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Panelists: SAM GUTTERMAN
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Summary: Attendees learn about the status of recent developments in international accounting standards for insurance. Panelists debate how the International Accounting Standards Board (IASB) Insurance Project should be completed with an opponent and proponent of fair-value type valuation methods. Specific topics include an update on IASB developments related to international accounting standards for insurance, fair value versus other measures, recognition of profits or losses at issue and balance sheet versus income statement focus for financial reporting.

MR. MARK FREEDMAN: This is "International Accounting Standards." I'm Mark Freedman, an actuarial partner at Ernst & Young. Joining me first today are Sam Gutterman and Dave Sandberg. Sam Gutterman is a director and consulting actuary with PricewaterhouseCoopers, and Dave Sandberg is a second vice president and corporate actuary with Allianz. The three of us have spent a reasonable amount of time in the IAS arena. In fact, Dave and I are members of an International Actuarial Association (IAA) accounting committee, which Sam chairs.

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We're also lucky to have Trish O'Malley join our panel. Trish is liaison board member on the IASB from Canada. She now lives in London. Trish O'Malley is going to talk about current events on the IAS insurance project, in terms of where it's headed for Phase I, and she's also going to talk about the board's direction for Phase II for insurance contracts. After Trish's presentation, we're going to have a debate on some fair value issues. (We're expecting two famous people here, one from California and one from France.)

MS. TRICIA O'MALLEY: I'd like to make the standard disclaimer from all of us who are on decision-making boards. We only have one vote out of a number. You're going to hear my views and my interpretation of what we're doing. I can't speak for any of the rest of the board and staff at the IASB.

To provide you with a little background, we should probably first talk about why the IASB is doing a project on insurance at all. There are a couple of good reasons. The first one is that we don't actually have a standard that covers insurance. There isn't anything in the IAS literature that deals with accounting for insurance contracts. Places where you think that insurance contracts might be covered, such as those dealing with provisions and contingencies and some other kinds of accounting standards, specifically exclude insurance from their scope. So there's really no guidance at all. In other jurisdictions where there are national standards dealing with insurance, they're different from each other. Generally speaking, within national jurisdictions that have standards on insurance and other things, the insurance accounting standards are very different from the standards for everybody else. So we have all of this diversity among countries and even between the insurance sector and other things that look remarkably similar.

There is a feeling that insurance accounting is seen by users of financial statements as being somewhat opaque and that it's very difficult even for people who spend a lot of time trying to understand it to figure out what's going on in insurance operations. These are all the reasons that our predecessor board put a project on insurance on its agenda and why we decided to continue it.

The phased approach for insurance was not the way we intended to go to start out with. We intended to have one standard and to do it all at once. The problem is that we were overtaken by events, which partly has to do with the European Union deciding that they were going to require all listed companies to adopt International Financial Reporting Standards (IFRS) from November 2005. It became clear as we started to work on the project that we were simply not going to finish the overall project in time for that deadline. We did need to do something for those large European insurers that were going to have to apply our standards at November 2005. If we didn't have any guidance at all, they were then forced by our GAAP hierarchy to try and figure out, on their own with no specific guidance, what GAAP was for insurance contracts. That was going to be costly, and it was probably going to result in a lot of time and energy spent on coming up with differing solutions.

Our objective for Phase I is to get something in place that will work for 2005 that will cause the least possible disruption in the short run. Then we will get on with life and try to get the final standard done as soon as we can. Some of the components that we expect to stick are in the Phase I 2005 standard. We are hoping not to create anything in Phase I that would have to be reversed in Phase II, and we also want to get on with Phase II pretty quickly.

One of the things that we've done in Phase I is to define insurance. That's critically important because we have to know what contracts this particular standard is going to apply to, particularly because of the grandfathering. We've designated an insurance contract as "one in which the insurer accepts significant insurance risk by agreeing to compensate the beneficiary if the insured event adversely affects the policyholder or beneficiary." There are a couple of critically important things in there. One is "significant" insurance risk, which is defined as "at least one plausible scenario of payment of an amount that's not trivial." The other thing is that the insured event has to adversely affect the policyholder or beneficiary. That condition is in there specifically to help us distinguish insurance from derivatives. You'll notice also that our definition of insurance defines insurance contracts, not insurance entities. In an international environment it's almost impossible to try to write a standard for entities, so we have to go with the distinguishing features of the contract in order to try and sort out which things this particular standard is going to apply to.

In Phase I there's a decision tree that you have to go through to figure out how you're going to do the accounting. This is why the definition of insurance is critically important, because that's where you start. If it is not an insurance contract, it's not going to be in the scope of this standard. In that case, it's going to be in what we call IAS 39, which was our financial instrument standard—the comparable U.S. GAAP is the FAS 115 or FAS 133 kind of requirements, the ones on marketable securities and derivatives—or other standards that that particular contract might be accounted for under.

If it is an insurance contract, this standard allows people to continue to use their existing accounting for that contract with some key modifications, which we're proposing in Phase I to try to get a slightly more robust framework for financial reporting.

