can choose to mark certain ones and not mark others. It doesn't really matter. And IFRS 4 also explicitly allows shadow accounting, similar to U.S. GAAP.

It also clarified some definitions within embedded derivatives and interdependence. It now says that if an embedded derivative is interdependent with the host insurance contracts such that it can't be measured separately, then it's considered to be insurance as well and doesn't need to be bifurcated. The proposed fair value disclosure for 2006 has been deleted. The board understood the comments and appreciated the comments that fair value could not have been disclosed if it wasn't defined, and IFRS 4 also said that unit denominator payments could be measured at current unit values. It contains an exemption from 2004 comparatives if you adopt IFRS 4, which means that you can choose an adoption date of January 1, 2005. There is also an exemption from certain disclosure requirements for 2004.

The IASB intends to have what we call a stable platform of standards for companies to adopt IFRS in 2005, and with IFRS 4 and IAS 32 and 39 they have achieved it to some extent. Certain things are outstanding within the near-to-median term. There's an international working party, also known as the Insurance Working Group. This is where the IASB has sent out invitations to industry groups and other interested parties to gather a small group of senior insurance professionals to discuss issues and come up with solutions to the problems within Phase I and to come up with a direction for Phase II. They are intended to serve as a consultative group to help the IASB. Any solutions that this group and the IASB come up with in the short term, if they are workable, might be introduced even before Phase II is

introduced.

There are certain amendments outstanding on IAS 39. There is an exposure draft for limitations under the fair value option that will limit the use of fair value to a profit and loss to certain assets and certain liabilities. The exposure draft for this is out right now, and the comment period closes in July of this year, but this one, when it becomes effective, will be effective for 2005. There is also an exposure draft due to come out on financial guarantees, which will affect credit derivatives, credit insurance and letters of credit, but this hasn't been published yet. Also to be published with that is an amendment that may define fair value measurement subsequent to initial measurement, but it isn't very clear what that means yet either.

Phase I is just supposed to be a stepping stone, a compromise solution, until we can come up with Phase II, which will be a comprehensive accounting standard for insurance. I'm going to talk a little bit about Phase II. When Maria first invited me to speak here she asked me to talk about implementation issues. She had originally invited Peter Clark, a gentleman from the IASB staff, to talk about Phase I and Phase II, and we later found out that Peter couldn't make it because of conflicts with an IASB meeting. So she asked me to talk about Phase I and IFRS. I thought, sure, I can do that. Then she asked me to talk about Phase II, and I thought I can't really do that because I don't know what's going to go on with Phase II and what Phase II is going to look like eventually. Then I thought about it further, and I realized that really nobody does know what Phase II will look like eventually, maybe not even Peter Clark.

I'm going to talk about what little we know about Phase II right now, and I'm also going to talk about some speculation and rumors that I've heard about Phase II. You can take it for what it's worth. In January 2003, the IASB stated the tentative conclusions for Phase II. This is the most recent technical discussion of Phase II, and it's actually one-and-a-half years ago, which is a fairly long time by IFRS standards. So a lot of things may have changed since then. One of the conclusions was that Phase II will be an asset and liability approach, not a deferral and matching of income approach, and assets and liabilities will be measured separately.

The measurement model for insurance liabilities is meant to be fair value with certain caveats. Entity-specific assumptions will be allowed when market-based assumptions are not available. Also, the fair value shall not be less than the entry price for new contracts with identical terms, which means that you will get no net gain at inception unless you have market evidence that proves otherwise. Implied by fair value is that the liabilities will be discounted. Also, it won't incorporate asset performance unless a liability captures a link to actual asset performance, and these will include market risk premiums or MVMs. In fair value you're supposed to reflect the credit characteristics of the contract, which means they're going to reflect your own company credit risk, any guarantee funds and collateralizations

within the contract.

Future premiums are included in fair value if you have non-cancelable renewal rights and if those rights will lapse if premiums are discontinued. Renewal premiums were a big issue when coming up with a fair value definition within the accounting community. Also, fair value acquisition costs are expense when incurred. I'm not sure how that ties in with the no net gain at issue. It might still allow loss to the extent of the acquisition costs. However, with the IAS 18 amendment that I talked about earlier, it already set some precedent for some acquisition costs being deferred as an asset.

One of the things that they did say when they talk about Phase II is that the outcome is not cast in stone, and when they sent out the invitations for the Insurance Working Group, they said that they would not be bound by any of the discussions that happened before. So, the issues paper and the DSOP would only be a useful reference. The only thing that would restrict them from taking a fresh look at Phase II is the IASB framework and other general principles that already exist in IFRS standards.

