

# RECORD, Volume 31, Number 1\*

---

2005 New Orleans Life Spring Meeting  
New Orleans, Louisiana  
May 23–24, 2005

## Session 31OF International Accounting Standards—Current Developments

**Track:** Financial Reporting

**Moderator:** MARK J. FREEDMAN

**Panelists:** JESSE M. SCHWARTZ  
MARK J. FREEDMAN

*Summary: International accounting standards for insurance are in the midst of being overhauled. This session covers the status of recent developments, including Phase I for insurance companies, IASB Phase II developments, the upcoming FASB/IASB convergence and related activities of the International Actuarial Association.*

**MR. MARK J. FREEDMAN:** This session is an update on international accounting. I'm Mark Freedman, an actuarial partner at Ernst & Young. Speaking with me is Jesse Schwartz, who is the U.S. Life Actuarial Leader with Watson Wyatt Insurance and Financial Services. I'm going to speak first about how we got to where we are with international accounting standards and where we seem to be headed globally. Then Jesse is going to talk about some of the research that he's working on with a group of North American companies.

I'm going to talk about the driving forces behind the accounting changes, what has happened in the last few years in Europe and what we ended up with for Phase I in 2005. Then I'll talk a little bit about the International Actuarial Association (IAA) activity and what that group's been doing plus where it looks like we're headed both in Europe and in the United States, along with a timeline.

The reason Europe pushed ahead with one set of accounting standards for companies listing in the European Union (EU) in 2005 is that there's no uniformity

---

\*Copyright © 2005, Society of Actuaries

in accounting around the world. For insurers, the biggest differences are in four areas. First is realized and unrealized capital gains; some accounting systems smooth these, some don't. Second is accounting methods for various products; some are historical cost, some are prospective in nature. Next is how to account for guarantees and options in products; some are fair value, some ignore them completely, and some accounting systems are somewhat in between. Last is how to account for claim reserves; some accounting systems discount them and some do not.

In fact, in some accounting systems, if you have a subsidiary in a country you just account for the subsidiary using that country-specific accounting method. So you could have the same product in two different countries, meaning two different accounting methods. Then, on your consolidated books, you add them up and you're really comparing apples and oranges. Because of all of these issues, insurance became a priority project for the International Accounting Standards Board (IASB). However, the road getting there has been very bumpy.

When the IASB pushed for fair value for all financial institutions, excluding insurance, they were unsuccessful, because there was a lot of opposition from a very strong bank lobby. Then, they forgot about banks for the time being and moved onto insurers, thinking that this industry would have trouble lobbying effectively, because no two insurance companies in the same country even talked to one another.

The IASB issued a draft statement of principles (DSOP) in 2001, which took a few years of effort. It was a fair value standard. The intent was that it was going to become the basis for an insurance standard. Then insurers started attacking this DSOP fairly randomly. AEGON organized a group called the CFO Forum, a European lobbying group. The main issues originally coming out of the CFO Forum were (1) the fair value principles were not well thought out enough and needed some input from the insurance industry, and (2) once a well-thought-out standard is introduced, given the complexity, companies are going to need anywhere from one and a half to two years to convert. Things shouldn't be rushed so fast.

As a result of all this, the IASB put in a giant compromise for 2005 conversions. Given that the 2005 date was a drop-dead date for conversion to International Accounting Standards, they had to do something.

On the asset side, IAS 39 discusses how invested assets are accounted for. For the most part, IAS 39 for invested assets smells like Financial Accounting Standards (FAS) 115 and 133. There are some differences in hedging, such as how one obtains hedge accounting treatment.

On the liability side, International Financial Reporting Standard (IFRS) 4 is applicable for Phase I. First, IFRS 4 contains rules for what's considered insurance. Quite honestly, the definition is fairly loose. For example, a single premium deferred

annuity (SPDA) would be considered insurance just because of the presence of guaranteed settlement options. So typically, 90 to 95 percent of insurers' liabilities are considered insurance contracts under IFRS even if they're not under U.S. GAAP.