The key modifications that we've put in Phase I have to do with practices that are clearly unacceptable within the accounting conceptual framework. These practices would never be considered to be possible in Phase II anyway, so we thought we might just as well get them done in Phase I. The first modification is that no catastrophe provisions are recognized through the income statement. There's nothing in this standard that says that if people want to make catastrophe provisions, they can't appropriate equity, but there will not be charges for catastrophe provisions going through the income statement. That's simply because from an accounting sense you have no liability, no present obligation, for events

that haven't happened by the end of the contract period. Similarly, no claims equalization provisions will be recognized; gains and losses and claims go through income as the claims happen.

A loss recognition test is required. If there is a loss recognition test in the national GAAP that you happen to be applying to these contracts, you can continue to use it. This provision is there for some national GAAPs that are out there that don't have a loss recognition test at all. Therefore, Phase I says that if you're using national GAAP, but your national GAAP doesn't have a loss recognition test in it, you'll apply the one that's in our provision standard.

Also, there will be no offsetting of reinsurance assets against direct liabilities. This is the simple application of the offsetting provisions that are already sitting in one of our existing standards. It's just making clear that those offsetting rules that are in IAS 22 apply with respect to insurance the same as they do to other kinds of contractual assets and liabilities.

The requirement to use this same measurement base for liabilities when they're reinsured is simply to deal with the possibility that someone who doesn't account for direct insurance on a discounted basis turns around and reinsures that business. Clearly the premium you pay is going to take into account the time value of money. The requirement is there to make sure that we don't have income statement items flowing simply because the measurement base of exactly the same item has changed in a transaction.

Finally, if you have an embedded derivative in an insurance contract that isn't itself an insurance contract, that derivative will have to be separated and fair valued in accordance with the derivative standard. In some respects that is a provision that we put in after having looked at some of the experience in the United States when FAS 133 was under development. The first thing that happened was that people were writing insurance contracts against changes in foreign exchange rates. We don't want the same kind of thing happening in the international environment.

What happens when you don't qualify? What happens when a contract that you've written that you had accounted for as insurance doesn't meet the definition of insurance in Phase I? It will probably fall into our financial instruments standard. How do you account for that? In our new version of IAS 39 we have put in an option for an entity, on a contract-by-contract basis, to decide that it wants to account for that contract at fair value with fair value changes going to profit and loss currently. That election has to be made at the inception of the contract, and it's irrevocable. You can't change that designation after the fact. But if you make it, you'd simply fair value the entire contract, both at inception and going forward, and you don't have to answer any more of these questions.

If you don't make that election, generally speaking, these contracts will be carried at amortized cost because that's the way we measure virtually all liabilities. The

only other question you then have to ask yourself is if the contract contains an embedded derivative. An embedded derivative is simply contractual provisions within a host contract where the economic characteristics and risks of those provisions are not closely related to the host contract. If you have some kind of contract that basically is a debt instrument with an interest rate, but it has some kind of embedded equity derivative in it, you'd have to separate the equity derivative because equity isn't closely related with interest rates.

Those contractual provisions would have to meet the definition of a derivative if they were written into a contract on their own. The combined instrument is not measured at fair value with changes in fair value and profit and loss. If you fair value the entire contract, you don't have to separate embeddeds. You also don't have to separate embeddeds if the embedded itself is an insurance contract. So to the extent that there is some kind of guarantee or option or something in there that has significant insurance risk, and it meets the definition of an insurance contract, you don't have to separate it; you can leave it with the host contract. If the whole contract doesn't contain an embedded derivative, the contract is an insurance contract, and the whole thing is valued at amortized cost. If not, you have to split out and fair value the embedded derivative. That's a quick summary of what's in Phase I.

Let's look at where we're going in Phase II. We said we're going in a fair value direction, but I think people have gotten the wrong impression about how far along this project is. The board made a number of tentative decisions in January 2003, which was pretty much the last time we talked about Phase II of this project, to provide the staff with direction about where we thought we wanted to go. All of the votes on the questions (I think there were about 14 of them) were approved by a majority of the board, but the majority was a shifting collection of board members. I don't know if there's any guarantee that we would actually have a majority on a combined package of all of them. That's where we would like to get if we could. There are a number of complicated issues that we still have to solve before we could write a standard based on this fair value direction. If there's panic taking place in any of your organizations, you can tell people to calm down a bit; it's not as bad as some people have been saying.

As for the Phase II scope, we're looking at all insurance contracts. We're not going to make, as some national GAAPs do, a distinction between property and casualty or general insurance and life. We are intending to go with what we call an asset and liability model, which says that what is reflected on the insured's balance sheet, is only contractual obligations that are liabilities and contractual rights that are assets. When we say those words, we mean them in the context of the accounting definitions of assets and liabilities, which require that the contractual rights and obligations be present rights and obligations that arise as a result of past transactions or events that have expected cash flows. When you think about some of the kinds of measurement issues that arise in dealing with insurance contracts, you can see that there are some tensions between the accounting definitions of

assets and liabilities and the kinds of things that you might think of as rights and obligations.