Phase II will be a single model for all insurance contracts, including reinsurance, life, health, annuities, everything. It's supposed to be fully prospective and attempts to measure your insurance liabilities directly. It's not a retrospective accumulation of prior cash flows. They intend to have discounting for all insurance, including nonlife, property and casualty (P&C) type stuff—intended not to have any lock-in of assumptions, so nothing like FAS 60. Economic assumptions are supposed to be consistent with market, and non-economic assumptions have to be entity-specific if the market data isn't available, and they should be current and updated regularly.

There is an explicit objective for risk margins: to reflect the market price. These are not provisions for adverse deviation, although they are similar. They're not there for prudence or for solvency. They're there to reflect what another buyer might pay for your insurance liabilities. That's why they're called MVMs. Fair value should reflect embedded options or guarantees, both a time value and intrinsic value. This implies option-pricing methods. It won't be necessary to separate embedded derivatives from insurance contracts because your insurance contracts will already be at fair value. The liability measurement should be independent of assets, and deferred tax should be undiscounted. This is all the official guidance that we've received on Phase II right now.

Here is the unofficial stuff: This is some speculation that I've heard fairly recently from other parties about future directions of Phase II, and this has come about because this isn't strictly fair value, but because the board has said that they're not really tied to fair value and they don't presume anything. So two possible solutions have come up. One is a modified U.S. GAAP with unlocked assumptions. We know they don't like FAS 60 with the lock-in, but maybe if we came up with a modified

version with assumptions unlocked—I'm not really sure what this would look like, but if you came up with something that looked like modified U.S. GAAP, it would certainly fulfill the convergence objective.

Another solution that comes up every now and then is embedded value, and actually there's a group of European insurers that get together, called the CFO Forum. They recently published the European Embedded Value Standards. They are definitely private sector, but they publish these standards that look quite similar to international standards. The purpose is to gain uniformity in embedded value, to gain greater credibility, and to show the board that here we have the solution called embedded value that analysts might like and that everyone understands. So why don't we go toward that direction? I'm not sure how far they'll get on that either. The thing about embedded value that the board doesn't like is that it includes future investment returns, and there are no restrictions on gains at inception. So, a possible solution could be a modified embedded-value-type calculation, but, like I said before, no one really knows.

MR. FRANCIS DE REGNAUCOURT: The title of my talk is "Let's Get Real Here," and my contribution to this panel is to talk a little bit about the practical, real-life aspects of what you can expect to see in international accounting. Let me say that I have absolutely no competence to tell you this. No one does because no one's really going to do international accounting until the first time there is a set of public financials put out on IFRS vetted by the auditors, and that'll be the first time people will have really gone through the process. I work for a Dutch company, and as a European company, it will be faced with this in a few short months. So we're going through a dry run, and in my role as the head of special projects, which has absolutely nothing to do with financial reporting, I went through a dry run.

Separately, as Maria said when she introduced me, I was an analyst for a long time, and I'm a CFA. The CFA Institute has an advocacy group that talks a lot about accounting, and they have an insurance task force because the accounting for insurance is second in complexity and lack of clarity only to oil exploration. So they felt they should have a special group just on insurance. You may not know this, but the CFA Institute says they want to see fair value of assets and fair value of liabilities, separately. So we talked about embedded value as something that might work, and certainly for the companies it would be very convenient. For actuaries it would work rather well, but let's make it clear. The analysts want to see fair value, and, if we have time for questions, we'll get into that more.

What I'm going to talk about cannot possibly be comprehensive in this kind of timeframe, plus we haven't seen all the problems. So I've selected three conundrums, just little things you have to deal with. When you go to deal with it and look at the rules, the rules are worded in pretty funny ways. Then you look at common sense, and common sense goes in a different direction, but you need to do the right thing, and you have to meet the rules.

I don't want to get too technical. There are people far more knowledgeable than I am in how you do fair value and look at MVMs. There is probably room for a couple of textbooks to be written on that subject. I'm going to give you one slightly technical example on discount rates, just so you see the kind of questions you're going to have to ask and what kind of mind-bogglers you'll be up against.

Finally, I'm going to talk a little bit about disclosure. That's not really a conundrum, but if I were a betting man, I'd tell you this: There are a lot of problems with international accounting, and it's going to take a lot of actuaries and a lot of accountants a lot of time, but they will one day be solved, and you'll move forward. Disclosure is something you're going to have to do every year, and I think it's a fair bet that there'll be ultimately more work done on disclosure than there will be on all the other problems put together.

So let's dive in, but before we do, I'm just going to take a common sense poll. The first example I'll give you is the plain old deferred annuity—not market-value-adjusted, not equity-indexed, not variable, just the plain, old, deferred annuity. Who thinks it's an insurance product, and who thinks it's an investment product?