Secondly, IFRS 4 says that if the contract is insurance or it has a discretionary participation feature—which you don't see too many of in the United States, but this feature is common in Europe—then in either of those cases, you could continue to use current accounting practices. So that means that if you're AXA, you could continue to use French GAAP for your insurance contracts; if you're ING, you would continue to use Dutch GAAP, etc. But, it does say that there are certain accounting practices that, even if they're a part of your current accounting practices, you have to discontinue.

Most investment contracts are accounted for under a combination of IAS 39 and IAS 18. Although Phase II does not have a date associated with it, it's clear that IFRS 4 is just an interim standard. It's interesting that if you read IFRS 4, which was in March 2004, it does state that the tentative conclusions of the board were for a fair value standard.

Again, IFRS 4 says that a company can continue its existing accounting, but if a company uses certain items, they have to end up in the trash. For example, if you have reserves for catastrophes, you must get rid of them. These are supposed to come out of surplus. Also, one can't have stabilization reserves; otherwise that obscures what the accounting system tells you is happening. You don't need another smoothing mechanism. You need to have loss recognition testing. Some standards have it; if they don't, then they tell you to look in IAS 37 for it. If you have a loss recognition system and it meets certain minimum requirements, then you just keep it. For coinsurance, you cannot net the reserves, but you must show a reserve as a gross reserve and a related receivable as an asset. Embedded derivatives have to be separated out. Interestingly, if a company's primary basis of accounting had been U.S. GAAP, there would be no disallowed items.

There's a provision that you can change your accounting policy to become what is called more relevant and reliable. There are some rules around this, too; you can't change to just anything. You have to have some basis for it. Even though a lot of European companies do embedded value, don't think about changing to embedded value if it's the type of embedded value that capitalizes interest spreads.

There are also some items that the Board isn't necessarily thrilled with. If you have any of these items, you can keep them, but you cannot change your accounting policy to start using these things. For example, if you have discounted best estimate claim reserves, you cannot move to undiscounted padded reserves. You cannot go to having an accounting policy for coverage in the United States that's different than, for example, the same coverage in France. If it's already part of your system, that's all right, but don't go there. The same thing holds true about reflecting future investment spreads. It says not to move to an accounting policy that allows future

investment spreads, but that's somewhat hard to do, because just about every accounting policy in the world allows future investment spreads in them. But it is clear that the board is not too happy with allowing these spreads.

As a result of IFRS 4, the industry had a concern that since most assets will be available for sale just like they are under U.S. GAAP, and most liabilities around the world are under some kind of amortized cost system, there's going to be volatility in a company's equity, although, perhaps, not net income. Some companies are starting to talk about ways to deal with this, but so far the best I've heard is to use some kind of shadow-type concept as in U.S. GAAP.

IAS 39 not only covers invested assets, but it also covers investment contract liabilities. Under IAS 39, there's an option of using, contract by contract, either amortized cost or fair value. If you're using amortized cost, then you also have to strip out your embedded derivatives and fair value them just like under U.S. GAAP. One thing to note, too, is if you're using amortized cost, the definition of deferral costs is stricter than under U.S. GAAP.

Another nuance is if you use fair value, there's a demand deposit floor, which basically means that your reserves at the end of the day can't be lower than your cash value. That causes a lot of problems. Especially in the U.K., where there is a lot of unit linked coverage that is classified as investment contracts. This demand deposit flow would cause a surplus strain at issue. The way companies have gotten out of this is to build a case, and the Board condones this, that part of the contract is really a service contract. You can bifurcate out the service contract piece, and then IAS 18 deals with service contracts and allows you to amortize the cost under them. In the United States, this has not really been an issue.

Now I'll get into what the IAA has been doing. If you're a member of a national actuarial association, for the most part, you're automatically a member of the IAA. Part of your dues goes to the IAA each year on a mandatory basis. It is a 100-year-old organization. The IAA has an insurance accounting committee, of which I'm a member. I'm the Society of Actuaries representative to this committee. This committee has a Standards Subcommittee, of which I'm also a member. The Subcommittee has a Standards Drafting Working Group reporting to it. In particular, they've drafted the recently exposed IAA standards.