The other thing that's important to recognize is that the direction that we're going here is that if you look at the accounting conceptual framework, income and expenses arise from changing values of assets and liabilities. Income and expenses aren't things, generally speaking, that we try to measure directly. They fall out of measuring and remeasuring assets and obligations. Then the question is, will that measurement be a fair value measurement?

One of the things that we're working with in this Phase II model is a fully prospective model. We will always be looking at trying to measure insurance liabilities directly; we will always be looking at the expected future cash flows and the expected value of those future cash flows. In many of the models that are used today, you end up with things on the balance sheet that we think don't meet our definitions of assets and liabilities. What you end up with is a process for putting things through the income statement that results in what we call "unexpired residuals" in the balance sheet. You store them up there in order to put them through the income statement at a later date. The assets don't give rise to contractual rights to future cash flows, and things that are recorded as liabilities in the same process don't create present obligations.

The fully prospective model attempts to measure the obligations directly. The assumptions to be used in that model would always be your best estimate, so that it's a continuously unlocked process rather than freezing assumptions at a particular point in time and leaving them alone until something very significant happens. The economic assumptions that we would be using in this model would be consistent with market assumptions, whatever the market economics are at the date of measurement. To the extent that market data isn't available for some of the non-economic assumptions, we would be expecting people to use the entity's own assumptions, with the caveat that they wouldn't be able to use assumptions that they knew were inconsistent with the market.

This model also would explicitly consider embedded options and guarantees. It would get rid of one of the problems that we're struggling with in Phase I, which says that we should separate embedded derivatives because we're going to continue to carry the host contract at amortized cost. The instant you go to a fully prospective model, you don't have to bifurcate and value any of those options or guarantee features separately because they become part of your package of expected future cash flows. You deal with it all as one lump instead of trying to separate out the cash flows that arise from some contractual provisions from cash flows that arise from others. The problem with that is that it's going to require some option pricing methodologies that some entities seem not to use at the moment.

There would be an explicit objective for the risk margins. Rather than a provision for adverse deviations, or some other provision for risk, the objective would be to reflect the market price for risk. What would the market charge for that risk that's being assumed?

Let's look at a couple of other features that have caused a certain amount of debate. When talking about insurance contracts and measuring the liabilities arising from insurance contracts, we have said, at least tentatively, that the liability measurement is independent of the measurement of assets unless the contract explicitly links them, meaning there's some kind of investment return directly related to a particular bunch of assets. The other major feature of this, because we're dealing with all insurance contracts, is that the same model should apply to all insurance contracts. Clearly we would be discounting the claims provisions for non-life business.

One of the other fair value issues that we have to deal with is the risk-free discount rate. Generally speaking, we're expecting most of the risks and uncertainties to be embedded in the cash flow assumptions rather than in the rate. But even if you are using or adjusting the rate, you need to be able to adjust from something. We know that there are some places in the world where finding a risk-free rate is difficult and that in some places where it does exist, the term doesn't match the kind of contracts that you're dealing with.

We've also said in our financial instrument standard that if you want to fair value a liability, you have to include in that fair value the credit standing of the liability. It's important once again to emphasize that people have misunderstood that to say that we want to embed the credit standing *of the entity*. We're being very careful to say it's *of the contract*. For example, if you have a secured contract, the liability is secured. If it's collateralized, the credit standing of the actual issuer of that liability is not nearly as important as one that is an unsecured or subordinated instrument. That is an area where we're being consistent between insurance and other kinds of financial liabilities.

Another big issue is the question of future premiums, and cancellation and renewal rights. The tentative decision is that non-cancelable continuation or renewal rights that constrain the issuer's ability to reprice define the only time that you would include future premiums in the measurement of the liabilities. If you've written a contract, the policyholder can continue to renew, and you can't change the price to what the current market for that risk would be, and if the policyholder stops paying premiums so that his access to those rights goes away, you can include those future premiums in the measurement of your liabilities. That has to do with our struggle with our definition of an asset because to the extent that the policyholder can quit paying premiums at his discretion at any time, we have difficulty with the asset definition about the control of those future cash flows. So we're trying to find a way to put them in but circumscribe it so you don't end up with every possible

future cash flow for every possible contract you could write with that policyholder for the rest of his life getting into these measurements.

The other conclusion that we've reached so far is that we would not expect there to be a gain at the inception of a contract. There's no net gain at issue unless there's market evidence that there really is a gain there. The assumption is that if we have a fair value objective, we assume that the price that was charged for that contract was the market price, unless there's something to indicate that the market somehow has an aberration in it or there's some kind of niche market or special product that is allowing that particular issuer to charge an off-market price.

There are big things that we still have to struggle with, and it was clear that we weren't going to solve them in time, which is why we had to break the project in two. There are conceptual and practical issues in trying to implement a fair value model for something that, generally speaking, nobody has tried before. There are many issues that we're going to have to sort through. When we're trying to deal with a fair value objective, and the contracts that we're talking about by and large aren't traded, it makes the whole thing much more difficult.

