TRANSITIONAL SOLVENCY PROVISION

MR. TREVOR C. HOWES: Bob has described our current thinking on the TSP standard, and some of the issues and possible controversy that surrounds it. Our difficulty as a committee in wrestling with these questions and our recent debates with members outside our committee have convinced me that there are a couple of fundamental issues which need to be addressed and resolved by the profession at an early stage, if we are going to make continued progress. While I think the members of our committee have reached a relatively uniform position on these issues, which has been reflected in our remarks earlier in this session, we may have tended to forget that the body of the membership has not yet made its agreement clear.

Part of the problem in addressing the need for interim solvency standards as a prerequisite for GAAP is the fact that there has been no clearly established basis for determining what is meant by solvency standards.

In fact, there is no existing or developing standard which clearly defines the actuary's role with respect to solvency at all.

The current Recommendations for Financial Reporting deal explicitly with standards for determining actuarial liabilities and for writing reports. They do not guide actuaries in the underlying objectives of the task. There has been an implied understanding of the dual context of fair income reporting versus prudent solvency protection, but no explicit statements on this topic nor any guidance on the proper balance. This has contributed to diverging practices in the past.

The Explanatory Notes to Part IV of the Recommendations (Method) come close by dealing with the following objectives of financial reporting:

1. Proper statement of net worth.
2. Proper reporting of current net income.
3. Confirmation of compliance with statutory solvency requirements.

Note that solvency is defined only in terms of complying with imposed requirements. Accordingly, the statutory opinion that actuarial liabilities are good and sufficient to provide for future obligations becomes the focus of the actuary's concept of his solvency role.

This is perhaps why our committee has been very concerned about the statutory opinion, and our continuing need and ability to sign it, or alternatively the presence and wording of any new opinion which may replace it. These are issues which will hopefully be clarified when the new draft standard dealing with the actuary's opinion in financial statements is released.

The current thrust within the Financial Reporting Committee appears to amend or interpret the existing Recommendations in the context of a concentration on the objective of fair income reporting for purposes of the PPM. The opinion has been expressed that prudent solvency protection will likely be addressed by DST, perhaps in combination with the MCCSR. The TSP is seen by some as merely a comfort to regulators, which will disappear once everyone is more familiar with the new reporting environment.

Unfortunately, these views are inconsistent with some basic conclusions of the Solvency Standards Committee with the respect to the solvency role, and the relative functions to be played by actuarial liabilities, TSP, MCCSR, and DST.

I believe it is important to address these views, at an early stage, and attempt to reach consensus on what standards will be necessary to formalize our eventual understanding of the solvency role.

I have already described how we see the dual role of the actuary being comprised of both DST and a static solvency assessment.

The proposal to the Minister of Finance on the broadened role is an excellent beginning to defining this dual role. It places emphasis on a continuing ongoing responsibility to monitor emerging developments, to report crises to management and regulators, and to annually report to the board on the current and expected future financial position. These concepts are all directly related to our concept of DST.

The fourth section of the proposal deals with financial reporting, requiring the actuary to confirm that actuarial liabilities and other prescribed amounts are fairly presented. It is here that an opportunity exists to clarify the static solvency assessment element of our role.

I think we need explicit underlying standards that confirm the dual context in which actuarial liabilities and other balance sheet amounts are determined, i.e., going concern financial reporting, and solvency protection. The latter role should guide the actuary in his obligation to insure that financial statements do not overstate free surplus, and thus compromise the future security of existing policyholders by allowing policyholder or shareholder dividends that might jeopardize the company's ability to meet its future obligations with respect to existing business within a reasonable margin of safety.

Perhaps I am wrong, but I feel most actuaries would consider this their responsibility already.

The static solvency assessment role can be fulfilled in the current environment by establishing adequate (i.e., "good and sufficient") actuarial liabilities, in combination with the prescribed surplus appropriations. Our committee feels that in the longer term the role should be met by establishing appropriate actuarial liabilities from a GAAP income reporting viewpoint, in combination with surplus appropriations which the actuary believes in total will meet solvency needs. Clearly, this may involve a combination of prescribed and discretionary appropriations, the second of which will require supporting standards from our committee.

Some have suggested that the MCCSR is a form of solvency protection, which should provide at least short-term comfort. The committee disagrees for the following reasons:

1. The MCCSR is still an arbitrary formula, and is unresponsive to company circumstances, especially such factors as degree of matching of assets and liabilities, and the levels of margin in reserve assumptions.
2. The MCCSR is partly designed to provide a vitality standard, and accordingly is an off-balance sheet test, that monitors free surplus levels. It provides no guidance in its current form as to the sufficiency of liabilities and appropriated surplus.

An underlying assumption of this position is that solvency concerns must be reflected by stronger provisions on the balance sheet and, therefore, cannot be handled merely by the dynamic assessment of surplus levels, which is intended to provide warning of financial deterioration. However, even this basic premise is open to debate, and should therefore be considered and resolved at an early stage.

Having now presented to you our current plans for pending standards, and some basic issues which should be addressed, we now invite your input.

While all verbal comments presented here will be fully considered by our committee, I hasten to remind you that written comments are earnestly requested. Whether typed on fancy letterhead, or scrawled on an envelope, they provide a clear, tangible record that a member has considered a question and stated his opinion.