This is the first set of international actuarial standards. They are for guidance for actuaries working in the IFRS space. They were formally exposed, received comments and the IAA intends to finalize them shortly. There are four classes of actuarial standards that the IAA can issue. They range from Class One, which is a mandatory standard you have to follow, to Class Four, which are called practice guidelines. These Class Four standards are largely educational and nonbinding. They're a lot like the American Academy of Actuaries practice notes. They might move up to Class Three over time, and it's also possible that a national association like the American Academy of Actuaries could adopt a variant of these standards

and call them Class Three.

Of the standards that have already been exposed, the one on actuarial practice is fairly general. The measurement of liability standard is concerned with how to deal with some of the issues in investment and service contracts, for example, whether you consider renewal premium or not. The current estimates guidelines covers how to make assumptions for investment and service contracts. The classification standard gives guidance as to whether a contract is insurance or not, and so on. There are some that are not yet issued, including one on embedded derivatives, and there might be one in the future on business combinations and reinsurance.

There are a few controversial items that came out in the exposed standards. The one on actuarial practice suggests that an actuary should look at the management selection of the measurement basis, determine if the results could be materially misleading and consider communicating this. That's somewhat open-ended and might apply, for example, to available-for-sale assets having a mismatch to some of the insurance liabilities, which are usually at amortized cost. So that might mean an actuary would have to think about communicating this.

In the measurement standards, the drafters got fairly quickly at an issue the Board doesn't seem to have gotten at, which is to calibrate the fair value basis to pricing. The Board, over the years, hasn't agreed to that one, so it will be interesting to see how this develops, although there aren't that many investment contracts yet, and there aren't too many that are at fair value.

It is also controversial that these standards are Class Four. As I said before, the standards are patterned after the American Academy of Actuaries' Practice Notes, yet there's a lot of Class Three language in there, such as "the actuary should..." There was a fight about this when the standards were being developed. The Academy of Actuaries' attorneys were helping the IAA and suggested that in the United States, if it says "the actuary should" and the actuary doesn't, then there could be litigation whether these things are educational or not. It doesn't matter what the intent is. There were comment letters that came in about this, particularly one from the Casualty Actuarial Society, who objected vehemently to this on the grounds it really could be inviting lawsuits. Consequently, the IAA did agree to take these words out and get the standards back down to being educational standards.

The IAA's next steps are to either reexpose the standards, sending them to national organizations such as the Society of Actuaries for a vote, or just adopting them, as a vote might not be required for Class Four standards.

Now the IAA is moving from Phase I to Phase II and starting to talk about those types of issues. In any case, if you're doing work in this IFRS arena, you ought to read the standards. They are informative. And if you're a member of the IAA, you have to be careful if you're doing anything differently, even though these are technically practice notes. The words "the actuary should" will probably come out,

but you still have to be careful.

As a result of the board's intentions for Phase II as fair value, the lobbying continued. This caused the IASB to rethink the future direction for insurance. They claim to have started with a clean slate. They promised to work together with the industry and set up an Insurance Working Group, which has global representation. It consists of preparers, users, actuaries, auditors, regulators and all types of companies like property/casualty, life and reinsurers. Although they claim to have started with a clean slate, I'm not sure the world believes that yet. At an IFRS seminar that the Society put on, attendees were asked what they thought Phase II would look like, and two-thirds of the attendees thought the Board would end up with fair value.

Meanwhile in the United States, with the exception of AIG and a couple of other companies, the industry has been asleep. IFRS was a European thing, and although U.S. GAAP isn't perfect, everyone was used to it. And then AIG woke everybody up. They seemed to read the tea leaves right on this one. Basically, the issue is that both FASB and the IASB have plans for conversions, so, in fact, FASB and IASB are working together on IFRS Phase II. In addition, the SEC has let it known that it desires convergence, too. The point of all this is that U.S. GAAP in its current state will not stay around. So if you care at all about a future insurance standard in the United States, you'd better start paying attention to some of the developments in Europe. The Group of North American Insurance Enterprises (GNAIE) was formed as a lobbying group.