Let's start with insurance. Who thinks it's insurance? Okay. Three people? Who thinks it's an investment product? Okay, most of you. That's a pretty common sense view. If you ask the people in the industry, the industry has a bias toward calling things insurance because the beauty of common insurance is that you get to do the same accounting during Phase I, and Phase I has the risk of lasting a very long time. Kim told you that she thought Phase II wouldn't happen until 2008 or 2009. My bet is more like 2010. My chief actuary over in Amsterdam says, "I don't care. It'll be after I retire." And he's only in his early 50s. So there are a lot of people who are saying Phase II is going to be a long time in coming.

Even in Phase I, there's a distinction you need to know about. For insurance products, you can use your existing accounting, which for most of you is FAS 60 or FAS 97. For investment products, you're allowed to continue using amortized cost accounting, but there are a lot of people who think that it might need to be FAS 91. In fact, some are even sure of that. There's a real risk that if your single premium deferred annuities (SPDAs) are classified as an investment product, you will need to change how you account for them. So there's a perfectly understandable bias, from the standpoint of the reporters and the insurance companies, to want this to be insurance. But an analyst will look at you like you have 10 heads and say, "What can be so complicated? It's a savings account. Why is there even a question?"

Now let's look at the rules. There is an implementation guidance, which addresses the SPDA question, and it breaks it down in two possibilities. In one possibility an SPDA is an insurance contract. In another, it's not an insurance contract, and that means it's an investment contract. Those are your only possibilities. So how do they make the distinction? Remember how all SPDAs have to have these guaranteed annuitization rates or else you're not an insurance contract by state law in the

United States? No one ever looks at these annuitization rates, but they're still there. The implementation guidance says that if these rates were guaranteed at inception, it's an insurance contract. If, on the other hand, annuitizations happen on the prevailing rate at the time of annuitization, then you can call it an investment contract. That's the rule.

Let's look at the facts: All companies have to have minimum guaranteed annuitization rates, which are required by state law in the United States. I can't say this in absolutely 100 percent of the cases, but every company I've ever worked for, any client I've ever had, had annuitization rates at 3 percent when SPDAs were paying 8 percent and 14 percent. Today's SPDAs have annuitization rates at 1.5 percent. In other words, they are at rates lower than ever intended for use. And virtually every company that I know has current annuitization rates that are used instead of what's guaranteed in the contract. Today's annuitization are around 3 percent. When you were paying 8 percent on the contracts, you might have your annuities at 7 or 6.5 percent.

We did a query. We said, "Okay, we've been issuing annuities since 1960. Have we ever paid annuitizations at the guaranteed rates and not the current in-effect rates?" And the fact was that in our individual line of business, through the end of 2002, and the answer was never. My group colleagues, however, said they started bumping into their guaranteed rates in 2002. Since then, individual started bumping into the guaranteed rates in 2003. Finally, in annuitizations, and I think this is most people's experience, we had \$65 million of annuitizations in a portfolio of \$5 billion or thereabouts.

So, it applies to 1.5 percent of your policies. It applies to one year out of 43. And, let me tell you, my pricing guys are doing everything to make sure that it doesn't apply to any more years in the future. So, is annuitization significant? Let's take a show of hands now. Who says SPDA is insurance now that you know the rules? Okay. We still have a small number of people. Who says it's an investment contract? Okay. Still a multiple more. Let's go back into the rules a little further. This is what Kim's been talking about, the definition of insurance.

Insurance risk is significant if an insured event could cause an insurer to pay, *excluding scenarios that lack commercial substance*. It's hard to know what this means. But we think this applies to the quantum of difference, and there's no doubt that if you have an annuity guaranteed at 3 percent and the company pays it out at 2.75 percent now, it's really 3 percent guaranteed in the contract. That can be deemed significant, and you can say the condition is met even if the insured event is extremely unlikely. We're talking about 1.5 percent annuitizers, once in 43 years—not a big difference because even now there is very little difference between the rates that are guaranteed in the contract and what we would be paying if we had our druthers.

So, where do we think we come out on this, because we haven't come out yet? It's

probably insurance. One of the things I didn't want to commit to paper is that I actually called up the IASB staff and asked them. In my CFA role I got to know them pretty well, and they say that they think most people are going to call it insurance. Then they won't tell you explicitly, but they'll let you understand that they're okay with that, and that's where we were a couple of months ago. Then some accountant, and I won't name anybody, I won't even tell you if they're internal or external, said that if you are going to rely on such a trivial subset of the commercial substance like guaranteed annuitization, you'd better have a more detailed position paper. Now, that is frustrating. It is probably also a very reasonable position for them to take. Isn't accounting supposed to be about commercial substance?

I've been told that the staff may be comfortable with people calling it insurance, but the staff may have been seeing too many insurers pounding on their doors. What's the IASB for? It's not to keep actuaries happy. It's not to keep insurers happy. It's to keep the users happy, and the users, for the most part, are the analysts. The analysts want commercial substance, and the analysts can tell you, it's an investment product. That's where we are. It's not solved yet, and I'm not the one who's going to solve it. I guess by the end of the reporting period for the first quarter of 2005, my company will have taken a position with or without their auditor, and so will all of yours—the ones who are affected by this. That was the SPDA conundrum, an idea of some of the details that come out in classification. That'll probably be solved once and for all.