I already mentioned the cancellation and renewal rights problem. It's going to be a huge conceptual struggle because people on our board aren't looking at this as truly an insurance problem. The question is: If we do this (whatever "this" is) for insurance, what does that mean for all of the other suppliers of various products who have ongoing customer relationships and continue to sell to the same people over time?

Regarding the discretionary participation features, one critically important question is whether that participating business is or isn't a liability or equity, and whether or how much is which. We also have to try and figure out how to do something sensible with the income statement display of all of this information. We don't want to create a different black box from the one that already exists. What we're trying to do is create a model that's actually going to be easier for the users of financial statements of people who issue insurance contracts to figure out what's actually going on in the business. I should probably also say to any of you who are familiar with the draft statement of principles (DSOP) that was the last part of the publications from the old board that there are some differences between where we're going and what was proposed in that DSOP. The definition of insurance is different. I should say right off the bat that we have deliberately erred in putting more things into insurance and letting people continue their existing accounting. If we had to make a cut, it was that way. I doubt very much if we're going to see anything that falls out of insurance in Phase I going back into insurance in Phase II, but we may see some things that are insurance in Phase I moving out of insurance in Phase II. We may tighten down the definition, but we're not likely to loosen it.

The notion of entity specific value versus fair value is, I think, a distinction without a difference. By the time you got to the kinds of entity specific values that were

being prescribed in the DSOP, we came to the conclusion it was virtually indistinguishable from the third level of fair value guidance that we're providing in our business combinations project. We thought there is no point confusing the world by using two different words when we actually meant the same thing.

As far as the credit standing issue: they said "out," but we said "in." Regarding the explicit requirement of no gain at issue, it wasn't nearly as explicit, I think, in the DSOP. I think this was part of the reason why people got so excited about the possibility that there were going to be these huge gains at issue. I don't think the people who wrote the DSOP thought that, because they expected the market value margins in most cases to end up in exactly the same place. We've just gotten more explicit about it, and we've slightly changed the wording around the notion of the renewal premiums, but I think in most cases we probably get to the same place.

MR. FREEDMAN: Now it's time for the debate. Our contestants today are Arnold Schwarzenegger and Jacques Chirac. Arnold and Jacques look a lot like Sam Gutterman and Dave Sandberg. Arnold took some time off his day job running California, and he's going to take a visionary role in this debate. Jacques, who has expressed some concern about the direction the board is headed in terms of fair value, took the day off from running France. He's going to express his views backing tradition.

Keep in mind that when you think you hear Sam or Dave express a view, it's not necessarily their views expressed. They are also not necessarily the views of their employers or clients or of Jacques' or Arnold's constituents.

The first question has to do with the type of accounting system you favor. The U.S. GAAP is one example of a deferral and matching accounting system. Do you favor a system such as this or one that's prospective in nature and more fair value based?

MR. DAVID SANDBERG, AS FRENCH PRESIDENT JACQUES CHIRAC: Merci beaucoup. I naturally am for the status quo. I think that we have had a fine tradition over centuries of having a deferral and matching system for insurance accounting. The cumulative effect of so many brilliant minds in the insurance field (and even some actuaries) is such that I can't imagine moving to some new-fangled, unfounded system like fair values. The first point is that the insurance industry—whether it be GAAP, statutory, United States, United Kingdom, or any country in the world—is on a deferral and matching system and has grown up in that system. Why change? It is a more orderly system and a more predictable system. Insurance investors punish companies if they reflect income that goes up and down with the whims of the marketplace. Also, a deferral and matching system looks at both the income statement and the balance sheet, while fair value basically looks at just the balance sheet. We have to have something that communicates meaning in terms of both where we're at now and how we've performed. Therefore, a deferral and a matching is a better overall performance measurement system.

In addition, a fair value system is probably not reliable. In terms of difficulty of assessment, fair value is far more difficult to do than a deferral and matching system that we're all used to and that we can all measure properly or reasonably. In any event, even if you like fair value for some strange reason, the deferral matching system can be thought of as an entry value fair value system. So let's do the measurement and do something reliable—we'll get something that's very close, anyway.

Lastly, the reporting of fair values in general is not in the public interest. A deferral and matching system that recognizes costs over the period of the contract is the business reality. That's what we do. We are in the business of long-term guarantees. By doing a deferral and matching system, we reflect the ultimate values of the insurance contract. Merci beaucoup.

MR. SAM GUTTERMAN, AS CALIFORNIA GOVERNOR ARNOLD

SCHWARZENEGGER: It is tactically dangerous to continue in a book value accounting system. I have heard nothing but whining for the last 20 years from banks and insurers about how difficult it is for them to access capital markets because their book value accounting is creating skepticism among investors. It seems like a simple solution to remember that insurance is just about estimated cash flows. Fair value is just defining a set of rules for discounting those cash flows. This allows the financial element that is an integral part of insurance to be accounted for on the basis that is consistent with where the other financial markets are. The challenge is then to be able to develop the methodology for the insurance elements so that you can create a set of balance sheets that will allow insurers and banks in the end to feel like they have clear and easier access to capital.