There are some other recent events going on in the United States at FASB, including a fair value measurement project. Fair value isn't required for insurance liabilities, but the point is that fair value is already in many standards, such as FAS 115 and 133 and the Business Combination standards. The project talks about how to perform fair value computations if you're required to do fair value. There's also a revenue recognition project going on separately. One item to note about insurance is that the FASB staff tentatively feels that insurance premiums should be recognized at fair value when received. So you can see from all of this that fair value concepts are starting to creep into U.S. GAAP.

However, things aren't moving quickly. Trish O'Malley, along with IASB board members, said in a recent presentation that her best guess was that Phase II insurance standards would be in effect by 2010 in both the United States and Europe. And at that IFRS seminar that the Society put on that I was talking about before, three-quarters of the people surveyed felt that convergence would come within 10 years.

The point is that change is coming, and all of these changes are going to impact the way companies manage themselves. Even a relatively mild change as caused by IFRS 4 in Phase I has impacts. For example, if you had an accounting system where capital gains were smoothed in the past and now they're not, a company will think

long and hard about selling a bond and taking a capital gain, which means it must change its whole way of investing and managing itself. As with U.S. GAAP, most assets under IAS 39 are going to be available for sale, so under most accounting regimes liabilities are going to be at some kind of amortized cost method, so you're going to have equity that's volatile.

If Phase II goes anything like a fair value route, then investment strategy is likely to be more matched. Some product designs are going to disappear, such as the SPDA, where it's almost impossible to match assets and liabilities because of the book value guarantee of the policyholder. In any event, I think that earnings and equity are going to be a lot more volatile. It's quite possible that a company's equity could change materially between the time of year-end, the time it announces earnings, the time of the shareholder analyst call, and then by the date that it publishes results.

That is the end of my discussion. Now Jesse is going to talk about what's been going on with GNAIE. Then we'll have a little time for Q&A.

**MR. JESSE M. SCHWARTZ:** GNAIE, as Mark said before, wants to develop an alternative to the work being done by the IASB. As a result, they asked Watson Wyatt to work with them for the purpose of figuring out, based on their criteria, what might be some research we could do on their behalf into alternative methods. We started with a really clean page and tried to figure out exactly what would be consistent with the standards. The only caveat that I'll mention is that, as with any organization, the results of the research that we did on their behalf, while it was approved for dissemination and put on their Web site, was not adopted as the position of the GNAIE, and it's not the formal position of Watson Wyatt as far as what route into IAS should be taken. So with that as background, let's get into this.

The objectives of the research report were to analyze a general accounting method that could be used around the world to enhance value of financial statements to investors and other users. One of the issues is the difficulty of one accounting method being used for multiple purposes. One of the biggest questions is how do you have one standard that's available for all multiple purposes. I think the answer is going to be that one standard is not available for multiple purposes. You have to identify what you're looking to accomplish.

Another objective was they wanted to retain the features that facilitate the measurement of value while introducing new features that facilitate comparison among companies. It was very important from the point of view of GNAIE that when individuals look at financial statements and look at the results of those statements that there would be some kind of comparability. As you'll see later on when we talk about the whole question of disclosure, the process of GNAIE's work was to see that everything would try to be comparable, and therefore we try to identify a method that would facilitate that kind of comparability.

Another objective was to minimize unnecessary volatility in earnings. That meant we wanted to immediately recognize systemic changes in experience that impact earnings expectations. If there was a volatility, then that should come directly into earnings, but under no circumstances from the point of view of the method did you ever want to change assumptions if that was appropriate as a result of a nonsystemic change in expected experience.

The final objective was they wanted to reflect earnings as realized rather than accelerated to issue. This is a very important principle. Should investors want to know at issue the value, then the assumption was you could disclose the embedded value once you got comfortable with whether the market is consistent embedded value or the European enhanced embedded value. The whole issue here was to distinguish between what was an appropriate accounting protocol and what was an appropriate disclosure for value and for shareholder value.

The method that we used was a gross premium valuation, which all actuaries are familiar with. The purpose of using one method was to level the playing field for everyone. Discounted cash flows were intended to be based on best estimate earned rates, and all assumptions would be based on best estimates. There is the question of what a best estimate earned rate is if, all of a sudden, interest rates are higher and you want to assume over time that interest rates return to some kind of a standard path. There's also a debate about what really constitutes a best estimate earned rate.