A few other things on classification: It's getting a bit trivial, but here are some of the things we've seen. The beauty of classification is, because we have to classify for Phase I, we actually have to really go through this now; it's no longer a dry run. So I can tell you a little bit more. Phase II, with its distance, is still a bit theoretical. Is there any insurance component to supplementary contracts, especially those without life contingencies? Can anyone think of any? There is a group of people who would say these are investment contracts. On the other hand, there's a rule that says, "Once an insurance contract, always an insurance contract." So, is your supplemental contract a continuation of the insurance contract, or is it a contract exchange? I refuse to get involved in such a pedantic debate, but somebody has to resolve this.

Riders. Say you decided that in SPDAs or variable annuities, before you looked at the death benefits or investment contracts, some people usually call their death benefits a separate rider. Can you have a situation where your base contract is an investment contract and your rider is insurance or vice versa? You have to worry about things like that. There is one piece of good news. (So far, I've given you all bad news and things that are problems.) One thing we found is that—since you've all done FAS 133, derivatives investment guidance (DIG) 36—there's a DIG out there that keeps everybody happy. Once you've done a lot of this work, at least when it comes to embedded derivative, the rules in IAS on hedging accounting are a bit different—they are tighter. But wherever the same rules hold, you're going to

be able to use a lot of your past work. That may be the only piece of good news I have to give you in this whole presentation.

Discounting conundrum. This is my one and only technical piece for you, but it's actually sort of fun. Kim's already told you that you can't take asset returns into account. This is going to look a lot like embedded value to you. How does embedded value work? Let me show you a diagram (Chart 1). This is an IAS income statement. I took out the numbers because they're not particularly relevant, but it works a lot like embedded value. Take last year's embedded value, and add some embedded value of a new business. Then unwind the discount for one year, and look at how experience deviated in the year to see if you will change your future estimates. A lot of work and money will go in here, but this was a theoretical exercise. So we assume that even if things meet assumptions perfectly, what will it look like? You create new business. It's supposed to have a zero value. Ours didn't, and even then, there's a half a year's worth of unwinding.

But let's look in the central part—the in force, which is really what I want to focus on. If you had the fair value of assets and your fair value of liabilities correct last year, you're going to earn money on your assets. You're just going to revalue them and have an increase or a decrease in fair value of assets. You'll unwind the discount of your market value on your fair value of liabilities, and the difference between the two will be your profit this year. Actually, you also have to release your MVMs. That's what you had counted on for profits in last year's fair value, and then one year's worth of investment earnings offset by one year's worth of discount unwinding on the fair value. So far it sounds simple, but let's go back a bit.

Let's look at the fair value of liabilities. You can't take into account your asset rate of return. On the other hand, if you're doing things in U.S. GAAP, you looked at the rate of return on assets. So, for IFRS, you have to really look at what you use to calculate your fair value of liabilities, and what it does—stuff like liability duration. Most people put all the risk characteristics in the cash flows that they're discounting, and then they figure out what the MVMs should be to reflect what the market is, and then use a risk-free curve for discounting.

We say risk-free curve like there's only one. Most of you who do asset-liability modeling (ALM) work use the risk-free curve. It's basically U.S. Treasuries. Well, what if you're a Dutch company, German company, South African company and you have business in 80 countries throughout the world, whose risk-free curve do you take? That's actually relatively easy to solve because there is a swap curve, and the swap curve is the basis for currency swaps, among other things. So it's not a bad international standard. But remember, you're now taking your U.S. business, based on the swap curve, and adding MVMs. But if you use a swap curve to look at your fair value of liabilities, how is the market value of assets determined?

Not with the swap curve, especially an international swap curve. For assets, it's the Treasury curve for the rating category of that bond. So you have a mismatch

already between your assets and your liabilities, assuming all your assets were fixed income. As you know, you're supposed to take into account the rating of your company. Well, what rating? A company like ING issues bonds in the Netherlands. It issued them all over Europe. It issues them through subs in the United States and probably has a lot of other private debt. Usually the ratings are the same. But take a South African company, and there is one that has substantial U.S. holdings. It's a pretty strong company. If it is issued in the United States, I'm going to guess it would be a single A, like most life insurers who aren't the very top level, but South Africa's rating, as I recall, was Baa3.

A financial institution in a country, at least according to some rating agencies, cannot have a rating higher than its sovereign central bank. If they ever have to pay bond coupons in a foreign currency and the central bank fails, the central bank will seize all the foreign currency and pay its debt before it lets any of its constituent companies pay. So, any South African company is going to have a rating capped above its South African rating. So now you're back in the United States at this company's U.S. operations and doing your international accounting, what rating do you use?