MR. FREEDMAN: Let's assume Jacques loses on the first point, and we end up with a fair value system. There are a couple of ways to go here. One would be an exit value approach, where the value of liability would be based on what could be obtained in the marketplace today if it were sold to a sophisticated buyer like a reinsurer. Under this approach you could have the gain or loss at issue. In theory, under an entry value approach, margins would be set. This would be what would be obtained in the retail market if the policy were sold to the policyholder. In that case there would be no gain or loss at issue. Obviously there could be a hybrid approach, where entry value might be a proxy for exit value. What do you two favor here?

MR. GUTTERMAN, AS PRES. CHIRAC: I think the answer is obvious. In France we have a saying that if there are 10 Frenchmen, there are 10 opinions. We're used to dealing with the difficulty of subjectivity. One of the major criticisms we've had of the fair value approach is a concern that you're able to set your own assumptions. We think that the entry value process would allow you to define a very verifiable and objective value that can be used in order to define the value. It certainly reflects the most recent information. We're also concerned because there typically is not information about take-over values of business. While there have been several proposed solutions, they all are based upon a second degree of

measurement. I'm going to go measure something else, and I'm going to assume those relationships will be as applicable when I apply them to the insurance market. Whatever methodology is used in the end may end up creating volatility within the insurance market that really doesn't reflect the underlying business dynamics. Merci.

MR. SANDBERG, AS GOV. SCHWARZENEGGER: I've a vision guy. I think that we've had enough of entry value. It's very nice to have a value at the time of contract issue, but how long do you stay at entry? First valuation is way after the entry price, so you have to come up with something after entry price. The only approach consistent with the IASB framework is an exit value, a fair value system. It's certainly more related to the economic reality of the business, but the key is that the entry value system can't be workable. Take the example of a non-life company where prices change overnight by 50 percent. Those prices in the marketplace go up without doing anything. Without changing the cost, the perceived reality is that the marketplace is not a reliable measure, but it is reliable in terms of modeling future costs and future cash flows. My opponent says that it's too volatile and that you can't trust exit price. We can put in a few tweaks, a little bit here and there, to come up with a more reliable system through appropriate disclosure so we can identify what changes might occur based on changes in assumptions. The bottom line is that with a few little rules added on, we can have a reliable exit value price and not have to worry about what happens after day zero.

MR. FREEDMAN: This next question has come up at recent IASB meetings. If a contract has a cash surrender value, which has been called a "demand deposit floor," should the liability be allowed to be lower than this amount?

MR. SANDBERG, AS PRES. CHIRAC: I will have to say that having a cash value floor is common sense. It's in most regulatory systems not to have a liability lower than what can be demanded by the policyholder. Otherwise you could have an unreliable system if the actuary's assumptions are not correct. It would then not be soundly based financial information. Accountants have told me that the true measure of a good accounting system is providing useful information and not misleading information. The difficulty, if there is no floor, is to distinguish between the pure demand deposit in an investment contract and the underlying insurance contract. The difference really is the value of a customer relationship. Therefore if you wanted to do something less than the cash value floor, what you're really doing is recognizing the value of an intangible, which is against the accounting Holy Grail. By having the minimum cash value floor, you can be sure that you're valuing tangible things, demandable things, and it's far closer to reality, which all Frenchmen appreciate.

MR. GUTTERMAN, AS GOV. SCHWARZENEGGER: I'm back. The intent of the fair value balance sheet is to create a consistency between assets and liabilities. It's important to remember that the dynamic that is driving the lapse behavior is not the value that shows up as the account value to the company, but it's often the

value after tax to the policyholder of receiving their funds. The real behavior that's driving that is often a different number. Insurance is rarely bought or sold with the intent to be a liquid investment. It has a long-term horizon. In particular, this seems to go against the grain of saying that you should reserve for the unlikely event that only happens in extremely rare situations where most of the policyholders in an insurance company wish to withdraw their funds. The banking industry is used to dealing with the idea that within 90 days I might need to liquidate my entire asset portfolio because within 30 to 60 days all of my policyholders could withdraw their funds, but the insurance world is not. It's also a bad precedent to start valuing an individual policy versus the behavior of a block of business.

As far as the intangible question, this behavior is observable. It can be seen historically. There is a lot of data, both publicly and within companies that allow them to value and estimate the lapse behavior. If that is the case, I find it hard to believe that it could still be called an intangible.

MR. FREEDMAN: The next question is an easy one. It's very non-controversial, especially with a group of actuaries. An insurance company can always default on its promises to policyholders. The question is, should that possibility be taken into account in establishing a liability, which would mean that a lower-rated company would have a lower liability than a highly rated company for the same promise?