We didn't want any gain at issue. So a calculation was made, an initialization margin to produce no gains at issue. At issue, the net reserve was zero unless there was a loss at issue. The report here assumed that the initialization margins were locked in at issue. This created an issue for further research, as did other initialization margin related issues. Assumptions could be unlocked at any time if systemic change occurs and there is a substantial impact on earnings, using two-way unlocking. This assumption regarding always retaining the initialization margins was, at least for this report, considered to be important.

In the final analysis, if you were looking at various financial statements among companies, you wanted to have a certain confidence level that the companies were maintaining the same initialization margin over the history of the balance sheet for that block of business. A key issue here was that there would be two-way unlocking so that if the assumptions got better, you would wind up changing assumptions to reflect the more favorable experience. If assumptions became poorer, you would wind up reflecting that as well, but at all times you would retain the same initialization margins. That created some issues, but was taken care of in the next research being undertaken.

The final thing is that we want to reflect the expected payment of renewal premiums and associate benefits, but this recognition should not accelerate profit. For some, particularly in Asia, it's a key issue as far as whether the methodology,



by assuming there would be future premiums, accelerated profits to issue. And the way the GNAIE wanted to respond to that was to generate these initialization margins that reflected the future payment of renewal premiums, but generated zero profit at issue. However, under no circumstances did they want any earnings accelerated based on the assumption of future renewal premiums.

Profits emerge as earned based on the difference between experience and assumptions in setting reserves. So at least theoretically, if actual experience monitored assumptions, then what you would release each year would be the initialization margin.

In the research that we conducted, we looked at fixed liability products, which included long-term care and level term, variable annuities, universal life and participating whole life. We used best estimates of the current dividends applied in the future, with adjustments to dividends where experienced. This is a reasonable approach to handle dividends, based on the contribution principle. We ran alternate scenarios that reflected increasing interest rates, improved and reduced policy persistency, increased mortality and alternate policyholder dividend option utilization. The purpose of all of this was to demonstrate what would happen under the various methods by using these different scenarios. But remember, in the case of the dividend or in the case of universal life, the assumption was that you were moving in lock step, so if interest rates went up fifty basis points, the declared rate went up similarly, given that the company had a policy to monitor it in unison.

Summarizing the alternative GAAP, the consistent calculation of net reserves for all products created a uniform basis of measurement. However, the requirement to unlock prospective assumptions created volatility of earnings, because by unlocking not only were you reflecting the present value of all future changes in the assumptions, but as a result you continue to have the initialization margin. We weren't, at that point in time, using initialization margins as cushions to the impact of changes in assumptions, but rather we maintained it because of the criteria that we set earlier. The initialization margins were intended to be held constant in order to give the readers a certain comfort regarding the ongoing strength of the financial statement. You didn't have two companies that you were comparing: one where the initialization margins were wound down to zero versus another company where you have the initialization margins retained throughout.

Two-way unlocking, for those of you who are familiar with FAS 60, was completely different from FAS 60, which has margins in it, although those margins are based on standards with respect to the industry. In FAS 60, obviously, as experience develops, you release margins, but there is no two-way unlocking. The only time you unlock is when you have loss recognition, but at that point in time, you are not reinstating margins. This method did not assume that and, as a result, it generated terrible volatility.

The manner of establishing initialization margins significantly increased the pattern

of emergence of earnings. As a result, as the second research report will address, there need to be standards to apply these margins. For instance, if you look at a universal life policy, if you have one company that had a margin on interest of 20 basis points and another of 80 basis points, the emergence of earnings is completely different than one that had loadings on mortality of 20 percent versus 50 percent. In the future, these initialization margins will be determined, we believe, based on some kind of standards of practice developed by the industry.