Another example is just figuring out what the discount rate should be, but let's assume you found one. I think most people are going to end up using swap curves, and they'll hide the differences in the MVMs. That's a classic actuarial way to do things, and I don't think anyone's come up with a better idea. So in such a swap curve, you'll find that it's not a single constant, it varies by duration. We, however, are discounting over one year. I had someone tell me that what we should be doing is taking our investment returns as whatever they were in 2003, which is what this is, and unwinding the discount at 1.46 percent plus an average MVM.

My assets earned about 5.5 percent in 2003 on a market value basis—1.46 plus an average MVM ended up being about 2.25 percent. Not surprisingly, I had a 60 percent return on equity (ROE). So, I don't think that's the answer, but what is the answer? What do you do? Do you take an aggregate rate? Even if you do that, you're not matching the theory that you were using for building up this fair value.

My favorite, and there are probably a lot of issues with this too, is to simply recalculate the fair value at the end of year one, with all the cash flows being moved forward one year. You apply the same curve, but now 1.46 applies to the 2004 cash flow instead of the 2003 cash flow and so on and so forth. I'm hoping most people will come to the same conclusion, but when you're trying to explain your IAS earnings, how do you say what came from unwinding the discount and what came from expense overruns and so forth. Consulting actuaries take note, there's going to be a lot of work there for you.

So that was the discounting conundrum. There's certainly not a good body of answers to this yet. There will almost certainly be a consensus of practice over time, but this is the kind of practical consideration at every step of the way that

you're going to come up against.

Disclosure. I don't know if I should call this a conundrum or just a ton of work. This is what the IFRS says about disclosure: "A process used to determine the assumptions that have greatest effect." What is greatest effect? Do we all agree that mortality has an effect? Certainly terminations do. Premium persistency. What about changes in interest rates? Changes in hedging strategies? Bond quality? And these are just the easy ones. I haven't even gotten to disability and health, which I'm thinking of in the U.S. context. There are plenty of them there.

How would you like to show people what process you used? Do you really want them to see how out-of-date your mortality tables are? When's the last time you actually looked at the incidence of lapse rates by duration? But just take this under advisement. You didn't have to disclose all the assumptions before. Now it's pretty clear you're going to have to, when practical. That gives you a big out, but still there's going to be pressure to give quantified disclosure.

Changes in assumptions—Do your companies show the separate effect of each change in assumptions every time? Then, of course, reconciliation of changes is almost full-time employment for a lot of people. But this is what the new disclosure requirements are. And that's just the easy part.

Look at it now from the other side. The CFA Institute is pushing for this. They're pushing for international accounting, and they are the ones who say there's something broken with the current accounting. Take all the work I described and break it down by business. How many countries are you doing business in? Anyone work for AXA? AEGON? Allianz? U.S. firms? AIG's going to have a lot of work, at least by country, by nature of business, all the different kinds of insurance they have, terrorism insurance, which, by the way, is common in other countries, but we don't have it here—by measurement attribute so differently by cash flow, differently by present values, typical earnings statements and balance sheet items.

My proposition to you is that disclosure hasn't just increased the amount of work. It's actually put whole dimensions of more work on it, which is why I said to you that this is going to be the big work. Some of the big companies are used to seeing 10Ks—160 pages now; 125 pages for the better reporters. I think that 10Ks of 1,000 pages are not out of the question under IFRS.

In closing, the point I wanted to make to you is this: There is an enormous number of outstanding practical issues still left to be sorted out. Phase II guidance is still a gleam in the eye of some accountants, and there's nothing to even sink your teeth into. If you are in the least bit worried with internal consistency, consistency by country, where you have different lines of business, consistency between assets and liabilities, etc., you'll have an enormous amount of work. It should be one reporting entity, one set of books, one set of assumptions. Probably it won't be, but I think people are going to try to get it as consistent as they want.

Convergence. Maybe I'm the cynic here. In October 2003 the Norwalk Agreements pledged convergence within three years. That takes us to October of next year. Do you think the FASB people are going to say, "our system is all wrong, we cave in, you guys are right," and then do everything on fair value? My suggestion to you is that when it does happen, convergence may end up looking very different than what we're looking at now. That's political. I don't know what else to tell you. But for a bunch of us in the room it's the law. It's the law in our countries now, and we start six months from now. In fact, we've already started.

MS. TORRES-JORDA: I am going to give you an overview of the IAS 39 and IAS 18 requirements for investment contract liabilities. Next, I am going to illustrate the profit emergence for an investment contract under IFRS. Finally, I am going to summarize the key challenges and business implications that companies are facing.