MR. GUTTERMAN, AS PRES. CHIRAC: Obviously those that wish to change are wrong. They're trying to be too precise, thinking that if they can take a value and calculate it, that it's going to give more information that's better for the policyholder or for the shareholder. First of all, the question itself has not been defined well enough that anyone actually understands how you would go about calculating it. What if a company has no reliable credit standing? What if I'm in a country where there is no A. M. Best? How do I determine what my credit rating is? Do I get to use the credit rating of my parent? Suppose that I have a risky disability income line with non-guaranteed elements that last for many, many years, and the probability of me being able to stay in that line of business is very different than if I'm in a participating life business. Should I be using different discount rates for my individual lines of business and then make sure that the average agrees with the discount rate that I have to use in my public financials? One suggestion has been that perhaps if I don't have a reliable credit standing in a country, I can start borrowing from either other countries or other industries. Again, the question of how you would define what the credit standing is seems too vague. The other thing that's interesting is that rating companies are really a function of book value accounting. I have a deferral and match basis. I don't know what the guarantees are. I want to understand what the financial risks are that don't show up in the balance sheet. If in the fair value world we actually captured the economic risks and were able to portray them in the balance sheet, would we even have a need for credit agencies? If so, how can I go get a rating if there's not a rating agency? In

theory, the financials should be showing what the company's credit rating is because it has captured those economic issues.

The other interesting thing that challenges the ability to come up with an objective answer is that if I look at past spreads, at my AAs and BBBs and at the average spread that's within each of those ratings, and if I look at the volatility within a bond that's rated, I will get bonds within the AA that have a credit spread that's wider than the average of the next grade down. Again, what is it that I should be using? Should I be using the average? If I'm considered an A company, do I get the average? As in France, there are too many views in order to come to an objective answer.

MR. SANDBERG, AS GOV. SCHWARZENEGGER: As expected, I completely disagree. We're talking about economic reality here. All financial economics will point you in the direction of saying this is a real phenomenon. This is going to affect the prices in the marketplace. The premium that a high-quality company will be able to charge will be higher than a low-quality company. It's often said that the results are not logical. It's obviously the wrong logic. Those who oppose me just look at the liability side. They look at the changes in value of just the liability. They should be looking at both sides of the balance sheet. If you have a credit problem, you will have a credit problem most likely generated on the asset side of the balance sheet. Therefore, if you increase or decrease the liability, you will have a corresponding matching effect on the asset side. As a result, the income statement effect will not at all be what opponents of this would say. Indeed, without such an effect, because the IASB has indicated that you have to use a somewhat-based risk-free rate, and we know that insurance companies have traditionally been able to earn higher rates than a risk-free rate without such an adjustment, most likely you will have losses at issue. That is not a good thing to show for the French economy because the French economy is far stronger than that.

MR. FREEDMAN: Trish noted that Phase I will be effective for year-end 2005. Assuming we do move to a fair value standard in Phase II, what do you two think in terms of a short or a lengthy transition period?

MR. SANDBERG, AS PRES. CHIRAC: In order to get to such a system, if we were forced to do so by outside regulators, then we need a great deal of time to be able to implement all the systems. Unlike most manufacturing companies, unlike banks whose liabilities are very short, our products are complex, which is the reason why we pay actuaries as much as we do. Not only do we need time to be able to implement these complicated calculations that most countries are not used to, but in addition it is going to take a long time to even get to the adoption stage. This project from International Accounting Standards Committee (IASC) is now in its seventh year, but if we're going to meet the deadlines that are in the proposal, we are going to be expected to resolve all the problems within the next 12 months. Not only do we need more time for the discussion stage, but we will also need a longer time for the implementation stage.

MR. GUTTERMAN, AS GOV. SCHWARZENEGGER: Why do we stop now? Let's move forward. First of all, I know that my esteemed colleague, Tricia, will be very good about removing any shortcomings from Phase I, but perhaps her colleagues will not be so wise. Perhaps there will be issues from Phase I that will have more of an impact than is expected. It would be easier to move quickly from the kind of short-term solution to the bold new vision that we need. It still is a concern that insurance could be seen as a black box. A lengthy transition might make it appear that insurers have something to hide and that we really don't understand our liabilities. Why is it taking so long to just simply line up your cash flows and discount them? While Phase I is an important step to allow some additional breathing room, it inevitably will have compromises. We need to recognize that in order for those compromises and the effects of them to be minimized; we need to move through them quickly.

MR. FREEDMAN: The next question has to do with what's going to happen in the United States. Assuming internationally there's going to be a fair value standard, what do you two think should be done with U.S. GAAP? Also, should the SEC stop forcing foreign filers to reconcile with U.S. GAAP? Should FASB change its rules?

MR. GUTTERMAN, AS PRES. CHIRAC: As hard as it is for me to say, the GAAP standards have reflected many years of thought and development. The legal risk in the United States is even worse than in France, and so you need to keep in mind that while accounting can have a consistent standard worldwide, the actual ability to implement it without significant legal challenges may mean that there are differences that need to be included within individual country standards. Lastly, as my mother used to say, "If all of your friends jump off a cliff, why should you?"