So what are the issues of future research that we identified? One was focused on when to unlock assumptions to avoid unnecessary volatility but to keep comparability among companies. For instance, one methodology could say that maybe you don't keep the initialization margins, but that if experience worsens, you're allowed to use them as a cushion and you allow the initialization margins to go to zero just like in FASB 60. Another method would say that if experience gets better and as a result you have more profits, you don't unlock. You just allow the better experience to be released each year in the form of the release of margins, plus the excess between your actual assumptions and what you expected. The difference between these various methods is important to determine, because in the final analysis the basis of setting the initialization margins can be a vehicle for manipulation.

Disclosure is of great importance to facilitate the objectives of comparability. The GNAIE feels very strongly about the usefulness of the disclosures that are being made either at the margins or the assumptions without violating antitrust as far as providing more details regarding pricing assumptions. There's also the question about treatment of guarantees to reflect policyholder behavior.

Finally, there's the issue of how to handle deposit floor. If you subscribe to the fact that the gross premium valuation is intended to demonstrate and derive an economic reserve, then if you have a cash value that is totally irrelevant in comparison with the economic reserve, what's the impact of a cash value floor? Does that really hide the evolving earnings coming out of these policies? If you go to Asia where this is being used for solvency standards, then they would probably argue that you need a deposit floor, because in the final analysis that is demand money, depending on the company.

So what conclusions did the GNAIE reach? I think they felt that using the gross premium valuation among all products provided a consistent basis as a result of a consistent application of a methodology. The methodology is compatible with the objective of preventing unnecessary volatility of earnings, but in practice, further research is required to achieve it. That further research is primarily centered upon whether you do two-way unlocking or one-way unlocking, and whether you retain the initialization margins or you don't.

For example, at the insurance working group meeting of the IAS, there were two groups. One group said that in FASB 60, there's supposed to be a cushion. If

experience gets worse and you're in loss recognition, you just wipe out the margins and it will be disclosed and the company will know it. The other said that if you take a look at the asset side of the balance sheet, if you have an asset that has impairments, you would retain the margins on that asset because you would want to have appropriate valuation.

There's a struggle here as far as when you're looking at products, what the best way is of reflecting these initialization margins from the perspective of the industry and the readers. Should the initialization margins be maintained to facilitate comparability, or should they use its function as a cushion and allow them to go to zero if experience deteriorated until you get to loss recognition?

A body of accepted practice needs to be developed to enhance the effectiveness of results including the determination of the initialization margins at issue and on unlocking, avoiding unnecessary volatility on unlocking, the desired relationship of asset and liability valuation method and methods of auditing for consistency of assumptions and margins over time.

I'd like to end with an example on the asset scenario.

In two scenarios where one is mark to market and the other one is kept at book, you would argue that since the market valuation is based on current interest rates, then theoretically the valuation of the liabilities should be based on a current interest rate forever to be consistent between the assets and the liabilities. It creates less volatility if you do that.

However, another argument would say that if you're doing a gross premium valuation, gross premium valuations are based on best estimate assumptions. If your best estimate assumption is that interest rates are going to return to some kind of normalized level, then you should use a best estimate assumption. Any discrepancy between assets, which are valued in a current interest rate, and liabilities, which are valued on a best estimate basis, reflects the real economics of the business. Financial economics would say that you should reflect the difference.

The GNAIE recognizes that there's a lot more research to be done. They're currently considering the results of some of our research to see whether they want to release that on their Web site as well. There's a commitment on the part of the GNAIE, particularly a group of North American Insurance Enterprises executives, to find the method that they feel will facilitate comparability and make it more useful for investors and readers. Thank you.

**MR. FREEDMAN:** Thanks, Jesse. Now it's time for questions or comments from the audience.

**MR. ROBERT NELSON:** My question is on the very last topic, the discussion about whether to change the interest rates as interest rates move for the valuation of

liabilities or to use a long-term average.

**MR. SCHWARTZ:** If you're valuing assets on an amortized book, the issue is whether you should look at what should be the interest rate on the liability side, and whether that should be a current portfolio of something for the purpose of consistency. If, on the other hand, you're valuing assets on market, the issue is whether you should value the liability at some kind of consistent new money rate. And finally, if you really believe the current new money rates aren't consistent with what you believe to be the expected returns, since this is premium valuation and its expected best estimates, then the issue is whether you should base your liabilities on some kind of an interest rate path that is consistent with the company's assumption regarding future best estimates as far as earned rates.