As Kim explained before, the IASB had defined a two-phased approach for insurance. Here are the key standards that will apply in each of the phases:

- In both Phase 1 and Phase II, assets will be accounted under IAS 39
- On the liability side, we should first determine whether the product is an insurance or an investment contract:
 - If it is an insurance contract, then International Financial Reporting Standard 4 (IFRS 4) applies in Phase 1. The standard for Phase II has not yet been developed, but the IASB is envisioning a full fair value framework for insurance liabilities.
 - In both Phase I and Phase II, investment contracts should be valued based on IAS 39 and some aspects in IAS 32 and IAS 18.

The focus of this presentation will be on how to value and account for investment contracts under IFRS. IAS 39 allows companies to choose an amortized cost or fair value measurement basis for investment contracts. The decision is purely elective and can be made on a contract-by-contract basis. However, companies should consider carefully which choice is most appropriate, as the decision will impact profit emergence and is irrevocable.

- If the investment contract is not classified as held for trading, then the host can be valued at amortized cost and any embedded derivative should be measured at fair value.
- If the contract is designated as trading, companies can fair value the entire contract.

It is important to note that if there is an embedded derivative that cannot be reliably separated from the host, then the entire contract must be measured at fair value, which is to say that in these instances, the designation is not optional, but contracts must be classified as trading.

Let's move now into a discussion of the methodology details for each of the options.

Under IAS 39, amortized cost is defined as the amount at initial recognition minus principal repayments, plus or minus the cumulative amortization determined using the effective interest method.

In other words, amortized cost is the value of the contract's cash flows accumulated at the effective interest rate. The effective interest rate is defined as the rate that equates the value of the contract at issue to the present value of future contractual cash flows through maturity, excluding maintenance expenses.

The initial measurement for financial liabilities is determined at inception of the contract and is known as the initial value.

The initial value of an investment contract is the fair value of net considerations, which would be equal to the initial premium less transaction costs.

Transaction costs have a similar impact to DAC accounting. However, for an acquisition cost to be considered a transaction cost, it should be incremental and it must be directly attributable. In general, the incremental cost criteria is more restrictive than many existing accounting policies and this would lead to significantly fewer costs being deferred.

The treatment of embedded derivatives under IFRS is very similar to the accounting under FAS 133, but there is no grandfathering.

Under Phase I, guarantees and options are exempted from fair valuation if there are themselves insurance contracts. Examples of these are GMDBs and GMIBs.

It is still unclear whether renewals premiums should be included in the calculations—no explicit prohibition exists in IAS 39 and the reference to future payments and receipts seems to allow them to be included. However, the Board's discussions around the inclusion of future renewals should be closely monitored.

For contracts with cancellation options, the effective rate is determined for a group of contracts with similar characteristics considering the estimated cash flows of the group of contracts.

IAS 39 does require an insurer to recognize changes in estimated cash flows:

- The liability for a contract measured at amortized cost will be the present value using revised estimates of future cash flows but discounted at the effective interest rate determined at inception of the contract.
- Earnings would tend to be more volatile than under FAS 91, since the effective interest rate is not unlocked.

Fair value is the alternative to the amortized cost option for the measurement of investment contract liabilities. As there is no specific guidance for calculating the

fair value of investment contract liabilities, companies will need to turn to the more general guidance in IAS 39 for financial instruments and to the Board's intent for the valuation of insurance contracts in Phase II.

Fair value is defined as the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

There are several practical implementation issues for a fair value framework:

- IAS 39 establishes that a valuation technique commonly used by market participants should be applied when there are no observable market prices. Companies should try to calibrate the fair value to market transactions. Part of the calibration of fair value models is the comparison of the fair value to the net proceeds at inception. The standard does not require that the initial fair value exactly equals the net proceeds, but does suggest that a large discrepancy may indicate a problem with the valuation technique, assumptions or discount rates used. This is an area of concern, as common actuarial approaches may not naturally reproduce the initial value. In such cases, calibration through the discount rate or adjustments to cash flows may be appropriate.
- Commonly used actuarial approaches tend to incorporate expectations about the performance of the assets in their liability measures. For example, this is the case with embedded value frameworks. When defining the Phase II methodology, the Board stated that liabilities should not reflect investment spreads and that the discount rate should be set equal to the risk free rate plus the company's own credit risk. It is unclear what discount rate should be used for investment contracts.
- The fair value of a financial liability should not be less than the amount payable on demand. This would create a minimum liability for most investment contracts equal to their cash surrender value. This requirement could potentially produce a significant surplus strain and pattern of earnings more commonly associated with regulatory accounting.

Some investment contracts may involve investment management services. This is the case for variable contracts with no death benefits sold in several European countries. IAS 18, which deals with service contracts, applies to these products. IAS 18 does not generally apply to U.S. products, since the insurance risk in separate account contracts is generally significant and they would therefore be classified as insurance contract.