MR. SANDBERG, AS GOV. SCHWARZENEGGER: I think that's inconsistent with today's reality. If we look to the future, and certainly I'm in favor of looking to the future, we see that what happens in the dynamics of the world stage is convergence—convergence of international, national and even state directions. Some things have to change. Some things have to be recognized, such as continuing globalization, continuing multi-national companies, and companies buying companies. In fact that reflects reality. The International Accounting Standards Board and FASB are already working together on a broad front of projects. It's going to work. It makes a lot of sense for this to happen in insurance because insurance indeed is becoming a far more multi-national, global industry, as is the actuarial profession. We have to make financial reporting consistent and more meaningful. The only way of doing that is to have a convergent set of financial statements worldwide.

MR. FREEDMAN: We're going to open up the floor for questions, and at the end we're going to take a vote. We want to see who you think won, Jacques or Arnold.

MR. MARTY UHL: When do you expect the comments on Phase I that are coming into the IASB to be published? Where would they be published at the end of the comment period?

MS. O'MALLEY: The policy in respect to comment letters is that all of them go at the same time, right after the meeting at which the board first gets the staff analysis. All of them come in, the staff does the preliminary analysis, and there will be a meeting at which the main agenda paper on the project will be the summary of the comment letter analysis. Sometimes that's the preliminary one, and then we go back and consider the comment letter comments on each one of the major questions as we debate those particular issues subsequently. The comment letter deadline is the end of the week. It's going to be incredibly difficult to have anything ready in time for the November 2003 meeting, so my guess is that they should all go up right after our December board meeting, which is the week before Christmas.

MR. SANDBERG: If you were interested in seeing the comments by the International Actuarial Association, they would be on the IAA Web site some time next week.

FROM THE FLOOR: I'd like to ask this question of Trish, Arnold, and Jacques. You've indicated that fair value will apply to liabilities in Phase II. I'd like to hear whether you expect to require fair value on the asset side of the balance sheet in 2007, when you introduce Phase II. Or are you going to leave it to management's discretion that the measurement of the assets is going to be under the IAS 39, which is the four optional measures? It's really a question on the relationship of the two.

MS. O'MALLEY: My expectation is that given the amount of difficulty that we're having at the moment with getting the amount of fair value that's required by those optional categories in IAS 39 through the system, it's highly unlikely that we're going to open up IAS 39 in the short run to require what the joint working group of standard setters proposed a few years ago, which is a full fair value model for everything. I don't think we'll require it. One of the reasons why we put the fair value option into IAS 39 in this go-around was specifically to deal with the situation of people who have matched positions and who can get those matched positions showing up appropriately in their income statement without having to go through all of the aggravation of documentation, designation, effectiveness testing, and everything else you have to do for hedging, even if hedging were permitted for cash instruments instead of just derivatives. You can actually get to the right answer, and that's why that option is in there. It's an option that doesn't currently exist in U.S. GAAP. If the FASB decided that it wanted to start dealing with an insurance project, I think that's one of the things that they might also have to think about. But I don't think we're likely to require that kind of accounting.

MR. SANDBERG: I think this is a significant question in terms of the consistency or lack of consistency of measurement of assets and liabilities. I think that it's

probably the common theme that will be provided to the IASB in just about every comment letter that it receives, about how important it is and potentially even suggested approaches that they could take. I think that's probably the thing that the IEA has been saying for a number of years, that one of the principles that actuaries buy into is the fact that assets and liabilities should be measured on a consistent basis if you're going to have a meaningful financial statement.

MR. GUTTERMAN: I think it's good to have laid out the option of marking your assets to fair value. The major concern that I have is that if the fair value rules on the assets are defined in a way that's different from the liability rules, it may be possible to be matched, but for some reason to look more volatile than I am due to the reporting.

MR. SANDBERG: Another concern about consistency is between the measurement basis for, let's say, an insurance company's investment contracts and an insurance company's insurance contracts. If it turns out that the measurement bases are very inconsistent, you'll see an awful lot of creative product development so that companies can move from one side to the other with the product development. Consistency between assets and liabilities is one issue; consistency between liabilities and liabilities is another.

MR. SEAMUS CREEDON: I was fascinated by the debate, which echoes debates that I've been hearing for many years on insurance accounting. It seems to me that the real issue is understanding and performance reporting. We've certainly seen in the United Kingdom this year where the analogous situation with pension fund accounting has created a lot of issues for analysts in terms of evaluating companies. What is being done and what can be done to bring the analyst community up to speed? What indeed would that community's view be of the issues that Arnold and Jacques have been debating?

MR. FREEDMAN: Tricia said we talk to the analysts more than she does, but I have to say that we did have a visit with some of the board members in July, and one of the comments that was made within that meeting from one of the staff people is that the analysts say different things to the board than they say to the insurance company.