**MR. NELSON:** For the first one, it seems like you would have a historic cost basis for the bonds, and you would have a historic cost basis for the liabilities, namely, you executed a trade to sell an annuity or a life product or whatever. The cash cleared at that time, and you and I could just go through the arithmetic to find out what the discount rate is that makes it all work. You'd carry that just like you would keep the book value of the bond and its book yield.

However, I still don't quite understand the last one, since it implies that the actuary has a better idea of what future interest rates are than the current yield curve and the forward rates. And that's uncomfortable for me as an actuary. I don't want to be put in a position of having to call interest rates in the future.

**MR. SCHWARTZ:** Since there's no position taken on this, the people who advocate that approach would probably argue that if interest rates now were 12 percent and you felt that interest rates were going to return to a reasonable level and since you're valuing long-term liabilities, you should reflect that level. I'm not in a position to tell you whether I agree or disagree with that assumption, but I wanted to let you know that's the argument that would be posed.

**FROM THE FLOOR:** I understand, and I'm just giving you a little feedback. I, as an actuary, don't want to be put in a position where I would be culpable in any way for having misguessed interest rates' long-term averages. I don't want to end up in a court case where they're saying, Bob, you said seven and, you know, four is what it came out, so grab the striped shirt.

**MR. FREEDMAN:** I think if you take that example a little further, consider a guaranteed investment certificate (GIC). It's possible, given the principle that you have to break even at issue, that even if you use market consistent interest rates, you'd probably end up with a negative margin over the forward rate curve under the model that the GNAIE wants, which is to break even at issue.

For example, a AA company generally credits a little more on a GIC than a AA bond. So, even if an allowance for credit spread is in the accounting model, in order to

break-even at issue, there will be a negative “required profit” margin.

Jesse, did the GNAIE think about starting with Canadian GAAP? The more I hear what you are saying, it reminds me of Canadian GAAP except for the break-even principle, given that the earnings emerge under Canadian GAAP as the provisions for adverse deviation (PADs) wear off.

**MR. SCHWARTZ:** I think the methodology reflects a number of different approaches to handling this, including parts of it that reflect what's in Canada.

**MR. FREEDMAN:** But they weren't pushing a market consistent approach at all, it seems.

**MR. SCHWARTZ:** No. If you think about it from the point of view of the United States, this goes back. I don't know anybody who prices in the United States on a market-consistent basis. I'm not sure necessarily if that's bad or that's good; it's just a fact. If you're creating expectations on the part of policyholders or on the part of your constituencies about where you're pricing, then it would be nice if you had an accounting mechanism that was consistent with the way you're doing your pricing. I think there's an issue with fair value, at least in the United States, about how individuals are going about pricing.

If you had a conversation with at least one individual at the working group, they would argue that for level term, for example, you would discount at the lowest rate possible, which is very risky because there are accountants there worried about mortality. However, they might consider if you're doing it with universal life, that you would bifurcate the contract, because maybe they would understand a little bit better how you're doing the investment side of the contract. But there seems to be some kind of a concern about what the volatility is and the right way to value the life insurance element of our contracts.

**MR. FREEDMAN:** When the IAA looked at a fair value standard for investment contracts, they gave guidance to actuaries on how to deal with all of this. They said that you should calibrate to your entry value if you have nothing else. So it wouldn't be that different from what either of you were talking about in terms of using market consistent assumptions, but then at the end of the day calibrating to the premium. In fact, if the insurance industry prices one way now and allows interest spread to be capitalized and that might mean there's a negative margin at issue, maybe in the future that pricing will change, and then the margin calibration will change. I think the GNAIE is saying to keep that margin locked in forever.

**MR. SCHWARTZ:** I actually think they're saying that's one of the potential approaches.

**MR. FREEDMAN:** Okay. The problem though, on the investment contract side, at least in the standards for investment contracts now, is this demand deposit issue.

And if that issue makes its way into insurance standards, it could become the spoiler there, too.