The incremental costs that relate to providing these services can be recognized as an asset and amortized as the insurer recognizes the associated revenue. This alleviates the strain resulting from the demand deposit floor requirement

Let's move now to a profit emergence case study to illustrate the concepts discussed so far. We are going to consider a 20-year immediate certain annuity.

The first year commission is 3 percent of the initial premium. The company invests the assets backing the product in a mix of 1, 5 and 7 single-A corporate bonds. In the base case, it is assumed that interest rates follow the forward rates and that the contract has been priced to achieve a 12 percent pretax target return.

Chart 3 shows the progression of earnings under Statutory, Amortized Cost and Fair Value. Under amortized cost, profits are quite depressed in the earlier years when compared to statutory earnings. This tends to happen under interest rate environment characterized by steep yield curves.

Think in terms of a FAS 97 income statement presentation. After issue, earnings can be thought as the investment income on the assets backing the liabilities plus the return on surplus less the unwind of discount on the liabilities, plus the effect of changes in estimates and assumptions. The investment return on the assets is increasing over time, while the unwind of discount on the liabilities, which is equal to the effective interest rate, is level by definition.

Assets are invested in a mix of one-, five- and seven-year bonds. Since forward rates are increasing, as the assets invested shorter mature, the proceeds will get invested in bonds with higher coupon rates. This explains the increasing rate of return on assets.

The average rate of return on assets for the whole duration of the contract is higher than the effective interest rate on the liabilities. However, in the earlier years, the rate earned on the assets is lower or very close to the unwind of discount. Net income will be negative until the book yields earned on the assets catch-up with the level effective interest rate.

Finally, let's see what happens when there are several interest rate shocks. From the first year, it is assumed that interest rates increase by 50 bps in one year and decrease by 50 bps in the next one.

Under a statutory or an amortized cost framework, earnings behave fairly well. However, we can see that there can be significant volatility under a fair value framework if assets and liabilities are not fully matched.

Under an amortized cost basis, equity will be quite volatile since assets will probably be classified as available for sale, that is, they will be at market value with unrealized gains and losses through equity.

The implementation of IFRS is a significant challenge, considering that the standards are still a moving target. Companies should decide whether they are going to use amortized cost or fair value for their investment contracts, which is a major decision in defining required data, systems and procedures.

Due to the volatility of results, ALM strategies may migrate to be better matched. Scenario testing and soundness of existing investment and ALM strategies will be

required. Product designs will be impacted to focus on those that give favorable results under IFRS.

Large swings in interest rates and equity markets will cause substantial net income volatility under fair value frameworks. A new way of communicating to public and analysts will be needed. Companies will need to do a good job in explaining volatility. Due to interest rate changes, the balance sheet may materially change from date of valuation, to date of filing, to date of shareholder or analyst meeting. Companies will need to provide very detailed disclosures for key elements of profits, key assumptions and valuation methodologies.

MR. GUTTERMAN: I think that the presentations were very well done. I appreciate it. I'm chairman of the IAA Committee on Insurance Accounting. In terms of the future, I think the assessment of the future Phase II is probably very well put—unknown. ISB staff has said just this week that they're really talking with no preconceptions, but they also say that they are also going to be looking at the framework of the ISB and re-looking at some of the fundamental concepts underlying accounting for financial instruments as well. So this raises an additional area of uncertainty about the next stage. But I would also like to mention a couple of upcoming events.

The IAA is planning on producing some actuarial standards and practice guidelines, for Phase I. An exposure draft is due to come out within the next month. So if you're affected, you might take a look at it and indicate to the IAA whether you agree or disagree in terms of whether it's the firm or the individuals or an association. We encourage comments on that because there are some tricky issues. My second point relates to the issue of the FASB. I think it was mentioned that the FASB might converge to the ISB in this regard. Right now they have an informal agreement that they will have a joint limited project on insurance accounting. So, it may very well be that what the ISB does will affect U.S. GAAP. So that's something to be aware of in terms of the FASB's action. In addition, FASB's exposure draft on fair value is due out in a couple of weeks. That also might be something that people might pay attention to.

PANELIST: Sam, you were talking about the IAA standards. Are these available on the Web site?

MR. GUTTERMAN: Yes. They're in a working draft right now. They will be exposed probably within a month.

FROM THE FLOOR: (INAUDIBLE)

FROM THE FLOOR: If you want to further follow this, you can get on the SOA's International Accounting listserv to get some information, or you can ask me to get on an IAA listserv to get periodic dissemination of information on this topic.

PANELIST: I have a question for Francis. You were talking about the CFA Institute and how analysts prefer fair value. Is that a comment on U.S. GAAP as well—that they would prefer fair value for U.S. GAAP?