MS. O'MALLEY: I think it's also fair to say that we have a great deal of difficulty when you say "talk to the analysts" because they have very different views. In particular, the views of the Association of Investment Management and Research (AIMR), the chartered financial analyst (CFA) designation-granting body, who have some sophisticated analysts and some people who are very knowledgeable about accounting issues, are very different from the views that you will get from a buy-side person some place or a sell-side person some place else. I think it's also fair to say that to the extent that the accounting is opaque, and to the extent that you understand it, us making it clearer for your competitors to be able to catch up with you is probably not a good thing for you. There is a certain desire to hang onto

existing reporting practices, if you think you have them sorted out, because it gives you a competitive advantage from an analytical point of view compared to the other people down the street who don't have it sorted out as well as you do. Clearly we are going to have to bring in the analyst community as part of the project in terms of the display and disclosure of this. We have on our agenda a project not just dealing with the display of the income statement for insurers, but for all companies because we know that the current display is not very good. We've called it "Reporting Financial Performance," which has unfortunately stirred up a lot of emotion because people leave out the "financial" part and think that we're trying to develop a new way to report on management performance. That's not actually what we're about. We're about trying to display the components in a useful way. The FASB has a project on its agenda as well. It hasn't to date been a joint project. We've been going along parallel paths and that was one of the projects that we talked about at our joint meeting last week in Toronto. They look more different than they are in some respects, and they look more similar than they are in other respects, but we have agreed that it is simply not realistic that both of us should come out with a project on how to do the income statement that would be different. So we will get to the same place. What we're going to need is a lot of help from people about what information does have predictive value for analytical purposes and how that information can best be displayed in the financial statements. The other big thing that analysts have told us is that they want a much better link between the income statement and the cash flow statement. The project includes the cash flow statement, too, but what we need to do is to get the income statement sorted out first, then design a cash flow statement that better coordinates with that and ties the two of them to the balance sheet.

MR. SANDBERG: I think this is a very important question because there are a number of people who think that whatever system that the IASB adopts, whether or not it's going to be successful is a function of how the income statement is affected. As a result, I think that people realize that the insurance contract project focusing on contracts can't be looked at alone. In order to be able to see if the effort is a success, you have to tie this together with the financial performance measurement, as well as the disclosure, so those really tie together. Everybody who is interested in this issue is going to be concerned and is going to follow the discussions on more than just the insurance contract project.

My firm interviewed European analysts 18 months ago to see what they thought about certain circumstances and then interviewed them again six months ago. Eighteen months ago, nobody was even aware of what was going on. Analysts didn't have a clue in terms of the discussions on international accounting standards, and they were touting embedded values as the answer, because that told them what the value of new business was, for example. It was a more effective financial performance measurement approach. Six months ago, the tide had changed significantly for the European analysts. I wouldn't say that for the U.S. analysts and the North American analysts, but the European analysts are listening to the discussion. You see a much higher acceptance of the direction that the IASB is

thinking of taking in terms of fair value. How it will play out—I think Trish is right—depends on the population of analysts you think about. But that's going to be an important one, particularly for the many insurance companies that feel as if their stock is undervalued because of—at least in some people's views—the opaque accounting system.

MR. GUTTERMAN: The suspicion I have of analysts is that when you ask them if they are for an accounting system that's going to show all the economic risk within a company, they will say, "Why sure, I'm for that." But the relevant item, I think, is the income issue. On the balance sheet issues, there are still some philosophically different forks in the road, so you can't even start to understand what the income statement looks like until you decide the balance sheet. What that means to me is that, particularly in the insurance industry, we need to be moving aggressively on developing some modeling and the ability to think about this and communicate this to the standards testers because the IASB insurance issue is one among many. So the performance reporting is a broad issue, but I'm concerned that because of the long-term nature of insurance we need to be able to react quickly and think about it—what if the balance sheet looked like this, what are the options for income reporting? If it looked like this, is there another way to think about it? Fortunately there is work that is starting on it. The Casualty Actuarial Society has started a modeling project, and the Insurance Institute of America (IIA) in conjunction with the ACLI have been trying to work through this. The IIA/ACLI work was completed this summer on a very simple annuity product. We are now scratching our heads on a universal life product, trying to deal with the different ways in which the balance sheet could go and say that here are some ways that we could start thinking about universal life. The scary thing is that once you get into it, you start realizing how complex this is. You feel like this is going to take a long time, but we're glad we're started down that road instead of reverting back to what I think tends to become a political dialogue between economic risk being disclosed—why that's great—versus why would we have serious volatility when we don't get beyond—what are the facts and what are the options for dealing with it?

MR. SANDBERG: I think it's very useful that actuaries are now getting interested in the discussion. European actuaries are being forced to, but others are not quite as pressured unless they're owned by European companies. Probably one-half or three-quarters of the people in this room are in that situation. But I think that actuaries have to continue to get involved and continue to provide insight to the process, because it's one thing to talk about principles and concepts, but it's just as important, if not more important, to see whether the results make sense.

MR. FREEDMAN: Now what I would like to do is poll the group here. Are you closest to the traditionalist views of Jacques or the visionary views of Arnold? I'd say it's about 80 percent toward the visionary views of Arnold.