MR. DE REGNAUCOURT: I don't know if it's a comment on U.S. GAAP specifically, but here's the way it happened. A lot of companies failed. A lot of life insurers failed. There weren't that many investors because a lot of them were mutuals, but still, the credit analysts, guys like me in those days, would say, "What happened? I looked at last year's financials, and you told me you had surplus of that was more than amply sufficient to cover all your adverse possible effects. You had any number of actuaries sign off on those."

Then you've got the equity analysts who look at Enron, WorldCom, even our own Consec. The holding company did file bankruptcy, but a year before there was a financial statement that was only just starting to give some serious hints of trouble, and two years before the financial statement was clean as could be. The problems didn't happen over just two years. They're saying "What's wrong with these financials?" The accountants say, "Well, we did them on a going concern basis. If we'd done them on a breakup basis, that would have been very different." And the analysts say, "Well, breakup is what I'm getting today, and it's sort of negative, isn't it?" What a fair value proponent says is "Better put it on a breakup basis because if there's going to be that much of a difference between going concern and breakup, I at least want to know what the breakup value is."

This is something the CFA Institute is very adamant on. They view themselves, and I think correctly, as the single biggest stakeholder in accounting in that they represent investors, investment banks, all the quiet investors you don't hear about—the pension funds, the mutual funds and things like that. The sell side investors are very vocal. You know all their names, but they don't add up to a hill of beans. The real investing is done by people whose names you've never heard. They're saying, "We've been burned too many times. We understand the distinction between going concern and breakup, and we don't give a hoot. Tell us the real facts. Yes, there will be volatility. We're not stupid, we can understand volatility. Don't automatically say we don't understand it and we'll penalize you for it."

They think, "We, the investors, have the money. We want the real facts on what's happening with our money. We'll make the decisions. We don't care whether you think it's fair or whether you don't. We believe in markets. We don't believe in actuaries. We don't believe actuaries. Nothing personal, folks. We believe in the markets, and if the markets tell us that we could sell the assets for this value and pay somebody to take the liabilities off our hands for that value, we know what the company's worth. We realize it's rough, we know it's going to be dated last December 31, but it's a lot closer than we've been." Now, this is not the position of my employer or anyone else that I'm related to right now, but that's where fair value proponents are coming from.

Chart 1

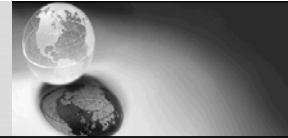
An IAS Income Statement (mil €)			
<u>Underwriting Activities</u>	<u>New</u>	<u>Inforce</u>	<u>Total</u>
New Business:			
(+) Expected PV of Premiums	xxx		xxx
(-) Expected PV of Expenses	xxx		xxx
(-) Expected PV of Payments to Policyholders	xxx		xxx
(-) Expected Present Value of Market Value Margins	<u>xxx</u>	-	<u>xxx</u>
Net Result of New Business	xxx		xxx
(+) Release of MVMs - Inforce Business	<u>x</u>	xxx	<u>xxx</u>
Net Underwriting	xxx	xxx	xxx
<u>Investment and Financing Activities</u>			
(+) Investment Return	xx	xxx	xxx
(-) Unwinding of Discount	xx	xxx	xxx
Net Investment and Financing Activities	xx	xxx	xxx
(+/-)Effect of Changes in Estimates and Assumptions	<u>0</u>	<u>0</u>	<u>0</u>
Profit Before Tax	<u>xxx</u>	<u>xxx</u>	<u>xxx</u>



9

Chart 2

Profit Emergence Comparison



Pre-Tax Earnings Base Scenario

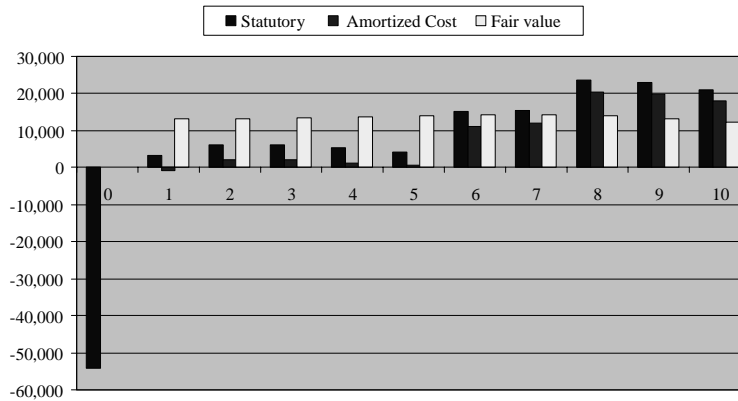
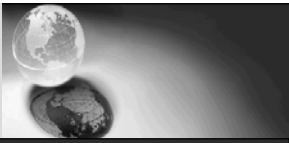


Chart 3

Interest Rate Shocks / Volatility



Pre-Tax Earnings
Changing Interest Rate Environment

